



## Market Analysis, Research & Education

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# How Will the Bear Market End?

## *Historical patterns of stock market reversals*

By Dirk Hofschire, CFA

After the U.S. stock market lost more than 50% of its value from its peak and hit new cyclical lows in early March 2009, the obvious question lingering on the minds of investors everywhere: When will it end? An 11% rise during the week of March 9-13 cheered investors, but did the market finally find a bottom?¹

Of course, no one can answer those questions precisely with any degree of certainty. There is no denying that the current economic backdrop looks dismal, with new data on many U.S. economic indicators frequently demonstrating multi-decade lows. Much of the rest of the world looks just as bad or worse. It is natural, faced with these circumstances, to assume that no end to the turmoil is in sight.

However, in a sense, this type of self-reinforcing negative psychology is similar to every other economic downturn that has occurred throughout history. When an economy enters recession, businesses respond to lower profits by cutting investments and laying

off workers. Consumers respond to job losses or anxiety by cutting back spending. Banks tighten lending standards and pull back on credit in the face of deteriorating creditworthiness of consumers and businesses. All of these negative trends reinforce each other in a way that makes it difficult to envision how the chain can be broken.

Eventually, however, economies do recover. The recoveries vary in magnitude and timing, among different economies and different types of business cycles. But the self-correcting mechanism of the free markets, sometimes with a bigger or smaller push from government or central bank policies, in the past has eventually stabilized economic activity. Just as no stock market rises every day in perpetuity, no economy continues to contract forever.

Today's litany of problems—from the crisis in the financial system, to a housing sector in free-fall, to heavily indebted consumers—may together pose a more challenging economic backdrop than the United States has experienced in decades. But this does not mean the economy will never recover. And if the economy recovers, as it always has, business profits and the stock market are likely to reverse course as well.

### **Historical patterns of stock market rebounds**

While the specific means and timing of exiting the current bear market are uncertain, there are historical patterns that may provide clues about how the market turnaround may unfold. There are three generalities that can be made about past market reversals:

#### **#1 – The market rebounds early**

In other words, the stock market begins to rise well before the economy starts to recover. The stock market—a collective opinion of investor expectations—is an anticipatory mechanism. Its movements are included in The Conference Board's Leading Economic Index (LEI), a widely used source on economic indicators, because stocks tend to move

### **KEY TAKEAWAYS**

- While the timing of an economic recovery is uncertain, there are historical patterns that may provide clues about how the stock market turnaround could unfold.
- History suggests the stock market often turns suddenly upward at some point during a recession; the biggest gains occur during the early months of the rally; and many investors who made a tactical move into cash miss out on much of the rebound.
- Though the current economic backdrop may be the most challenging the U.S. has experienced in decades, these patterns represent a cautionary tale for investors about the risks of being too bearish after a huge stock market decline has already occurred.

in advance of economic reversals. For instance, the U.S. market sold off abruptly in October 2007 in advance of the recession, which officially began in December 2007. The bigger market declines in the autumn of 2008 presaged a more severe economic contraction in late 2008 and in early 2009.

On the upside, the stock market has typically turned up well before an economic recovery occurs. During the past 14 recessions since 1926, the stock market has typically bottomed about halfway through the recession—about six months after a recession has begun (see Exhibit 1, below). The median return thereafter, from the market low point until the end

**EXHIBIT 1: The stock market historically has rallied well before an economic recovery.**

Stock Market Performance During Recessions (1926-2008)	
	Median
Recession Duration (Months)	11
# Months Until Market Low Point	6
Return From Low to End of Recessions	25.2%

Stock market performance represented by S&P 500® Index. Recessions are defined by the National Bureau of Economic Research. Source: Ibbotson, National Bureau of Economic Research, Haver Analytics, FMRCo (MARE) as of 2/28/2009.

of a recession, has been 25%. Even during the worst of the Great Depression, the stock market bottomed and began to rebound a full nine months prior to the end of the 1933 recession. So historically, the market has looked beyond current conditions and begun to rally while the economic data still indicated contraction and the unemployment rate continued to go up. For the 11 recessions that coincided with stock bear markets since 1926, eight of them experienced the beginning of a bull market well before the end of the recession.<sup>ii</sup> (See MARE article, *U.S. Stocks Often Have Rebounded During Recessions.*)

**#2 – Individual investors arrive late**

During bear markets, especially ones as severe as the current downturn, the obvious temptation for investors is to reduce their allocation to stocks and move into the safety of cash. A common refrain from investors is that they will “wait until things get better” to restore their allocation to stocks at a level that is consistent with their longer-term investment strategies. The criteria for improvement often implies the investor will hold out for some positive news about the economy, or possibly wait for the market to start rising again in a more sustained manner.

