CAPITAL GROUP®

Guide to Recessions

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

2022 EDITION

When is the next recession?

That's one of the questions we hear most often, especially now as the Federal Reserve aggressively hikes interest rates to rein in inflation at 40-year highs. It seems clear to us that the U.S. will enter a recession by early 2023, if it hasn't already. Our expectation is that it will be less damaging than the 2008 global financial crisis, although the full extent of the economic impact won't be known for some time.

Recessions can be complicated, misunderstood and 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?**

Let's start with the most basic question: **What causes recessions?**

Darrell Spence
Economist

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Economist

Investments are not FDIC-insured, nor are they deposits of or guaranteed by a bank or any other entity, so they may lose value.

– PAUL SAMUELSON, 1966

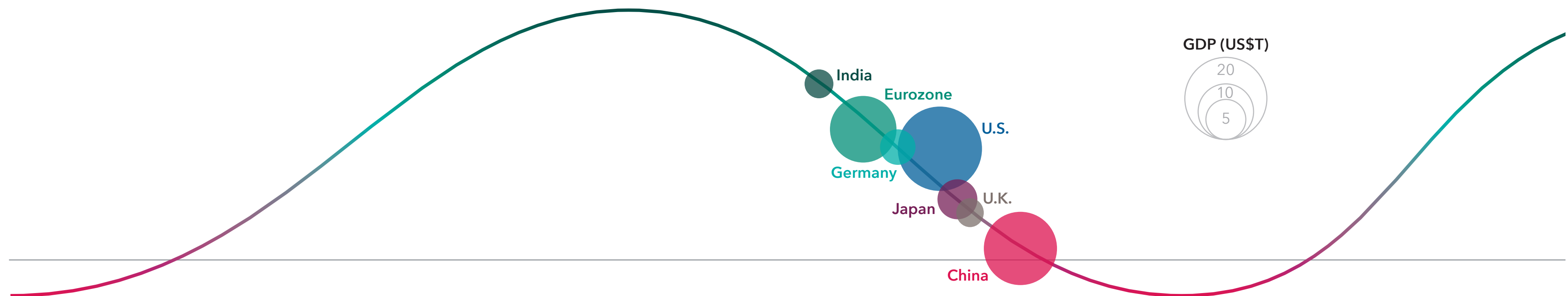
What causes recessions?

A recession is commonly defined as at least two consecutive quarters of declining GDP (gross domestic product) after a period of growth, although that isn't enough on its own. The National Bureau of Economic Research (NBER), which is responsible for business cycle dating, defines recessions as "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." In this guide, we will use NBER's official dates.

Past recessions have occurred for many reasons, but typically are the result of economic imbalances that, ultimately, need to be corrected. For example, the 2008 recession was caused by excess debt in the housing market, while the 2001 contraction was caused by an asset bubble in technology stocks. An unexpected shock such as the COVID-19 pandemic, widespread enough to damage corporate profits and trigger job cuts, also can 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 cycle that topples an economy. Although they can be painful to live through, recessions are a natural and necessary means of clearing out excesses before the next economic expansion.

Tracking a recession



EARLY

- Economic activity accelerates
- Hours worked rise
- Housing activity increases
- Central bank policy eases

MID

- Profit margins peak
- Employment improves
- Credit demand picks up
- Inflation nears target

LATE

- Labor markets tighten
- Costs soar
- Profit margins contract
- Central bank policy tightens

