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CAPITAL MANAGEMENT

RECESSIONS AND THE STOCK MARKET

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As economic growth has slowed measurably during the early part of 2022 from 2021's torrid pace, investors have become increasingly concerned that the economy may be heading for a recession. Naturally, this has led to questions about how the stock market has fared during past recessions. In this brief commentary, I examine the performance of the US stock market in the months preceding, during and following past recessions.

The analysis covers the last 11 US economic recessions, the first of which started in 1953. I rely on the National Bureau of Economic Research (NBER) for the official start and end dates of the recessions. The NBER's Business Cycle Dating Committee is generally accepted as the official arbiter of recessions and is responsible for assigning the dates associated with turning points in the economic cycle. The NBER defines a recession as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales."

STOCK MARKET PERFORMANCE DURING RECESSIONS

Exhibit 1 presented below examines the performance of the stock market (measured by the S&P 500 Index) during the past 11 recessions as well as during the market's corresponding correction or bear market associated with the recession.

Exhibit 1: Stocks have tended to peak eight months prior to a recession and declined by approximately 30%, on average

Economic recessions and corresponding equity market corrections / bear markets (daily data; price returns only)

Economic Recessions				Corresponding Equity Market (S&P 500 Index) Corrections /Bear Markets				
Recession Start	Recession End	Recession Length (Months)	S&P 500 % Change During Recession	Market Peak	Market Trough	Market Peak-to-Trough Length (Months)	Market Peak-to-Trough Decline	Time From Market Peak to Recession Start (Months)
07/31/53	05/31/54	10	17.9%	01/05/53	09/14/53	8.3	-14.8%	6.8
08/31/57	04/30/58	8	-3.9%	08/03/56	10/22/57	14.6	-21.5%	12.9
04/30/60	02/28/61	10	16.7%	08/03/59	10/25/57	14.8	-14.0%	8.9
12/31/69	11/30/70	11	-5.3%	11/29/68	05/26/70	17.9	-36.1%	13.1
11/30/73	03/31/75	16	-13.1%	01/11/73	10/03/74	20.7	-48.2%	10.6
01/31/80	07/31/80	6	6.6%	02/13/80	03/27/80	1.4	-17.1%	-0.4
07/31/81	11/30/82	16	5.8%	11/28/80	08/12/82	20.4	-27.1%	8.1
07/31/90	03/31/91	8	5.4%	07/16/90	10/11/90	2.9	-19.9%	0.5
03/31/01	11/30/01	8	-1.8%	03/24/00	10/09/02	30.5	-49.1%	12.2
12/31/07	06/30/09	18	-37.4%	10/09/07	03/09/09	17.0	-56.8%	2.7
02/28/20	04/30/20	2	-1.4%	02/19/20	03/23/20	1.1	-33.9%	0.3
	Median	10	1.4%			14.8	-27.1%	8.1
	Mean	10	-1.0%			13.6	-30.8%	6.9

The table reveals that during the last 11 recessions, which have lasted roughly 10 months on average, the S&P 500 Index has been approximately flat (see the fourth column in from the left). In fact, during five of the recessions examined, the stock market delivered positive performance during the recession.

The columns to the right, however, expand the scope of the analysis to reveal details on the equity bear market or correction corresponding with each of these past 11 recessions. The table shows that on average the stock market has declined by approximately 30% around the time of these recessions.

Reflective of the stock market's forward-looking nature, the column farthest to the right shows that the market has, on average, peaked approximately eight months prior to the start of a recession. In fact, just once during the 11 recessions examined did the stock market peak after the recession had already begun. Put differently, the general pattern historically has been for the market to peak well in advance of the start of a recession.

This is because the price of a stock—and, by extension, the market as a whole—at any given point in time is essentially a prediction. The price of a stock is a function of how much the market collectively expects the company to earn in perpetuity. More specifically, the price of a stock is the present value of all expected cash flows from a company—which is ultimately a function of its future profitability.

Accordingly, if investors collectively come to recognize storm clouds on the horizon and anticipate that a recession is forthcoming and that corporate profitability is likely to decline (as a likely result of a recession), it doesn't mean that the stock market is about to go down. Rather, it means that the market has probably already gone down. In finance-speak, we'd say that a recession is typically "priced in" well before it actually begins. As we saw above, this is precisely what's happened historically.

