Capital Group

Guide to recessions: When is the next U.S. recession and how should you prepare for it?

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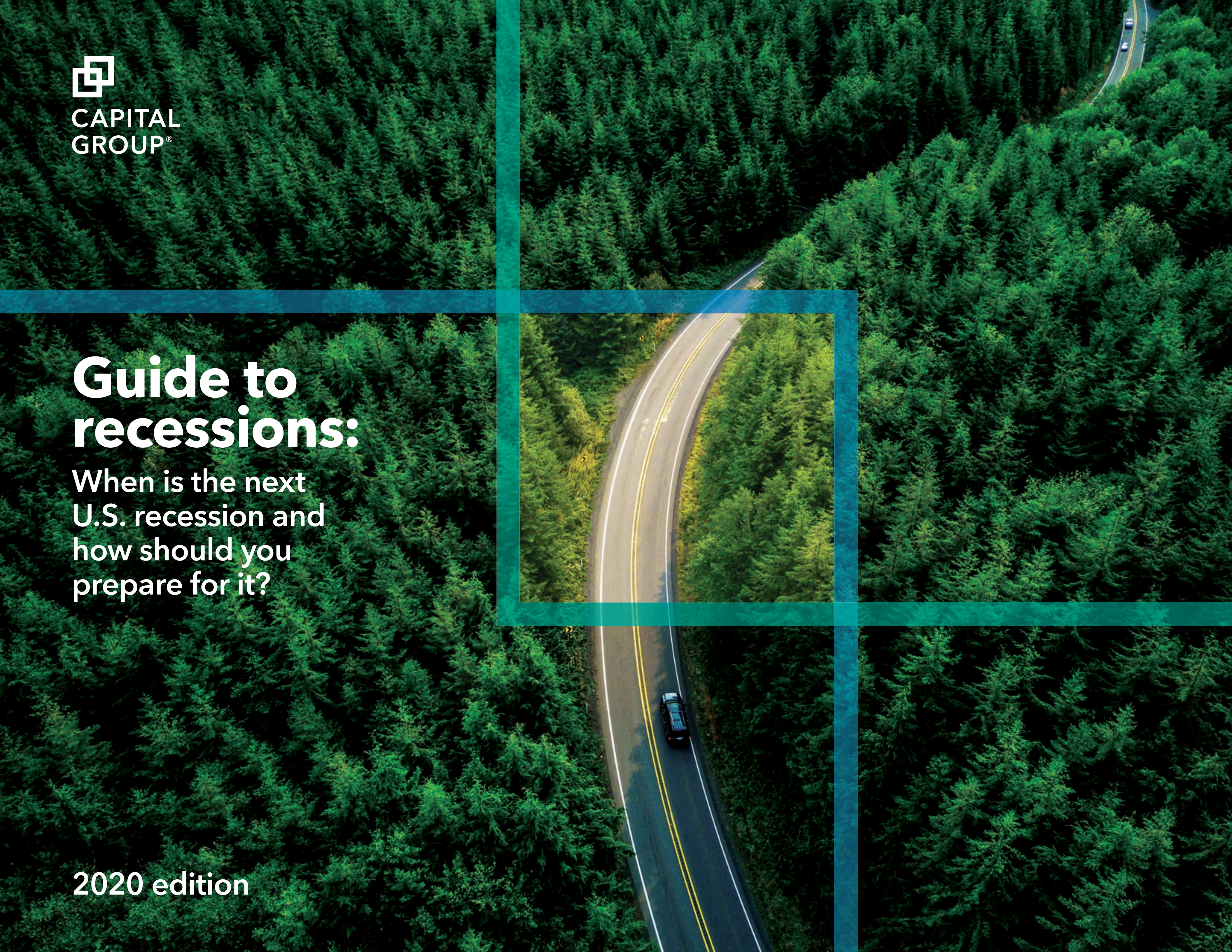

Guide to recessions:

When is the next U.S. recession and how should you prepare for it?

2020 edition

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"The stock market has predicted nine out of the last five recessions!"

PAUL A. SAMUELSON, 1966

When is the next recession?

