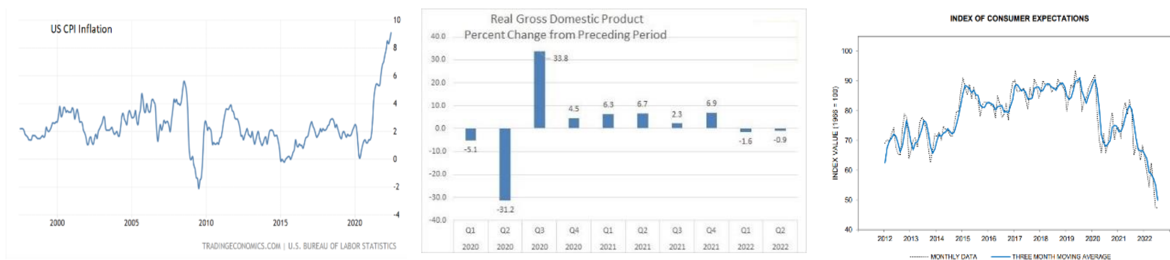
Market View by Mr. Amit Nadekar, Senior Fund Manager - Equity

Recession 101

Are you worried about recession? Here is a handy guide for you.

The Backdrop



Source: BEA, Tradingeconomics.com, University of Michigan

US Inflation hit 9.1% for June 2022, highest since 1981 and forecast for July 2022 remains elevated at 8.9%. (Source: Bloomberg)

US GDP declined 0.9% in the second quarter of 2022 as against expectations of positive 0.5%. (Source: Bloomberg)

Consumer confidence index hit a record low of 50 in June 2022 while business confidence as indicated by ISM Manufacturing PMI at 52.8 in July 2022 is weakest since June 0f 2020. (Source: Bloomberg)

Central banks which helped the World and markets recover from Covid-19 blow, are not seen today to be in a position to help improve the worsening situation. In fact, central banks' action to fight the inflation by raising interest rates is expected to further slowdown the economy through higher cost of capital and asset deflation.

Consensus is predicting 40% probability of a US recession. With 2 quarters of consecutive negative growth, technically, US economy is already into a recession. (Source: Bloomberg)

We are hopeful that the recent correction in commodity prices and concerted efforts of the central banks will help inflation cool off in coming months. However, there is always a risk of unknown. A prolonged war, escalation of geo-political tensions in Asia, unresolved European energy crisis or stressed supply chains can send global economy into a tailspin.

Given the heightened uncertainty, investors are naturally a worried lot and growing noise about recession is not helping the cause.

Though our base assumption remains a gradual recovery from here onwards or at worst a mild recession, we better be prepared for any unpleasant outcome. We attempt therefore to provide our investors with granular insights into 'Recession' so that you are well prepared for any eventuality.

Hope you find these insights helpful in your endeavor to build a resilient portfolio and achieve sustainable wealth.

Warm Regards,

Amit Nadekar
Sr Fund Manager

Recession – Definition and a Brief History

National Bureau of Economic Research, the official body which officially announces the Recession, defines one as "Significant decline in economic activity that is spread across the economy and lasts more than a few months". The Bureau examines various economic indicators like employment, personal income, consumer spend, manufacturing and industrial activity to decide whether there is a recession or not. Generally, The Bureau therefore has always been behind the curve in announcing both start of the recession as well end of it.

General definition of recession is a period between a peak and a trough in business cycle where there is a significant decline in economic activity across the economy that can last from few months to few years. A more technical definition to pronounce a recession is only when Gross Domestic Product (GDP) growth is negative for a period of two or more consecutive quarters. US has seen eight occurrences of recession over the last 55 years. On an average the economy contracted between 5.5% to 8.5% (on annualized basis) during these past recessions while it took around 10-11 months for the economy to come out of recession. The following table summarizes these events.

