CAPITAL GROUP® RIA Insider™

Guide to recessions: 9 key things you need to know

How bad will the next recession be?

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, but the full extent of the economic impact won't be known for some time.

3 facts about market recoveries

To help you prepare for these uncertain times, we researched 70 years of data including the last 11 economic downturns to distill our top insights and answer key questions about recessions:

1. What is a recession?
2. What causes recessions?
3. How long do recessions last?
4. What happens to the stock market during a recession?
5. What economic indicators can warn of a recession?
6. Are we in a recession?
7. How should you position your stock portfolio for a recession?
8. How should you position your bond portfolio for a recession?
9. What should you do to prepare for a recession?

1. What is a recession?

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.

2. What causes recessions?

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.

As Capital Group vice chair Rob Lovelace recently noted, “You can’t have such a sustained period of growth without an occasional downturn to balance things out. It’s normal. It’s expected. It’s healthy.”

Go deeper:

- Rob Lovelace on all-weather investing
- Fed's aggressive path could mean more market turmoil

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rate hikes: How high will they go?

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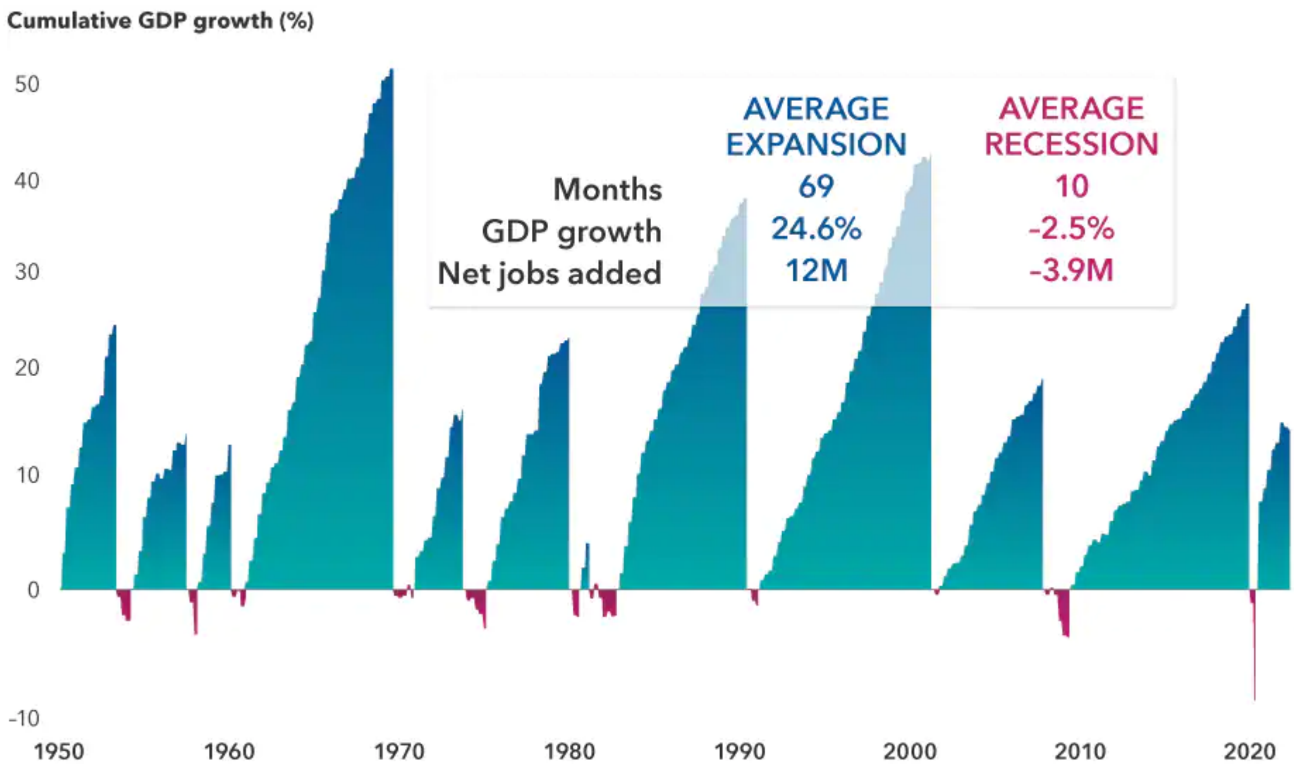
3. How long do recessions last?

