What is a recession? Everything you need to know

Learn more about what a recession is, the key signs and indicators to spot one, and the impact and opportunities it affords.

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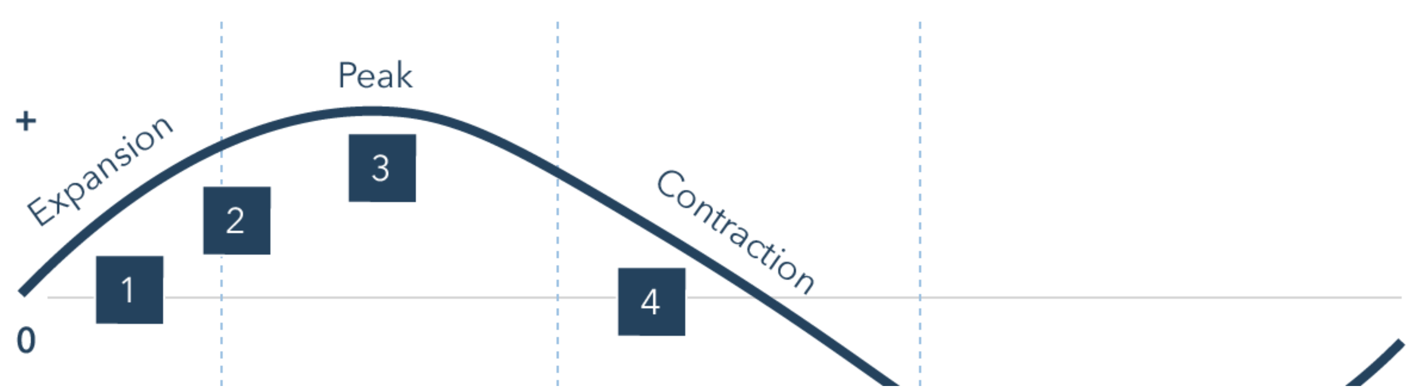
What's on this page?

What is a recession?

A recession is when an economy contracts over a six-month period. It is generally accepted that a country has entered a recession if an economy contracts for two consecutive quarters, measured primarily by gross domestic product (GDP).

Recessions are the length of a time that a country, region, or the world is shrinking rather than growing. Although recessions can have drastic effects on the economy, they are a necessary part of the business cycle: economies expand until they reach a peak, and then contract until they hit a trough before expanding once again, and so on. A country is in recession when it is going from the peak to the trough.



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A recession lasts for at least six months but there is no defined limit on how long one can last. The National Bureau of Economic Research, the authority on recessions in the US, says the average duration of each recession since 1945 has been just over 11 months, with expansionary periods lasting an average of 58 months.

If a recession is particularly hard-felt over a longer period of time then this is known as a depression, the most famous of which was the Great Depression of the 1930s that saw US GDP decline by one-third between 1929 and 1933.

What causes an economic recession?

A recession can be sparked by any single area of the economy collapsing and creating a domino effect that starts to spread to other areas. A housing bubble could cripple the banks, which then struggle to serve businesses and customers, many of which would lose their homes, and leading to a wider meltdown.

A lengthy oil crisis could push prices up and bring major industries to a halt, leading to job cuts that start to force large amounts of people to tighten their belts.

Lenders could be too liberal with their lending when economic times are good only to be left out of pocket when times get tough, saddling people with large debts at a time when they might be losing their job or taking a pay cut.

An economy is an amalgamation of multiple things – how many and what type of jobs are on offer, the state of the housing and construction market, how manufacturing is performing, and so on – and they are all heavily interlinked, so if one collapses then the entire economy is under threat.

Read more on whether the property cycle was behind the 2008 financial crisis

Some economists believe once a recession starts it naturally swells because people and businesses – run by the emotions of humans rather than rationality – respond to the fact they are being told the economy is in trouble and things are about to get worse, prompting them to defensive actions that in turn help fuel the recession further.

Read more about market sentiment and how to trade it

Key indicators and signs of a recession

The fact there are so many ways a recession can start means there are several indicators that one could be on the way. Some indicators tend to raise the red flag before others. For example, sales tend to fall before a business sacks workers, meaning a decline in retail or wholesale sales is likely to be followed by a rise in unemployment. These are known as ‘lagging indicators’.

