Recessions in the service age

"Recessions have become less common and, when they occur, less severe than in the past."

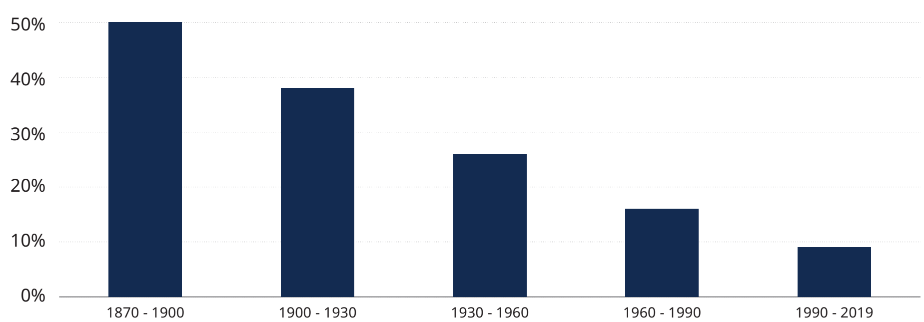
David Arpin
MA, CFA

Senior Vice President,
Portfolio Manager, Team Co-Lead
Mackenzie Bluewater Team

Historically, the biggest drawdowns (i.e., losses of capital) for equity markets have tended to happen during recessions. As conservative growth investors, the Mackenzie Bluewater Team maintains a strong focus on risk management, making the understanding of economic downturns an important part of our investment process.

When looking back in history, the amount of time the United States economy has been in recession has steadily declined over the past 150 years.

U.S. economy – percentage of months in recession



Source: National Bureau of Economic Research

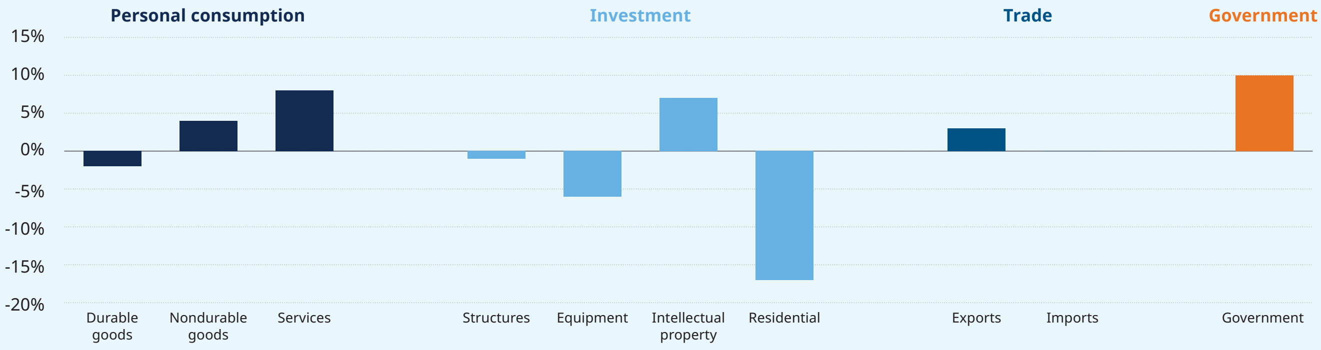
In the late 1800s, the U.S. economy was in recession nearly 50% of the time. This rate has dropped to less than 10% today, in what appears to be a gradual structural change in how the economy works.

What parts of the economy are cyclical?

If we look at the components that make up the U.S. economy, as measured by gross domestic product (GDP), some parts of the economy are clearly more cyclical than others (i.e., depending on conditions at the time, they tend to alternate between periods of strength and periods of weakness). In the chart below (page 2), we show the average growth across the past six recessions (November 1973 to March 1975, January 1980 to July 1980, July 1981 to November 1982, July 1990 to March 1991, March 2001 to November 2001, and December 2007 to June 2009) in the U.S. for the major components of GDP.

MACKENZIE
Investments

Average growth rates over the last six U.S. recessions



Source: Bureau of Economic Analysis; calculations by Mackenzie Investments

None of this is surprising, as we all know that certain parts of our spending are easier to cut back on (e.g., home renovations, buying a new car) than others (e.g., health care, utility bills). When spending is cut back for the entire economy, it signals a recession.

The least cyclical areas in the chart above are personal spending on services (which includes household spending on heath care, rent, utility bills, telecommunications and education), investment in intellectual property and government spending.

Several categories appear to be semi-cyclical, including personal spending on nondurable goods (gasoline, food, clothing) and trade.

