Bear Market Basics

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As the U.S. business cycle matures, it may be time to remember what down markets look like.

Key Takeaways

- The S&P 500® is in the midst of the longest continuous bull market in history.
- Periods of volatility, like the one in late 2018, are a reminder that pullbacks are a regular part of investing.
- As the business cycle changes, investors should be more cautious about overweighting stocks during corrections. History has shown that during the late cycle, corrections have more frequently turned into bear markets.

The bull market that started in March of 2009 has now run for more than 10 years—the longest bull market in the history of the S&P 500.* When the run began, the stock market had lost more than half of its value, and people were questioning the stability of the financial system overall.

While the ride has been relatively smooth, it hasn't all been clear sailing. The general calm has been punctuated by a few bouts of market volatility, with a series of 10% corrections and two downturns that flirted with bear market territory—20% losses.

The market still hasn't reached new highs since the most recent of those downturns—the roughly 20% selloff from September to December of last year. So technically, the bull market could be over, or just taking another breather. Regardless, it may be a good time to look at what bear markets have meant historically with your financial advisor and what today's market conditions tell us about the potential for another serious downturn.

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. It has happened 15 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 pass—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.

Peak	Trough	Duration (months)	Bear market magnitude	Recession during bear?	1-Year return after trough
9/3/1929	7/8/1932	34	-86%	Yes	124%
3/10/1937	4/28/1942	61	-60%	Yes	59%
10/9/2007	3/9/2009	27	-59%	Yes	68%
3/24/2000	10/9/2002	31	-49%	Yes	34%
1/11/1973	10/3/1974	21	-48%	Yes	38%
11/29/1968	5/26/1970	18	-36%	Yes	44%
8/25/1987	12/4/1987	4	-34%	No	23%
5/29/1946	6/13/1949	37	-30%	Yes	42%
12/11/1961	6/26/1962	6	-28%	No	33%
11/28/1980	8/12/1982	21	-27%	Yes	58%
2/9/1966	10/7/1966	8	-22%	No	33%

Peak	Trough	Duration (months)	Bear market magnitude	Recession during bear?	1-Year return after trough
8/2/1956	10/22/1957	14	-22%	Yes	31%
7/16/1990	10/11/1990	3	-20%	Yes	29%
Average		**22**	**-39%**		**47%**

Source: ISI, Bloomberg, National Bureau of Economic Research, Haver Analytics, FMRCo (Asset Allocation Research Team) as of 4/2/19.

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How do you know when a bear market is coming?

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.

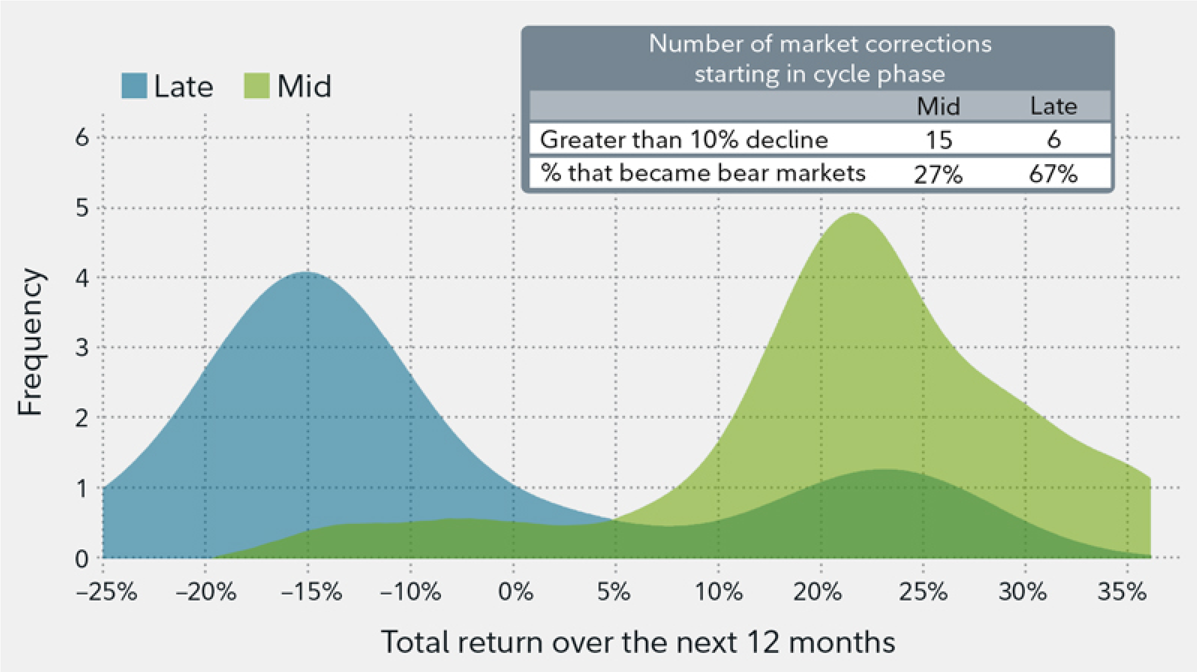
But how can investors know if a market pullback is going to be a typical correction, or something more?

