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Lessons from past recessions

The best offense is a good defense

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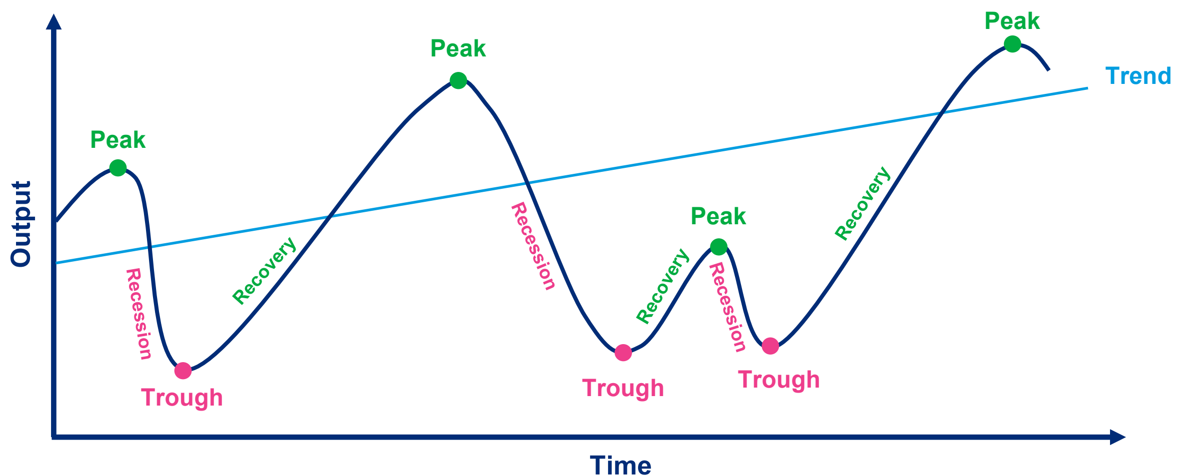
Introduction

Concerns over a looming global recession have picked up of late, even if the narrative has shifted to a 'soft' or even 'no landing' scenario since the onset of 2023. Nevertheless, a recession remains a possibility, the distress seen in the financial sector in March 2023 serves as a reminder of how quickly things can change. Asset owners are rightfully worried about what this could mean for their portfolios. Recessions are nothing new, though. As we discussed in our 2023 Themes and Opportunities, *history doesn't repeat itself but it tends to rhyme*[1]. The general principles derived from experiences of past recessions can help investors to weather whatever storm may come while remaining positioned for the ensuing recovery.

What is a recession – Economics 101

The 'business cycle' describes the trajectory of the economy, with its ups and downs, akin to the biblical proverb in ancient Egypt, where 'Joseph told Pharaoh that a period of abundance would be followed by a period of famine.'[2] A recession is the down leg, or 'famine', in this naturally occurring cycle.

Figure 1. The business cycle



Source: Mercer. For illustrative purposes only.

Recessions can be caused by a variety of factors, including monetary and fiscal policy, changes in consumer and business confidence, shocks to the financial system, and exogenous events such as natural disasters or military conflicts that can lead to the broad and sudden disruption of entire economies and global commodity supply chains.

Monetary tightening has been the most frequent cause of recessions. As formalized in the Austrian Business Cycle Theory, periods in which central banks force interest rates to levels below their rates set in a free market lead to credit expansion and thus malinvestment, asset bubbles and, ultimately, inflation as material and labor shortages constrain the expansion. At that point, central banks reverse course, many investments need to be written off and the economy enters recession. However, the last three US recessions (2020, 2008 and 2001)

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[1] Source unknown but often attributed to Samuel Clemens aka "Mark Twain"

[2] Genesis 41

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were not solely triggered by monetary tightening, even though loose monetary policy was among the primary causes for the build-up of the pre-2008 excesses.

