



INVESTMENT INSIGHTS

Analysis, Insights and a Different Perspective

August 2020

THE ALPHABET OF RECESSIONS

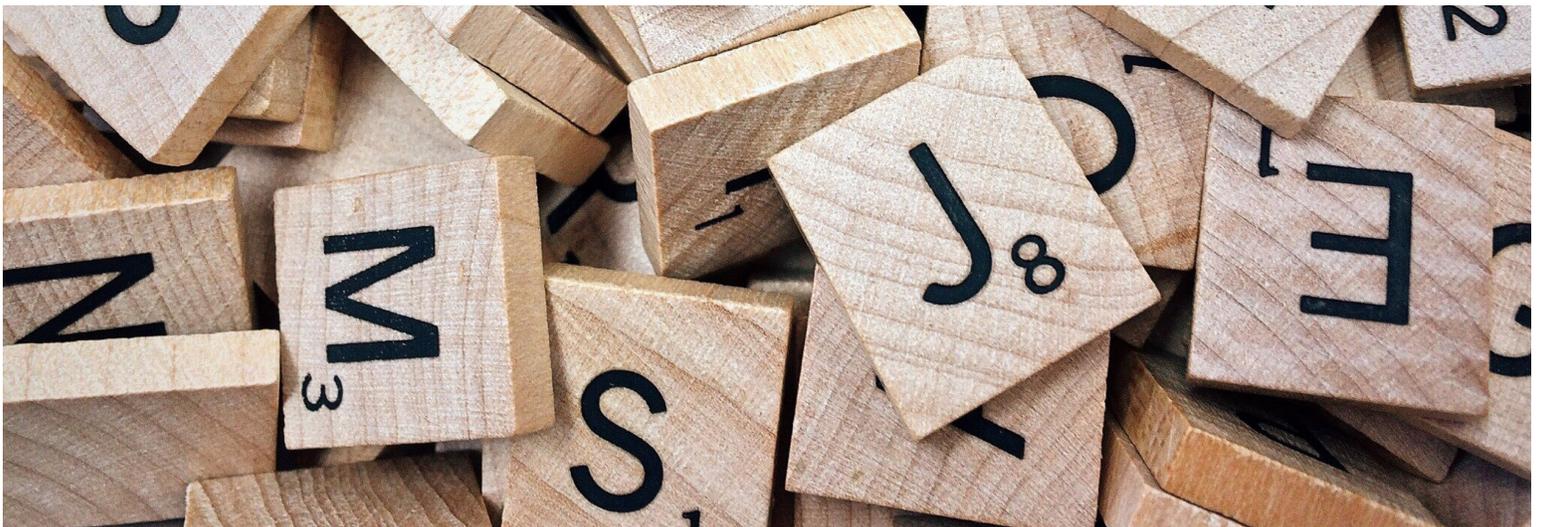
A recession is a period of slowdown in economic activity that lasts more than a few months. In June, the official scorekeeper for the U.S. economy, the National Bureau of Economic Research (NBER), declared that the U.S. economy fell into a recession in February 2020. This is the first recession for the U.S. since the Great Recession that began in December 2007 and lasted until June 2009. The NBER defines a recession as “a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in the real domestic product (GDP), real income, employment, industrial production, and wholesale-retail sales.”

Since February, early economic data suggest that the U.S. economy has begun to improve. While the duration and path of the recovery from recessions are typically only clear in hindsight, they have historically followed some common shapes. In this issue of Investment Insights, we examine the alphabet of recessions.

KEY POINTS

- This issue of Investment Insights takes a close look at typical paths and durations that recessions have historically tended to follow.
- Economists generally describe recessions using four common shapes: V, U, W, and L.
- While studying these shapes can be insightful into the path of the current recession, the true picture of recession typically only becomes clear in hindsight.

