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Investment Institute

Special Report

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Global Asset Allocation Strategy Team

The bear is back — Out of hibernation so soon?

Key takeaways

- U.S. equity markets entered bear market territory on June 13 as concerns about elevated inflation, slowing economic growth, and aggressive Federal Reserve (Fed) policy rattled the markets.

What it may mean for investors

- Historically, diversified portfolios have helped investors weather equity volatility and often have recovered more quickly than individual asset classes.

Equity markets have been declining for most of the year after peaking on January 3, 2022, with the S&P 500 Index officially entering bear market territory on June 13. The decline started as investors fretted over the sustained high level of inflation and the Fed's plans for aggressive monetary policy tightening. Since January, the war in Ukraine and its impact on markets exacerbated the inflation pressures triggered by supply chain disruptions and growing consumer demand as economies emerged from the pandemic. Moreover, in more recent meetings, the Fed announced its determination to fight inflation, indicating less likelihood of moving away from an aggressive stance.

Concerns about the impact of inflation on the consumer and whether the Fed will be able to navigate a soft landing for the economy have further rattled markets. Growing economic, geopolitical, and market uncertainties have all contributed to the current volatile market environment; we do not anticipate the choppiness will ease soon, unlike the previous bear market sparked by COVID-19. In 2020, a record short bear market commenced on February 19, hit the -20% threshold 16 trading days later on March 12, bottomed another seven trading days after that on March 23, and recovered within five months on August 18. It was the shortest bear market in history (Table 1), as global governments provided stimulus to consumers and central banks provided liquidity to the markets. In contrast, it took the current bear

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market 111 days to reach bear market territory, and we expect it will take time to repair as major central banks are prepared to tighten in order to contain inflation.

No one knows for certain how long and how deep this bear may be, but a look back at previous bear markets may give us some historical context. Historically, bear markets have occurred, on average, once every cycle and typically are much longer-lived than the 2020 bear market. Since 1929, bear markets have averaged slightly less than 11 months in duration and have experienced an average S&P 500 Index return of -35.5%.

Table 1. A history of bear markets

S&P 500 Index bear markets	Decline (%)	Duration (months)
September 7 – November 13, 1929	-44.7	2.2
April 10, 1930 – June 1, 1932	-83.0	25.7
September 7, 1932 – February 27, 1933	-40.6	5.7
July 18 – October 21, 1933	-29.8	3.1
February 6, 1934 – March 14, 1935	-31.8	13.2
November 9, 1938 – April 8, 1939	-26.2	4.9
October 25, 1939 – June 10, 1940	-31.9	7.5
November 9, 1940 – April 28, 1942	-34.5	17.6
May 29 – October 9, 1946	-26.6	4.4
June 15, 1948 – June 13, 1949	-20.6	11.9
July 15 – October 22, 1957	-20.7	3.3
December 12, 1961 – June 26, 1962	-28.0	6.4
February 9 – October 7, 1966	-22.2	7.9
November 29, 1968 – May 26, 1970	-36.1	17.9
January 11, 1973 – October 3, 1974	-48.2	20.7
November 28, 1980 – August 12, 1982	-27.1	20.4
August 25 – December 4, 1987	-33.5	3.3
July 16 – October 11, 1990	-19.9	2.9
March 24, 2000 – October 9, 2002	-49.1	30.5
October 9, 2007 – March 9, 2009	-56.8	17.0
February 19 – March 23, 2020	-33.9	1.1
Current: January 3 – June 16, 2022*	-23.6	5.4
Average	***-35.5***	***10.8***

Sources: © 2022 – Morningstar Direct, All Rights Reserved[1], and Wells Fargo Investment Institute, as of June 24, 2022. For illustrative purposes only. The S&P 500 Index is a market-capitalization-weighted index considered representative of the U.S. stock market. **Past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment.
*Current bear market data is as of June 24, 2022, with the peak on January 3, 2022 and trough on June 16, 2022. Averages do not include the current bear market.

It is important to note that Wells Fargo Investment Institute's investment objective allocations carefully weigh market volatility risk against the potential for long-term growth in the value of the portfolio. The goal is to construct a mix of asset classes designed to provide a path of returns calibrated to the volatility risk an investor is willing to assume. In other words, allocations aim to match specified risk and return objectives.

