What Causes a Recession?

Harry S. Truman once said, “It’s a recession when your neighbor loses his job; it’s a depression when you lose yours.” This article will explore the causes of recessions and its impact on investors.

A recession is simply defined as a period of two or more consecutive quarters in which the economy contracts, as measured by gross domestic product (GDP). Stated another way, a recession is when there are at least six consecutive months when economic output is decreasing. Generally, a recession is marked with higher unemployment rates, falling wages, and possibly even falling prices (deflation).

The economic cycle is important for investors to understand as economic cycles highly influence near term stock and bond market returns. For example, in years when there has not been a recession, the S&P 500 stock index1 has produced positive returns 84% of the time2. For bonds, recessionary periods generally lead to declining interest rates which lead to higher bond prices.

Recessions are bred from overages, or excesses that build up as a result of overconfidence, overspending, oversupply, or over borrowing. These overages lead to unbalanced and unsustainable economic conditions which are ultimately flushed out and corrected through a recession. This purging of excesses sets that stage for future economic growth and recovery.

There have been three recessions in the United States in the last 30 years. According to LPL Financial Research3, “Overspending clearly played the largest role in the 1991 recession, as a wind-down of the runaway inflation of the late 1970s and early 1980s triggered spending sprees from consumers and businesses alike. Prior to the 2001 recession, it was confidence that peaked as overzealous investors chased overvalued dot-com stocks with misplaced conviction. And the Great Recession of 2008 saw subprime loans surge and consumers using their homes as credit cards to propel the over borrowing component to record levels.”

It is difficult to detect exactly where excesses are currently building within our economy or timing when that bubble will burst leading to the next recession. As investors, we cannot control economic cycles so our efforts should instead be focused on what we can control. Despite where we are in the economic cycle, it is our belief that investors will be served well by clearly defining their investment goals and objectives, diversifying and maintaining balance, and keeping perspective while avoiding panicking behavior.

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*1 –* *The S&P 500 is an unmanaged index and cannot be invested into directly. Past performance is no guarantee of future results.*

*2 - LPL Research: Outlook 2017 Executive Summary. https://rc.lpl.com/content/dam/rc/documents-new/Research/Publications/Outlook/Outlook\_2017\_ExecutiveSummary.pdf*

*3 – “The Over Index”updated November 2016. http://lpl-research.com/~rss/Thought\_Leadership/TL\_OverIndex.pdf*