Cornerstone
WEALTH MANAGEMENT LLC
A Registered Investment Advisor

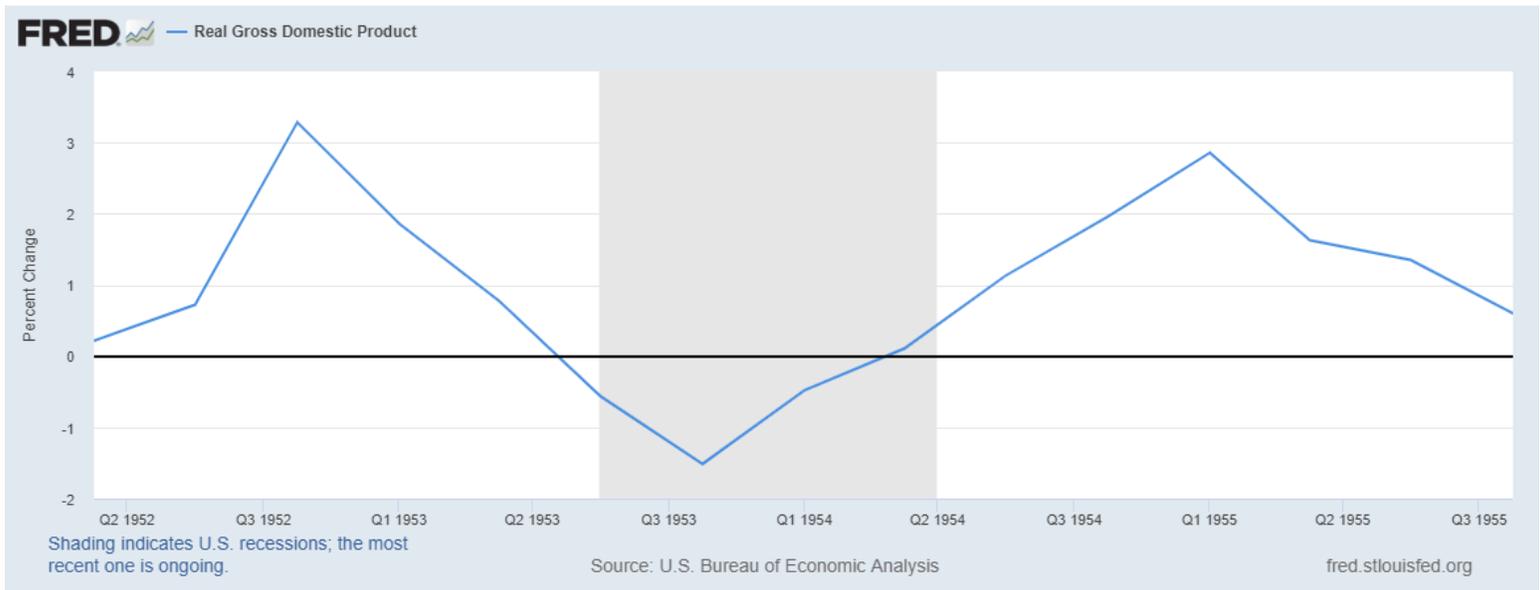


WHAT IS THE SHAPE OF A RECESSION?

When economists study the path and duration of an economic recovery, they often study previous recessions for insights. Previous recession and subsequent recoveries can broadly be categorized as having four common shapes: V, U, W, and L. These letters come from the shape of graphs of economic metrics, such as Gross Domestic Product (GDP), that track economic activity. Let us take a closer look at recessions with a V, U, W, and L shape.