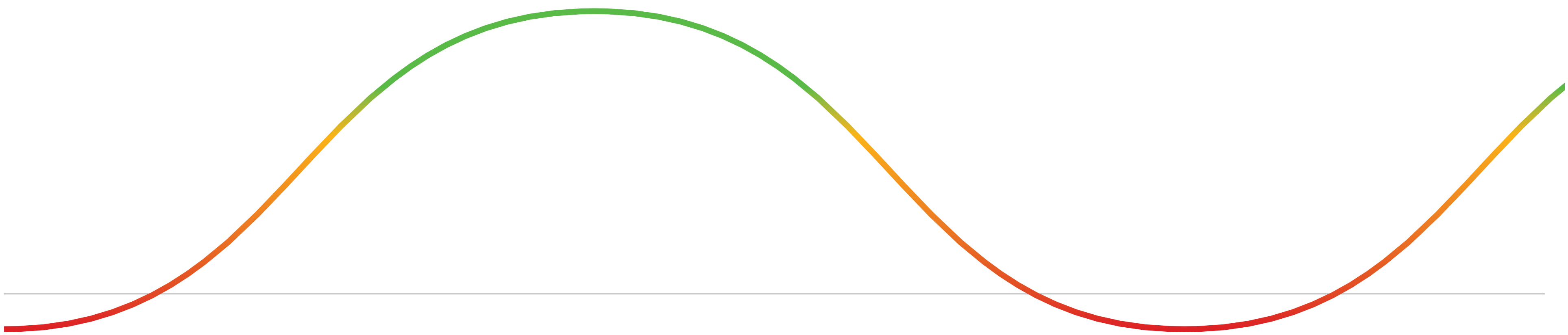
That's one of the most frequently asked questions we hear. And for good reason. The coronavirus outbreak has caused disruptions in unprecedented ways, sparking the first bear market in 11 years. Although the full extent of its economic impact will not be known for some time, it's clear that the likelihood of a U.S. recession has increased since the start of the year.

Recessions can be complicated, misunderstood and sometimes downright scary. But, most of all, they're hard to predict, as Paul Samuelson – the first American to win the Nobel Prize in Economics – wryly noted in the 1960s. So rather than predicting the exact date of the next recession, this guide will offer perspectives on the following questions:

- What factors have contributed to previous recessions?
- How have equities moved during past contractions?
- What are the most consistent economic indicators to watch?
- How close is the next recession?
- What can investors do to prepare?

But let's start with the most basic question: What is a recession?

What is a recession?



EARLY
- Economic activity accelerates
- Housing activity increases
- Easier central bank policy

MID
- Full employment
- Wages accelerate
- Profit margins peak
- Inflation rising toward target
- Modest imbalances

LATE
- Profit margins contract
- Credit moderates
- Tighter central bank policy
- Inflation above target
- Rising breadth of imbalances

RECESSION
- Rising unemployment
- Declining activity
- Contracting profits
- Easing central bank policy

Recessions occur when economic output declines after a period of growth. They are a natural and necessary part of every business cycle. The National Bureau of Economic Research (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 gross domestic product (GDP), real income, employment, industrial production and wholesale-retail sales.” It is also commonly defined as at least two consecutive quarters of declining GDP. In this guide, we will use NBER’s official dates.

Past recessions have occurred for a variety of reasons, but typically are the result of imbalances that build up in the economy and ultimately need to be corrected. While every cycle is unique, some common causes include rising interest rates, inflation and commodity prices. An unexpected event shock – such as a health crisis – that is widespread enough to broadly hurt corporate profits and trigger job cuts can also be responsible. When unemployment rises, consumers typically reduce spending, which further pressures economic growth, company earnings and stock prices. These factors can fuel a vicious negative cycle that leads an economy into recession.

