Bear-o-meter shows excessive market optimism

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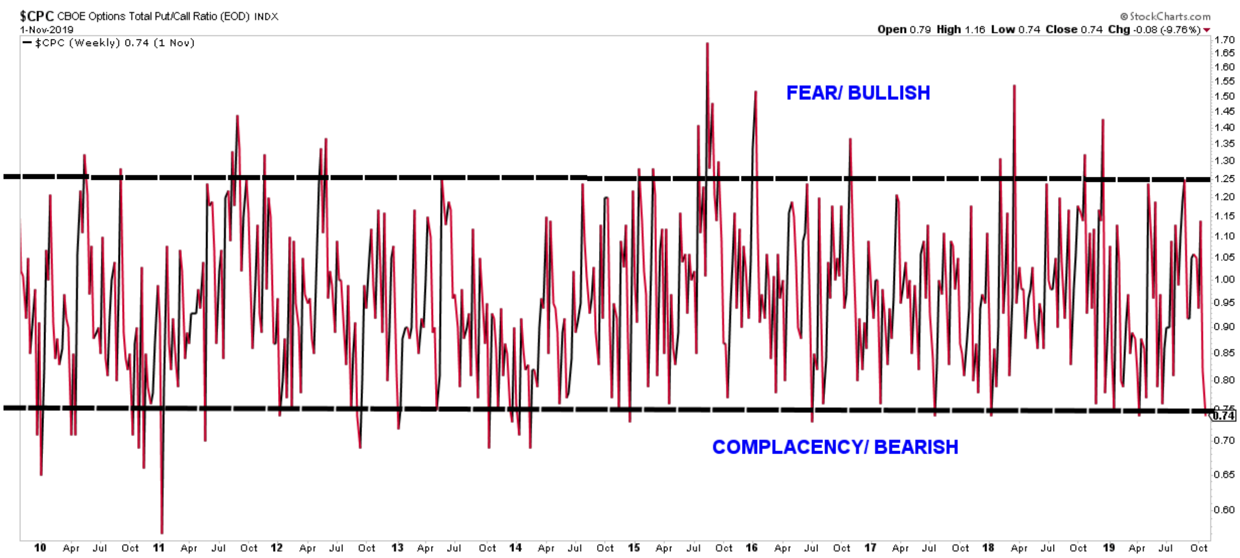
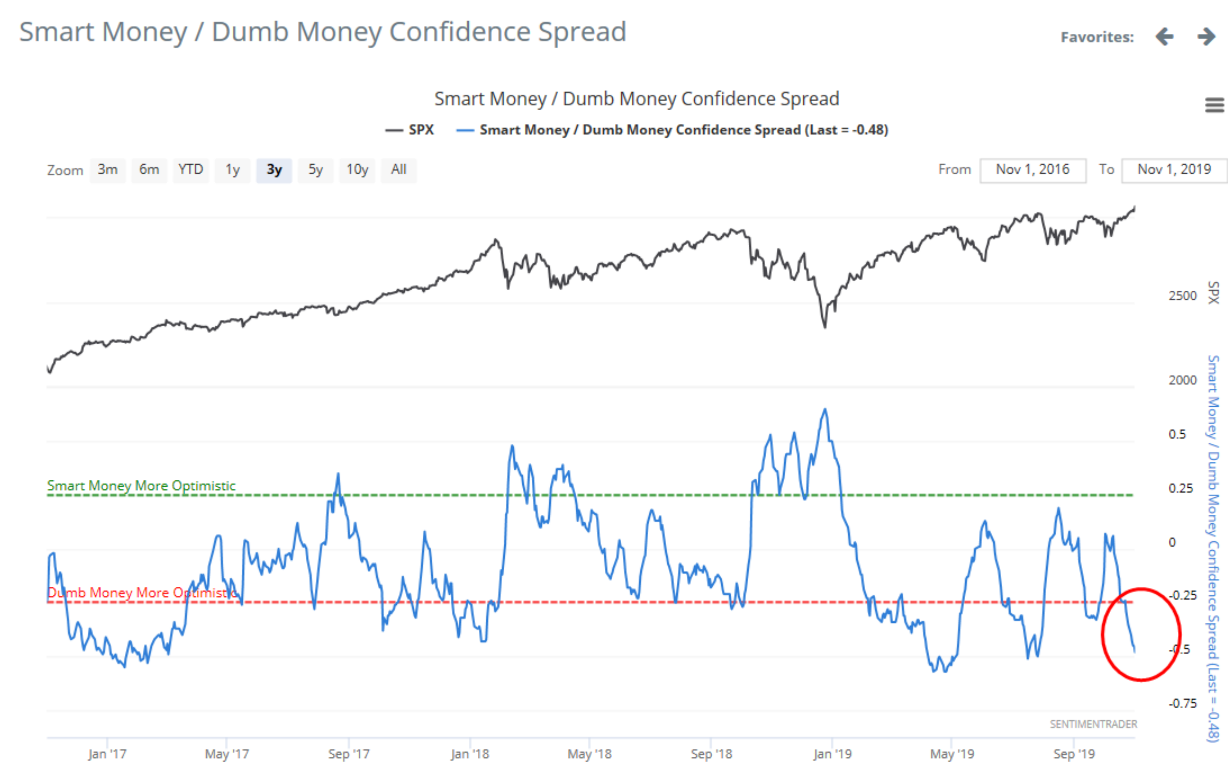
Sentiment indicators are contrarian. Essentially, if market participants (particularly retail investors, aka “dumb money”) are “too” bullish, its something to be worried about. Sentiment indicators are quantitative measurements of investor confidence. They look at moneyflow statistics, and confidence surveys. They play off of the “Greater Fool Theory”–which essentially says that a stock, or any asset (real estate, commodity, currency, country indice, etc) can go up and become more and more overvalued because there is always a greater fool ready to pay a higher price. However, once the greatest fool (or the final group of greater fools) has/have bought -there are no greater fools waiting on the sidelines to bid the asset up any higher.

