Markets Continue Healing Process

Key takeaways

- After an almost 35% decline, the S&P 500 Index of large-cap U.S. equities has staged a sharp recovery of more than 40%.

- Given the quick gains, investors may now be wondering if the worst is behind us—and if it is time to lean into equity markets.

What it may mean for investors

- We believe the powerful global monetary and fiscal policy response and the earlier-than-expected economic recovery have reduced the time that history suggests markets need to fully recover after such a significant drawdown, but additional volatility lies ahead.

- We advise investors to maintain recommended equity allocations within portfolios, especially on pullbacks.

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 if 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. For more details, please see The Bottoming Process—A Step-by-Step Guide (Institute Alert, March 30, 2020).

Where are we currently?

Since March 23, the S&P 500 Index has staged a remarkable and historically atypical recovery, driven by a significant amount of monetary and fiscal measures, an economy that is rebounding earlier than most—including us—expected, and the declining odds of a scenario in which a new round of COVID-19 cases would lead to a global shutdown. The equity market’s recovery has also happened much faster than we expected, and there are some conclusions we can draw from recent price action.
First, a retest of the March lows remains very unlikely as long as policy makers remain resolute in their efforts to soften the coronavirus-related economic blow, the reopening of the global economy continues, and the uptick in new cases does not lead to a widespread shutdown or freeze consumer spending. Second, despite the market’s retracement of losses, we are still in Phase 2 (the Consolidation), which is defined by markets chopping sideways in a wide trading range, and is consistent with our 2020 year-end target range of 3150-3350.

The two signposts needed to confirm a Bullish Breakout on the S&P 500 Index would be a breakout to new all-time highs (previous all-time high was 3393.52) and the 50-day moving average crossing above the 200-day moving average, which tends to be a significant technical development known as a “golden cross” (Chart 1). Historically, these accomplishments have been reliable signals that we are at the start of a new, sustained, multi-year bull market in equities.

The chart below shows that these two conditions for a new bull market are unmet, despite the rapid rebound in the S&P 500 Index. What’s more, the pace of the recovery thus far does not preclude ongoing bouts of volatility. Such bouts of volatility are typical of Phase 2 and could be driven by upcoming U.S. political uncertainty, U.S.-China relations, geopolitics, and the ongoing spread of COVID-19; this is especially true as we approach the resistance the market is bound to encounter at the upper end of the trading range.

**Investment implications**

We believe investors should stay disciplined and use time-tested strategies, such as asset allocation, dollar-cost-averaging, and rebalancing, in order to contend with these fast-moving markets. As a reminder, we continue to favor U.S. large- and mid-cap equities and the Information Technology, Consumer Discretionary, Health Care, Communication Services, and Financials sectors.

**Chart 1. The S&P 500 Index with 50- and 200-day Moving Averages**

Source: Bloomberg, 6/19/20. Copyright ©2020 Bloomberg Finance L.P. SPX Index is the ticker for the S&P 500 Index on Bloomberg. An index is unmanaged and not available for direct investment. *Past performance is no guarantee of future results.*

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Risk Considerations

Asset allocation cannot eliminate the risk of fluctuating prices and uncertain returns and does not guarantee profit or protect against loss in declining markets.

Dollar cost averaging does not assure a profit or protect against a loss in declining markets. Since such a strategy involves continuous investment, the investor should consider his or her ability to continue purchases through periods of low price levels.

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. 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. Investing in the Financial services companies will subject an investment to adverse economic or regulatory occurrences affecting the sector. Some of the risks associated with investment in the Health Care sector include competition on branded products, sales erosion due to cheaper alternatives, research and development risk, government regulations and government approval of products anticipated to enter the market. 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.

Definitions

S&P 500 Index is a market capitalization–weighted index composed of 500 widely held common stocks that is generally considered representative of the U.S. stock market. An index is unmanaged and not available for direct investment.

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