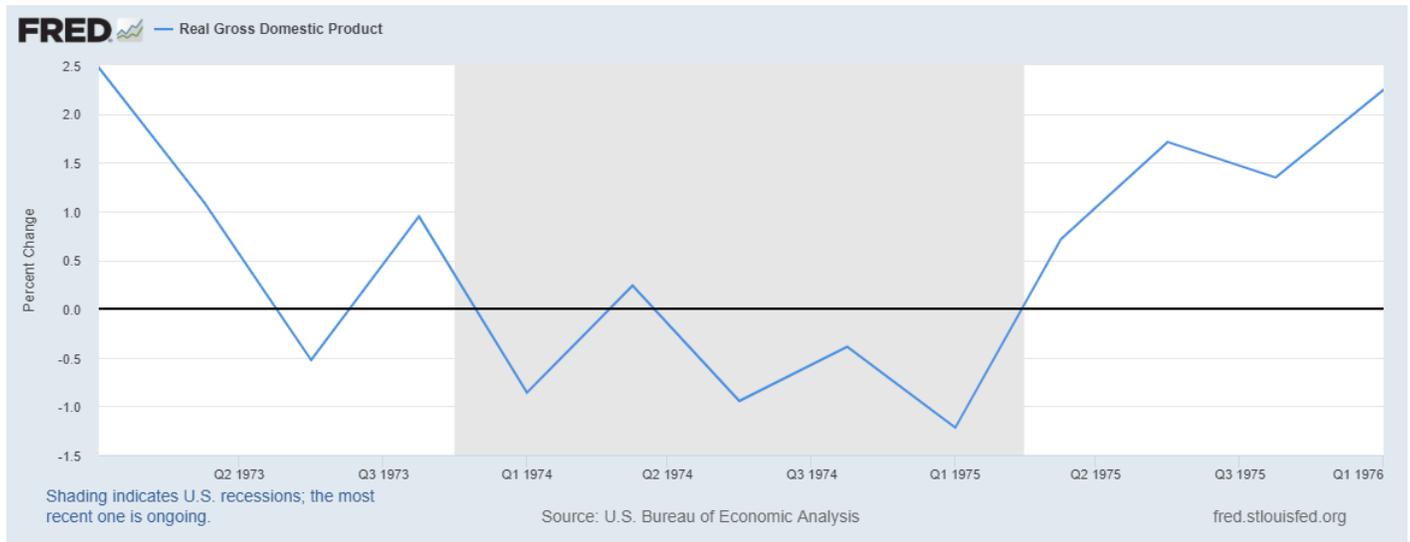
V-SHAPED

Compared with all other shapes, a V-shaped recession is considered the best-case scenario because, during such a recession, the economy rebounds as quickly as it declines. The graph below shows a classic example of a V-shaped recovery that occurred in the U.S. in 1953 when the Federal Reserve raised interest rates to prevent inflation from the booming post-war economy. The economy experienced a steep decline, followed a quick recovery in just about a year. The “V” is preferred because, under this scenario, the duration in which economic activity recovers to levels before the recession is typically measured in months and not years. The quick rebound tends to avoid any long-lasting economic damage. For the current recession, a V-shaped recovery would mean that the recession is relatively short-lived, and that the economic activity recovers to pre Covid-19 pandemic levels quickly.



