RECESSIONS & BEAR MARKETS - WHEN AND WHY

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“The close tie between GDP growth and the equity market makes a recession the most negative factor that could send stocks lower.”

This line from a Janney Investment Strategy report issued August 7, 2017 was one of eight items listed that could prompt a major market pullback or a bear market. This makes determining if a recession is on the horizon a critical component in formulating an investment outlook.

Defined as a drop of 20% or more in the S&P 500, since 1929 there have been 16 bear markets that in all but one period coincided with a recession – a period loosely defined as two or more consecutive quarters of negative GDP growth.

The Great Depression stands out in everyone’s mind as it prompted a severe market drop. From the end of the Depression through the late 1940s there were five bear markets; each coming alongside a recession ranging in severity from as little as a peak to trough GDP decline of 1.7% in 1949 to as much as 18.2% in 1937-1939. The 1937-1939 recession often is looked at as the prime example of how the Federal Reserve erred by tightening credit too much before the economy regained solid footing following the extended period in and around the Great Depression.

Since 1999, the equity market endured three major recessions. The most recent, dubbed the Great Recession, saw a 5.3% GDP decline. This was well shy of the 1930s drop, but it was the most severe GDP drop since the 12.5% decline registered when the U.S entered the Second World War. All three post-1999 recessions were accompanied by notable market drops.

1987 was the key exception to the general rule that recessions and bear markets (market drops of 20% or more) always coincide.

October 19, 1987, the Dow Jones Industrial Average fell 508 points. Ahead of the October event, however, the inflation rate began accelerating in the first quarter of the year as oil prices surged. In July 1987, West Texas Intermediate crude peaked at $22 per barrel, the highest price in 18 months and nearly double the price from a year earlier. This and program trading produced a technical bear market that ended in slightly more than four months, but not before the S&P 500 had fallen 33.5%. US economic growth, however, remained solid as GDP growth never turned negative.

Recession-driven bear markets often have similar characteristics. As evidenced by the 1937-1938 recession, restrictive monetary policy often has been a key precipitant of recession. A surge in the inflation rate can also lead to tighter credit policy. There is no better example of this than the 1980-1982 recession when the Federal Reserve broke the back of inflation by pushing interest rates to the highest level since the Civil War. Inflation peaked in April 1980 at 14.76% and then fell to 6.51% by the following April.

The Great Depression was the prime example of what can happen if the financial system is stressed. More recently, the 2007-2009 recession also was the result of financial system disarray.

Unforeseeable events, commonly called “Black Swans”, investors fear can lead to a prolonged economic and market slump, but history shows that beyond a short-term negative reaction, the market and the economy tend to rebound rather swiftly unless the event persists for an extended period. The initial effect of natural disasters temporarily can be disruptive, but often the recovery actually accelerates GDP growth as the rebuilding process unfolds.
There are other factors that on their own or combination with monetary policy and inflation led to recessions, but at this time we do not see any of the classic characteristics that lead to a major economic downturn and resulting bear market.

The Federal Reserve Open Market Committee (FOMC) has expressed its desire to raise short-term interest rates. The Fed’s “dot-plot”, which shows what each FOMC member thinks is the proper level of interest rates; even at the highest level, it does not reach a rate that threatens the stock market or the economy. The inflation rate has remained subdued, which has allowed the FOMC to retain a highly accommodative credit policy. An inverted yield curve (long-term rates lower than short-term rates), which often has led to sharp market drops, is not apparent on the current horizon.

The current GDP growth rate may frustrate investors who feel that a much higher growth rate is desirable, but they do not appreciate that the present 2-3% GDP growth rate historically has been the “sweet spot” for the equity market. A sudden spurt in GDP growth to 4% or more actually could do more harm than good if it leads the FOMC to adopt a much more restrictive credit policy, which as it has been outlined, could generate one of the key components of a possible recession-bear market.

Conditions can change, but with interest rates low and likely to remain so for an extended period, tame oil prices, manufacturing indexes remaining at levels indicative of an expanding economy, unemployment at multi-year lows and the absence of excesses within the financial system all support our belief that the likelihood of a recession in the next 12 months is very low. By extension, the probability of a bear market also is low.

But as always, stay in touch with your Janney Financial Advisor who can alert you to changes that could influence the economy and the stock market.

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