STREETWISE

Bear Market Growl?

When bear markets occur without a recession, they tend to be shorter and shallower.

By BEN LEVISOHN
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To modify the old saying: If it growls like a bear, and it bites like a bear, then you might have to acknowledge that it is indeed a bear.

The bear we're talking about, of course, is a bear market. Despite sinking 2.2% last week, the Standard & Poor's 500 has yet to drop the necessary 20% for that designation. Still, the popular benchmark is more than halfway there, and as much as we hate to admit it, we should at least consider the possibility that this is the start of something more than your run-of-the-mill correction.

When you're stalked by a bear in the woods, it's probably not wise to pause and ponder whether it's, say, a black bear or a grizzly. Not so when the S&P 500 starts falling. At that point, it's important to ask, What kind of bear are we in?

It isn't an academic question. Most bear markets occur in tandem with a recession. That was the case with the bear market that started in October 2007 and saw the S&P 500 tumble nearly 60%. It was also the case during the dot-com bust, when stocks lost about half of their value. Of the 15 bear markets that have occurred since 1928, 10 fit this pattern. These bear markets tend to be long—a median of just over 20 months—and deep—the S&P 500 has dropped 44% on average.

If one looks only at the headlines, it's easy to imagine the worst. China's stock market is in free fall, pushed lower by investors who fear the total collapse of the world's second-largest economy. The junk-bond market, meanwhile, appears to be signaling a 20% chance of recession, even if you strip out the beleaguered energy sector. Manufacturing in the U.S. is slowing, and in what was a decent start to earnings season, Michael Ward, CEO of railroad operator CSX (ticker: CSX), mused that his company is feeling pressures it has never felt outside a recession. If this isn't just another growth scare, then the road ahead will no doubt be a painful one.

Yet despite the chaos at home and abroad, there is a very good chance that the U.S. will avoid a recession in 2016. The economy is still cranking out close to 200,000 jobs a month, and labor growth shows little sign of slowing, says RBC Capital Markets economist Tom Porcelli. He notes that the Labor Department's Job Openings and Labor Turnover Survey showed there are 2.5 times as many job openings as people collecting unemployment insurance. And while all of the manufacturing surveys point to continued weakness, manufacturing makes up just 12% of the U.S. economy. The services sector makes up 86%, and the nonmanufacturing sectors appear to be holding up just fine. In the past, the strength in the services sector helped the U.S. weather weakness in manufacturing, as was the case during the emerging market crisis of 1998-99. "There are issues to be sure," Porcelli says. "But the U.S. economic backdrop is relatively sound."

But if it isn't a recession, why is the market freaking out? Chris Verrone, head of technical analysis at Strategas Research Partners, argues that the market is starting to price in some sort of financial crisis that will most likely occur in the energy and commodity sectors, where bond prices have fallen and the cost of credit-default swaps—which pay out if a company can't pay its debt—have spiked. The collapse of China's currency is also a fear, as the markets fret that it will reverberate through the developing world, and ultimately take down the global economy. At this stage, it doesn't matter whether the fears are overblown. Market participants believe them, and that could cause a bear market even if they never materialize.

NONRECESSIONARY BEAR MARKETS tend to be shallower and recover more quickly. The most famous case was the 34% drop in the S&P 500 in 1987—the one that included the 21% drop on Black Monday, Oct. 19—but there have been four others, including 2011, when the S&P 500 fell 22% from its May high to its October intraday low, and the 23% tumble during the emerging market crisis of 1998. These bear markets tend to be shorter—a median of five months—and the drops smaller—"just" 26% on average. These, Verrone says, "are the road maps we should be familiar with."

If there's a silver lining, it's that the market is a lot cheaper than it was a few months ago. The S&P 500 trades at 15.9 times 12-month forward earnings forecasts, notes Bank of America Merrill Lynch strategist Savita Subramanian, back where valuations were at the beginning of 2014. That means there are values to be had. She recommends looking at cash-rich companies, which have outperformed companies with heavy debt loads by 4.8 percentage points so far this year; investment-grade companies, which have outperformed their junk-rated counterparts by four percentage points; and high-quality companies, which have outperformed low-quality by four percentage points. Don't expect that to change until the selling pressure finally comes to an end.

Then again, maybe we'll get lucky. Maybe this is neither a black bear nor a grizzly but a koala—not a bear at all.

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