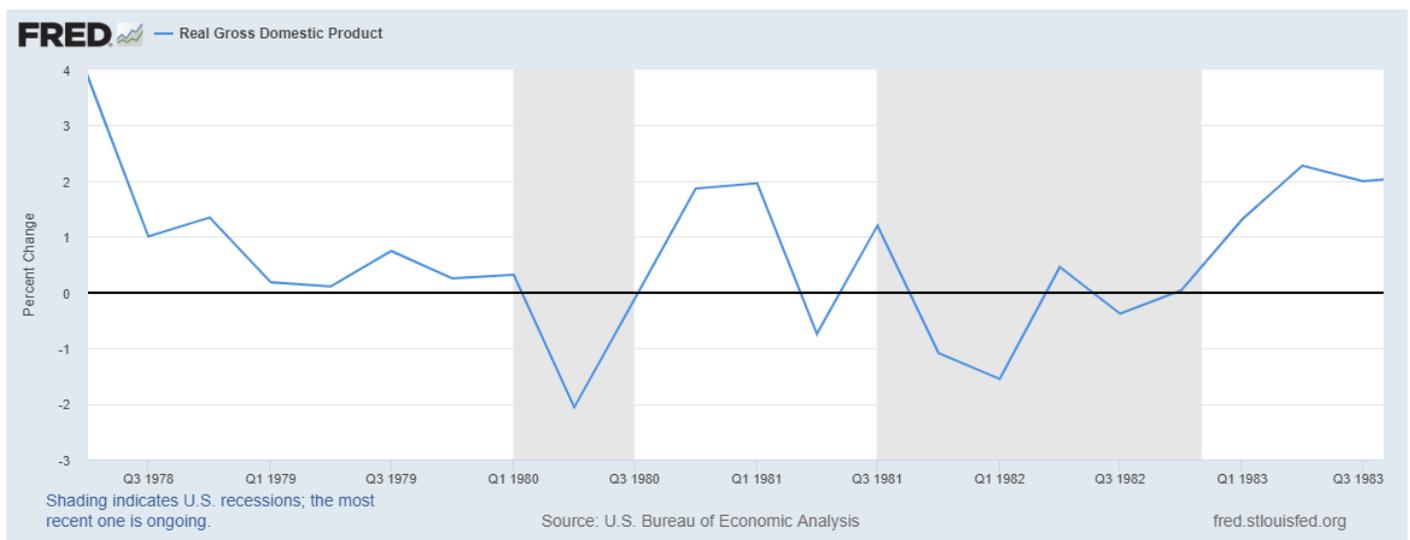
U-SHAPED

U-shaped recessions are similar to V-shaped recessions, but they last longer because the economy typically contracts for an extended duration and slowly returns to economic activity at levels before the recession. The graph below shows an example of a U-shaped recovery that the U.S. experienced in the mid-1970s. In 1973, the U.S. economy began to slow down and experienced almost no growth for nearly two years and did not return to previous levels until 1975. A more recent example of a U-shaped recession was the Great Recession of 2008-09 that lasted for more than 18 months. Overall, the duration of the “U” tends to be measured in quarters, if not years. The current recession could follow a U-shape if economic activities take a while to recover to pre-pandemic levels.



