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# Equity market bottoming — A step by step guide

## Key takeaways

- After an almost 25% decline from early January to mid-June, the S&P 500 Index of large-cap U.S. equities staged a sharp recovery of close to 19% from mid-June to mid-August. This proved to be yet another rally that failed to regain the high from earlier in the year.
- Given the quick gains, and the quicker reversal lower, investors may now be wondering when the time will come to increase equity allocations.

## What it may mean for investors

- We believe, and history concurs, that markets will need time to fully recover after such a significant drawdown since January.
- At this point, we favor leaning into quality assets and not to over allocate to equities.

Given the recent volatility in equity markets, we thought it would be helpful to remind investors about the historical framework we use when assessing whether markets have bottomed, from a technical analysis standpoint. In essence, we view the market bottoming process and its gyrations as falling into three phases: the breakdown, the consolidation, and the bullish breakout. Below, we take a look at some of the tendencies each of these phases display, based on price action during previous periods of turbulence.

**Phase 1: The breakdown**

Historically, markets in uptrends tend to look at new developments, especially negative ones, through a glass-half-full lens and are initially quick to dismiss those developments as insignificant, with the most recent example being the first signs of a shift in the Federal Reserve's inflation-fighting stance. Over time, the damaging impacts of the new development continue to nag at market participants and can lead to negative surprises on the economic and fundamental data fronts, making it harder and harder to ignore them. Eventually, there is acceptance that the investing environment has changed, and investors must mark down their outlooks and reposition by selling risk assets, such as equities.

Unfortunately, when the trend changes from higher to lower, the herd must reposition portfolios simultaneously, and that can lead to bouts of illiquidity, which in turn can lead to markets overshooting their fair value. Defining characteristics of this phase tend to be spikes in volatility, oversold markets, and washed-out market internals (for example, very few stocks at 52-week highs and deteriorating cumulative advance-decline lines). It is worth noting that this tends to be the shortest of the three phases in the market bottoming process. We believe we are currently in the later stages of Phase 1 or at the very beginning of Phase 2.

**Guidance** — For investors who went into the market breakdown with portfolios that were in-line with our favored allocations, the decline in asset values has likely lead to underweights in risk assets. This presents a potential opportunity to maintain those allocations by selectively purchasing high-quality stocks with good growth prospects that could assume market leadership coming out of the downturn. Currently, we favor the U.S. Large Cap and U.S. Mid Cap asset classes, along with the Information Technology, Energy, and Health Care sectors.

**Phase 2: The consolidation**

Once the selling exhausts itself, markets tend to jump sharply off the lows and retrace a good chunk of the price decline. Unfortunately for investors' frayed nerves, this is the very beginning of the consolidation phase, which is often the longest of the three phases in the market bottoming process. After the initial retracement is over and investors realize that a V-shaped bottom is highly unlikely and that they are going to be living in the new regime for the foreseeable future, markets often retest the previous lows. During this retest, markets can also reach new lows from time to time. A couple of signposts that Phase 2 is underway — a well-defined trading range is eventually established; and markets spend as long as needed for the underlying issue to resolve itself and for the economic impact to become clearer.

**Guidance** — For investors, the consolidation phase will likely present the biggest test of emotional fortitude and investment discipline. Sharp rallies may present a siren song of opportunity that will try to entice investors back to the lowest quality areas with promises of quick gains, only to be dashed quickly by disappointments that lead prices back to the lower end of the trading range. We believe investors would do well to focus new purchases in areas with better risk-reward outlooks, like the ones mentioned above, and even then, only on price weakness.