I include 3 sentiment indicators in my Bear-o-meter compilation. They are the CBOE Put/Call ratio, the VIX volatility index, and sentimentrader.com’s Smart/Dumb money confidence spread. Each one of those three indicators has moved in a negative direction (aka are now indicating high risk overly bullish sentiment) since last month. Officially, the Put/Call ratio is reading bearish.

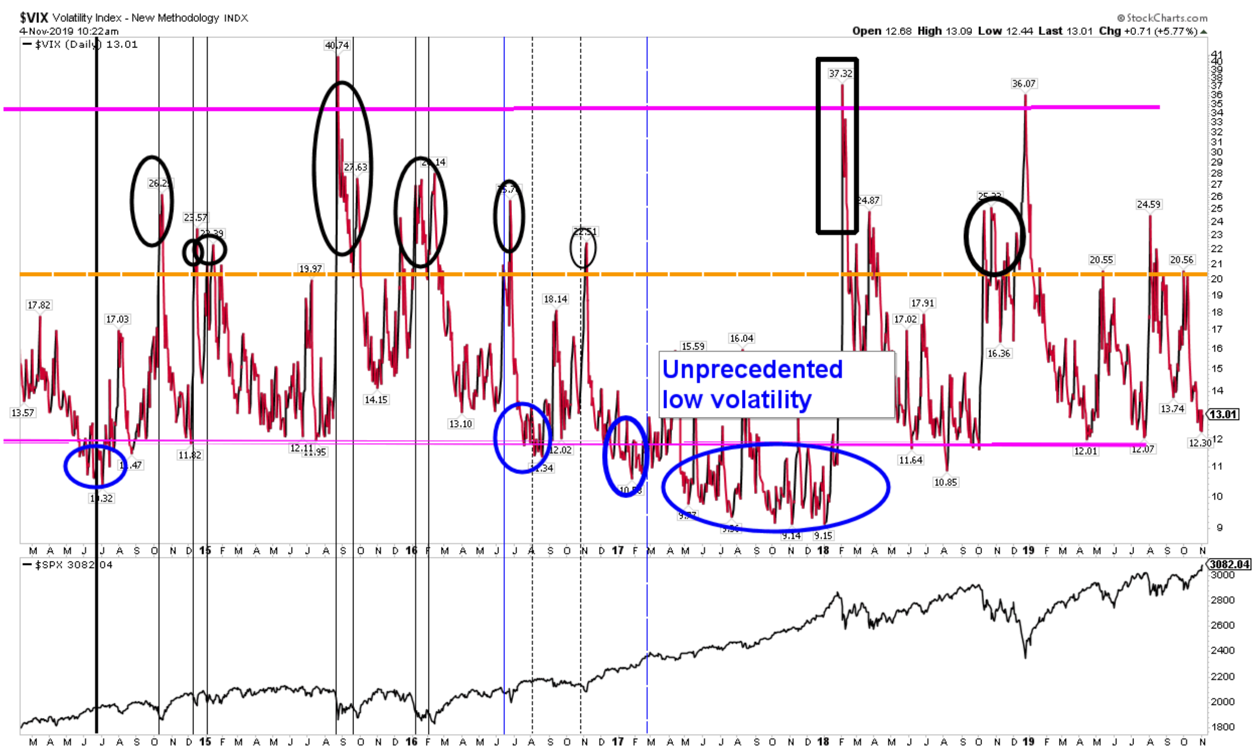


That, along with the Smart/Dumb confidence spread.

Keith Richards, Portfolio Manager can be contacted at krichards@valuetrend.ca