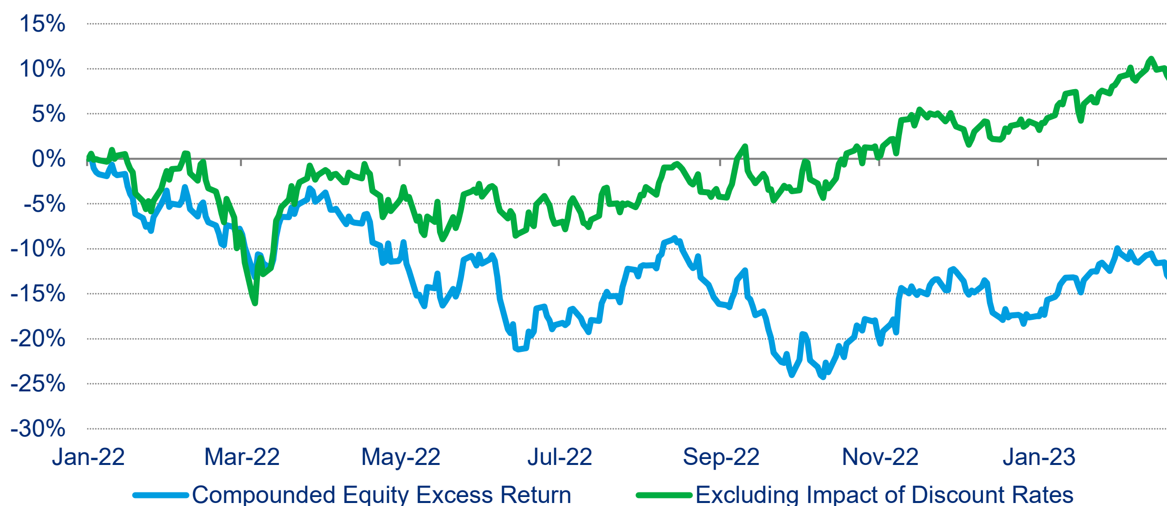
Recessions are followed by a ‘period of abundance’ as the economy begins to expand again, with the speed and strength of the recovery dependent on various factors, including the severity of the recession and its cause. In practice, recessions are often described in letter form, such as ‘V’ (indicating a sharp recession followed by recovery) or ‘W’ (a double-dip recession). A financial crisis and the subsequent de-leveraging tend to cause drawn-out, ‘U’-shaped recessions that take longer to recover from than a once-off exogenous shock.

Where has 2022 left us?

In our 2023 Economic and Market Outlook,[3] we argued that a severe global recession is likely to be averted. Instead, we expect a mild, shallow contraction – simply put, the economy will bend, but not break. From the end of 2022 until the time of writing,[4] economic growth and inflation forecasts have largely come around to this view, with most of the ‘hard landing’ rhetoric having given way to ‘no landing’ or a continuation of the inflationary boom of the last two years, which makes a hard landing further down the road more likely.

Nevertheless, 2022 was the worst year for US markets in over 150 years, as equities and fixed income tanked simultaneously.[5] However, the rerating in equity markets seems to be a consequence of increasing discount rates rather than a fundamental change in earnings expectations. In spite of the substantial fall in equity markets since early 2022, a severe recession scenario may not yet be priced in, which leaves plenty of downside in the medium term.

Figure 2. Global equity returns



Source: Bridgewater. Data as of February 23, 2023.

[3] 2023 Economic and Market Outlook

[4] March 2023

[5] Source: Bloomberg, NBER, Jordà-Schularick-Taylor Macrohistory Database; Note: Data to 1871.

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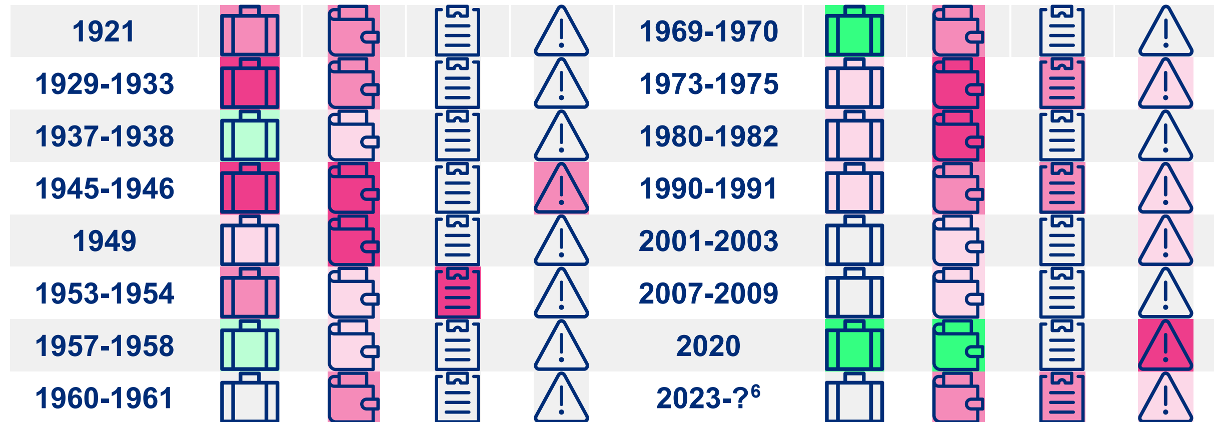
What lessons can we learn from previous recessions?

This too shall pass

History doesn't repeat itself but tends to rhyme. Thus, we can look back at past recessions and compare current conditions to those that prevailed at the onset of each US recession on.



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The recessions of the 1970s and 80s resonate. These were both driven by high inflation exacerbated by geopolitical shocks and a forceful monetary response even as the economy was weakening. Central banks cannot fix commodity supplies or other supply-side constraints, so the only way to reduce inflation is through demand destruction, thus a deep recession and protracted economic malaise as experienced in the 1980s.

At the same time, the current situation also has commonalities with recessions triggered by sharp exogenous shocks like the reaction to Covid in 2020, the 9/11 terror attacks in 2001 and the Gulf (1990/1991) and Korean (1953/1954) wars. These recessions were shorter and less severe.

