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April 6, 2020

The stock market vs. the economy

Key Takeaways

- Fear of a COVID-19 led recession sent US stocks into the fastest bear market in history in March 2020.
- The stock market is typically a leading indicator, it tends to fall before the start of an economic recession and recover before the end of the recession.
- No matter how deep the recession or how long the downturn, markets have always bounced back.

Fastest bear market in history

Market volatility, market corrections (drop of 10% from a peak), and bear markets (drop of 20% from a peak) are sadly a part of long-term investing in the stock market. In the month of March, investors experienced the trifecta. The S&P 500 entered bear market territory in just 16 days, ending the longest bull market in US history just days after its 11th anniversary. This was the shortest time period in history for the market to enter a bear market. The S&P 500 fell 30% in 18 days but recovered some of the losses since then. For some perspective, it took the markets a year to fall 30% during the great recession of 2008[1]. Historically, when the market declines 30% or more it has already priced in a recession.

Should we wait for the recession to end?

Recessions are defined as two consecutive quarters of negative GDP growth. Gross Domestic Product (GDP) is the value of all goods and services produced by the economy. Officially, we haven't even had one negative quarter yet, so formally the recession has not started. The economy, as measured by GDP, is a backward-looking statistic and will likely take some time to be known and publicly available. As investors, we are likely to see a slew of bad economic news in the weeks ahead. Does that mean we have to wait for the recession to end before the markets recover? To understand that, let's look at the difference in the stock market and the economy.

The stock market is not the economy. The stock market is forward looking, and often starts going down before the economy turns south and similarly start turning back up before the downturn ends. This is evident by looking at stock market returns during years when GDP was negative. Since 1930, there have been 18 years of negative GDP growth. In 12 of those 18 years, the stock market returns were positive, and in most cases well over 18%[2].

Years with Negative GDP Growth and Positive Stock Market Performance

Year	Real GDP	S&P 500 Return
1933	(1.2)	53.99
1938	(3.3)	31.12
1945	(1.0)	36.44
1947	(1.1)	5.71
1949	(0.6)	18.79
1954	(0.6)	52.62
1958	(0.7)	43.36
1975	(0.2)	37.20
1980	(0.3)	32.42
1982	(1.8)	21.55
1991	(0.1)	30.47
2009	(2.5)	26.46

Source: Forbes, St. Louis Trust Company, Fred and S&P

We saw this during the Great Financial Crisis, when the stock market reached a peak in October 2007, and began to decline two months before the start of the recession and 14 months before it was officially announced. On the way out, the market bottomed in March 2009, and began to rise three months before the recession ended and 16 months before the end of the recession was announced[3].

What can investors do?

It is normal to feel uneasy during bear markets. We would all love to know when the economy, the markets and our lives will get back to normal. It is nearly impossible to know the bottom just as it is impossible to know the top of any market. Using the S&P 500 as a guide, according to Capital Group, the average bear market lasts 14 months[4]. Similarly, the US economy has been in an official recession less than 15% of the time over the last 65 years[5]. While bear markets and recessions are painful, they are temporary. If you are already invested in a well-diversified portfolio, your bear market experience will be very different than that of the S&P 500. Sticking to your plan is key, so resist the urge to make drastic shifts out of stocks or into cash. Historically, markets tend to bottom and head higher when economic news is still grim. In waiting for an economic recovery, investors run the risk of missing out on gains by trying to time the markets. The goal for all investors should be to remain invested long enough to reap the benefits of long-term compounding.

[1] https://www.marketwatch.com/story/algorithms-sped-up-selling-leading-to-the-fastest-bear-market-in-stock-market-history-2020-03-26
[2] https://www.forbes.com/sites/johnjennings/2020/03/26/why-the-looming-recession-doesnt-mean-you-should-sell-out-of-the-stock-market/#50ff261951cc
[3] https://www.nber.org/cycles.html
[4] https://www.capitalgroup.com/europe/capitalideas/article/market-corrections.html
[5] https://www.capitalgroup.com/advisor/insights/articles/guide-to-recessions.html

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19737 | C20-15804 | 04/2020 | EXP 04/30/2021