LPL RESEARCH

WEEKLY MARKET COMMENTARY

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# DID STOCKS BOTTOM?

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## KEY TAKEAWAYS

The S&P 500 has experienced some intense declines, but it may have bottomed for the year.

Market technicals suggest the bull market is alive and well.

Market sentiment is flashing levels of pessimism consistent with major lows.

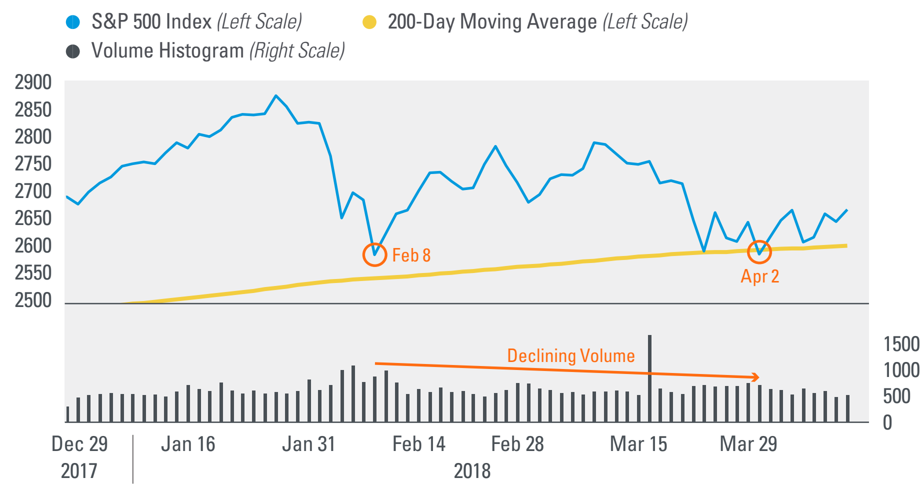
**The February 2018 market correction caught many investors off guard, but the longer-term trend remains higher.** This year has provided more volatility than we've seen in recent years, with many wondering if the movement is a sign that the bull market is ending. Remember that when the market is finding its lowest point (the bottom), the process to get there can be quite frustrating and even confusing for investors. As a result, we acknowledge we are amidst the bottoming process, and we don't think the bull market is ending, as longer-term technicals continue to look strong, along with sentiment flashing levels of worry seen at other previous major market lows.

## TECHNICALS SUGGEST A BOTTOM

Our methodology at LPL Research revolves around three basic tenants: fundamentals, valuations, and technicals. This week we will focus on technicals and show why we believe there may be an above-average chance that stocks have made their lows for 2018.

One major trendline we monitor to gauge the health of a bullish trend is the 200-day moving average. This is the average of the closing prices for the previous 200 trading days and is a nice way to assess longer-term trends. As Figure 1 shows, the S&P 500 Index has continued to find support near this important trendline.

**1 THE S&P 500 INDEX DAILY LINE CHART WITH VOLUME HISTOGRAM**




Source: LPL Research, Bloomberg 04/12/18

The S&P 500 Index is unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. All performance referenced is historical and is no guarantee of future results. Estimates may not develop as predicted.





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The last time we saw market volatility similar to what we experienced in the first quarter of 2018 was during August 2015, and the S&P 500 didn't fully bottom until February 2016. In other words, bottoms are a process, but we are seeing signs that this bottom could be near completion. Additionally, the S&P 500 recently tested the early February lows, but did so on lower volume. This appears to be perfectly healthy market behavior, as we tend to see tests of lows on lower volume.

Taking things a step further, we found that there have been 11 other times since 1991 that the S&P 500 tested recent lows (also known as a "double bottom") on lower volume. We like to see lower volume on the test of lows, as it shows there isn't the same level of extreme selling seen as the earlier bottom, thus the sellers have dried up. As Figure 2 shows, the various returns going out a full year are very bullish after this rare event—this may bode well for a continuation of the equity bull market.

Last, we like to see a "buying thrust" at major lows. A buying thrust is an uncommon signal that occurs when nearly all stocks go higher for multiple days. On April 3 and 4, the ratios of the number of S&P 500 stocks higher to lower were 10:1 and 7:1, respectively. This strength could be a good sign, but the fact that it also took place at the 200-day moving average and early February lows makes it even better. These buying thrusts, though rare, have a knack for flushing out any final sellers. As Figure 3 shows, a year after a buying thrust, the S&P 500 has gained more than 16% on average and risen 93% of the time.

