by Larry Macdonald (Contact Author | Biography)

"Nobody rings a bell at the bottom of a bear market", goes the old Wall Street adage, but there are plenty of indicators investors can monitor in the hope of divining when a bottom might occur. The key to judging this accurately is to avoid relying on one or two indicators. Instead, use several in combination because while some may be sending clear messages that the bottom is at hand, others may predict something else entirely; it's the degree of divergence between the indicators you examine that will help you determine where the market's headed. Let's take a look at 15 indicators that can help you determine whether the market has hit bottom, or is still falling.

Are We There Yet?

The levels reached by the indicators at the bottom of past bear markets are commonly used as signposts for current bear markets. Unfortunately, history doesn't always repeat the same way. In the bear market of 2008, for example, the epochal nature of the financial crisis produced readings that were off the charts for many indicators, and far beyond their predictive thresholds.

Although indicator readings associated with past bottoms may only be instructive during typical bear markets, their direction and rates of change may still help during the more severe bear markets. Specifically, when they decline from their peaks and gather momentum on the downside, recovery mode is likely unfolding. (For ways to get through a down market, read *Surviving Bear Country*.)

There is always a great deal of interest in when the stock market might bottom. Many investors with a trading approach look for the best time to commit money to the market. They don't want to try to "catch a falling knife."

However, the average investor, who is busy with family and career, should be wary of such market timing. Academic studies have shown they are better off buying and holding the market through index funds or exchange-traded funds (ETFs) and rebalancing at intervals.

Of course, if the average investor can start investing or rebalancing in the depths of a bear market, this should enhance long-run returns. The indicators may thus be helpful in providing a more objective picture of market conditions and the periods when increasing exposure to equities are more likely to enhance long-term returns (not so much the exact bottom).

Types of Indicators

The indicators are grouped into the following five types:

1. *Market Sentiment*: Heightened pessimism signals proximity to the trough
2. *Technical Analysis*: Extremely oversold markets are more likely to snap back
3. *Credit Markets*: Markets struggle when bankers/bond markets are skittish

4. *Valuation*: Bear markets face an uphill climb if valuations are still high
5. *Economic Indicators*: The economy can sustain a rally off the bottom

Market Sentiment
Investors who want to look at market sentiment should consider the following indicators:

- **Investor Intelligence Sentiment Survey**: This weekly survey monitors the market sentiment of more than 100 independent investment newsletters. When the bull and bear spread (percentage of bullish less bearish advisors) falls to -20 or thereabouts, pessimistic sentiment is at its peak, which usually heralds a bottom in the market. An example would be 30% bullish and 50% bearish (with 20% neutral). There are several other sentiment gauges, including the American Association of Individual Investors (AAII) survey and TickerSense's blogger survey. (For related reading, see *Investors Intelligence Sentiment Index*.)

- **Mutual Fund Redemptions**: Periods of heavy redemptions of equity mutual funds and hedge funds have marked stock-market bottoms in the past. Within the past 25 years, there have been three periods when the 12-month rolling sum of U.S. equity mutual-fund sales was negative:
  - The October 1987 crash
  - Technology bust of the early 2000s
  - The financial crisis of 2008

  Data is supplied monthly by the Investment Company Institute and weekly by Trim Tabs Investment Research.

- **CBOE Volatility Index (VIX)**: This index measures how much fear is in the market based on premiums in option contracts on the S&P 500. Option premiums increase as more investors buy put options to hedge their portfolios from market declines. A rise to 30 in the VIX has predicted a bearish climax in the past. However, the financial crisis of 2008 saw extended readings above this level - as high as 89 in October 2008. That said, there are volatility measures for other major indexes, such as the CBOE Nasdaq Volatility Index (VXN), to which VIX readings can be compared. Related indicators are ratios of put options to call options for major indexes. (For further reading, check out *Getting a VIX on Market Direction*.)

