Bear sightings: What bear markets could mean for investors

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Kristina Hooper
Chief Global Market Strategist

Bear sightings

This month has brought bear sightings in markets all over the world, including the US and China.

Buying opportunities?

Stocks can become oversold in a bear market when emotions exacerbate sell-offs, making them far less rational.

Tech sector

I believe this may be a time for investors to consider selectively adding to their technology exposure

We live in a suburb with a lot of wildlife. Wild turkeys will occasionally run across our street, squirrels outnumber the human population by many multiples, and occasionally a hawk circles our house looking for a small creature to grab as an appetizer (which makes me quite nervous since we have several plump chihuahuas). We even have a raccoon who lives under our deck and regularly peers into our sliding glass door looking for food. But it is very rare for us to have a bear sighting anywhere in our neighborhood. That changed last week, with reports that a black bear has been seen in backyards within two miles of our house. It felt quite ironic that this rare sighting occurred the same week that the S&P 500 Index briefly dropped into bear territory.

There have been some bear sightings (the market kind) in other parts of the world as well. Most notably, the MSCI China Index has fallen more than 20% this year, and we have also seen bear markets in Russia and eastern Europe, as we would expect given the geopolitical crisis engulfing the region.[1] Other major indices have experienced significant corrections but have thus far avoided bear market territory.

But what could a bear market mean for investors? Based on history, we know:

1. **It does not definitively signal a recession is to follow.** Now most bear markets do foreshadow recessions, but not all of them have. The last three S&P 500 bear markets were followed by recessions, but a US recession did not follow the bear market of 1987 – or the bear markets of 1961 or 1966.[2]

2. **Typically, the depth and length of a bear market will correlate somewhat with the depth and severity of the economic downturn.** For example, the S&P 500 bear market of 2020 lasted less than two months, and the recession of 2020 was very brief as well.[3] Conversely, the bear market of 2007-2009 saw an S&P 500 Index drop of 56% and proved to be a leading indicator of a severe global recession from 2008-2009.[3]

3. **It can create buying opportunities.** Stocks can become oversold in a bear market. Sentiment is typically very negative, with pessimistic headlines focused on the stock market sell-off. Emotions can take over, exacerbating sell-offs and making them far less rational. We know that every S&P 500 bear market has been followed by a recovery that has taken the index to new highs. The caveat is that sometimes that recovery can take significant time.

An opportunity in the tech sector?

Speaking of opportunities, one big bear sighting has been in the technology sector. The NASDAQ Composite Index is well into bear market territory, down nearly 30% since its peak through last Friday.[4] That makes sense given that tech stocks have higher valuations and typically come under pressure as rates begin to rise. In addition, tech stocks are generally "long duration" assets, which means they have stronger earnings growth and therefore higher earnings expected further out in the future. As is the case with fixed income, where a 30-year bond typically experiences a greater impact from a rise in interest rates than a short-term bond, higher growth stocks can experience greater downward pressure when rates rise and their longer-term earnings are discounted by a higher interest rate – especially when an aggressive hiking cycle is anticipated.

While the current sell-off started in the more speculative corners of technology, it has spread to larger companies with strong balance sheets. I believe the current re-rating has been overdone, especially since I believe the Federal Reserve (Fed) will not ultimately tighten as much as markets currently expect.

In a higher inflation environment, I find the technology sector has typically been attractive because it generally has wider profit margins and can therefore tolerate higher input costs. And the tech sector, while still expensive, has valuations that are far lower than they were during the tech bubble. Now this is a challenging environment, so there will clearly be winners and losers in the tech sector. However, I believe this may be a time for investors with longer time horizons to consider selectively adding to their technology exposure.

Now the caveat is that there could be more volatility – and sell-offs – to come in the near future. Especially given that the Fed will begin quantitative tightening in about a week. We also have had more hawkish talk from Fed Chair Jay Powell and European Central Bank President Christine Lagarde in recent days, and that is adding to the nervousness and tension in markets. However, any weakness should offer entry points for dollar-cost averaging into the technology sector for long-term investors.

Where bears walk, opportunity follows (at least when it comes to markets). When it comes to backyards, I'll keep my doors locked.

Notes

[1]Source: MSCI as of May 20, 2022. [2]Recessions defined by the US National Bureau of Economic Research. [3]Source: Bloomberg, L.P. [4]Source: Bloomberg, L.P.