WHAT INVESTORS CAN DO IN A RECESSION

NEI

The term “recession” comes up frequently in the headline news during periods of economic and geopolitical uncertainty. Today’s climate is no different, with the war in Ukraine, policy responses to inflation, and shifts in the yield curve for bonds raising the possibility of a recession (for more on what it means when the yield curve flattens or inverts, review our article on yield curves [PDF]).

Times of economic recession can present financial challenges for Canadians. However, it is important for investors and advisors alike to keep in mind what a recession actually entails, how it has impacted securities markets historically, and especially what actions investors and advisors can take during these conditions.

Definition of a recession

A recession is generally known as a significant decline in economic activity lasting several months. While there is no 100% official definition of a recession, a commonly accepted one is two consecutive quarters of decline (negative readings) in real GDP. Other definitions of recession require additional declines in economic activity, such as increased unemployment, falling industrial production levels, and decreased wholesale/retail sales. The National Bureau of Economic Research (NBER) broadly defines a recession as a “significant decline in economic activity spreading across the economy, lasting more than a few months”—NBER’s Business Cycle Dating Committee is considered the official arbiter for declaring recessions in the U.S.

Some well-known periods of recession include the most recent COVID-driven decline in worldwide economic activity and the so-called “Great Recession” of 2007–9 sparked by the U.S. housing bubble and other underlying factors. However, not all recessions are as notable or significant. For example, in the first and second quarters of 2015, Canada’s GDP declined moderately, indicating a “technical recession” that reflected some challenges to the economy at that time but with growth quickly returning. In fact, more than a year after this technical recession, many credible economists re-reviewed the data and stated this was not a recession, citing otherwise strong employment levels during that period and the concentration of the decline in the country’s energy sector.

This past episode actually illustrates another important point about recessions: **that they are typically well underway long before they’re formally announced.** The start of the 2007–9 Great Recession, for instance, was announced 11 months after it was said to have started, and the end was announced 15 months after it was said to have ended. Incidentally, similarly as to how there’s no standard definition of when a recession begins, there is no standard definition as to when a recession ends. Some economists identify a recession’s end as when a sustained growth cycle begins, others contend it is when growth has returned to pre-recession trend.

So how long do recessions typically last? As there is no standard definition of when recessions begin or how severe they are, there is no standard length either. NBER estimates that on average recessions last 11 months, but individual recessions can vary considerably in duration. Note that amid the grave consequences of the pandemic, NBER declared an end to the COVID-related recession in the U.S. in April 2020 after declaring it February 2020, making that short period the briefest U.S. recession on record.* Of course, the ground-level economic and health effects of the coronavirus continue to last to this day, which helps to underscore that simply seeing the term “recession” does not automatically signal a certain set of conditions, that macroeconomic events will move in the same direction, or that the downturn will be experienced by individuals in the same way.

Recession misconceptions

Since recessions are often perceived one way but can actually vary considerably by cause, length, and severity, there tend to be many misconceptions that often arise when the term is used in the headline news. Often these

misconceptions can lead investors to make portfolio decisions that are not in their best longer-term interest, so it's important to be aware of them. Common myths about recessions include the following:

- **Global recessions affect all countries broadly**—Even amid worldwide economic downturns, individual countries can experience economic declines differently. Factors like the structure of a country's economy, its major trading relationships, or fiscal policies can increase or decrease a recession's effects. For example, Canada weathered the 2007–9 Great Recession better than other countries because of the strength and regulatory regime in its financials sector, among other reasons.
- **Recessions are the result of major economic/geopolitical dislocations**—Major recessions are often associated with grave global events, such as COVID-19. However, it is more useful to understand recessions as a more typical part of the business and investment cycle, even though economic effects can be difficult. Recessions are sometimes an unfortunate necessity as industries evolve, financial market bubbles normalize, and policymakers act to moderate wild swings in economic growth.
- **Market corrections/bear markets coincide with recessions**—Volatility in risk assets (such as stocks), along with corrections and possibly even bear markets, often occur around recessionary periods. However, the belief that recession news sparks market corrections is not borne out by evidence. In fact, market drops tend to come before the start of a recession is identified, and more importantly, market recoveries tend to come before the end is identified.