Technical Analysis
Investors who want to look at technical analysis should consider the following indicators:

- **Historical Milestones**: Past market bottoms, on average, take three to six months to complete. They are characterized by a volatile trading range and tests of the low. A "capitulation event" usually occurs, and is evident by steep price declines on abnormally high trading volumes. Dramatic intraday reversals make appearances. Another milestone is when the market stops reacting to bad news. The bottoming out process finishes with a strong breakout on heavy volume. (For related reading, see *The Anatomy Of Trading Breakouts*.)

- **Relative Strength Index (RSI)**: The RSI compares the average daily gain in a stock or index to its average daily loss over the past 14 days (or other period). It is mathematically transformed to vary between 0 and 100. When the average daily gain falls relative to the average daily loss and brings the RSI down to 30, it's a sign of significantly oversold conditions. When calculated for the S&P 500 Index, it may mean the market is close to bottoming out. (For more information, see *Getting to Know Oscillators: Relative Strength Index*.)

- **Other Technical Indicators**: Besides the RSI, there are many other technical indicators. Just about any used to analyze stocks at the individual level can be applied at the index level for purposes of generating signals of market tops and bottoms. (The *Technical Analysis Tutorial* gives a range of indicators that can be extended to the market level, as does the *Active Trading Tutorial*.)

  Another approach is to calculate the percentage of stocks surpassing a technical threshold. For example, when the number of stocks making 52-week lows rises above 50%, it is seen by some as a wash-out. Yet another approach is to look for divergences, such as when the advance-decline line fails to follow a market index to a new low; this is seen as a "bullish divergence" and can signal the bottom.

  Other oft-used technical signals include:
  - A decline in the bullish percent index to 30% (For more, see *Which Direction Is the Market Heading?*)
  - Substantial deviation of the indexes from their trend as represented by a moving average (MA)
  - At least one day where volume traded in declining stocks is 90% of total volume (panic selling) followed by at least one day where volume traded in rising stocks is 90% of the total (panic buying)
  - Forced selling by mutual and hedge funds; anecdotal reports in the media may indicate to some degree the extent, as might a continuing pattern of sharp sell-offs in the last hour of daily trading. Funds often put in "market on close" orders because fund values are based on closing prices.

- **Leading Sectors**: Many analysts believe the bottom is in place when certain sectors begin to show absolute or relative strength. These sectors tend to be the financials, consumer cyclicals, technology (especially semiconductors) and transportation. Basic materials and energy shares are late-stage gainers during bull markets. Indeed, once commodity stocks stumble, the bottom of the bear market is at hand, in their view. Other analysts believe that the rally off the bottom will show up first in whatever groups were most oversold.

Credit Markets
Investors who want to look at credit markets should consider the following indicators:

- **TED Spread**: The TED spread is the difference in yields between three-month interbank (LIBOR) loans and three-month U.S. Treasury bills (T-bills). When financial stress rises and banks become less willing to lend to each other, interbank loan rates climb relative to T-bill rates (perceived as risk free). The wider the spread becomes, the greater the likelihood of a credit crunch that spreads deflationary impulses to the economy. Historically, spreads over 100 basis points were indicative of a peak, although they did shoot up above 250 basis points during the crash of 1987 and more than 450 basis points (highest till that date) during the financial crisis of 2008.

- **Bond-Yield Spreads**: When economic stress is elevated and corporations are at greater risk of going bankrupt, yields on their bonds tend to rise relative to government bonds (seen as riskless). For 'Baa'-rated corporate bonds versus 10-year Treasuries, a widening of spreads to 300 basis points has historically marked a turning point for financial markets. However, spreads did escalate to nearly 400 basis points in 1982 and 550 basis points in 2008. Other bond spreads are watched too, such as the difference in yields on junk bonds versus government bonds.