RECESSION

- Economic activity declines
- Credit contracts
- Unemployment rises

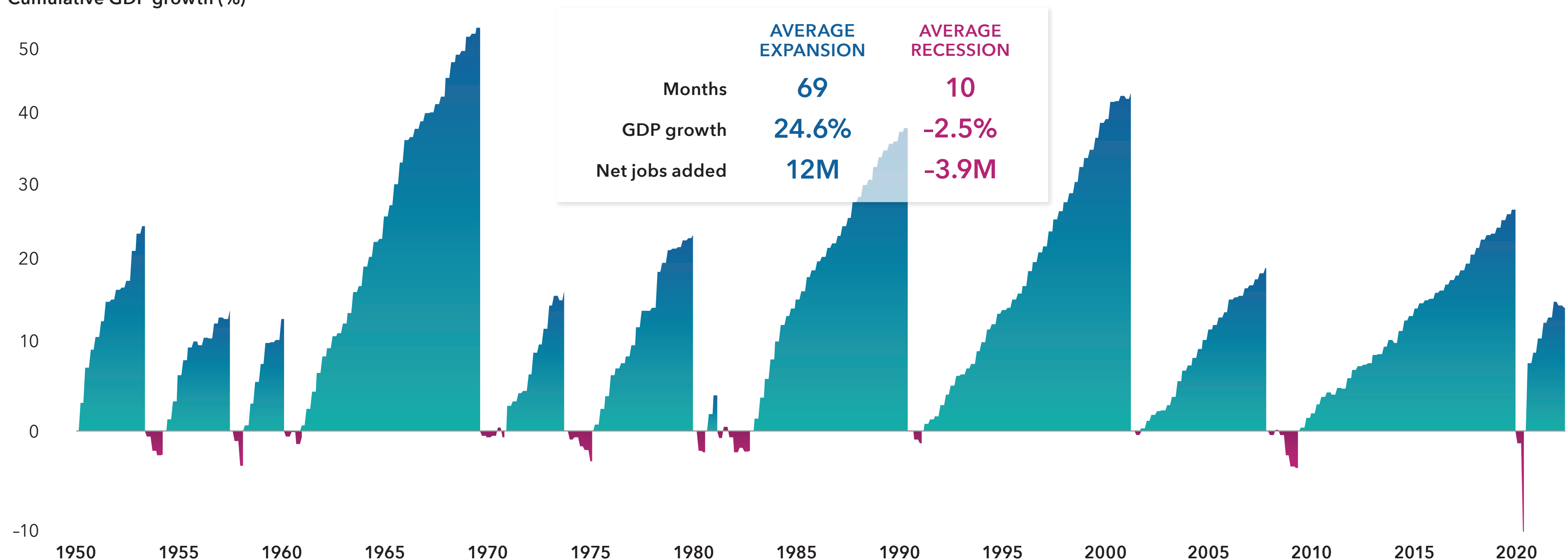
Sources: Capital Group, FactSet. GDP data are in USD and are the latest available through 3/31/22. Country positions within the business cycle are forward-looking estimates by Capital Group economists as of June 2022.

How long do recessions last?

The good news is that recessions generally haven't lasted very long. Our analysis of 11 cycles since 1950 shows that recessions have persisted between two and 18 months, with the average spanning about 10 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 70 years, the U.S. has been in an official recession less than 15% of all months. Moreover, their net economic impact has been relatively small. The average expansion increased economic output by almost 25%, whereas the average recession reduced GDP by 2.5%. 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. Chart data is latest available as of 8/31/22 and shown on a logarithmic scale. The expansion that began in 2020 is still considered current as of 8/31/22 and is not included in the average expansion summary statistics. 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.

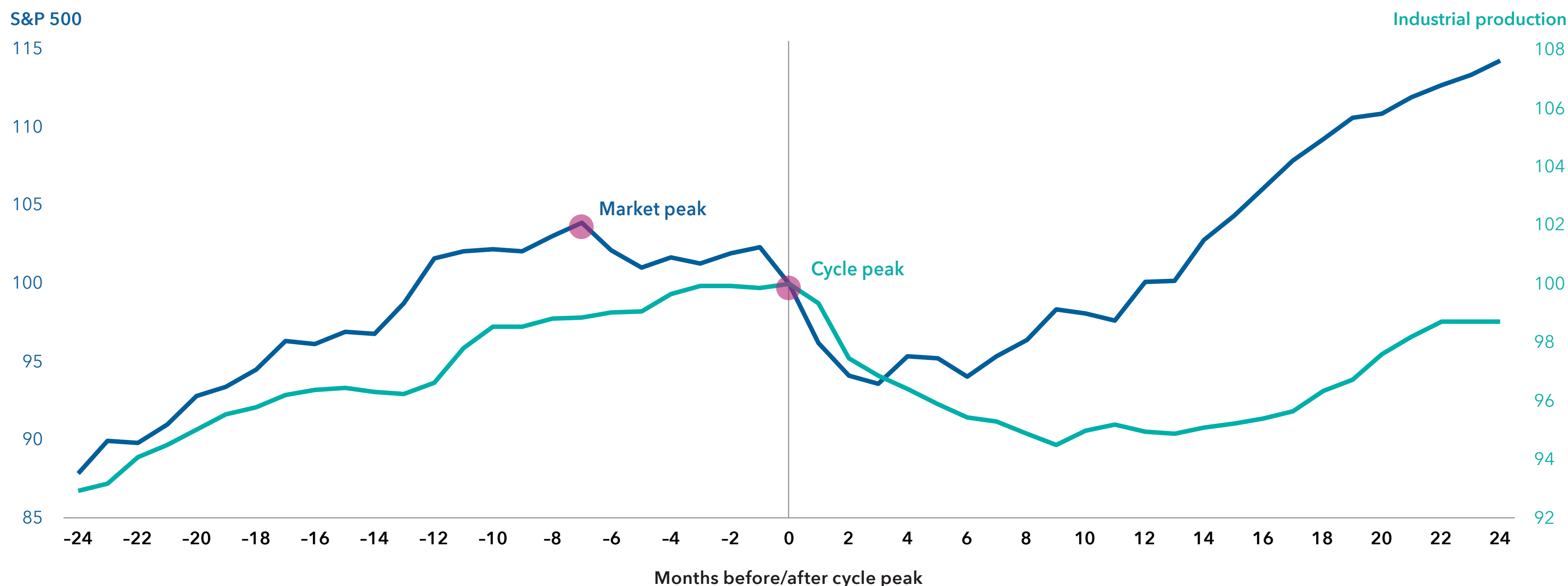
What happens to the stock market during a recession?