**Phase 3: The bullish breakout**

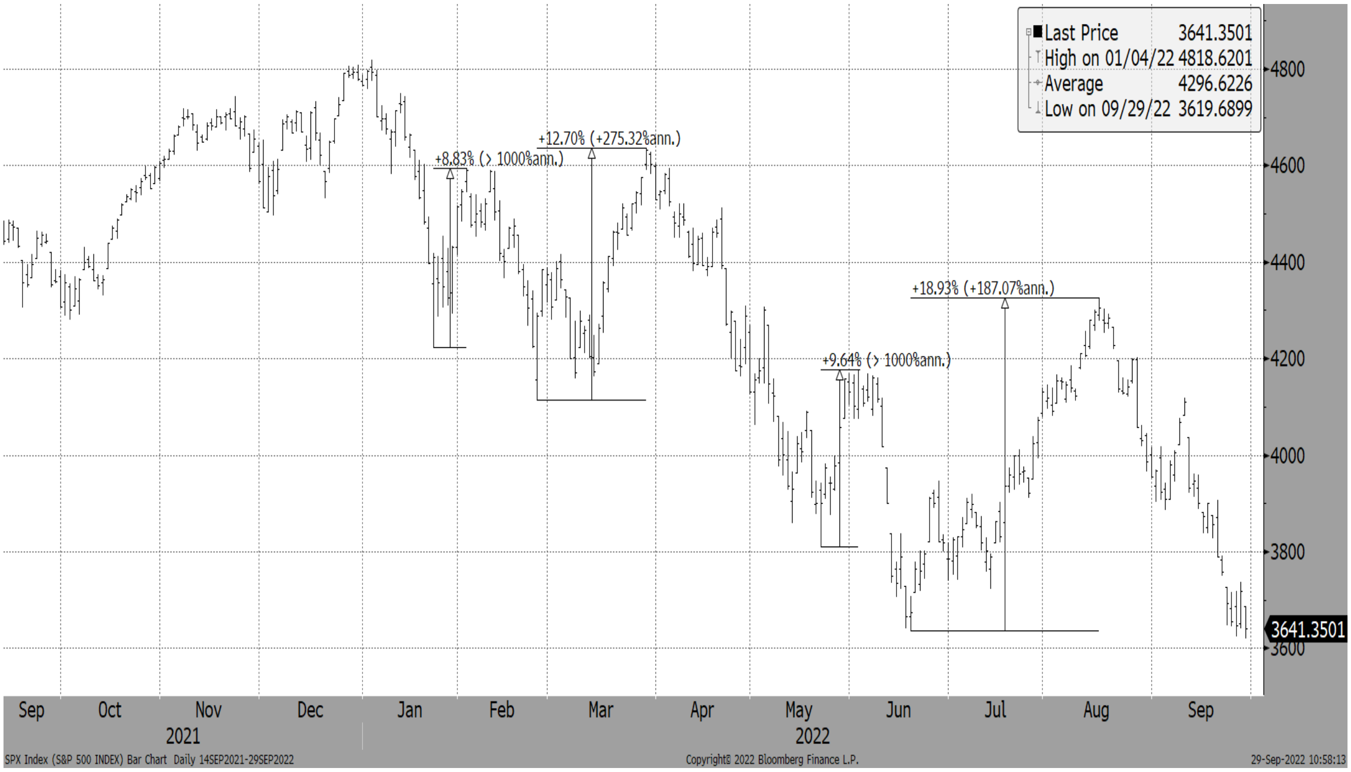
If much of Phase 2 is defined by a stalemate between bulls and bears, Phase 3 is kicked off by a breakout above the upper end of the trading range. This is an initial signal that the bulls may finally be regaining the upper hand. By this point, the economic and earnings outlook should also be coming into focus, and growth should be turning back toward the positive side. The real debate is likely to be what valuation multiple investors are willing to pay for those earnings. Any pullbacks tend to be short and shallow, frustrating investors who may be looking for one more retest of the lows as a chance to buy equities.

**Guidance** — Investors should be prepared to fight an initial bout of skepticism that markets really are back in an uptrend. The temptation will likely be to continue selling rallies in the hopes of being able to buy back at lower prices. We believe this is the time for investors to continue maintaining allocations, while taking care not to lean out too far over their skis in equities.

**Where are we currently?**

We currently believe we are in the later stages of Phase 1 (the breakdown) or the very early stages of Phase 2 (the consolidation). We do not expect a V-shaped recovery, and we believe the markets will face plenty of overhead resistance the further they climb (Chart 1). We expect markets to eventually carve out a trading range in the coming weeks and months and spend time consolidating until investors have a clearer picture of how long and high the Federal Reserve will hike interest rates to combat inflation, and the resulting impact on the economy and corporate earnings.

### Chart 1. S&P 500 Index

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