Attempting to Avoid a Recession: Fortune or Folly?

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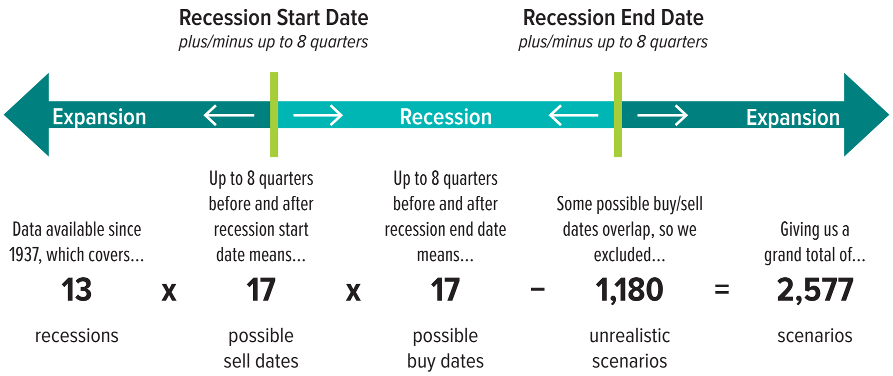
Snapshot

- Conventional wisdom says you should never time a recession. We explored this by examining thousands of hypothetical scenarios.
- Our analysis showed that the odds are not in our favour when attempting to avoid losses associated with recessions.
- It's important to remember that maintaining a disciplined investment strategy can help weather any market storm that may be on the horizon.

We're often asked the question, "If there's a recession on the horizon, what should investors do about it?" Inside the circles of investment professionals, conventional wisdom says you should never try to time a recession. Getting the timing right on not just one major decision point, but two—when to exit the market and when to reenter—is both ambitious and risky. Yet we can't help but sympathise. It's natural to wonder whether there is some way to avoid the pain of a downturn. Is there a realistic basis to think that trying to time a recession is a chance worth taking?

To explore this possibility, we looked at the last 13 recessions in the U.S. dating back to 1937. U.S. data was used due to availability of a longer history; we believe the core conclusions of the analysis should be the same for any geography or market. We considered a range of sell-and-buy scenarios surrounding the official start and end dates of each recession, as determined by the National Bureau of Economic Research (or NBER, a private, non-profit, non-partisan organization). The timing of our hypothetical decisions to sell out of the market and buy back into the market varied by up to eight quarters before and after each actual recession start and end date. This gave us a grand total of 2,577 scenarios to consider, as highlighted in Exhibit 1.

Exhibit 1: Endless Possibilities



While eight quarters may seem like a fairly wide margin of error, keep in mind that many of today's investors have been anxious about recession since 2018—a recession that has yet to arrive in 2019 and is, in our view,

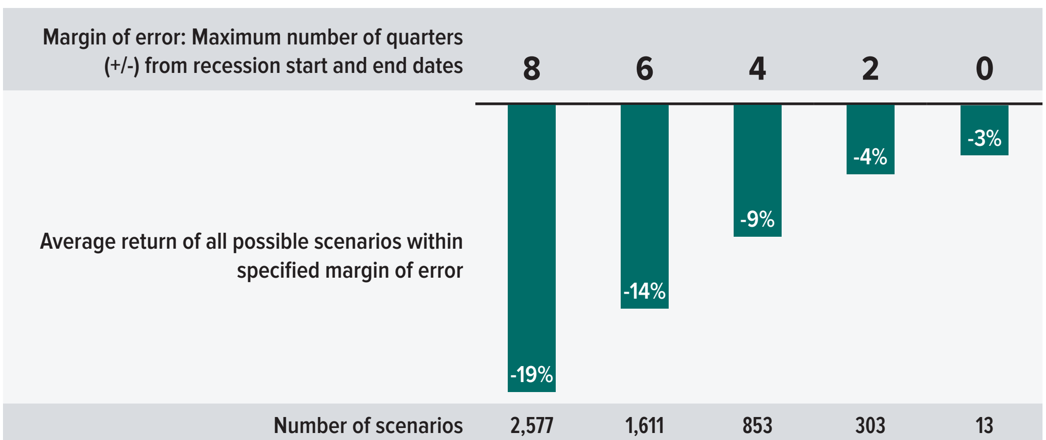
Data is in U.S. dollar terms unless otherwise noted.

still nearly two years away (see our Second Quarter Economic Outlook for the rationale). That's our best guess anyway. But it's anyone's guess really, and that's the point. Also, based on the 13 economic cycles we considered, expansions have ranged anywhere from one year to 10 years, with a standard deviation of 10 quarters; it therefore seems that plus-or-minus eight quarters is a reasonable starting point.

