Bear-o-meter suggests current selloff is reducing market risk

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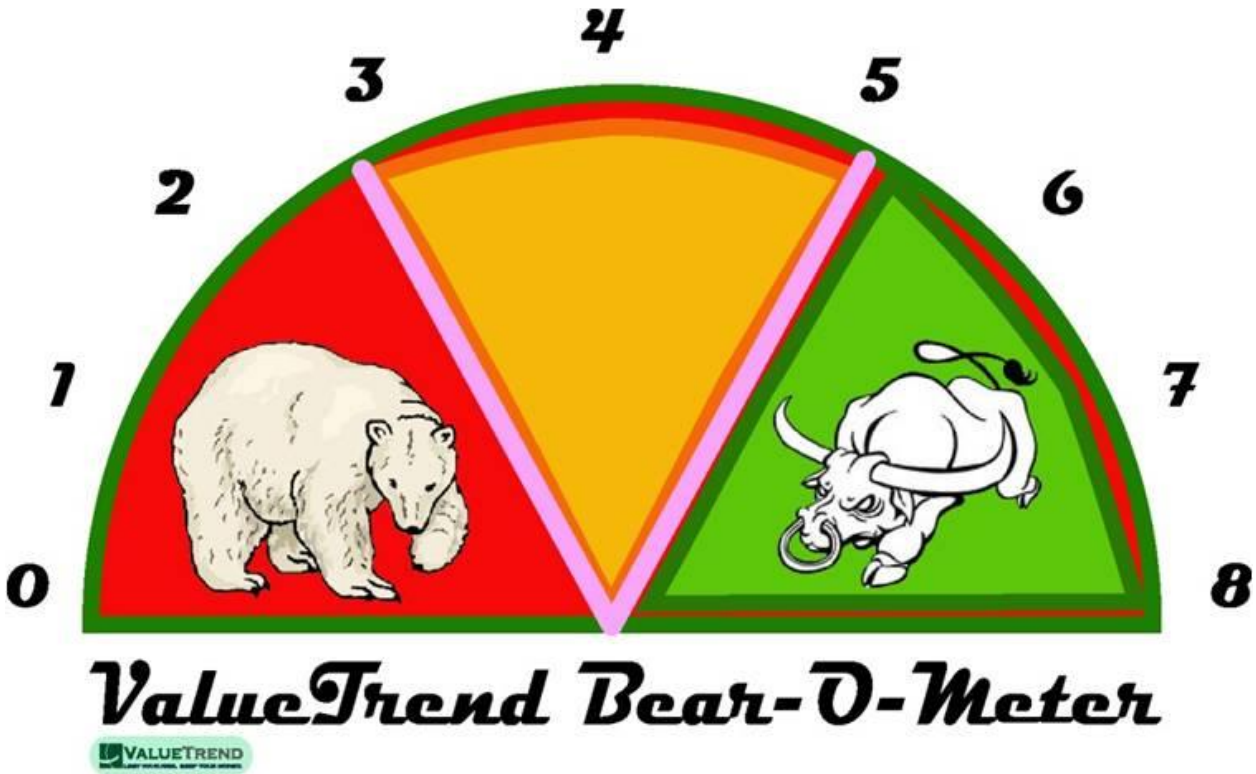
Today's blog is a little longer than usual. Please take the time to read its entirety. This one is important. I think things may be setting up for an opportunity in the markets soon, with one caveat. Read on…

The Bear-o-meter is a risk/ reward indicator. It's a compilation of indicators falling under general classifications of:

- **Breadth:** This is an indication of the market's "conviction" – it measures things like the movement of the Dow Industrials vs. the Dow Transports, and the cumulative number of advancing stocks vs. declining stocks on an index. More participants in a move, be it up or down, means more conviction by market participants in that move.
- **Trend:** Moving averages tend to indicate how strong a trend is, depending if the market is above or below the given moving average. The longer the moving average, the more significant that average is in determining the strength of the trend.
- **Breadth momentum:** Sometimes, when too many stocks are moving up or down too vigorously, we have a problem. Breadth momentum looks at things like the total number of stocks making new highs vs. new lows, and the number of stocks above or below their moving averages. If they go over or under certain numbers, we get overbought/oversold indications. I find breadth momentum more telling of forward looking risk than standard momentum indicators like RSI and ROC- which simply focus on overall index price moves. That's because breadth momentum shows the internal convictions of the markets by examining the individual participation of a move more closely.
- **Sentiment:** Sentiment looks at fear and greed. Its a contrarian indicator. Too much bullishness is bad. Too much fear is good. I'm looking for extreme ends of those two market attitudes. A good sentiment indicator like the VIX or the put/call ratio can give us a heads-up of irrational exuberance or despondency by market participants.
- **Seasonality:** Season studies were first conducted by Yale Hirsch, founder of the Stock Traders Almanac. Canadian analysts Brooke Thackray and Don Vialoux took up the gauntlet for seasonal studies here in Canada. All of these analysts have proven the statistical relevance of reducing equity exposure in the summer months and re-entering the market in the fall. It doesn't work every year. But, it works well enough to be a factor in the Bear-o-meter.
- **Valuation:** As a Technical Analyst, I try not to spend too much time examining market valuations. However, one indicator remains a reasonably good longer termed indicator of relative market value. That's be the good old PE ratio on the S&P 500. Too high, and its an extended market. Too low, its undervalued. The problem with the pE ratio is that its really

not a good timing factor. Markets can remain overvalued for extended periods of time. But, its still a factor that should be noted, as valuations will at some point regress to their longer termed mean average. Hence, I use it as one factor in the Bear-o-meter.

