Bear-o-meter drops considerably

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Here is the link for my BNN MarketCall show last night.

Roughly every month, I try to post the results of a compilation of financial indicators that measure the current risk/reward picture for US markets. Long-time readers are familiar with this compilation, which I call the "Bear-o-meter".

For those new to my blog: The Bear-o-meter is a risk/reward measurement against the US markets. *It is not a pure market timing tool* – rather, it gives us an idea of the current environment stacks up against ***historical risk and reward tendencies***. I rank 12 indicators that fall into 5 broad market macro Technical analysis parameters. They are:

- Trend,
- Sentiment,
- Breadth/Breadth-momentum,
- Value,
- Seasonality

The Bear-o-meter is ranked 0-8 from least attractive risk/ reward to highest. Three categories, which can be seen on the graphic above, shows high risk, neutral, or lower risk zones—all depending on the recent numeral reading of the compilation.

Last month (April 6th) the Bear-o-meter read "7" out of 8. That was a pretty darned bullish reading. The market followed through over the next number of weeks with a positive return. But things have taken a negative turn for the Bear-o-meter this month. Its now sitting at "4". While not officially into the higher risk zone, the bear-o-meter now teeters in the "neutral" reading. At ValueTrend, we like to use the Bear-o-meter readings to give us some guidance on how much cash we should be holding. We have a scale that gives us the approximate cash levels to hold in our equity platform. The lower the Bear-o-meter score, the more cash the scale recommends. For example, for most of the winter, the Bear-o-meter jumped around from 4 (in January) to 1 (in March). We held 15-30% cash during those periods. When the Bear-o-meter moved to seven in April, we moved our cash levels down to the 10% range.

