Are Stocks a Better Investment Than Bonds in a Recession?

Description

Recession and stagflation are all over the media. The World Bank and the Organization for Economic Cooperation and Development have reduced their global growth outlook, warning of a risk of stagflation. Stagflation is one of the worst economic conditions, where economic growth stagnates and prices (mostly raw materials) continue to rise. Does it ring a bell?

The current scenario hints at stagflation in 2022/2023 and a recession in 2024

Rising oil and gas prices due to the Russia-Ukraine war are increasing the prices of other goods. Essential items are becoming expensive, leaving little in the hands of low-income groups to spend on discretionary items.

The University of Michigan's Consumer Sentiment Index stood at 50.2, its lowest since 1978. Such low confidence doesn't come overnight. Probably it has been in the making since September or November 2021, when tech stocks, especially e-commerce stocks, started decelerating. Even then, the economy has been holding up well. Consumer demand recovered in some industries like airlines, as consumers used their pandemic savings. Moreover, a strong labour market kept the economy from falling into a downturn.

But unemployment rates are rising, savings are drying up, and the supply chain disruption shows no sign of easing prices. The result is a slowdown in consumer spending, leading to stagflation. The central banks are hiking interest rates at an accelerated pace to curb inflation, but this has started to affect consumer demand. With borrowing costs rising, people have lower liquidity to spend.

At this point, the economy is at the start of stagflation. The only way to control stagflation is to boost production. The war has disrupted the global supply chain, and COVID lockdowns in the world's biggest manufacturer China have made it difficult to boost production. Hence, the effects of stagflation are seeping in.

If the central bank continues to hike interest rates, it will be difficult for an average consumer to thrive, thereby reducing demand. This demand shock will start reflecting in companies' earnings and push the economy into negative growth, leading to a recession.

> "From a timing standpoint, we do not have a recession call on the table for this year. Our models are suggesting that 2024 is the more likely recession timetable."
> *said Federated Hermes chief equity market strategist Phil Orlando*

What is the best investment in a recession?

Mild or severe, a recession is very likely coming. While the above are U.S. figures, history shows that the Canadian economy is closely related to its neighbour. A recession in the United States could result in one in Canada, as the former is one of the biggest export markets of the latter.

What is the best investment option in a recession: stocks or bonds? Treasury bonds are considered to be risk free, but they give low interest. The 10-year U.S. T-bill gives 2.46% interest. This return is losing you money in an inflationary environment of 8.6%. Even if inflation eases, the 2.46% interest won't be enough to meet the rising prices 10 years from now.

On the contrary, stocks are volatile in the short term. The demand shock will likely seep into the business cycle and pull down the economic growth. The equity market could fall. But unlike bonds, businesses can adapt to changing business environments, for they work with the sole objective of making profits. When inflation rises due to a growing economy, companies can pass on the cost to consumers and grow alongside demand. In the long term, stocks could beat inflation and generate wealth.

Which stocks to buy?

Which stock should you buy in a recessionary environment? The lowest-risk equity investment is in index funds, which track top companies by market cap. Some companies may perish in the recession, and some may flourish. Index funds can replace perished companies with the flourishing ones, keeping you invested in market leaders for a minimal cost.

Horizons S&P/TSX 60 Index ETF (TSX:HXT) is my choice because it has one of the lowest expense ratios of 0.04%. This ratio is way below **iShares S&P/TSX 60 Index ETF's** 0.18%. A 0.14% difference might look small now, but it compounds into a huge amount as your portfolio grows. Apart from an index fund, a defensive stock like **Descartes Systems** is a good fit.

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pujatayal