Table 1.0: US Recessions since 1969

Sr.no.	Event	Start Date	End Date	Period (In Months)	Period (Quarters)	GDP Decline (peak to trough)	Worst Quarter Annualised
R-1	Inflation/Vietnam War	01-Dec-69	30-Nov-70	12	4	-0.6	-4.0
R-2	Oil Crisis/Stagflation	01-Nov-73	31-Mar-75	17	6	-3.2	-4.7
R-3	Credi Control Program	01-Jan-80	31-Jul-80	7	2	-2.2	-7.9
R-4	Fed Tightening	01-Jul-81	30-Nov-82	17	6	-2.7	-6.5
R-5	S&L Crisis	01-Jul-90	31-Mar-91	9	3	-1.4	-3.4
R-6	Dot-com	01-Mar-01	30-Nov-01	9	3	-0.3	-1.3
R-7	GFC	01-Dec-07	30-Jun-09	19	6	-5.1	-8.2
R-8	Covid-19	01-Feb-20	30-Apr-20	3	1	-19.2	-31.4

Source: NBER, Bloomberg, BEA, LICMF

One can note that each recession has been quite different in term of scale and size. It has varied from 6 years during 1873-79 economic depression to as low as 2 months in the recent Covid-19 pandemic. However, a good point to note here that generally the frequency of recessions has gone down over a period with only 3 occurrences so far in the 21st century.

Also, as Central Banks have learned more about recession and honed their policy responses, they have been successful to minimize the damage to the economy and restart a recovery.

Does recession impact all parts of the economy equally?

Just as we saw, all recessions are not exactly similar, so is the impact of recession on various sectors of the economy – it is uneven. The following table depicts how various parts of the economy have fared during the past recessions.

Table 2 - Sectoral Growth Rate during past recessions

Sector	R-1	R-2	R-3	R-4	R-5	R-6	R-7	R-8
Discretionary	-11.90	-3.68	5.33	18.27	-15.27	21.80	-3.19	-13.55
Staples	8.14	11.03	8.63	4.60	3.63	3.25	2.11	23.05
Retail	3.24	5.57	6.10	3.88	0.43	-2.65	-2.55	-44.55
Financials	9.70	16.25	10.20	19.20	7.53	-3.05	-3.53	-2.85
Healthcare	14.30	15.62	15.80	12.03	10.00	9.08	5.24	-33.50
Industrials	-1.26	5.62	2.87	-2.30	-1.27	-10.45	-12.69	-28.45
IT & Software	19.18	29.28	18.93	15.37	8.07	-5.98	4.90	2.85
Transportation	10.84	10.53	6.80	5.43	-3.80	-6.00	-1.81	-56.45
Entertainment	-3.56	4.87	-8.63	5.50	7.10	-1.88	-4.78	-11.70

Source: Bloomberg, NBER, BEA, LICMF

Staples, Healthcare and IT sectors have withstood the recent economic downturns much better for different dynamics of each sector as well as different nature of each crisis.

On the other hand, Discretionary, Industrials, Financials and Retail have been more vulnerable to recessionary shocks. H

One should, however, be careful and gather granular insights of each of such crisis before generalizing and extrapolating the past experiences. For instance, IT & Software industry has been more resilient in the past growing in high teens in recession R1 to R3, as it was a nascent industry then. However today it has become a relatively matured industry and thus, it might not exhibit past growth rate in recessions ahead. Though given the increasing integration of both hardware and software, the industry could still turn out to be far more resilient than some of the other industries in the economy.