While this strategy may sound reasonable at a time when stock markets continue to decline and investors take comfort from avoiding losses, the flaws are exposed when the bear market comes to an end. As noted, the market tends to rise six months before the economy stops contracting, so waiting for good economic data to hit the headlines inevitably means missing out on the early stages of the rally. Of course, waiting for the stock market to go up as a signal of the end of the bear market also necessarily means an investor has to sit on the sidelines while a new bull market begins.

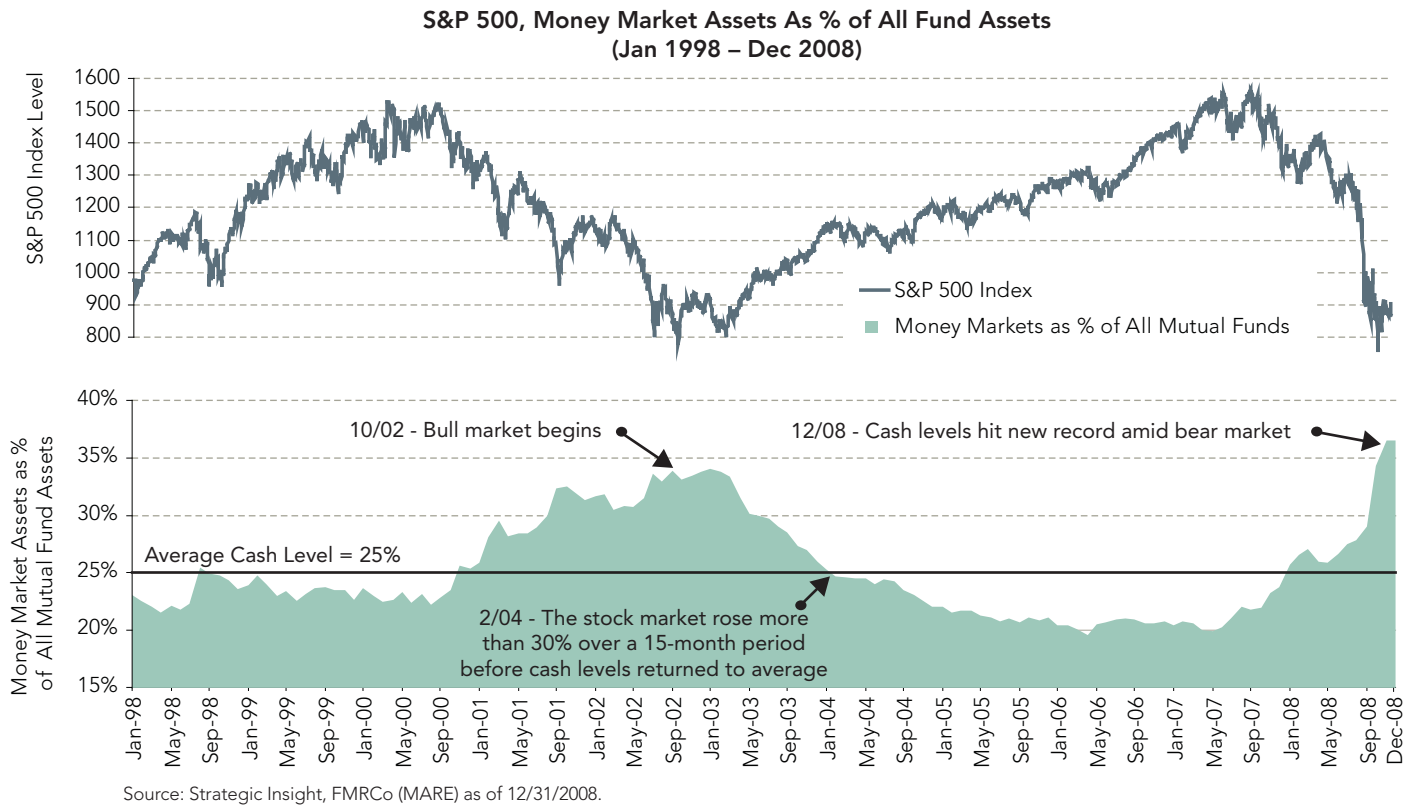
This pattern of investor behavior, and its pitfalls, can be demonstrated looking at the end of the 2000-2002 bear market (see MARE article, *Bear Markets Often Breed Bad Behavior: The Perils of Herding to Cash*). Investors moved into a record-high cash position by the end of 2002, during the exact period when the U.S. stock market was bottoming after a three-year downturn (see Exhibit 2, next page.) It took investors roughly until February 2004—15 months after the end of the bear market—to reduce their cash position back to an average level, during which time many had missed out on the stock market’s return of more than 30% during the simultaneous bull market rebound.

