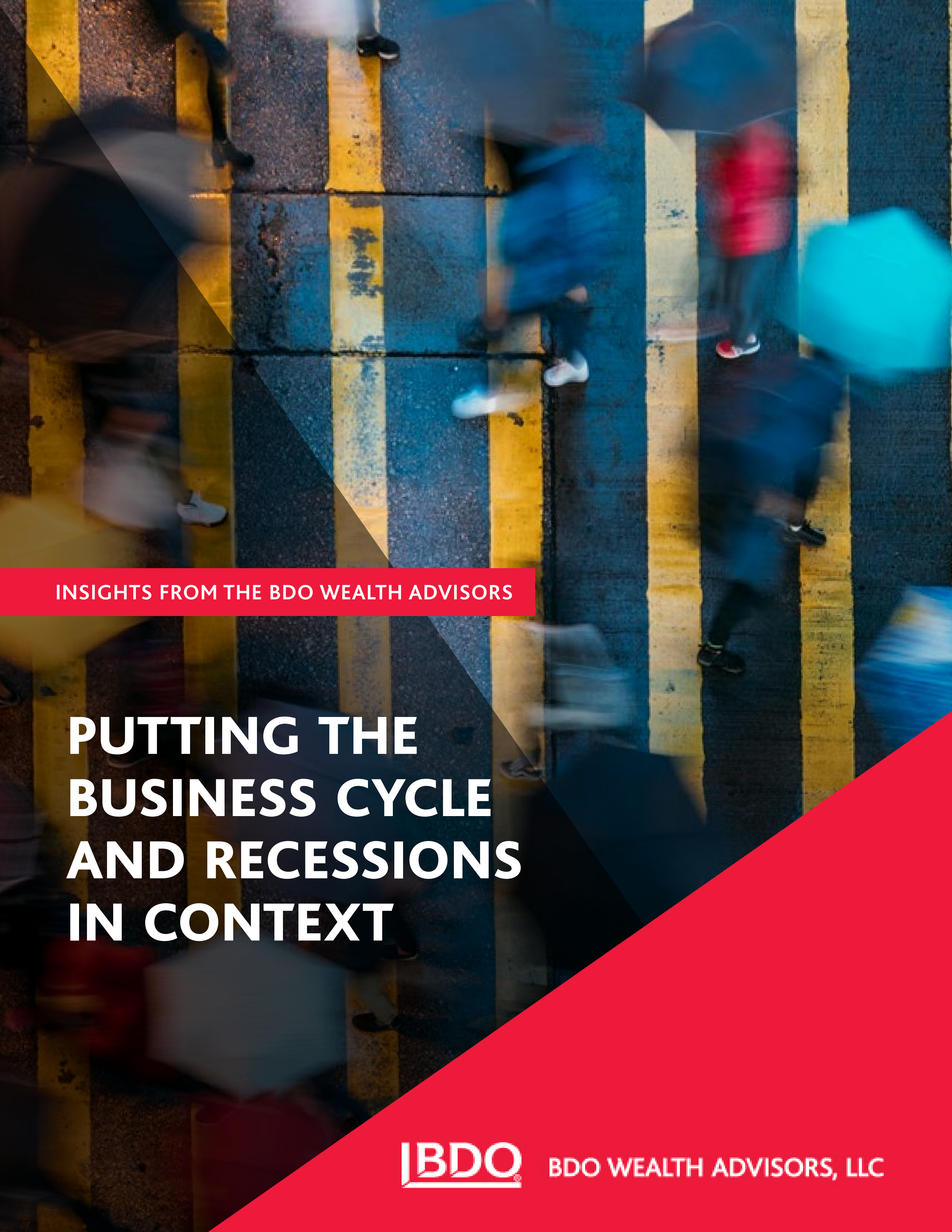


INSIGHTS FROM THE BDO WEALTH ADVISORS

PUTTING THE BUSINESS CYCLE AND RECESSIONS IN CONTEXT

BDO WEALTH ADVISORS, LLC

Concerns about economic growth are topping the headlines in early 2023 as the U.S. Federal Reserve continues to raise interest rates to alleviate concerns about inflation. But there are also encouraging signs, including strength in the U.S. job market, which added 263,000 net hires in November 2022.[1]

These mixed signals typically occur at turning points in the business cycle. Economists categorize business cycles into four phases: expansion, peak, contraction, and trough. Contractions, the phase of the business cycle that includes recessions, occur as the economy is decelerating from its peak after a period of strong growth. Recessions tend to be short-lived, and they present opportunities just like any other phase of the business cycle.

