Tracking Stock Market Performance Through Past Economic Recessions

Although the Federal Reserve has aggressively eased monetary policy and Congress has approved a $168 billion stimulus program of tax rebates and business incentives, investors remain concerned that the economy may be headed for its first recession in seven years—if the contraction hasn’t begun already.

The two-year-old housing slump, a broadening credit crunch, and eroding consumer confidence all contribute to the unease about the economy, which in turn has been reflected in sharp declines in stock prices since the market peaked last October. In an effort to ease the credit crisis and give the economy a boost, the Federal Reserve has sharply reduced the federal funds rate and taken other measures to pump more liquidity into the overburdened credit markets.

A recession is often thought to consist of two consecutive quarterly declines in gross domestic product (GDP). However, the National Bureau of Economic Research, the arbiter of business cycle dating, defines a recession more broadly, as a sustained and broad-based decline in employment, income, production, and sales, and often does not officially announce the onset of a recession until well after it occurs.

Economic growth, if not contracting, has at least slowed to a crawl. With investors reviewing their investment strategies in this troublesome environment, it may be useful to examine how stock markets performed in recession periods since World War II.

Stocks: A Leading Indicator

Ned Davis Research (NDR), an investment research firm, recently analyzed market performance before, during, and after the 10 recessions since 1945. These have had a median duration of about 10 months. And, as seen in the chart on page 2, the stock market has generally been a good indicator of these economic slumps.
In past recessions, the broad market began declining several months beforehand, as investors anticipated weaker corporate profits, and continued to drop over the five to six months after the start of the recession, the NDR study shows. From pre-recession bull market peak to recession low, the S&P 500 Index of large-cap stocks fell an average of 23.6%, NDR calculates.

But just as the stock market has anticipated economic downturns, it also has looked ahead to the economic recovery and an earnings rebound.

The market historically began rising about midway through these past recessions. On average, the S&P 500 gained 24% six months after reaching a recession low and skyrocketed an average of 32% a year after the recession low. (See table on page 3.) However, it has taken an average of 20 months for the index to recover to its pre-recession peak after hitting its recession low. (It took the index more than five years, though, to recover from the severe 1973–74 and 2000–2002 bear markets, both of which were accompanied by recessions.)

“The stock market is a great anticipation machine,” says Jack Laporte, a 30-year veteran who has managed the small-cap New Horizons Fund since 1987. “It does not look in a rearview mirror and try to reflect what happened in the past because what's important to investors is what's going to happen in the future. So it has historically anticipated upturns in the economy and earnings growth.”

At the time, of course, no one knows if a recession has begun, how long it might last, or when stock prices may recover. So it is important for investors to maintain their equity positions and perhaps add to them throughout recessions, even if stock prices are declining.

“The challenge for investors is that stocks begin to perform better before investors feel better,” says Brian Rogers, T. Rowe Price’s chairman and chief investment officer. “The magnitude of some of these write-offs [on losses related to subprime mortgages by some Wall Street firms and banks] is gargantuan, but as we work through the year, the news will begin to be less bad, and less bad will translate into optimism.”

Recession Patterns

NDR observes that each of the 10 postwar recessions was accompanied by a bear market, as defined by the firm. In each of these cases, the stock market’s low during the recession was also the bottom of the bear market. (Unlike recessions, there is no official definition of a bear market. The firm notes that 10 of the past 18 bear markets were accompanied by a recession.)

While the research firm calculates that on average the stock market peaked about nine months before the onset of recessions, the pattern of each recession is different. In the 1990–91 recession, for example, the market hit its high less than a month before the recession began, while stocks peaked 14.5 months before the most recent recession began in March 2001.

And while the study shows that the market bottomed on average about five months before the end of recessions, this low has ranged from just about two months before the end of the 2001 recession to more than eight months prior to the end of the 1953–54 recession.

On average, corporate earnings peaked about 10 months prior to the start of recessions and bottomed out about four months after recessions began (excluding the 1953–54 recession). It can take several quarters for earnings to regain some momentum. In more recent recessions, earnings did not reach their prior peak until 15 to 33 months after hitting their low.

“The market’s recovery halfway into recessions has a lot to do with changing expectations,” explains Tim Hayes, chief investment strategist for NDR. “Ahead of a recession and during its initial months, the market tends to doubt that Fed rate cuts can do anything to save the sinking economy. The market tends to be focused on earnings growth and the
slim chances for earnings to recover anytime soon.

"Earnings growth has usually peaked before, or soon after, the market peak, and a recession has tended to follow, starting a median of nine months after the market peak," Mr. Hayes adds. "Yet, by the time the recession has gotten well under way, the market has mostly priced in the bad news, liquidity has reached excessive levels, and the market has started to focus on the potential stimulus—the improved chances for the economy to recover—and the improved valuations."

The bottom line, Mr. Hayes says, is that "a recession could keep the market in retreat, but it could also lead to a great buying opportunity."

