EPOCH

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Watchlist for the Market Bottom

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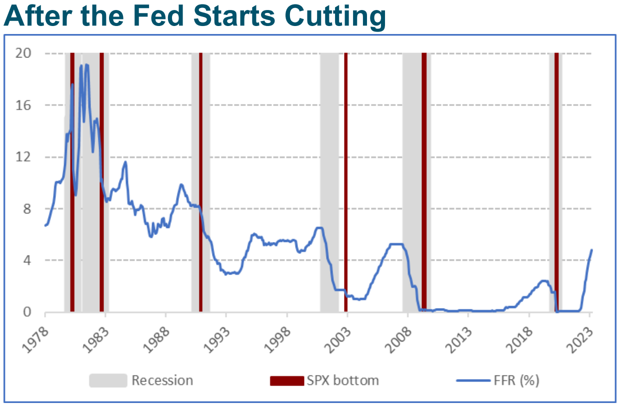
It might not feel that way, but the S&P 500 (SPX) is actually flat over the last eight months, albeit with considerable choppiness and several false starts (most notably the 18% rally from mid-June). We've remained cautious though, primarily because the signals in our watchlist suggest the SPX won't bottom until Q2 or Q3 of this year. The first signal in our watchlist is the Fed Funds Rate, which typically declines before the SPX troughs (**Figure 1**). However, today's futures curve implies the first Federal Funds Rate cut won't occur until the second half of this year and Fed officials have repeatedly warned they don't anticipate reducing policy rates anytime soon (unless a recession occurs, forcing the Fed to pivot).

FIGURE 1 – Bottoms in the SPX Typically Occur After the Fed Starts Cutting

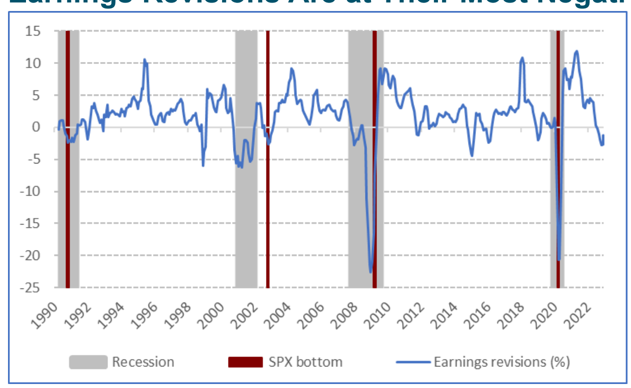


Source: Bloomberg

It is also worth highlighting that, since WWII, the SPX has never bottomed before a recession. This is of particular relevance today as the consensus views a recession as 65% likely over the next twelve months. We agree with this probability and believe that avoiding a downturn requires "immaculate disinflation" – that is, wage growth and services inflation plummeting despite the lowest unemployment rate since "Hey Jude" topped the charts.

The second signal in our watchlist is earnings revisions, which usually remains negative for 4-6 quarters (**Figure 2**). Because the SPX is forward-looking it normally bottoms four months before revisions turn positive. In this cycle, revisions turned negative six months ago, which suggests we still have another quarter or two before the next bull market starts.

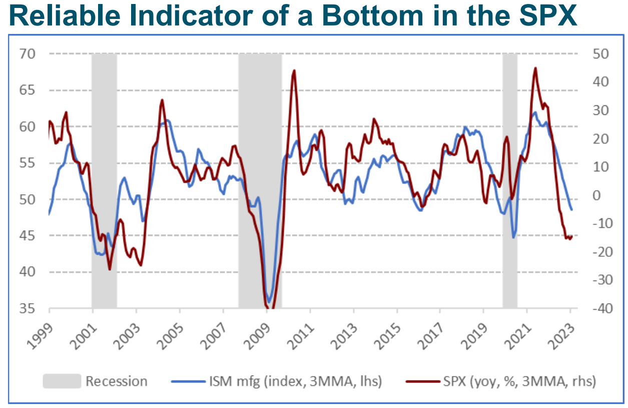
FIGURE 2 – The SPX Usually Bottoms When Earnings Revisions Are at Their Most Negative



Source: Bloomberg

Our third signal is the manufacturing ISM, which is 77% correlated with the SPX (**Figure 3**). The ISM and most other PMIs continue to plummet suggesting we still haven't reached the bottom of this cycle.

FIGURE 3 – The Manufacturing ISM is the Most Reliable Indicator of a Bottom in the SPX



Source: Bloomberg

While we are big believers in a disciplined approach to investing, it is critical to remember that every cycle is different. This has been particularly true this cycle, with several "unprecedented" shocks reminding us of the importance of being nimble and open-minded. Finally, we believe it is one-third likely the SPX has already bottomed. However, this requires the U.S. to avoid an earnings recession which seems feasible only under the "immaculate disinflation" scenario discussed above.

Implications for Investors

The signals in our watchlist suggest equities will remain choppy for another quarter or two until the Fed pivots, the end of negative earnings revisions is in sight and/or the ISM rebounds. This timing is critical because, after the market troughs, the typical 6-month SPX return is 25-30%, with much of the rally being front-loaded.