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Surviving and Thriving in A Recession

Lately I've been asked by a few investors if we think a recession is in our immediate future. I suspect the reason for the questions is some combination of the media, political tension, and the fact that it's been a while since the last recession. Regardless of what factors are at fault, if this is something possibly creating stress for investors, and particularly our clients, we want to address it. To that end, in this month's Manager's Report, I will explain what a recession is and how to survive and even thrive.

Contrary to what some might believe, a "recession" is not when stock markets fall or decline in price. A recession is a term referring to a material decline in economic activity as measured by Gross Domestic Product ("GDP"). GDP is basically a measure of the health of an economy and the speed at which money is turning over. Specifically, the formula is:

$$GDP = C + I + G + (X - M)$$

The **C** (Consumption) represents what consumers are spending. This is an important part of our economy because it makes up about 70% of GDP. The **I** (Investment) refers to gross domestic investment. This variable captures things like business spending, such as companies buying equipment or adding to inventory. The **G** (Government) is government spending, which contributes about 18% of our economy's total GDP. By way of comparison, some European countries have a G/GDP ratio of over 50%.

Lastly, the variables in the parentheses are net exports. The **X** and **M** stand for "exports" and "imports", respectively. This number can be negative, effectively illustrating that an economy imports more than it exports. In fact, it is currently negative for the U.S., which means it *reduces* GDP. See the graph below from JP Morgan which displays the components of U.S. GDP and their weights. Keep in mind that all economies are different and the graph below is only the U.S. Currently, U.S. GDP is reduced by about 3% because of our trade deficit.

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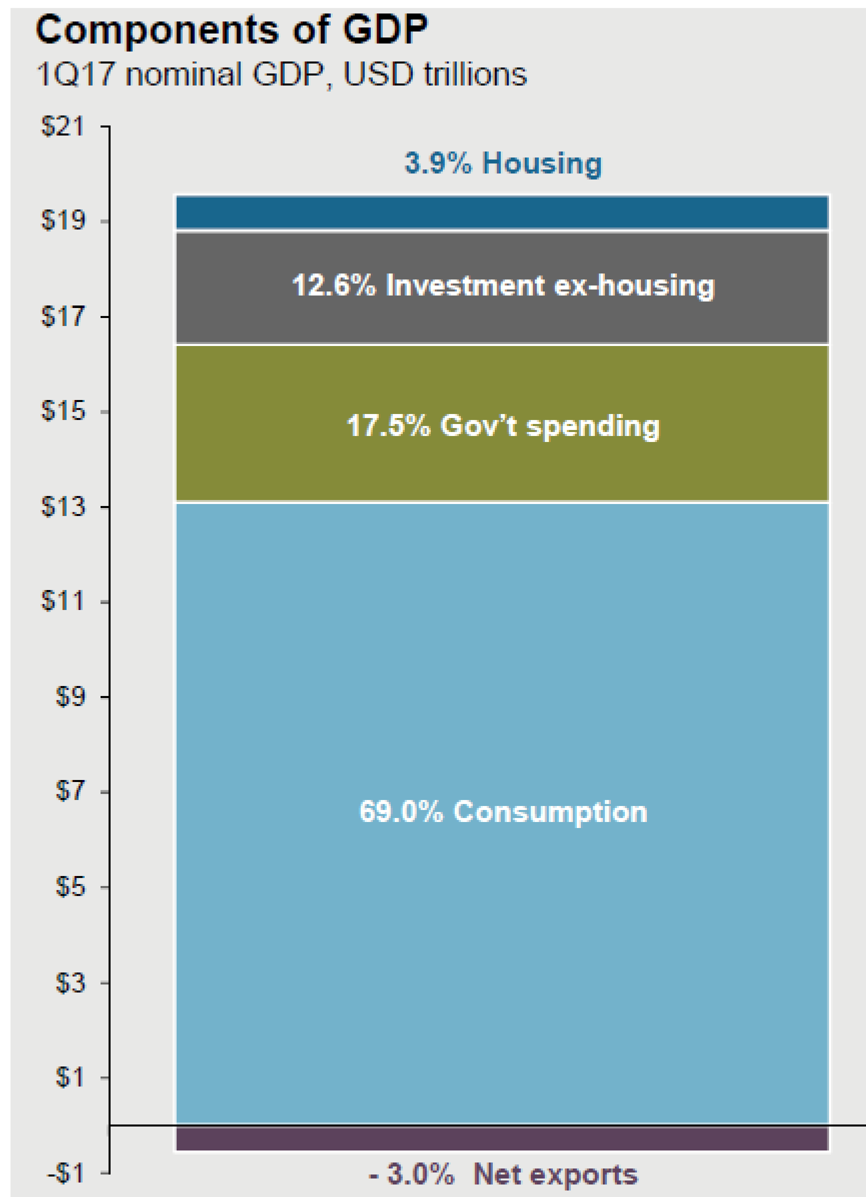
Chart 1