As many of my regular readers know, the Bear-o-meter assigns risk on a scale of 0-8. A reading of 3 or under is generally a higher risk market. A reading of 3-5 is about "average" for a risk/reward tradeoff. Anything 5+ is considered lower than average risk. The illustration below shows us that a rating of 3, or 5, is kind of borderline. I look at those readings in context of where the last reading was. If the rating is 3, for example, but the last reading was 4, I'd look at that as a more bearish reading than a move UP from 2 to 3.



Last month vs. this month

The Bear-o-meter read "4" on September 9th – my last reading date. The SPX was at 2978 on that date. Yesterdays close on the SPX was 2940. That's a pretty flat return. So a neutral reading was perhaps merited. As of today, the Bear-o-meter has moved up a notch to "6". "But wait", you say, "Shouldn't it be flashing higher risk, given the market selloff over the past two days?"

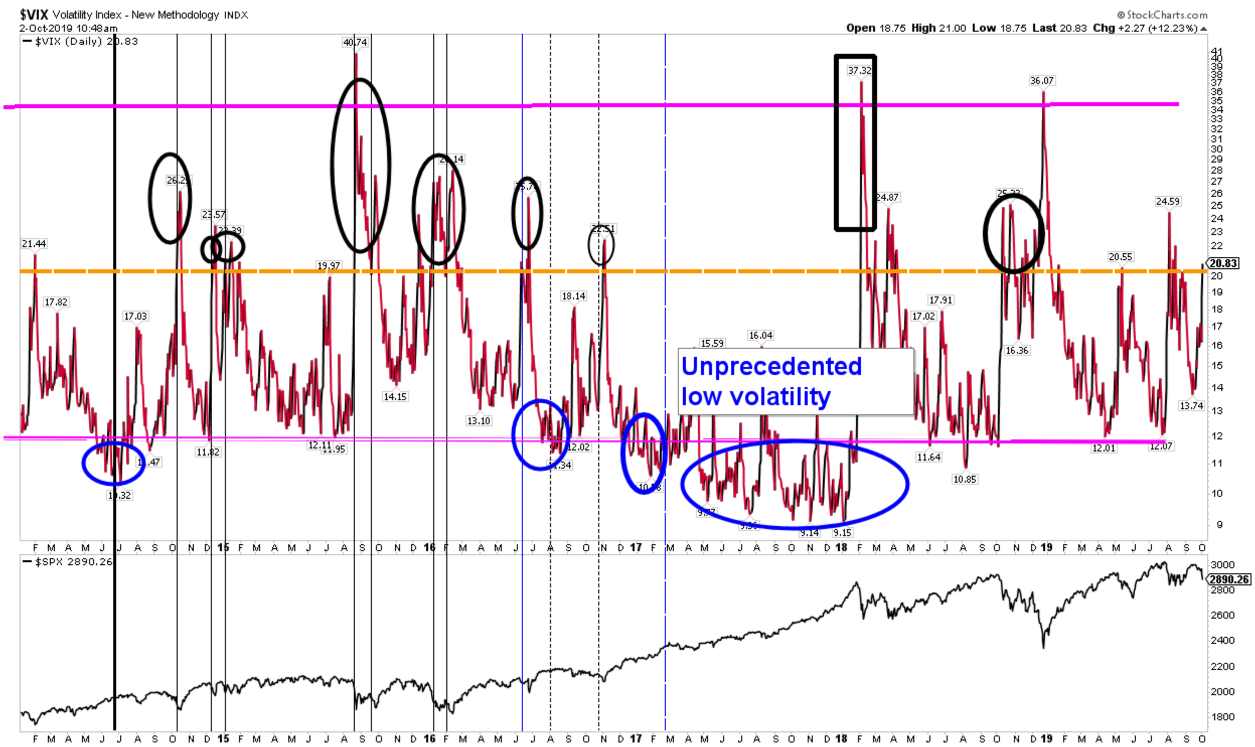
The answer to that question is NO! Recall that the Bear-o-meter isn't a timing instrument. Its a risk/reward instrument. As markets move lower, they become less risky if the prior valuations were too high. In this case, we had an already neutral environment, and the current selloff is simply adding to the case that markets are nearing a low point. The encouraging thing I am seeing – per my blog on Monday – is that we may get an entry point in the coming days or weeks. I'm watching for a pullback into the mid 2800's -2900 as a support level. It would be extra enticing if I see some of the faster sentiment indicators I watch such as the VIX and Smart/Dumb money move into contrarian buy zones.