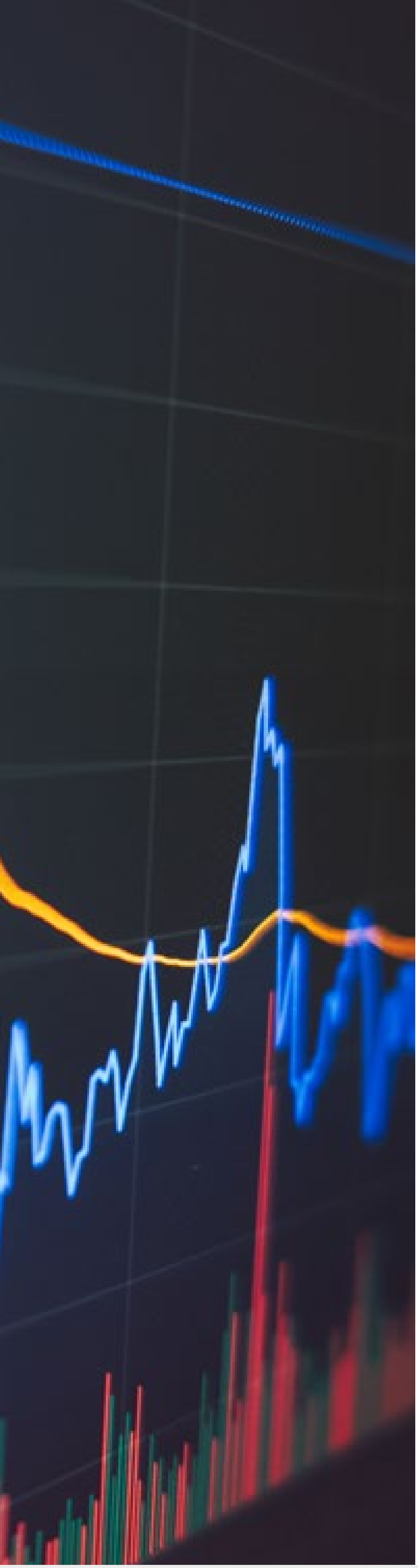
Here, we provide context on the various phases of the business cycle with a particular focus on recessions. Our hope is that with a better understanding of the business cycle, investors can avoid the temptation to make sudden changes to their financial plan that may be damaging to long-term success.

RECESSIONS TYPICALLY A BLIP COMPARED TO EXPANSIONS

A recession is usually defined as at least two consecutive quarters of economic contraction—or negative growth—in a country's gross domestic product (GDP), an aggregate economic measure of everything spent, earned, or produced in a given period.

In the United States, the National Bureau of Economic Research (NBER) is the official arbiter of business cycles. The NBER defines a recession as "a significant decline in economic activity that is spread across the economy and lasts more than a few months."[2] It judges a recession based on a number of factors including personal income, employment, business spending, and industrial production.

By the NBER's count, the economy has seen 12 recessions since 1945, with the average downturn lasting 11 months.[3] The longest recession in that span lasted 18 months (from 2007 to 2009), while the shortest lasted just two months (in 2020). By comparison, the average expansion since 1945 has lasted 64 months. The economy has been even more resilient recently, with the average expansion since 1990 lasting 103 months.[4]



HOW LONG DO RECESSIONS LAST?[3]