Some of the key indicators of a recession are:

- GDP
- Manufacturing
- Retail/wholesale sales
- Bond yield curve

- Wages and income
- Employment
- Inflation and interest rates
- Other

GDP

If economic growth has slowed, usually to below 2%, then this is regarded as a possible precursor to a recession. If GDP falls in one quarter but then rebounds the following quarter, then a country has technically avoided a recession, but it also suggests two consecutive periods of contracting GDP (ie a recession) could be more likely soon.

Manufacturing

GDP represents the value of everything that is made in a country, so the manufacturing sector, as the producer of goods, makes a huge contribution. In most major economies, this is measured by some form of manufacturing purchasing managers index (PMI) or other similar piece of data.

Importantly, these PMIs are usually calculated more often then quarterly GDP, often monthly, which means a decline in manufacturing can be seen before it begins to feed through to GDP. This means manufacturing PMIs can indicate a potential drop in future GDP.

Retail/wholesale sales

Similarly, a decline in the amount of goods being purchased by businesses and people can also be a sign that the economy is slowing and heading for a recession. Wholesale sales represent the amount of goods being purchased by businesses, usually with the intention of selling them on to consumers through retail sales.

If businesses start to buy less at a wholesale level, then this should eventually feed through to a drop in retail sales, which again are usually calculated more often (monthly) than GDP – helping them act as an indicator.

Bond yield curve

The bond yield curve has grabbed a lot of attention recently. When people buy government bonds they are effectively lending money to the government, which in return pays the owner of the bond interest (or a coupon). Bonds mature over different lengths of time: some last for months while others can last ten or 20 years.

In a ‘normal’ economic climate, bonds that mature over a longer period of time boast a higher coupon than shorter-term bonds (shaping the yield curve). But when bond buyers feel uncertain about the economy or think a recession could be on the way, the opposite happens, and they start to demand higher interest rates for shorter-term bonds than ones that will mature over the longer term (which inverts the yield curve).

This means buyers of bonds think there is more risk lending to governments over the immediate future than lending to them over the coming decades – effectively indicating that a recession could be on its way.

Read more on whether the US yield curve is a good predictor of future equity returns

Wages and income

If business is booming, then companies are more willing to raise the amount they pay their workers and when growth is slowing then wage growth tends to stagnate. This can mean that a slowdown in growth or a decline in wages could be a precursor to a wider economic downturn. But wages can be heavily impacted by other factors without necessarily signalling a recession is about to happen.

For example, if unemployment levels are robust but higher than normal then this means there is less incentive for companies to pay their workers – particularly those with no or little skills – more money because there is a pool of unemployed people to replace them.

Employment

Employment is key to any economy and will always be influenced by whatever stage of the business cycle the economy is at, rising when it is expanding and falling in times of a recession.

However, businesses only tend to begin laying off workers once a recession has already kicked in, meaning employment is often a lagging indicator of a downturn. Still, a country can have high levels of unemployment and avoid a recession, but it will usually accelerate a country toward one.

Inflation and interest rates

One of the key indicators of a recession is inflation, and how central banks respond to it using interest rates. Inflation measures what rate the general price of goods and services is rising – and therefore the day-to-day costs of living. Some inflation is regarded as integral to an economy's health, but if inflation rises too much too quickly then it can quickly cripple every aspect of the economy.

Everything ends up becoming more expensive: consumers see the price of their weekly shop increase and businesses can see their production and energy costs increase. Debt becomes harder to service and the economy has to tighten its belt as a result. Inflation will rise in the lead-up to a recession, but this will decrease (or deflate) during the actual recession itself.

One of the main tools used to keep inflation in check is the interest rates set by central banks that dictates how expensive credit is. If there is a need to stimulate the economy then lower interest rates are introduced, giving people less reason to hoard their cash in savings accounts and more reasons to access debt to spend more, because the cost of borrowing is lowered.

One fear at present is that interest rates are at record lows in most major economies, meaning the economy should be encouraged to spend, but this has not been the case. Plus, with some central banks having already hit the floor with an interest rate of 0%, like the European Central Bank (ECB), many wonder what wiggle room central bankers will have if there is a recession.

If an economic downturn occurs, then they would have to turn to negative interest rates (whereby the lender would effectively pay someone to borrow money from them) if they wanted to use interest rates to encourage spending in the economy.

