Motley Fool's *Rule Your Retirement* Newsletter

Prepare for the Coming Recession

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You're hearing a lot more about the dreaded R-word these days.

Recession!!!

It's been more than 10 years since the last recession ended, making this longest economic expansion since the 1850s (which is as far back as such official data exists). A little over a year ago, we pointed out that the U.S. has experienced a recession in every decade since the 1850s. With less than five months left of the 2010s, it looks like this recession-free decade will be a first.

That is, assuming we reach Dec. 31 without a significant drop in the economy. These days, that doesn't feel like such a sure thing.

Portions of the U.S. Treasury yield curve have been inverted for several months; that is, some shorter-term rates were higher than some longer-term rates. However, the most-monitored yield differential – the gap between the two-year and the 10-year Treasuries – went negative on Aug. 14, though it has since turned slightly positive.

In the meantime, the yield on the 30-year Treasury has dropped to an all-time low. Nowadays, you can earn more from a one-month Treasury than the 30-year bond. That's just not normal.

Current Yields on Treasuries

Maturity	1 Month	6 Month	1 Year	2 Year	5 Year	10 Year	30 Year
Yield	2.08	1.86	1.72	1.48	1.42	1.52	1.98

Source: Treasury.gov

Historically, an inverted yield curve has been a frequent precursor to recessions. Add it to the recent drop-off in U.S. stocks and the signs that many economies around the world are slowing down (for example, Germany's economy shrank 0.1% from April to June), and many experts are warning of storm clouds on the horizon.

Economists polled by *The Wall Street Journal* last week said there's a 33.6% chance of a recession over the next 12 months, up from 30.1% in June and 18.3% a year ago. This morning, CNBC reported that Ray Dalio, one of the most successful hedge-fund managers of all time, says there's a 40% probability that the next recession will come before the 2020 election. (In our most recent Market Update, we highlighted a LinkedIn post from Dalio in which he points out that markets tend to experience a change in paradigms at the turn of the decade; what did well in the previous decade begins to falter, and something else becomes the asset class of choice.)

Finally, back in March, Yale professor and Nobel Prize winner Robert Shiller said that there's a 50-50 chance of a recession over the subsequent 18 months, though he acknowledged that such things are very difficult to predict. "We're trying to predict human behavior," Shiller said. "And humans thrive on surprising each other."

So, despite the warning signs, we don't claim to know exactly when a recession will occur. However, we do think this is a good time to become reacquainted with what happens during an economic slowdown, and what you can do to ensure your financial plan survives – and maybe even thrives.

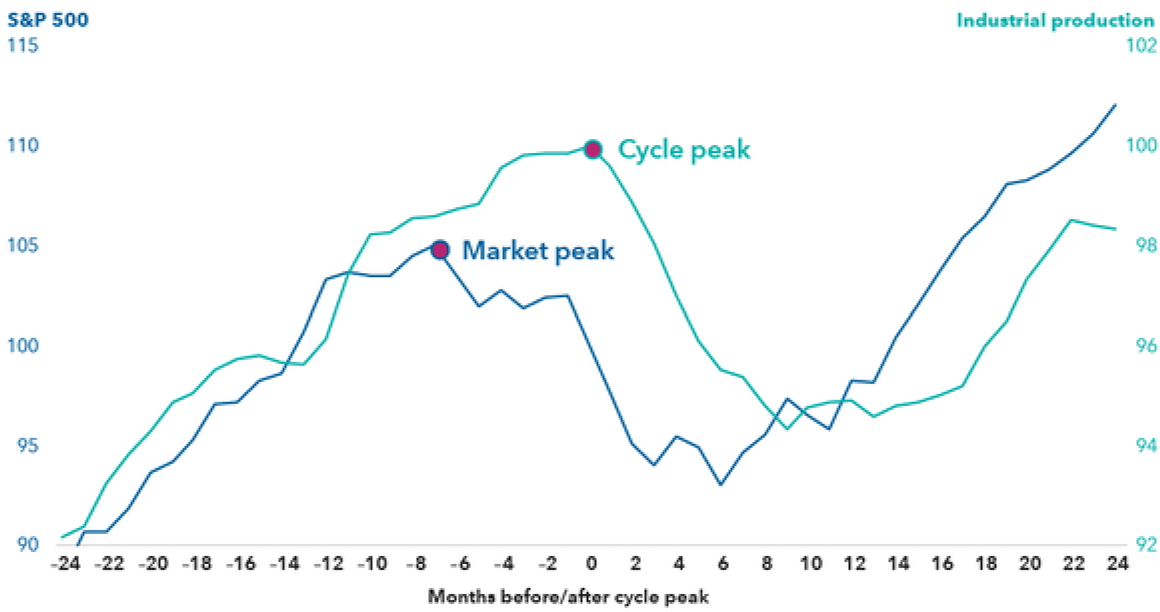
Here are eight ways that recessions have historically affected the finances of most American households.

1. Stocks drop

The stock market is considered a leading economic indicator; it tends to drop several months before the recession officially begins. According to research by former *RYR*contributor Doug Short, the market has posted declines during 13 of the 14 recessions (including one depression) since the 1920s. The losses have ranged from -13.6% (recession of 1960) to -86.1% (the Great Depression of 1929), with the average being -35.7%.