The exact timing of a recession is hard to predict, but it's still wise to think about how one could affect your portfolio. Bear markets (market declines of 20% or more) and recessions have often overlapped – with equities leading the economic cycle by six to seven months on the way down and again on the way up.

Still, aggressive market-timing moves, such as shifting an entire portfolio into cash, can backfire. Some of the strongest returns can occur during the late stages of an economic cycle or immediately after a market bottom.

A dollar cost averaging strategy, in which investors systematically invest equal amounts at regular intervals no matter the market's movements, can be beneficial in down markets. This approach not only allows investors to purchase more shares at lower prices but positions them to benefit when the market eventually rebounds. Regular investing does not ensure a profit or protect against loss. Investors should consider their willingness to keep investing when share prices are declining.

Equities have typically peaked 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 reflects the average of completed cycles from 1950 to 2021, indexed to 100 at each cycle peak.

What economic indicators can warn of a recession?

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

Many factors can contribute to a recession, and the main causes often change. Therefore, it's helpful to look at several different aspects of the economy to better assess where excesses and imbalances may be building. Keep in mind that any indicator should be viewed more as a mile marker than a distance-to-destination sign.

Four examples of economic indicators that can warn of a recession include the yield curve, unemployment rate, consumer confidence and housing starts. Aggregated metrics, such as The Conference Board Leading Economic Index® (LEI), which combines 10 different economic and financial signals into a single analytic system to predict peaks and troughs, have also been consistently reliable over time.

These factors suggest the U.S. is in a late part of the economic cycle and moving closer to a recession, even as the labor market remains relatively resilient. New economic data can quickly change the story though, and the closely watched yield curve recently inverted.

	Inverted yield curve	Unemployment	Consumer confidence	Housing starts	Leading Economic Index®
Recession warning sign	10-year yields below two-year yields	Rising from cycle trough	Declining from previous year	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 unemployment rises it can lead to declining consumption and business output	When consumers are pessimistic they often cut back on spending	When the economic outlook is poor, homebuilders often cut back on housing projects	Provides a broader look at the economy through an aggregation of multiple leading economic indicators
Average months until recession	14.5	5.6	2.9	5.3	3.6
Where we are now	Yield curve has been inverted since early July	Unemployment rate rose in August but remains near 50-year lows	Consumer confidence declined in July and August compared to the previous year	New housing starts are growing, but at a slower rate than post-pandemic peaks	LEI growth rate has decelerated in recent months

Source: Capital Group. Reflects latest data available as of 8/31/22.