Only time will tell where the current downturn will lead us. While we all hope for the best – a short, mild recession – we must also be prepared for the worst – a 1970s/80s-style scenario. Given what we have learnt from past recessions and even depressions, the only seeming guarantee is that 'this too shall pass'. How long that takes and how investors react in the meantime will be crucial for long-term portfolio performance.

[6] As of the beginning of 2023, the US was not in a recession yet.

[7] Such as terrorist attacks and pandemics.

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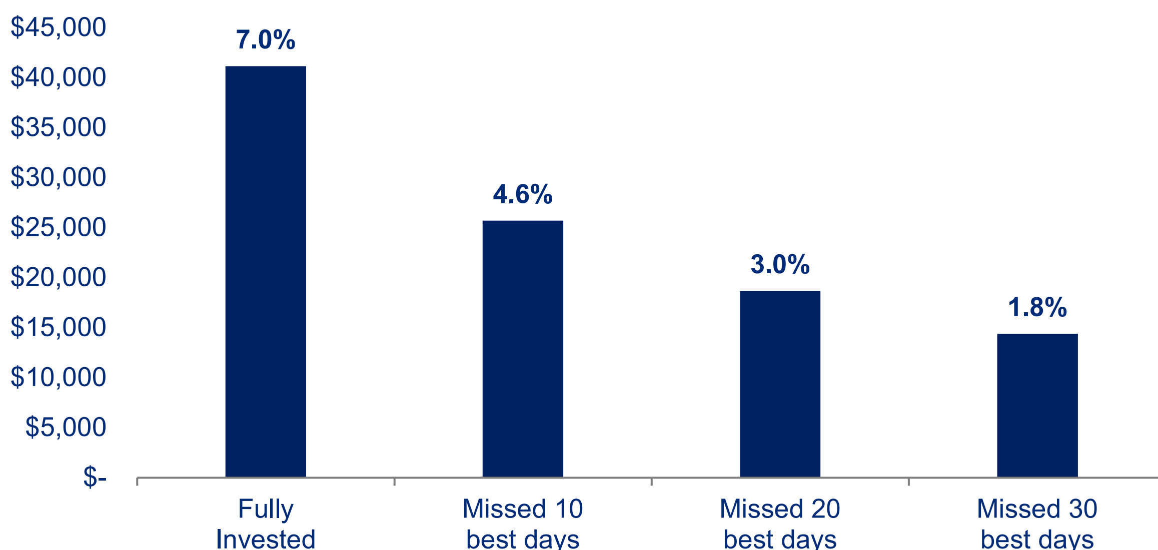
Cool, calm and collected

When a storm hits, the intuitive course of action is to run for cover. Investors, at the height of market turmoil, may feel tempted to sell their assets, hold cash and metaphorically 'sit on the sidelines' until the storm blows over and markets bottom out. However, when a storm hits financial markets, not running and not panicking can be the most sensible decision.

Figure 3 shows that those who remain fully invested through these aforementioned periods of market stress have tended to outperform those selling out of the market and seeking a re-entry point later on. Trying to time the market is a very challenging task: it requires investors to call both the top and bottom of the market and there is little margin for error.

The old adage remains true: 'it is not about timing the market but time in the market'.

Figure 3. Annualized performance of a $10,000 investment between January 2002 and January 2023



Source: Refinitiv, Mercer. Performance of 60/40 portfolio. Data as of January 31, 2023.

The best offense is a good defense

Therefore, we believe in two principles:

- **Playing defense** by staying invested with a diversified portfolio positioned for long-term growth and to mitigate the impact of a wide range of recessionary outcomes.
- **Playing offense** through disciplined rebalancing policies and tactical deployment of dry powder (if available in the portfolio) into asset classes whose valuations have become attractive relative to fundamentals.

Figure 4 highlights how individual asset classes have performed relative to each other in the year leading up to a recession.

