

# **How to Survive a Bear Attack**

May 6, 2022

*"The best way of being kind to bears is not to be very close to them."*

- Margaret Atwood

The U.S. economy surprisingly contracted by 1.4%, on a seasonally adjusted and annualized basis, for the first quarter of 2022. The consensus expectation for Q1 GDP, according to Bloomberg, was for a 1% gain, much slower than Q4 2021 GDP of 6.9%. While the number was negative, there were some positive components to the final number—such as strong imports, services, and purchases of durable goods (goods that have the ability to be kept for a period of time), which indicate a healthy consumer. A slowdown in U.S. economic growth has been long expected but the surprising negative period has led to increased chatter of a recession, broadly defined as two consecutive quarters of negative GDP growth and the potential of an equity bear market along with it.

## **Our Take**

While the market was surprised at the negative announcement, our capital market strategy team maintains the stance that a typical recession in 2022 remains a low-probability event. An economic slowdown is their base case, and it could lead to a pivot in the U.S. Federal Reserve's hawkish narrative, which would be positive for both equities and fixed income. Despite the surprise, it's not the time for a knee-jerk reaction when it comes to an investment portfolio.

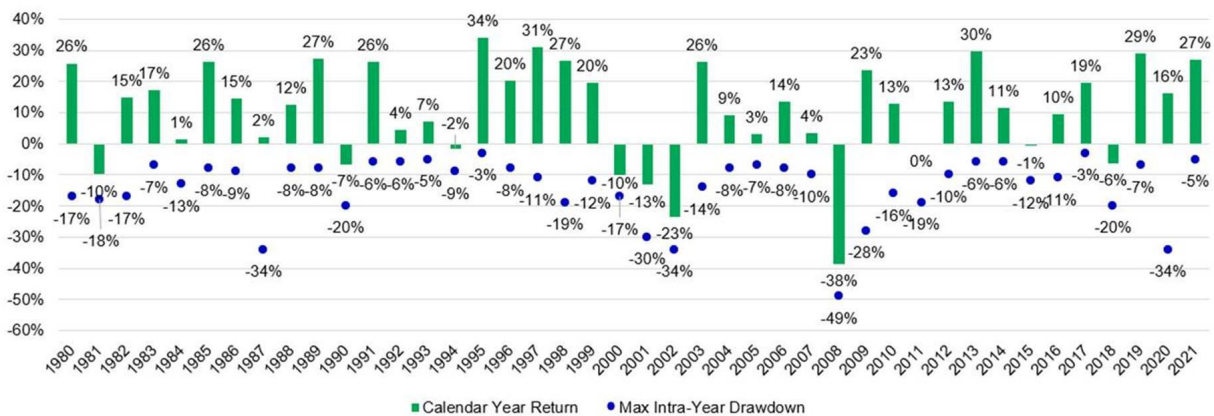
The team has four simple rules that they like to use as a framework during these periods of heightened volatility. They're loosely based on advice in the event one comes face to face with a bear in the wild.

## **Rule #1 - Vanquish fear and panic.**

When it comes to the stock market, there'll always be a reason to sell. Negative headlines stoke fear in the minds of investors and that's a natural reaction from a human behavioral perspective. Loss aversion is a cognitive bias, which explains why individuals feel the pain of a loss twice as much as the equivalent pleasure of gain. As a result of this, individuals tend to try to avoid losses in whatever way possible.

Similar to a bear attack in the wild, corrections can happen at any time. Stock market corrections (a drop of 10% or more) are common and very difficult to predict. Since 1980, the S&P 500 Index has fallen an average of 14.3% in any given calendar year but is positive 78% of the time with an average return of 10.3! The key is to position an investment portfolio defensively prior to recessions that correspond to large equity drawdowns.

**S&P 500 Index - Calendar Year and Max Intra - Year Returns (1980 - current)**



Source: Bloomberg, Capital Markets Strategy. As of December 31, 2021

Another cognitive bias when it comes to humans and investing is *availability bias*, where we tend to listen the most to the information that's most readily available—like why we tend to read headlines and not the entire news article. It's important that investors take in all available information and make a sound, informed decision rather than one based on the most sensational headline.

