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QUICK MARKET UPDATE

Stock Market Declines and Recessions

Kandarp R. Acharya, CFA®, Director of Quantitative Research
Sean Lynch, CFA®, Global Investment Strategist

September 9, 2011

On August 4, 2011 the S&P 500 Index, a barometer of U.S. equity markets, closed at 1200.07, down 12 percent from its prior high of 1363.6 established on April 29, 2011, pushing the index into "correction" territory. The market's move coupled with weaker economic data has revived the common mantra that a stock market decline can be a predictor of an economic recession down the road. After all, today's stock valuations are derived from projected cash flows, and an economic slowdown could decrease those cash flows, or make them less certain, or potentially both. What remains fresh in many investors' minds is the severity of the 2007-2009 bear market, followed by one of the deepest recessions in history. In this Quick Market Update, we examine historical data on recessions and stock market performance and dispel the myth that stock market declines are harbingers of economic recessions.

U.S. Equity Market Corrections and Recessions

The National Bureau of Economic Research (NBER) declared that from December 2007 through June 2009 the U.S. economy experienced a recessionary period, lasting 18 months, making it the longest recession since the Great Depression. Interestingly enough, a stock market decline preceded the Great Depression by a few months. In fact, as the table below shows, with the exception of one period (January–July 1980) each of the ten recessions measured by the NBER since 1950 was preceded by a correction in the S&P 500 Index. Moreover, the average gross domestic product (GDP) growth during the quarter when the decline started was 2.76 percent, which quickly slowed over the subsequent two quarters, followed by a weak and an uneven recovery.

NBER Recession		S&P500 Price Decline			GDP Growth Following Start of Market Decline (%)				
Start	End	Start	Length (Days)	% Decline	Q+0	Q+1	Q+2	Q+3	Q+4
Jul-53	May-54	1/5/1953	252	-14.8	7.7	3.1	-2.4	-6.2	-1.9
Aug-57	Apr-58	7/15/1957	99	-20.7	3.9	-4.1	-10.4	2.5	9.7
Apr-60	Feb-61	8/3/1959	449	-13.9	-0.5	1.4	9.3	-1.9	0.7
Dec-69	Nov-70	11/29/1968	543	-36.1	1.7	6.5	1.2	2.6	-1.9
Nov-73	Mar-75	10/12/1973	122	-18.6	3.9	-3.5	1	-3.9	-1.6
Jan-80	Jul-80	2/13/1980	43	-17.1	1.3	-7.9	-0.7	7.6	8.6
Jul-81	Nov-82	11/28/1980	301	-19.7	7.6	8.6	-3.2	4.9	-4.9
Jul-90	Mar-91	7/16/1990	87	-19.9	0	-3.5	-1.9	2.7	1.7
Mar-01	Nov-01	9/1/2000	215	-27.5	0.3	2.4	-1.3	2.7	-1.1
Dec-07	Jun-09	10/9/2007	153	-18.6	1.7	-1.8	1.3	-3.7	-8.9
Mean			**226.4**	**-20.69**	**2.76**	**0.12**	**-0.71**	**0.73**	**0.04**

Source: National Bureau of Economic Research, August 2011

If data is king, then it must be the case that stock market declines invariably predict recessions, right? Not so fast, we say. The analysis above suffers from an insidious bias called the “confirmation bias,” which is just another way of saying that one only considers information that supports, or confirms, the hypothesis one attempts to validate. In this case, it is the hypothesis that stock market declines predict economic slowdowns. If you only look at what happened to the S&P500 Index when the NBER declared recessions, then you’d draw the erroneous conclusion that stock market declines almost always precede recessions.

But we can challenge this confirmation bias. One way to do it is to review all of the declines in S&P 500 Index that were greater than 10 percent, and then check how many of those declines preceded recessions. In fact, we have done just that, and discovered that there have been 47 separate instances when the S&P 500 Index declined more than 10 percent since 1950. If all of the market declines over 10 percent were included, the average length of the decline would be reduced from 226 to 134 days, and the average decline would also be slightly less, at 18.3 percent vs. 20.7 percent. However, only 10 of those 47 declines resulted in a recession. In other words, a stock market decline led to a recession only 21 percent of the time—not a statistic you can rely upon. If we include all of the declines in the table above, the averages change to:

	Length (Days)	% Decline	Q+0	Q+1	Q+2	Q+3	Q+4
Mean for All Declines	134.5	-18.35	2.73	2.07	1.41	2.5	2.56

GDP growth during the quarter when the S&P 500 Index decline started was about the same, 2.73 percent. But on average, the economy continued to grow, albeit at a slower pace than the 3.35 percent pace the GDP has grown since 1950.

Based on the expanded data that avoids the confirmation bias, we might be able to infer that stock market declines greater than 10 percent occur with some regularity, but what we cannot deduce is that all such declines have led to recessions. Average economic activity slowed down two quarters after the start of the decline, but quickly recovered to within 0.25 percent of the pre-stock market decline levels. As a result, such declines cannot be reliably used to time business cycles or make market timing bets in investment portfolios.