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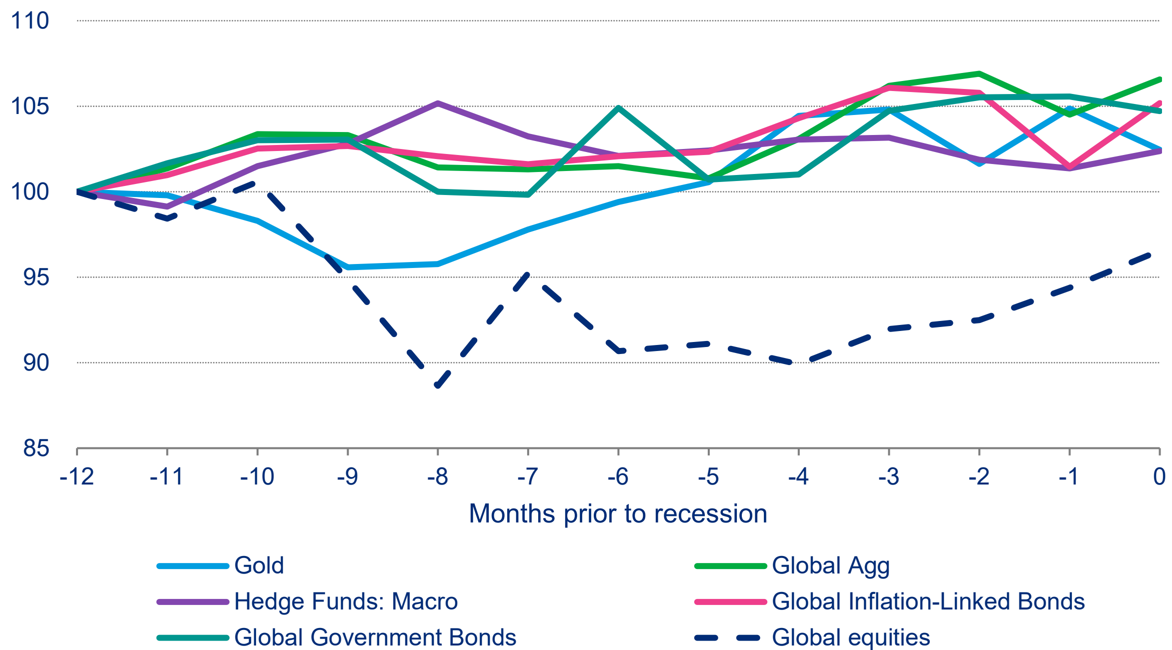
Figure 4. Median asset class performance in the 12 months leading to a recession



Source: Refinitiv, National Bureau of Economic Research and Mercer analysis. Data as of January 31, 2023. Median performance is rebased to 100 in the 12 months prior to GDP growth hitting the trough. The asset class lines show the median performance in each individual month. Gold and Global equities are the median return of the prior seven US recessions. Hedge Funds: Macro is the median return of the prior four US recessions. Global Agg, Global Inflation-Linked Bonds and Global Government Bonds are the median return of the prior three US recessions.

Rather than timing the markets, which requires investors to call both the top and bottom of the market, they can play offense by taking profits from those asset classes that hold up or even increase during market declines (top of **Figure 4**). They can then buy into those that have become attractively valued relative to fundamentals (bottom of **Figure 4**), either through simple rebalancing or more aggressive deployment of dry powder, and thus magnify returns when markets recover. Such an approach allows investors to take advantage of attractive (and predefined) entry points when they materialize rather than trying to call the bottom of the market. The past may of course be different from the future, which is why we have built forward-looking scenarios that show how we expect asset classes to perform in potential future recessions (see **Appendix 1**).

A recession is usually followed by a period of recovery. Asset classes that perform poorly in a recession while *playing defense* tend to perform strongly in the recovery years, and investors switch to *playing offense* (see **Figure 5**). **Appendix 2** also shows our forward-looking assessment of asset classes in the years following a recession.

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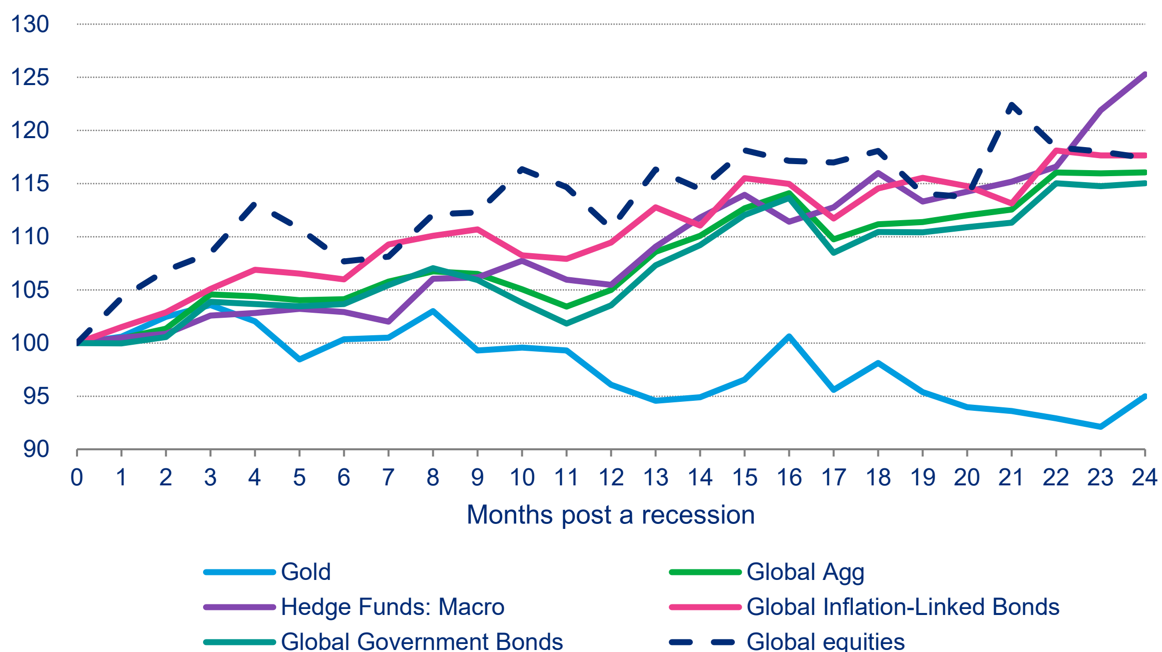
Figure 5. Median asset class performance in the 24 months post a recession