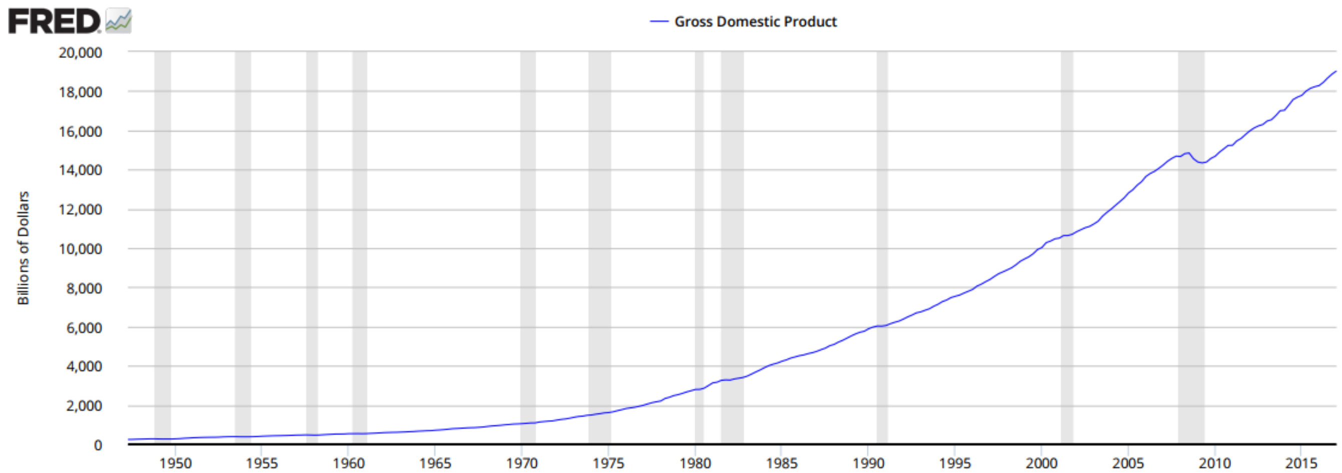
Source: BEA, FactSet, J.P. Morgan Asset Management.
Values may not sum to 100% due to rounding. Quarter-over-quarter percent changes are at an annualized rate. Average represents the annualized growth rate for the full period. Expansion average refers to the period starting in the second quarter of 2009.
Guide to the Markets – U.S. Data are as of June 30, 2017.

J.P.Morgan
Asset Management

Now that we have defined the components of GDP and what it really measures, let's address the dreaded "R Word" – recession. In the U.S., the National Bureau of Economic Research (NBER) determines the official business cycle dates. A recession is generally considered to be two consecutive quarters of declining GDP.

Recessions are by no means uncommon. Indeed, since the late 1940's there have been 11 recessions. As can be seen in Graph 1 below from FRED (**F**ederal **R**eserve **E**conomic **D**atabase), historically recessions happen somewhere between every 4 to 10 years. The gray vertical bars show the timing and the length of the recession.

Graph 1



The wider the bar, the longer the decline in GDP. This is what I was referring to earlier in this Report when I wrote that the fact that it's been a while since we have had a recession might create some concern. If someone were trying to forecast a recession based solely on historical timing, it would be a logical conclusion that we are due – if not overdue.

In my experience, when investors express concern about a possible recession they are actually nervous about a significant decline in stock prices, and not necessarily the contraction of the US economy. To that end, let's review what happens to equity markets before, during and after recessions.

Chart 2

Recession	GDP Contraction	Duration	Time Until Next Recession
August 1929 - March 1933	-26.7%	3 Years 7 Months	4 Years 2 Months
May 1937 - June 1938	-18.2%	1 Year 1 Month	6 Years 8 Months
February 1945 - October 1945	-12.7%	8 Months	3 Years 1 Months
November 1948 - October 1949	-1.7%	11 Months	3 Years 9 Months
July 1953 - May 1954	-2.6%	10 Months	3 Years 3 Months
August 1957 - April 1958	-3.7%	8 Months	2 Years
April 1960 - February 1961	-1.6%	10 Months	8 Years 10 Months
December 1969 - November 1970	-0.6%	11 Months	3 Years
November 1973 - March 1975	-3.2%	1 Year 4 Months	4 Years 10 Months
January1980 - July 1980	-2.2%	6 Months	1 Year
July 1981 - November 1982	-2.7%	1 Year 4 Months	7 Years 8 Months
July 1990 - March 1991	-1.4%	8 Months	10 Years
March 2001-November 2001	-0.3%	8 Months	6 Years 1 Months
December 2007-June 2009	-4.3%	1 Year 6 Months	???
Median	**-2.7%**	**9 Months**	**4 Years 2 Months**

Source: National Bureau of Economic Research

Chart 2 shows every recession going back to the Great Depression in the 1930s up until the most recent recession (2007-2009), which is often referred to as the "Great Recession." The chart also shows the degree to which GDP contracted during each period, the duration of the recession and the time until the next recession. During a recession, on average, GDP falls by about 3%, with the average recession lasting about 9 months, with an average period of 4 years from the end of one recession to the beginning of the next.

