MARKET MOVERS

History Lessons: Past Recessions Yield a Few Clues

Stocks Can Suffer Badly, As Happened During '01, But Not So in 1990-91

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If the economy is heading into recession, as many on Wall Street fear, history may offer some clues about what that might mean for stocks.

No two downturns are alike, but a look at market performance during previous recessions gives some clues about whether the market will have a relatively smooth rebound, meaning investors should be setting themselves up for the recovery, or a long, tough slog.

In many ways, today's situation is reminiscent of the recession of 1990-91, which featured a housing bust and piles of bad loans, which hurt banks. The Federal Reserve started cutting interest rates even before the recession began. The economic downturn was no day at the park, but it was fairly easy on stocks, which rose during the recession and managed to avoid a bear market.

Stocks and Recessions

Recessions don't always coincide with stock drops. Performance change in the S&P 500 index before, during and after recessions.

Recession period	Six months before	During recession	Six months after
Dec. 1969 - Nov. 1970	−8.9%	**−11.3%**	20.5%
Nov. 1973 - March 1975	1.1	**−24.7**	6.5
Jan. 1980 - Nov. 1980	5.8	**5.8**	18.8
July 1981 - Nov. 1982	−3.8	**1.9**	23.0
July 1990 - March 1991	−0.5	**2.5%**	7.7
March 2001 - Nov. 2001	−18.3	**−8.1**	−6.3

Source: Standard & Poor's

In the 1970s and in 2001, recessions were marked by nasty bear markets. In both cases, investors ignored the risks that were building in the market, believing that high valuations were justified, be they on houses or stocks, because prices would continue rising. The earlier recession also featured soaring energy prices.

In the more benign scenario, market performance is ugliest before and in the early days of a recession as investors panic about the effects of a downturn on earnings. In the three recessions between 1980 and 1991, stocks turned positive before the recession ended, leading to runaway gains in the months after the downturn. Stocks on the whole rose modestly during those recessions.

"The stock market is a powerful discounting mechanism, so by the time it becomes clear to everybody we're in a recession, the market has factored in the ensuing recovery," said John Bollinger, president of Bollinger Capital Management in Manhattan Beach, Calif.

But that isn't always the case. Stocks fell during the recessions of the 1970s and 2001. The circumstances of those downturns may be helpful when thinking about today's market.

What happens to the economy -- how much it contracts and how high unemployment rises -- doesn't necessarily determine how the market performs. The 1973-75 recession is generally considered the worst since World War II, and the market selloff associated with it was appropriately ugly. The S&P 500 fell about 25% from the beginning to the end of the recession, as defined by the National Bureau of Economic Research, and the index fell about 48% during the entire bear market.

The 2001 recession was caused by the double whammy of the popping of the technology-stock bubble and a major corporate-profit downturn. Though the labor-market downturn that followed was tough, the effect on economic growth was arguably quite mild.

But the stock market's decline was prolonged and ugly. The S&P 500 fell about 8% during the recession and about 49% during the entire bear market, the steepest decline since World War II. The S&P 500 was still down nearly 18% a year after the 2001 recession was over. Typically, stocks are higher 12 months after a recession.

The fact that the chain of events stretched out longer than usual may have prolonged the market's agony. That could be a bad omen for today's market, given the slow unfolding of the housing debacle. But the market's decline was largely caused by the tech-stock bubble that preceded it.

That should give investors confidence, because the valuation of the market appears relatively inexpensive. The price/earnings ratio for the S&P 500 today, when looking ahead to 2008 earnings, is just 13.8. That could mean the index doesn't have much further to fall.

The anomaly in the market over the past few years has been the strength of corporate profits. If profits return to their long-term trend, then forecasts for earnings growth this year could be too optimistic. In that case, the low P/E multiple would be misleading.

"The market is not as cheap as it looks," said Alec Young, equity market strategist at Standard & Poor's. "People know that these [earnings] numbers are too high."

The S&P 500 has fallen just 10% from its latest peak. A recession could drive it lower. But some industries, such as the financial sector, may already be priced for the worst. Industries that have benefited from strong global growth, such as basic materials and technology, could suffer much more if the U.S. economy's problems deepen.

The economy "is not going to turn around on a dime; this could grind on for quite some time," said Tim Hayes, chief investment strategist at Ned Davis Research. One risk today is that a recession could make the housing market worse, because job losses tend to be the biggest cause of mortgage defaults, so home prices would keep falling. That would mean still more trouble for the home-building sector and for banks plagued by toxic subprime assets, delaying the recovery of their earnings.

If a recession's cause does hurt stock performance, the 1973-75 downturn offers another ominous precedent: It was driven mainly by an oil-price shock, and oil prices are near record highs once again.

But crude's climb has taken much longer than it did 30-plus years ago, giving consumers time to adjust. And the economy relies much less on oil than it did then, so $100 oil likely will do less damage.

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