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Nothing Like a Recession to Shake Things Up: How the Economic Cycle Influences Market Leadership

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Snapshot

- Low points in economic activity tend to serve as pivot points for relative asset-class performance.
- In order to understand how trends in market leadership can change, we examined isolated historical performance of asset-class pairs during periods close to recessions.
- While impossible to know what the next five years will look like, we have a high degree of confidence that they won't look the same as the past five years.

Recessions have a way of shaking up leadership trends in financial markets. These economic low points also tend to serve as pivot points for relative asset-class performance.

Should investors today expect this to hold true as the COVID-19 crisis—the sharpest economic downturn since the Great Depression—gives way to recovery? We will not venture a prediction, and we don't expect to learn the answer until after having the benefit of several years' hindsight. Nevertheless, it's worth reviewing the historical record to get an idea of how asset classes have behaved around past recessions.

Our Research

Given our goal to understand trends in market leadership, we examined five-year return figures (rather than short-term performance) of the following asset-class pairs:

- U.S. versus non-U.S. equities
- U.S. large-capitalization stocks versus U.S. small-capitalization stocks
- U.S. growth stocks versus U.S. value stocks
- Inflation-sensitive assets versus nominal assets (that is, assets that tend to be negatively impacted by rising inflation)

We sought to determine whether continuity or change in relative asset-class performance was more prevalent by contrasting the five-year periods before and after each of the following U.S. recessions:

- Early 2000s recession (2000 to 2001)
- The Great Recession between 2007 and 2009

Our Findings

U.S. and non-U.S. equities have shown a clear pattern of exchanging market leadership when an economic cycle is near a turning point. This is what occurred in the early 2000s when U.S. stocks led their non-U.S. counterparts before the recession and international stocks took the lead after the downturn. The inverse of this shift occurred later in the decade, when non-U.S. equity leadership prior to the Great Recession gave way to U.S. equity leadership in the period that followed.

Growth and value also swapped performance positions during each of the last two recessions. In the early 2000s, growth initially led the market before yielding to value. The pair once again swapped places several years later when value leadership ahead of the Great Recession turned over to growth after the downturn.

Large- and small-capitalization stocks have also tended to reverse leadership roles at economic inflection points. Larger caps went into the recession of the early 2000s as market leaders and came out of the period overtaken by small caps. As for the time around the Great Recession, the dynamic between these two asset classes appears a bit atypical at first glance as small caps led large caps both before and after the historic downturn. However, large caps outperformed when looking at shorter periods (three or four years rather than five years) leading up to the Great Recession. This dynamic fits well with our expectations for the inherently more mature, stable businesses and stronger financials of large-capitalization stocks to deliver stronger relative performance in challenging periods.

Inflation-sensitive assets (commodities, real estate, and energy stocks) have also tended to alternate with Treasurys (typically considered the standard-bearer for nominal assets) as market leaders. Inflation assets trailed Treasurys before the early 2000s recession and ranked near the top coming out of the turn. While the Great Recession was a bit more mixed, Treasurys once again led before the 2007-to-2009 downturn yet came out of the period lagging real estate and energy.

Early 2000s Recession		Great Recession	
5 years prior (November 1996 to October 2001)	5 years after (November 2001 to October 2006)	5 years prior (June 2004 to May 2009)	5 years after (June 2009 to May 2014)
U.S. Large 61.2%	Real Estate 197.7%	Energy Stocks 80.5%	Real Estate 173.8%
Treasurys 61.2%	Energy Stocks 128.0%	Treasurys 40.6%	U.S. Small 141.7%
U.S. Growth Stocks 60.9%	Non-U.S. Stocks 115.8%	Non-U.S. Stocks 31.3%	U.S. Growth Stocks 141.7%
Energy Stocks 60.0%	Commodities 107.1%	Cash 15.9%	U.S. Large 132.6%
U.S. Value Stocks 53.1%	U.S. Small 90.3%	Commodities -3.4%	U.S. Value Stocks 125.7%
Real Estate 45.5%	U.S. Value Stocks 56.9%	U.S. Small -5.9%	Energy Stocks 96.7%
U.S. Small 34.2%	U.S. Large 41.9%	U.S. Value Stocks -6.7%	Non-U.S. Stocks 67.6%
Cash 27.7%	Treasurys 31.0%	Real Estate -6.9%	Treasurys 43.9%
Non-U.S. Stocks 1.1%	U.S. Growth Stocks 26.8%	U.S. Large -9.1%	Commodities 7.6%
Commodities 0.8%	Cash 11.6%	U.S. Growth Stocks -9.9%	Cash 0.2%

