Question: Has the Market Bottomed?

Answer: Yes, we believe so

Reasoning: Indicators of bottoming, specifically:

Sell Side Trading Volume Drying Up

On-Balance Volume is a cumulative indicator that tracks volume flow by adding the volume on up days and subtracting it on down days.

Trading volume patterns offer near-term forecasts for large-scale investor behavior. High volume moves are more predictive, while low volume moves are more often misleading.

On-Balance Volume is currently telling us that major institutional money managers have started buying stocks more aggressively, which points to a market bottom and resulting up cycle. These up cycles typically run for 75 days.

Insider Trading

During the initial phase of this market sell-off, corporate insiders were hesitant to personally purchase much of their own company stock. Unscheduled insider trading activity tends to be viewed as smart money because these individuals have the best understanding of their companies and current business activity.

Within the past week, the ratio of companies with insiders buying compared to those selling has doubled, reaching the highest level since March of 2020. And in terms of dollar amounts, the ratio of buying to selling has tripled. Finally, big block sales are down sharply. Net selling of big transactions (either 100,000+ shares or $1 million+) has dwindled to less than 1%.

Retail Capitulation

This represents wholesale selling by retail investors who feel that the market will not stop going down, irrespective of the prospects of the stocks they hold. This feeling of despair overwhelms their ability to rationally evaluate the prospects of the companies they own and is generally referred to as capitulation.

Deleveraging

This occurs as the most well thought of companies are being sold and posting big declines. This is usually driven by deleveraging by institutions and hedge funds who have borrowed to buy stocks. Lending covenants require forced sales when collateral value of stocks decline past a

certain level. Margin is an example for retail investors where stocks are automatically sold if a margin loan exceeds 50% of the value the underlying stocks. Hedge funds often have arrangements that allow leveraging of 3, 4 and as much as 30 times the collateral value. Once they cross the threshold, they sell what they can. In a declining market, this is often the biggest and most liquid names.

Stock Differentiation

When all of the above has occurred and investor paralysis has dissipated, the market begins to differentiate stocks based on their individual merits and long-term prospects.

For example, all mid-cap technology has been hit hard since November. It did not matter if it was a company that was growing rapidly with consistently high profit margins well before Covid-19 (e.g. Zoom), or if it was a stay-at-home "flash in the pan" story with an unproven and questionable long-term business model (e.g. Teladoc).

Now that the undiscerning, large-scale forced selling has abated, investors are beginning to sort through and dissimilate between the bargains. Which companies have high quality products and assets, and which are simply relics of a hyped-up story with no competitive advantage? In our opinion there are a plethora of companies that fall into both buckets.

Sticking with the above example, let's look at Zoom and Teladoc.

Zoom was profitable and expanding for all three years prior to the pandemic, with double digit cash flow margins and an annualized sales growth rate of over 133%. Zoom has nearly $6 Billion of cash and equivalents on its balance sheet and just $80 Million of long-term debt.

Teladoc conversely, has never had a profitable year (including 2020). They have a very weak balance sheet with thin liquidity, indicating the possible need for a near-term dilutive capital raise.

On the valuation front, Zoom trades for 5.7x this year's revenue and 18.8x cash flow. For context, McDonald's trades for 9.8x this year's revenue and 20.6x cash flow. Zoom is expected to continue to grow sales and operating profit 10%+ while analysts project McDonald's sales to be flat year-over-year and operating profit to decline modestly.

Recommended Steps

Review every single holding to determine if:

a. Challenges have or will permanently impair the ability of the company to grow earnings at a healthy rate.
b. Does the company still have a sound business model or has the world changed its viability?
c. Are they better than their competition?
d. Are they well capitalized, allowing them to sustain an economic downturn?
e. Do better alternatives exist going forward?

Closing Thoughts

This downturn, as others have, will pass. High prices have already caused consumers to trade down for staple purchases and reconsider discretionary buying (see Wal-Mart and Target's recent earnings and sales mix commentary). In addition, very bloated retail inventory and markdowns will limit new orders, which will begin to pull down inflation.

China has reopened its economy and ports and has begun to aggressively stimulate its economy. This will reverberate positively through global equity markets.

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