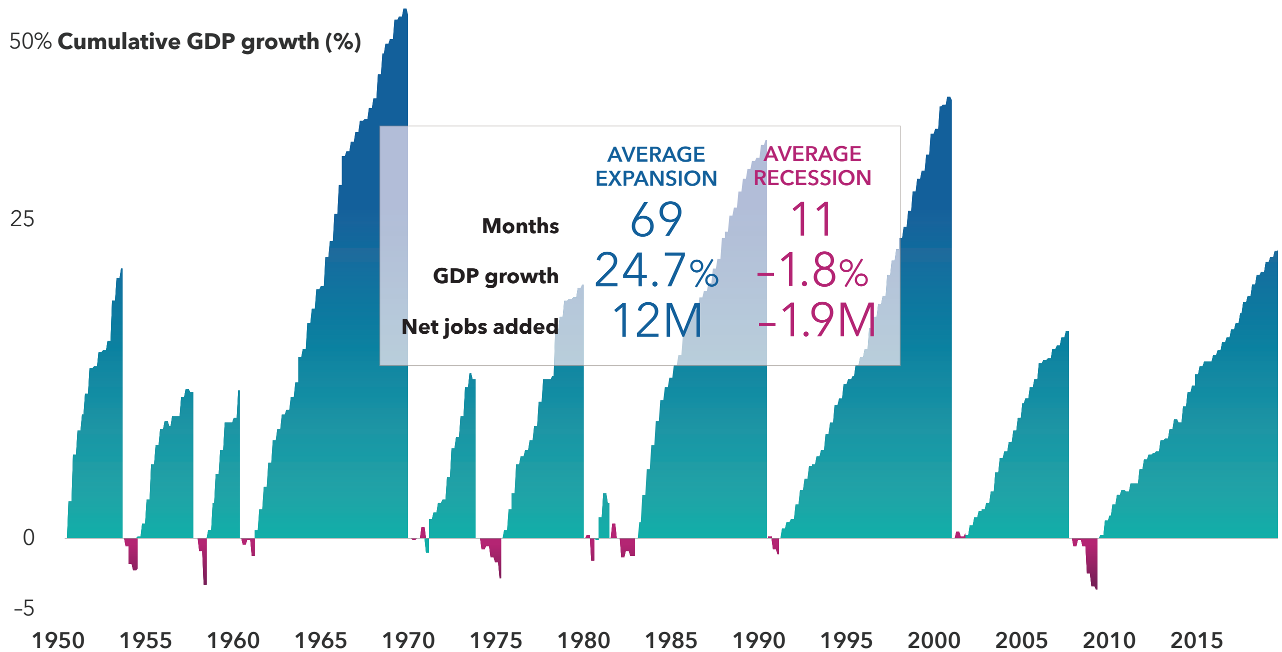
SOURCE: Capital Group

How long do recessions last?

The good news is that recessions generally don't last very long. Our analysis of 10 cycles since 1950 shows that recessions have ranged from eight to 18 months, with the average lasting about 11 months. For those directly affected by job loss or business closures, that can feel like an eternity. But investors with a long-term investment horizon would be better served looking at the full picture.

Recessions are relatively small blips in economic history. Over the last 65 years, the U.S. has been in an official recession less than 15% of all months. Moreover, the net economic impact of most recessions also is relatively small. The average expansion increased economic output by 25%, whereas the average recession reduced GDP by less than 2%. Equity returns can even be positive over the full length of a contraction, since some of the strongest stock rallies have occurred during the late stages of a recession.