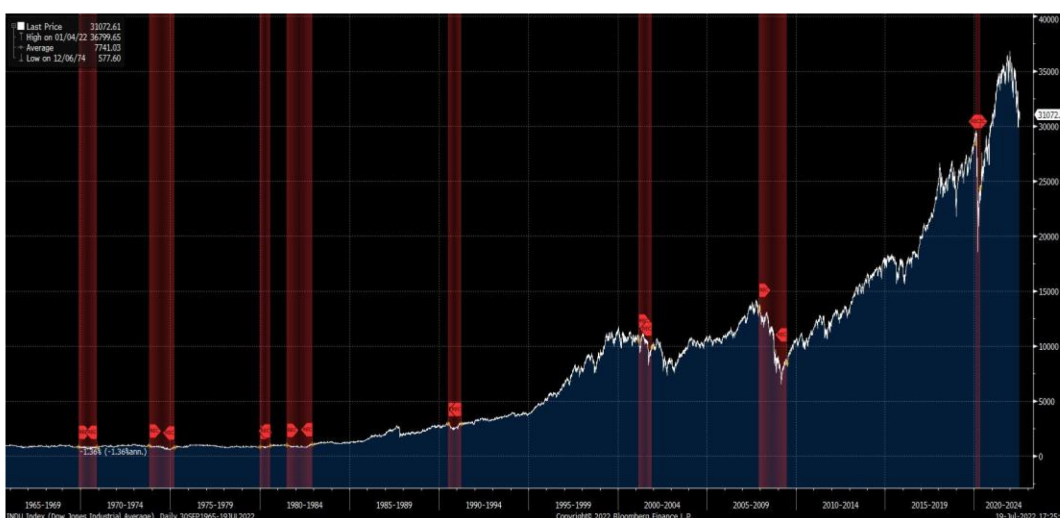
Similarly, 'Retail' industry which remained in the positive growth trajectory during R1 to R5 period, has turned progressively susceptible to economic shocks. In fact, 'Retail' was the second worst hit sector in Covid-19 led recession, primarily because the industry could not remain open for the business as the World got locked-down as a policy response to contain the spread of virus. Discretionary which is generally vulnerable did exceedingly well during the dot.com bubble burst led recession.

The key takeaway from the industry analysis, therefore, is that rather than trying to find a perfect answer in terms of pockets (sectors) of resilience during recession from empirical data, it's is more important to understand and accept that there would be sectors which will do

much better than general economy even during the recessionary period. Investors response to the crisis/recession should be a) not to panic and b) to study the forces behind a particular recession and identify bottoms-up beneficiaries to align the portfolio accordingly.

Is BUY & HOLD a good response to Recession?

Having understood what is recession and performance of various sectors during recessionary times, let's move on to understand how equity markets have fared during recessionary periods. The following chart provides performance of Dow Jones Industrial during the past 8 recessions in the United States.



Source: Bloomberg, LICMF

The average fall during the last 8 recessions has been over 28%, 2008 GFC crisis been the deepest with around 55% plus fall in the major indices. Individual portfolios in such cases would have seen even worse fall.

Index wise average fall have been as follows –

1. Dow Jones – -28.9%
2. S&P500 – -29.8%
3. Russel 2000 – -30.8%
4. Nasdaq – -39.4%

Index	R-1 1969 Inflation	R-2 1973 Oil Crisis	R-3 1980 Oil Crisis	R-4 1981 Oil Crisis	R-5 1990 SL Crisis	R-6 2001 Dot-com	R-7 2008 GFC	R-8 2020 Covid19	R-9 2022 Ongoing
Dow Jones	-34.9	-45.1	-15.4	-24.1	-19.4	-27.2	-53.6	-36.5	-19.7
S&P 500	-34.8	-48.2	-11.7	-25.2	-19.6	-36.5	-56.4	-32.5	-24.4
Russels 2000	N.A.	N.A.	-18.8	-29.2	-33.9	-30.2	-59.9	-41.9	-32.9
Nasdaq	N.A.	-59.9	-18.5	-28.8	-30.5	-71.8	-55.6	-27.0	-34.5

