WELLS FARGO
Investment Institute

FIRST ANALYSIS
Institute Alert

News or events that may affect your investments

March 30, 2020

Sameer Samana, CFA
Senior Global Market Strategist

The Bottoming Process—A Step-by-Step Guide

Key takeaways

- After an almost 35% decline, the S&P 500 Index of large-cap U.S. equities staged a sharp recovery last week of close to 20%.
- Given the quick gains, investors may now be wondering if the worst is behind us, and whether it is time to rush back into equity markets.

What it may mean for investors

- We believe, and history concurs, that markets need time to fully recover after such a significant drawdown.
- We believe investors would be well-advised to maintain recommended equity allocations within portfolios, rather than leaning too heavily into stocks.

Given the recent drawdown and rebound 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 bottoming process and its gyrations as falling into one of three phases: the Breakdown, the Consolidation, and the Bullish Breakout.

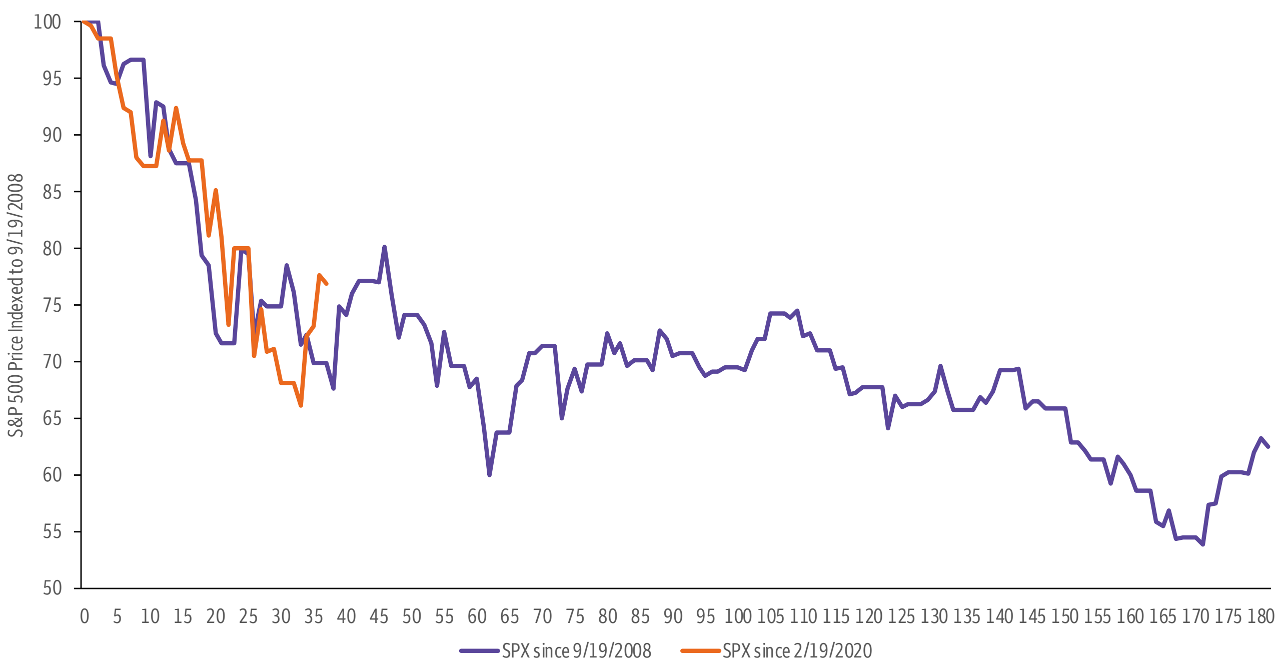
Below, we take a look at some of the tendencies each of these phases displays, based on price action during previous periods of turbulence.

Phase 1: The Breakdown

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 coronavirus (COVID-19) cropping up in China. Over time, the damaging impacts of the new development continue to nag at market participants and lead to negative surprises on the economic and fundamental data fronts, making it harder and harder to ignore them. Eventually, there is an 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 markets to overshoot 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 or deteriorating cumulative advance-decline lines). It is worth noting that the Breakdown Phase tends to be the shortest of the three phases in the bottoming process. Based on what we see in Chart 1, which overlays the trajectory of the current S&P 500 Index price (orange line) against the bear market of 2008-2009 (purple line), we believe that we are currently in the latter stages of Phase 1 or at the very beginning of Phase 2.

Chart 1. Bottoming of equity market is a process, not a price



Sources: Bloomberg and Wells Fargo Investment Institute, as of March 24, 2020. The S&P 500 Index is a market-capitalization-weighted index considered representative of the U.S. stock market. For illustrative purposes only. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Guidance – For investors who went into the market breakdown with portfolios that were in line with recommended allocations, the decline in asset values has led to underweights in risk assets. We believe this presents an opportunity to rebalance to 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, and the Information Technology, Communication Services, Consumer Discretionary, and Financials sectors.