### 2 SUBSEQUENT RETURNS FOR THE S&P 500 INDEX FOLLOWING A DOUBLE BOTTOM RETEST OCCURRING ON DECLINING VOLUME

| | 1 Month | 3 Month | 6 Month | 9 Month | 1 Year |
|---|---|---|---|---|---|
| Count | 11 | 11 | 11 | 11 | 11 |
| Average | 9.2% | 14.7% | 15.5% | 13.5% | 12.8% |
| Median | 9.2% | 12.9% | 15.3% | 19.1% | 23.9% |
| Max | 17.5% | 30.8% | 36.7% | 43.8% | 39.3% |
| Min | 4.7% | 5.3% | -5.3% | -31.3% | -47.7% |
| % Positive | 100.0% | 100.0% | 81.8% | 81.8% | 81.8% |

Source: LPL Research, Bloomberg 04/11/18

January 1991–Current.

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### 3 SUBSEQUENT RETURNS FOR THE S&P 500 INDEX FOLLOWING A BUYING THRUST EVENT

| | 1 Month | 3 Month | 6 Month | 9 Month | 1 Year |
|---|---|---|---|---|---|
| Count | 29 | 29 | 29 | 29 | 29 |
| Average | 1.3% | 3.4% | 8.4% | 11.7% | 16.3% |
| Median | 0.3% | 5.5% | 7.1% | 10.8% | 16.9% |
| Max | 18.0% | 16.2% | 28.6% | 33.9% | 45.0% |
| Min | -11.0% | -12.7% | -18.1% | -13.2% | -8.7% |
| Standard Deviation | 6.2% | 7.1% | 9.7% | 10.8% | 11.9% |
| % Positive | 51.7% | 72.4% | 89.7% | 89.7% | 93.1% |

Source: LPL Research, Bloomberg 04/11/18

July 2002–Current.

Standard deviation is a historical measure of the variability of returns relative to the average annual return. A higher number indicates higher overall volatility.

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## INVESTOR SENTIMENT

We believe the overall global economy is on firm footing, powering a resurgence in earnings. The overall technical backdrop continues to look strong as well, but one other major positive is that investor sentiment is getting quite pessimistic here.

History has shown that the crowd can be right during trends, but wrong at extremes. This is why sentiment can be an important contrarian indicator—if everyone who might become bearish has already sold, only buyers are left. The reverse also applies.

On multiple levels we see as much worry now as we have at other major market lows the past few years. When everyone expects trouble, it can pay to be a contrarian. Here are six data points which indicate that market sentiment is flashing a potential buy signal for suitable investors:

1. The number of bears in the American Association of Individual Investors Sentiment Survey soared to 42.8%, the highest level in over a year. Not to be outdone, the bulls dropped to 26.1%; the lowest level since last August.
2. CNNMoney's Fear & Greed Index hit single digits last month. This marked the lowest level since August 2015, reflecting a high level of investor fear.
3. Derivatives are suggesting a lot of investor nervousness. According to the Chicago Board of Options Exchange, the 10-day moving average of bearish versus bullish derivatives on equities just hit the highest level since the U.S. presidential election—suggesting many market participants are quite worried.
4. The spread between the bulls and the bears is the lowest it has been since the election, based on the Investors Intelligence U.S. Advisors' Sentiment survey of newsletter writers.
5. The National Association of Active Investment Managers Exposure Index showed the lowest exposure to equities since Brexit in June 2015.
6. Last, it is important to note that we still aren't seeing huge flows into equities, as Investment Company Institute data showed three consecutive weeks of outflows from domestic equity mutual funds and exchange-traded funds. Again, right before the election is the last time investors pulled money out like this.

## CONCLUSION

While valuations may be somewhat elevated, when factoring in the historically low inflation and interest rates we are not concerned with price-to-earnings ratios, which indicate valuations aren't the worry many make them out to be. The fundamental backdrop continues to be quite positive and we are not seeing any signs of an impending recession over the next 12–18 months. Lastly, the technicals support the longer-term bullish trend and market sentiment is flashing contrarian buy signals. Overall, we continue to expect potential double-digit stock returns this year, with leadership from small caps, value, and emerging market equities. ■

*Special thanks to Dave Tonaszuck for his contributions to this week's commentary.*

## IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

The economic forecasts set forth may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

The prices of small cap stocks are generally more volatile than large cap stocks.

Value investments can perform differently from the market as a whole. They can remain undervalued by the market for long periods of time.

Investing in foreign and emerging market securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment.

## DEFINITIONS

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

## INDEX DESCRIPTIONS

The S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.



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