Recessions are painful, but expansions have been powerful



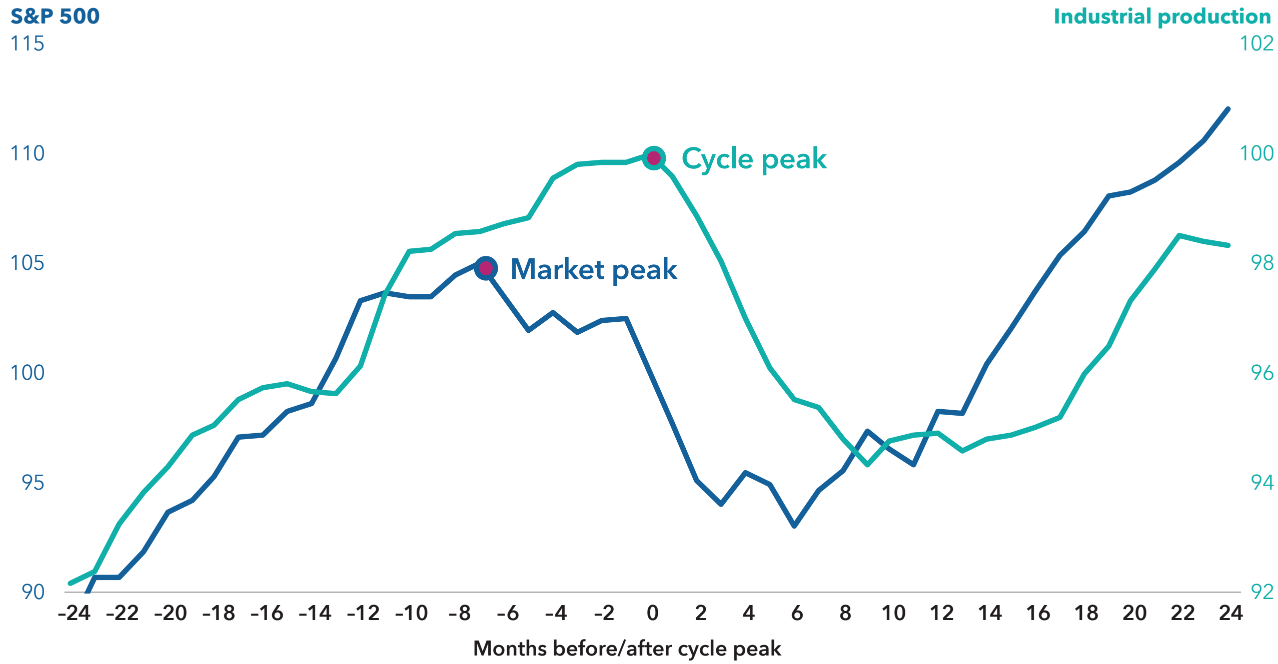
SOURCES: Capital Group, National Bureau of Economic Research, Refinitiv Datastream. As of 12/31/19. Since NBER announces recession start and end months rather than exact dates, we have used month-end dates as a proxy for calculations of jobs added. Nearest quarter-end values used for GDP growth rates. GDP growth shown on a logarithmic scale.

What happens to the stock market during a recession?

While the exact timing of a recession is hard to predict, it's always wise to think about how one could affect your portfolio. That's because bear markets and recessions often overlap, with equities tending to peak about seven months before the economic cycle. NBER doesn't officially identify recessions until well after they begin. By then, equities already may have been declining for months.

But even if you think a recession is already underway, that doesn't necessarily mean its time to start selling stocks. Just as equities often lead the economy on the way down, they have also led on the way back up. The Standard & Poor's 500 Composite Index has typically bottomed out about six months after the start of a recession, and usually begins to rally before the economy starts humming again. (Keep in mind, these are just market averages and can vary widely between cycles.) Aggressive market-timing moves, such as shifting an entire portfolio into cash, often can backfire. Some of the strongest returns can occur during the late stages of an economic cycle or immediately after a market bottom. It's often better to stay invested to avoid missing out on the upswing.

Equities typically peak months before a recession, but can bounce back quickly



SOURCES: Capital Group, Federal Reserve Board, Haver Analytics, National Bureau of Economic Research, Standard & Poor's. Data reflect the average change in the S&P 500 Index and economic activity (using industrial production as a proxy) of all completed economic cycles from 1950 to 2019. The "cycle peak" refers to the highest level of economic activity in each cycle before the economy begins to contract. Both lines are indexed to 100 at each economic cycle peak, and also indexed to 0 "months before/after cycle peak" on the *x*-axis. The negative values (left of the cycle peak) reflect the average change in each line in the months leading up to the cycle peak. The positive values (right of the cycle peak) indicate the average changes after the cycle peak.

What economic indicators can warn of a recession?

	Inverted yield curve	Corporate profits	Unemployment	Housing starts	Leading Economic Index®
Recession warning sign	10-year yields below two-year yields	Declining from cycle peak	Rising from cycle trough	Declining at least 10% from previous year	Declining at least 1% from previous year
Why it's important	Often a sign the Fed has hiked short-term rates too high or investors are seeking long-term bonds over riskier assets	When profits decline, businesses cut investment, employment and wages	When unemployment rises, consumers cut back on spending	When the economic outlook is poor, homebuilders often cut back on housing projects	Aggregation of multiple leading economic indicators, gives broader look at economy
Average months until recession	15.7	26.2	6.1	5.3	4.1
Where we are now	Yield curve briefly inverted in August 2019	Corporate profits as a percent of GDP may have peaked years ago	Unemployment rate is near 50-year lows	New housing starts have picked up after declining in mid-2019	LEI growth rate has flattened in recent months

Wouldn't it be great to know ahead of time when a recession is coming? Despite Paul Samuelson's warning about the hazards of predictions, there are some generally reliable signals worth watching closely as the economy reaches its late cycle.

