



By Patrick Fearon-Hernandez, CFA

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I Miss Recessions

One of the most striking aspects of today's world economy, and the United States economy in particular, is its ability to keep growing despite confidence-shaking events such as the US's waning geopolitical power, large-scale wars, fracturing trade relations, global supply disruptions, an aging population, the coronavirus pandemic, persistent price inflation, dramatic policy change, and the rise of populist politics. In spite of all these challenges, gross domestic product (GDP) continues to expand, even after stripping out the impact of price changes.

GDP growth isn't necessarily strong at the moment. In fact, in most key countries, it's sitting below the long-run average rate. All the same, the continued expansion and lack of recessions would be expected to have big implications for consumers, businesses, and investors. Focusing on the US, this report examines why recessions have become so rare and what the implications might be for financial markets and investment strategy going forward.

The Function of Recessions

To comprehend why today's relative lack of recessions is so important, we first need to understand how recessions have affected the economy and financial markets in the past. We begin by exploring how recessions operated on the supply side of the economy, on the demand side, and in the financial markets.

Supply Side Impacts. We suspect that most people who have taken an economics class or two are familiar with the famous term "creative destruction," coined by economist Joseph Schumpeter in his 1942 book *Capitalism, Socialism and Democracy*. In Schumpeter's telling, innovation and entrepreneurship in capitalism lead to older economic structures being constantly destroyed from within and replaced with new ones. This process involves the introduction of new goods, technologies, production methods, markets, and organizational forms, which render existing products, firms, or even entire industries obsolete. However, economists also tend to talk about economic recession or depression as another force that weeds out weak, less competitive firms and allows stronger, more flexible firms to prosper once the recovery begins.

- Poorly capitalized, badly run, or uncompetitive firms can survive for years when demand is rising, but they may need to adopt aggressive pricing strategies to compete with stronger firms with better products. That can hold down average prices for an entire industry. However, the collapse in demand during a recession can be the final nail in their coffin, putting them out of business for good. Then, when demand starts to recover, the stronger companies that survived have more price freedom and can do better.
- Those workers who lose their jobs in a recession often find bleak employment prospects in the near term, so many start

their own businesses. Those new, innovative firms that survive until the recovery begins can develop into much bigger, successful companies in the future.

Demand Side Impacts. The plunge in demand during a recession often forces companies to cut their prices or at least hold the line on price increases. For consumers who keep their jobs with little or no decline in their income, the result can be an effective rise in their purchasing power. If the recession is severe enough and forces strong price discipline on companies, they may be reluctant to increase prices again for years into the future, helping to keep a lid on overall consumer price inflation over time.

Asset Price Impacts. Of course, reduced demand and weaker pricing are likely to weigh on corporate profitability, which in turn can prompt investors to become more wary and undermine asset values. Stock prices typically drop sharply going into and during a recession. Importantly, other assets can also experience price drops or slower price hikes during a downturn. This includes housing prices. And again, for those buyers who are still in a position to purchase, this creates the opportunity to buy assets at a temporarily advantageous price.

In our view, younger investors are a prime beneficiary. After all, the typical decline in interest rates and moderation in home price inflation during a recession can create the conditions for young families to buy their first home, while younger employees can also buy stocks at prices that may be down 20%, 30%, or even more from their levels prior to the recession. As the stock market recovers in the recovery phase, it can often rise rapidly, making workers' mid-recession stock purchases an important part of their future wealth.

The New Policy Environment

In sum, the traditional understanding, acceptance, and even embrace of recessions reflect a view that economic downturns are not just normal but are helpful for rejuvenating and revitalizing the economy. The traditional view sees the business cycle as natural and healthy over the long run. Our thesis here, however, is that political leaders nowadays seem to have abandoned that perspective. They've developed new tools to avoid or shorten recessions, and they've become much more willing to use those tools to keep economic activity growing and asset prices rising. We note three key crises that led to this change.

The Great Financial Crisis. The first major crisis that forced a change in the approach to recessions was the implosion of the US housing bubble in 2008-2009. Also known as the Great Financial Crisis, this downturn is broadly seen as the sharpest, most severe US recession since the Great Depression. Gross domestic product fell 3.8%, while job cuts surged and drove the unemployment rate to as high as 10.0%. And importantly, a sudden downward revaluation of mortgage debt threatened to spread and freeze the entire financial system, which would have slowed the economy further and destroyed even more jobs. Government leaders therefore embraced a range of novel large-scale policy interventions aimed at stabilizing the economy.

