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THE BEAR-O-METER

Macro market timing models

For those who follow my articles and blogs regularly, you may know that I follow two macro-market timing models. One of these models is less of a "timing" model than a "risk versus reward" model. It's called the Bear-o-meter.

Keith Richards

It looks at big-picture factors like breadth, seasonality (per Brooke Thackray's as well as Don and Jon Vialoux's work), long-termed trends, and sentiment. It doesn't tell you to sell or buy NOW. It gives you a heads-up – often months in advance – of a significant move. It's not great with near-termed timing – and it's not supposed to be.

Further, it only measures potential risk-to-return. As you know, risk and return are present in the markets at all times. A weak Bear-o-meter reading doesn't imply that return potential is gone. By the same token, a strong reading doesn't rule out the risk.

The Bear-o-meter is designed to give us a probability reading for the market direction over the coming one to six months. For those who have followed my blog posts (www.valuetrend.ca) for the past five-plus years, you will recall the signals it gave before the 2011, 2014 and 2015 market corrections.

It accounts for the following factors:

- Advance/Decline (A/D) line slope and comparatives to the S&P 500 slope
- Trailing price-to-earnings (P/E) ratio
- S&P 500 relative to 200-day moving average (MA)
- S&P 500 relative to 50-day MA
- Smart/Dumb money spread
- Put/Call spread
- Dow Jones industrials versus transportation correlation
- Seasonality
- Number of stocks over 50-day MA levels
- VIX level
- NYSE new high and new low levels

The other model I use is a short-termed timing model. It is designed to offer some guidance on the potential for a near-term move. It's pretty accurate.

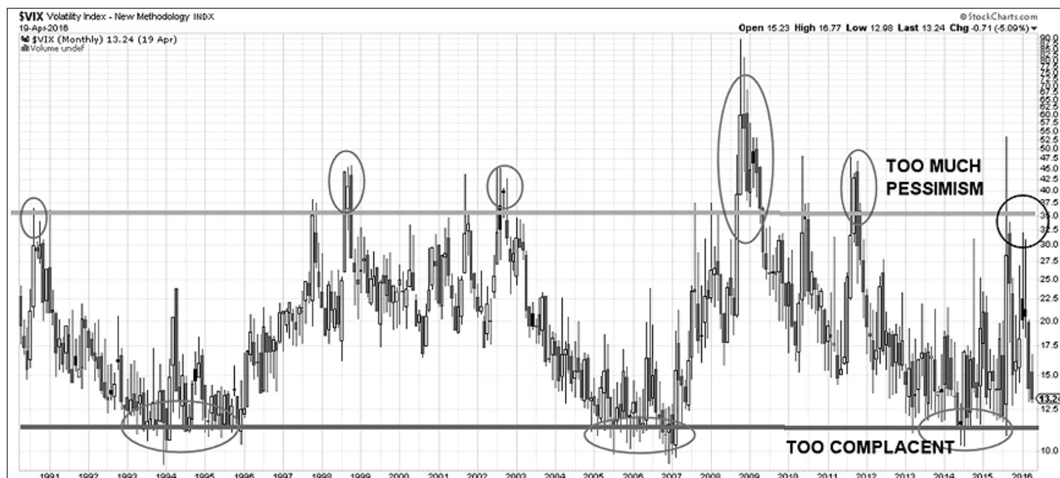
The system tends to catch many peaks and troughs. The downside with the short-termed timing model is that it does not signal macro moves- it doesn't tell us the extent of a move. We can get a sell signal and thereafter witness a three per cent move, hardly worth trading.

I use both models to give me a feel for what's going on. Obviously a sell signal on the short timing model is more significant within a "high-risk" Bear-o-meter environment. Again though, the Bear-o-meter is a probability indicator, not a timing model. So the signal on the short timing model within a low Bear-o-meter environment can still just lead into a blip.

Nevertheless, the odds are, it will be a bigger-than-normal "blip" in a low Bear-o-meter environment. Whew! All of that sounds like a disclaimer—which I guess it is. I needed to put into context what I am about to tell you. Which is…that the market looks to be setting up for a correction within a cautious (but not high-risk) Bear-o-meter reading.

A reading of three (out of eight) was taken on Sept. 7. Most indicators within the model were neutral (such as breadth, one of the sentiment indicators) or bullish (trend).

One of the sentiment readings is the VIX. It is still reading at a higher-risk (bearish) level – although it's been there for quite some time. Note that the VIX has a history of staying at the low extreme for many, many months – even a few years. It has been accurate in signalling eventual selloffs, albeit way ahead of time! The long-termed VIX chart at the right shows a good signal ahead of the 1997-98 Asian Contagion (Russia near bankruptcy, etc.) selloff.



The VIX wasn't at the lows before the 1999 tech peak and subsequent crash –so no signal there. I think that's because the tech stocks commanded a higher option premium in the late 1990s for the excitement surrounding them.

The VIX normally tries to read complacency versus fear, but any form of volatility – even a shaky period that passes thanks to positive expectations – can increase option premiums to abnormal levels. The VIX isn't as good of a contrarian sentiment indicator in that environment.

Note that the VIX did provide good buy signals (shown by the top pessimism line in the second chart) after the 1998, 2001, 2008, 2011 and early 2016 market selloffs.

So, we have a low-neutral-to-cautious reading on the Bear-o-meter macro risk compilation—right on the line between neutral and high-risk. This suggests hold-

ing stocks, but also holding some cash. It's not a "run for the hills" environment, but it's not a "sell the farm and buy stocks" environment either. Far from it.

Here is how the short-termed model works, in a nutshell: A sell is signalled by a concurrent overbought signal on two momentum indicators, and a touch of the upper Bollinger Band (which traces the market's movements via moving averages). A buy is signalled by an oversold signal on momentum and a lower Bollinger Band test. (Both the upper and lower bands are plotted two standard deviations away from the actual moving averages.)

Keep in mind you might get a false signal, and that the extent of a move might be minimal and not worthy of a trade—something you can't measure ahead of time. This short-termed timing system shows a sell signal forming right now. We are in a macro environment of neutral-to-poor returns compared to risk potential, according to the Bear-o-meter.

We have a near-termed sell signal, or close to it, on the short-termed timing model. All in, it may be wise to maintain a cautious stance at this point. There may be a buying opportunity approaching.

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