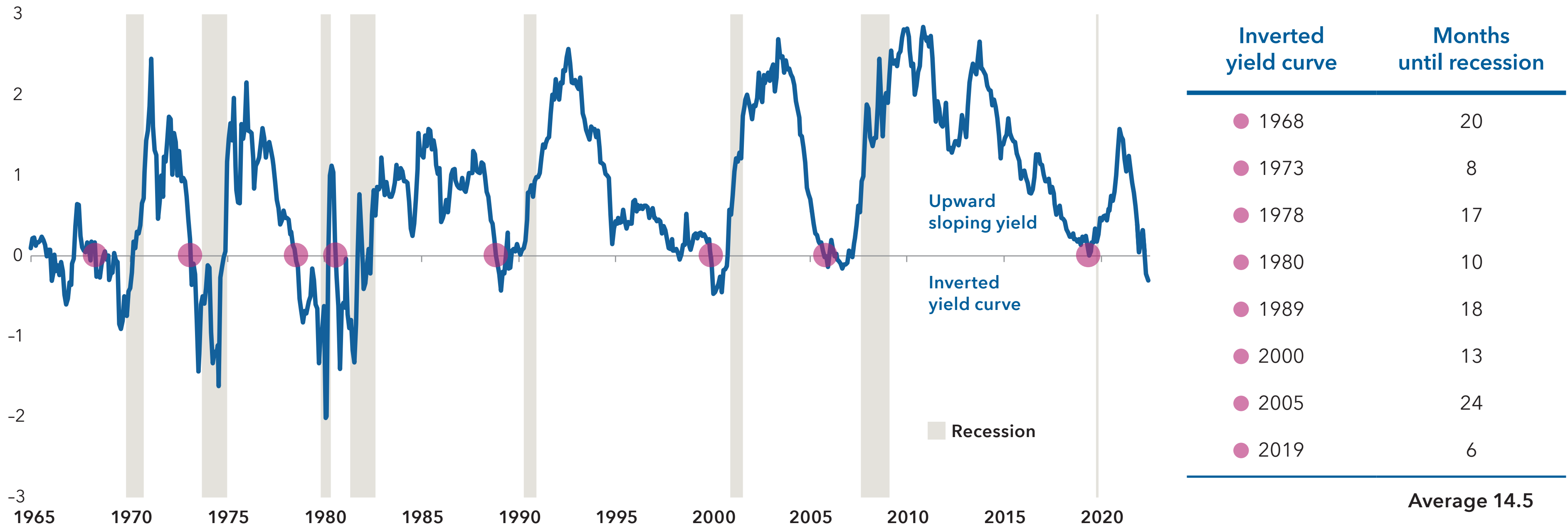
What is an inverted yield curve?

An inverted yield curve may sound like an elaborate gymnastics routine, but it actually has been 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 safety of long-term government bonds rather than buying riskier assets.

The yield curve between two-year and 10-year U.S. Treasuries inverted briefly in April and June before dropping to new cycle lows in July. Other parts of the curve – such as two-year and five-year yields – have also turned negative at times this year. It wouldn't be surprising to see further inversion should the Fed continue to boost short-term rates and the economic outlook darkens. However, even an inverted yield curve is not cause for immediate panic, as there typically has been a significant lag (14.5 months on average) before the start of a recession.

An inverted yield curve has preceded every recession in the last 50 years

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
2019	6
	Average 14.5

Sources: Capital Group, Refinitiv Datastream. As of 8/31/22. One-year rates used instead of two-year rates prior to 6/30/76. When a brief yield curve inversion (less than two consecutive months) occurred before a more sustained inversion, the sustained period is listed as the starting date in the table. Shaded bars represent U.S. recessions as defined by the National Bureau of Economic Research.

How close are we to the next recession?