Other potential indicators of a recession

There are many other potential indications that a recession could be on the way. For example, a slowdown in construction work – which feeds through to housing, the number of new businesses being set-up and therefore jobs being created, and efficiency being attained through investment in infrastructure – can lead to lower prices for key materials like copper or iron.

Cargo freight shipments tend to fall if consumers and businesses are buying less goods, and the amount of money being invested by businesses tends to decline when they feel bearish about the economy. A country’s currency can lose ground against others if fears of a recession are isolated to one country or region, and investors tend to start putting more of their money into safe havens such as gold as fears of a recession grow.

Ultimately, spotting a recession is about piecing together the giant jigsaw that is the economy. The globalised nature of the world, however under threat it is today, means financial crises and recessions can spread quickly from one country to another.

Although GDP is the favoured measure by which to judge whether a recession has occurred, you need to track all aspects of the economy if you are going to identify it before it happens and have time to prepare.

What are the effects of a recession?

A recession can last a relatively short period of time, but its effects can be wide-ranging and long-lasting. Some businesses go bust because of their inability to weather the storm, jobs are lost, and people struggle to pay their mortgages and debt, possibly losing their homes.

Recession effects on businesses

Businesses of all sizes are impacted by recessions, but larger ones are in a better position to survive. Costs have to be cut across the business, from marketing to research and development (R&D) to the amount being spent on equipment. If they avoid redundancies or cutting jobs, then they usually at least put the brakes on hiring any new staff.

They become less willing to invest for the long term, which can come back to bite them later in life, and postpone the launch of new products or ideas. Businesses obviously grow when the economy is in good shape, but many simply end up unwinding previous growth after realising how bloated and inefficient they are during a downturn.

Recession effects on stock market

Stock markets, unsurprisingly, suffer during a recession. If the economy is struggling, then businesses are struggling, and this hurts valuations. Publicly-listed companies, under the scrutiny of investors, turn their attention to cutting costs and focus on efficiencies to improve profitability to offset any slump in sales.

Earnings forecasts are downgraded, and guidance often abandoned. They can become pressured to sell off non-core assets to bolster the balance sheet and, failing that, some will have to make the unpopular decision to freeze, cut or abandon dividend payments to save cash.

Vital industries deemed ‘too big to fail’ – such as the banks or the automotive industry – received hundreds of billions in bailouts in the 2008 financial crisis.

Read on things you need to know about dividend policies

As stocks become less attractive, money tends to flee equities during a recession to be deployed in more attractive, or at least stable, areas. That could involve anything from investors deploying their cash in safe havens like gold rather than equities, transferring their investments overseas, or pull their cash out of the market altogether.

Recession effects on bonds

The bond market is regarded as one of the strongest indicators of economic health. Like equities, some bonds are deemed riskier than others, so capital tends to flow toward the relative safety offered by government bonds over the likes of corporate ones.

This usually means the price of government bonds rises but the interest they offer goes down, while the price of riskier bonds falls but the coupon increases.

Recession effects on house prices

House prices will fall during a recession, but the reasons why can vary. An oversupply of new homes combined with over-generous lending has ignited financial crashes before, revealing bubbles that must burst.

For people who have owned their home for a long-time, a recession can prove to be nothing more than a temporary loss of value, but for those that buy when the economy is at its peak risk finding themselves in the very dangerous position of negative equity.

How to trade or invest during a recession

The bears takeover from the bulls during a recession and attention turns to protecting your portfolio. But recessions can offer plenty of opportunity for those that haven't battened down the hatches. Proactive investors can take steps to insure their portfolio, while sell-offs lead to bargains for the buyers that remain.

Trading or investing in stocks in a recession

Generally, stocks will experience a decline in value during a recession to account for the weaker business environment. Investors looking to mitigate risk should consider defensive stocks that remain robust during a downturn, such as consumer staples or utility stocks.

The two worst things a business can have when the economy is entering a recession is poor cash flow and high levels of debt, whereas those with strong cash flow and little debt are in a much better position. When looking at particular sectors, investors need to look at which stocks are exposed to what and move their money accordingly.

For example, in the UK banking sector, Lloyds is much more geared toward the domestic market compared to its international peers, meaning it is more exposed to a recession or downturn in the UK. Similarly, the recent disruption in Hong Kong has hit HSBC harder than other banks. Again, it is about putting the right pieces together.