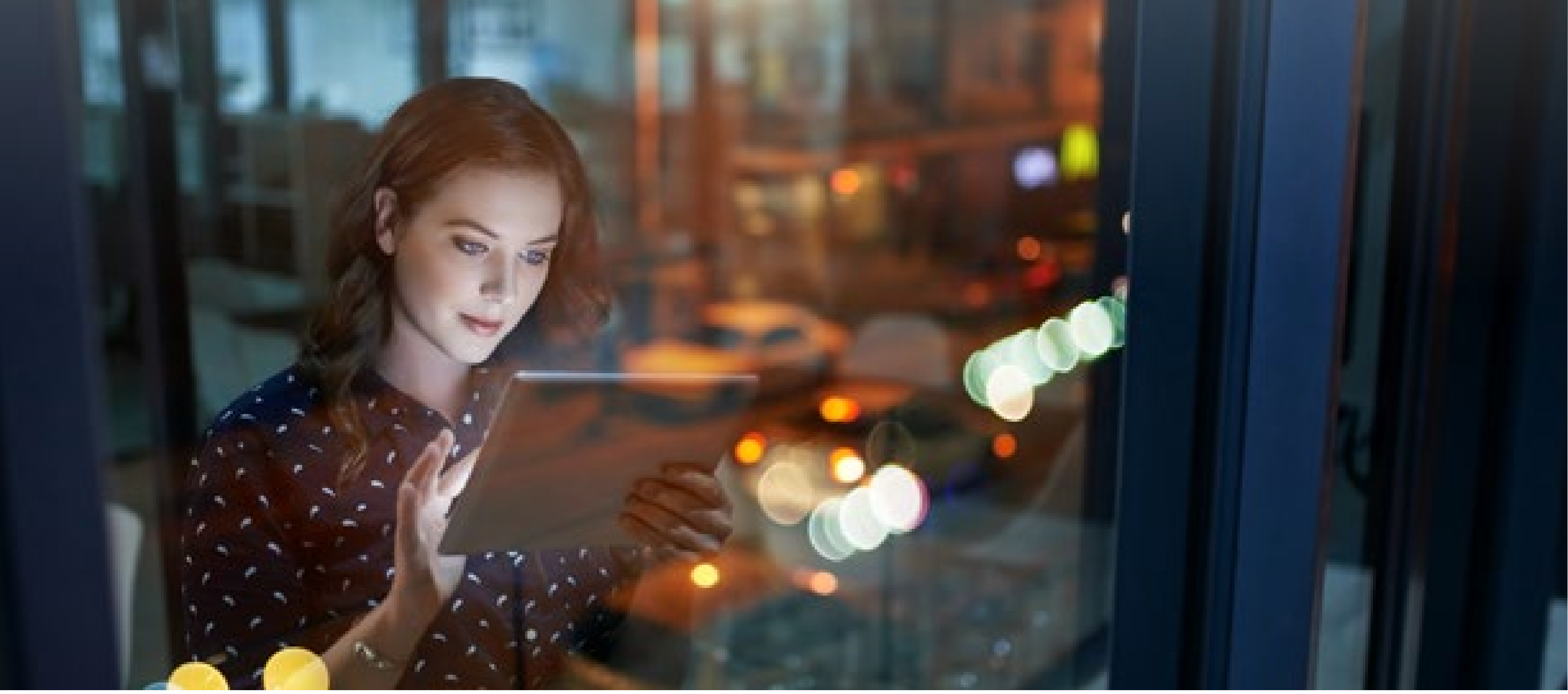
AVERAGE EXPANSION	AVERAGE RECESSION
64 months	**11** months

Every business cycle is different, but the recessionary phase is typically caused by one of four catalysts:

- **Significant tightening of financial conditions:** When inflation rises well above the Fed's targeted range, the Fed may hike interest rates to get them back in line. Unfortunately, policymakers have a history of going too far. Runaway inflation in the 1970s, for example, forced the Fed to raise rates so high (above 20%) that it sent the economy into a recession.[5]
- **Excessive debt levels:** Loose mortgage qualification standards in the mid-2000s enabled consumers to purchase homes they could not afford, sparking a collapse in the housing and bond markets starting in 2007. These events led to the bankruptcy of several investment banks and ushered in the "Great Recession."
- **An asset bubble:** The bull market of the late 1990s inflated profitless Internet stocks to unsustainable levels which eventually cratered, causing a substantial drop in personal wealth that negatively impacted consumption and economic activity.
- **Sudden financial shock:** The COVID-19 pandemic forced a rapid global shutdown of businesses and non-essential services in early 2020, causing economic activity to ground to a near complete halt.