Many factors can contribute to a recession, and the main causes often change each cycle.

Therefore, it's helpful to look at many different aspects of the economy to better assess where excesses and imbalances may be building. Impacts from the coronavirus outbreak have not yet been reflected in most economic data, but these five indicators should still provide a broad look at the U.S. economy. Keep in mind that these should be viewed more as a mile marker than a distance-to-destination sign.

Overall, these factors seem to indicate that the U.S. entered 2020 in a late cycle, but in a generally strong position. Although the yield curve briefly inverted last year, none of these indicators stood out as an imminent concern, and the labor market remained particularly resilient.

SOURCE: Capital Group. Reflects latest data available as of 2/29/20.

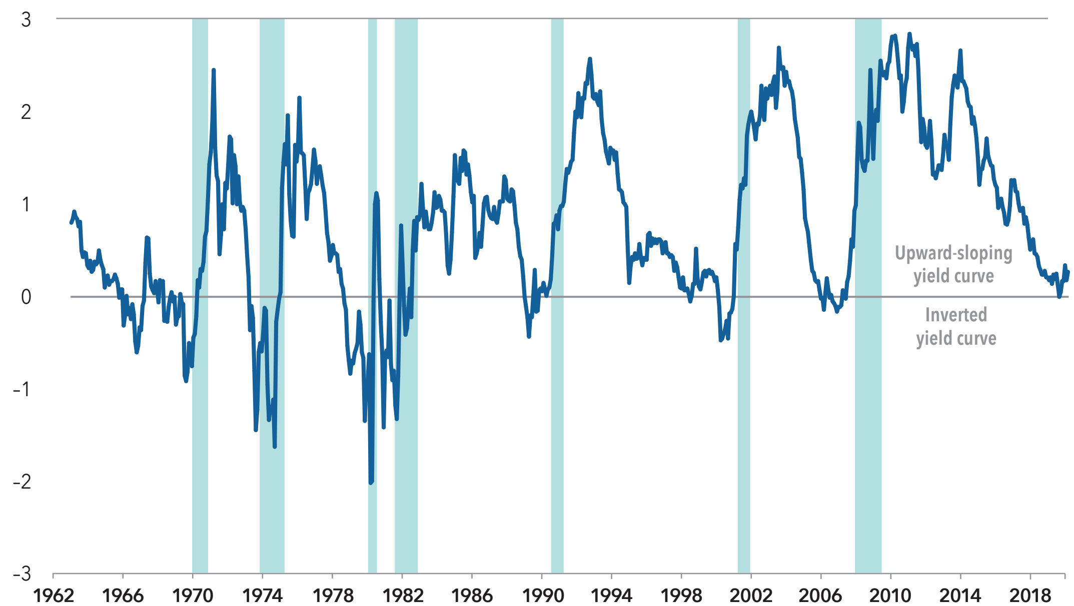
What is an inverted yield curve?

An inverted yield curve may sound like an elaborate gymnastics routine, but it actually is one of the most accurate and widely cited recession signals. The yield curve inverts when short-term rates are higher than long-term rates. This market signal has preceded every U.S. recession over the past 50 years. Short-term rates typically rise during Fed tightening cycles. Long-term rates can fall when there is high demand for bonds. An inverted yield curve is a bearish sign, because it indicates that many investors are moving to the perceived safe haven of long-term government bonds rather than buying riskier assets.

In December 2018, the yield curve between two-year and five-year Treasury notes inverted for the first time since 2007. Other parts of the curve – such as the more commonly referenced two-year/10-year yields – did not invert until August 2019. However, even an inverted yield curve in that range is not cause for immediate panic, as there typically has been a significant lag (16 months on average) before the start of a recession. There is debate over whether central bank interventions in the bond market have distorted the yield curve to the point where it now may be a less reliable economic indicator, but that remains to be seen.

