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Do Markets Predict Recessions?

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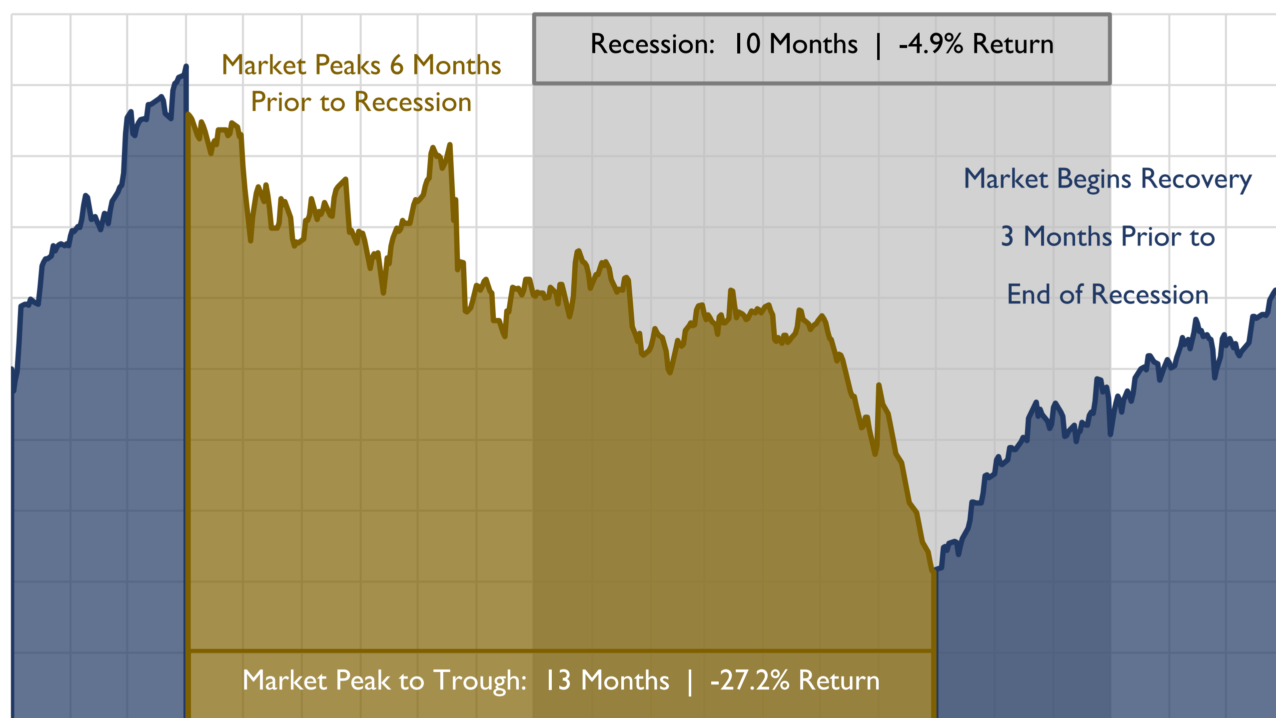
"The Stock Market has forecasted 9 out the last 5 recessions!" Nobel Prize Economist Paul Samuelson quipped in 1982. It turns out that the stock market is an unreliable predictor of recessions, as Samuelson so cleverly put it. A recent update confirms the stock market has a bit better than 50/50 prediction record, reporting that it has now predicted 13 out of the last 7 recessions! Was the recent market decline from January to October of 2022 another false signal?

AVERAGE EQUITY MARKET PERFORMANCE ASSOCIATED WITH US RECESSIONS (1945 - 2020)



Source: Dow Jones Indices LLC | Note : The chart above is an illustrative composite of market movements in and around US recessions and does not depict any specific time period.

The chart above shows the average relationship between the stock market and the 13 US recessions since 1945. The 2022 market peak to trough decline of -25.4% does indeed closely match the longer-term average -27.2% decline prior to a recession.

But the typical timing of the subsequent recession does not match the current situation. The typical 10-month recession begins 6 months after the market peak and ends 3 months after the market trough. This means if the 2022 market decline were a recession signal, the economic downturn would have begun around June 2022 and ended earlier this year. Since there has been no recession declared by the National Bureau of Economic Research (NBER), last year's market decline may be another failed signal. This conclusion is reinforced by recent strong DGP growth reported for Q3 of this year.

Recession has been anticipated by many market participants. However, even with the Stock Market's 2022 decline there has been no recession. There may or may not be one in the future. The point is that like many things the relationship between the media, the economy and the stock market are not particularly useful in the short run. Over the long run, staying invested is often the best path regardless of headlines, economic conditions, and short-term market gyrations.

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From the Behavioral Viewpoint

What is going on?

1. Bad news sells! There is a **Bias** towards predicting market and economic declines rather than successes. Actual stock market declines turbocharge this bias, leading to an **Availability Cascade of negative news**, making it difficult to grasp the actual relationship between the stock market and the economy.

2. Investors are subject to **Loss Aversion,** which means they feel losses more strongly than gains. When the market experiences declines, investors exhibit **Transference**, in which negative feelings are projected onto the economy.

3. Investors are overwhelmed by the complexity of the stock market. **We want to believe the stock market is Informationally Efficient and driven exclusively by fundamentals**. It turns out that these only explain a small portion of volatility.

What can we do?

1. The stock market is only a bit better than a 50/50 at predicting recessions. The daily flood of market and economic information is great for stirring up emotions but is of little help in making sound investment decisions.

2. Learn to understand markets as a long-term return distribution. The more draws from the distribution, the better the outcome. Develop realistic expectations and accept that both positive and negative returns will inevitably occur.

3. Develop a needs-based plan that separates short-term and long-term investments and stay fully invested over time. Build a strategy-diverse equity portfolio that can be resilient in a variety of market conditions and designed for the long-run.

4. Work with an experienced financial advisor who has been through different market environments. Advisors can provide perspective and coaching to help stay on track and remain focused on long-term goals.

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