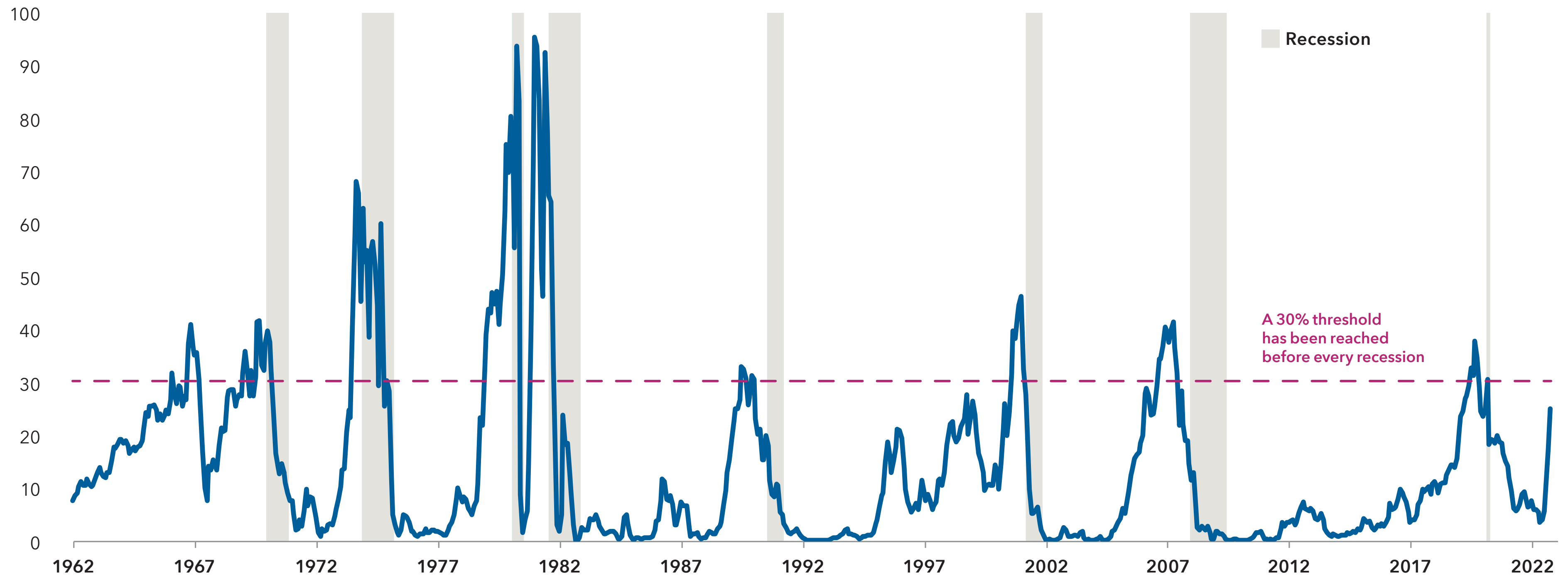
While it may feel like we're already in one, we believe an official recession is still unlikely until later this year or early 2023. Despite the impact that high inflation has had on consumer sentiment and corporate earnings, a strong labor market continues to support the economy in the near term.

The exact timing will likely depend on the pace and magnitude of the Fed's moves. It is hard to see a clear path to bring inflation back to the Fed's 2% target without pushing the economy into recession. In our view, the only way to break the spiral of escalating wages and prices is to create a lot of slack in the labor market. Given the labor market disruptions caused by the pandemic, the unemployment rate may need to rise to at least 5% or 6% before wage growth starts to moderate. We believe this will make a recession very difficult to avoid by 2023.

Geopolitical shocks – such as an escalation of the war in Ukraine – or the consequences of a recession overseas are even harder to predict but could quicken the timeline for a U.S. recession.

The likelihood of a recession rose sharply in recent months

NY Fed model: Probability of recession in 12 months (%)



Sources: Federal Reserve Bank of New York, Refinitiv Datastream. As of 8/31/22. 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 is not suggested. So should investors do nothing? Certainly not.

