EMPOWER INVESTMENTS | Thomas Nun, CFA | Portfolio Strategist

Splitting the tab

The U.S. may be headed for recession. The good news: We may have already paid part of the bill.

- The U.S. economy may be headed for recession, causing retirement savers to worry about what that might mean for their investments.
- Each recession is unique, and a post-COVID recession might be the most unique of all. But if history is any guide, it's quite possible that markets may have already "priced in" much of the damage.
- By looking at U.S. recessions dating back as early as the late 1800s, we find evidence that stock markets tend to anticipate economic weakness by trading lower well before a recession actually occurs — and by beginning to recover some months before recessions actually end.
- In fact, in the modern era, U.S. large-cap stocks sometimes actually manage to book small gains when measured from the day a recession begins to the day it officially ends.
- We applied the same framework to other asset classes and, while there are subtle differences, found hints of similar behavior for stocks in the growth, value, international and emerging markets as well.

Unless you've been living under a rock, you've probably heard it, too: the U.S. economy could be headed for (or may already be in) a recession.

Recessions are scary for a number of reasons, some directly related to your investment portfolio and others not. Common concerns include "Will I be able to sell my house if I want to?" and "What if I want to change jobs?" (or, worse yet, "What if I lose my job?"). Unfortunately, nothing I write here will help answer any of those questions, all of which are certainly relevant to your overall financial situation. But by looking at past recessions and how financial markets have reacted to them, we can at least hope to provide some context around how your investment portfolio might react if and when the U.S. economy finally crosses that line into recessionary territory.

The bad news: Nobody can know for sure what lies ahead for either the economy or their investments, especially because each recession is fundamentally different from the last. (And given the economic extremes wrought by the COVID-19 pandemic and all the efforts to combat it, a post-COVID recession might be the most unique of all.)

The good news? If history is any guide, things might not be as bad as you think.

Markets that anticipate rather than reflect

In a modern economy, financial markets exist for one (and only one) reason: to funnel investment capital from investors to businesses that, in turn, use that capital to provide the goods and services we all consume as participants of a

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well-functioning economy. That means financial markets are inevitably tied to the ebbs and flows of the business cycle: When economic times are good, our capital is put to good use and financial markets tend to reflect that. When times are bad, markets reflect that, too.

But the relationship between capital markets and the economy isn't quite so straightforward. Investors generally aren't interested in providing capital to businesses simply to oil the machinery of capitalism or achieve some kind of greater good. Instead, investors demand a competitive return to compensate them for the risk they take by making their excess capital available to businesses in the first place. And in the presence of a vibrant marketplace where investors can quickly and cheaply trade investments of literally thousands of flavors and types, markets themselves become a sort of gladiator arena in which investors are constantly trying to out-compete each other by finding the next great thing before someone else finds it first and bids the price higher.

The result? A hyper-competitive environment in which investment markets try to anticipate — rather than simply reflect — the economic environment they help create.

To test that idea, we looked at recessions dating back to the turn of the last century and compared returns for various assets across each. While far from perfect, our analysis suggests that markets are indeed pretty good at anticipating changes in the economic environment even before they occur. For example, we found that on average stock markets tend to peak and begin declining roughly six to 12 months before a recession officially arrives. Moreover, they tend to bottom out (and begin rising) three to nine months before the recession officially ends. It's even possible to find a few examples where stocks actually ended a recession higher than where they began.

Anticipation or reflection?

Markets have anticipated big changes in economic growth, not just reflected them[1]

			Market peak pre-recession time frame	Market trough after pre-recession peak	Market trough once recession hits	Peak-to-trough return	Return during recession
Post-war era (1945 –today)	12	Average	8.4 mos	14.2 mos	5.7 mos	-27.4%	+2.4%
		Median	8.1 mos	16.3 mos	5.3 mos	-22.6%	+3.5%
All periods (1858- today)	**24**	**Average**	**7.1 mos**	**16.4 mos**	**5.9 mos**	**-30.1%**	**-3.0%**
		Median	3.8 mos	17.4 mos	5.7 mos	-27.4%	+0.5%

Equity market returns represented by the price return of the Dow Jones Industrial Average, the only equity index with consistent history throughout the analysis period. Data: Bloomberg, NBER, Bureau of Labor Statistics and Empower Asset Management analysis.

Maybe the most encouraging message in the numbers above is the idea that by the time a recession begins, markets have already done a fair job of "pricing in" much of the damage. For example, during the 24 recessions sampled, the average peak-to-trough decline during the period surrounding the recession was roughly -30.1% while the average decline during the recession itself was only -3.0%.

The implication is that the market has already suffered a majority of its declines by the time the National Bureau of Economic Research officially declares a recession to have begun. In fact, during the modern era (1945 to present), our data suggests that both the average and median equity market return during the recession itself may have actually been slightly positive.

1 Our analysis focused on the period beginning two years before the onset of each recession and extending two years after each recession's official end. Accordingly, there is occasional overlap in the period of market returns analyzed, and our dataset naturally expanded during more recent periods as the increasing reach and sophistication of domestic capital markets was reflected in a broader and more diverse set of benchmark indices.

Said another way, by the time the check comes due, markets have, in at least some cases, already paid much of the tab.

A question of style: Beyond U.S. large caps

To a modern reader, however, it might be more interesting to understand how different investment styles and asset classes have performed during recessions and the months that surround them. While our dataset is more limited here, our numbers once again suggest a tendency for stocks beyond U.S. large caps to anticipate a recession by trading lower before it actually occurs and bottoming out some number of months prior to its official end. And the same general rule that the steepest losses tend to occur before (and not during) a recession seems to apply as well. Notably, international stocks — developed and emerging market equities alike — tend to suffer deeper losses during and around U.S. recessions than do U.S. stocks. I suppose the old adage that "When the U.S. catches cold, the rest of the world sneezes" has mostly held up, at least as far as this analysis is concerned.

In addition to that, growth stocks appear to wait longer to react to economic weakness (and to sell off more deeply once they catch on) than both their value-oriented peers and U.S. large-cap stocks more generally. But they also tend to recover more quickly (and robustly once a recession is actually "declared").

Finally, we attempted to extend this exercise to non-equity assets as well. Perhaps most notably, core bonds have tended to weather recessionary periods quite well and in fact finished each of the six recessionary periods for which we have sufficient data with at least marginal — but in some cases quite robust — gains. Also worth a mention is the observation that, like equities, credit spreads appear to reach their most extreme levels prior to the end of the recession, not before. In fact, if history is any guide, a peak in credit spreads appears to lead the official end of a recession by around three to six months.

Conclusion: Don't fear the "R-word"

It's worth reiterating that a survey of this sort is fraught with difficulties, not the least of which is the relative lack of data and the small number of recessionary periods ("observations") from which to draw our conclusions. It's also worth reiterating that each and every period of economic difficulty is unique, and the post-COVID recession — if that's what this becomes — is perhaps the most unique of all. However, many of the tendencies identified here square fairly well with capital market orthodoxy that is hardly controversial, such as the idea that markets tend to anticipate economic weakness before it occurs, or that non-U.S. equities are often more challenged by U.S. recessions than domestic ones.

Regardless, if there is one message of hope to take away from all this, it's simply this: If a recession is ultimately in the cards, you can at least take some comfort in the idea that it's quite possible the market has already anticipated it. Which means that some of the worst market performance may already be behind us.