This chart from [Capital Group] shows that since 1950, equities (on average) have peaked six months before the start of a recession, reached their trough six months into the recession, and had fully recovered within 18 months of the previous peak. Of course, that's the average; the market took more than five years to recover from the dot-com crash of 2000 and the Great Recession of 2007.

Equities typically peak months before a recession, but can bounce back quickly



Sources: Capital Group, Federal Reserve Board, Haver Analytics, National Bureau of Economic Research, Standard & Poor's. Data reflects the average of all cycles from 1950 to present, indexed to 100 at each cycle peak.

The sectors that tend to hold up better during recessions are consumer staples, utilities, and healthcare. Those that have historically fared the worst are industrials, tech, and financials.

2. Rates also drop

The bond market and the Federal Reserve both react to recessions by driving down interest rates. This means you'll earn less on your cash and recently issued bonds. Some banks have already announced cuts to the rates of their savings accounts; however, the reductions haven't been drastic, so there's still time to lock in at least a little bit of yield with CDs.

The lower rates make it cheaper for businesses and households to borrow money, which can tide folks over until the economy recovers. The current decline has brought mortgage rates back down to near historic lows. According to Freddie Mac, the current rate on a 30-year mortgage is 3.6%, and the rate on a 15-year mortgage is 3.06%.

The more rates decline, the more refinancing your mortgage can pay off. That is, as long as you qualify. Banks often tighten their lending standards during tough times. Former Fed Chair Ben Bernanke famously mentioned in a speech that he was unable to qualify for a mortgage refinancing back in 2014.

3. Bonds hold up... depending on the bonds

Investors often seek shelter in the bond market during recessions, which often boosts their prices. In 2008, while the S&P 500 lost 37%, the overall bond market gained more than 5%.

However, bonds lower down on the credit-rating scale – such as those rated as below investment-grade, i.e., junk – often decline in value with the stock market, though not as much. So the more concerned you are about a recession, the more you should own U.S. Treasuries, FDIC-insured cash, and corporate debt rated A or higher.

This year, we haven't had to wait for a recession for bonds to do well. As rates have dropped, the prices of existing bonds have gone up. For the trailing 12 months, the **Vanguard Total Bond Market ETF** (NYSE: BND) has returned a surprising 10.3%, according to Morningstar.

4. The price of your house *might* hold up

Given that the last recession was accompanied by the first nationwide decline in home prices in U.S. history, it may be surprising to learn that housing often holds up rather well during economic downturns. According to real-estate data provider ATTOM Data Solutions, home prices declined in just two of the five recessions since 1980; in one of those instances (the recession of 1990), the decline was less than 1%.

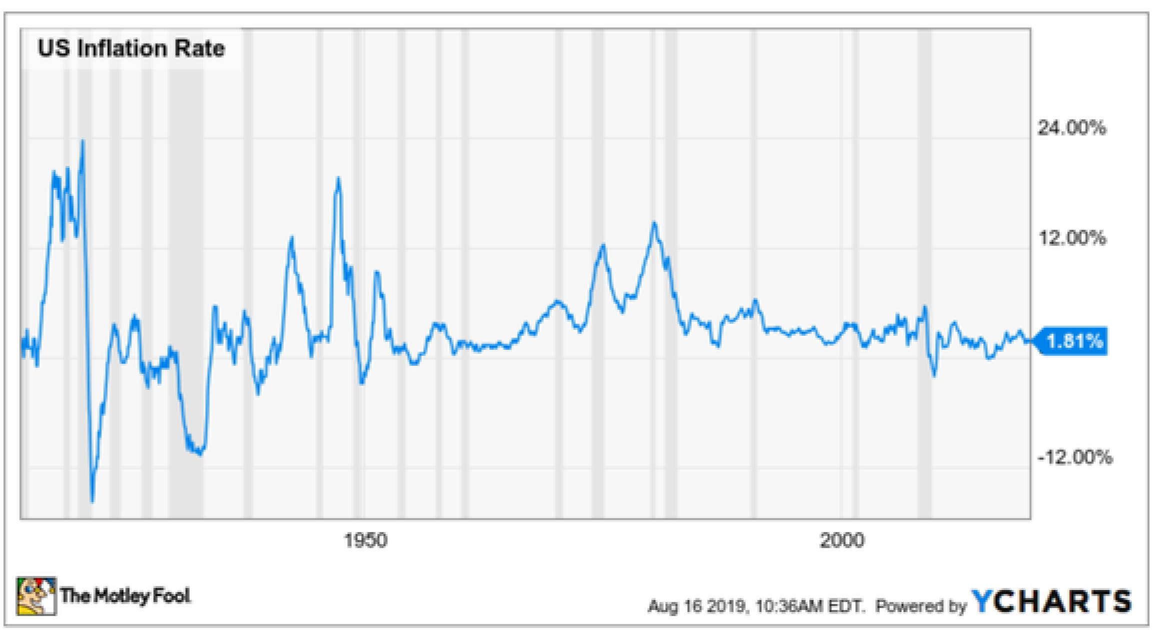
In a previous article, we cited evidence that a home can actually be a good hedge to a stock portfolio. As we wrote back then: "[MarketWatch columnist Mark] Hulbert used data from the Case-Shiller Home Price Index to examine how residential real estate performed during the 20 bear markets in stocks since 1952. There were only two instances when home prices also fell, and one was a minor 0.4% decline. The other was the most recent: The Great Recession of 2007-2009. And it was painful. But on average, home prices went up when stocks went down. In fact, the Case-Shiller Index actually performed slightly better during bear markets than it did during bull markets."

