

Equity Markets and Recessions

Overview: With the U.S. economy showing several signs of recession, investors may be tempted to move assets out of equity markets and into historically safer investments. The following discusses how equity markets have behaved before, during and after recessions and why moving assets may not be in investors’ best interests.

How do stocks perform before, during and immediately after economic recessions? What about the performance of small-cap and value stocks? One way to address this question is to consider the historical record. We did, and here is what we found.

We examined the periods six months prior to a peak in economic activity, the recession that followed and the six months following the trough in economic activity. The period of recessions varied from as short as seven months (January 1980 through July 1980) to as long as 17 months (November 1973 through March 1975, and July 1981 through November 1982). The study covers the period 1945–present and includes 11 different recessions. For the purposes of this study, we used the definition of a recession as provided by the National Bureau of Economic Research (NBER):

- ▲ “The NBER does not define a recession in terms of two consecutive quarters of decline in real GDP. Rather, a recession is 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.”

The results can be seen in the table below.

| Monthly Average Return for All Periods | | | |
|--|------------------------|--------------------|-------------------------|
| | Six Months Before Peak | During Contraction | Six Months After Trough |
| Market minus T-Bill | -0.35% | 0.20% | 1.69% |
| Small-cap minus large-cap | 0.25% | -0.01% | 0.92% |
| Value minus growth | 0.35% | 0.38% | 0.37% |

Source: Dimensional Fund Advisors

The “Market minus T-Bill” row shows the equity premium, or the performance of U.S. stocks in aggregate. The negative average equity premium for the six months preceding a peak explains why economists view the stock market as a *leading economic indicator*: A drop in stock prices generally precedes (and helps forecast) an economic downturn. It is important to understand the direction of this relationship. Economists look to the stock market for an early indication of where the economy is headed. Alas, this does not work in the other direction: As we shall see, an investor (or advisor) cannot tell where the stock market is going, based on the observed performance of the economy.

The equity premium has been positive on average (0.20 percent per month) during economic recessions. So, even if we knew that a recession was just about to begin, the historical data would provide no good reason to move assets from stocks to bonds. More importantly, the months immediately following an economic trough have been exceptionally good for stocks. The opportunity cost of missing the stock returns in those months was several times greater than the cost of having been fully invested in stocks in the months preceding the peak in economic activity.

The table shows that neither small-cap stocks nor value stocks are leading economic indicators, as both premia have been positive on average during the six months preceding a peak.

Small-cap stocks underperformed large-cap stocks by a minimal margin, 0.01 percent per month on average. In many cases, the cost of changing the allocation (adopting a large-cap bias) would be of the same order of magnitude. And, just as for stocks in general (the equity premium), the opportunity cost of not being exposed to small-cap stocks in the months immediately following the end of recessions would have been substantial, 0.92 percent per month on average.

Finally, by examining the value premium, we see that it does not seem to be related to economic cycles at all — at least on average across all recessions included in the study. Over the entire period, the value premium was about the same, on average, in the months leading up to recessions, during the recessions themselves, and in the months immediately following the recessions.

How can this information be used? During the past few months, investors may have experienced significant losses in their equity holdings. Recent losses, coupled with reasonable suspicion that the economy may be headed toward recession (or in recession already), have many investors concerned about their equity positions. Some investors may be tempted to sell their equity holdings and move into fixed income, or transition from a small-cap or value tilt to a large-cap or growth tilt, far from their target IPS allocations. The data shows the inherent danger in selling out of stocks in times of weak economic performance. Given the extreme difficulty of accurately predicting when the economy is at a trough and on its way to recovery, investors may not only sell at a bad time (when prices are low), but also miss out on the substantial gains that, on average, follow a recession.

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