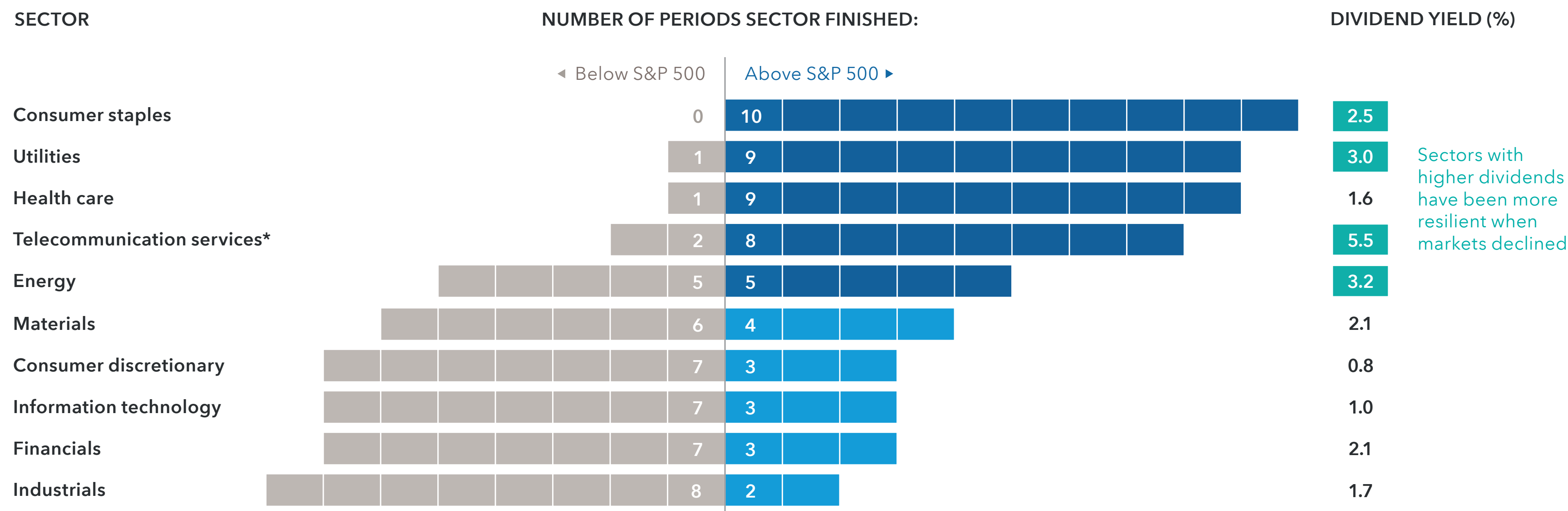
To prepare, investors should take the opportunity to review their overall asset allocation, which may have changed significantly during the bull market, to ensure their portfolio is balanced and diversified. Consulting a financial advisor can help immensely since these can be emotional decisions for many investors.

Not all stocks respond the same during periods of economic stress. In the 10 largest equity declines between 1987 and 2022, some sectors held up more consistently than others – usually those with higher dividends such as consumer staples and utilities. Dividends can offer steady return potential when stock prices are broadly declining.

Growth-oriented stocks can 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 may remain profitable. Focus on companies with products and services that people will continue to use every day such as telecom, utilities and food manufacturers with pricing power.

Through 10 declines, some sectors have finished above the overall market



*In September 2018, the telecommunication services sector was renamed communication services and its company composition was materially changed. The dividend yield shown is for the telecommunication services industry group, a subset of the newly constructed communication services sector.

Sources: Capital Group, FactSet. Includes the last 10 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 data set. The 2022 bear market is considered current as of of 8/31/22 and is included in this analysis. Dividend yields are as of 8/31/22.

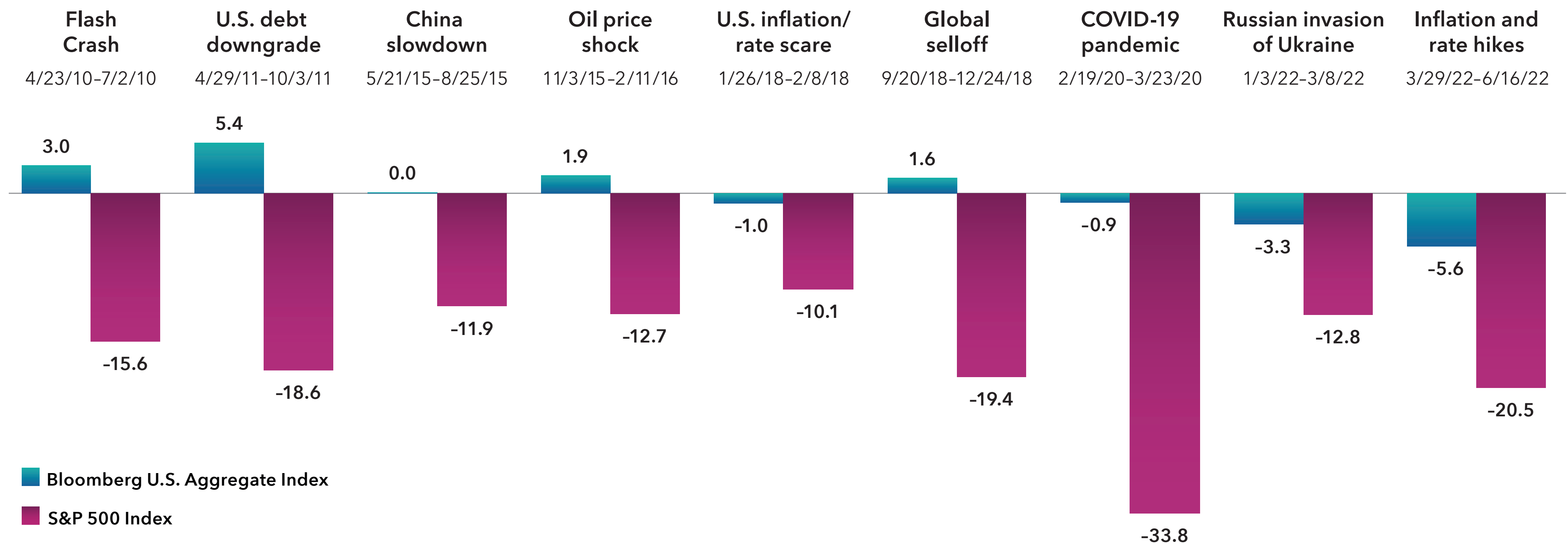
How should you position your bond portfolio for a recession?