Of course, every home and location is different.

In April, real-estate brokerage Redfin released a [study] that identified the features of homes that saw the smallest declines during the Great Recession. They tended to be two-story single-family homes or townhomes built before 1940, with five or more bedrooms, in spread-out neighborhoods.

5. Inflation tends to decline

If there's an upside to a downtrodden economy, it's that the cost of living doesn't go up as much – and might even go down. This chart shows the historical U.S. inflation rate, with recessions indicated by the gray-shaded bars.

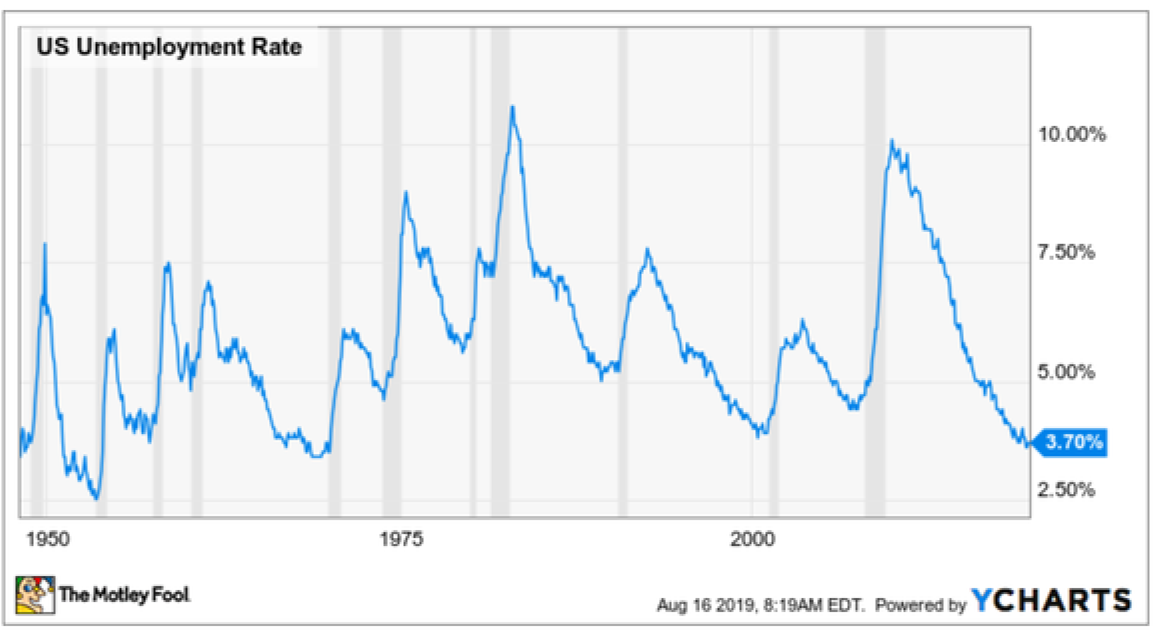


For those who have the means, a recession can be a great time to buy a car, replace an appliance, or make other major purchases, as businesses respond to decreased demand by lowering prices.

However, those of us in our 50s or older will remember the stagflation of the 1970s, when higher rising prices and economic sluggishness went hand in hand. As with most things when it comes to money and investing, there's always an exception.

6. Unemployment goes up

According to *The Washington Post*, the unemployment rate has risen 2.4 percentage points, on average, during the 11 recessions since World War II. The biggest jump was during the last recession, when the unemployment rate doubled to 10%. According to the Department of Labor, the median duration of unemployment during the Great Recession was 25 weeks.



The best way to weather a layoff is by having a sufficient emergency fund, and keeping your debt to manageable levels so that you're not forced to sell assets at significantly reduced prices.

7. Employers reduce benefits

Workers who are fortunate enough to keep their jobs could still experience a reduction in their overall compensation packages during a recession. Wages stay flat or get reduced, 401(k) matches get cut, bonuses are postponed, and the holiday party is held in the office conference room instead of a downtown hotel.

Now is a good time to evaluate your so-called "human capital" to increase your chances that you'll remain among the working and reduce the chances that you'll experience an income disruption.

8. Stocks go back up, and the economy eventually recovers

For those with "dry powder" and the guts, buying stocks during a recession can be a profitable decision. But you can't wait until the recession is over, since the market recovers before the overall economy.

Eventually, though, the economy will indeed recover. Unemployment will come down. The holiday party will once again be held at a downtown hotel. And the stock market will reach new highs.