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.

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 have been 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.

Go deeper:

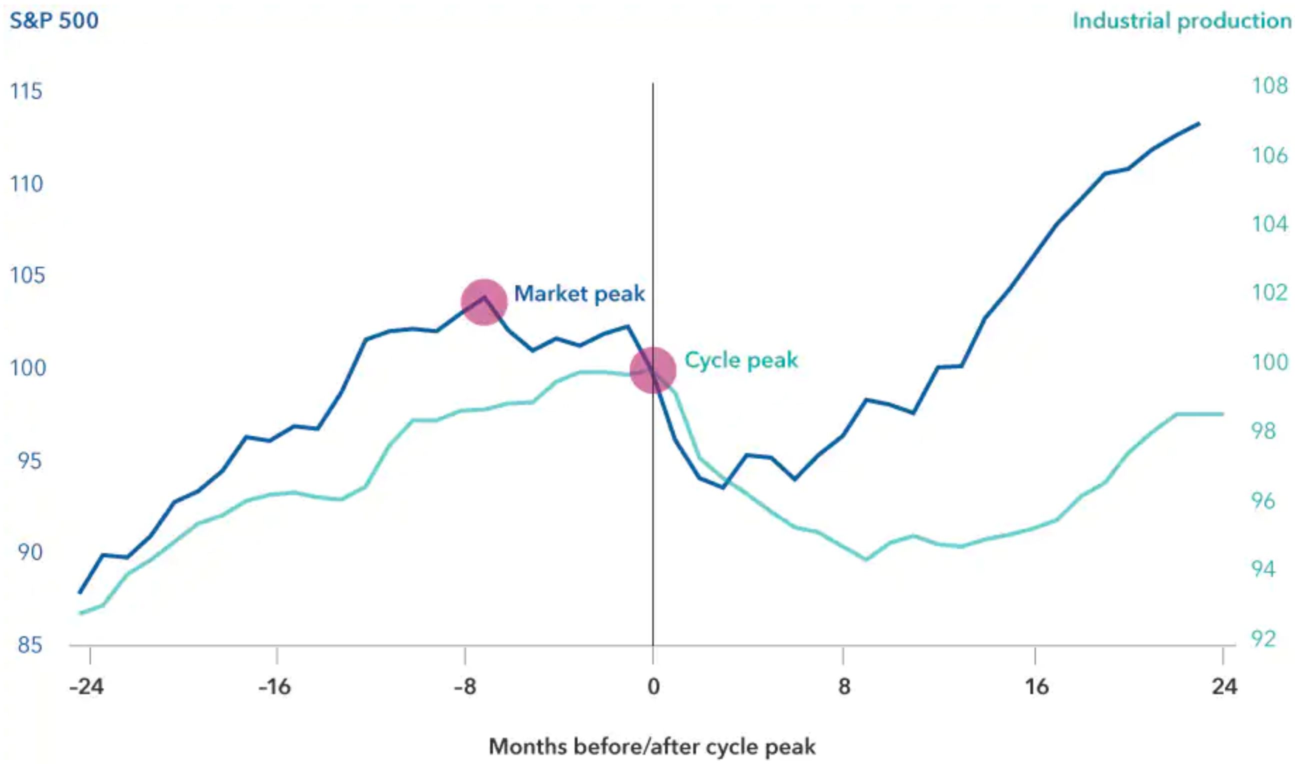
- Braving bear markets: 5 lessons from seasoned investors
- Is the era of easy money coming to an end?
- [Webinar] All-weather investing amid the storm

Get the *Guide to Recessions* e-book

4. 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 (economic declines) have often overlapped – with equities leading the economic cycle by six to seven months on the way down and again on the way up.

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 change in the S&P 500 Index and economic activity (using industrial production as a proxy) of all completed economic cycles from 1950 to 2021. The "cycle peak" refers to the highest level of economic activity in each cycle before the economy begins to contract. Both lines are indexed to 100 at each economic cycle peak and also indexed to 0 "months before/after cycle peak" on the x-axis. A negative number (left of the cycle peak) reflects the average change in each line in the months leading up to the cycle peak. The positive numbers (right of the cycle peak) indicate the average changes after the cycle peak.