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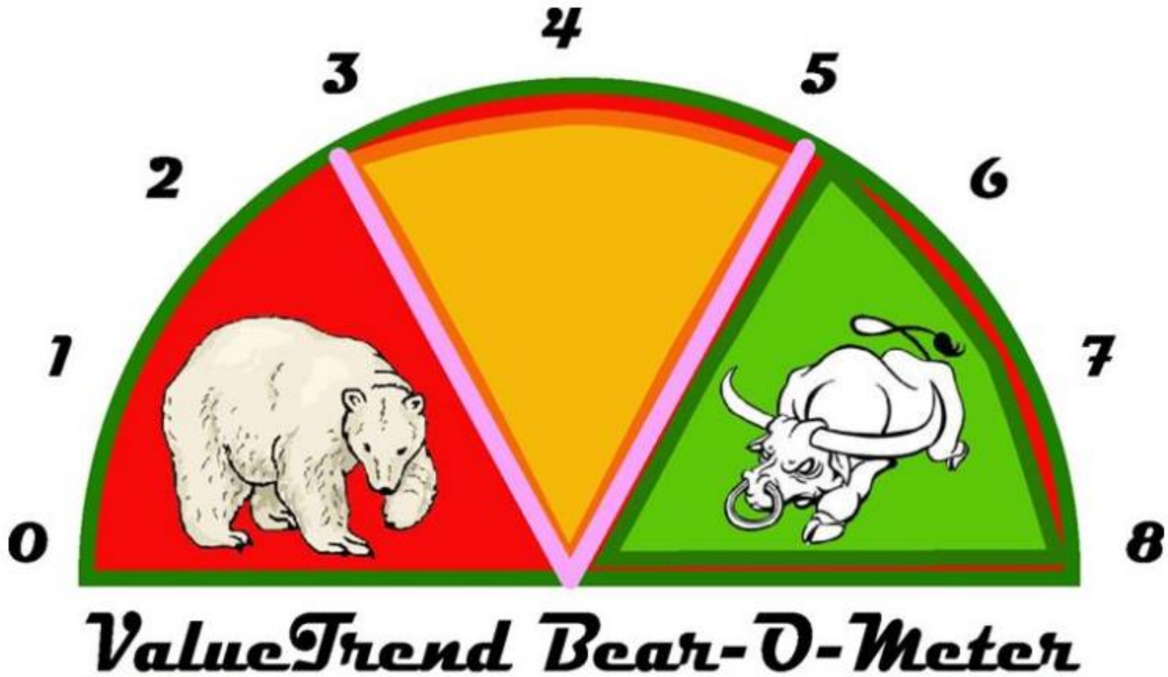
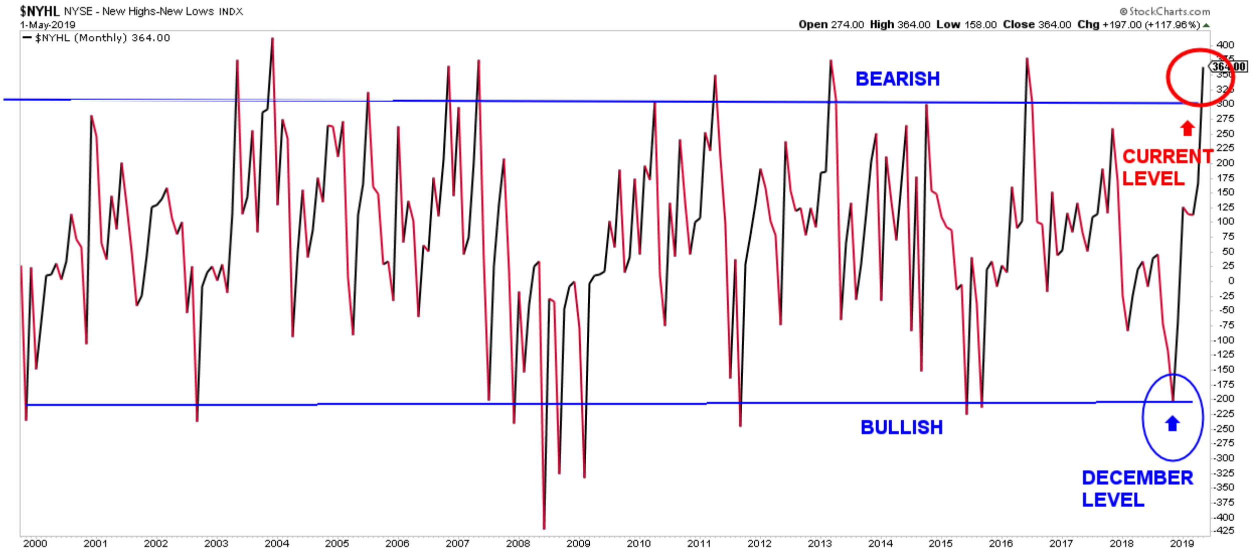


This month, because the Bear-o-meter has dropped a full 3 points back into the low-neutral zone – we are looking to hold 15% cash. In fact, we shuffled in and out of a positions recently and currently sit pretty much at 15% as I write.

What caused the big drop in confidence?

The Bear-o-meter uses seasonality as one of its factors. During the winter, the Bear-o-meter gets 2 full points added to its score – this, because of the tendency towards more positive markets over the winter. After April, that 2 points gets removed off of the scale. It's not necessarily a bearish thing for the markets over the summer, but because markets have a tendency to have corrections more often in the summer than over the other 6 months, the bear-o-meter eliminates the positive score it would assign over the winter months to the total. So, that explains 2 of the 3 lost points.