This last point is particularly critical for investors, as the assumption that the market moves can be mapped in direct relation to when recessions are declared can lead to poor investment decisions. We can see real-life examples of these phenomena when examining the last 11 recessions in the United States in comparison to the equity benchmark S&P 500 Index. Individually, we can see no real case for markets always declining shortly before and during recessions. In aggregate, the declines are actually fairly moderate. However, what is most important to note is the degree to which stocks bounced back in the months after recessions end.

How stocks behave before, during, after recessions (as gauged by the S&P 500 Index)

Recession Start	Length (Months)	12 Months Before	6 Months Before	During Recession	6 Months After	12 Months After
31-Jul-53	10	-3%	-6%	18%	17%	30%
31-Aug-57	8	-5%	5%	-4%	18%	33%
30-Apr-60	10	-6%	-5%	17%	7%	10%
31-Dec-69	11	-11%	-6%	-5%	14%	8%
30-Nov-73	16	-18%	-9%	-13%	1%	23%
31-Jan-80	6	14%	10%	7%	6%	8%
31-Jul-81	16	8%	1%	6%	-19%	20%
31-Jul-90	8	3%	8%	5%	3%	8%
31-Mar-01	8	-23%	-19%	-2%	-6%	-18%
31-Dec-07	18	4%	-2%	-37%	21%	12%
29-Feb-20	2	6%	1%	-1%	12%	44%
Average		-3%	-2%	-1%	7%	16%
Median		-3%	-2%	-1%	7%	12%
% Positive Return Periods		45%	45%	45%	82%	91%

Source: Bloomberg, cumulative price returns of the S&P 500 Index.

What these data mean is that investors who leave the market during recessions might only cement their losses, and then miss the sustained growth cycle that usually follows.

Investor strategies during recessions

While each recession presents a different set of difficulties for investors, there is a common set of strategies that investors and their advisors can use to weather these conditions:

- **Don't invest based on the news cycle**—As previously discussed, risk markets are often forerunners of recessions in the broader economy. Trying to time investment decisions based on short-term recession news might leave you far behind where markets are heading.
- **Stay invested**—Similarly, remaining invested in the portfolio that matches your investor profile has proven to be a sound strategy to ride out market volatility. As previously discussed, staying invested during throughout recessions can position you for gains when markets bounce back.
- **Diversify**—Risk assets do not move in lockstep, declining to different degrees during corrections and regaining ground at different rates during growth periods. Diversifying portfolio allocations within the range of your longer-term goals and investor profile helps ensure you are not over-exposed to risk in any one market. Also, periodic rebalancing is an important part of this process, to maintain the right level of diversification as the values of your portfolio assets change over time.
- **Be patient**—The average length of a recession is 11 months, and while individually they can vary considerably by time horizon, every recession has ended, with risk markets rebounding after their declines.

Recessions are typical of a given business cycle, and they don't last. Focusing on longer-term investment goals amid the volatility characteristic of economic contractions is a demonstrably beneficial strategy, and can help investors ride out temporary challenges, avoid adopting common pitfalls, and capitalize on new opportunities created by the growth cycle that follows.

* National Bureau of Economic Research, "Business Cycle Dating Committee Announcement July 19, 2021."

This material is for informational and educational purposes, and it is not intended to provide specific advice including, without limitation, investment, financial, tax or similar matters. The views expressed herein are subject to change without notice as markets change over time. Information herein is believed to be reliable, but NEI does not warrant its completeness or accuracy. Views expressed regarding a particular security, industry or market sector should not be considered an indication of trading intent of any funds managed by NEI Investments. Forward-looking statements are not guaranteed of future performance and risks and uncertainties often cause actual results to differ materially from forward-looking information or expectations. Do not place undue reliance on forward-looking information.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. NEI Investments is a registered trademark of Northwest & Ethical Investments L.P. ("NEI LP"). Northwest & Ethical Investments Inc. is the general partner of NEI LP and a wholly-owned subsidiary of Aviso Wealth Inc. ("Aviso"). Aviso is the sole limited partner of the NEI LP. Aviso is a wholly-owned subsidiary of Aviso Wealth LP, which in turn is owned 50% by Desjardins Financial Holding Inc. and 50% by a limited partnership owned by the five Provincial Credit Union Centrals and the CUMIS Group Limited.