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Planning for the recession: More comparisons to the past

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In brief: As we noted last week in the first installment of this series, we have been receiving a steady stream of client inquiries about scenario planning for the recession, and we expect these questions to multiply now that the US has recorded a second consecutive quarter of negative GDP growth. In last week's post, we reviewed how current economic conditions are similar to and differ from the environment of 2007–2009. In this second installment, we look at comparisons to other past recessions, including those of 1973, 1981, 1990, and 2001. We conclude that it would be a mistake for strategy planners to adopt the recession of 1990 as their base-case planning scenario, thereby dismissing the possibility of a more serious event.

The US economy contracted by 0.9% (on an annualized basis) in the second quarter of 2022, after contracting by 1.6% in the first quarter. The combined contraction over the first half of 2022 was 1.3% (annualized), which surpasses the entire 0.14% contraction (annualized across three quarters) seen in the 2001 recession. While a recession can occur even in the absence of two consecutive quarters of contraction (i.e., 2001 featured one quarter of growth sandwiched by two quarters of contraction), every instance of two consecutive quarters of declining GDP has marked a recession.

As we've highlighted in other pieces, we are currently concerned by two economic dynamics:

- The Federal Reserve is tightening monetary policy into the beginning of recession.

- The size of the financial economy, relative to the real economy, has skyrocketed over the past several decades.

This combination makes scenario planning based on historical comparisons especially challenging because we haven't seen the overlap of these two conditions since World War II. The Federal Reserve has not had to prioritize inflation fighting above all else, at least not to this degree, in over 40 years. And what did not exist *until* the last 40 years is a large financial economy (relative to the real economy), a trend we've referred to in our other writing as the age of capital superabundance.

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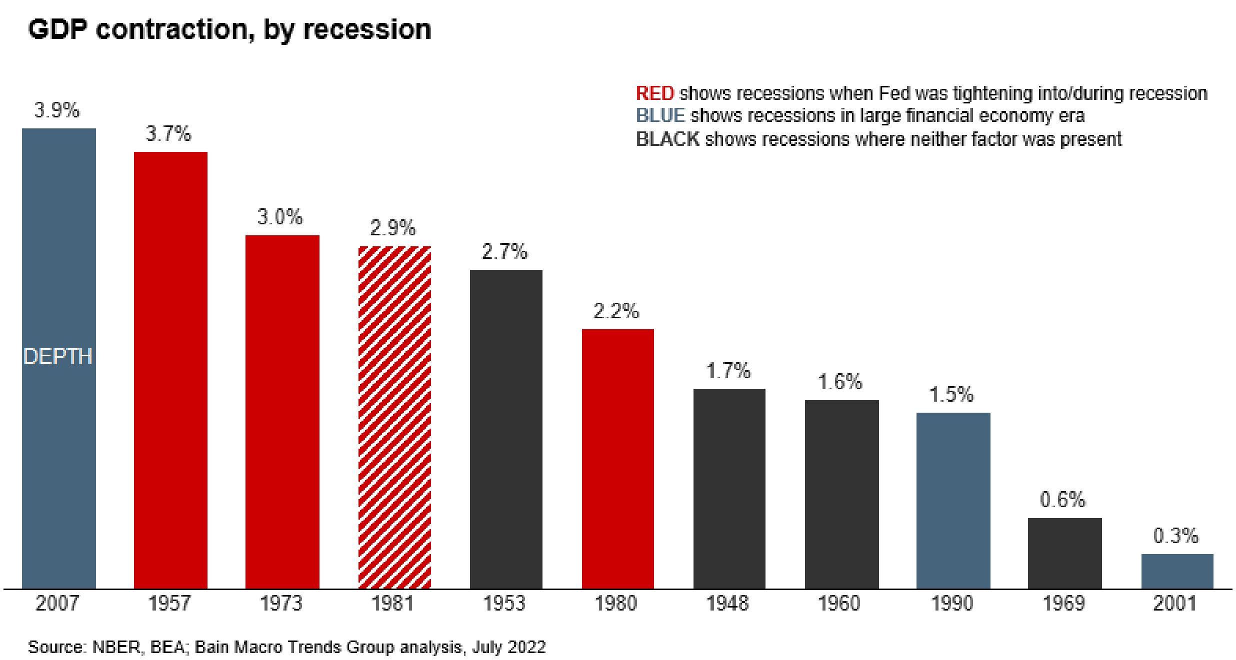
While there is no perfect historical comparison to current conditions, the record does offer some lessons about what recessions look like when these conditions are in place (see Figure 1).

