Do negative GDP numbers signal a recession?

Today's report may not tell the whole story.

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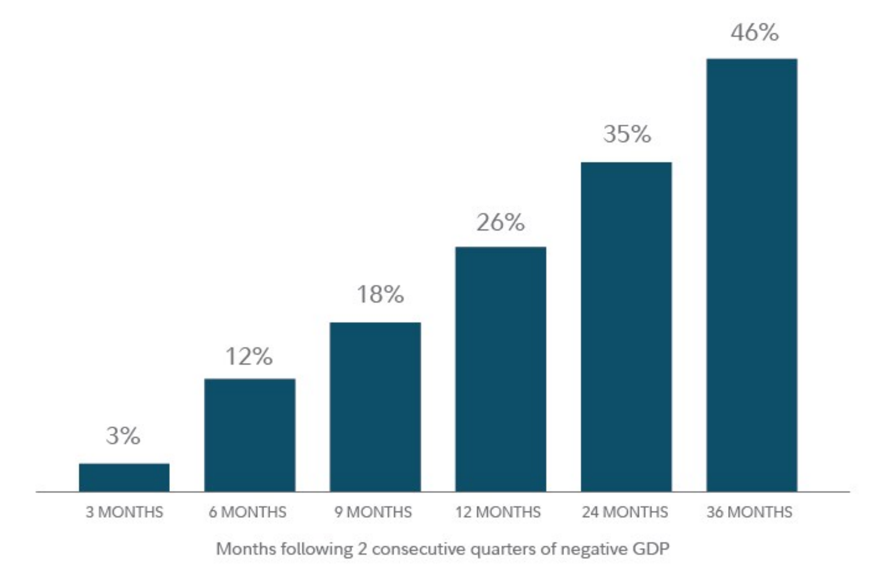
- Many believe that two consecutive quarters of negative gross domestic product (GDP) growth indicates that the economy is in a recession, but that's not necessarily the case.
- Whether or not a recession has begun is determined by the National Bureau of Economic Research (NBER), which considers a variety of indicators, not just GDP.
- Historically, the stock market has generally risen after 2 consecutive quarters of negative GDP.
- Predicting a recession is impossible, and investors may want to stay invested so as not to miss out on a potential market rally

Lately, it can feel like a lot of the news regarding the US economy has been negative. Inflation recently reached its highest point in 41 years. Stocks entered a bear market earlier this year and are down 14.9% from their peak as of July 27.[1] Meanwhile, bonds, which are often a haven for investors in times of trouble, are down 8.8% in the same period.[2]

Today's announcement that the US gross domestic product (GDP) declined 0.9% in the second quarter of 2022 is another disappointing addition to this list of gloomy indicators. With two consecutive quarters of negative GDP growth on the books, many investors are no longer wondering whether a recession is coming—they're wondering if it's already started. "When you have 2 negative quarters of GDP growth, many news headlines will point to that as a sure sign of a recession," says Naveen Malwal, institutional portfolio manager with Strategic Advisers, LLC. But while GDP does provide some insight into the health of the US economy, it may not be the whole story. It's also not a clear-cut indicator of a recession.

"One limitation of GDP is that it's a backward-looking indicator," says Malwal. "This latest number tells us what happened between April and June. It doesn't tell us where we're headed in the future. In fact, the historical data shows that the stock market has generally risen after 2 consecutive quarters of negative GDP. So investors who make investment decisions based on GDP may miss out on stock market recoveries."

S&P 500 index total return after 2 quarters of negative GDP



Past performance is no guarantee of future results. This chart illustrates the average total return of the S&P 500 Index in the months following two consecurive quarters of negative GDP growth. Index returns include reinvestment of capital gains and dividends, if any, but do not reflect any fees or expenses. This chart is not intended to imply any future performance of an investment product. It is not possible to invest directly in an index. All indexes are unmanaged. Please see disclosures for index definitions. Source: Bloomberg, S&P 500 Index total annual return, 1/1/1953–6/30/2022.

What makes a recession, and are we in one now?

