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Buying the Dips: When Does this Approach Run the Most Risk?

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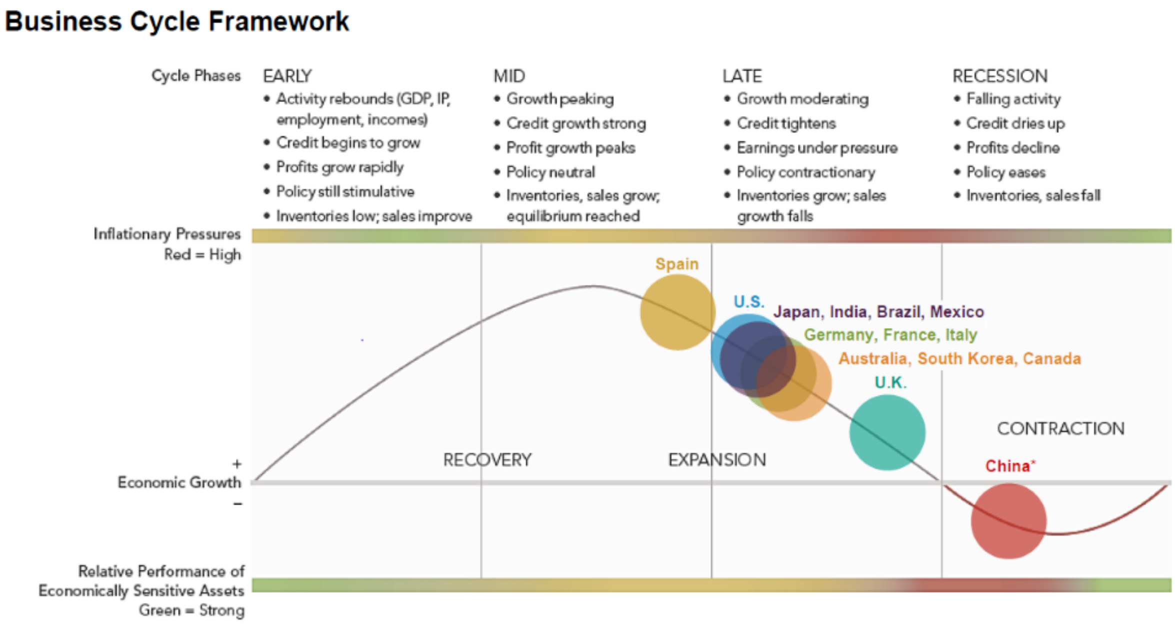
About a year ago now, Fidelity, in their 1Q19 Market Update, suggested that the U.S. was following many other global economic powerhouses into the late stage of the current economic cycle.



Note: The diagram above is a hypothetical illustration of the business cycle. There is not always a chronological, linear progression among the phases of the business cycle, and there have been cycles when the economy has skipped a phase or retraced an earlier one. * A growth recession is a significant decline in activity relative to a country's long-term economic potential. We use the "growth cycle" definition for most developing economies, such as China, because they tend to exhibit strong trend performance driven by rapid factor accumulation and increases in productivity, and the deviation from the trend tends to matter most for asset returns. We use the classic definition of recession, involving an outright contraction in economic activity, for developed economies. Source: Fidelity Investments (AART), as of 12/31/18.

As we've mentioned before, investors never truly know where we are in the economic cycle until enough time has passed and we can look back and define it with certainty. Often, we have entered and exited a recession before the data confirms a recession even existed. As we show signs of entering the late stage of the cycle, should we change our investment behavior? Will the historically successful "buy the dips" investment approach become too hot to handle? **Fidelity presents us with some startling research on page two.**

Historically, what the chart on the following page demonstrates is that if you bought the dips in mid-cycle (light green), your most frequent outcome over the next 12 months would have been a positive return and the majority of those positive returns would have produced double digit gains. Better yet, losses, if realized, would have been relatively modest. Bravo! Buy the dips confirmed! However, once we move to the Late Cycle stage, all bets are off.

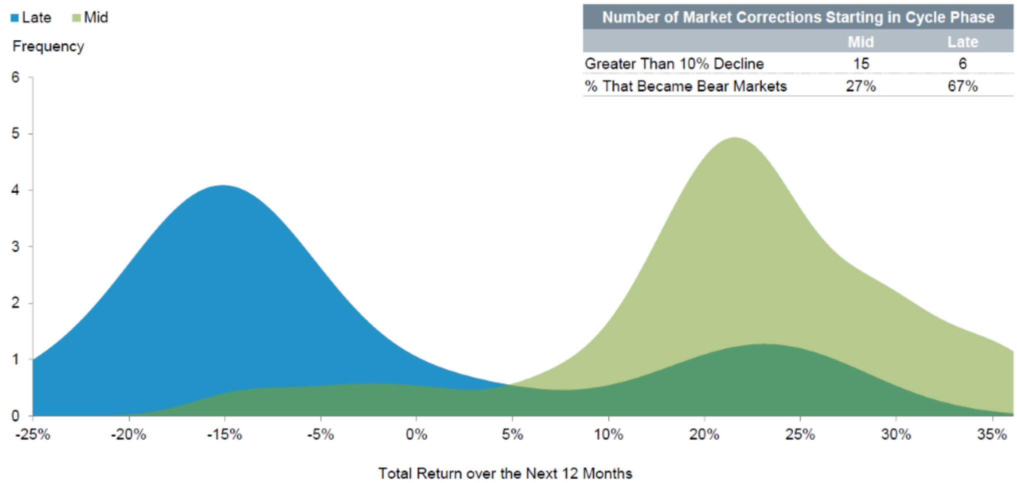
The **blue color** denotes the results of buying the dips in the late stage of the business cycle. Yes, positive, double digit gains are possible, but there have been significantly fewer positive outcomes and unexpectedly 2/3rds of the events have produced negative returns. Whoa!

Stocks' Return Profile Less Favorable during Late Cycle

Data suggests "buying the dips" is a less reliable strategy in late cycle compared with the mid-cycle phase. Historically, after declines of 5%, U.S. stocks in mid cycle had a much higher probability of positive returns over the next 12 months. Post-decline positive returns have occurred in late cycle, but the wider distribution of outcomes skews toward the downside, and 10% corrections have often turned into bear markets.

Subsequent Stock Market Returns after 5% or More Decline (1952–2016)

Number of Market Corrections Starting in Cycle Phase	Mid	Late
Greater Than 10% Decline	15	6
% That Became Bear Markets	27%	67%



Past performance is no guarantee of future results. The above charts are density plots generated from the 12-month forward returns of a US Equity Index sourced from Fidelity Investments. Declines of 5% or more refers to the trailing 3-month cumulative return for each month in the stated phase.

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Picture this: you are an NFL coach. If you run a special play, it will give you a score most of the time and usually a touchdown. If the play is botched, the damage is usually modest. But in the 4th quarter, after you've run the play throughout the game, the odds change. Now you might score 1 in 6 times but the chance of a pick six against you jumps to 2/3rds. Are you still going to call the play? *Are you still going to buy the next dip?*

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