STOCK MARKET PERFORMANCE BEFORE AND AFTER THE START OF RECESSIONS

Shifting our focus a bit, Exhibit 2, presented below, examines the performance of the stock market in the months leading up to and after the start of the last 11 recessions.

The left side of Exhibit 2 demonstrates that generally, the stock market has effectively been flat during the three and six months leading up to the start of the recession, delivering approximately 0% returns on average. Given that the stock market tends to peak approximately eight months prior to the start of a recession—as we saw in Exhibit 1 above—it's not too surprising to see that markets tend to move sideways in the months immediately before the start of a recession.

Exhibit 2: On average, stocks have been roughly flat during the six months leading up to the start of a recession and have rallied strongly in the months after the recession begins

Stock market returns before and after the start of recessions (monthly data; total returns)

S&P 500 Index Returns Corresponding to Recessions (%)

Date of Recession Start	6 Months to Start of Recession	3 Months to Start of Recession	3 Months After Start of Recession	6 Months After Start of Recession	1 Year After Start of Recession	2 Years After Start of Recession
07/31/53	-3	2	28	49	69	109
08/31/57	7	-4	8	19	35	32
04/30/60	-4	-1	27	31	37	30
12/31/69	-4	-0	10	14	9	40
11/30/73	-7	-7	6	-5	18	18
01/31/80	13	14	16	19	24	7
07/31/81	4	-0	24	37	44	48
07/31/90	10	9	8	14	20	38
03/31/01	-19	-12	-3	-7	-17	-5
12/31/07	-1	-3	-25	-20	-26	-3
02/28/20	2	-6	12	12	44	45
Average	-0	-0	10	15	23	32

What does stand out, however, is that in the months immediately following the start of the recession, stocks have historically tended to rally quite strongly. The four columns to the right on Exhibit 2 present the performance of the stck market in the months after the start of recessions. The charts reveal that on average stocks are up 10% three months following the start of a recession and 15% six months after the start of a recession. More impressively, stocks have historically gained 23% and 33% in the one and two years after the start of a recession, respectively.

This again reflects the forward-looking nature of markets. Even though economic conditions on the ground are axiomatically worsening during the initial months of a recession, investors historically have collectively come to recognize the old truism that “this too shall pass”—the recession will not last forever and eventually economic conditions will improve and so too will corporate profitability. Accordingly, the market collectively begins to bid the prices of stocks higher, and a new cyclical rally begins.

SO, HOW SHOULD WE INVEST IN A RECESSION OR IF ONE IS COMING?

We generally believe that market timing (i.e., moving in and out of stocks in general, or in and out of certain sub-categories of stocks) based on one’s market or macroeconomic outlook usually doesn’t make sense and is far more likely to destroy rather than add value.

This is because it’s really difficult to consistently outguess other investors (or more aptly, traders). To wit, if the current prices of stocks are effectively predictions about the future, then to make a prediction about what the stock market will do next is to make a prediction about a prediction.

John Maynard Keynes long ago wrote about the challenges of attempting to outguess others regarding the short-term direction of the stock market:

> *Professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view…We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practise the fourth, fifth, and higher degrees.*

It’s because of these challenges—among many others—that we believe a more reliable path to long-term investing success is one of deliberate and properly calibrated risk taking whereby one commits to an allocation of stocks that fits their individual objectives, preferences and risk tolerance and sticks to it through the inevitable ups and downs of the stock market.

We take comfort in the fact that this also happens to be the approach recommended by many of the brightest minds and the most successful investors in our industry. This list includes Warren Buffett, the man who many regard as history’s most successful investor who recently told the audience at Berkshire Hathaway’s annual shareholder’s meeting: "We haven't the faintest idea what the stock market is gonna’ do when it opens on Monday — we never have…I don't think we've ever made a decision where either one of us has either said or been thinking: 'We should buy or sell based on what the market is going to do," Buffett added, referring to his longtime business partner Charlie Munger. "Or, for that matter, what the economy is going to do."