Figure 1: Depth of GDP contraction, by recession, 1948–present



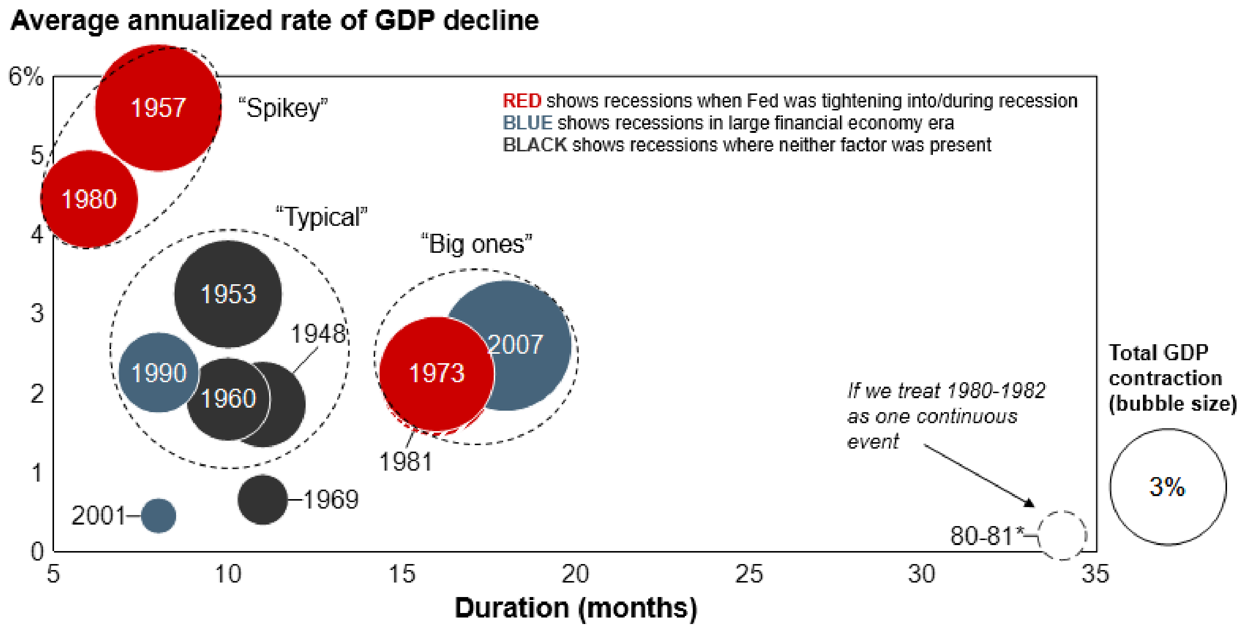
Monetary tightening into the start of a recession clearly exacerbates the contraction. The figure above depicts the 11 recessions since World War II (we excluded the 2020 pandemic contraction from this analysis, as it's not a comparable event). Four of the six most severe recessions involved monetary tightening into recession (these are highlighted in red); the 2007–09 recession was the major exception. Three out of the four largest quarterly declines within a recession were recorded in the instances in which monetary tightening continued into the recession. Of course, this is not surprising: monetary policy effects have long lags, so tightening into a recession will cause downward pressure to persist even as an economy is already in the midst of a recessionary process.