- In ***monetary policy***, for example, the Federal Reserve slashed its benchmark short-term interest rate from 5.25% in September 2007 to a range of 0.00% to 0.25% by December 2008. It kept the rate at that historically low level for a full seven years to December 2015 (see Figure 1, next page). Just as important, as financial markets froze and asset holders needing to raise funds couldn't find buyers, the Fed launched a series of

liquidity “facilities” or funds by which the Fed would buy up a wide range of important assets. Finally, as the fed funds rate hit the “lower bound” of 0.00%, the Fed adopted the truly unconventional policy of “quantitative easing,” by which it bought up trillions of dollars of US Treasury obligations, agency debt, and mortgage-backed securities (MBS), greatly expanding its balance sheet (see Figure 2). The rapid development of these programs established a precedent and requisite skill set for the Fed to rapidly deploy similar programs in the future.

- Meanwhile, in **fiscal policy**, Congress passed several big spending programs to shore up the banking system and bolster consumer demand. For example, it appropriated some \$700 billion for the Troubled Asset Relief Program and almost \$800 billion for the American Recovery and Reinvestment Act, which provided for infrastructure spending, aid to state and local governments, expanded unemployment benefits, tax cuts, and social safety-net spending. The result was to massively widen the federal government’s budget deficit (see Figure 3).
- Finally, in **regulatory policy**, Congress passed a major bank reform known as the Dodd-Frank Wall Street Reform and Consumer Protection Act, and it founded the Consumer Financial Protection Bureau. These laws generally tightened regulation over commercial banks and other financial institutions. This probably helped reduce risky behavior by financial firms but also tied the hands of financial institutions and arguably reduced the financial industry’s ability to fund economic growth going forward.

Figure 1

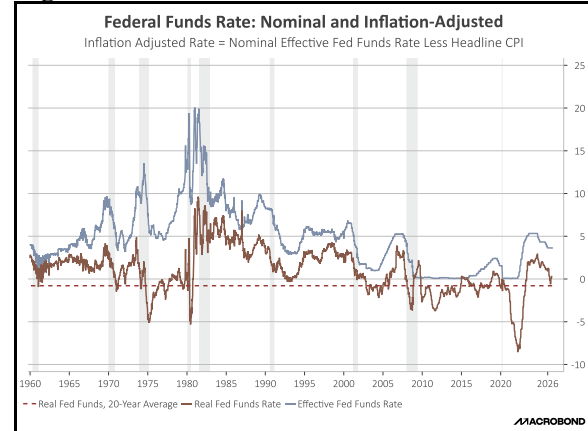


Figure 2

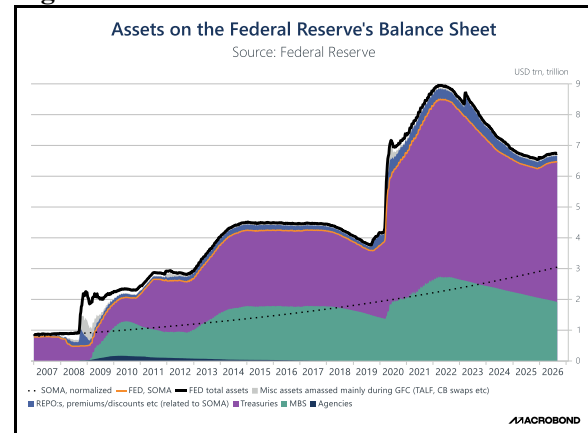
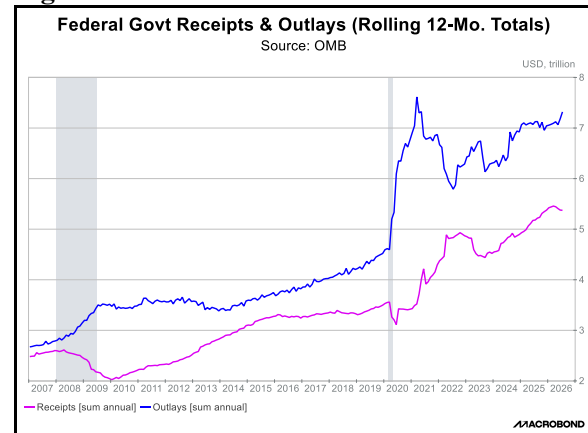