The caveat

Remember, though. The chart comes first. A break in the 200 day SMA and a lower low means that things have changed. That hasn't happened yet. I'm just noting that the trend trumps Bear-o-meter readings. But for now, things look to be sitting up for a potential buying point.

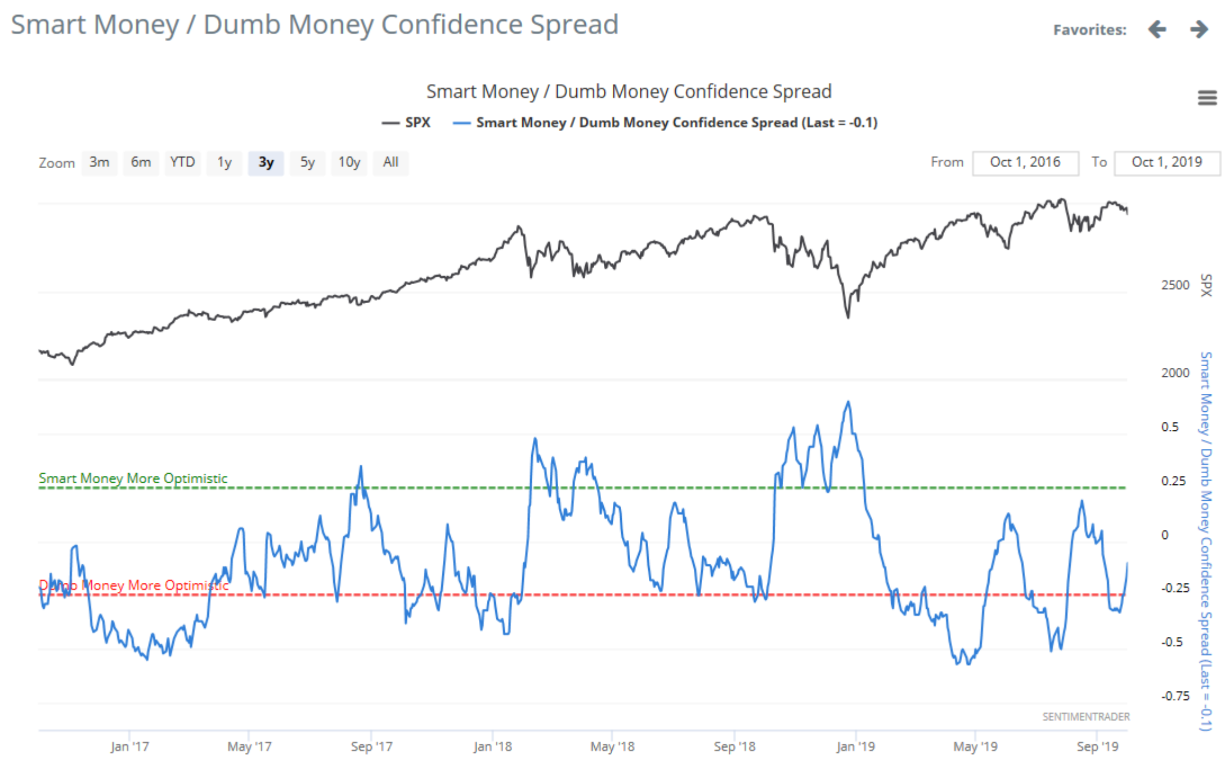
Watch the VIX

Note the VIX chart below. Its just above my minimum level (20) to assign a positive score in the Bear-o-meter. But you'll note that most minor market bottoms (ie within a bull trend) are signalled closer to 25. So its in the zone, but it may go higher (ie the market may sell off a bit more) before a true buy point arrives. That buy point may be very, very soon…



Smart/dumb

Also note the Smart/Dumb money chart below – courtesy sentimentrader.com. You can see that September flashed a sell signal as it breached its lower (red) line. Its possible it may hit the upper (green) line in a very short timeframe (days?) if markets keep selling off.



Conclusion

As noted on Monday's blog, I feel that the markets will settle down by about mid October. Perhaps sooner…we shall see. Technical evidence surrounding sentiment in particular backs that potential. So too do seasonal tendencies. Keep an eye on price, though. You don't want to see the last significant low on the charts (around 2820) broken. Should that happen, I will be counting my 3-days, and reduce exposure. The indicators I look at suggest that to be a lower probability. I am cautiously optimistic at this point.

Keith on BNN next Monday October 7th at 6:00PM

Keith appears regularly on BNN Bloomberg MarketCall to answer viewer questions on the technical analysis of stock trends, and to provide unique insights on the factors of technical analysis used in successful investment management.

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