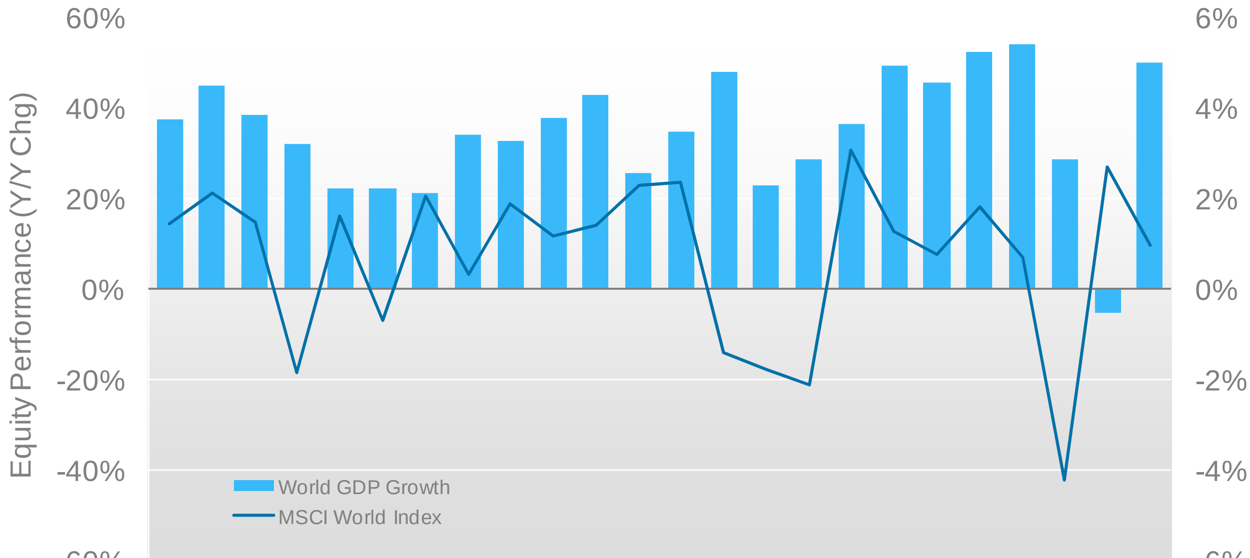
Because we are global investors who happen to live in the U.S., let us take a look at this from a global perspective. The major macroeconomic issue facing investors today is the possibility of a global recession. Whether it is a full-blown recession or sluggish global economic growth, two questions likely weigh on investors’ minds in the current economic environment:

- How would a global recession impact risk assets such as equities?
- Why not limit investing to the fastest growing economies?

Global Recessions and Risk Assets

In addressing the first question, we look at GDP data sourced from the International Monetary Fund (IMF) and use the MSCI World Index as a proxy for global large-cap equity. We approach our analysis beginning with data from 1985 and measure global GDP growth relative to equity market performance. Over time, as economies and capital markets become more interlinked, our initial observation is that equity market declines generally result in a global GDP slowdown in the following year, but not a recession.

Global GDP and Equity Market Performance



	'87	'88	'89	'90	'91	'92	'93	'94	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09	'10
World GDP Growth	4%	4%	4%	3%	2%	2%	2%	3%	3%	4%	4%	3%	3%	5%	2%	3%	4%	5%	5%	5%	5%	3%	-1%	5%
MSCI World Index	14%	21%	15%	-19%	16%	-7%	20%	3%	19%	12%	14%	23%	24%	-14%	-18%	-21%	31%	13%	8%	18%	7%	-42%	27%	10%

Source: Bloomberg, LP; IMF World WEO April 2011

Investing in High-Growth Economies

If a relationship exists between global GDP and equity market performance, it may beg the question: why not simply invest in the fastest growing economies? This question highlights the double-edge sword of high growth—high inflation. Today many of the fastest growing emerging economies, such as India and Brazil, are trying to control inflation by reining in GDP growth from 10 percent to eight percent. Alternatively, slower growing developed economies, such as the U.S. and countries within the Eurozone, are trying to grow GDP from one percent to two percent annually. Not addressing overheating or sluggish economic growth can have a significant impact on the global economy and serious implications for investors. Furthermore, countries with some of the poorest performing equity markets, such as Brazil and India, still boast some of the fastest growing economies. Therefore, a one-year GDP forecast based on equity market performance is unlikely to be accurate.

So how should an investor approach a slowdown in global GDP growth comprised of above average growth coming from emerging markets and anemic growth in the largest economies of the developed world? We suggest a number of strategies in the current uncertain environment.

- We believe that emerging-market equities, despite the significant sell-off from earlier this year, remain attractive vs. those of the developed market.
- Given the economic slowdown, investors also may wish to consider actively managing fixed income exposure and including an allocation to alternative income sources where appropriate. One alternative source of income that investors many want to consider is income from dividend-paying equities.
- From a tactical standpoint, countries with exports that represent a smaller portion of total GDP, such as India and China, likely will be better insulated from the slowdown in developed economies, than countries that have higher exports as a percent of GDP such as Singapore and Malaysia. Even though we have a number of underweights in our tactical country model, we remain neutral on China and India.

Naturally, there is no “one size fits all” investment strategy. Each investor must consider their investment objectives, time horizon, and risk tolerance prior to making any investment decision.

Data for this QMU sourced from Bloomberg unless otherwise noted.

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(972) 870-6000.
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