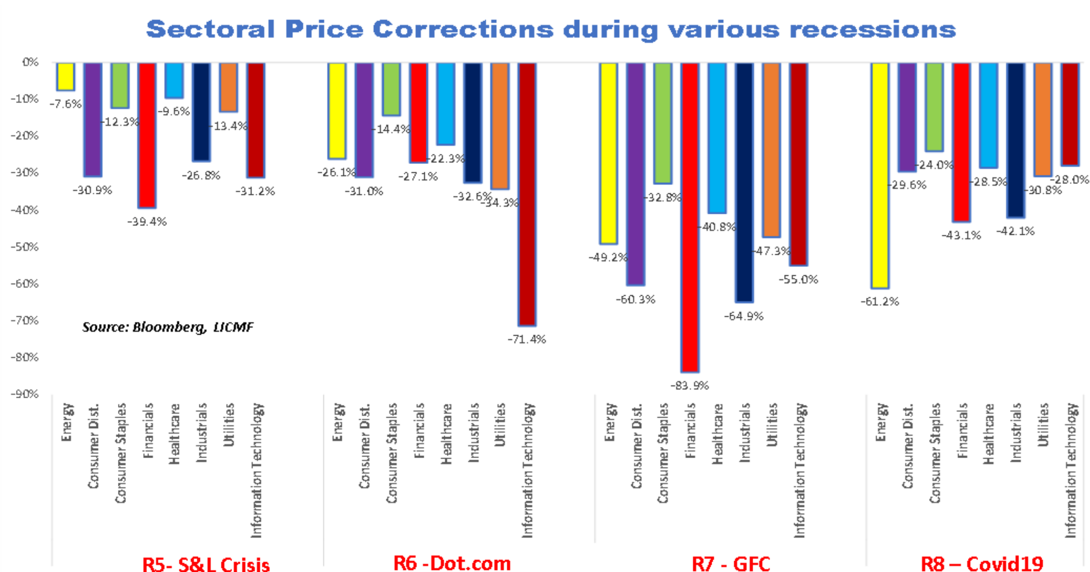
Source: Bloomberg, LICMF; *R9 Ongoing – Data as of xxx

So, going back to the original question? Is BUY & HOLD strategy a good strategy during recession? The answer could be, “May be, Yes”, as markets have recovered from each of such crisis and gone on to scale new highs.

We would, however, simply say, recessionary impacts on equity markets are not to be ignored and there could be better ways to protect and grow capital even during such trying times.

But if you are thinking sectoral winners could be one such strategy then hold your horses.

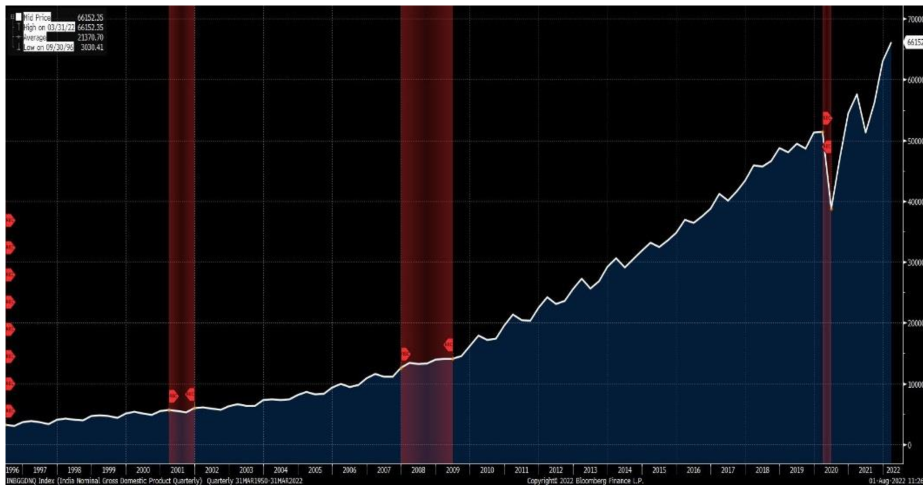
Though that is a possible strategy as some of the sectors do retrace much lesser than other sectors, but on a whole none of the sectors have been spared during the recessionary falls in the equity market. The following graphical representation of some of the key sectors highlights how none of the sectors are spared during an equity rout following recessionary pressures.



