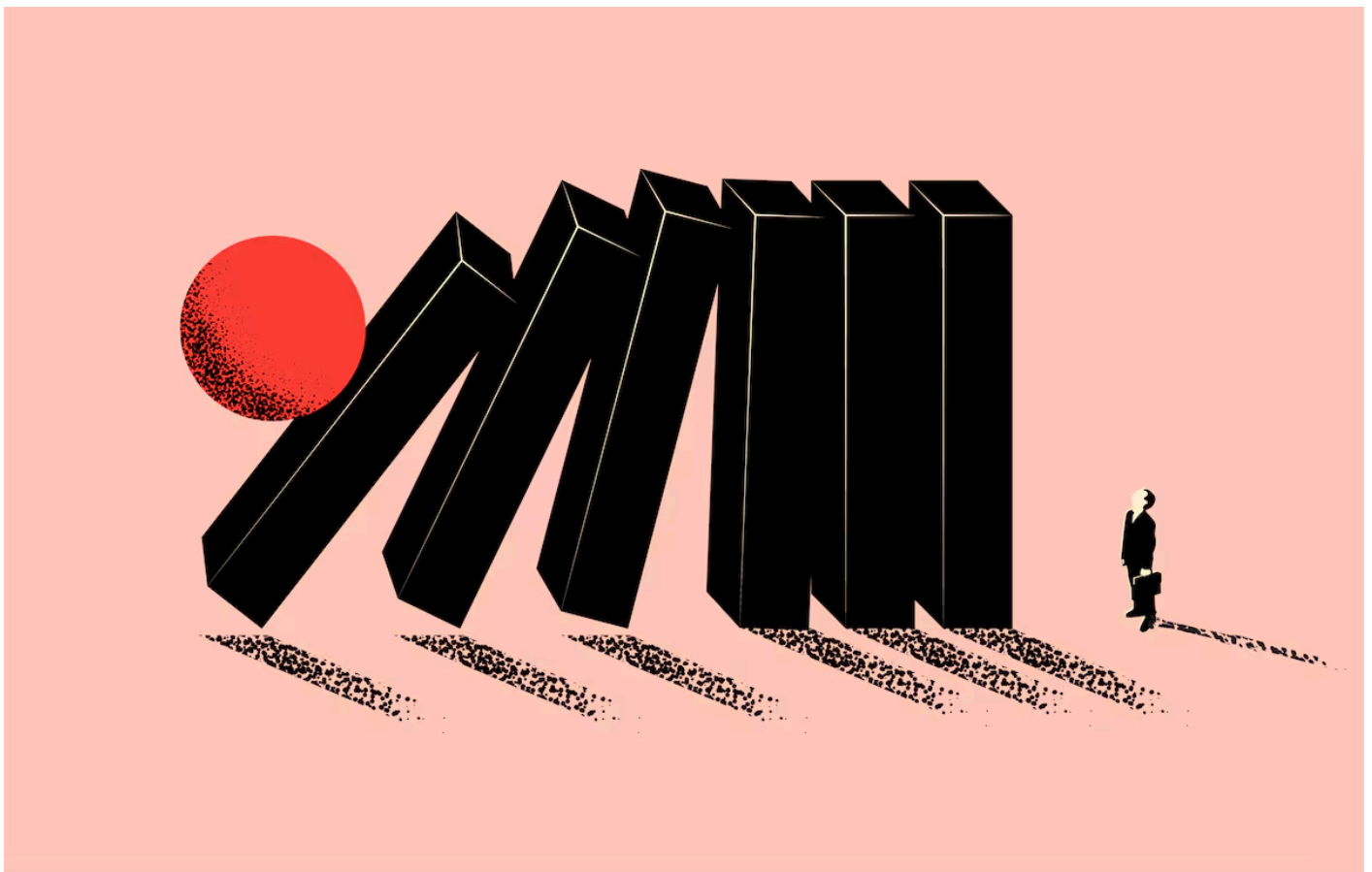


OPINION

Does a recession loom this year? Not if you listen to the stock market



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The November-to-April period this year is not turning out to be a bust for the stock market and the signal it gives is that the economy won't be either, writes George Athanassakos.

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Is a recession unavoidable this year? Surging oil prices amid the Middle East conflict and cracks in private credit markets provide plenty of reason for concern.