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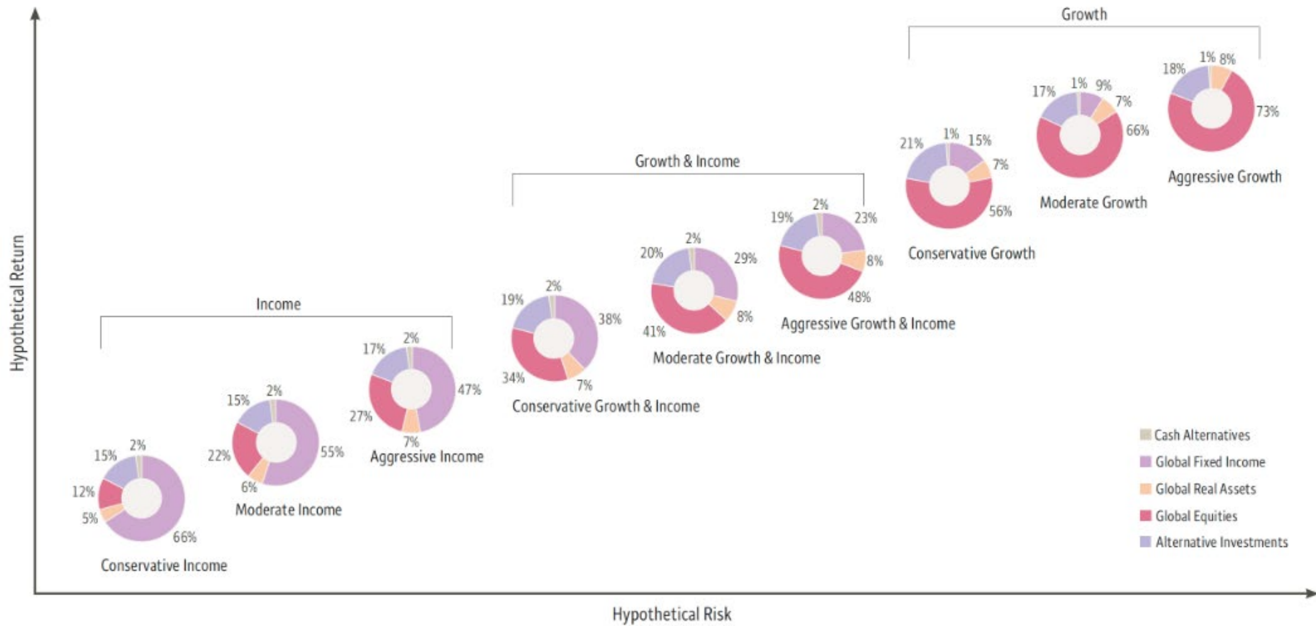
Chart 1 shows our strategic allocations' exposure to equities for potential long-term growth and their exposure to fixed income for potential stability and income generation. Some allocations also may include hedge funds for the diversification benefits that they may provide for qualified investors. In today's volatile market environment, asset allocations that favor fixed income have been faring better than those that favor equities, despite fixed income asset classes this year experiencing the worst losses they've seen in several decades. This is in contrast to last year's returns, when both equities and fixed income posted positive returns, and the returns we expect for both asset classes over the course of a full market cycle (a full bull market and a full bear market).

Chart 1. WFII's asset allocations for a range of investment objectives



Source: Wells Fargo Investment Institute (WFII); as of July 19, 2021. Chart is conceptual and does not reflect any actual returns or represent any specific asset classifications.