The answer, therefore, to the question that how do you minimize the damage to portfolio and protect large drawdown probably lies somewhere else. Before we get on to that let’s see how Indian economy and Indian equity markets have fared during the US recessions.

India a mixed bag when it comes to US/Global Recession

India's Quarterly GDP Graph



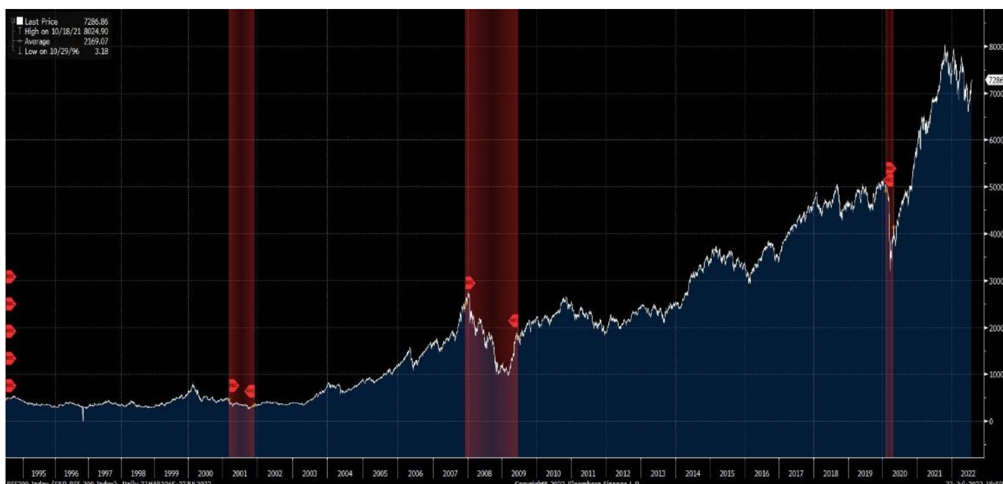
Source: Bloomberg, LICMF

One can notice that barring Covid-19 recession, Indian economy continued to perform very well during the past few recessions. Though the growth rates slowed down, it didn't experience any meaningful contraction.

Unfortunately, it was never enough to save equity market.

