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WEEKEND EDITION

## Five signs the stock market has bottomed

### Investor sentiment, technical indicators, Treasury yields are your best clues

By [Jonathan Burton](#), MarketWatch

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**SAN FRANCISCO (MarketWatch) -- Are we there yet? That's what investors want to know as they search for a bottom after six punishing months for stocks. People are understandably eager to be done with this downturn and see markets move forward.**

It's a tough wish at a time when the U.S. economy is clearly contracting and likely in recession. The good news is that stocks typically recover several months ahead of the economy. The bad news is that we're probably closer to the beginning of this slump than the end.



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"People are just stunned by what's going on in the economy, by their finances, by the stress," said Bernard Baumohl, managing director of The Economic Outlook Group, a forecasting firm. "We're in the belly of the recession beast, and we're going to have to get used to it."

Easier said than done. Debate rages about what stage our economic crisis is in. Some are optimistic that the government's moves to flood the economy with liquidity means a shallow recession or none at all; others believe Washington alone can't repave deep potholes on Wall Street and Main Street, and are braced for a long, bumpy road ahead.

Remember that the stock market will show signs of bottoming well before every bit of bad economic news is wrung from the headlines. These milestones won't be obvious or appear at once, and keep in mind that just because stocks stop going down doesn't mean prices will roar to new records. The damage to the economy is done, and will take time to repair.

Knowing what to watch for can help you invest with greater confidence. Here are five key leading indicators to put on your radar, along with five

caveats to keep them in focus:

#### 1. Investors Intelligence survey

Home values are down, unemployment is up, consumers are tapped out and so, for that matter, are lenders. Consumer confidence hasn't been this bleak in more than 25 years, and people's expectations for the economy are the worst since the inflation-ridden mid-1970s.

Many American families now actually earn less, after inflation, than they did at the start of this decade. Buyers and businesses alike are retrenching. Cash is king, and debt is a four-letter word. Reflecting this grim mood, almost 80% of Americans say the country is worse off than it was five years ago, according to a recent New York Times/CBS News poll.

No surprise then, that more investment professionals are bearish nowadays on U.S. stocks than bullish. But from a contrarian viewpoint, that's a positive.

"The longer it takes for people to throw in the towel on bearishness, the more bullish it is," said Mark Hulbert, founder of Hulbert Financial Digest, a service of MarketWatch, the publisher of this report. [Read Hulbert's comments on Dow 'buy' signal.](#)

One closely watched sentiment indicator comes from Investors Intelligence, an investment service that measures the mood of more than 100 investment newsletter writers each week.

Investors Intelligence editors Michael Burke and John Gray spied trouble for stocks last fall when more than 60% of newsletters were bullish. The poll as of April 15 showed 37.8% of newsletters were upbeat, above the 30.9% reading in mid-March, which was the lowest since October 2002. Meanwhile, 38.9% of newsletters were bearish and 23.3% belonged to the correction camp, expecting further market declines but hopeful that lower prices will spell buying opportunities.

The persistent pessimism says to Burke that the market is bottoming. "We could be moving pretty much to the upside starting in July or so," he predicted.

**Caveat emptor:** The investing climate is unsettled, and the broad capitulation that generally heralds the end of a market downturn hasn't happened, said Kathy Bostjancic, a senior economist at Merrill Lynch & Co.

Indeed, many portfolio managers are shifting more into stocks. "A lot of people on the equity side are very eager to see the bottom and anxious about missing it," Bostjancic said. "But it looks to us like the job losses and consumer recession is just in the very early stages."

The time to be bullish, she added, is when buyers are "anxious that there is no sight to the bottom. But we're not there yet."

## 2. New highs/new lows

Sentiment also influences the chart readings that guide Mark Arbeter, chief technical strategist at Standard & Poor's Inc.

"You can try to call a bottom when there's a lot of pessimism," Arbeter said, "but the market doesn't normally start to right itself until sentiment moves away from bearish extremes -- and that's what we're starting to see."

One gauge that Arbeter favors is the number of stocks hitting new 52-week highs or lows on the New York Stock Exchange and Nasdaq.

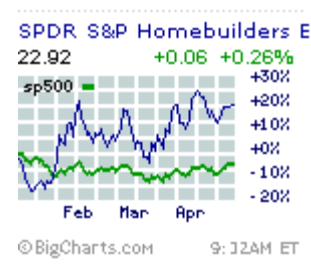
"Many times you'll see a shrinkage in the number of new lows as the market is bottoming out," Arbeter said.

For example, the S&P 500 (SPX) closed at 1310.50 on Jan. 22, a day that saw 1,865 new lows. The S&P retested that level on March 17, closing at 1277. Although the benchmark breached January's base, the number of stocks hitting new lows was 1,236.

"That says the internal framework of the market -- the numbers underneath the indexes -- is improving," Arbeter noted. "That was a key support."

Stock prices will recover steadily and substantially, Arbeter said, with the S&P 500 forming a near-term foundation between 1,380 and 1,410 before climbing to a 1,500-1,550 range by year end. He sees good prospects continuing for the materials and energy sectors, and relative strength in home-builder shares, evidenced by the surging exchange-traded fund SPDR S&P Homebuilders (XHB) .

"The market will start to improve three to six months before the economic fundamentals," Arbeter added. "If I am right and the market is bottoming out here, then six months down the road things are going to get better from an economic standpoint."