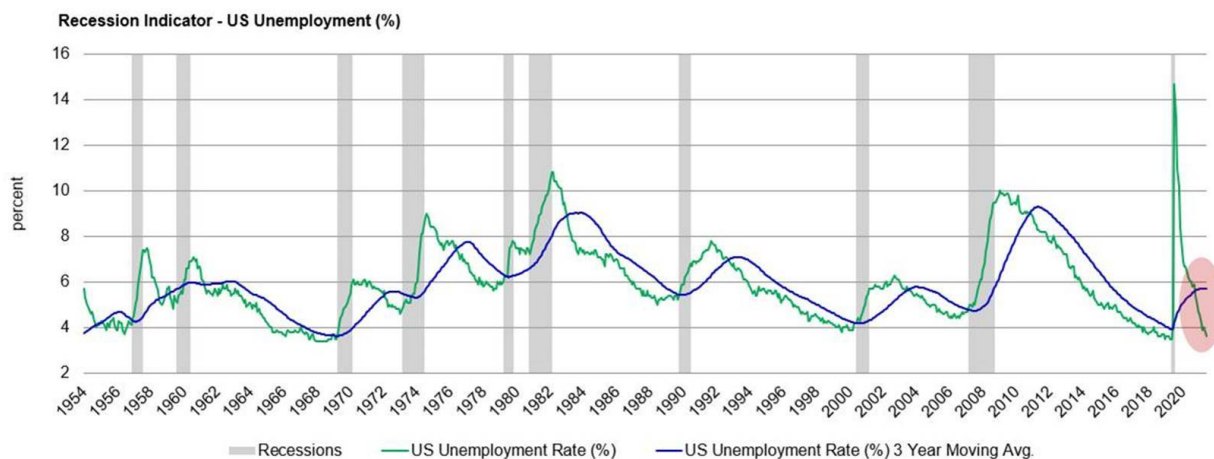
## Rule #2 - Know your environment.

Our work would suggest that the U.S. economy has begun to slow down and will continue to do so throughout the year. But let's be clear: despite the slowdown, the probability of a traditional U.S. recession over the next 12 months remains low. When we say *traditional*, we mean one that lasts 10 months, on average, and often coincides with elevated unemployment. A technical recession, where GDP is negative over two consecutive quarters, is possible, but we believe a sustained bear market is unlikely.

Historically, there are warning signals prior to falling into a traditional economic recession. Some of the signals that we look at are highlighted in the table below. Other than inflationary pressures, which was already signaling a higher risk of recession, we've now seen two other indicators: the yield curve, measured by the difference between the 10-2 year U.S. government bond yields, and financial conditions that have started to signal an economic slowdown. However, the other signs of a recession aren't present today, which supports our narrative of a slowing economy.

Signs of a Recession	Present Today
Inverted Yield Curve	Neutral
ISM Manufacturing PMI Below 45	No
Positive Inflationary Trends	Yes
Tighter Financial Conditions	Neutral
Housing Starts Declining	No
Labour Market Weakening	No
Leading Economic Indicators Negative	No

Although the economic data is slowing, there's evidence that corporate earnings remain quite resilient. We're almost halfway through Q1 2022 earnings for the S&P 500, and 76% of companies have exceeded expectations. Given the negative sentiment today, they're not being rewarded in the form of a higher share price. In their earnings calls, many CEOs are talking about their continued hiring intentions and the tight labour market. Unemployment in the U.S. is very low at 3.6%, and arguably a level that's synonymous with full employment. It's very rare to see recessions when unemployment is this low.

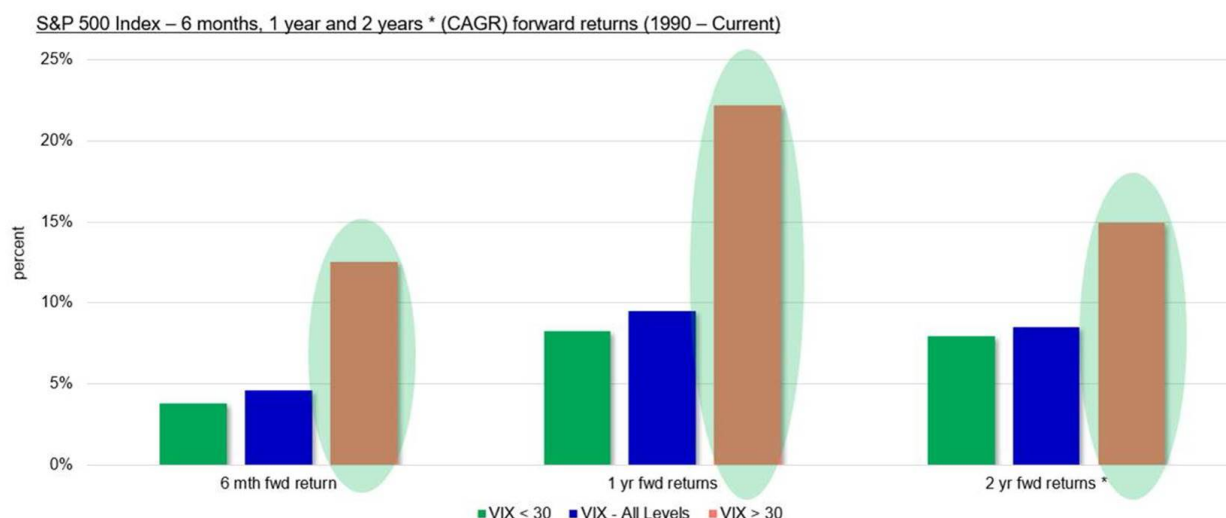


### Rule #3 - Take advantage of opportunities.

For the long-term investor, it's important to remain focused on the fundamentals. Warren Buffet attributes some of his success to being a contrarian investor. He famously said, *"We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful."* Investors know this investment truism to be accurate but it's often hard to execute.