IMPORTANT DISCLOSURES

Sources

Recession dating from National Bureau of Economic Research (NBER).
S&P 500 Index daily closing values from Yahoo Finance.
S&P 500 Index monthly returns from Dimensional Fund Advisors.
Buffett on market timing: 'We haven't the faintest idea' (Yahoo Finance, 4/30/2022)

Important Disclosures

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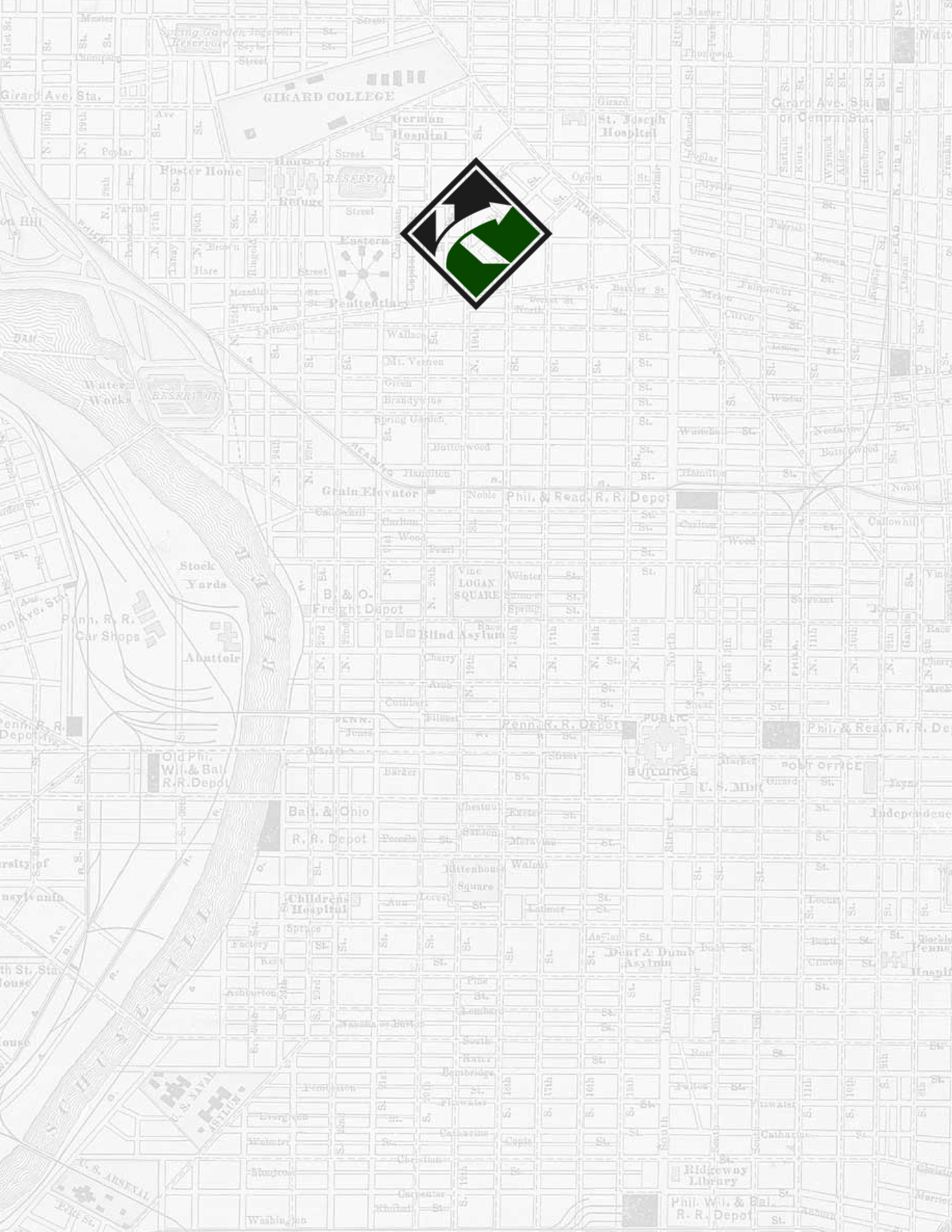
S&P 500 Index is an unmanaged, capitalization-weighted index designed to measure the performance of the broad U.S. economy through changes in the aggregate market value of 500 stocks representing all major industries.



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