Crucial Conversations
Putting Pullbacks in Perspective

Pullbacks & Bouncebacks

We can gain important perspective on market pullbacks by considering post-World War II declines in the S&P 500® Index. The majority of declines fall within the 5-10 percent range with an average recovery time of approximately one month, while declines between 10-20 percent have an average recovery period of approximately four months. Pullbacks within these ranges are not uncommon, occurring frequently during the normal market cycle. While they can be emotionally unnerving, they will not generally undermine a well-diversified portfolio and are not necessarily signals for panic. Even more severe pullbacks of 20-40 percent registered an average recovery period of only 15 months.

The Deeper the Stock Market Decline, the Longer the Recovery

<table>
<thead>
<tr>
<th>Decline %</th>
<th>Number of Declines</th>
<th>Average Decline %</th>
<th>Average Length of Decline in Months</th>
<th>Average Time to Recover in Months</th>
</tr>
</thead>
<tbody>
<tr>
<td>5-10</td>
<td>79</td>
<td>(7)</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>10-20</td>
<td>29</td>
<td>(14)</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>20-40</td>
<td>8</td>
<td>(27)</td>
<td>12</td>
<td>15</td>
</tr>
<tr>
<td>40+</td>
<td>3</td>
<td>(51)</td>
<td>23</td>
<td>58</td>
</tr>
</tbody>
</table>

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In contrast, pullbacks of 40 percent or more, while occurring much less frequently, post an average recovery time of 58 months and can potentially compromise an investor’s financial plan. Pullbacks above 20 percent (including all pullbacks above 40 percent), which have registered the longest recovery periods, have been associated with economic recessions. When evaluating a market pullback, the probability of a recession is a key insight to consider when determining whether or not to reduce equity exposure.

While recessions are readily identifiable in hindsight, prospectively they can be difficult to spot. This makes access to reliable market analysis all the more important when determining the probability of a recession.
“Looking ahead, we expect the economy to grow around a 2.0 percent pace in the third quarter.”

**Where Are We Now?**

(Guggenheim Investments provides its view of the current market environment - as of 8.2019)

U.S. economic growth slowed to 2.1 percent annualized in the second quarter from 3.1 percent in the first quarter. Personal consumption expenditures rebounded sharply, as expected, while government spending contributed an outsized 0.9 percentage point to growth, the most since mid-2009. However, negative contributions were seen from housing, business capex, inventory investment and net exports. Looking ahead, we expect the economy to grow around a 2.0 percent pace in the third quarter.

The Q2 gross domestic product (GDP) release also featured annual revisions to the five prior years of data, which showed that growth peaked in year-over-year terms in Q2 2018, earlier than previously thought. An upwardly revised personal savings rate gives consumption room to run, while downwardly revised and shrinking corporate profits will continue to pressure investment spending and could begin to weigh more heavily on hiring.

With growth in the first half of the year coming in somewhat above potential, the labor market continued to strengthen, albeit at a slower pace than the year before. Net monthly payroll gains averaged 172,000 in the first half of 2019, down from 235,000 in the first half of 2018. This was enough to push the unemployment rate down by 0.2 percentage point to 3.7 percent. While the labor market remains strong, we believe the sharper slowdown in aggregate hours worked—a component of our U.S. Recession Dashboard—foreshadows a deterioration in labor market conditions in 2020.

After a weak start to the year, core inflation picked up in the second quarter but remained below the Federal Reserve’s (Fed’s) target at 1.8 percent annualized. We expect inflation to firm a bit further in the second half of 2019. The Fed is also closely watching inflation expectations, which currently sit below levels the Fed would like to see.

Although the U.S. economy is in good shape overall, on July 31 the Fed announced its first rate cut since 2008 amid growing downside risks to policymakers’ baseline growth and inflation forecasts. Key among these are slowing global growth, the threat of additional U.S.-China tariffs and a possible hard Brexit, the odds of which have increased with the ascendancy of Boris Johnson as the U.K. Prime Minister. While a possible U.S. fiscal contraction in 2020 was averted by the recently-signed budget deal, we expect two more Fed rate cuts in 2019 as Fed Chairman Jerome Powell seeks to sustain the expansion. In our view, this could serve to embolden the White House to impose new tariffs on China and Europe later this year, which would in turn further cloud the outlook for global growth.

**Guggenheim’s Recession Dashboard and Recession Probability Model Point to the Next Recession in the First Half of 2020**

The business cycle is one of the most important drivers of investment performance. It is therefore critical for investors to have a well-informed view on the business cycle so portfolio allocations can be adjusted accordingly. At this stage, with the current U.S. expansion showing signs of aging, our focus is on projecting the timing of the next downturn.

Guggenheim has developed several tools to guide this effort. The last several expansions have shown similar patterns leading up to a recession. We have created
a Recession Dashboard of six indicators that have exhibited consistent cyclical behavior, and that can be tracked relatively well in real time. These six indicators include a measure of the unemployment gap, the stance of monetary policy, the shape of the yield curve, the Leading Economic Index, changes in aggregate weekly hours worked, and changes in consumer spending. In addition to our dashboard of recession indicators, we have also developed an integrated Recession Probability Model that attempts to predict the probability of a recession over six-, 12-, and 24-month horizons. Our methodology is explained in greater detail on our Forecasting the Next Recession page on GuggenheimInvestments.com.¹

Taken together, our Recession Dashboard and our proprietary Recession Probability Model point to the next recession beginning as early as the first half of 2020. Naturally, there are substantial risks that our recession date could be too early or too late. Nevertheless, we believe that successful investing requires a roadmap, as with any other endeavor. Our investment team uses this roadmap to help guide our portfolio management decisions in order to seek superior risk-adjusted performance over time and across cycles.


**Interval Since Last Pullback**

While there is a relationship between the days since the end of the last correction and the magnitude of pullback, as shown on page four, the majority of pullbacks during non-recessionary periods registered declines under 20 percent. As we discussed earlier, pullbacks falling within the 5-20 percent range historically experience recovery periods of one to four months. These are not periods typically associated with severe economic deterioration, and do not necessarily represent a signal to reduce equity exposure. As of the date of this analysis (8.1.2019), there had been 220 days since a non-recessionary pullback of greater than 10 percent.

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Putting Pullbacks in Perspective

Pullbacks are often not a time to panic and should rather be used as a reason to analyze and assess. Under certain circumstances, it may even be the case that a pullback represents an attractive buying opportunity for certain portfolios. The benefit of gaining reliable market and economic perspective is essential in preparing for market pullbacks. Rather than act on emotion, it’s important to put these events in context to determine what they mean.

Working with your financial advisor, you may then better assess any potential impact on your portfolio and implement a proper course of action.

To learn more, speak to your financial advisor about Guggenheim Investments’ timely insights and thought leadership.