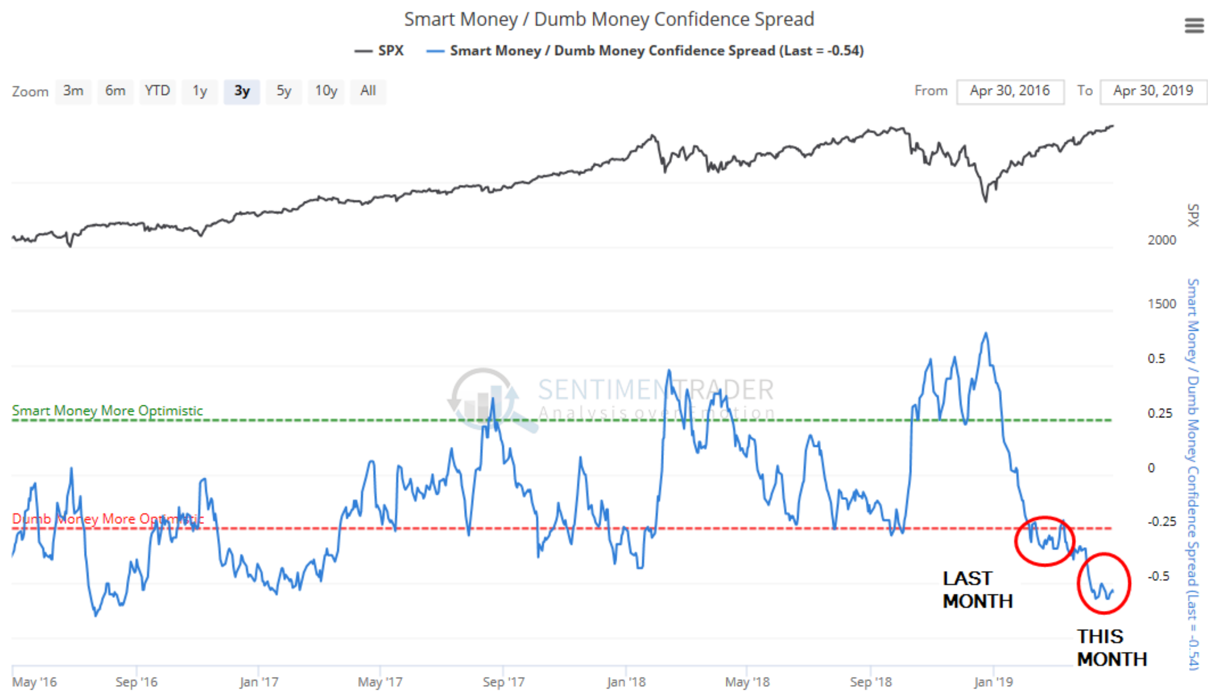
The other point was lost on the NYSE "New High / New Low reading". Its overbought – meaning that there are too many stocks making new highs on the NYSE. Normally, while you do want to see more stocks rising than falling to support a bull market – you don't want to see a stampede into stocks. The chart below shows the level where I have noted as "too bullish" for this indicator. It's really just a sign of an overbought market. In other words, it's a sign of potentially irrational exuberance. This kind of overly optimistic sentiment is typically washed out of the market over time.



Conclusion

The market is not in the danger zone, but it is a bit overbought. One of the other indicators that follows a similar structure as the New High/Low indicator that I use in the compilation is the % of stocks in the SPX that are over their 50 day SMA's. This indicator did not quite make it to the overbought level that I use for a point score – but it is very close. As with the New High/Low indicator, I use it as a sign of overbought/ oversold markets if the level is extreme in either direction. Again, it isn't officially overbought, but its close enough.

Putting it all together, it appears that the market is safe from a trend perspective, but a bit overdone from a momentum and sentiment perspective. You can see on the smart/dumb money indicator, for example, tha the reading was bearish last month and remains so this month. However, the line has gone deeper into bearish territory over the past few weeks as dumb money got even more confident, and smart money got even less confident. The spread between these groups has widened further.



These observations suggest we might expect a minor correction fairly soon.

That correction, should it happen, doesn't look like it is anything to be too concerned about for most mid to longer termed investors. The real key will be to see no further deterioration in the Bear-o-meter's risk/reward ranking. We'll measure it again in a month. For now, keep calm, and let the Portfolio Manager handle it!

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