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, can be beneficial in down markets. This approach can allow investors to purchase more shares at lower prices while remaining positioned for when the market eventually rebounds.

Go deeper:

- How to handle market declines
- Guide to market recoveries

5. What economic indicators can warn of a recession?

Wouldn't it be great to know ahead of time when a recession is coming? Despite the impossibility of pinpointing the exact start of a recession, there are some generally reliable signals worth watching closely in a late-cycle economy.

	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
Average months until recession	14.5	5.6	2.9	5.3	3.6
Current status					

Recession threshold met   Recession threshold not met

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

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 sentiment 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.

Go deeper:

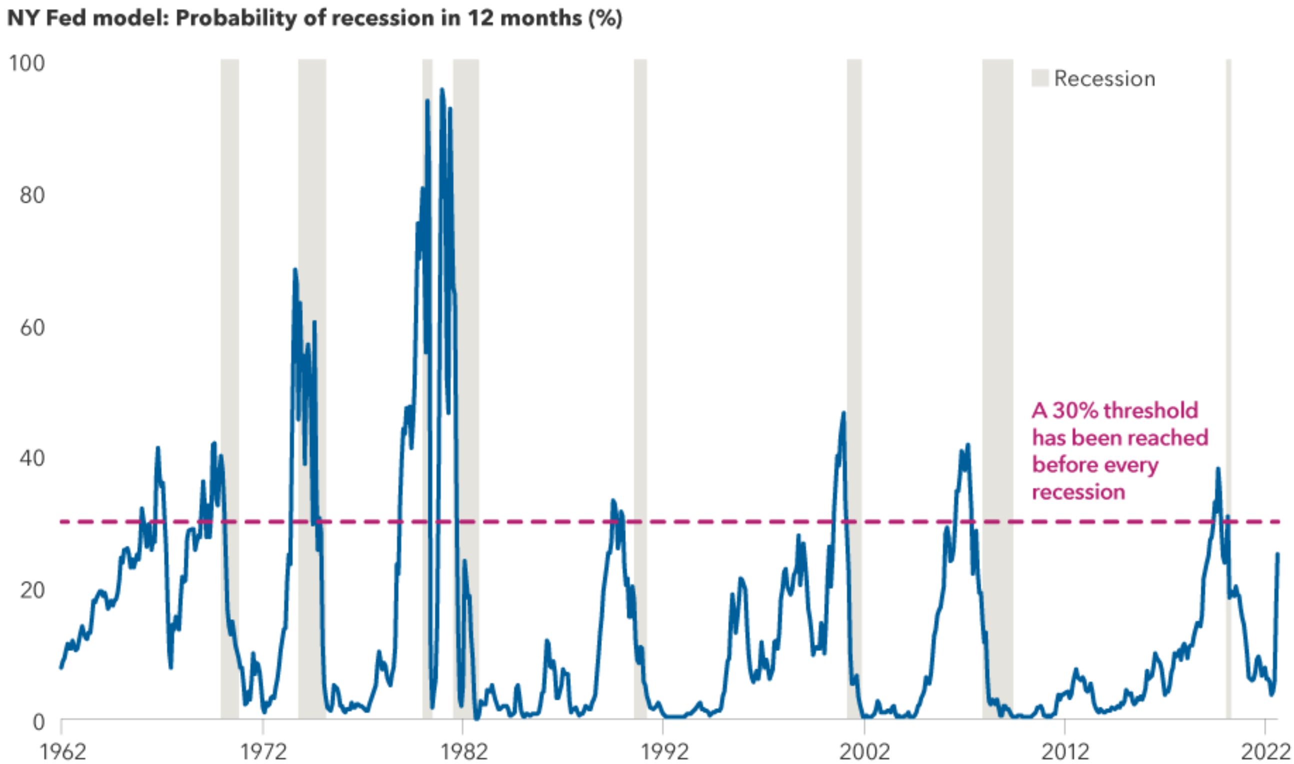
- 4 charts that explain U.S. labor dynamics

- Explaining the mystery of the yield curve

6. Are we in a recession?

Although 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 likelihood of a recession rose sharply in recent 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.

