Has the U.S. Stock Market Discounted a Recession?

- January 22, 2008
**Summary**

**Key Takeaways:**
- Important thing is not whether the U.S. economy has or may enter recession, but to what extent the stock market may have already discounted economic weakness.
- Today – as of January 22, 2008, the stock market had declined more than 16% from its October peak, in the neighborhood of previous recession-related declines in 1980 and 1990.
- More volatility may be on the way, but Federal Reserve interest rate cuts and widespread recognition of the slowdown may indicate the stock market is closer to a “bottom” than a “top.”

**U.S. Recessions and the Stock Market (as of 1/22/2008)**

**Analysis of U.S. Economic Recessions:**
- Economic recessions generally take awhile to officially diagnose, on average being announced six months after the recession already began.
- Economic recessions generally coincide with stock market downturns; the last four recessions coincided with market corrections of between 17% and 49%.
- Because economic data lags & stock markets look forward, sometimes much of stock market declines have occurred before a recession is officially diagnosed.
- In two out of the four most recent recessions (1980 and 1990), the entire market decline occurred prior to the announcement of recession.
- During those two recessions, the market (represented by S&P 500 Index) registered significant rallies of more than 27% during the 12 months after the recession trough.

**Compare / Contrast:**
- 1982 – The stock market corrected even after the announcement of a recession, which was particularly painful because prior to the start of the recession the Fed had increased its key interest rate to 14%.
- 2001 – The stock market continued falling after the recession announcement due to lofty stock valuations and the bursting of tech sector bubble.
- 1990 – The circumstances surrounding this recession might be the most similar to today: a real-estate-induced economic downturn; a banking system spillover; the Federal Reserve already easing; and average stock valuations.
In two out of the four most recent recessions (1980 and 1990), the entire market decline occurred prior to the official announcement of recession, with significant stock market rallies during the 12 months after the recession trough.

The other two recessions (1981 and 2001) had different backdrops compared to today, with the Federal Reserve hiking rates in 1981 and lofty stock valuations in 2001.

The 1990 recession might be the scenario most similar to today, with a real-estate-induced economic downturn, a banking system spillover, the Fed already easing, and average stock valuations.

Please note: Past performance does not guarantee future results.

Sources: National Bureau of Economic Research (NBER), Haver Analytics, FactSet, FMRCo (MARE) as of 1/22/08
See last page for full sources and footnote information.
Of the most recent U.S. recessions, the 1990 episode appears to display the most similarities to today:

- In both instances, the U.S. economy slowed in the face of a weakening housing market exacerbated by real estate lending excesses (savings & loan crisis in 1990, subprime mortgage crisis today).
- Massive losses among financial institutions (and bankruptcies of S&Ls in 1990) threatened the banking system and resulted in tighter credit conditions for businesses and consumers.
- The Fed began rate-cut cycles prior to the beginning of the recession, lowering the federal funds rate from 8.25% to 3% (1990-92) and from 5.25% to 3.5% (Sep 2007 – Jan 2008).
- Valuations were near historical averages. At 15.2 at the beginning of the 1990 recession, the price-to-earnings (P/E) valuation for stocks was a bit below its historical average of 17.4, compared to slightly above (18.7) today.

Source: NBER, Haver Analytics, Factset, FMRCo (MARE) as of 1/22/08
Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.

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All recession dates are defined and announced by the National Economic Bureau of Research (NBER). Source: Haver Analytics, NBER as of 1/22/08.

Stock market returns represented by S&P 500 Index. Source: FactSet, FMRCo (MARE) as of 1/22/08.

Total stock market decline measures cycle peak to trough of period that coincides with an economic recession.

Fed action prior to recession indicates the most recent action taken by the Federal Reserve prior to the recession start date.

The stock market valuation is measured by the price-to-earnings (P/E) ratio of the S&P 500 Index, using 17.4 as the long-term historical average (Source: FactSet, Haver Analytics as of 12/31/07). The valuations immediately prior to the start of recessions were as follows: 7.5 (1980), 15.2 (1990), 8.6 (1981) and 25.5 (2001).

For recessions when entire correction occurred prior to the recession announcement, the recession trough was used as the starting point. For recessions when the correction continued past the recession announcement, the announcement date was the starting point.

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