Five past bear markets and what they taught us

David Leduc (DL), head of fixed income at Mellon, and George Saffaye (GS), global investment strategist at Mellon, dissect five past bear markets (20% peak-to-trough) and reveal what they think the biggest takeaways were for investors.

1. The Global Financial Crisis

The seeds of the biggest crisis since the Great Depression lay in a US debt-fueled home purchase binge, which ultimately led to a spike in the home-price index.

At the same time, US lenders relaxed their lending standards and issued ‘no-doc’ loans, which required no proof of assets or income. The financial system started to crumble under the weight of low-quality loans and many flagship financial services companies went bankrupt, or were sold at distressed prices. This resulted in a bear market, which lasted 17 months and the S&P 500 underwent a loss of 56.4% in dollar terms.

DL: “This bear market highlighted the danger of misusing a financial innovation. A notable feature was the use of extraordinary monetary policy by the Fed and other central banks to save the financial system. This set a precedent for the aggressive policy actions taken during the European debt crisis and this most recent crisis.”

GS: “A critical flaw in most financial models that underpinned mortgages, and the exotic securities related to them, was the assumption that housing prices would not fall. Sadly, there is no warning as to when a bubble will burst nor a way to systematically avoid them. Investors can only try to understand when markets appear extended, push on all market and economic assumptions underpinning current market conditions, and adjust for risk appropriately.”
2. The Dot-Com Crash

This bear market was driven by the tech bubble and the associated dot-com crash. IPO volume was unprecedented during 1999 into 2000, and the market became increasingly speculative. Companies with dubious business models found raising capital easy with accommodating capital markets, which led to surging stock prices.

The market was already struggling to shake off the excess from prior years when the 9/11 attacks occurred. We think this helped push the economy into a recession—a 30-month bear market, during which the S&P 500 took on a total loss of 49.1%.

**DL:** "The dot-com crash was the result of many years of exuberant investment in technology companies—many with questionable business models. This was also the era of some major financial accounting scandals, notably World Com and Enron."

**GS:** "It's very unlikely stocks can grow high double-digits into perpetuity. Stock price appreciation was way ahead of earnings, and many of these companies had questionable business models, jeopardizing the delivery of those earnings, even into the future. Sticking to fundamentals, modeling a company's business growth, understanding its product set, IP or business model are examples of how to properly measure a company's growth sustainability."
3. The Gulf War

The economy had already been weak as a result of tighter monetary policy. This led to a decline in stocks that accelerated when the Gulf War began.

The war caused oil prices to spike to their highest levels in a decade and a recession followed in the US. The downturn ended up almost as short-lived as the war itself with the market bottoming in October 1990 and making new highs by February 1991.

DL: “During this time, Executive Life Insurance Company, the largest of its kind in California, failed as a result of many years investing in ‘junk bonds’. The use of ‘junk bonds’ or high yield bonds to finance corporate investments and leveraged buyouts is an example of overuse of a financial innovation which ultimately created systemic risks.”

GS: “Despite continuing conflicts that contribute to an uncertain future, I believe we must persevere through it and remain focused. This will always be a part of the investment landscape. Skittishness during increased market volatility can lead to questionable decisions. I think investors should remain focused and look past short-term noise for long-term opportunities.”
4. Black Monday

This bear market was one of the most volatile in financial market history and was one of the first highlighting the potential impact of quantitative trading strategies.

Middle East tensions further exasperated volatility when Iran fired missiles at oil tankers and the US responded by destroying Iranian oil platforms. This ultimately led to Black Monday (October 19, 1987) when the S&P 500 declined by more than 20% in one day.

DL: “This was the first market crash where the use of computer models, to guide hedging and trading strategies, was singled out as a potential cause or accelerant. There was a continuing debate about whether these quantitative strategies known as ‘portfolio insurance’ both contributed to the run up in valuations and exacerbated the volatility.”

GS: “We live in a world fraught with risk and conflict, something that is ever-present. This will always be a part of the investment landscape. In this bear market, we hit bottom approximately six and a half weeks after it began and the recovery was swift and stable. Those who exited the markets and then capitulated missed a significant rally versus those who invested or rebalanced towards equities and boosted their returns during the rally.”

(Source: Bloomberg, March 2020) Charts are provided for illustrative purposes and are not indicative of the past or future performance of any product.
5. Extreme Monetary Policy

After a decade of sustained inflation, in early 1980 the Federal Reserve raised interest rates to nearly 20% pushing the economy into a recession.

Inflation, which had been elevated ever since the 1973 oil shock, had risen to an astounding 13.5% by 1980. The Fed, under Paul Volker, increased interest rates aggressively over the course of six months, with the Fed Funds Rate eventually reaching 17.6% in April of that year. The market finally bottomed in August 1982 after steadily declining for approximately two years. But by November 1982, just three months after bottoming, the market reached new highs.

**DL:** “One lesson from this environment is the economic cost of persistent high inflation. The stimulus package being instituted during the current crisis may remain in place long after the medical crisis has past, raising the risk of a high inflation environment in the future.”

**GS:** “The quick recovery demonstrated that economic challenges do not necessarily require government stimulus or low interest rates to aid recovery. Actually, the response that worked well during this time period involved raising interest rates, lowering taxes, and removing regulation. The lesson learned is that even when the economy is in the throes of double-digit inflation and unemployment, staying invested can be better than not.”

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6. And what now?

So much for five previous bear markets. Today, with the spread of Covid-19, we face equal or greater challenges than those faced by previous generations of investors. Stock markets have already seen the biggest sell-off in a generation, even gold – that ultimate ‘go-to’ asset for investors in troubled times – suffered in the face of a dramatic dash for cash over recent weeks.

Since then, central banks and policymakers – like the Bank of England and the US Federal Reserve - have stepped in with a coordinated and unprecedented response. Among many actions they have taken is the lowering of interest rates – in some cases to levels never seen before. For now, volatility appears to have calmed slightly. But as Covid-19 continues to spread around the world – and as the resulting economic lockdown gathers pace – where we go from here remains an open question.

One thing previous bear markets may have taught us, however, is that life goes on. In each of our five bear markets, sell-off was ultimately followed by recovery. As ever, a small dose of historical context goes a long way in explaining our current predicament.