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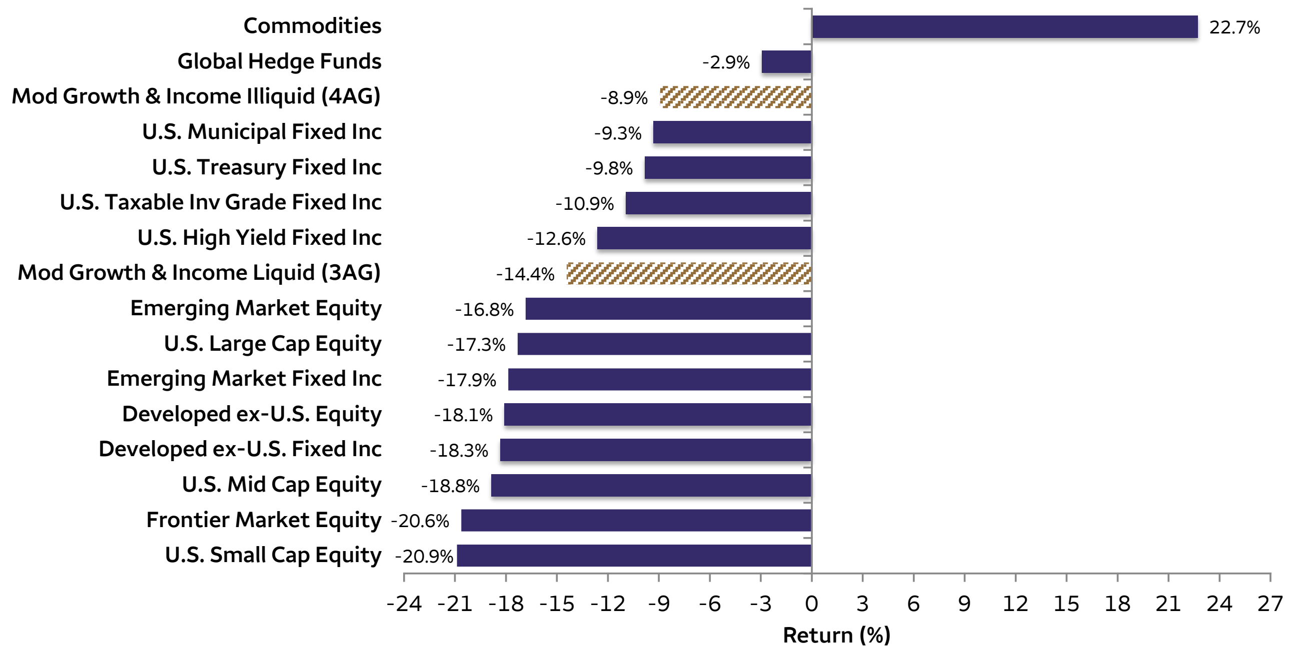
As Chart 2 illustrates, financial markets can be extremely volatile on a short-term basis, and some investors may be unwilling to tolerate sizable drawdowns in their portfolios. One way to participate in the financial markets, while potentially minimizing wild swings in investment portfolios, is through asset allocation. Having exposure to a diversified mix of asset classes that do not always move in the same direction historically has provided some downside risk mitigation. The inclusion of real assets in a portfolio, such as commodities, and alternatives, such as hedge funds, has helped mitigate downside risk this year.

Chart 2. Year-to-date returns of hypothetical diversified portfolios and individual asset classes



Sources: © 2022 – Morningstar Direct, All Rights Reserved[1], Bloomberg, and Wells Fargo Investment Institute Total return from January 1, 2022 to June 24, 2022. Global Hedge Funds and Mod Growth & Income Illiquid (4AG) are as of May 31, 2022. Hypothetical portfolio returns are shown in the striped bars—individual asset classes (indexes) are in the blue bars. 3AG = three asset group. 4AG = four asset group. Performance results for the WFII Liquid (3AG) and Illiquid (4AG) portfolios are hypothetical and presented for illustrative purposes only. Index returns do not represent investment performance or the results of actual trading. Index returns reflect general market results, assume the reinvestment of dividends and other distributions, and do not reflect deduction for fees, expenses, or taxes applicable to an actual investment. An index is unmanaged and not available for direct investment. **Hypothetical and past performance does not guarantee future results.** Please see the end of this report for portfolio compositions, index definitions, and risks associated with the representative asset classes.

Market downturns have historically taken time to recover, typically longer than the fast-paced recovery from the 2020 bear market. Portfolio diversification historically has been a tool to both help mitigate downside risk and aid in accelerating recovery time. In past cycles, our research suggests well diversified allocations did not take as long as the S&P 500 Index to return to the previous peak after markets fell (Table 2). Chart 3 highlights periods throughout the past 40 years in which the S&P 500 Index entered a correction or bear market territory. The chart also shows how a hypothetical diversified allocation generally has not experienced losses that were as sharp as those of an all-equity position (based on S&P 500 Index) during equity market drawdowns. Although fixed income has suffered losses during this downturn, we do not expect that fixed income and equities will remain highly correlated in the long term. We continue to believe bonds play an important role in risk mitigation.