Fixed income is often key to successful investing during a recession or bear market. That's because bonds can provide an essential measure of stability and capital preservation, especially when equity markets are volatile.

The market selloff in the first half of 2022 was unique in that many bonds did not play their typical safe-haven role. But in the seven previous market corrections, bonds – as measured by the Bloomberg U.S. Aggregate Index – rose four times and never declined more than 1%.

Achieving the right fixed income allocation is always important. But with the U.S. economy entering a period of uncertainty, it's especially critical for investors to focus on core bond holdings that can provide balance to their portfolios. Investors don't necessarily need to increase their bond allocation ahead of a recession, but they should review their fixed income exposure with their financial professional to be sure it is positioned to provide diversification from equities, income, capital preservation and inflation protection – what we consider the four key roles fixed income can play in a well-diversified portfolio.

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



Sources: Bloomberg Index Services Ltd., RIMES, Standard & Poor's. 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. Includes all completed corrections between 1/1/10 and 8/31/22. Returns are based on total returns in USD. Past results are not predictive of results in future period.

What should you do to prepare for a recession?

- **Stay calm and keep a long-term perspective**
- **Maintain a balanced and broadly diversified portfolio**
- **Consider balancing 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**
- **Speak with your financial advisor before making changes to your portfolio**

Past results are not predictive of results in future periods.

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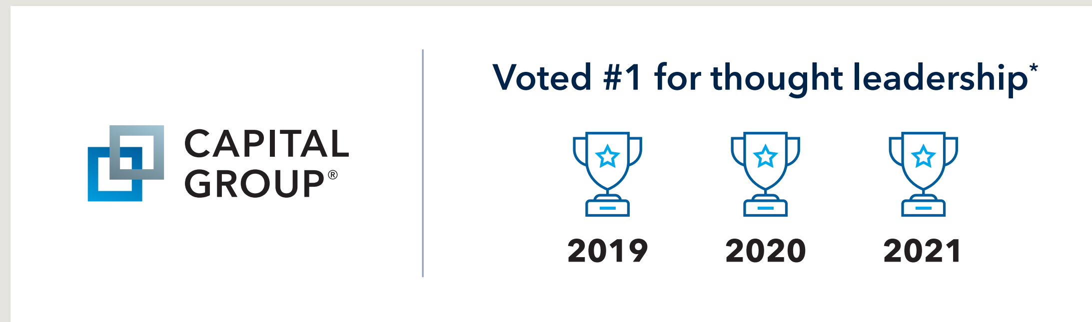
Guide to Recessions: Key takeaways

- **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**
  Recessions have ranged from two to 18 months, with the average lasting about 10 months.
- **Recessions have been less impactful compared with expansions**
  The average recession leads to a contraction of 2.5% in GDP. Expansions grow the economy by about 25% on average.
- **An inverted yield curve has preceded each of the last eight recessions by an average of 14.5 months**
  It's one of the most consistent signs that a slowing economy has reached a tipping point.
- **Equities have typically peaked 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 topped the S&P 500 Index during each of the last 10 major market declines.
- **A core bond portfolio can provide stability during recessions**
  When stock markets decline sharply, high-quality bonds have shown resilience.



*Source: Fund Intelligence, February 20, 2020. FUSE Research survey of nearly 600 advisors identifying the "most-read thought leaders." Marketing Support: The Advisor View, June 2020. FUSE Research survey of more than 700 advisors identifying the "most-read thought leaders." Marketing Support: The Advisor View, July 2021. FUSE Research survey of 720 financial advisors identifying the "most-read asset manager thought leaders."

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