Figure 3



The Coronavirus Pandemic. Another big revolution in economic management came out of the COVID pandemic that began in 2020. The government’s sudden, dramatic shutdown of the national economy brought

economic growth to a screeching halt and idled tens of millions of workers, making it obvious that the federal government would need to take steps to support economic activity and protect the financial markets. Below, we review the key steps taken.

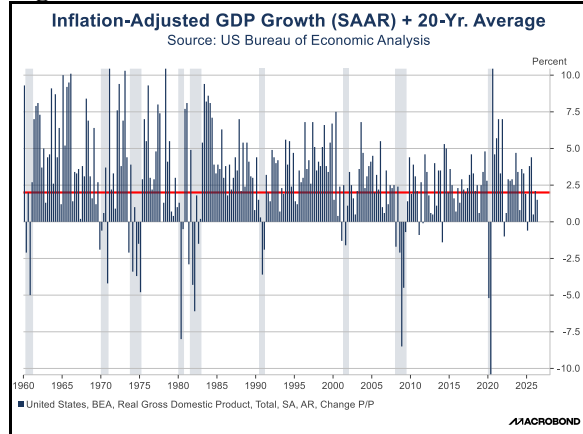
- In ***monetary policy***, the Fed again slashed the benchmark fed funds rate back down to 0.00% to 0.25%. It also resumed its quantitative easing program, this time focused on buying up US Treasury securities and agency MBS. Finally, it established numerous new facilities to buy up assets ranging from commercial paper and corporate debt to municipal debt. Notably, the central bank also expanded its communications strategy to include strong “forward guidance” in the form of assurances that the fed funds rate would remain near 0.00% and monetary policy would stay loose until the economy recovered and employment moved toward maximum sustainable levels.
- In ***fiscal policy***, Congress adopted and funded numerous programs aimed at replacing lost income, supporting businesses, aiding state and local governments, and sustaining aggregate demand. Over three major bills from March 2020 to March 2021, Congress appropriated almost \$5 trillion for programs including direct payments to both employed and idled workers, expanded unemployment benefits, payments to firms that didn’t lay off their workers, direct Treasury lending programs to support key industries, fiscal aid to state and local governments, and child tax credits.
- In ***regulatory policy***, Congress and the administration built programs that helped provide flexibility to financial firms and encourage them to work with

idled workers who might have trouble making their debt payments.

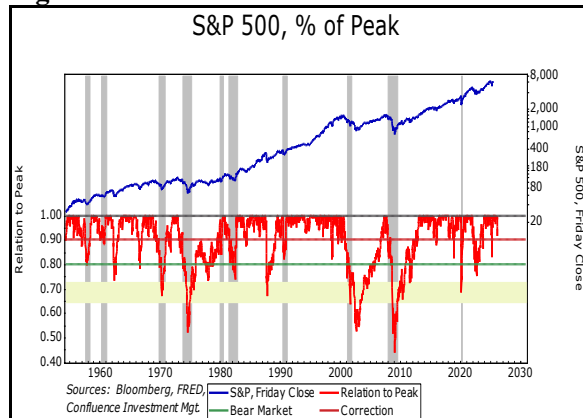
The Impact of Populism. Finally, we think any discussion of the expanded 21st-century policy tools requires an explanation of the political environment that encouraged the federal government to develop all these novel policies. In our view, the catalyst for these aggressive programs was the increasingly populist sentiment of the working class. As we have written before, the policies that the US used for decades to maintain geopolitical hegemony eventually imposed high economic and social costs on the working class. One key policy, for example, was to embrace relatively free trade and capital flows, leading to voluminous imports, high trade deficits, and de-industrialization, especially after China was granted entry into the World Trade Organization in 2001. Federal officials have probably always been sensitive to the voters’ fear of recession, but the new, sharp political populism of the 21st century likely encouraged officials to be more assertive in finding ways to ameliorate the effects of large issues such as the housing crisis and COVID.