SEI's View

As we can see from looking at the five-year period leading up to the COVID-19 crisis, many of the trends among these pairs have been subject to stark divergences.

We cannot possibly know what the next five years will look like (let alone the next 12 months), but we have a high degree of confidence that it won't look the same as the past five years.

Whether investors analyze economic-cycle-induced changes from year to year or decade to decade, or compare five-year periods as we've showcased here, the overarching story has consistently included three key themes: (1) market leadership historically changes; (2) no one knows what the future will hold; and (3) the future will likely look different.

We believe this reinforces the necessity of continued discipline in adhering to a strategic long-term approach for constructing and maintaining globally diversified investment portfolios.

COVID-19 Crisis	
5 years prior (July 2015 to June 2020)	
U.S. Growth Stocks 141.7%	?
U.S. Large 132.6%	
Treasurys 31.0%	
U.S. Value Stocks 53.1%	?
U.S. Small -5.9%	
Real Estate -6.9%	
Non-U.S. Stocks 115.8%	?
Cash 27.7%	
Commodities 7.6%	?
Energy Stocks 96.7%	

Our analysis uses U.S. recession end dates for the Early 2000s and Great Recessions, and uses mid-year (i.e. June 30, 2020) for the COVID-19 crisis. Sources: National Bureau of Economic Research, Bloomberg, Morningstar, SEI.

Index Definition

Asset classes are represented as follows:

U.S. Large-Cap Stocks = S&P 500 Index: The S&P 500 Index is a market-capitalization-weighted index that consists of 500 publicly-traded large U.S. companies that are considered representative of the broad U.S. stock market.

U.S. Small-Cap Stocks = Russell 2000 Index: The Russell 2000 Index is composed of the smallest 2000 companies in the Russell 3000 Index, representing approximately 8% of the Russell 3000 total market capitalization.

Non-U.S. Stocks = MSCI ACWI ex-US Index: The MSCI ACWI ex-US Index is a free float-adjusted market-capitalization-weighted index that is designed to measure the performance of developed- and emerging-equity markets, excluding the U.S.

Treasurys = Bloomberg Barclays US Long Treasury Index: The Bloomberg Barclays US Long Treasury Index measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury with 10 years or more to maturity.

U.S. Growth Stocks = MSCI USA Growth Index: The MSCI USA Growth Index captures large- and mid-cap securities exhibiting overall growth style characteristics in the US. The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend and long-term historical sales per share growth trend.

U.S. Value Stocks = MSCI USA Value Index: The MSCI USA Value Index captures large- and mid-cap US securities exhibiting overall value style characteristics. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield.

Commodities = Bloomberg Commodity Index: The Bloomberg Commodity Index is a broadly diversified index composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME).

Real Estate = FTSE Nareit Equity REITs Index: The FTSE Nareit Equity REITs Index contains all Equity Real Estate Investment Trusts (REITs) not designated as Timber REITs or Infrastructure REITs.

Energy Stocks = S&P 500 Energy Index: The S&P 500 Energy Index comprises those companies included in the S&P 500 Index that are classified as members of the GICS energy sector.

Cash = IA SBBI U.S. 30-day Treasury Bill Index: The IA SBBI U.S. 30-day Treasury Bill index, a custom unmanaged index designed to measure the performance of U.S. 30-day Treasury Bills.

Important Information

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice, nor should it be construed as a recommendation to purchase or sell a security, including futures contracts. There are risks involved with investing, including loss of principal.

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