

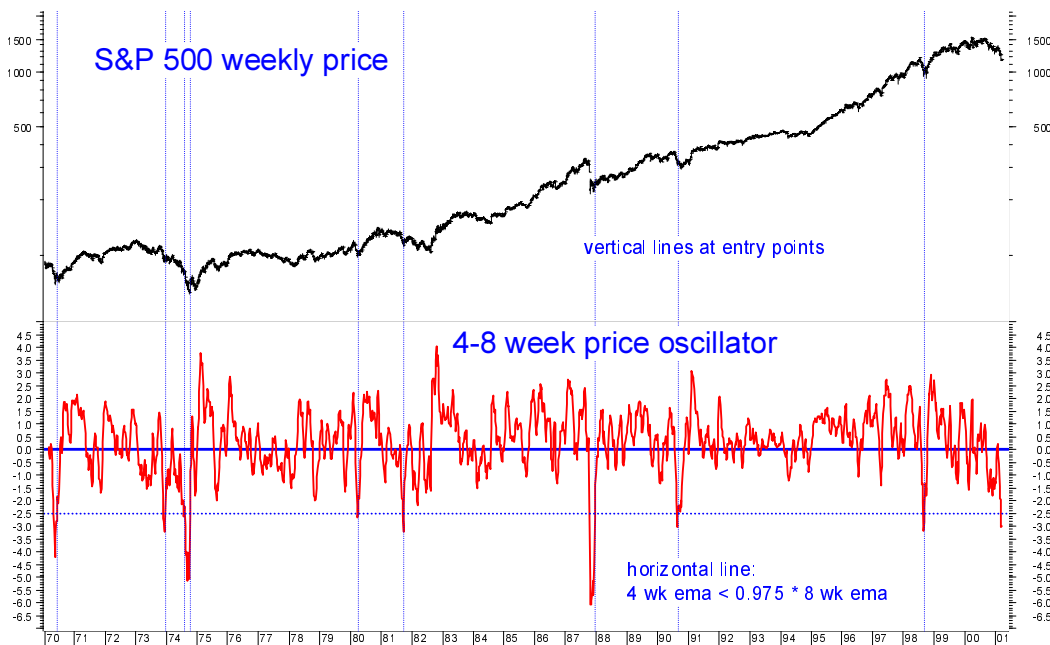
# How to recognize the next market bottom

## A simple indicator has provided timely warnings

The S&P 500 has recently joined the bear market that has long plagued the Nasdaq. Declines this severe in the S&P 500 have occurred only eight times since 1970. The question on many investors' minds is when this bear market will end. Calling market bottoms can be fraught with peril, in part because the market has often been extremely volatile during bear market climates, which has increased the penalty for poorly timed decisions. The simple indicator presented here has had a good record of signaling relatively safe entry points after major sell offs have been under way. The growth in the S&P 500 from three months to one year after the signal has been better than average.

This indicator requires only weekly closing data on the S&P 500. Calculate four week and an eight week exponential moving averages on this data. The oversold level is defined as a decline during which the four week average of the S&P 500 declines to less than 0.975 times the level of the eight week average. After reaching this very oversold condition, the entry point occurs on the first Friday close when the four week average narrows its gap by rising to 0.975 times the eight week average or higher.

The chart of the S&P 500 below shows the nine entry points that have occurred since 1970. It is clear that the S&P 500 does not become oversold very often. When it has, some excellent buying opportunities have been signaled by this 4-8 week oscillator.



The table shows the dates of the entry signals and the percentage change (excluding dividends) in the S&P 500 at 6, 13, 26 and 52 weeks afterwards. On average, the S&P 500 was weaker than its historical norm for six weeks following the end of very oversold conditions. However, by 13 weeks the S&P 500 tended to accelerate to the upside and by 26 weeks, its outperformance relative to all 26-week periods was quite marked. Even one year out, the S&P 500 has done better than average following the end of very oversold conditions compared to all 52 week periods.

Some entries did not work out well. After a sharp 16% decline from October-December, 1973, the S&P

stabilized and triggered a buy on December 28 of that year. The market drifted sideways for the next three months until the second major leg of the 1973-1974 bear market set in. In 1981, the S&P 500 also suffered a 15% decline in the space of roughly one month and stabilized, triggering an entry. It rallied by 6% during the coming weeks but the market did not hold on and rolled over until the August, 1982 bottom.

There is of course no guarantee that the performance of this indicator in the future will be as successful as in the past. However, it does provide an objective and simple method that has provided timely notice of major market bottoms. Overall, there has been no need to rush back into the market once conditions improve from very oversold, since history suggests that serious declines require several weeks (and often a double bottom) to unwind. As of this writing the S&P 500 is in very oversold territory. The entry signal will occur if the S&P 500 closes on Friday, March 23, 2001 at or above 1204.43.

date of signal	S&P 500 change after			
	6 wks	13 wks	26 wks	52 wks
6/19/70	1.3%	7.2%	17.1%	28.4%
12/28/73	-5.3%	-3.6%	-11.8%	-30.3%
8/9/74	-13.3%	-7.4%	-2.8%	6.4%
10/18/74	-3.2%	-1.8%	19.4%	22.9%
4/3/80	5.1%	15.0%	26.6%	32.6%
10/2/81	1.9%	2.7%	-3.6%	2.2%
12/24/87	-0.4%	2.6%	8.6%	10.3%
9/7/90	-3.4%	1.3%	15.9%	20.3%
9/18/98	7.7%	16.5%	27.4%	30.9%
<b>average of signals</b>	<b>-1.1%</b>	<b>3.6%</b>	<b>10.8%</b>	<b>13.8%</b>
<b>all periods 1970-2001</b>	<b>1.1%</b>	<b>2.5%</b>	<b>5.3%</b>	<b>10.9%</b>

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