But for the sake of argument, we also narrowed the margin of error to just plus-or-minus four quarters (rather than eight), putting the spotlight on 853 scenarios—a smaller subset of the 2,577 scenarios. To assess the outcome of these recession-dodging scenarios, we used the S&P 500 Index as "the market" and we assumed that cash gets stuffed under the mattress, earning no return, when out of the market.[1] We found this smaller group of 853 scenarios averaged a loss of nearly 10% relative to remaining fully invested through the downturn. Only about one-third of attempted dodges were successful (producing a positive return relative to staying fully invested). And the magnitude of losses, on average, exceeded that of gains by a multiple of 1.5 times.

What can we learn from these hypothetical attempts to avoid being hurt by a recession? On average, it turns out that market timing has been a losing strategy—even when reducing the margin of error. In fact, further shrinking the margin of error to plus-or-minus two quarters (rather than four) left us with the same lesson: Investors tend to be more successful when they remain fully invested throughout recessions. Exhibit 2 shows the average returns for different margins of error.

Exhibit 2: No Good Time to Market Time?



Analysis uses official business cycle dates, as determined by the National Bureau of Economic Research (NBER), and compares cumulative returns of the S&P 500 Index over various time periods surrounding the 13 recessions since 1937. S&P 500 Index returns prior to 3/4/1957 is backtested data provided by Bloomberg based on S&P 500 Index methodology. Source: NBER, Bloomberg, SEI. As of 11/30/2019.

Even when narrowing the margin of error to zero—meaning we timed each recession exactly right—the average return was negative 3%. Why would we still see a loss with the full benefit of hindsight? Expansions and recessions are part of the economic cycle, which is not necessarily aligned with the market cycle.

Nobody can predict the future

If any reasonable forecasting ability exists in the world of investing, it probably resides within the economic cycle rather than the market cycle. The bravest of economic forecasters may suggest that an economic cycle is relatively well-behaved, exhibiting steadier trends and clearer relationships between macroeconomic variables. However, even if we accept this to be true, predicting its turning points is particularly challenging.

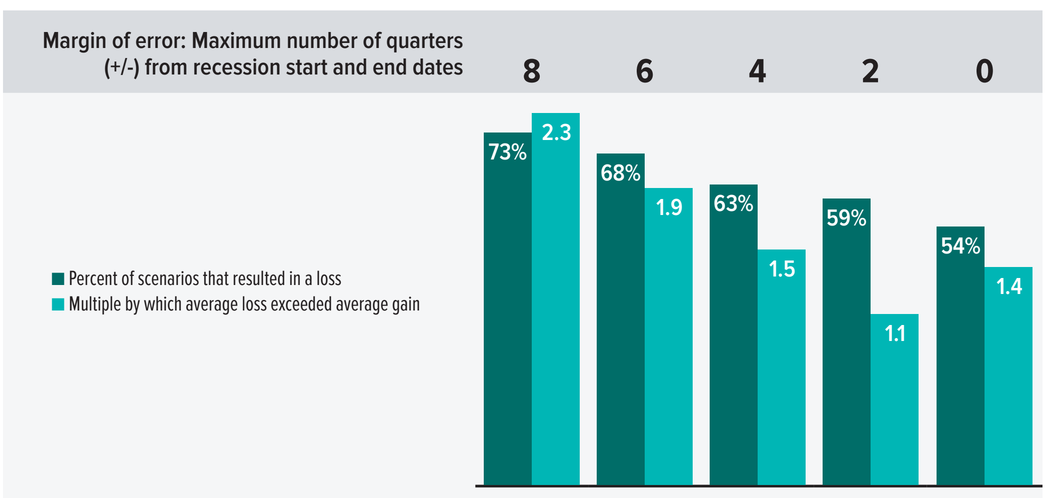
[1] S&P 500 Index returns prior to 3/4/1957 is backtested data.

As one macroeconomist has put it, "The record of failure to predict recessions is virtually unblemished." This was the sentiment that Prakash Loungani expressed in his 2000 research report for the International Monetary Fund, "How Accurate Are Private Sector Forecasts: Cross-Country Evidence From Consensus Forecasts of Output Growth"—which he then echoed in subsequent updates: "Can economists forecast recessions? Some evidence from the Great Recession," Ahir and Loungani, 2014; "How Well Do Economists Forecast Recessions?," An, Jalles and Loungani, 2018.

If economic cycles are difficult to predict, market cycles must be next to impossible. Relative to macroeconomic indicators such as gross domestic product, inflation and employment, the behaviour of financial markets can be faster-moving, noisier, more driven by sentiment, and detached from economic fundamentals. Even if we could make accurate recession forecasts, it remains unclear whether we could profit from our predictions (as illustrated by the 3% average loss across 13 recessions depicted in Exhibit 2). And the speed and efficiency with which markets incorporate new information unfortunately make it increasingly difficult to forecast any financial variable that would have more direct linkage to potential profits. It's a "catch 22" of financial markets: The clearer it is that you could profit from an accurate forecast of a financial variable, the more difficult it is to accurately forecast in the first place. Essentially, to successfully time markets, you have to be a better forecaster than the market as a whole. That's a very high bar.