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. 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 in 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.

Go deeper:

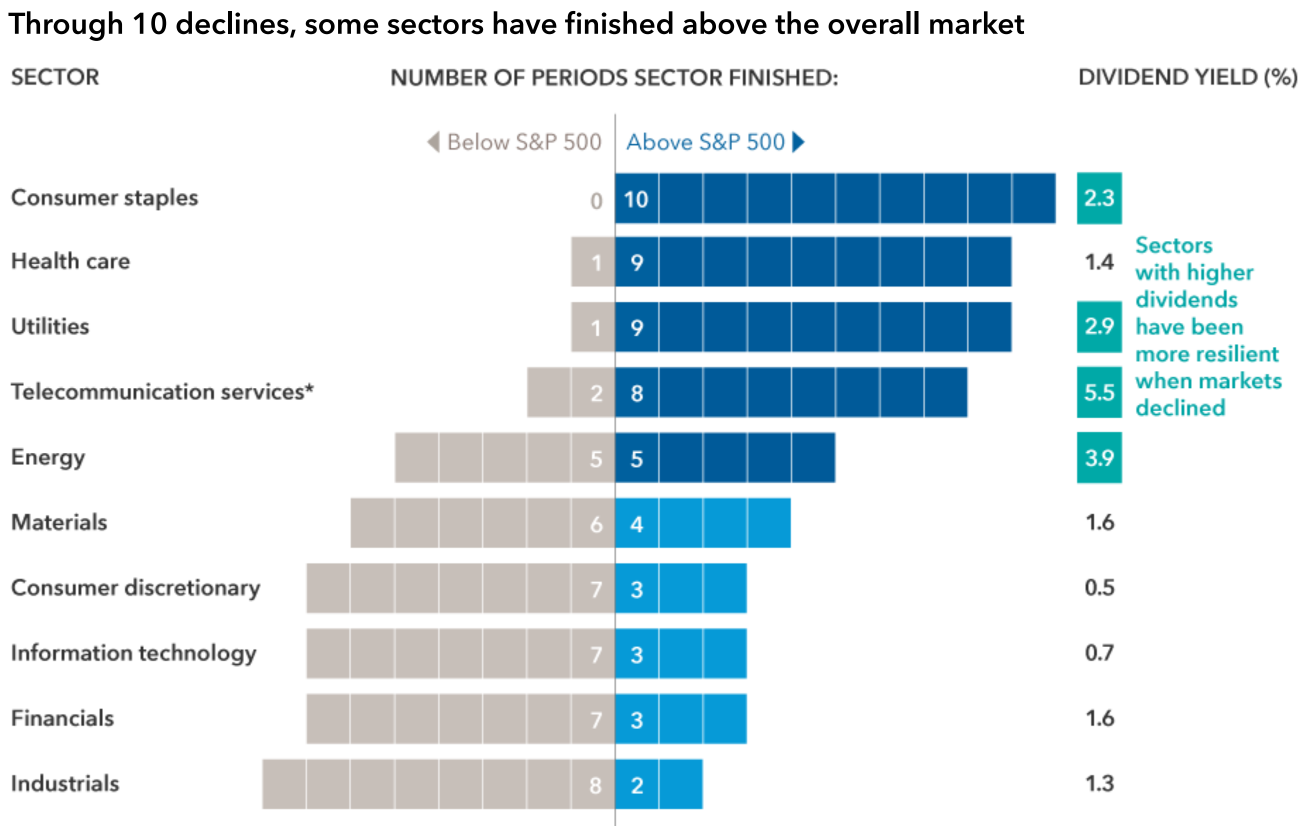
- Is the U.S. already in a recession?

- U.S. outlook: Time to pursue all-weather investing
- [Webinar] Recession watch

7. 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.



*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 Index 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 still considered current as of 8/31/22 and is included in this analysis. Dividend yields are as of 8/31/22.

Not all stocks respond the same during periods of economic stress. In the 10 largest equity declines between 1987 and August 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.