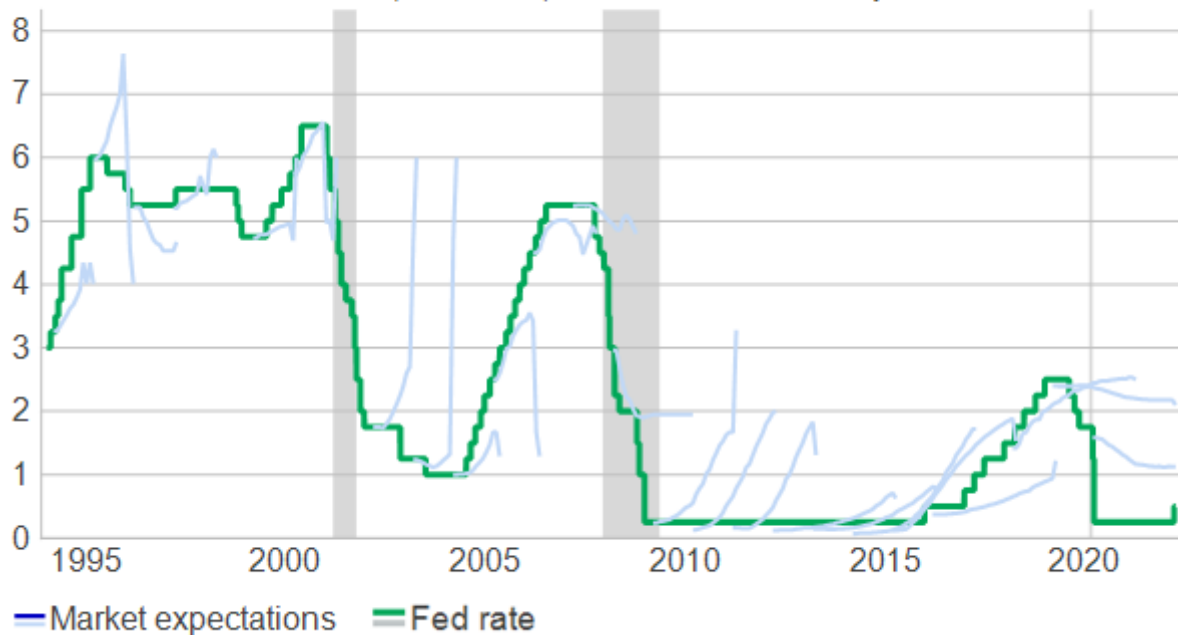
The VIX Index is a great measure of the amount of *fear* in the markets. When the VIX index is high, there's more fear amongst investors. Since 1990, the VIX has averaged approximately 19, and a measure above 30 is an important level that signifies extreme aversion to equities. The VIX is once again above 30. Historically, when the VIX has breached 30, the S&P 500 Price Index return has been positive more than 80% of the time one year later.

The table below contrasts six-month, one-year, and two-year annualized returns for the S&P 500 Index since 1990 in periods when the VIX is greater than 30, in periods when the VIX is less than 30, and in all periods combined. History suggests that investors can improve their returns by becoming greedy and embracing risk when others are fearful and selling. However, in this environment, it's also important to take advantage of the right opportunities. This isn't a time to add to the higher risk areas of the market but rather to be selective.



When it comes to predicting the number of U.S. Federal Reserve rate hikes, the market is notoriously and historically bad at it, as the chart below illustrates. During most rate-hike cycles, the market tends to be overly aggressive in their expectations for the number of rate hikes by the Fed at the beginning of the cycle. Market expectations are for the Fed to raise the overnight interest rate a total of ten times over the next seven meetings leaving the Federal Funds Rate near 3% after the February 1, 2023 meeting. Should we see weaker economic data, it could give enough reason for them to pivot from their ultra-hawkish tone. Any shift in that tone to a less hawkish stance would likely be positive for both equities and fixed income.

## Fed Funds Rate (Actual) vs Market Expectations



Source: Federal Reserve, CME Group, Macrobond, Manulife Investment Management. As of March 2, 2022

### **Rule #4 - Don't be afraid of what goes bump in the night. If something is meant to harm you, it'll stalk you silently.**

There's another behavioral bias called *confirmation bias*. This is where investors seek out information to prove their beliefs. If they're worried about the economy or markets, they'll look for articles or comments on the internet, social media, TV, or elsewhere that helps support their fears. They won't look for information that'll help calm their fears. While it's important to not dismiss the fears, it's important to gather all information to come to an informed decision. It's likely that what they believe will cause the next recession and/or bear market won't be the main catalyst; it's likely to be something completely different.

### **Final thoughts – don't run**

The data is showing a slowdown in the U.S. economy and abroad, which will also likely impact the Canadian economy. However, it's important not to panic and have a knee-jerk reaction. One of the other key rules when coming across a bear in the wilderness, is not to run away, and that applies to investments. Take a step back, survey the environment, remember, or revisit the plan, and stay on course.