Source: Refinitiv, National Bureau of Economic Research and Mercer analysis. Data as of January 31, 2023. Median performance is rebased to 100 at the point of the trough in GDP growth. The asset class lines show the median performance in each individual month. Gold and Global equities are the median return of the prior seven US recessions. Hedge Funds: Macro is the median return of the prior four US recessions. Global Agg, Global Inflation-Linked Bonds and Global Government Bonds are the median return of the prior three US recessions.

Public market equities are expected to rally as the business environment improves and optimism returns after a recession. The same can be said for public market credit, both investment and sub-investment grade. In a recession, credit spreads typically widen as the credit risk premium and default expectations increase. As markets begin to price in a recovery and risk sentiment returns, spreads tighten and credit performs positively. While defaults do indeed increase during recessions, the increase in credit spreads has historically been disproportionally higher, reflecting both behavioral factors and short-term liquidity needs. The temporary rise in credit spreads has therefore constituted an opportunity for buy-to-hold investors able to see through the temporary worsening of drawdowns in credit markets to lock in attractive spreads for the long term.[8]

If approached correctly, private markets such as private equity and private debt can also provide fruitful opportunities in the years following a recession. Committing to private equity during recession years, and in the years following, has typically been rewarding for investors who maintained their commitment pacing (**Figure 6**).

[8] Mercer (2020): Time to Buy: High Yield Debt and Time to buy high yield debt: Where now?

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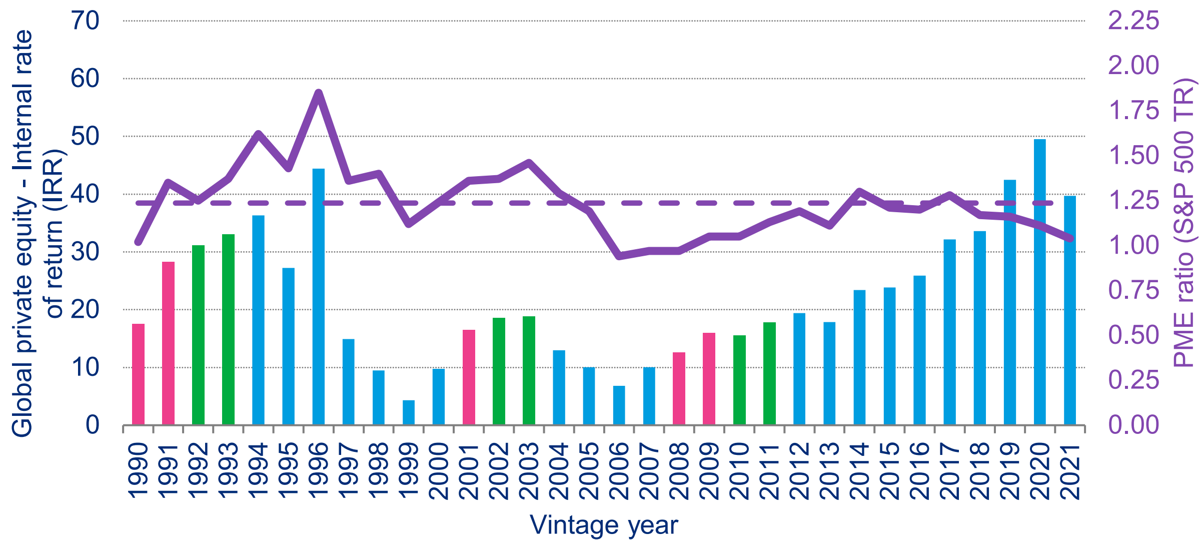
Figure 6. Consistent commitment can allow investors to capture upwards-trending vintage returns following recessions



Source: Burgiss, Mercer. Data as of December 31, 2021. The bars indicate the internal rate of return (IRR) per vintage year. The pink bars indicate vintage years where recessions occurred and the green bars indicate the two years following a recession. The dashed purple line indicates the average PME ratio[9] over the period.

Staying invested – or just playing defense – will historically have paid off for long-term investors by preventing them from making the wrong call, as highlighted in **Figure 3**. At the same time, these returns can be further magnified (**Figure 7**) through rebalancing whenever the equity allocation deviates +/- 5% from its target allocation (purple line), or through deploying dry powder (green line) when equity valuations become significantly more attractive – being *greedy* and playing offense when markets are *fearful.* By deploying dry powder during the global financial crisis from a 60/30/10 portfolio with 10% allocated to asset classes that provided downside protection as markets were falling back into equities (and thus a 70/30 portfolio), investors could have enhanced returns by 1.9% p.a. throughout the cycle (October 2007 – December 2019). When deployment began, the MSCI ACWI had fallen ~42%, and the price-to-earnings ratio had dropped from 15.3x to 10x. This was not a case of timing the market though (as the equities proceeded to bottom at ~55% in 2009), but rather tactically taking advantage of more attractive valuations when they materialized in October 2008. Even if this meant buying into falling markets in the short term, buying at these attractive valuations still led to significantly enhanced returns in the long run.