Chart 3 shows what happened to the S&P 500, a proxy for large cap U.S. stocks, a year before, during, and 1, 3, and 5 years after the respective recession.

Chart 3

	1 Year Prior	Recession	+1 Year	+3 Years	+5 Years
Aug 1957 - Apr 1958	0.8%	-6.4%	37.2%	66.1%	89.3%
Apr 1960 - Feb 1961	3.1%	18.3%	13.5%	34.8%	67.7%
Dec 1969 - Nov 1970	-10.7%	-3.4%	11.3%	20.4%	24.8%
Nov 1973 - Mar 1975	-0.1%	-18.2%	28.3%	21.6%	54.8%
Jan 1980 - July 1980	18.5%	16.4%	13.0%	56.0%	100.0%
July 1981 - Nov 1982	20.7%	14.4%	25.5%	66.4%	102.4%
July 1990 - Mar 1991	16.5%	7.6%	11.1%	29.9%	98.3%
Mar 2001-Nov 2001	-8.2%	-7.2%	-16.5%	8.4%	34.2%
Dec 2007-June 2009	7.7%	-35.5%	14.4%	57.7%	136.9%
Averages	**5.4%**	**-1.5%**	**15.3%**	**40.1%**	**78.7%**

Source for Chart 2 and 3: Stock Performance Before, During and After Recessions – Ben Carlson. National Bureau of Economic Research.

In reviewing the data within this chart a few things stand out:

1. The theory that markets are perfectly efficient and predict economic downturns is not fully supported by this data. Apart from the recessions that started in 1969 and 2001, the stock market *increased* in value 1 year prior.
2. During the recessions, although there are clearly some negative returns, about 45% of the time the S&P 500 *increased* in value. In some instances, stock returns rose well into the double digits.
3. History suggests that recoveries present opportunity for investors as the 1, 3 and 5 year returns post-recession have above average equity returns.

At this point let's move on to how to survive and thrive in a recession. To begin with, it's perfectly normal to be nervous about recessions. Contracting economic activity can have implications that go beyond stock prices. Business owners can have a reduction in income and others can find themselves unemployed. Unfortunately, recessions are normal and occur with some degree of frequency. I find it analogous to turbulence on a plane. It's unpleasant and a little stressful but it is normal and should be expected. It is not reasonable to believe that economic activity will grow in perpetuity without contracting temporarily. That said, being nervous is not a strategy.

The first step in surviving a recession is to accept the fact that recessions do happen with some degree of frequency. The second step is to embrace the reality that predicting recessions is a herculean, and arguably impossible, task. Taking it a step further, even in the event an investor could foresee a recession, there is the additional job of predicting how the market will react. Based on history, there is no consistency with how the markets behave before or during a recession. The only consistent pattern observed in history is that investing during a recession has led to strong returns over the following 1, 3, and 5 years.

After accepting the truth that recessions and the market's response are both inevitable and unpredictable, the third step to survival is to make sure your portfolio is budgeted for your risk tolerance. The level of risk an investor decides to pursue should focus on how the portfolio would likely behave in a declining equity market. At Baystate Wealth, this is exactly why we budget for risk using our RAD Ratio ™, which focuses on how investments behave when the stock market is trending lower. I've found that many investors have two risk tolerances. The first is their tolerance when markets are performing well. The second is their "real risk tolerance" which often becomes apparent when stock markets are falling. Our goal is to have our clients in a strategy that is optimal for their real risk tolerance.

How to thrive in a recession? If we do enter a period of declining GDP coupled with falling stock prices, history suggests it could be an opportunistic environment. A well-diversified portfolio with an appropriate risk budget that owns assets with low or negative correlations to stocks will have parts of the portfolio that fall less than the overall stock market. In fact, there may be assets that gain in value as stock markets fall. The benefit of this dynamic is that it creates the possibility to rebalance and own more equities at a lower price before the eventual recovery. As Morgan Housel of the Collaborative Fund said: *"It's also why every past market crash looks like an opportunity, but every future market crash looks like a risk."*

The bottom line is that investors who own well-diversified investment portfolios that are in-line with their real risk tolerance will not only survive a recession, but will likely thrive as time progresses.

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Submission# 1142270