**#3 – Late investors miss big returns**

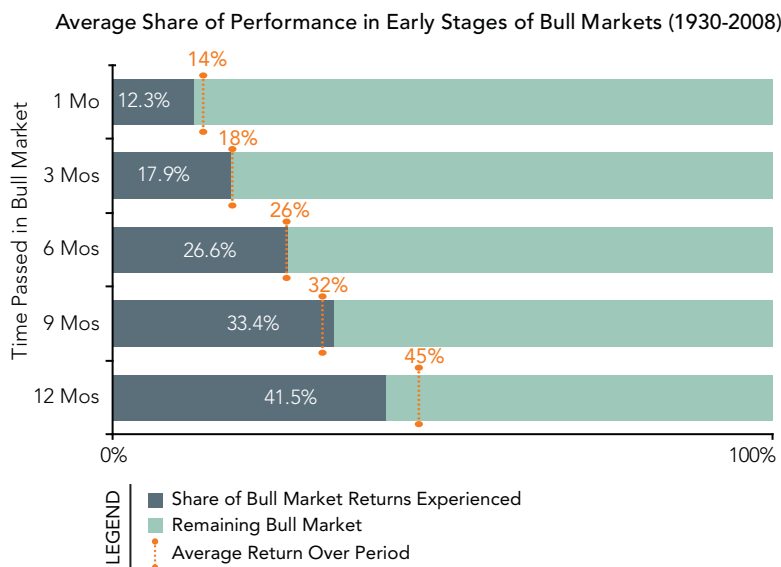
If new bull markets rose gradually and accrued their largest gains as the cycle matured over a multi-year period, perhaps missing out on the early stages of the rebound would be a small price to pay for the safety of making sure a bear market had truly ended. However, the reality has been the exact opposite. Bull market returns tend to be front-loaded, with the bulk of returns accruing to the earliest months of the rally. Being late to the party can mean the birthday cake is half eaten by the time you arrive.

For example, evaluating all the bull markets since 1930, the first month of a new bull market on average has provided more than 12% of an entire bull market’s gains, with an average return of 14% during these initial months (see Exhibit 3, next page). Within six months, more than one quarter (27%) of an entire bull market’s performance (on average) was already in the books. The first 12 months of the average bull market has provided more than 40% of an entire bull market’s price appreciation, yielding on average 45% for investors—well above the category’s long-term average annual return of 10%. So while bull markets typically last an average of three years and have even spanned

**EXHIBIT 2:** Historically, many investors overcome with fear have increased cash positions during bear markets, but have been slow to reallocate to stocks in the early stages of a new bull market.



**EXHIBIT 3:** A large percentage of a bull market's gains have accrued in the early months of a rally.



All stock market performance figures in this article represented by S&P 500® Index using daily data. Source: Bloomberg, FMRCo (MARE) as of 1/31/2009. Past performance is no guarantee of future results.

an entire decade, the biggest bang for the buck has typically come in the initial months of the rebound. Because by definition bull markets account for all of the gains during stock market cycles, missing just a few months of an early bull rally has historically meant missing out on a hefty chunk of the gains of an entire multi-year period. (For the entire study, please see MARE article, *Bull Markets: Early Bird Caught Returns.*)

**Investment Implications**

No one can predict with exact certainty when the current bear market will end. But if historical patterns are a guide, the stock market will turn suddenly upward at some point during the recession, the biggest gains will come in the early months of the rally, and many investors who made a tactical move into cash will miss out on much of the rebound. This analysis may offer little guidance to those who are looking for the precise best moment to re-enter the stock market. However, it should be a cautionary tale for all investors about the risks of being too bearish after a huge stock market decline has already occurred.

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*Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.*

**Past performance is no guarantee of future results.**

[i] All references to stock market performance in this article, unless otherwise noted, refer to S&P 500 Index performance. Index peak occurred on 10/9/07, index low occurred on 3/9/09. Source: FMRCo (MARE) as of 3/13/09.

[ii] Source: Ibbotson, National Bureau of Economic Research, Haver Analytics, FMRCo (MARE) as of 2/28/2009.

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