Letter on the Economy

Understanding Bear Markets

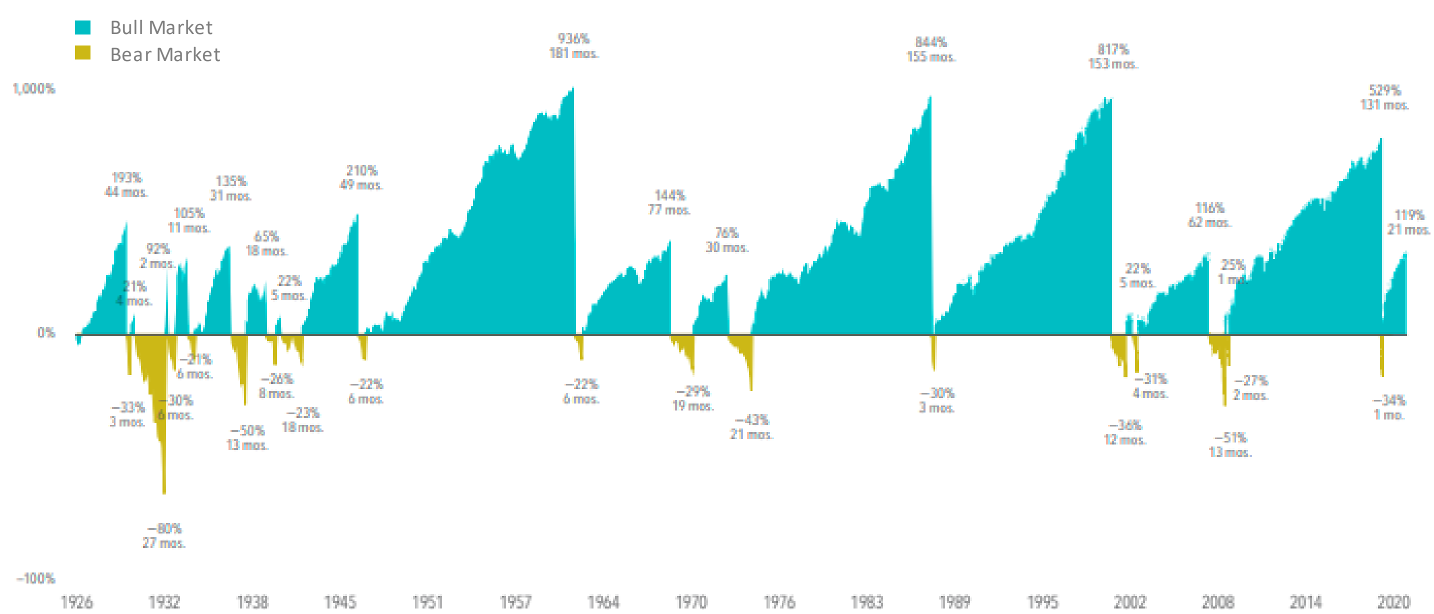
In June 2022, markets reached bear market territory for the fourth time in twenty years. The previous bear market began in March 2020 near the beginning of the pandemic and lasted only five short months. This bear market, however, is shaping up to be more typical of those we have seen throughout history.

Although bear markets can materialize in an otherwise healthy economy, they are often accompanied by an economic recession and high unemployment. Understanding that corrections and bear markets are relatively common may put investors at ease. Many long-term investors know that bear markets can also be great buying opportunities. In this article we explore some common questions regarding bear markets and provide insights on what recoveries can bring.

What is a bear market? A bear market is generally defined as a 20% or greater decline, peak-to-trough, for a major market index, usually the Dow Jones Industrial Average or the S&P 500. Our current bear market started from an S&P 500 Index peak on January 3rd and declined by 23.6% to its low point on June 16th. [1]

How often do bear markets happen? Since 1926, a bear market has occurred, on average, once every five to six years. In the last 95 years, 17 bear markets have occurred, not counting this current one.[2, 3] See the S&P 500 Index historical chart below.

S&P 500 Index Total Returns, January 1926 – December 2021 (Logarithmic Scale) [3]



Why do bear markets happen? Boom and bust cycles are a natural part of a capitalistic economy. Economies tends to grow for long periods of time and then contract afterwards for much shorter periods, before growing again. The stock market typically moves alongside this growth and contraction in the economy, because stocks are linked to corporate earnings. Studies show that the stock market often moves about 6 - 9 months ahead of the economy.

How much does the average bear market decline? Over the past 60 years, the average bear market decline on the S&P 500 Index was -34%. [3] But as the chart on page 1 shows, bear markets have been less severe in recent decades. This may be attributed to a better economic understanding and skill of the Federal Reserve.

How much do bull markets rise, and how long do they last? Since 1926, the 18 bull markets averaged 55 months in length, and advances ranged from 21% to 936%. [3] From 1945 to 2020, investors lived through a cumulative 68 years of bull markets and seven years of bear markets. [3] When viewed together, stocks reward disciplined investors.

How does a stock market decline affect the economy? Declining stock prices result in less wealth for both companies and consumers to spend, meaning less money is available to fuel the economy. Declining share prices also make companies cautious to take on new endeavors thereby stunting growth; make it harder for new companies to raise capital; and make consumers less likely to spend on big-ticket items.

When will the bear market end? Bottoms often form when we are in recession and the news is bleak. The initial leg up is often misunderstood. If history is any guide, we might expect stocks to form a bottom within the next six months.

What about the big day of capitulation? People talk about capitulation because most bear markets in history ended with a large day or two of selling, with the market falling several percentage points on intense trading volume. From there, the selling subsides, and stocks, in theory, can begin to rise. The challenge is, days of capitulation are easy to see in retrospect, but difficult to spot as they are happening. And there is no guarantee that one blowout down day will be the last.

Why stay invested during a bear market? Returns following bear markets tend to be incredibly strong. And the recoveries are front loaded, meaning the biggest gains happen in the first few days of the turnaround. Unfortunately, turnarounds are only seen in hindsight. Investors who stay the course and weather the risks are rewarded for their patience.

Recoveries are Front-Loaded [4]

Investment Strategy	Average Return 1 Year after Bear Market
Stayed 100% in stocks through bear market bottom	45%
Stayed in cash until 1 month after the bear market ended	32%
Stayed in cash until 3 months after the bear market ended	19%
Stayed in cash until 6 months after the bear market ended	12%

Are there better investments than stocks? Over the last century, stocks have been the best performing liquid asset class (meaning readily bought/sold) one could make on a risk-adjusted basis.[5] Even after long slides, stocks have performed far better than bonds, Treasury bills, savings accounts, CDs, commodities, and especially gold over the decades. For long-term investors, it is hard to beat owning a stake in global companies.

Notes and Acknowledgements:

1. S&P Technology Sector, S&P 500 Index, S&P Value Index, S&P Growth Index, S&P Commodities Index, S&P Energy Index, All Country World Index, Capital Markets Performance data Black Diamond, June 30, 2022
2. Based on S&P 500 Index, JP Morgan, FactSet, NBER, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management., March 2022
3. Dimensional Fund Advisors, Advisor Research December 31, 2021
4. Charles Schwab Center for Financial Research, 2009; Sharper Granite Research, through 2021
5. *Stocks for the Long Run*, Fifth Edition, Professor Jeremy J. Siegel, Wharton School of Business at Penn University