

What Happens to the Stock Market During a Recession?

As inflation continues to put pressure on household budgets across the country, it's not surprising that many people are worried about the potential impacts of a recession. However, the National Bureau of Economic Research (NBER) hasn't officially declared that the U.S. economy is in a recession.

Nevertheless, fears of a recession have been circulating for over a year. If those fears become a reality, everyone will want to know how that will impact their financial situation.

Let's explore what happens to the stock market during a recession and how a recession might affect you.

Key Takeaways

- When a recession occurs, stock market returns often decline.
- Falling stock prices aren't the only potential implications of a recession.
- Preparing for a recession can include building up savings, paying down debt, and refining your investment strategies.

What Happens to the Stock Market During a Recession?

When the economy falls into a recession, stock market returns usually plummet into the red. For example, in the 2008 recession, S&P 500 returns for the year were 38.5%.

However, the stock market doesn't always follow this pattern.

In the 2020 recession, S&P 500 returns for the year were 16.3%. During that recession, the stock market put up some impressive returns.

While it's possible to predict what will happen to the stock market based on historical data, only time will tell what will actually happen.

The Chain Reaction of Inflation

Fear of a recession ramped up in 2021 when the annual inflation rate started reaching heights not seen since 2008. As the inflation rate crept over 5.0%, people began to fear the Federal Reserve would raise interest rates to fight the climbing prices.

Interest rates are the main piece of monetary policy the Fed can control. When the Fed raises the federal funds rates, it influences the rate at which banks lend each other cash from their reserves. Banks have to meet specific reserve requirements related to how much cash they keep on hand, so when the cost of borrowing money from each other increases, it incentivizes banks to save money.

Not only will short-term interest rates typically increase when inflation is high, but interest rates on savings accounts start to increase. This is to encourage individuals to deposit their money with banks.

When interest rates increase, it also drives the yield on bonds higher. Higher bond yields make existing bond yields seem comparatively low, driving down their price on the secondary bond market.

As consumer borrowing becomes more expensive, discretionary spending decreases, and businesses stop expanding at their previous rate. This is good for prices as the decreased demand allows prices to drop, but it can be risky for the economy. As

demand decreases, it's possible companies will start laying off workers to save money. This can drive demand even further down.

Investors pull their money out of the stock market, the drop in demand damages corporate profits, and optimism about the economy wanes. The Fed walks a fine line between driving down inflation and pushing the economy into a recession. While the Fed ideally wants to create a soft landing where inflation decreases without causing a recession, this is sometimes a precarious scenario to manufacture.

How Will a Recession Affect Me?

The unpredictability and potential for significant losses put many investors on edge as the threat of a recession looms. A recession isn't a positive experience for most people, and the reality is that it impacts everyone who participates in the economy in some way.

Typically, you'll see your stock portfolio go down during a recession. The dropping stock values partly stem from massive sell-offs as many investors try to get out of the market.

As more investors sell their shares, the stock prices fall. This can become a vicious downward spiral as more investors get spooked and sell off their stock portfolios. Even companies in an excellent position to ride out the new economic climate may see their stock prices fall.

Unfortunately, many investors lose significant value from their portfolios when a recession strikes. This is especially true for investors who choose to sell, which essentially locks in their losses.

To avoid significant losses, many experts advise focusing on the long-term. Instead of trying to avoid the fall, look at the overall plans for your portfolio.

Before a recession, it's best to evaluate your portfolio goals regularly. You can avoid selling at an inopportune moment of panic through regular rebalancing and a long-term focus.

Beyond the stock market, a recession can significantly impact your financial situation. As the economy slows, some businesses lay off workers. If you are unlucky enough to lose your job, surviving the recession might come down to how much money you've saved.

2022 and Recessionary Fears

Many people were afraid of a recession in 2022 for several reasons. The Russian invasion of Ukraine caused worldwide economic uncertainty and created an energy crisis in Europe. Gas prices increased as many countries instituted boycotts of Russian power, and investors were warier about putting their money into risky assets with the threat of global conflict.