Yield curve briefly inverted in August 2019

Spread between 10-year and two-year Treasury yields



Inverted yield curve	Months until recession
1968	20
1973	8
1978	17
1980	10
1989	18
2000	13
2005	24
Average	**15.7**

SOURCES: Capital Group, Refinitiv Datastream. As of 2/29/20. One-year rates used instead of two-year rates prior to 6/30/76. Start dates in table do not include periods when the curve was only inverted at month-end for one month. Shaded bars represent U.S. recessions as defined by the National Bureau of Economic Research.

How close are we to the next recession?

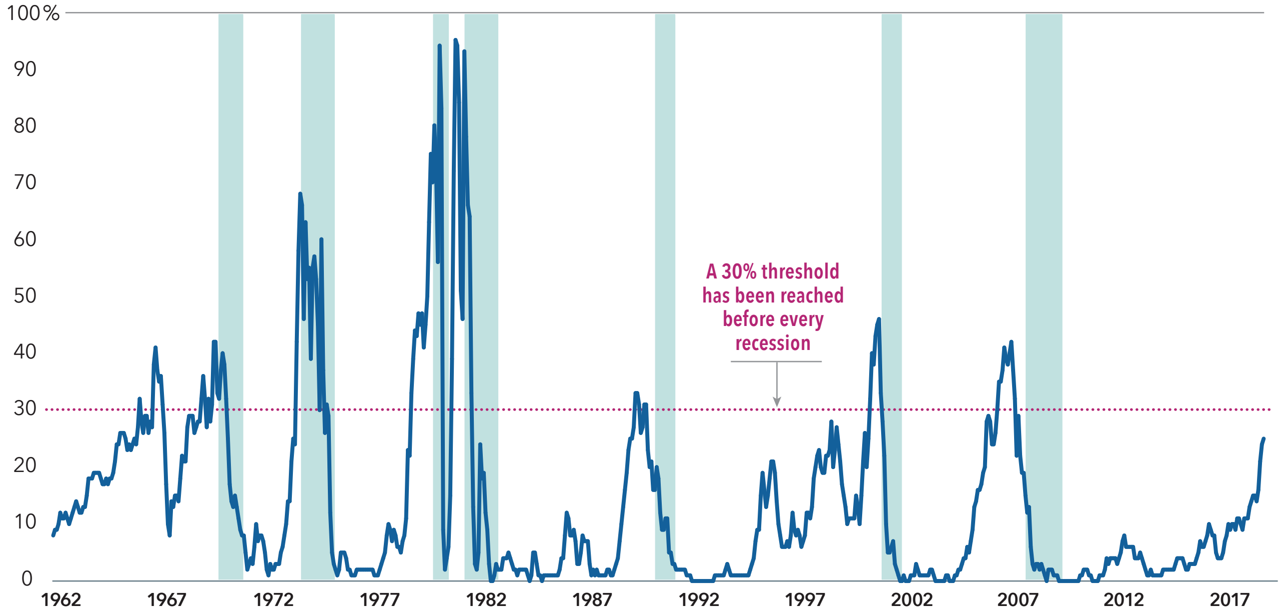
Even though the U.S. economy was relatively healthy a few months ago, the outbreak of the coronavirus has significantly altered that view.

The full economic impact may not be known for some time, but a combination of global supply chain disruptions and lower consumption will materially impact corporate earnings in 2020. Certain industries such as travel and hospitality will be hit the hardest, but the effects will likely be felt across sectors.

Our base case is that a recession is now more likely than not in 2020. If the government and Federal Reserve respond with strong measures of fiscal and monetary stimulus, it could go a long way toward mitigating the economic impact. How long it takes to contain the outbreak will, of course, also be a key factor.