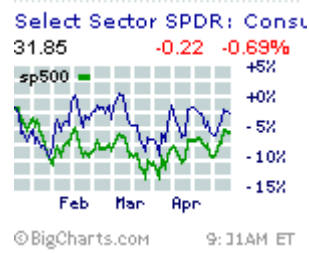
**Caveat emptor:** The credit crisis may have peaked, but the consumer crisis is just beginning, and historically stocks do not post extended rallies when consumer sentiment is so weak.

### 3. Discretionary consumer spending

The customer may always be right, but right now the customer is tight. Record household debt, declining prices for stocks and real estate, a bleaker jobs picture, plus rising fuel and energy costs and other inflationary pressures, are fraying consumers' purse strings.

It's not that people aren't spending, but given mounting money worries, they're buying mostly what they need and less of what they want. That's expected in tough economic times: food, drinks, medicine and other basics top the shopping list. Meanwhile, new cars, designer clothes, jewelry, restaurants, vacations and other "nice to have" goods are penciled on the bottom lines, if at all.

"Consumer discretionary has been totally beaten up in terms of P/E and price," said James Swanson, chief investment strategist at MFS Investment Management. An ETF proxy for the sector, Consumer Discretionary SPDR (XLY), is down 19% in the past 12 months, trading just above its 52-week low.



These companies tend to be canaries in the data mines. "Consumer discretionary typically is the first to fall heading into recession," Swanson said, but it also rebounds earlier than other market sectors.

"When XLY improves in relative strength vis-a-vis the entire market, that would be a good sign" added Marvin Appel, editor of Systems & Forecasts, a biweekly investment newsletter.

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— Marvin Appel, editor, *Systems & Forecasts* newsletter

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Since January, Appel notes, the Consumer Discretionary SPDR has in fact outperformed the market. The ETF was down 3.6% so far this year through April 17, but that beat the S&P 500 by almost three percentage points.

As a confirmation, Appel divides the price of the Consumer Discretionary ETF by the price of the SPDR S&P 500 ETF (SPY). If that ratio is rising -- as it has lately -- it means the sector ETF is stronger and that other market segments should follow, he said.

"My general market outlook is that the worst is over," Appel said. "Not that the consumer is doing great, but the bad news is out."

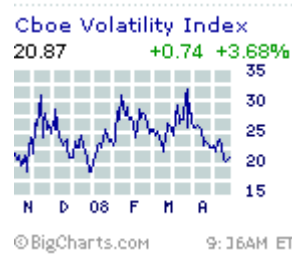
**Caveat emptor:** Market gyrations have slowed dramatically since the Bear Stearns bailout in March, as measured by the CBOE Volatility Index (VIX). Yet another shoe could drop as recession's noose tightens -- namely debt-crunched consumers grappling with credit-card bills and higher expenses.

### 4. TED spread

This is a complex but telling signpost. When banks borrow from each other, the interest charged on short-term loans (three-month London Inter-bank Offered Rate, or Libor) usually isn't much greater than three-month U.S. Treasury bills, which are considered essentially risk-free.

The difference in these rates (Treasury bills minus Libor) is known as the three-month TED spread, and is a litmus test of financial-market liquidity. A widening spread suggests that banks are less confident about their peers, so greater compensation -- a "risk premium" -- is required.

As of April 17, the TED spread was around 1.5 percentage points -- more than a full percentage point higher than average. If banks need such assurances lending to each other, they're certainly not about to offer consumers and businesses attractive borrowing terms.



"The [TED] spread is remaining high, which means the market still doesn't have enough confidence to lend to others in the private sector," said Komal Sri-Kumar, chief global strategist at TCW Group Inc., the mutual-fund manager.

"Once that begins to come down," he added, "you'll see it's an indicator of more confidence returning to the financial market, and that would say to you that the equity market is also likely to do better."

**Caveat emptor:** The TED spread narrowed to below 1 percentage point recently, but has since widened sharply. For financial-market stability, Merrill's Bostjancic wrote in a recent report, there needs to be a more normalized 0.35-0.40 percentage-point spread.

## 5. Two-year Treasurys versus fed funds

The federal funds rate is the overnight rate at which banks and other deposit-taking institutions lend to each other. The Federal Reserve has lowered fed funds during the credit crisis to bring down short-term interest rates. That strengthens the financial sector, as banks can borrow money cheaply and lend at higher rates, which stimulates the economy.

The two-year Treasury note, meanwhile, is the short-term rate that investors classically embrace when they're nervous about the future and aren't comfortable in higher-risk securities.

Demand pushes up bond prices and depresses yield. In this credit crisis so many investors flocked to two-year Treasurys that its yield slipped below the fed funds rate. "That's not a sign of a healthy economy," said Baumohl, the Economic Outlook Group strategist.

"You want to see the two-year Treasury yield go up," he added. "The only way the yield will go up is if there are better and safer investment opportunities elsewhere," such as stocks.

**Caveat emptor:** The two-year Treasury yield at around 2.2% is now on par with fed funds -- vastly improved from a yawning 1.65 percentage-point gap in mid-March.

"This is probably the best indicator in predicting better times ahead," Bostjancic noted.

Still, the needle should point into positive territory to verify a turnaround, she said. The two-year yield needs to be about 0.20 percentage points above fed funds, Bostjancic noted, "before we can say conditions are normal." ■

*Jonathan Burton is an assistant personal finance editor for MarketWatch, based in San Francisco.*



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