Indian Equity markets corrected equally badly with the global market

Chart 5- BSE200

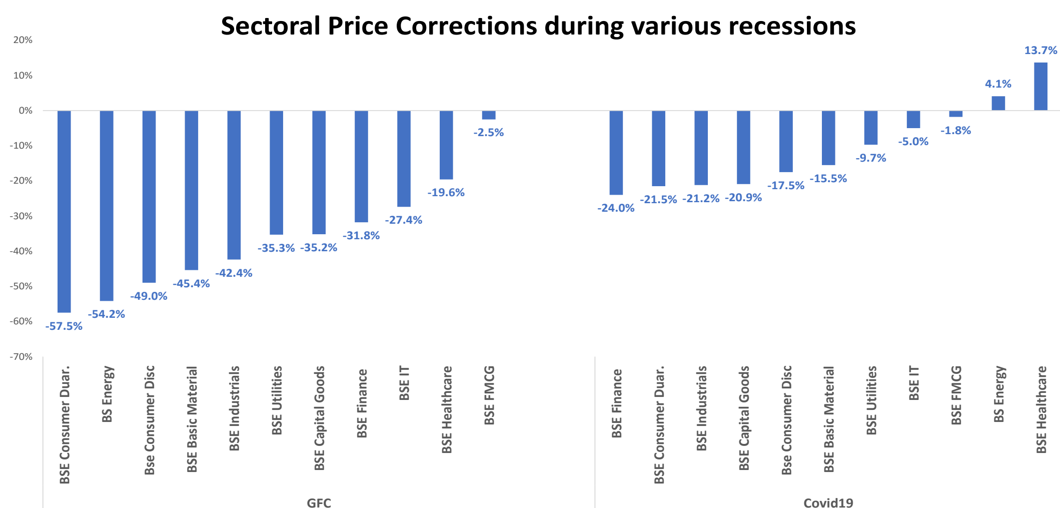


From peak to trough, BSE200 corrected 48% in 2001 recession, 61% in 2008 recession and 38% in 2020 recession. So there is not much to cheer for equity investors despite the fact that Indian economy has been resilient through most of the recessions.

The reason for such a poor equity market performance is that the globalization has shrunk the world into a village; capital markets globally have become even more interwoven. Indian economy though fared much better than countries facing economic recession, the deteriorating macro – rupee depreciation, widening current account deficit and fiscal deficit,

dwindling fx reserves, rising imports and rising inflation have led to equally sharp or even deeper cuts into equity markets compared to equity markets in these developed nations.

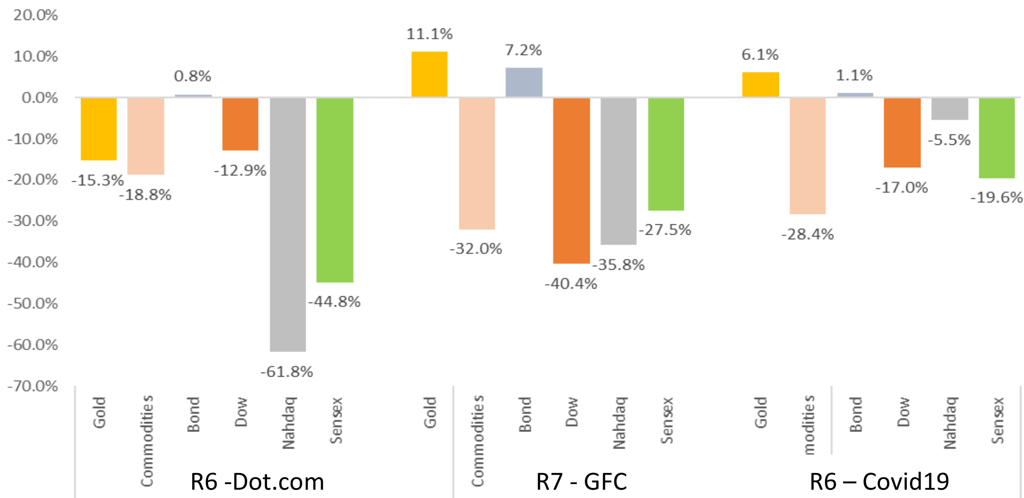
On the sectoral front however, there is some respite, with FMCG generally holding up better compared to not a single sector holding up in positive territory for US equity markets. This might be again attributable to higher penetration/higher maturity level of US staples industry coupled with higher individual consumer leverage apart from the fact that Indian equity markets are relatively shallow and this impact of relative sector rotation could be much larger in India.



Bottomline, the decoupling theory, though logical and appealing has not worked during times of crisis, though in terms of recovery and post heightened panic stage, at times Indian markets have performed much better compared to some of the emerging as well as developing markets.