But I don't think one will materialize - not in the United States, and probably not in Canada either. And that's largely because of stock market performance so far this year and what history suggests it portends.

Let me explain.

For months now, the signs of similarities between 2007-08, the period of the global financial crisis, and 2026 have been hard to deny. Financial conditions are tightening up while inflationary expectations are building, and interest rates are rising. The war with Iran may be the primary cause for the most recent uptick in inflation and interest rates, but underlying forces have been building for some time now.

And all this is happening amid growing pressures in private credit markets and asset-backed assets and securities. It's an echo of the subprime loans and mortgage market pressures in 2007-08 that finally imploded in an environment of weak economic growth and rising inflation and interest rates.

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In 2007-08, the crisis was caused by the bursting of the housing bubble, which was fuelled by predatory lending and low interest rates in the U.S. The next crisis will be caused by an AI-induced bursting of the private credit market owing to major exposure to vulnerable securities such as software in an environment of high interest rates and rising inflation.

That said, I don't expect this new crisis to unfold this year. The reason: U.S. market returns in the November-to-April period have not been negative. Historically, a recession only materializes when this occurs.

There is a well-known seasonal effect that relates to the expression "Sell in May and go away." It refers to stock markets doing better in the November-to-April period than in the May-to-October one. This seasonal effect is driven by the behaviour of institutional investors and the way they trade.

Portfolio managers invest throughout the year to outperform benchmark portfolios and secure their Christmas bonus. To do so, they put their money in risky securities at the beginning of the year and move away from risky ones toward year end. As a result, for risky securities, returns in January (or the first few months of the year) tend to be quite high. In such cases, the second half of the year tends to be weak in comparison to January, as managers bail out of those securities to lock in profits.

My research documents that, owing to portfolio rebalancing and arbitrage that takes place around the end of the year, seasonal strength is documented in more than just January, namely from November until April for risky securities and the reverse from May to October. This gives rise to the "sell in May and go away" expression.

War-torn bonds may need recession to bounce back

Research I conducted a few years ago shows that stocks have experienced a positive return in the November-to-April period in 38 out of the 47 years of my sample (1957-2003) and a negative return in only nine years. Out of the nine negative return years, seven years – 1960, 1970, 1973, 1974, 1982, 1990 and 2000 – were recession years.

This pattern has not changed in more recent years. That is, the November-to-April period has been dominated by positive stock returns, except during recessions when returns turn negative. By way of comparison, stock returns in the May-to-October period were negative in 18 out of the 47 years and only one of these years was a recession year.

Having said that, my research also shows that the strength in risky securities around January is not a sure thing; it largely depends on what institutional investors think of the year ahead.

Portfolio managers do not invest in risky securities indiscriminately, irrespective of whether the year is (or is expected to be) a bull or a bear market and irrespective of whether the year is (or is expected to be) a recovery year or a recessionary year.

They only invest in risky securities when the year ahead is expected to be a good one and withhold their investment from such securities if the year ahead is expected to be adverse. If institutional investors are, on average, right when they expect a recession or a bear market in the year ahead, and they divest from risky securities in such cases at the beginning of the year when portfolios are rebalanced, it is only natural to also expect risky securities to experience weakness in January and in the months of the year that follow and, as a result, for the year as a whole.

The bottom line is this: A “semi-annual” seasonal effect is only observed when there is no recession or bear market. In recessions or bear markets, no semi-annual stock return seasonality is normally documented.

The November-to-April period this year is not turning out to be a bust for the stock market and the signal it gives is that the economy won't be either. For example, the S&P 500 has been up about 4 per cent year-to-date (to April 23) and about 3.5 per cent since the end of October. The corresponding numbers for the S&P/TSX composite have been about 6 per cent and 11 per cent, respectively.

As of the last day of April, markets are hovering around all-time highs, providing strong evidence to support the argument that the Canadian and U.S. economies are not headed toward a recession this year.

George Athanassakos is a professor of finance and holds the Ben Graham Chair in Value Investing at the Ivey Business School, Western University. His latest book is Value Investing: From Theory to Practice.

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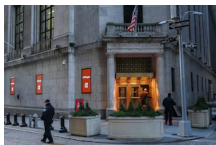
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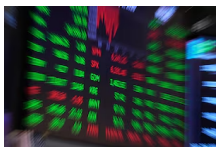
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