Some categories appear very cyclical, shrinking during past recessions. These include personal spending on durable goods (cars and appliances) and business investment in new buildings and equipment. Finally, spending on residential construction—building new houses—has been the biggest determining factor of recessions in U.S. GDP. Although it is tempting to assume this purely comes from the deep housing downturn during the 2008-2009 recession, it does not. Generally, housing investment has fallen at double-digit rates during U.S. recessions, leading one economist in 2007 to declare that "Housing IS the Business Cycle" [1].

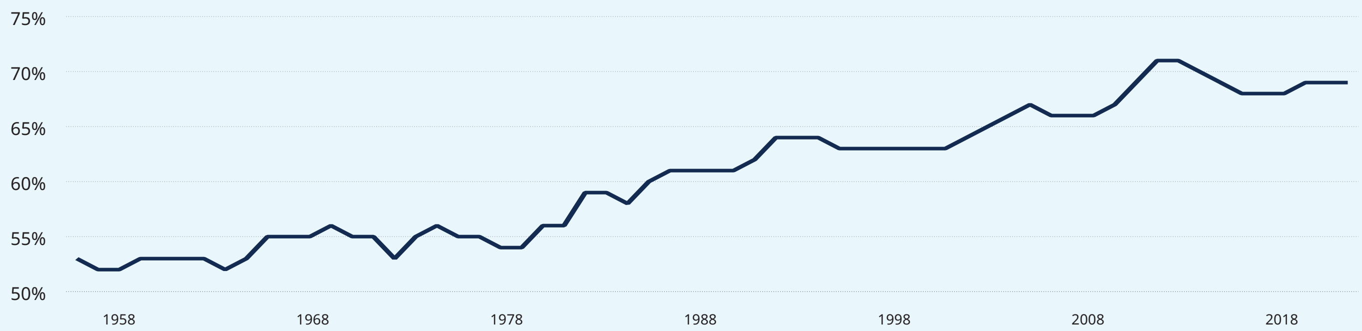
Why might the economy be less cyclical today than in the past?

Over the past 150 years, we have seen a gradual change in the importance of various industries. In the late 1800s, the U.S. economy was very rural, with around 40% of families living on the farm [2]. Farming is a highly cyclical industry, with good years and bad years, and this cycle was reflected in the economy, with recessions occurring roughly 50% of the time. As the economy evolved, manufacturing rose in importance, peaking at more than 30% of employment in the 1950s.

Manufacturing can be seen as a cyclical area, although cycles do not happen as often as they do for farming. As a result, the economy became less prone to recession.

The past 40 years has seen a steady increase in the importance of services, intellectual property and government, as shown in the chart below (page 3).

Non-cyclical percentage of U.S. GDP



Source: Bureau of Economic Analysis; calculations by Mackenzie Investments

As the non-cyclical components of GDP have become a larger percentage of the entire economy, it seems almost inevitable that GDP itself would gradually become less cyclical—that recessions would be less common than in the past. This shift is exactly what we find when looking at history.

Are recessions a thing of the past?

If the economy is structurally becoming less cyclical, does this mean that recessions will no longer occur? In our view, this is very unlikely. Although services are a rising component of GDP, the cyclical areas remain large enough to pull the overall economy into (and eventually out of) a recession, as most recently demonstrated during the Global Financial Crisis (GFC) in 2008-2009.

The greater stability of the economy was also demonstrated in this tumultuous 2008-2009 time period. The GFC is generally viewed as the worst downturn since the Great Depression of the 1930s, yet there is no comparison if you look at the underlying economic data. From peak-to-trough (i.e., from the high point to the low point), the U.S. economy shrank 2.2% in 2008-2009. During the Great Depression, the U.S. economy shrank by a staggering 45%.

Conclusion

Over the past 150 years, it appears that the gradual shift in the economy from farming to manufacturing to services has made the economy less cyclical. Recessions have become less common and, when they occur, less severe than in the past. From an investment perspective, this suggests that investors should expect longer cycles with fewer dramatic swings. In our view, the Bluewater Investment Style, focused on finding companies that can consistently and steadily outgrow the overall economy, is well suited for this economic environment.

MACKENZIE
Investments

For more information about the Mackenzie Bluewater Team, please contact your financial advisor.

[1] E. Leamer, 2007. "Housing IS the business cycle," Proceedings - Economic Policy Symposium - Jackson Hole, Federal Reserve Bank of Kansas City, pages 149-233.

[2] Jayson L. Lusk, 2016. "The Evolving Role of the USDA in the Food and Agricultural Economy", page 7.