[9] The Kaplan-Schoar public market equivalent (PME) provides a relative performance measurement that is informative and supports our opinion. The Kaplan-Schoar PME is a ratio describing the relative performance of a private investment versus a public index. In Figure 6 above, we show the Burgiss Global All Private Equity Pooled IRR versus the S&P 500 Total Return (TR) PME. For example, the PME ratio (solid purple line) for 1991 is 1.35, indicating that the Global All Private Equity Pooled IRR for the vintage year 1991, as of December 31, 2021, exceeded the S&P 500 TR PME by 35%.

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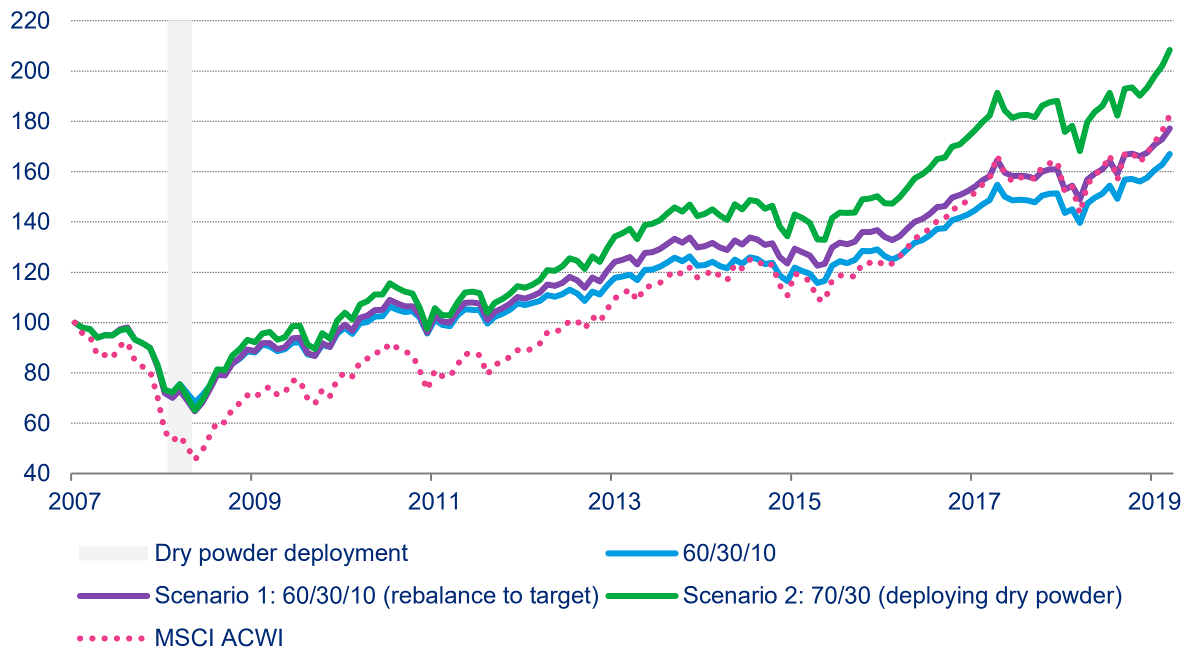
Figure 7. Using optionality from playing defense to deploy into more attractive markets over time rather than trying to time the bottom



	60/30/10	Scenario 1: 60/30/10 (rebalance to target)	Scenario 2: 70/30 (deploying dry powder)
Model Returns p.a.	4.3%	4.8%	6.2%
Model Return enhancement p.a.	-	0.5%	1.9%

Source: Refinitiv, Mercer analysis. Data as of December 31, 2022. Model returns shown for 31/10/2007 - 31/12/2019. Model portfolio is made up of 60% global equities, 30% global bonds and 10% cash, gold, macro hedge funds and short-duration credit. Transaction costs assumed to be 0.1%.

Use your degrees of freedom

In our Themes & Opportunities paper for 2023[10], we highlighted the importance of building robust governance frameworks in order to nimbly react to opportunities such as repositioning portfolios during business-cycle fluctuations. Investors should consider the following:

- Have a strategic allocation to liquid downside protection assets (for example cash, gold, hedge funds, short-duration bonds)[11] that become dry powder in times of market drawdowns.

[10] https://insightcommunity.mercer.com/v1/api/uploads/4a80be83cf75490392c151e9c429e05d.pdf?public=false

[11] Even these seemingly liquid asset classes may not always offer daily liquidity (especially hedge funds) due to redemption periods, and liquidity conditions are also subject to prevailing market conditions. Cash is typically readily available at short notice, however, the market events of March 2022 serve as a reminder to investors to make sure that ongoing monitoring of counterparties is performed to ensure that counterparty risk exposure is managed effectively. More than one provider should be considered, especially where cash is held in or passes through bank accounts.