With respect to the size of the financial economy, the historical record on this factor is mixed. A key concern of ours, reflected in our commentary in recent years, has been that the extraordinarily large size of the financial economy relative to the real economy has introduced a fragile dynamic that appears to require ever-increasing monetary interventions when under stress. The three recessions that have occurred during the age of capital superabundance include the deepest recession since World War II but also two out of the three most shallow recessions. It's possible that recession outcomes in the era of capital superabundance are somewhat bimodal, depending on whether monetary interventions are well-played (as they were in 1990 and 2001) or inconsistent (as we saw after Lehman collapsed).

At present, based on the key factors outlined above—inflation-fighting monetary tightening into a recession and a financial economy bigger than it has ever been relative to the real economy—we think a 2001-type scenario (with a <1% GDP contraction) is now assuredly off the table. At the moment, a 1990-type scenario featuring a 1–2% contraction lasting less than a year represents one of the better plausible paths for the US economy. That said, we caution planners against relying on this scenario as their base case, as the growth in the size of the financial economy since 1990 may have increased systemic fragility.

As we discussed in the first piece in this series, the current macroeconomic climate bears a notable similarity to the climate preceding the recession of 2007–2009. This is also the only recession in recent history that resembles (in depth, duration, and pace) those of previous high-inflation eras in which the Fed tightened into the contraction (e.g., 1973 and 1981). As Figure 3 illustrates, the recessions of 1973, 1981, and 2007 are a cluster by themselves with respect to duration and severity.

Figure 2: Recent recessions, by annualized rate of GDP decline

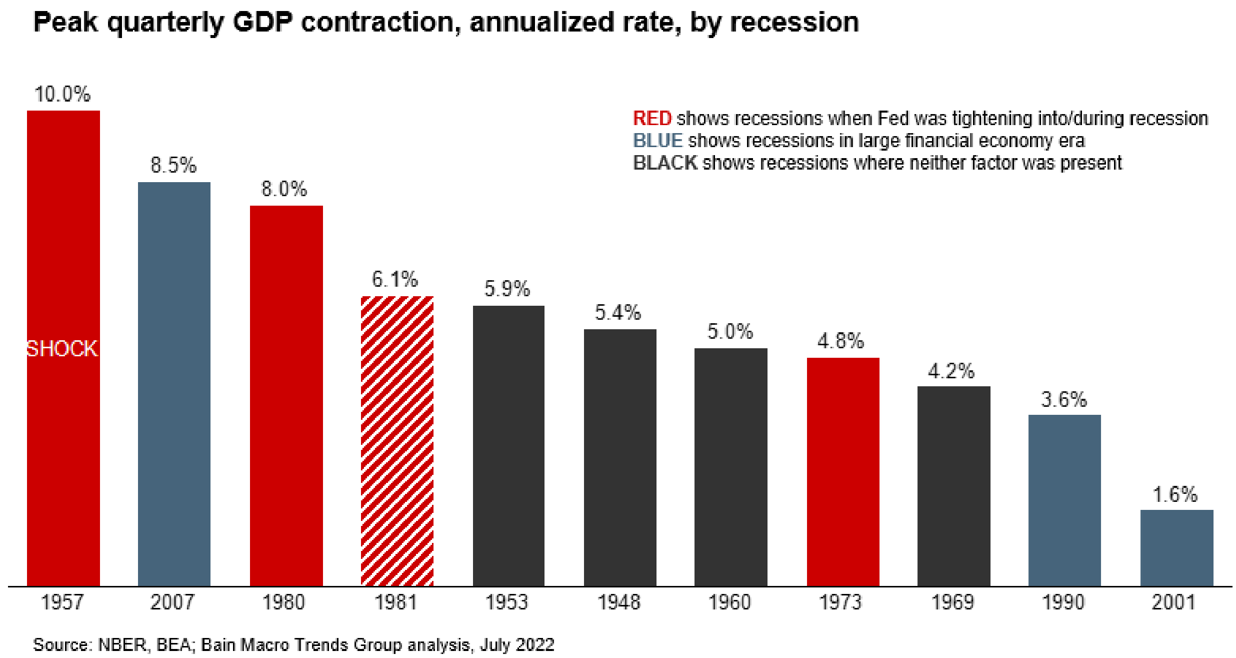


Source: NBER, BEA; Bain Macro Trends Group analysis, July 2022

Because of these similarities, we believe companies must take seriously the possibility that this recession may repeat key elements of the recession of 2007–2009.

