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LONGER-TERM TESTS TO DETECT IMPENDING MARKET TROUBLE

From Dow Theory to 'dumb' money

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In addition to classic trend analysis such as trend and moving average work, I like to look at macro (long-termed) signals that can provide a heads up for potential risk in the months ahead.

Long-termed signals include: sentiment, breadth (participation by various sectors), volatility indicators like the "VIX" and valuation metrics like price-to-book and price-to-earnings ratios.

Short- and mid-termed signals include: momentum oscillators, overbought and oversold indicators, money flow, and comparative relative strength studies.

The investment game is all about attempting to determine the relative risk on the markets in relationship to potential reward.

Today I'd like to cover four longer-termed indicators that may suggest trouble ahead for markets.

Let's get right into them, starting with a set of ideas that includes a tenet I rely on as one of my breadth indicators: Dow Theory.

That tenet is the comparative movement between industrial stocks and their transportation counterparts.

Charles Dow pointed out 100 years ago that when the companies that make stuff, (industrials and technology stocks like Microsoft) aren't shipping that stuff (rail, trucking, air), then you have a problem.

For longer-termed readers of my articles, you know that I have cited divergence (opposite trends) of these indices on a few occasions in the past, and these divergences (in conjunction with other macro indicators) are very accurate in predicting market trend changes.

The current trend appears to be changing for the transports, while the Dow Industrials keep pushing to new highs.

As you will note in the chart on the final page *(see page 155)* of this column, this does happen periodically–and when it does, it can be a harbinger of a correction- although it is a very leading indication.

Sentiment: Smart and dumb money

I look at plenty of sentiment indicators. But if you were to put a gun to my head and told me to choose my favourite, it'll always be the "smart/dumb" money compilation of surveys that sentimentrader.com puts together.

Retail investors such as small stock investors and mutual fund buyers are known to make decisions emotionally.

They buy high and sell low. That's why we call that group "dumb money". Meanwhile, sophisticated traders, large institutions, pension managers, and commercial hedgers are selling. They notoriously call the markets correctly, which is why we call them "smart money".

We track these groups independently. Take a guess how the smart and dumb money investors are positioning themselves… Hint: it's not looking good for the dummies.

This is another leading indicator, and you want to see the two sides reach their respective extremes before panicking – but it's getting darned close!

This is a really, really big-picture indicator. Note that on the long-termed chart that the VIX indicator can stay in my observed extreme zones for months – and even years – at a time.

However, you'll also want to note that the markets cannot – absolutely will not- remain there forever. When the VIX gets into the extreme "low volatility" zone of around 11, for example, it's not going to stay there forever. Markets will correct, and the VIX will spike. And it's getting closer to that point.

By the way, it's kind of a no-brainer to buy the VIX in some form or another if it does get into the 11 zone.

Historically, it's seen spikes down to just below 10, but that appears to be the maximum downside–compared to the maximum upside of 35-plus in an extreme market reversal.

After all, volatility cannot completely disappear and go to zero. So a trade from 11-ish in a VIX investment seems to be a good market hedge, and a profitable opportunity for those who are looking for a good risk/return investment.

It's not there yet, given its current level of 14, but it's getting closer. I have been buying into a VIX exchange traded fund gradually, based on the current low levels.

Upside target for the S&P 500 is at the old highs of 2,135. That's about three per cent upside from here. I am not providing a prediction here, but that is the obvious next target, should markets keep moving up.

Risk vs. return

The S&P 500 hit and fell from that approximate 2,130 ceiling numerous times over 2015. Based on that duration, it's going to take a significant event to drive the markets up through old highs. But what is it that could drive markets to accomplish new highs, and when could it happen?

Federal Reserve chair Janet Yellen recently implied that the Fed will *not* raise rates for a while, given poor job numbers and world events. However, she is stuck between a rock and a hard place, as far as stimulating growth again. She can't go back on her words spoken back in late 2015 to become fiscally tighter.

So, don't expect more stimulus in the near term. The market is cut off from its favourite drug. Seasonals are not in favour. As the saying goes, "Sell in May and go away."

Soon it will be the end of the best-six-months strategy. What about the election? The historic pattern for markets during an election year is for volatility leading into an election, and then bullishness after the election is decided.

Further, world events that could negatively impact markets are still front and center. Greece, China, Brazil, Europe, Japan—all remain in trouble.

Or, how about– Daesh, oil pricing, currencies, bond yields, and immigrant challenges?

There are lots of issues in the world for the markets to get worried about. Earnings and valuation ratios are not favourable, either.

The trailing price-to-earnings (P/E) ratio on the market is at the high end of its historic range at 22.6 times earnings. With the exception of the bubble at 2001 and 2008 levels, you will note that the trailing price-to-earnings ratio doesn't like venturing much past the low 20s before reversing. Strength in the markets has been driven to a large degree by these expanding multiples and not earnings growth.

Meanwhile, we enter into the current earnings season with the risk that earnings do not support the recent market strength. The result of a disappointing earnings season will very likely lead to weak markets. Finally, global debt may also be a negative factor on the markets, blowing through their May 2015 highs.

Since the financial crisis, many of the advanced economies have prudently reduced private debt, only to significantly increase public debt.

In emerging economies and those economies less impacted by the financial crisis - the Bank for International Settlements points out - are now increasing private debt to record levels.

As the world struggles with this excessive use of leverage, we believe this represents an additional risk to markets.

Meanwhile, the lows of both last summer and this past January lie around 1,880 for the S&P 500.

If the upside potential to 2,135 from here represents a three per cent reward, and the downside potential based on 1,880 represents an eight per cent risk – I'd say we have more than a two-to-one risk-to-reward ratio.

That's unfavourable.

Positioning defensively

We're doing a few things to position our portfolio for a potential market pullback.

First, in the equity platform we run on behalf of clients, we hold cash. Lots of it.

Next, we're gradually adding hedge positions to the equity platform. We recently began legging into the **Horizons VIX ETF** (HUV-TSX), which goes up when markets get more choppy and the **Ranger Bear ETF** (HDGE-NYSE/ARCA, $10.60), which shorts about 30-40 stocks from the S&P 500.

It goes up if markets go down. We're looking to do more hedging by stepping into this type of position a bit at a time. "Slowly, slowly catchy monkey," as the Ashanti (Ghana) proverb goes.

Finally, we're reducing growth stocks and increasing our exposure to defensive stocks: We recently increased defensive sectors like gold through **iShares Global Gold Producers** (XGD-TSX, $12.57) and **Horizons Comex Gold ETF** (HUG-TSX, $11.87) and consumer staples through the **SPDR Consumer Staples ETF** (XLP-NYSE/ARCA, $52.95) and individual stocks like **Mondelez International Inc.** (MDLZ-NASDAQ, $42.70).

We're looking to buy further into defensive stocks such as the REIT space, and possibly add some higher dividend plays or buy an ETF such as **iShares Canadian dividend ETF** (XDV-TSX, $21.98)that plays that theme.

The fancy term for this strategy of selling growth to buy defence is "beta reduction".

Both risk and reward are present in the markets at all times. It's our job to make educated guesses as to which is the dominant potential. As Howard Marks of Oaktree Capital says:

"The future isn't a predetermined scenario that's sure to unfold, but rather a range of possibilities, any one of which may happen.

"Investors formulate opinions as to which of them will happen. Those opinions may be well-reasoned or dart throws. But even the most rigorously derived view of the future is far from sure to be right. Many other things may happen instead."

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