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- Set valuation triggers for out-of-cycle rebalancing or deployment of dry powder:
  - For example, if equities fall by x% or non-investment grade yields go above y%, allocate all or some dry powder to this asset class.
  - Once markets have recovered, rebuild dry powder by taking profits from risk assets to prepare for the next downturn.
- Set up a governance framework that allows for the monitoring of opportunities and swift execution.
  - Assign or outsource clear responsibility to individuals to identify when pre-determined triggers are hit (for deployment of dry powder) or to execute the agreed rebalancing accordingly.

Conclusion

Rather than predicting the next recession, investors should work on the assumption that they occur on a regular basis. In sports, neither the offense nor defense can win a match on their own, it is the interaction between the two that produces the most successful results. This applies to investment strategy and asset allocation considerations. The defenders are allocations to downside protection assets within a well-diversified portfolio, while the offensive play is to deploy them during downturns as well as a solid governance framework that allows for implementation at short notice. Predefining the price at which an asset is deemed sufficiently attractive to be bought is a more viable strategy than trying to time the market by shifting the portfolio in and out of cash. Investors who cannot allocate to downside protection assets can still add value through a solid rebalancing framework and potential out-of-cycle rebalancing during extreme market dislocations.

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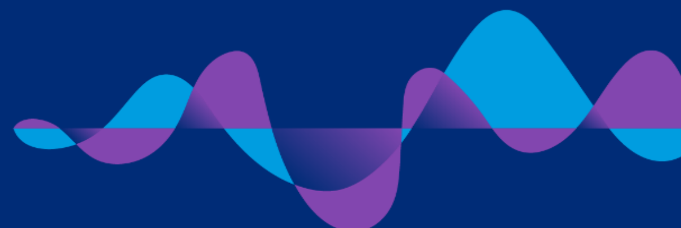

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Appendix 1

	Year of recession			
Asset Class/Scenario	Hard Landing	Overheat	Global Liquidity Crisis	Stagflation
Gold				
Global Government Bonds				
Global Inflation-Linked Bonds				
Global Agg Bonds				
Commodities				
Hedge Funds – Macro				
Diversified Hedge Funds				
Large Cap Equity				
China Equity (All-Share)				
Emerging Market Equity				
Small Cap Equity				
Listed Infrastructure				
Natural Resource Equity				
Global Credit				
Global Defensive Equity				

Source: Mercer scenarios. Data as of December 31, 2022. The expected returns shown in the table are the returns for each asset class in the year in a scenario when growth is slowing and turning negative.

Appendix 2

	Recovery years			
Asset Class/Scenario	Hard Landing	Overheat	Global Liquidity Crisis	Stagflation
Gold				
Global Government Bonds				
Global Inflation-Linked Bonds				
Global Agg Bonds				
Commodities				
Hedge Funds – Macro				
Diversified Hedge Funds				
Large Cap Equity				
China Equity (All-Share)				
Emerging Market Equity				
Small Cap Equity				
Listed Infrastructure				
Natural Resource Equity				
Global Credit				
Global Defensive Equity				

Source: Mercer scenarios. Data as of December 31, 2022. The returns shown in the table are the p.a. returns for each asset class in the years when growth bottoms and turns positive, returning to equilibrium.

Key	
	<-15%
	-15% to -5%
	-5% to 5%
	5% to 15%
	>15%

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Appendix 3: Asset class scenarios

Examples of scenarios around our base-case capital market assumptions based on where markets and economies were at the end of 2022.

Scenario	Description
Global liquidity crisis (financial crisis)	Global markets are roiled by a financial crisis similar to 2008/09, with sharp losses from equities and other risky assets in a short period as liquidity rapidly disappears as financial entities default.
Overheat	A "mini-Volcker[12]", with US interest rates peaking around 5-6% in the medium term and rising much faster than is currently being discounted by markets, with the aim of countering persistent rising inflation. This leads to a recession in the medium term and weak bond performance. Note that expected bond performance would be even weaker if we were still in the beginning of the tightening cycle like in early 2022.
Stagflation	Aggressive monetization of debt driven by rising debt levels, supply shortages, structural inflationary pressures arising from a slowdown in globalization, a commodity shock and/or geopolitical event driving higher structural inflation and/or a sudden inflationary shock. Initially, central banks allow inflation to rise above targets for sustained periods, bond vigilantes drive rates higher and a wage-price spiral sets in. At some point, central banks scramble to tighten monetary policy. Economic growth remains considerably below long-term consensus for the foreseeable future as a consequence.
Hard landing	Global growth continues to disappoint over the next few years, with weak overall growth, descending into a hard recession as de-leveraging intensifies. Unemployment and deflation risks are at the forefront of central bankers' concerns, leading to real rates remaining very low or becoming negative again. This scenario can be driven by either an involuntary return to austerity due to political gridlock, a monetary tightening cycle, a sudden exogenous shock such as the emergence of another virus or other events that have a deflationary rather than inflationary impact.