BUSINESS CYCLES AND INVESTMENT PERFORMANCE

The direction of the stock market roughly coincides with the business cycle. In expansions like the robust recovery from the COVID-19 pandemic, stocks have historically delivered strong gains with high-flying growth companies leading the way in the most recent bull market. And like expansions, bull markets tend to have staying power.



BULL MARKETS SHOW MORE ENDURANCE THAN BEAR MARKETS[6]

Recessions have the opposite effect, exerting pressure on stocks. The S&P 500 Index has fallen into a bear market in eight of the 12 recessions since World War II.[7] This makes sense, because reduced economic activity leads to lower sales and profits for companies, which are often forced to tighten expenses or lay off workers to cope with more.

The short-term pain for investors, however, can lead to long-term benefits. The natural course of the business cycle clears out excesses in the stock market, such as companies with weak fundamentals, heavy debt loads, or no clear path to profitability. It also provides opportunities to purchase high-quality stocks at attractive prices. Regular investment when stocks are down due to recessionary headwinds enables investors to “buy low,” accumulating more shares than they would when stocks are soaring.

BEAR MARKET

-33% Total Return | **13** months

BULL MARKET

+265% Total Return | **67** months

STOCKS AND THE ECONOMY DON'T ALWAYS MOVE IN LOCKSTEP

While stocks usually decline in the contractionary phase of the business cycle, markets and the economy don't always move in tandem. This is because the stock market acts as a leading indicator, peaking six to seven months on average[8] ahead of downturns and recovering prior to expansions. On the other hand, economic data is backward looking, meaning that the official start and end of recessions are usually determined months after they occur. As a result, trying to time business cycles and the market reaction is difficult. We believe the best way to cope with uncertainty is to stay invested through the ups and downs of the market and economy.

Just as economic indicators behave differently through the business cycle, so do stocks. Companies considered defensive, like utilities, consumer staples, and health care companies, have historically held up better during recessions while those considered cyclical, like industrials, financials, and consumer discretionary stocks, tend to do best during economic recoveries.

A diversified portfolio can help investors weather economic storms and prevent panic selling that could cause them to miss the key turning points in markets when most gains are achieved.

STAYING COMMITTED IS CRITICAL TO SUCCESSFUL INVESTING

Investors will likely endure many downturns in their lifetimes, yet the U.S. economy has always shown resilience, rebounding from these slowdowns to produce even longer expansions. We believe the most effective way to benefit from the growth stages of business cycles and the performance gains they produce is to stay invested in a diversified portfolio that is customized to personal goals and risk preferences. Rather than panic at the first sign of recession, by understanding the causes and implications, investors should be better positioned to make wise decisions in planning for the future.

Don’t hesitate to reach out to BDO Wealth Advisors if you have questions about the business cycle and how it affects your plan. **www.bdo.com/wealthadvisors**.

FOOTNOTES

[1]Forbes, “**Strong U.S. Labor Market: Economic Armor – or Achilles Heel**,” December 19, 2022.

[2]National Bureau of Economic Research (www.nber.org), “Business Cycle Dating”

[3] National Bureau of Economic Research (www.nber.org), “US Business Cycle Expansions and Contractions”

[4]Ibid

[5] Macrotrends.net “Federal Funds Rate – 62 Year Historical Chart”

[6]Source: Capital Group, **2023 Outlook**, accessed on December 27, 2022. Total return shown for the S&P 500 Index. Includes all completed cycles from January 1, 1950 to November 30, 2022.

[7]Marketwatch.com 9/14/22 “Is the stock market already pricing in a recession? What the S&P 500’s tumble shows”

[8]Capital Group, **www.capitalgroup.com** “Guide to Recessions 2022 Edition”

HAVE QUESTIONS OR WANT TO LEARN MORE? CONTACT US!