One key is the business cycle. From time to time, while the economy and earnings are growing and interest rates are low, 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 the chart labeled "Stock market returns after a 5% sell-off).

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

"In general, buying corrections has been a good strategy in mid cycle, but you can get caught in a value trap in late cycle," says Jake Weinstein, research analyst on Fidelity's Asset Allocation Research Team. "On the other hand, the late cycle could last a while and provide several years of positive returns. So how do you invest at this juncture of the cycle? I think it is prudent to stick to your long-term positioning and avoid the temptation of buying stocks when they appear cheap after a correction. As the late cycle matures and recession risks rise, then you may want to consider becoming slightly more defensive."

Stock market returns after 5% or more decline (1952–2016)



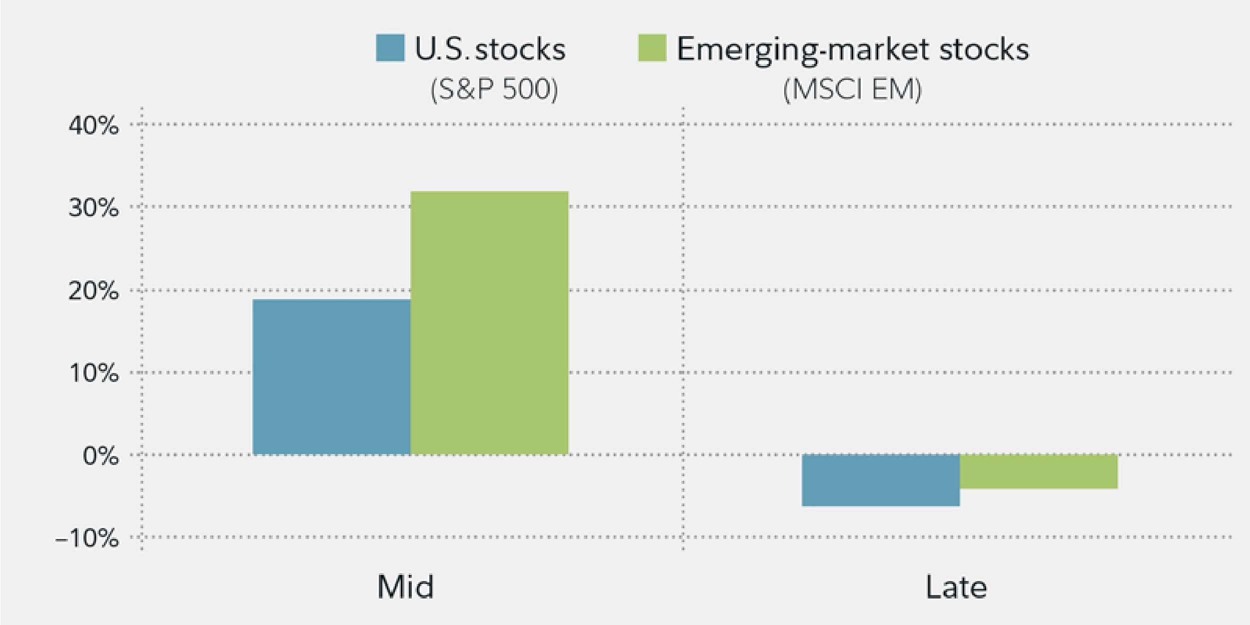
Past performance is no guarantee of future results. The above charts are density plots generated from the 12-month forward returns of a U.S. Equity Index sourced from Fidelity Investments. Declines of 5% or more refers to the trailing 3-month cumulative return for each month in the stated phase. Source: Fidelity Asset Allocation Research Team, as of January 2019.

What about the Fed?

Early in 2019, stocks have staged a significant rally, recovering much of the losses from late last year. One reason: The Fed indicated it may slow the pace of rate hikes. This isn't the first time markets have seen a scenario when weakness in financial conditions caused the Fed to pause during a tightening campaign. Historically, when that scenario happens in mid cycle, equities have often posted positive performance over the following 12 months. However, in the instances when the Fed was responding to financial conditions in the late cycle, equity markets and high-yield bond markets have had negative average returns over the next 12 months.

"The markets have rallied in part because of the Fed pause, but as individuals, we don't want to make investment decisions based on that one factor—it's probably not the right time to overweight stocks just because the Fed is becoming more dovish," says Weinstein. "I think it makes more sense to position a portfolio based on the overall cycle. Economic growth has been decelerating, earnings growth has slowed, financial conditions are tighter—there may be more good months in the near term but overall the cycle is maturing."

Average 12-month equity return after Fed pauses



Past performance is no guarantee of future results. Performance based on Fed rate hike cycles since 1960, including "pauses" as defined by Fidelity Asset Allocation Research Team. Data as of January 2019.

The bottom line

The long bull market in stocks has been a boon for investors. But bear markets do happen. As the U.S. business cycle moves further into the late phase, the risks that market volatility transforms into a more significant bear market increase. However, recession risks are still low and the late cycle could last for months or even years. Investors may want to stay close to long-term allocations for now, and when signs of recession risk increase, may want to consider tilting to slightly more conservative positioning.

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

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