[12] Refers to the era of Paul Volcker as Chairman of the Federal Reserve Bank (1979 - 1987) when rampant inflation was brought down by material monetary tightening that led to high unemployment throughout the 1980s.

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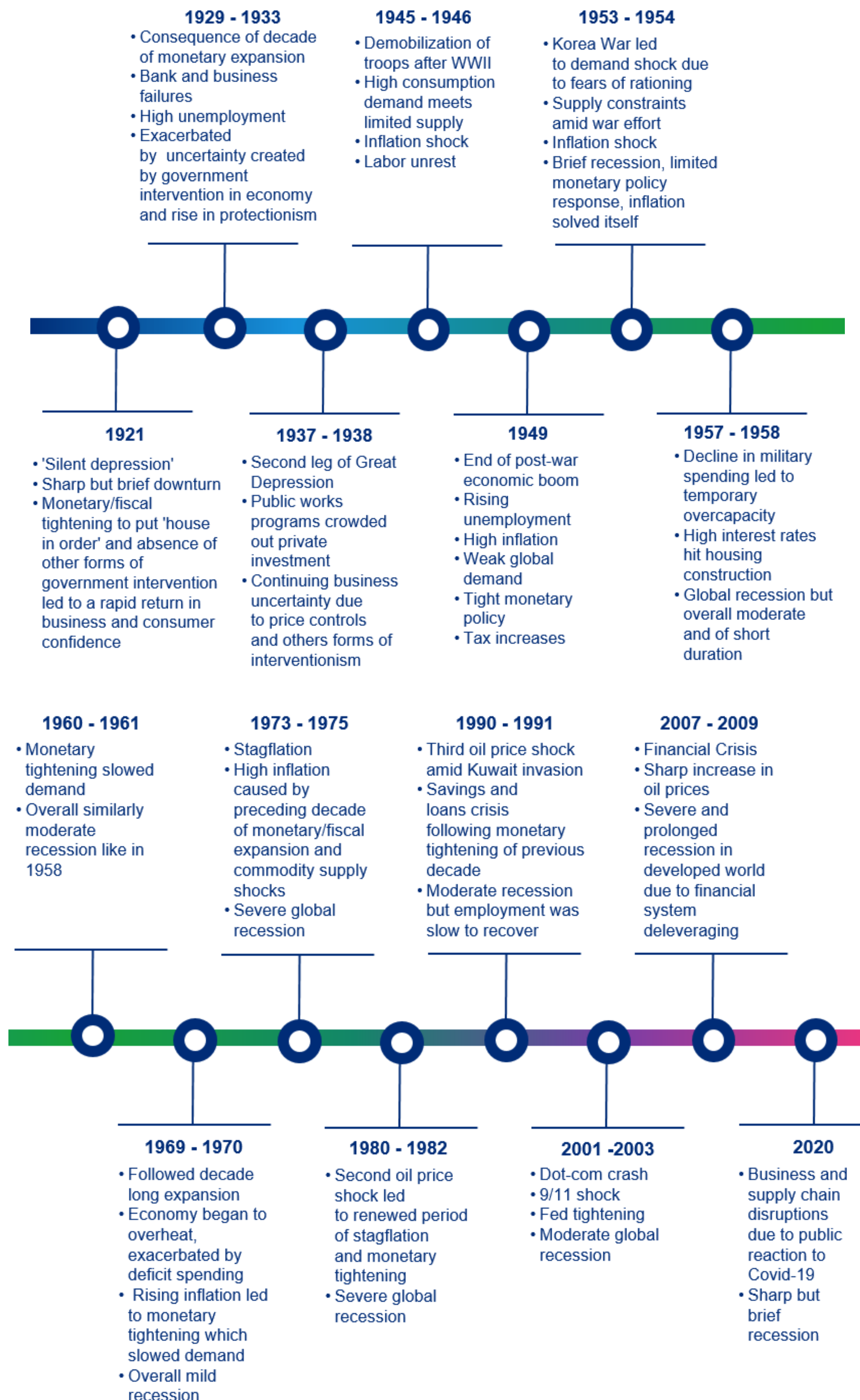
Appendix 4. A history of US recessions



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Portfolio expectations are forward looking and reflective of Mercer's capital market assumptions, as defined by asset class and incorporating return, standard deviation, and correlations. Our process for setting asset class expected returns begins with developing an estimate of the long term normal level of economic growth and inflation. From these two key assumptions, we develop an estimate for corporate earnings growth and the natural level of interest rates. From these values, we can then determine the expected long term return of the core asset classes, equity and government bonds. We combine current valuations with our expectations for long term normal valuations and incorporate a reversion to normal valuations over a period of up to five years. Volatility and correlation assumptions are based more directly on historical experience except in cases in which the market environment has clearly changed. Manager impact on performance is not incorporated into expectations. The views expressed are provided for discussion purposes and do not provide any assurance or guarantee of future returns.

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