Inflation also reached frightening heights in 2022, with the annual rate peaking at 9.1% in June. High oil prices, food prices, and shelter costs kept the Consumer Price Index high for months, and the Fed led an aggressive rate hike campaign, decreasing discretionary spending and pushing mortgage rates to historic highs.

Corporations saw significant hits to their revenue reports last year, with thousands of layoffs and reduced company spending dominating headlines. It was a generally pessimistic year, as investors saw prominent cryptocurrency exchanges crash, the largest-ever outbreak of avian flu, and layoffs across the tech industry.

2023 and Recessionary Fears

Though most experts still anticipate the NBER will announce a recession in 2023, investors seem to have more optimism so far

this year. The Fed has yet to stop its rate hike campaign, but analysts expect just one more hike this year before rates drop again.

Food prices have also started to drop, and the annual inflation rate decreased to just 5.0% in March 2023. However, this is still well above the target of 2%, so the campaign may continue if the Fed's next rate hike doesn't lead to the results they want to see.

Bitcoin, which saw its value crash from over \$60,000 in 2021 to under \$20,000 in 2022, has rebounded these first few months. The recent collapse of Silicon Valley Bank may have partially encouraged this price jump, as it caused some investors to express skepticism over centralized banking.

How to Prepare for a Recession

Preparing for a recession can help you avoid unnecessary financial hardship. The appropriate preparations vary based on your unique situation.

Here are some ways you can help your household weather the storm.

Build an Emergency Fund

Many experts suggest maintaining an emergency fund with enough money to cover three to six months of expenses. If you lose your job or face unexpected expenses, you can rely on these funds to survive.

For example, if your job unexpectedly fires you and one of your children happens to break their leg one day coming home from school, you'll need your emergency fund to help pay for the medical bills.

Pay Down Debt

Debt can be a real drain on your finances since monthly payments can quickly add up. If possible, pay off high-interest debt first. Financial experts refer to this as the snowball method of paying off debt. It helps to automatically direct a portion of your paycheck toward debt payments every month if you're a forgetful person.

During a recession, you'll be happy to have more wiggle room in your budget.

Hold Off on Major Purchases

If you can avoid making a large purchase, consider holding off until you know more about what's going on with the economy. As an example, you might decide to wait to replace your current vehicle if it's still a safe driving option.

How to Invest During a Recession

As an investor, a recession presents an interesting mix of possibilities. On the one hand, some investors will panic and sell off their holdings. Conversely, some investors treat a recession like a discounted buying opportunity.

The right approach is likely somewhere in the middle. While some investors prefer a more hands-off approach involving investing in an index fund, others prefer to adjust the market on the fly.

Remember that not every industry will be impacted by a recession equally. Stock for discount retailers, utility companies, and grocery companies tends to stay relatively stable during a recession, as their products are essential.

Changing market conditions are bound to impact your investment portfolio. With that, monitoring various economic indicators

can help you make necessary adjustments.

The downside is that staying on top of these indicators takes time and effort. Luckily, as technology evolves, people have invented ways to outsource this sometimes tedious task to a portfolio powered by artificial intelligence (AI).

The Bottom Line

When a recession hits, stock market returns usually drop like a rock. Beyond a falling portfolio, some may have to face a job loss during a recession. 2022 saw many publications and individuals predicting the NBER would call a recession sooner rather than later. Though they have yet to call it, many experts predict it will happen later this year.

You can prepare for a recession by making yourself even more essential to your team at work to avoid being laid off. You can also build an emergency fund and work to pay off debt.

As an investor, keeping up with market changes is the best way to inform your financial choices.

The post [What Happens to the Stock Market During a Recession?](https://www.entrepreneur.com/finance/what-happens-to-the-stock-market-during-a-recession/454320) appeared first on Due.

<https://www.entrepreneur.com/finance/what-happens-to-the-stock-market-during-a-recession/454320>