That said, there are two factors that should be considered when relying on historical analogies for forward-planning purposes. The first concerns the accelerated pace of macroeconomic developments we've seen throughout the current business cycle. If this accelerated pace carries over into the actual recession, we may see a recession that's shorter than that of 2007–2009 but that features a higher peak intensity. The peak (annualized) quarterly GDP decline in the 2007 recession was 8.5%, the second-highest (excluding the pandemic experience) in modern history. The largest peak decline on record was the 10% decline of the 1957 recession (see Figure 3). While the economy of today is vastly different from the economy of the 1950s and we thus would not typically recommend comparing the two, the CPI has recently accelerated to a pace and a level that's roughly equivalent to that of the 1950s; we find no other period as comparable with respect to pace of change.

Figure 3: Recent recessions, by peak contraction



The second factor concerns timing. The US economy has already slipped into recession, a reality only now acknowledged by official indicators, just as we saw in the first half of 2008. The first-quarter US GDP contraction of 1.6% was not easy to dismiss, though many did. Real final sales of domestic product (on a rolling three-quarter basis) dropped below 0% in the first quarter; this metric has a perfect record of predicting past recessions and has done so again. If the timing of this recession is a bit of a surprise to some, it is because leading indicators like the recently released July PMI data are just now starting to point downward, which suggests the US economy may contract even more steeply in the second half of the year than it did in the first half. Putting these different pieces together—a shorter, sharper recession than 2007–09, of similar total depth, that may have already technically begun in the first quarter—would imply a scenario with, at a minimum, a very bumpy second half of 2022.

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A 2008-type scenario would require the emergence of a Lehman-type trigger event. As we explained last week, the Great Recession began with a fairly mild initial contraction that went largely unnoticed; it was Lehman's failure in the second half of 2008 that acted as the trigger for a much deeper downturn. Today, there are any number of complications that could arise in the second half of 2022, serving as the trigger for a deeper downturn, including the potential for an unprecedented winter energy shortage in Western Europe (and the global havoc that would emanate from such a development), new supply chain snarls, and ongoing havoc in the financial markets. We are especially concerned by the potential for more turbulence in the financial markets. The global equity and bond markets—which gained $56 trillion in value (or 29%) over the course of the pandemic—lost $31 trillion (or 12%) in value during the first six months of 2022. Unlike in 2008, when equities were pummeled but bonds rose, the rout of the past six months has been synchronized. One major investment bank recently noted that the year-to-date performance of global benchmark 10-year US Treasuries was the worst since 1788; bonds more generally have suffered their biggest YOY loss since 1920. This unprecedented loss was met with a detachment and complacency that we fear could soon be replaced by volatility in both the financial markets and the Fed's monetary policymaking.

It's certainly possible that a trigger event will not materialize, in which case the recession of 1990 is a reasonable comparator for planning purposes. However, the array of serious and interlinking challenges currently confronting the global economy—some of which stem from the disruptive events of 2020 and others that are the culmination of policies that far predate the pandemic—argues for strategy planners to carefully consider the possibility that we may see a deeper downturn. That said, fiscal and monetary intervention will also shape the path of this recession. The pandemic created a new global high-water mark for throwing money at the problem of an economic slowdown, and we see no reason to expect thrift in the face of a new major recession. How much shorter might the 2007–09 recession have been (at least initially) if trillions of dollars of stimulus money had been mailed out to millions of households? How much sharper might the rebound have been? How much earlier might inflation have become entrenched? On the other hand, less intervention than expected (if, for example, another surge of inflation stays central banks' hands) could be a rude awakening for financial markets and could cast a pall over the recovery.

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