Read more about top defensive stocks to protect your portfolio or find out how to start trading or investing in shares

Those hoping to capitalise during a recession have to look for the possible bargains that come about as the market panics. Many stocks can fall below their book value during the mayhem, or investors can end-up apply a new discount to a stock that isn't quite right. Those that see their share prices fall will only see them rise so long as they survive the downturn.

It is also worth looking for bullish companies, such as ones that are increasing the amount they spend on marketing or new product launches during a recession. Not only can this be a sign that the stock is shielded from the ongoing recession but that it is capturing market share and custom at a time when its competitors may be struggling.

These types of companies tend to come out on top when the recession ends, and consumer spending starts to pick up again.

Trading commodities in a recession

Different groups of commodities have different drivers. Most metals are used to build things, such as houses or electronics. Energy commodities like oil and gas are used to power buildings, machinery and transportation.

Agricultural goods are mostly consumed as food. While things like construction and number of new technological products being launched can fall during a recession, people still need food and energy.

High oil prices have contributed to previous recessions, pushing the energy bills for businesses and squeezing the purses of consumers by raising the cost of their energy and petrol bills.

Generally, there is a sell-off in most commodities as a recession takes hold in preparation for overall demand to tighten, but the vital need for natural resources does mean they can prove one of the more resilient parts of the markets in a downturn. If a recession is contained to one country or region, commodities tend to hold-up because they are needed globally.

One commodity that earns a specific mention is gold, regarded as a safe haven asset that stores its value during times of uncertainty. Investors flee to the metal when they are feeling wary about the future direction of the future economy and take refuge there to protect their investments during a recession.

Read more about commodities trading and how it works

Trading bonds in a recession

Another place investors tend to flock in fears of a recession is government bonds. Bonds offer buyers low returns relative to alternative financial investment opportunities, but they are more stable than the volatile world of small-cap or high-growth stocks.

Bonds are less popular when the economy is doing well because investors are willing to seek higher returns even if it comes with more risk. But the stable returns offered by government bonds become more enticing as the returns on things like equities begins to fall as an economic downturn starts to take hold, and they can act as a refuge for investors much like gold.

Read more about how to trade or invest in bonds

Trading forex in a recession

The effect of a recession on the forex market is much more complex – but an area ripe for the taking. It really depends on where the recession is happening, whether it is in one major nation or in a bloc of countries that, in terms of trade and finance, are heavily intertwined – like the eurozone.

Currencies always trade in pairs, meaning one has to go up if another is to go down, creating opportunities for traders. Again, it is about piecing the right conditions with the right country. For example, Australia exports most of its natural resources – a key engine of its economy – to China, so any downturn there would be bad news for the Aussie dollar.

Concerns of a recession in any major economy in the eurozone, such as Germany, spark fears that will drag the value of the euro down and cause disruption for neighbouring countries. One of the reasons the world fears a US recession more than most is because of the outsized role of the dollar in the world economy.

Most of the world's debts and foreign exchange reserves are denominated in dollars – so a US recession, by passing through exchange rates, tends to have a larger influence on the rest of the world than most other countries.

Learn about forex trading and how it works

Central banks will undoubtedly move interest rates to try to revitalise the economy during a recession, which influences the value of currencies. If a country cuts interest rates then this generally lowers the value of the respective currency, while higher interest rates increase the currency’s value.

Trading real estate in a recession

We have established that house prices are almost guaranteed to fall during a recession, but they are among the fastest recovering parts of an economy once a recession begins to ease. For those that have owned their property for a long time before a recession, it often proves nothing more than a temporary dip in the market and prices recover within five years.

However, those that bought at the peak of the economy can find it difficult to make a return as it would rely on the next peak being bigger than the last, and falling into negative equity becomes more likely.

However, there is an opportunity for those willing to buy during downturns. Many people are forced to sell their homes at discounts if they experience financial difficulty, which can present an opportunity for others to swoop in. Investors can gain exposure to this without directly investing in property, through the likes of a real estate investment trust (REIT).

If you have formed a strategy that you want to try-out risk-free, then why not sign-up for an IG demo account. Once you're ready to place your first real trade or investment you can open an IG live account within minutes. Or, find out everything you need to know about trading and investing during a recession.