Go deeper:

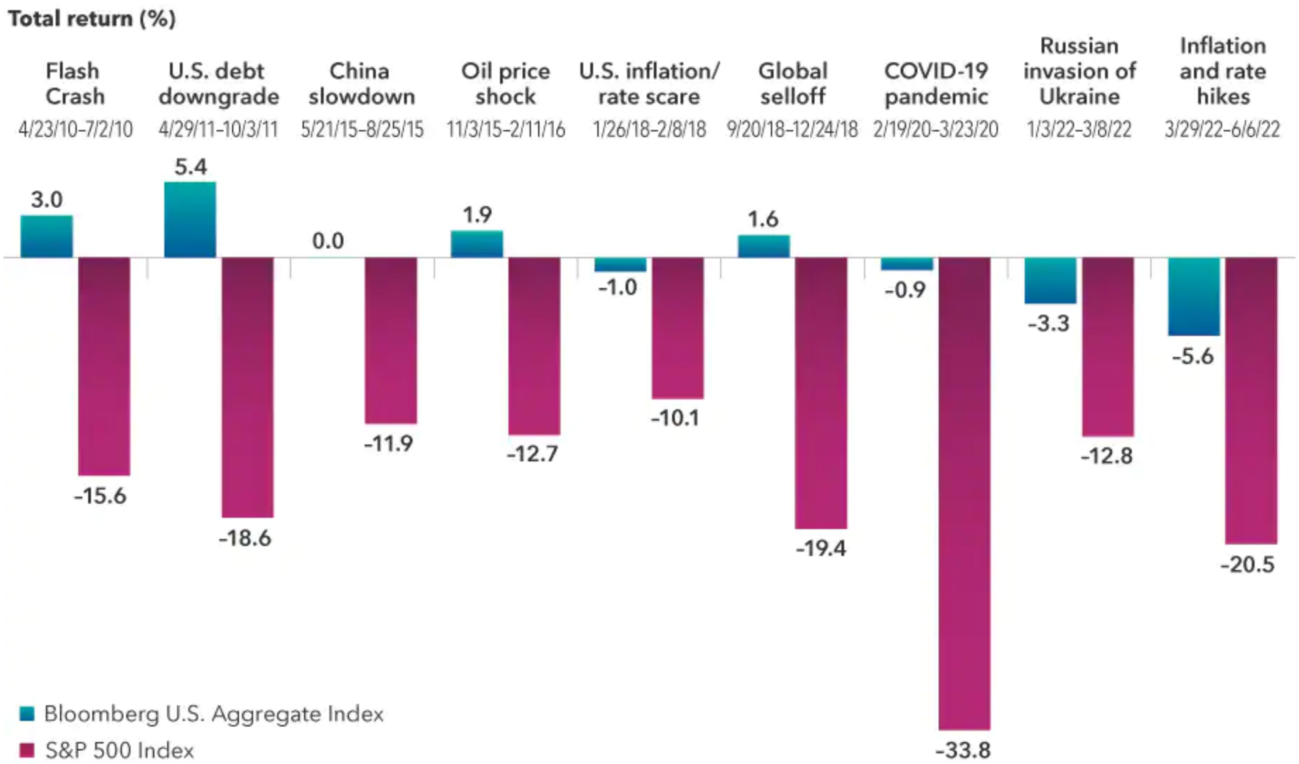
- When volatility is rising, boring is beautiful
- Rotating into dividends in an inflationary world

8. 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%.

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 periods.

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 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 professionals 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.

Go deeper:

- Rising yields put bond markets back on a road to normal
- Bond outlook: What to know as Fed fears hit markets
- Investing for income as rates rise

9. What should you do to prepare for a recession?

Above all else, investors should stay calm when investing ahead of and during a recession. Emotions can be one of the biggest roadblocks to strong investment returns, and this is particularly true during periods of economic and market stress.

If you've picked up anything from reading this guide, it's probably that determining the exact start or end date of a recession is not only impossible, but also not that critical. What is more important is to maintain a long-term perspective and make sure your portfolio is designed to be balanced enough to benefit from periods of potential growth before it happens, while being resilient during those inevitable periods of volatility.

Go deeper:

- Investing ahead of a recession: 5 mistakes to avoid
- 3 ways to prepare for down markets

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Regular investing does not ensure a profit or protect against loss. Investors should consider their willingness to keep investing when share prices are declining.

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