A World with No Recessions

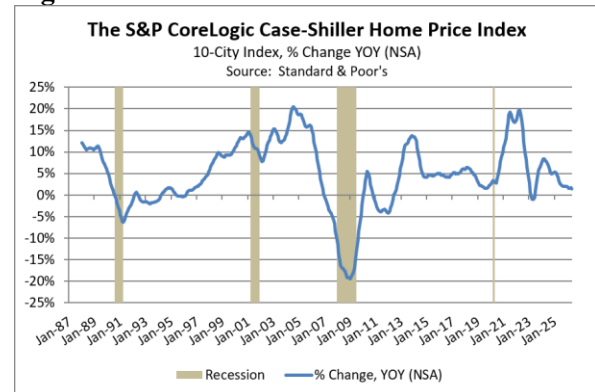
While these new policy tools probably helped avoid outright economic depression during the Great Financial Crisis and the COVID Crisis, it appears that they have also helped lengthen the business cycle and delay the onset of any new recession. In Figure 4 on the next page, the vertical gray bars representing recessions have clearly become less frequent since the beginning of the century. In the 1970s and 1980s, the average time between US recessions was 15.75 quarters, or a bit less than four years. In the 21st century to date, the average time between US recessions has risen to at least 30 quarters, or more than seven years.

Figure 4

As we noted in our introduction, the relative infrequency of recessions these days correlates with the infrequency of deep, long declines in stock prices that can constitute attractive buying opportunities for investors. In Figure 5, the steep drop in stock prices around recessions is clearly shown. The blue line in the top half of the chart shows the S&P 500 price index on a logarithmic scale, while the red line in the bottom half shows the index reading compared to its most recent maximum. The chart shows that in each of the last 10 US recessions, stock prices fell by at least 10%. In seven of the last 10 recessions, stock prices fell by at least 20%, and in six of the last 10 recessions, prices fell by a whopping 30% or more. For intrepid investors, these recessions offered unusually good opportunities to pick up stocks on the cheap.

Figure 5

Home prices have traditionally been much less volatile than stock prices. Nevertheless, as shown in Figure 6, home prices have typically softened around recessions. At the very least, home price increases have usually slowed going into or during a recession. In some cases, prices actually declined on a year-over-year basis, presenting buyers with more attractive buying opportunities (especially given that interest rates normally decline around recessions, making mortgage finance cheaper).

Figure 6

Investment Implications

As we've shown here, the 21st century so far has been marked by dramatic policy innovation aimed at postponing or softening recessions. While we've focused on developments in the US, similar innovations have occurred abroad. For example, the European Central Bank also developed a range of new liquidity facilities to deal with the Great Financial Crisis. Against the backdrop of a demanding, populist political environment, we think federal officials will continue to embrace these kinds of policies going forward. Aggressive government intervention in the economy is now in vogue in a way that it hasn't been for decades.

To the extent that these policies are successful, they are likely to be positive for existing holders of price-volatile assets such as equities. One important implication is that

current owners of these assets perhaps shouldn't adjust their portfolios as aggressively as they used to when they feared a recession was coming. After all, if policymakers respond to signs of an impending recession by forcefully wielding the new policy tools described here, they may prevent the downturn or at least shorten it, which could imply averting a serious pullback in stock prices or home prices, or at least shortening any such pullback.

For younger investors or those seeking to rapidly build their portfolios, however, the implication is probably that it will become harder to build wealth over time. There will be relatively fewer opportunities to buy wealth-creating assets on the cheap, so a higher level of on-going investment may be needed to reach one's goals. Of course, when recessions do occur and asset prices do fall in spite of the new tools, it may be

more important to take advantage of them by buying more vigorously than in the past.

Finally, we would note that if the government artificially staves off recession, there is a possibility that the underlying economic and financial systems will become overly complacent and take excessive risks. As the resulting economic or financial distortions build up, the stage could be set for an even worse downturn or adjustment period than would have otherwise been the case. In other words, one can't assume that the new policy tools will be totally successful. They won't entirely eliminate risk; instead, the tools may just concentrate risk to a point sometime in the future.

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