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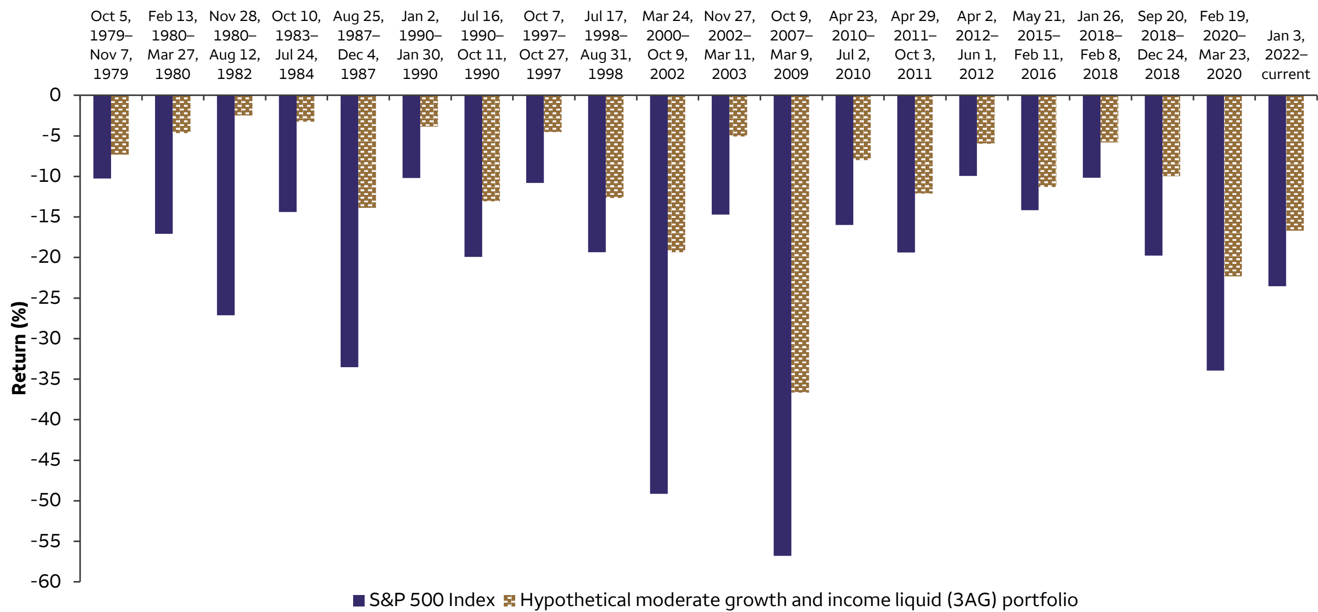
Chart 3. Diversification may reduce downside risk during a correction or bear market



Sources: © 2022 – Morningstar Direct, All Rights Reserved[1], and Wells Fargo Investment Institute, as of June 24, 2022. Current bear market is peak to trough drawdown as of June 21, 2022, with trough date of June 16, 2022. Performance results for the Moderate Growth and Income Liquid (3AG) Portfolio is hypothetical and is presented for illustrative purposes only and does not represent an actual investment. Index returns do not represent investment performance or the results of actual trading. Index returns reflect general market results, assume the reinvestment of dividends and other distributions, and do not reflect deduction for fees, expenses or taxes applicable to an actual investment. An index is unmanaged and not available for direct investment. **Hypothetical and past performance does not guarantee future results.** Please see the end of this report for portfolio compositions, index definitions, and risks associated with the representative asset classes. Note: Corrections are declines of 10% or more. Bear markets are declines of 20% or more.

Using the same corrective periods from Chart 3 (with the exception of the current drawdown), we examined how long it took to recover to the prior peak. Table 2 shows that, on average, historically the MGI Liquid (3AG) diversified allocation recovered in less time (under a year, on average) after a bear market than the S&P 500 Index (just under two years).

