SHOULD WE EXPECT MORE STOCK MARKET DECLINES IF THE ECONOMY SLIPS INTO A RECESSION?

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The U.S. stock market has entered "bear market territory" by declining more than 20% from recent highs. The decline is another sign of volatile markets that have understandably stressed investors. However, the silver lining for long-term investors is that stock valuations are now much cheaper, typically resulting in better future returns. Nevertheless, despite better long-term return prospects, it's understandable that investor anxiety remains about what may lie ahead in the short term.

With continued concerns related to inflation's impact on consumer spending and company earnings, potential effects from the Federal Reserve's (the Fed's) aggressive interest rate hikes, and the possibility that this could all lead to recession, investors are left wondering if more severe market declines are to come. No one knows for sure, but we can look to the past for some perspective to offer some calm.

Before we look at how stock markets have historically performed during a recession, we want to address the question of what it means to be in recession and whether we're currently in one.

WHAT CONSTITUTES A RECESSION?

A recession is a general decline in a country's production of goods and services - that is, an economic contraction. One common definition of a recession is two consecutive quarters of negative Gross Domestic Product (GDP) growth. However, recessions are technically determined by the National Bureau of Economic Research (NBER)—the official scorekeepers for recessions and expansions. The NBER defines a recession as a significant decline in economic activity spread across the economy, lasting more than a few months. Economic activity mainly includes personal income, employment, consumer spending, and industrial production.

ARE WE IN OR HEADED TOWARDS A RECESSION?

Based on the most recent economic data, the economy is still firing on all cylinders. Recent payroll growth has been robust, signaling strong demand for labor. Personal income levels are higher relative to a year ago. Spending continues to expand as consumers shift from buying goods to paying for services. Industrial production has been rising, aided by increasing manufacturing output. So at the moment, economic data suggest the economy continues to expand healthily, albeit at a slower pace after roaring out of the pandemic.

That said, recession risks are rising as we look ahead to 2023. First, inflation could remain stubbornly high, pushing the Fed to overtighten its monetary policy. In addition, less government spending (i.e., fiscal drag) this year is likely to slow economic momentum. Finally, a lack of labor supply will also likely weigh on growth.

WHAT WOULD HAPPEN TO THE STOCK MARKET IF THE ECONOMY SLIPS INTO A RECESSION?

If we officially enter a recession, or economic contraction, as defined by the NBER, is it a foregone conclusion that stocks will decline materially more than they already have? Looking at historical data over the last 50 years, we can compare how stocks have performed on average during all months, months of contraction (recessions), and months of expansion. See **Figure 1**. The data show that during official periods of recession, the stock market's average monthly return has been significantly lower than the average monthly return over the entire period.

Average Stock Market Returns Have Been Lower During Official Periods of Economic Contraction (Recessions) Over the Last 50 Years

	ENTIRE PERIOD	ECONOMIC CONTRACTION (RECESSION)	ECONOMIC EXPANSION
Number of Months	557	74	483
Average Monthly Market Return	0.98%	-0.05%	1.14%

However, Average Stock Market Returns Have Been Positive During Most of the Recessions

PEAK MONTH	TROUGH MONTH	MONTHS IN CONTRACTION	AVERAGE MONTHLY MARKET RETURN
November 1973	March 1975	16	-0.31%
January 1980	July 1980	6	1.66%
July 1981	November 1982	16	0.99%
July 1990	March 1991	8	1.21%
March 2001	November 2001	8	0.14%
December 2007	June 2009	18	-2.00%
February 2020	April 2020	2	0.19%

FIGURE 1. This figure shows the average U.S. stock market monthly returns during the seven full business cycles of the past 50 years.

Data from 12/01/1973 to 04/30/2020. The Stock Market is represented by the CRSP U.S. Total Market Index. Source: Avantis Investors, National Bureau of Economic Research, Center for Research in Security Prices.

However, when you dig into the seven recessions over the past 50 years, we see that of the seven periods, the stock market produced a positive return in five of them. During two of those periods, the average market return was *higher* than the average monthly return over the full period. Lastly, the meaningly negative returns during the Great Financial Crisis (December 2007 to June 2009), one of the most severe and prolonged recessions on record, brought down the overall average during recessions.