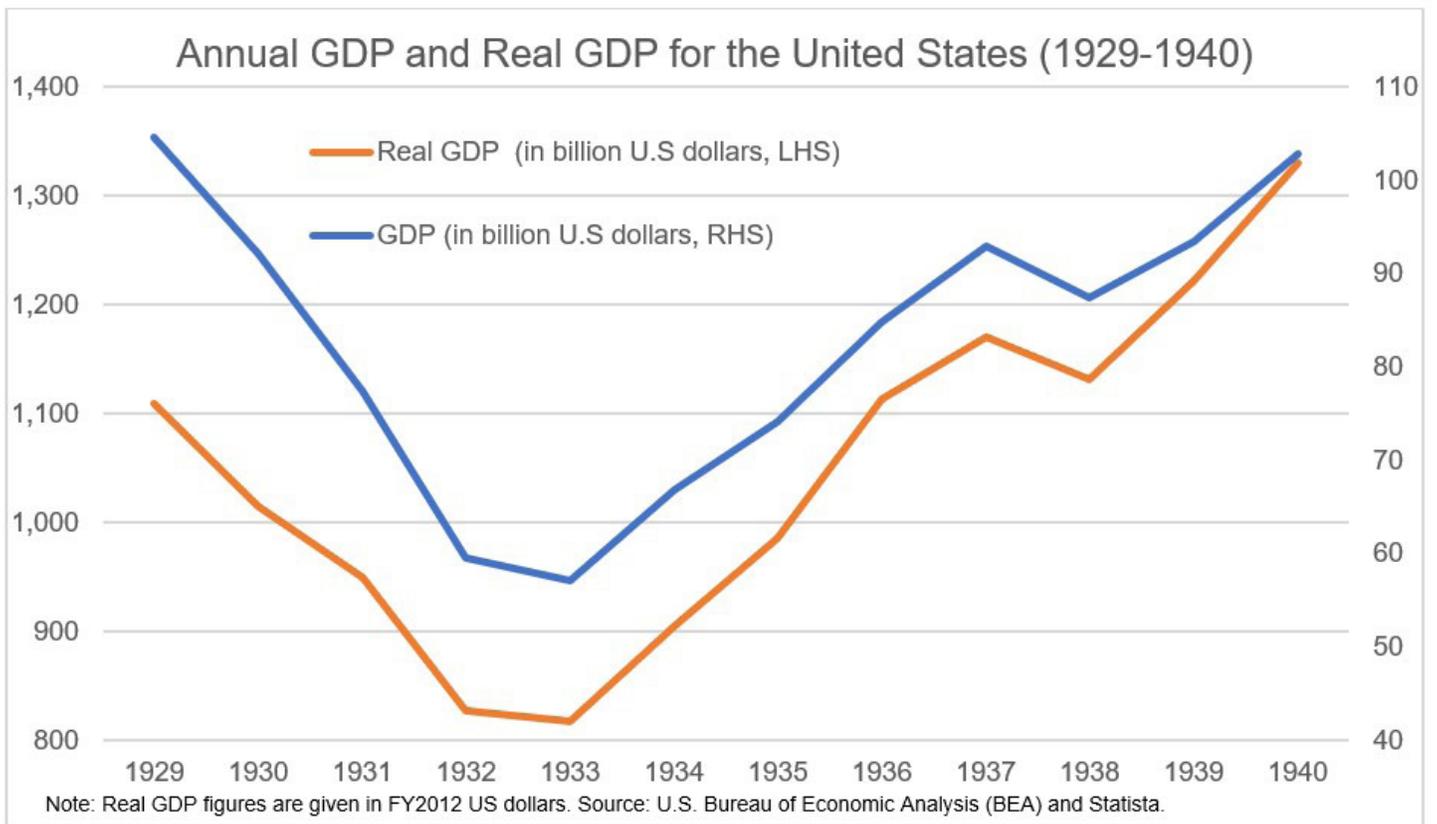
W-SHAPED

In W-shaped recessions, the economy initially recovers from contraction only to contract again for a second time. A W-shaped recession is also called a double-dip recession due to the economy dipping twice (down up down up) before recovering. The recession of the 1980s in the graph below is an example of a W-shaped recession. The 1980s recession was in effect two recessions in 1980 and 1981-1982. The 1978-79 oil shock resulted in the first contraction, and the subsequent rapid growth elevated inflation. Worried about high inflation, the Federal Reserve under the leadership of Paul Volcker raised interest rates from 11% in 1979 to 19% in 1981. The rate hikes pushed the economy into another recession that lasted more than a year. The current ongoing recession could be W-shaped if the second outbreak of the virus is not contained, and states across the country reimpose restrictions to stop the spread of the virus.



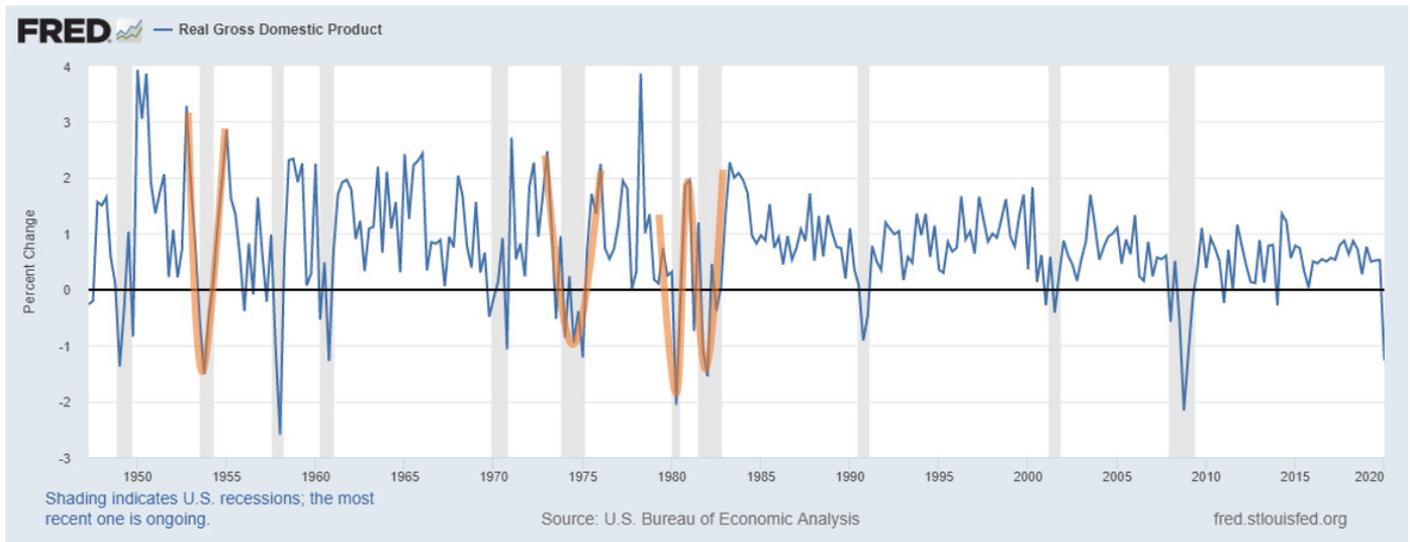
L-SHAPED

An L-shaped recession is considered the worst-case scenario. Also called a depression, during an L-shaped recession, the economy suffers a deep contraction and does not fully recover for years, loosely resembling the shape of the letter L. The longest and deepest recession since 1900 was during the 1930s in the United States. As you can see in the graph below, the economic activity decline for more than three years starting in 1929 did not recover to previous levels until 1936 in real (inflation-adjusted) terms and 1940 in nominal terms. Another recent example of an L-shaped recession occurred in Japan in the 1990s. During the so-called “lost decade,” the Japanese economy experienced a steep contraction followed by slow growth for more than ten years. The possibility of the current recession following an L-shape appears to be low. The worst-case scenario under which it could happen is if it takes years to get the virus under control, causes extended shutdowns, and slows economic growth for years.

