



PRATO CAPITAL



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Market and Economic Downturns

In our last newsletter, we discussed how the current situation is different this time and how the reactions of the equity markets have been similar to events causing downturns. There has been much discussion in the media that the recent gains in the markets have happened too soon and much greater than the economy would signal. This is a concern when one sees economic growth decreasing and unemployment rising to historic levels so quickly and the S&P 500 gaining from its March lows. We hear that the stock markets have disconnected from economic reality.

Is the US economy heading to the next Great Depression?

When we look back at the Great Depression of the 1930s, there are some major differences between the causes and underlying structure of the financial system compared to today. An economic slowdown in the second half of 1929 is just one of many factors leading to the stock market crash that year. The economy started to recover from a recession in 1930 until the collapse of some regional and commercial banks finally lead to further economic contraction to the Great Depression [1]. Because the Federal Reserve Bank system was not the centralized institution we know today, there was no coordinated national response to this financial crisis. In fact, regional Federal Reserve governors intervened in ways that conflicted with other interventions that increased the severity of the crisis [2]. Many laws and regulations have changed the financial system of the United States since the Great Depression to maintain a much more healthy and functioning banking system.

As we have seen over the past 50 years, the Federal Reserve is now very proactive to prevent a banking crisis from becoming a national economic crisis. Examples of this can be seen in the Savings and Loan crisis of the 1980s and the intervention of 2008 to prevent a financial collapse from spreading past Lehman Brothers and Bear Stearns.

There are many pundits and 'experts' predicting an economic depression from today's coronavirus pandemic. With the response from the Federal Reserve, the stimulus from the Federal Government, and the news of progress towards a vaccine, the chances of a prolonged economic depression have been reduced and it does not seem likely.

Looking at previous economic downturns and market reactions

At times there appears to be a disconnect between the stock markets and the growth of the global and US economies. In theory, it makes sense that as the economy grows or contracts, the stock market should be going in the same direction. This is not always the case. In the short-term, the direction of the economy and the stock markets can be much different. Recently, Economist and Nobel Laureate Paul Krugman commented in the New York Times "the stock market is not the economy."^[3]

Below are just a few of many headlines in 2009 after the stock market recovered but the economy was still in its latest downturn:

- *June 24, 2009*: Warren Buffett to CNBC: 'U.S. Economy In "Shambles"... No Signs of Recovery Yet'
- *April 6, 2009*: George Soros to Reuters: 'The U.S. economy is in for "a lasting slowdown" and won't recover this year, while "the banking system as a whole is basically insolvent"'.
- *November 6, 2009*: The New York Times, 'U.S. Unemployment Rate Hits 10.2%, Highest in 26 Years'^[4]

By the time the New York Times had reported October 2009's unemployment report, the S&P 500 had gained over 58% since its March 2009 low.

Exhibit 1 below shows recessions over the last 75 years and the returns of the S&P 500:

Exhibit 1: S&P 500 Returns Before, During, and After Recessions^[5]

Dates of Recession	1 Year Prior	During Recession	1 Year After	3Years After
11/1948 – 10/1949	+5%	+5%	+33%	+23%
7/1953 – 5/1954	+2%	+19%	+44%	+67%
8/1957 – 4/1958	-2%	-5%	+40%	+59%
4/1960 – 2/1961	+1%	+15%	+16%	+33%
12/1969 – 11/1970	-12%	-1%	+14%	+29%
11/1973 – 3/1975	-9%	-17%	+26%	+19%
1/1980 – 7/1980	+17%	+11%	+13%	+52%
7/1981 – 11/1982	+13%	+8%	+25%	+54%
7/1990 – 3/1991	+12%	+6%	+13%	+32%
3/2001 – 11/2001	-17%	-3%	-18%	+8%
12/2007 – 6/2009	+6%	-37%	+19%	+45%
Average	+1%	-1%	+20%	+38%

It is difficult to see a pattern correlating stock market returns and economic growth before and during recessions. It becomes evident that stock market returns are normally very strong as economic growth returns after a recession.

Conclusion

The long- and short-term outcome from this pandemic along with the questions of the stock market and economic growth will only be answered in time with the advantage of hindsight. Research proves over and over again we can not predict if the markets will rise or fall in the short term.

Rather than going with a 'gut feeling' about where the stock market will be in the future, we believe investors can benefit by looking back in history to see how markets have reacted before, during, and after previous economic downturns. This is using history as a guide.

“I believe that the more you know about the past, the better you are prepared for the future.”

- Theodore Roosevelt

We wish you and your families health, safety, and happiness.

Thinking of you always,
Gregory, Gabriella, Brian, Chris, and Samer

References

[1] Banking Panics of 1930-31, Gary Richardson, Federal Reserve Bank of Richmond, https://www.federalreservehistory.org/essays/banking_panic_1930_31

[2] The Great Depression, Gary Richardson, Federal Reserve Bank of Richmond, https://www.federalreservehistory.org/essays/great_depression

[3] Paul Krugman, ‘Crashing Economy, Rising Stocks: What’s Going On?’, The New York Times, April 30, 2020, www.nytimes.com/2020/04/30/opinion/economy-stock-market-coronavirus.

[4] Peter S. Goodman, ‘U.S. Unemployment Rate Hits 10.2%, Highest in 26 Years’, The New York Times, November 6, 2009, www.nytimes.com/2009/11/07/business/economy/07jobs.

[5] Historical S&P 500 Data retrieved from Schiller, Robert, U.S. Stock Markets 1871-Present and CAPE Ratio, www.econ.yale.edu/~shiller/data.

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