The likelihood of a recession rose sharply in early 2020

NY Fed model: Probability of recession in 12 months



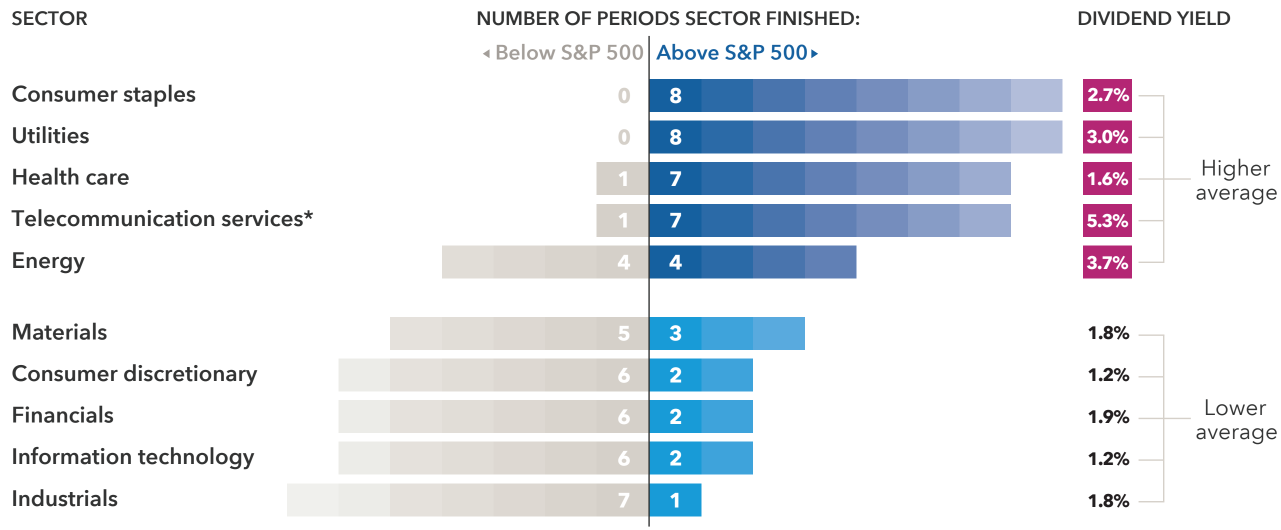
SOURCES: Federal Reserve Bank of New York, Refinitiv Datastream. As of 2/29/20. Shaded bars represent U.S. recessions as defined by the National Bureau of Economic Research.

How should you position your stock portfolio for a recession?

We've already established that equities often do poorly during recessions, but trying to time the market by selling stocks can be ill-advised. So should investors do nothing? Certainly not. Investors should take the opportunity to review their overall asset allocation – which may have changed significantly during the bull market – and ensure that their portfolio is balanced and broadly diversified. Consulting a financial advisor can help immensely since these often can be emotional decisions for investors.

Not all stocks respond the same during periods of economic stress. In the eight largest equity declines between 1987 and 2019, some sectors held up more consistently than others. Consumer staples and utilities, for example, often have paid meaningful dividends, which can offer steady return potential when stock prices are broadly declining. Growth-oriented stocks still have a place in portfolios, but investors may want to consider companies with strong balance sheets, consistent cash flows and long growth runways that can withstand short-term volatility. Even in a recession, many companies remain profitable. Focus on companies with products and services that people will continue to use every day.

Through eight declines, some sectors have finished above the overall market



Dividends can offer steady return potential when stock prices are broadly declining

SOURCES: Capital Group, FactSet. As of 12/31/19. Includes the last eight periods that the S&P 500 declined by more than 15% on a total return basis. Sector returns for 1987 are equally weighted, using index constituents from 1989, the earliest available.

