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WHY RECESSIONS ARE GREAT

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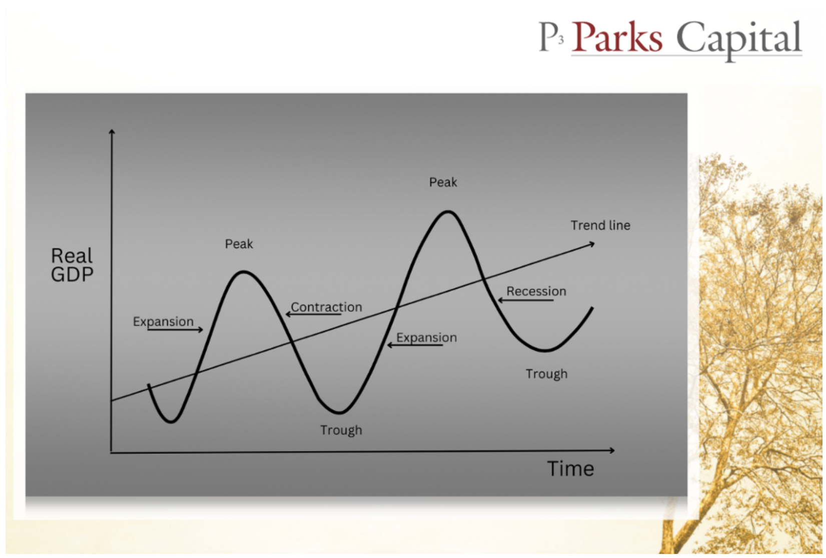
Introduction

On the first of February 2023, Fed Chair, Jerome Powell, announced that the Federal Reserve would be raising interest rates by a quarter of a percentage point, the smallest rate increase since March of 2022. While the market rejoiced at the suggestion of inflation beginning to calm down, Powell made it clear that in his eyes, the risk of not fighting inflation enough was more dangerous than fighting too hard and causing a recession (WSJ1). Even with the good news about inflation, over 60% of economists are still predicting there will be a 2023 recession, a part of the business cycle that everyone dreads (WSJ2).
Yes, recessions are painful and are equated with increased unemployment, tighter budgets, and just the general disruption of everyday life; we are all extremely well versed in the horrors of recessions, so today I will be making an argument for the opposite: why recessions are great!

What is the Business Cycle?

Okay, “great” might be a bit of an overstatement, but recessions are a necessary part of the business cycle. The business cycle is a pattern in the economy that continuously repeats itself. There are four stages of the business cycle: expansion, peak, contraction, and trough.



When the economy is in the expansion stage, the economy is growing. Productivity is on the rise, gross domestic product (GDP) is experiencing healthy growth, and prices in the market are rising, making both businesses and investors happy. The peak stage of the business cycle is when all that growth begins to level off; the economy has reached its fill and GDP stops growing as quickly as it was during the expansion stage (Balance).

Inevitably, after the peak stage, the economy begins to contract, more commonly known as a recession. During economic contraction, GDP begins to shrink, often leading to higher unemployment and lower prices throughout the market. Recessions are most often characterized by two successive quarters of declining GDP, but it is not a hard-and-fast rule. The fourth stage of the business cycle is the trough, when the rate of GDP decline begins to slow down and eventually transitions back to the expansion stage, beginning the cycle all over again (Balance).

Why Can't GDP Just Keep Growing?

Although frustrating and painful, recessions play a vital role in the health of the economy. Continuous growth in GDP cannot be healthfully sustained without the occasional reset. When the economy is booming, investors, consumers and businesses are excited about any and all prospects for the future. This is when "bubbles" in the economy are created; investors overvalue a commodity or asset, and its rising price is a result of investors not wanting to miss out on what seems to be a great investment. Intrinsic or "true" values of assets can be very difficult to determine, and this murkiness convinces investors that maybe things like Beanie Babies really are worth more than we originally thought (Investo1).

One of the earliest and most famous instances of a speculative bubble was the Dutch Tulip Bubble of the 1630s. With their rise in popularity, tulip prices skyrocketed with single bulbs costing as much as houses did in early 1637 (History). Unsurprisingly, consumers began to realize they may be overvaluing tulips, which lead to the bubble being burst and the price of tulips plummeting 99% by May 1637 (Investo1).

When the economy is growing very quickly, it is easy for assets and commodities like Beanie Babies and tulips to be overvalued because investors are excited; during the expansion stage, every idea sounds like a great idea. The economy gets overheated at this point and the market struggles to effectively evaluate what things are truly worth. If GDP were to have unchecked growth, valuing assets, commodities, or new inventions would be nearly impossible. A recession is reset for the economy, allowing it to slow down and reassess the valuations it has made.

How is a Recession Helpful?

The main way in which a recession helps the economy is by trimming the fat from the market and strengthening its foundations for future growth. When recessions occur, investors direct their money towards companies and commodities they believe in and start to pull away from those they think might be at risk. Unfortunately, this often means that companies go out of business, but taking the weaker links out of the market makes its foundation stronger in the long run.

Not only does the foundation become stronger, but gaps in the market that were previously in the shadows of those weaker businesses become exposed, creating opportunities for innovation and better efficiency. Take the Great Recession of 2008-09 for example: households across the nation were struggling as unemployment rose and their budgets for luxuries like going on vacations or taking a taxi instead of public transit were much smaller than they had been previously. Two companies, founded in the thick of the Great Recession, saw opportunities in smaller budgets and higher unemployment, and very successfully capitalized on them: Airbnb and Uber.

Airbnb, founded in 2008, saw individuals with multiple homes, unwilling to sell them in such a downturned market, and offered them an opportunity to gain a second stream of income. They also saw consumers with tighter travel budgets and offered them a cheaper alternative to hotels. Uber did the same in 2009, giving flexible and achievable employment opportunities to the rising number of unemployed people, as well as cheaper and more reliable transportation for consumers. Recessions bring necessary restructuring and give the market opportunities for innovation with staying power, fostering future growth down the road.

How Do I Benefit as an Investor?

In general, downturned markets do not benefit most investors; however, there are silver linings. Interest rates often rise in the early days of a recession and while higher interest rates make borrowing more expensive, they also have some positive effects like raising returns on savings accounts, boosting interest income for retirees, and increasing the yields on bonds (Money). Because recessions often cause market prices to lower, they give investors an opportunity to lower their average cost paid for their assets, making it easier to breakeven and gain when the market recovers. Furthermore, downturned markets sharpen your instincts on what is worth investing in and what is not, better preparing you for the next contraction in the business cycle (Investo2).

Conclusion

Recessions are filled with uncertainty and difficulty, but they are necessary and unavoidable, so it is worth coming into them thinking about the positives as well as negatives. A 2023 recession is not guaranteed but a recession sometime in the future is. Whenever that stage of the business cycle arrives, we at Parks Capital will be here to help you avoid some of the market losses and help you take advantage of the opportunities that come out of the recession. Recessions may be disruptive and painful in the short-run, but in the long-run they foster innovation, increase efficiency, and provide the foundation for a stronger and more dynamic economy.

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