**Small-Cap Surge**

As reflected in the chart on page 4, small-cap stocks tend to underperform those of larger companies leading into and during the early stage of a recession. However, NDR says, just as the S&P 500 Index starts its recovery about six months into a recession on average, small-cap stocks tend to significantly begin outperforming large-cap stocks at about the same time and typically continue leading for at least a year after the recession has ended.

For the 12-month period following the end of the last nine recessions, small-cap stocks on average provided a 24% gain compared with 17.6% for the S&P 500. Explaining the pattern, Mr. Laporte says that when investors become more concerned about the economy, they tend to favor "perceived higher-quality companies and better liquidity. Small-cap stocks are more volatile than large-caps and are more cyclical or sensitive to the U.S. economy than large-caps. Large-caps also have the advantage of being more diversified and having exposure to the global economy. So it’s not surprising that small-caps take a harder hit as we head toward recessions.

"But, historically," Mr. Laporte adds, "coming out of every recession and every significant bear market, small-caps lead the way because at that point investors are looking to a stronger environment and are willing to assume greater risk for the potentially higher returns that small-caps may provide."

Indeed, a recent Merrill Lynch study observes that in 18 bear markets since the 1930s, small-cap stocks have suffered a median decline of 29% versus 21.4% for large-cap stocks. However, small-caps have shown a median gain of 41.4% for the 12-month period after the end of these bear markets versus a median gain of 32.4% for large-cap stocks.

Since peaking on July 13, 2007, the Russell 2000 Index of small-cap stocks declined 24.1% to its low in the first quarter on March 10. Meanwhile, the S&P 500 declined 17.9% from its peak last October to its recent low, also on March 10.

**Sector Performance**

In terms of market sectors during recessions, NDR found that health care and consumer staples (such as food, household products, and beverage firms) were the best-performing sectors on average six and 12 months after the start of the last five recessions, dating back to 1973. In fact, health care led in each of these five recessions.

That may not be unexpected, since “illness generally is not correlated with either good or bad economic times,” says Kris Jenner, manager of the Health Sciences Fund. “As a result, the revenue and earnings profile of health care products tends to be quite stable and becomes

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<th>S&amp;P Low Date in Recession*</th>
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*Low date for the S&P 500 Stock Index during recession, as defined by the National Bureau of Economic Research (NBER).
**Months needed for S&P 500 Stock Index to recover to its pre-recession peak from its recession low.
more attractive when earnings are declining or moderating for the rest of the world in a recession. But the market will gravitate back to more economically sensitive companies as conditions improve.”

The historical pattern could be upset this year, Dr. Jenner notes, by the presidential election, which “is causing concern about meaningful changes in policy that will have a longer-term consequence.”

Another complicating factor to keep in mind, he adds, “is that many of the pharmaceutical companies, the largest companies in the health care sector, have quite anemic top-line revenue growth. So they are generally not as attractive as they were in previous recessions over the past 10 to 20 years.”

Stocks that are more susceptible to the economy have fared the worst in recessions. The energy and industrial sectors on average were the biggest laggards in performance over the first six months of the past five recessions, and information technology and telecommunication services trailed the most over a 12-month period. Energy stocks have benefited from the record rise in energy prices recently, so they may fare better than usual in this economic slowdown.

At the same time, Morningstar, the mutual fund tracking and research firm, cautions in a recent report that “markets haven’t always responded predictably to recessions. That’s because other factors, such as the valuations of various asset classes at the outset of the recessionary period can affect what performs well and what suffers during an economic downturn.”

For example, in the last recession, which lasted from March to November of 2001, the report notes that “highly cyclical tech stocks sunk like a stone. At the same time, equally cyclical industrial materials stocks held up quite well, despite the widespread view that they should be avoided during a downturn. That was partly because industrials were so cheap after being beaten down during the tech bubble of the late 1990s.”

Similarly, Mr. Laporte notes that heading into the 2001 recession, small-cap stocks had lagged those of larger companies for years, so their relative valuations had hit a record low. As a result, small-caps actually held up better in the 2000–2002 downturn.

In recent years, small-caps have become relatively expensive compared with large-cap stocks, “and that probably accounts for their sharp underperformance over the last nine months,” Mr. Laporte says. “Every recession is different, despite their similarities,” Morningstar concludes, “and it’s not a good idea to try to time the market in reaction to a recession.”

Staying the Course

For investors reassessing their strategies in this more challenging investment environment, T. Rowe Price managers advise that those taking a disciplined, long-term approach typically do better over time than those who restructure their portfolio with every significant change in the investment climate.

“I would not try to shift from one asset class to the next, but I would rebalance the portfolio back to what you believe is a good long-term stock/bond allocation for you if the stock portion has declined,” advises Ned Notzon, chairman of T. Rowe Price’s asset allocation committee. “You want to at least have the same allocation to stocks when the market is recovering as when it was going down. And it’s very easy to miss the recovery since the market anticipates an earnings rebound before you see the data that support it.

“T’s really important to have an equity exposure you are comfortable with,” Mr. Notzon advises, “but if you decide to change it, don’t do it in the midst of market turmoil.”