The VIX is teetering on the brink of becoming "too low" but, as of today, isn't there. My parameter is for a reading below "12" on that index. Its at 12.8 as I type this. One or two optimistic days could shove it down into a bearish reading.



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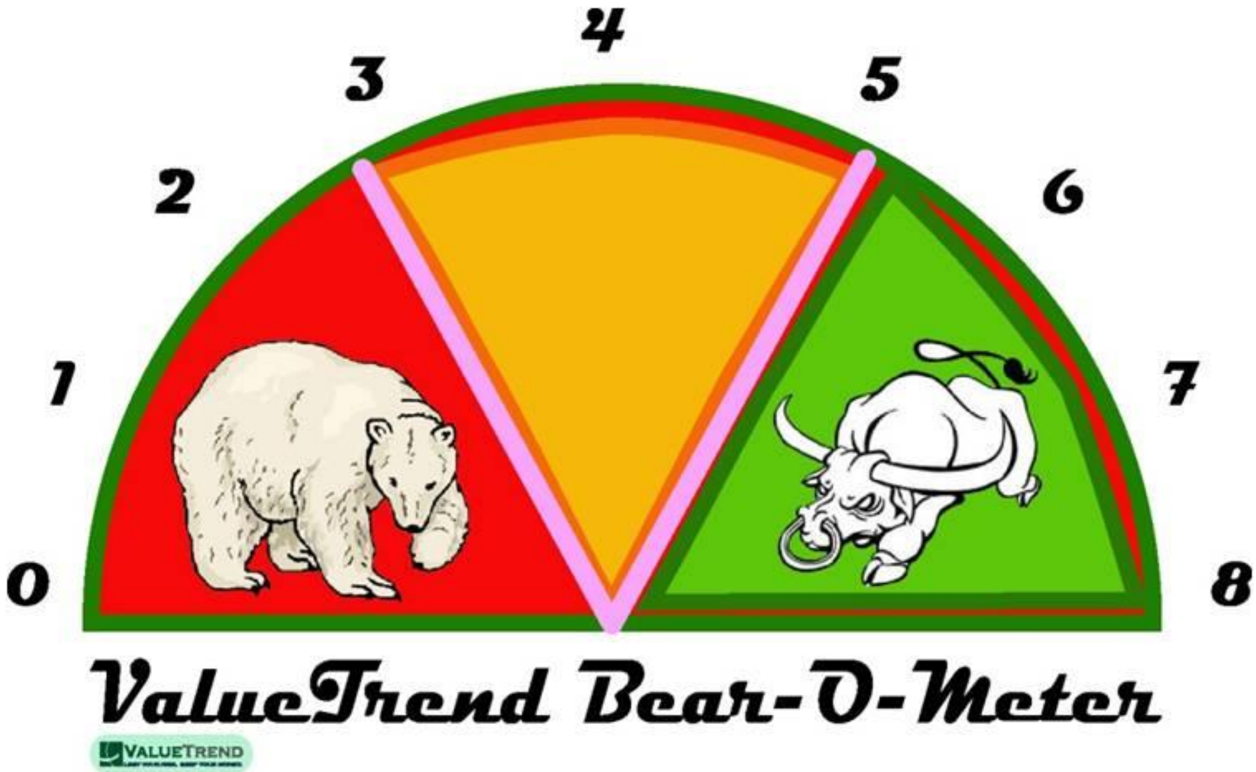
Last month on October 2nd, the Bear-o-meter moved into a very bullish reading of "6" (out of a possible 8). The compilation correctly identified that the market was, on a relative basis, a lower risk bet than it had been for most of the summer. The SPX advanced 3% since that signal. Not bad for a month.