Who decides when a recession has started, and what criteria do they use to determine that? "The official organization that defines whether or not the US is in a recession is called the National Bureau of Economic Research (NBER)," says Malwal, "and they look at a range of indicators to gauge if the US is in recession. For example, they believed the 2020 recession took place from February to April of that year, which doesn't line up with 2 entire quarters of GDP. We'll have to wait and see what their views are if and when they decide to make an announcement."

While the headline Q2 2022 GDP number declined, the different components that comprise GDP were a mix of positive and negative. For instance, consumer spending, which typically drives about 60-70% of US economic activity, remained positive. But other components of GDP, like government spending, private investment, or imports and exports, were mixed.

"Given this mix of indicators," says Malwal, "there is likely to be some debate as to whether or not the US is in a recession. On a positive note, the US still has an extremely tight job market and corporate profits are still rising. In a typical recession, unemployment is usually rising while corporate profits normally experience declines. So this would suggest that it is unlikely that the US is in a recession."

Why do things feel so challenging?

That said, this can still feel like a relatively difficult economic environment. "While these indicators aren't necessarily showing strong signs of recession, they also aren't pointing to a strengthening economic expansion where everything is getting better," says Malwal. "Right now, the picture is decidedly mixed."

"This can be a confusing time for investors, and low consumer confidence readings that we've seen of late may reflect what's happening across several fronts," says Malwal, noting that the combination of rising inflation and falling stocks may be impacting how people view the broader economy. "Many people feel frustrated by high inflation. Whether you call it a recession or not, it's certainly not a pleasant experience for many people."

Slower growth can feel discouraging. After the steep recovery the economy experienced in 2021, this year's more modest gains may seem less impressive. "In 2021, corporate profits grew over 40% compared to 2020,"[3] says Malwal. "But in Q1 of 2022, the companies in the S&P 500 reported profit growth between 8% and 10% on average;[4] in Q2 it could be as low as 4% to 5%. So while profit growth is still positive, it's growing at a much slower clip. It's the same situation in the job market. Unemployment is under 4%, but there's been a dip in the number of job openings. Things appear to be gradually leveling off or slowing down." While these are clear signs of an economic slowdown, Malwal believes that this doesn't necessarily show the contraction that one would expect if we were in a recession.

What can investors watch for?

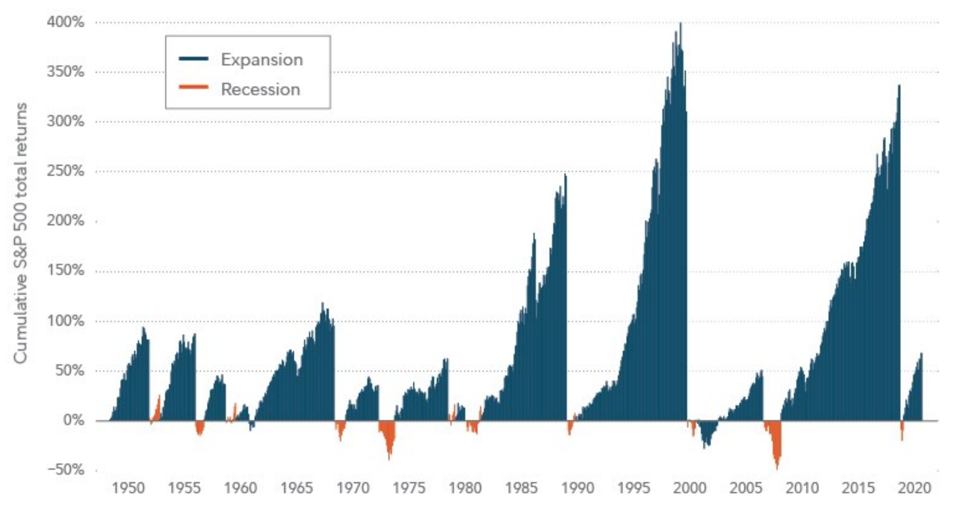
"I'm often asked, 'Is the recession here?' or 'Is it coming soon?,'" says Malwal. "And the truth is that it's nearly impossible to predict the start or end of a recession. It's also exceedingly difficult to determine when stocks and bonds may find a bottom and start to recover. Maybe we will experience more market volatility. Or perhaps the worst is behind us."