Suffice it to say, we think our analysis is more than fair; examining various windows that surround actual recession dates already builds in a generous amount of hindsight. When attempting to avoid the losses associated with recessions, the odds are simply not in our favour. Exhibit 3 helps to bring this into focus.

Exhibit 3: An Uneven Playing Field



Analysis uses official business-cycle dates, as determined by the National Bureau of Economic Research (NBER), and compares cumulative returns of the S&P 500 Index over various time periods surrounding the 13 recessions dating back to 1937. S&P 500 Index returns prior to 3/4/1957 is backtested data provided by Bloomberg, based on S&P 500 Index methodology. Source: NBER, Bloomberg, SEI. As of 11/30/2019.

Looking at the same 2,577 scenarios and subsets thereof, Exhibit 3 shows that the majority of attempts to avoid a recession left investors worse off than if they had simply stayed put. And, importantly, the magnitude of the loss when getting it wrong far outweighed the gain by somehow managing to beat the odds and getting it right: On average, losses were larger than gains (relative to staying fully invested) by a multiple of about two times in many cases. Not only are there steep consequences to getting the timing wrong, the rewards do not appear to be adequate compensation for the risk.

Consider, for example, the roughly 1,600 scenarios that got the timing right within plus-or-minus six quarters: We lost over two-thirds of the time, with an average loss of almost 30%. In the remaining one-third of positive scenarios, we averaged a gain of about 15%—half the magnitude of average losses.

Staring at a chart of past performance, it's deceptively easy to think that market peaks and troughs are obvious. The influence of hindsight can easily start to create the perception that they're also easy to spot going forward. But identifying tops and bottoms as markets are moving in real time is a completely different story. It's very difficult and can be costly, as opportunity costs of missing late-cycle returns or potentially sharp rebounds can stack up quickly. (We explored this at the end of 2018 in our paper, "The U.S. Bull Market: Is it Time to Get Out?") Exhibit 4 shows late-cycle returns in the two years leading up to each of the last 13 recessions.

Exhibit 4: Opportunity or Opportunity Cost?

NBER recession start date	Two-year period leading up to recession	Cumulative total return of S&P 500 Index
May 1937	4/30/1935 to 4/30/1937	86%
February 1945	1/31/1943 to 1/31/1945	43%
November 1948	10/31/1946 to 10/31/1948	24%
July 1953	6/30/1951 to 6/30/1953	29%
August 1957	7/31/1955 to 7/31/1957	19%
April 1960	4/30/1958 to 4/30/1960	34%
December 1969	11/30/1967 to 11/30/1969	6%
November 1973	10/31/1971 to 10/31/1973	22%
January 1980	12/31/1977 to 12/31/1979	26%
July 1981	6/30/1979 to 6/30/1981	41%
July 1990	6/30/1988 to 6/30/1990	40%
March 2001	2/28/1999 to 2/28/2001	3%
December 2007	11/30/2005 to 11/30/2007	23%
Average		**30%**
Annualised		**14%**

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Some other interesting observations from the analysis:

- If we followed a reactive strategy for which we were two quarters late on both the exit and re-entry, the average loss was 23%. This is an intuitive strategy to test, given the conventional way of identifying a recession by observing two consecutive quarters of negative gross domestic product readings.
- If we sold six quarters ahead of a recession (perhaps roughly where we sit today), the average loss across all re-entry scenarios within just plus-or-minus two quarters of the recession end date was 16%.
- Generally, performance has varied inversely with length of time out of the market, which also means the window to get it right is quite narrow. We do not find this surprising given that markets have a positive expected return over time.

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Staying Diversified, Staying Invested

To more grizzled investors, we may be preaching to the choir. But to the more skeptical (or just plain curious) among us, we hope this analysis will provide renewed confidence that maintaining a disciplined investment strategy can help weather any storm that may be on the horizon. For those who manage to stay the course, the data show the playing field might be tilted in their favour.

We're not suggesting that the answer to our original question is "do nothing." In fact, actively-managed portfolios have already budgeted for a prudent amount of room to maneuver without straying too far from their strategic positioning. And, more importantly, if a portfolio has somehow drifted toward a more concentrated mix of investments over the course of an expansion, taking the opportunity to diversify may help mitigate recession-related losses. When signs of a downturn emerge, it can also serve as an important reminder for investors to review their goals and investment objectives—making sure that portfolios are taking the minimum amount of risk possible, while remaining appropriately positioned in pursuit of those goals and objectives.

Glossary of financial terms

Standard Deviation: Standard deviation refers to a formula used to predict potential future volatility of performance. High deviation suggests the outcome could be very different from historical averages, while low suggests the outcome could be closely matched.

Index definition

The S&P 500 Index is an unmanaged, market-capitalization-weighted index comprising 500 of the largest publicly-traded U.S. companies and is considered representative of the broad U.S. stock market.

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