Table 2. Diversification may help recovery times after a downturn

Corrections	Average decline	Months to reach previous peak
S&P 500 Index	-14.32%	3.80
MGI Liquid (3AG)	-7.28%	2.96

Bear markets	Average decline	Months to reach previous peak
S&P 500 Index	-36.73%	22.63
MGI Liquid (3AG)	-17.96%	8.28

Sources: © 2022 – Morningstar Direct, All Rights Reserved[1], and Wells Fargo Investment Institute, as of June 21, 2022. Same timeframes used as in Chart 3. Index return information is provided for illustrative purposes only. Performance results for the Moderate Growth & Income (MGI) Liquid (3AG) Portfolio are hypothetical. Index returns do not represent investment performance or the results of actual trading. Index returns reflect general market results, assume the reinvestment of dividends and other distributions and do not reflect deduction for fees, expenses or taxes applicable to an actual investment. An index is unmanaged and not available for direct investment. **Hypothetical and past performance do not guarantee future results.** Please see the end of this report for portfolio compositions, index definitions, and risks associated with the representative asset classes. Note: Corrections are declines of 10% or more. Bear markets are declines of 20% or more.

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Although bear markets have typically been relatively short-lived, how investors react (or do not react) can be extremely important in meeting long-term financial goals. We have offered guidance for shorter-term tactical adjustments to our strategic allocations that we believe can help to reduce risk and improve overall return. For our tactical positioning, we stress quality as we transition to late cycle and a likely recession. In fixed-income portfolio positioning, we prefer short- and intermediate-term fixed income over long-term fixed income, which carries a higher duration (a measure of a bond's interest rate sensitivity) risk as interest rates rise. We also favor Investment Grade Fixed Income over High Yield Fixed Income as we suggest moving up in credit quality. In equities, we also have continued to stress our preference for quality asset classes and sectors. We currently favor U.S. over international equity markets and large- and mid-cap equities over small caps. In addition to our unfavorable guidance on small caps, we are unfavorable on Emerging Market Equities and most unfavorable Developed Market (ex-U.S.) Equities. From an equity sector standpoint, we prefer Information Technology, Health Care, and Energy for their high quality and defensive characteristics.

We believe that the best investment approach is to set a strategic asset allocation that represents an investor's goals, risk tolerance, and time horizon — and to rebalance back to those strategic targets on a regular basis. We caution investors not to be overly cautious or led by fear. Trying to time the market during periods of heightened volatility is extremely difficult. Yet, investors may want to consider employing tactical asset allocation to make modest adjustments to portfolio allocations based on a nearer-term (6- to 18-month) outlook. These actions, combined with maintaining a well-diversified asset allocation, may assist in reducing downside risk and could help a portfolio to recover more quickly after negative market-moving events.

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Risk considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. **Municipal bonds** offer interest payments exempt from federal taxes, and potentially state and local income taxes. Municipal bonds are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer. Municipal securities are also subject to legislative and regulatory risk which is the risk that a change in the tax code could affect the value of taxable or tax-exempt interest income. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

Alternative investments, such as hedge funds, private equity/private debt and private real estate funds, are speculative and involve a high degree of risk that is appropriate only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt and private real estate fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund's offering documents should be carefully reviewed prior to investing.

Hypothetical portfolio compositions

Moderate Growth & Income Illiquid (Four Asset Group): 2% Bloomberg U.S. Treasury Bill (1–3 Month) Index, 21% Bloomberg U.S. Aggregate Bond Index, 4% Bloomberg U.S. Corporate High Yield Bond Index, 4% JPM EMBI Global Index, 18% S&P 500 Index, 8% Russell Midcap Index, 3% Russell 2000 Index, 6% MSCI EAFE Index, 6% MSCI Emerging Markets Index, 6% NCREIF Property Index, 2% Bloomberg Commodity Index, 10% HFRI Fund Weighted Composite Index, 7% Cambridge Associates U.S. Private Equity Index, 3% Burgiss Private Debt Index.

Moderate Growth and Income Liquid (Three Asset Group): 2% Bloomberg U.S. Treasury Bill (1–3 Month) Index, 30% Bloomberg U.S. Aggregate Bond Index, 6% Bloomberg U.S. Corporate High Yield Bond Index, 5% JPM EMBI Global Index, 24% S&P 500 Index, 10% Russell Midcap Index, 6% Russell 2000 Index, 8% MSCI EAFE Index, 7% MSCI Emerging Markets Index, 2% Bloomberg Commodity Index.

Index definitions

An index is unmanaged and not available for direct investment.