Phase 2: The Consolidation

Once the selling exhausts itself, markets historically have tended 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 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 also can reach new lows from time to time. Once a well-defined trading range has been established, markets wait as long as needed for the underlying issue to resolve itself and for the economic impact to become clearer. These are signposts that Phase 2 is underway.

Guidance – For investors, the Consolidation Phase historically has presented the biggest test of emotional fortitude and investment discipline. Sharp rallies can 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 us back to the lower end of the trading range. We believe investors would be wise to trim exposure to U.S. Small Caps, Emerging Market Equities, and Developed Market ex-U.S. Equities, as well as the Energy, Materials, and Industrials sectors on the bounces. Investors should focus new purchases in areas with better risk-reward outlooks, in our view, like the ones mentioned at the end of the Phase 1 section 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 be coming more clearly into focus, and growth should be turning back toward the positive side. The real debate becomes what valuation multiple investors are willing to pay for those earnings. Any pullbacks in this phase have tended 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 may have to fight an initial bout of skepticism that markets really are back in an uptrend. They may be tempted to continue selling rallies in the hopes of being able to buy back at lower prices. We believe this is the time to continue maintaining allocations, while taking care not to lean out too far over their skis in equities.

Where are we currently?

- We believe we are currently in the latter 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 think the equity markets should face plenty of overhead resistance the higher they climb.
- We expect markets to eventually carve out a trading range until more progress is made on the containment and treatment of coronavirus and until investors can get a clearer view on the eventual impacts to the economy and corporate earnings.

Risks 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.

Communication services companies are vulnerable to their products and services becoming outdated because of technological advancement and the innovation of competitors. Companies in the communication services sector may also be affected by rapid technology changes; pricing competition, large equipment upgrades, substantial capital requirements and government regulation and approval of products and services. In addition, companies within the industry may invest heavily in research and development which is not guaranteed to lead to successful implementation of the proposed product. Risks associated with the **Consumer Discretionary** sector include, among others, apparel price deflation due to low-cost entries, high inventory levels and pressure from e-commerce players; reduction in traditional advertising dollars, increasing household debt levels that could limit consumer appetite for discretionary purchases, declining consumer acceptance of new product introductions, and geopolitical uncertainty that could affect consumer sentiment. The **Energy** sector may be adversely affected by changes in worldwide energy prices, exploration, production spending, government regulation, and changes in exchange rates, depletion of natural resources, and risks that arise from extreme weather conditions. Investing in the **Financial** services companies will subject a investment to adverse economic or regulatory occurrences affecting the sector. There is increased risk investing in the **Industrials** sector. The industries within the sector can be significantly affected by general market and economic conditions, competition, technological innovation, legislation and government regulations, among other things, all of which can significantly affect a portfolio's performance. **Materials** industries can be significantly affected by the volatility of commodity prices, the exchange rate between foreign currency and the dollar, export/import concerns, worldwide competition, procurement and manufacturing and cost containment issues. Risks associated with the **Technology** sector include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products, and the departure of key members of management. Technology and Internet-related stocks, especially smaller, less-seasoned companies, tend to be more volatile than the overall market.

General Disclosures

Global Investment Strategy (GIS) is a division of Wells Fargo Investment Institute, Inc. (WFII). WFII is a registered investment adviser and wholly owned subsidiary of Wells Fargo Bank, N.A., a bank affiliate of Wells Fargo & Company.

The information in this report was prepared by Global Investment Strategy. Opinions represent GIS' opinion as of the date of this report and are for general information purposes only and are not intended to predict or guarantee the future performance of any individual security, market sector or the markets generally. GIS does not undertake to advise you of any change in its opinions or the information contained in this report. Wells Fargo & Company affiliates may issue reports or have opinions that are inconsistent with, and reach different conclusions from, this report.

The information contained herein constitutes general information and is not directed to, designed for, or individually tailored to, any particular investor or potential investor. This report is not intended to be a client-specific suitability analysis or recommendation, an offer to participate in any investment, or a recommendation to buy, hold or sell securities. Do not use this report as the sole basis for investment decisions. Do not select an asset class or investment product based on performance alone. Consider all relevant information, including your existing portfolio, investment objectives, risk tolerance, liquidity needs and investment time horizon.

Wells Fargo Advisors is registered with the U.S. Securities and Exchange Commission and the Financial Industry Regulatory Authority, but is not licensed or registered with any financial services regulatory authority outside of the U.S. Non-U.S. residents who maintain U.S.-based financial services account(s) with Wells Fargo Advisors may not be afforded certain protections conferred by legislation and regulations in their country of residence in respect of any investments, investment transactions or communications made with Wells Fargo Advisors.

Wells Fargo Advisors is a trade name used by Wells Fargo Clearing Services, LLC and Wells Fargo Advisors Financial Network, LLC, Members SIPC, separate registered broker-dealers and non-bank affiliates of Wells Fargo & Company. CAR 0320-04503