The Bear-o-meter is showing a fairly low reward/risk reading. Its reading a very low score of "1". The diagram below indicates that we stand at the low end of the risk reward scale, at least according to this compilation.



Currently, the Bear-o-meter presents a much higher risk picture for the markets. Not only have the 3 sentiment readings turned bearish since October. Its also showing an overbought reading on the New High, New Low indicator. Normally, you want more highs than low – but if a market becomes overly enthusiastic, this indicator tends to show us that momentum is becoming overdone. And that's the case right now.

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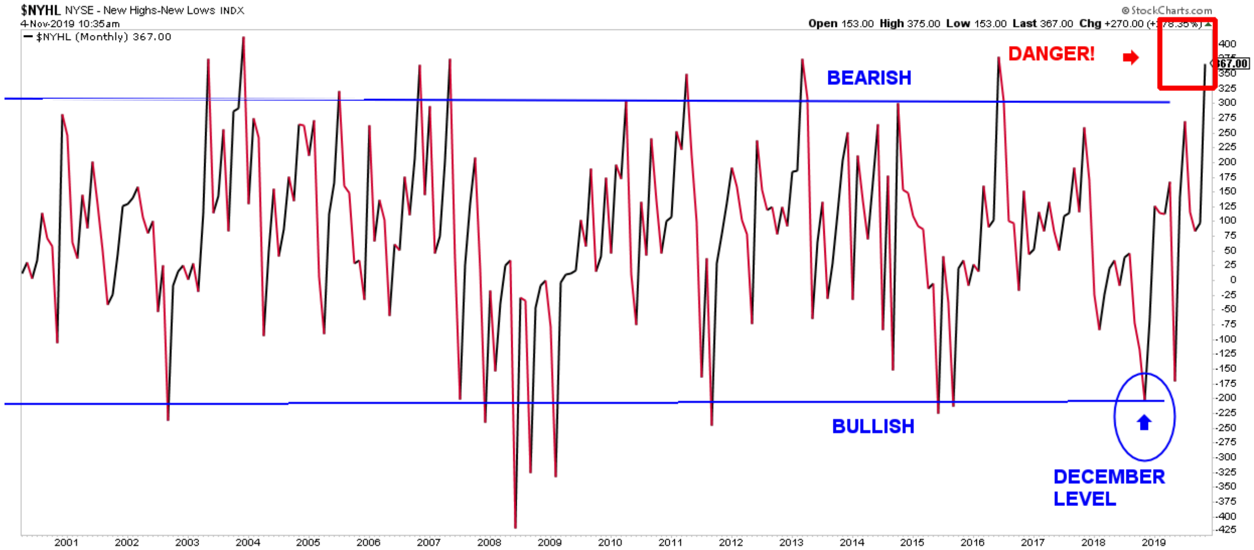

Conclusion

I'll finish this blog with a reminder. That is: the Bear-o-meter is not a pure market timing tool. Markets have risk and reward built into their structure at all times. A high risk market, like now, can go higher. A lower risk market, like we had last month, can still decline. The Bear-o-meter simply attempts to measure the odds. Right now, odds are we may get some noise on the markets. But, seasonality is very, very strong in November. So I might suggest that if risk does decide to make itself known, it may hold off for a month. Or not. Again, its a relative thing, this game of risk vs. reward. Anything can happen.

I'll admit that we are almost fully invested in the ValueTrend Equity Platform right now. We hold about 14% cash in the Equity Platform (we raised some today), but thats substantially lower than our average cash weighting of about 25-30% over the summer. That smaller amount of cash we currently hold is there for some specific stocks should they hit our buy prices. Otherwise, we're in. But we're aware of the risk. Perhaps you should be too.

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