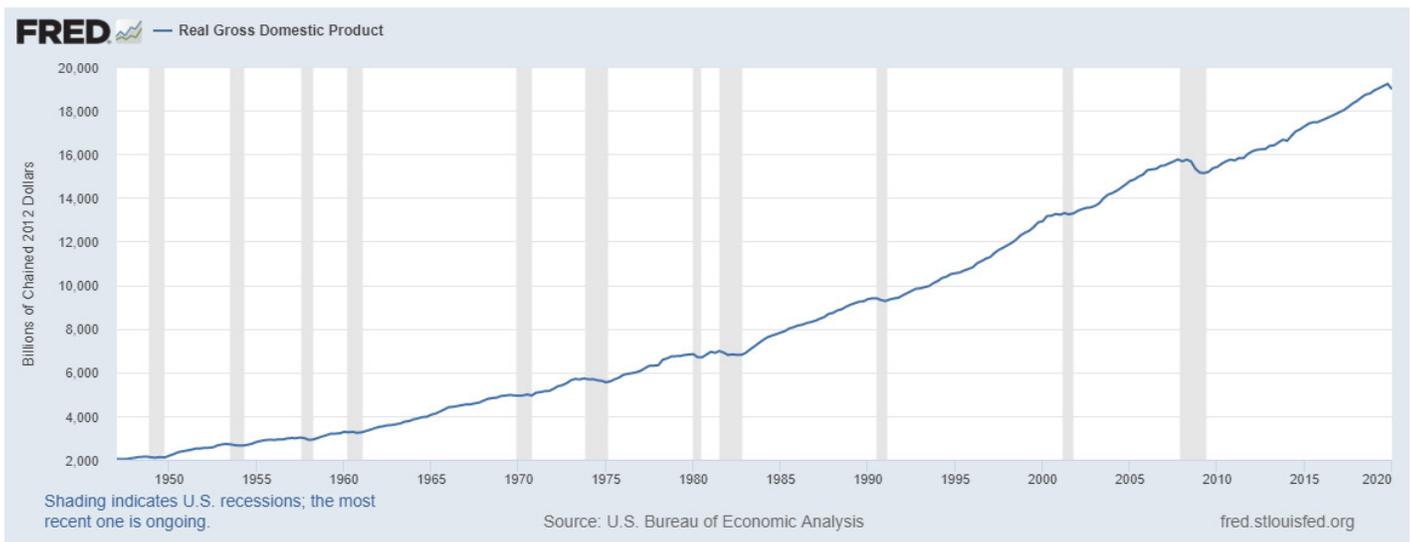


WE WILL PERSEVERE

There is an endless debate today about what type of recession the U.S. economy will experience. Historically, the path and duration of the recession only tend to become clear looking back. The first graph below shows the change in quarterly GDP in the United States since 1947 (earliest available). Highlighted in orange are the letters V (1952-53), U (1973-75), and W (1980-82), indicating the post-World War II recessions discussed above. The gray vertical bars mark recessions, and as you can see, even with hindsight, the shape of a recession is not always clear. Historically, what has been clearer is that the U.S. economy grows more than it contracts.



The second graph shows the U.S. GDP over the same time period in billions of U.S. dollars. The U.S. economy has been growing more than 85% of the time since 1947 despite all previous recessions. That is why, regardless of the shape of this recession, we believe that in time the U.S. economy will recover and will continue to grow again.



This report was prepared by Khurram Naveed
Senior Analyst, LPL Operations Manager
Model Wealth Program

Important Disclosures: The information contained in this report is as of July 29, 2020 and was taken from sources believed to be reliable. It is intended only for personal use. To obtain additional information, contact Cornerstone Wealth Management. This report was prepared by Cornerstone Wealth Management. The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. Investing involves risk including the potential loss of principal. No strategy can assure success or protection against loss.

Securities offered through LPL Financial, member FINRA/SIPC. Investment advice offered through Cornerstone Wealth Management LLC, a registered investment advisor and separate entity from LPL Financial.