Different Asset classes' performance during the recession

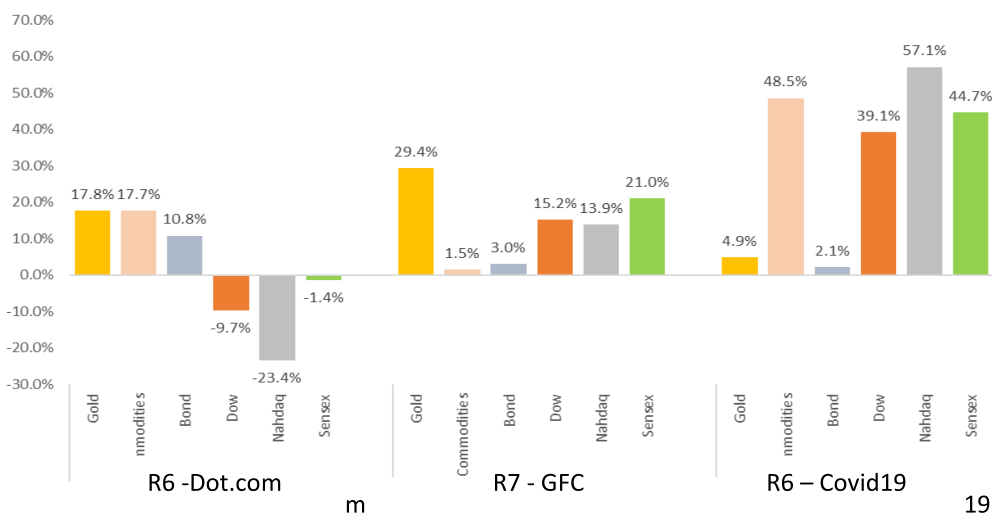
Having understood, the recession, it's impact on economy/markets, let's see if asset allocation can benefit investors, during such periods. The chart below compares the performance of equity markets with Gold, Bonds and Commodities during the past periods of recession. We have purposely excluded real estate sector because the real estate cycles are extremely long running over multi-years to decades. Hence comparing it with short cycle of few months to quarters won't be appropriate.



Source: Bloomberg, LICMF

The above analysis clearly suggests that, theoretically, one can protect the capital and minimize the drawdowns by raising the asset allocation to Bonds and Gold during the period of allocation. Like mentioned earlier, each of the recession is unique and hence relationship and performance of each of these asset classes is not a given. Investors must analyze multiple factors like the forces leading to recession, gauge the breadth and depth of contraction, collateral damage to the economy and businesses and policy responses to decide the best asset allocation in a given situation. Nonetheless, it would not hurt to approach any recession with a properly diversified portfolio across various asset classes. Asset allocation therefore is the right answer to our earlier question of how to protect the portfolio during recessionary times.

But before we pronounce that let's also have a look at how different asset classes have performed 12 months post end of the recession. The graph ahead summarizes the price performance of gold, bonds, commodities and equity markets 12 months after the end of the recession.



Source: Bloomberg, LICMF

It should not come as a surprise that almost all asset classes bounce back sharply as the economy starts the recovery and investor confidence comes back. However, there is no

uniform pattern and or a consistent performance for any of the asset classes. Thus, it's again important that a proper asset allocation and sticking to the asset allocation is the key.

Recap and Summary

1. Recessions have been a frequent phenomenon over many centuries though the frequency and duration has shortened over the period driven by better understanding and responses of central banks and governments.
2. Not all the sectors get equally impacted and some of the industries could continue to flourish during the recessionary times as well.
3. Impact of recessions on equity markets is not be shrugged off as drawdowns during such periods have been very large.
4. Right approach is to have a dynamic asset allocation strategy appropriate to the situation

Finally, it all brings us down to Recession Playbook

Recession PlayBook

1. Don't get confused. Don't panic or freeze.
2. Rebalance the portfolio across the asset classes to protect and benefit for unique characteristics of upcoming recession. For instance, if inflation is the primary force driving recession through central bank policy actions to combat the inflation, reduce the share of debt allocation
3. Talk to your money manager to understand the nature of crisis and ensure that the portfolio is positioned in the right sectors
4. Allocate higher proportion of money to strategies/fund manager which prefer stock selection to deliver alpha rather than one who merely align to the benchmarks
5. Lastly, and more importantly do not exit equity markets, as timing the markets is not practically possible. In fact, double down on SIPs to take benefit of the falling prices.

I hope that you find this Recession 101 note useful in managing your money.

Happy investing!

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