U.S. Taxable Inv Grade Fixed Inc: Bloomberg U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

U.S. High Yield Fixed Inc: Bloomberg U.S. Corporate High-Yield Bond Index covers the universe of fixed-rate, noninvestment-grade debt.

U.S. Municipal Fixed Inc: Bloomberg U.S. Municipal Index represents municipal bonds with a minimum credit rating of at least Baa, an outstanding par value of at least $3 million and a remaining maturity of at least one year. The index excludes taxable municipal bonds, bonds with floating rates, derivatives and certificates of participation.

Bloomberg U.S. Treasury Bills (1-3M) Index is representative of money markets.

U.S. Treasury Fixed Inc: Bloomberg U.S. Treasury Index is the U.S. Treasury component of the U.S. Government Index. The index consists of public obligations of the U.S. Treasury with a remaining maturity of one year or more.

Commodities: Bloomberg Commodity Index is comprised of 23 exchange-traded futures on physical commodities weighted to account

Global Hedge Funds: HFRI Fund Weighted Index is a global, equal-weighted index of over 2000 single-manager funds that report to HFR Database. Constituent funds report monthly net-of-all-fees performance in U.S. dollars and have a minimum of $50 Million under management or a 12-month track record of active performance.

Note: The HFRI Indices are based on information self-reported by hedge fund managers that decide, on their own, at any time, whether or not they want to provide, or continue to provide, information to HFR Asset Management, LLC (HFR). Results for funds that go out of business are included in the index until the date that they cease operations. Therefore, these indices may not be complete or accurate representations of the hedge fund universe, and may be biased in several ways. Unlike most asset class indices, HFR index returns reflect fees and expenses. Index returns do not reflect any fees, expenses or sales charges. Unlike most asset class indices, HFR index returns reflect fees and expenses.

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Emerging Market Fixed Income: JPM EMBI Global Index is a U.S. dollar-denominated, investible, market cap-weighted index representing a broad universe of emerging market sovereign and quasi-sovereign debt. While products in the asset class have become more diverse, focusing on both local currency and corporate issuance, there is currently no widely accepted aggregate index reflecting the broader opportunity set available, although the asset class is evolving.

Developed ex-U.S. Fixed Inc: JPMorgan Global ex-U.S. Government Bond Index measures the performance of non-U.S. government bonds.

Developed Market ex-U.S. Equity: MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure equity market performance across 21 developed market countries excluding the U.S. and Canada.

Emerging Market Equity: MSCI Emerging Markets Index is a free float-adjusted market capitalization index designed to measure equity market performance of emerging markets. The index consists of 23 emerging market countries.

Frontier Market Equity: MSCI Frontier Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of frontier markets. The MSCI Frontier Markets Index consists of 24 frontier market country indexes.

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U.S. Mid Cap Equity: Russell Midcap Index measures the performance of the 800 smallest companies in the Russell 1000 Index, which represent approximately 25% of the total market capitalization of the Russell 1000 Index.

U.S. Large Cap Equity: S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index with each stock's weight in the index proportionate to its market value.

NCREIF Property Index is a quarterly time series composite total rate of return measure of investment performance of a very large pool of individual commercial real estate properties acquired in the private market for investment purposes only.

Cambridge Associates LLC U.S. Private Equity Index® uses a horizon calculation based on data compiled from more than 1,400 institutional-quality buyout, growth equity, private equity energy, and subordinated capital funds formed between 1986 and 2021. The funds included in the index report their performance voluntarily and therefore the index may reflect a bias towards funds with records of success. Funds report unaudited quarterly data to Cambridge Associates when calculating the index. The index is not transparent and cannot be independently verified because Cambridge Associates does not identify the funds included in the index. Because Cambridge Associates recalculates the index each time a new fund is added, the historical performance of the index is not fixed, can't be replicated and will differ over time from the day presented. The returns shown are net of fees, expenses and carried interest. Index returns do not represent fund performance.

The Burgiss Group, LLC (Burgiss) Private Debt Index is a pooled quarterly time weighted rate of return series based on data compiled by the Burgiss Group, LLC (Burgiss) from over 800 private debt funds (generalist, senior, mezzanine, and distressed debt), including fully liquidated partnerships, formed after 1986. The return series is net of fees, expenses, and carried interest. The benchmark is issued on a quarterly basis, approximately 80 calendar days after quarter end.

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