"What we know from history is that recessions come and go," says Malwal. "But stocks have historically risen over time. That's why I believe it's important that investors not react too strongly to predictions of what's going to come. In this kind of environment, I believe it's important to stay invested. Historically, when investors get out of the market at a time like this, it's rare for them to get back in at the right time, and this often leads to them missing out when things start to improve."

What might lead to a turnaround in the market? According to Malwal, anything that points to things not being as bad as investors fear. That could be a decline in the rate of inflation, corporate earnings exceeding expectations, or the Federal Reserve signaling that it doesn't feel the need to hike interest rates as much as previously thought. "The eventual recovery might take weeks or months to develop. But looking back through time, markets have eventually recovered from bear markets and recessions and gone on to make new highs."

Stocks have experienced significant gains during economic expansions

Recessions have been moderate detractors from performance.



Past performance is no guarantee of future results. This chart illustrates the cumulative percentage return of a hypothetical investment made in the S&P 500 Index during periods of economic expansion and recession. Index returns include reinvestment of capital gains and dividends, if any, but do not reflect any fees or expenses. This chart is not intended to imply any future performance of an investment product. It is not possible to invest directly in an index. All indexes are unmanaged. Please see disclosures for index definitions. Source: Bloomberg, S&P 500 Index total annual return, 1/1/1950–12/31/2021; recession and expansion dates defined by the National Bureau of Economic Research (NBER).

Planning and diversification may help

Staying invested can be challenging for many investors when markets become volatile. One thing that can help is having a financial plan in place. Investors often find that a diversified mix of stocks and bonds may help them reach their financial goals without experiencing the full effects of stock market volatility. "Historically, well-diversified portfolios of stocks and bonds have usually experienced less volatility than investing solely in stocks," says Malwal.

The investment team at Strategic Advisers seeks to adjust the mix of stocks, bonds, and other investments within the client accounts that they manage as the US economy moves through different phases of the business cycle. Starting last year, anticipating a potential economic slowdown, Strategic Advisers began to reduce the level of risk in highly diversified client portfolios. They did this by reducing allocations to stocks and increasing exposure to bonds.

"At this point, our typical well-diversified client account has much less risk in it today than it did last year. In making these changes, we hoped to potentially reduce the impact of the volatility we expected," says Malwal.

They also stand ready to act should the economy deteriorate further. "If we do see any contraction in areas like corporate profits, or the job market, or manufacturing activity, we would seek to further de-risk our client accounts in an effort to mitigate the volatility that could happen during a potential recession."

"But more importantly," says Malwal, "We've seen historically that stock markets often start to recover before the economy does. So we'll also be ready to increase exposure to stocks when we see early signs that an economic slowdown may be bottoming. We would do this in anticipation of strong stock market performance, which has often followed economic slowdowns or recessions."

1. Stock returns from 12/31/2021 to 7/27/2022, as represented by the S&P 500 index.
2. Bond returns from 12/31/2021 to 7/27/2022, as represented by the Bloomberg US Aggregate Bond Index.
3. Bloomberg Finance LP, based on S&P 500 index trailing 12-month earnings per share figures
4. Bloomberg Finance LP, based on S&P 500 index trailing 12-month earnings per share figures

Keep in mind that investing involves risk. The value of your investment will fluctuate over time, and you may gain or lose money.

Indexes are unmanaged. It is not possible to invest directly in an index.

The S&P 500 Index is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance.

The Bloomberg U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage-back securities (agency fixed-rate pass-throughs), asset-backed securities and collateralized mortgage-backed securities (agency and non-agency).

Neither asset allocation nor diversification ensures a profit or protects against loss.

Past performance is no guarantee of future results.

Generally, among asset classes stocks are more volatile than bonds or short-term instruments and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Although the bond market is also volatile, lower-quality debt securities including leveraged loans generally offer higher yields compared to investment grade securities, but also involve greater risk of default or price changes. Foreign markets can be more volatile than U.S. markets due to increased risks of adverse issuer, political, market or economic developments, all of which are magnified in emerging markets.

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