This tells us that it is *not* a foregone conclusion that stock markets will continue to decline during a recession. The reality is that most market losses happen ahead of the actual economic contraction period. Markets are forward-looking, so if the market is anticipating an economic slowdown, the effects and the probability of these effects should already be reflected in prices. In other words, recession or no recession, market prices are already capturing this risk based on currently available information.

WILL THE NEXT RECESSION BE A SEVERE OR MILD ONE?

If stocks fall during a recession, the degree to which they decline can depend on the contraction's severity. If we enter a recession at some point, unless another unexpected shock causes it, it is likely to be mild and short for multiple reasons. First, we don't see traditional economic excesses such as unsustainable levels of home building, auto sales, inventory growth, or business fixed investment. Additionally, consumer and corporate balance sheets are in a solid position to better weather an economic contraction. Finally, the financial system is not overleveraged like it was before the Great Financial Crisis.

PERSPECTIVE ON THE RESILIENCY OF MARKETS

It's been quite a bumpy ride for investors in 2022. Understanding why market volatility is normal and how markets have performed during recessions in the past can help calm the anxiety we may feel during these times. But the resilience we've seen from markets over time is likely the most helpful takeaway. See **Figure 2.**

The U.S. Stock Market Has Climbed Despite Numerous Drawdowns

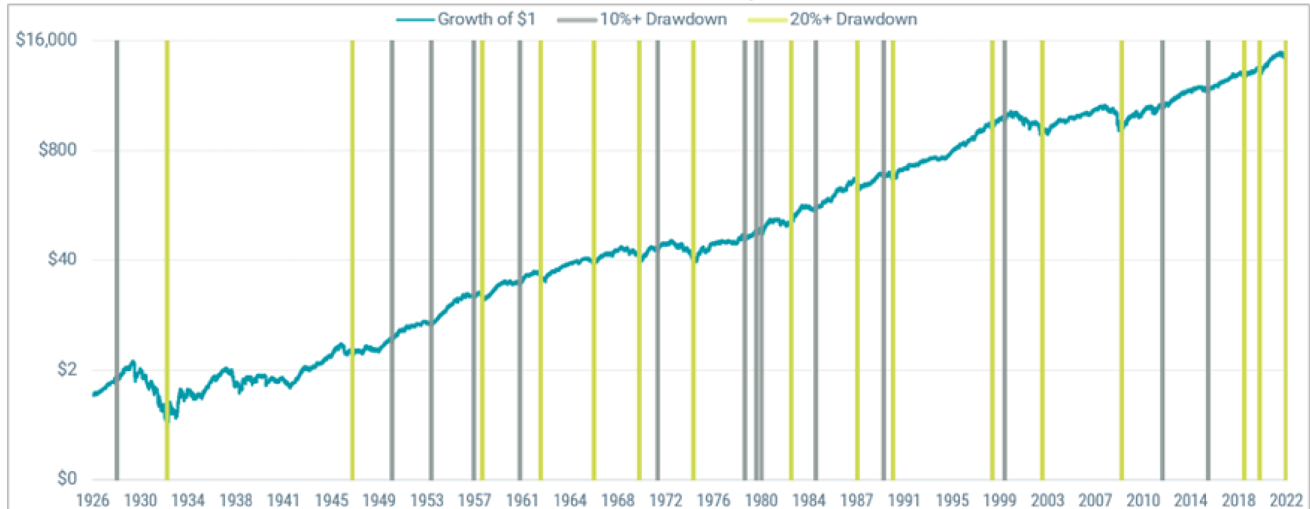

FIGURE 2. This figure illustrates the growth of $1 since 1926, including market pullbacks. The stock markets have delivered long-term growth for disciplined investors despite countless periods of corrections and bear markets.

Data from 07/01/1926 to 05/26/2022. The U.S. Stock Market is represented by the CRSP U.S. Total Market Index. Source: Avantis Investors, Center for Research in Security Prices.

This perspective reassures us that while it's normal to have anxiety about uncertain times, keeping our focus on the long term may help quell fears about the volatility of the day. Past data reminds us of many other volatile periods and economic contractions. However, historically those investors who have stayed invested through the tough times have been rewarded for bearing that risk.

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