Bear market basics
With stocks reaching bear market territory, here’s what to think about.

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Key takeaways

✔ When stocks do decline sharply, this can serve as a reminder that pullbacks are a regular part of investing.

✔ As the business cycle matures, investors should be more cautious during stock declines about overweighting stocks relative to their target benchmarks.

The bull market that started in March of 2009 is the longest in the history of the S&P 500*, but stocks haven’t marched steadily upward since then. Thirteen corrections have taken place and the market has moved down by at least 20% into bear market territory 3 times. This includes the latest pullback that started in late February and officially entered bear territory on March 12. Jurrien Timmer, director of global macro in Fidelity's Global Asset Allocation Division, says it’s too soon to tell whether this move into bear territory means the bull market is over. “Bull markets are defined as a series of higher lows and higher highs. Therefore, we will only know that the 11 year bull run is over if we do not make a higher high after this decline,” he says.
While US stocks followed global markets sharply lower in recent weeks as coronavirus and the Saudi Arabia oil shock have gripped investors, the market is still up dramatically since the start of the bull market rally. Of course, there are unique elements to the current market environment that make any prediction of the duration or severity of the market correction uniquely challenging. Regardless, it may be a good time to look at what bear markets have meant historically and what today's market conditions tell us about the potential for another serious downturn.

However, provided you have a well-diversified asset mix that is consistent with your investment time frame, financial situation, and risk tolerance, corrections and bear markets should not cause you to deviate from your plan.

What bear markets have looked like historically

Like it or not, and most people don't, bear markets are a regular part of investing. Bear markets are commonly defined as a decline of at least 20% from the market's high point (peak) to the low during the selloff. Using the S&P 500 as representative of the market, this has happened 16 times since 1926, an average of about once every 6 years. When a bear market does happen it tends to be fairly dramatic, with an average loss of almost 40%. And it tends to take a while to recover those losses—the average duration is 22 months.

The good news is that in every case markets have come back, and often have made sizable gains in the months immediately following the downturn. The past is no guarantee of future results, but historically even the worst markets have been temporary dips in a general march higher for stocks (see the table below which depicts bear market periods and subsequent returns). Of course, there was significant variability of outcomes around these averages.
Looking into bear markets

Stock market corrections, commonly defined as 10% drops, are an even more frequent part of investing than bear markets—in fact, a correction happens more than twice a year on average looking at the S&P 500.

But as an investor, how can you know if a market pullback is going to be a typical correction, or something more? And how do you assess the investing landscape when bear markets do occur?

One key is the business cycle. From time to time, while the economy and earnings are growing and interest rates are low relative to other phases of the business cycle, markets sell off. This is a typical "mid-cycle" correction. But when the business cycle approaches the late phase—as inflation and interest rates start to rise and earnings come under pressure—the odds of a correction turning into a bear market have increased historically (see Stocks’ return profile less favorable during late cycle chart).
Historically, this phase of the business cycle has had implications for asset market forward returns. When the US economy has been in the mid-cycle phase, forward 12-month real returns for the S&P 500 have been generally positive, displaying a favorable distribution skewed to above-average returns. But as expansion matures into late cycle, the forward distribution of real equity returns has typically displayed a less favorable, more negative skew.

**Subsequent stock market returns given business cycle phase (1952-2019)**

![Density plot of 12-month forward returns of the S&P 500](chart.png)

Past performance is no guarantee of future results. The chart above is a density plot generated from the 12-month forward returns of the S&P 500. Source: Standard & Poor's, Fidelity Investments (AART) as of 9/30/19.

Just 2 out of 6 late-cycle corrections made it back to the peak without turning into a bear market. That's important, because today the US business cycle is in the late phase, even though recession risks remain low.

"In general, buying corrections may be worthwhile in mid-cycle, but has historically been less successful late cycle," says Jake Weinstein, research analyst on Fidelity's Asset Allocation Research Team. "The coronavirus adds a significant degree of uncertainty during late cycle, which is the most uncertain business-cycle phase with respect to asset market returns." And now that markets have turned into an official bear, there is even more reason to be cautious and stick to your plan.

**What about the Fed?**

During 2019 and some of the early portion of 2020, US stocks rallied. In addition to sufficient earnings strength, this was due in large part to support from the US central bank. The Fed cut the fed funds rate 3
times in 2019, helping boost stocks toward new all-time highs. But over 12-month periods, rate cuts have historically been better for stocks when the business cycle is in an earlier phase (see Rate cuts better for risk assets in mid cycle versus late cycle chart). In fact, as of the end of February, the S&P 500 gave up all of its gains since the Fed made its first rate cut in July 2019.

Rate cuts better for risk assets in mid cycle versus late cycle

Since 1984, the Fed has initiated 7 monetary easing cycles through cuts to its policy interest rate. When the rate cuts were started during the mid-cycle phase, they consistently boosted global equities and tightened credit spreads over the next 12 months. Rate cuts beginning in late cycle, however, resulted in a broader range of outcomes with negative average equity returns and wider credit spreads.

Equity returns after initial Fed cut (1984-2007)

The bottom line

The long bull market in stocks has been a boon for investors. But bear markets are not unusual, especially as the US business cycle matures. While it is challenging to know which direction the market will move in the near term, the risks that market volatility transforms into a more significant bear market increase
during the late-cycle phase. Coronavirus and the recent oil shock have rattled markets to the point of nearing a bear market.

Consider talking to your advisor to ensure your current asset allocation is appropriate to meet your long-term objectives and how you can prepare for a volatile market environment.

*The length of this bull market is based on daily closing prices and considers this bull market in tact because there has not been a peak to trough drop of 20% or since the market low on March 9, 2009.

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