Valuation
Investors who want to look at valuation should consider the following indicators:

- **Price-Earnings Ratios (P/E Ratio)**: Valuation measures for stocks, such as the P/E ratio, may not be timely indicators but nonetheless provide context, especially for investors focused on the long-term. A complication is the range of formulations possible. One of the simplest is the S&P 500 P/E ratio based on trailing fourth-quarter earnings per share (EPS). During major bear markets since 1937, it has bottomed out at an average of 50% below its long-term average of around 17 times earnings.

  More sophisticated versions, such as Capital Economics' S&P 500 P/E ratio adjusted for inflation and business cycles (using the 10-year average of earnings), show similar overshooting: during the 14 recessions since 1923, it bottomed (on average) at 11 times earnings, 35% below the long-term average of 17 times. Other valuation yardsticks can be used, such as Tobin's Q ratio, which compares market values to replacement costs; its lower boundary is 0.5.

- **Guru Investors**: Buying by savvy value investors, such as Warren Buffett, can be a signal the bottom is approaching. They sometimes reveal their buying activities to the media, as

Buffett did in a *New York Times* article on October 16, 2008. However, market timing is not their game, so they tend to be early. (For more on this, see *Think Like A Stock Market High Roller*.)

Macroeconomic
Investors who want to look at valuation should consider the following indicators:

- **Historic Patterns**: Since World War II, recessions in the U.S. have averaged just over a year. Knowing when the current recession started may assist with calling a bottom, since stock markets traditionally rally two to six months before the end of a recession.

- **Consumer Confidence Index (CCI)**: In the last week of each month, the Conference Board publishes the CCI, which is based on interview data obtained from a representative sample of 5,000 U.S. households. The index is an average of responses to questions eliciting opinions on current and expected business conditions, current and expected employment conditions and expected family income. Whenever the CCI falls to 60, it has usually indicated a bottom for the stock market, but in 2008 it plunged below 40. (Read more on this highly regarded survey in *Economic Indicators: Consumer Confidence Index (CCI)*.)

- **Revisions to Earnings Estimates**: During economic downturns, brokerage analysts making bottom-up estimates of company earnings typically lag strategists who issue earnings estimates for market indexes. The strategists, who are more attuned to macroeconomic developments, are usually the ones who have it right during downturns. The bottom-up analysts therefore need to revise their estimates downward to at least be in line with strategists' estimates before the market can bottom. (Learn how this key metric is calculated and how it is used to judge market performance, read *Earnings Forecasts: A Primer*.)

- **Leading Economic Indicators**: Although the stock market usually turns up several months before the end of a recession, settings on leading economic indicators may solidify investor confidence during the recovery phase. Those of note include:
  - Increases in the Conference Board's Leading Economic Indicator and/or its components, such as manufacturers' new orders for consumer/capital goods, housing starts, purchasing managers indexes, jobs created and money supply
  - Rising Baltic Dry Index, which measures prices charged by ocean tankers to ship raw materials
  - Positive readings on leading indicators/projections from economic forecasters with good track records.
  - Falling inventory of houses for sale and rising mortgage applications

The Bottom Line
Although no one rings a bell to inform investors that the bear market is about to turn around, this

doesn't mean that there aren't clear signals. If you find yourself wondering whether the market has hit bottom, use a combination of indicators to see what they predict. If you hit it right, your ears will be ringing with the sweet sound of investing success.

For more, read *Economic Indicators* and *Leading Economic Indicators Predict Market Trends*.

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Larry MacDonald writes for leading business and financial publications in Canada. His home base is at Canadian Business Online where he contributes a regular column and posts daily to a blog called Investing Ideas. He has also been a regular contributor to The Globe and Mail, Investor's Digest of Canada, the Montreal Gazette, and the Ottawa Citizen. He has also authored a book called "The Bombardier Story: Planes, Trains, and Snowmobiles" (2002). Prior to taking up business and financial writing, MacDonald earned a master's degree in economics and worked for several as an economist in the federal government of Canada.

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