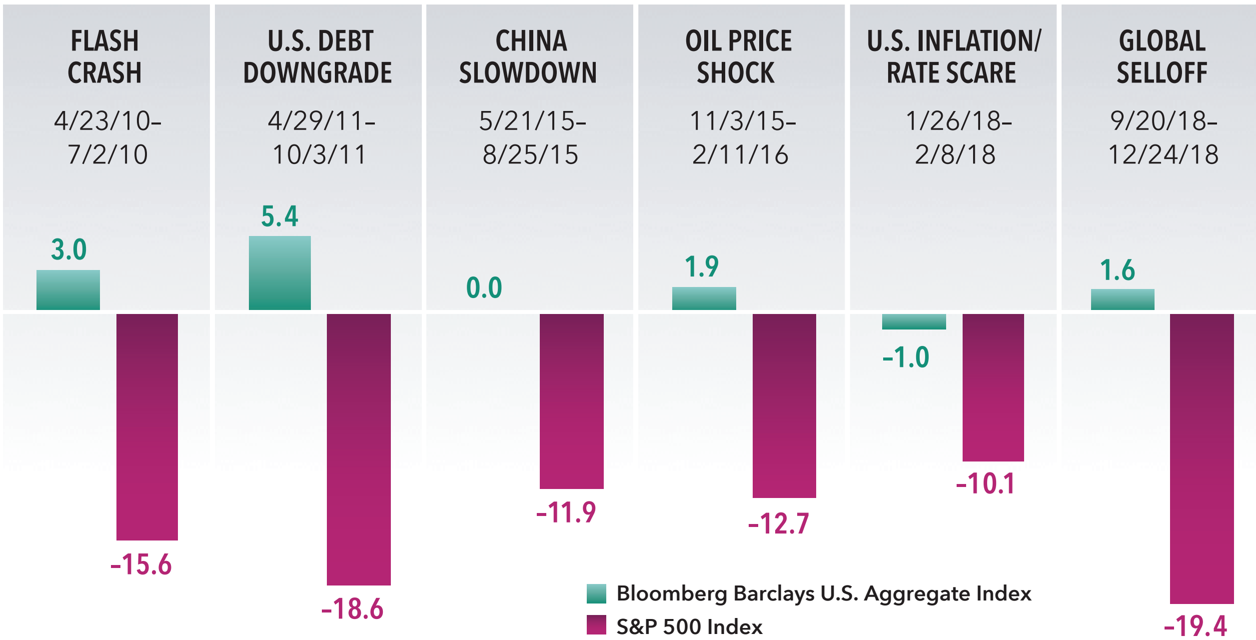
*The telecommunication services sector dividend yield is as of 9/24/18. After this date the sector was renamed communication services and its company composition was materially changed. During the 2018 decline, the sector would have had a higher return than the S&P 500 using either the new or old company composition.

How should you position your bond portfolio for a recession?

Fixed income investments can provide an essential measure of stability and capital preservation, especially when equity markets are volatile. Over the last six market corrections, U.S. bond market returns – as measured by the Bloomberg Barclays U.S. Aggregate Index – were flat or positive in five out of six periods.

Achieving the right fixed income allocation is always important. But with the U.S. facing significant economic headwinds as a result of the coronavirus outbreak, it's critical for investors to ensure that core bond holdings provide balance to their portfolios. Investors don't necessarily need to increase their bond allocation ahead of a recession, but they should ensure that their fixed income exposure provides elements of the four roles that bonds play: diversification from equities, income, capital preservation and inflation protection.

High-quality bonds have shown resilience when stock markets are unsettled



SOURCES: Bloomberg Index Services, Ltd., RIMES, Standard & Poor's. As of 12/31/19. Dates shown for market corrections are based on price declines of 10% or more (without dividends reinvested) in the S&P 500 with at least 50% recovery persisting for more than one business day between declines. The returns are based on total returns.

What should you do to prepare for a recession?

- Stay calm and keep a long-term perspective.
- Maintain a balanced and broadly diversified portfolio.
- Balance equity portfolios with a mix of dividend-paying companies and growth stocks.
- Choose funds with a strong history of weathering market declines.
- Use high-quality bonds to help offset equity volatility.
- For some investors, income protection in the form of variable annuities can be a good strategy.
- Talk to your advisor about how to navigate periods of market volatility.

Guide to recessions: Key takeaways

- **Recessions are a natural and necessary part of every business cycle.** They occur when economic output declines after a period of growth.
- **Recessions have been infrequent.** The U.S. has been in an official recession less than 15% of all months since 1950.
- **Recessions have been relatively short.** The current expansion has been longer than the last 10 recessions combined.
- **Recessions have been less impactful compared with expansions.** The average recession leads to a contraction of less than 2% in GDP. Expansions grow the economy by about 25% on average.
- **An inverted yield curve has preceded each of the last seven recessions by an average of 16 months.** It's one of the most consistent signs that a slowing economy has reached a tipping point.
- **Equities typically peak seven months before the economic cycle.** They also often rebound before a recession officially ends.
- **Some equity sectors have held up better during severe declines.** Consumer staples and utilities have topped the S&P 500 during each of the last eight major market declines.
- **A core bond portfolio can provide stability during recessions.** When stock markets decline sharply, high-quality bonds have shown resilience.

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