Sector Surfer
Change the Game
Shoot The Curl
Monthly Perspective

Perspective: A Financial Canary in the Coal Mine?

Aug 03, 2016

Dear Scott,

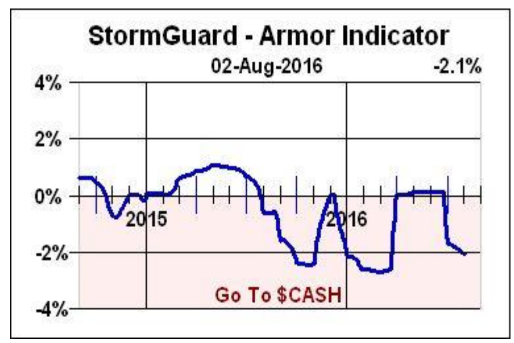
Optimism or Pessimism?

Optimism is easily supported by the 5-year S&P 500 chart (right), which reveals how nicely the market has returned to its all-time high following a year long hiatus of stagnation. That said, pessimism is likewise easily supported by StormGuard-Armor's chart (below-right) showing nine months of weakness followed by a precipitous drop shortly after June's Brexit vote. Additionally, there is no sign of recovery despite the market's minor July rally. Thus, we must carefully decide whether the market has been taking a pause that refreshes, or whether it's been dying on the vine in preparation for a serious bear market. A few more charts may provide a better perspective.

5-YEARS

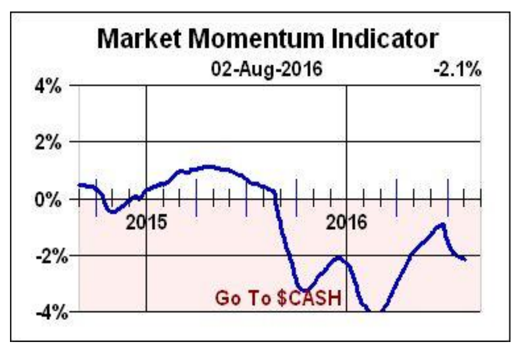
New StormGuard Charts

An additional three daily indicator charts have just been added to the Market Sentiment page, including the Market Momentum Indicator, Value Sentiment Indicator, and the McClellan AD Oscillator Indicator. The Market Momentum and Value Sentiment Indicators are the new components that were combined with the original StormGuard (Price Trend) Indicator to form StormGuard-Armor. Notably, while both the Price Trend and Value Sentiment Indicators are quite positive, the Market Momentum Indicator (right) has turned strongly negative and is responsible for StormGuard-Armor's current negative indication.



Click for all SG-Armor Components

The Market Momentum Indicator is like a "poker tell," providing a peak at the behavior of high volume institutional investors. It suggests they've seriously pulled back and are at the door ready to run at the next sign of trouble. Perhaps there'll be trouble, and perhaps there won't. However, if there is trouble, the market isn't safe because they'll be out the door before anyone knows what has happened. Although domestic and world events have only rattled the market a little this past year, institutional investors are acting as though they've become quite concerned about weakening investment prospects. The following charts may offer an explanation of what is weighing on them.



Click for all SG-Armor Components

Interest Rate Hikes?

The "Failed Interest Rate Predictions" chart (right) depicts the forward rates implied by futures contracts — clearly everyone has "known" for at least five years that interest rates would be imminently rising. Even today it is commonly believed that the Federal Reserve (Fed) will start hiking rates this fall. An institutional investor believing near-term interest rate will rise would likely reduce expected corporate earnings projections (and fair value price) by the expected future increased cost of corporate debt service.

That said, any number of geopolitical events could derail the improving economy, and cause the Fed to change its tune yet again. It's worth noting that both Europe and Japan have recently proven there is plenty of room to take rates still lower, perhaps through zero to deflationary negative rates.

Falling Velocity of M2 Money?

The velocity of money is essentially the number of times per year the same dollar passes from one transaction to the next as business is conducted. The Velocity of Money chart (right) shows the velocity of money has declined about 30% from its peak nearly two decades ago, and currently is about 15% below its long-term average and continuing its rapid decline. The underlying reasons for decline are almost certainly driven by a combination of demographics, regulatory policy, and labor automation. Regardless of the cause an institutional investor would likely see this as an ominous trend for future corporate growth and earnings prospects.

High NYSE Margin Debt?

The New York Stock Exchange (NYSE) Margin Debt chart (right) has three sharp red peaks, the first two of which correspond to the market tops just prior to the 2001 and 2008 market crashes. The reason why this chart is important is two-fold: (1) margin debt is an excellent proxy for euphoria and complacency risk, and (2) when an otherwise normal market correction occurs, the additional downward price pressure from triggered margin calls can become large enough to produce a self-sustaining crash that stops only when there are insufficient margin calls to further drive down prices. The Market Momentum indicator says institutional investors believe the story will likely be the same this time. Thus, they've already stepped back from the precipice months ago.

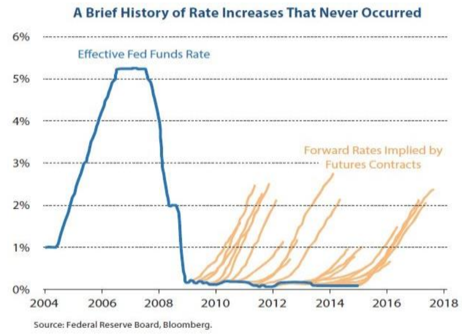
Bear Market Strategy Safe Harbor Candidates

Early this year we added the Bear Market Symbol (see advanced StormGuard settings) to provide a means for specifying something better than $CASH when StormGuard triggers. While extended long-term treasuries perform spectacularly, they are problematic because they have not always been negatively correlated with stocks like they have for the last 20 years.

The Interest Rates vs 10yr Treasuries table (right) suggests that when interest rates start rising, the 10yr treasury expected returns will be inversely affected in proportion to the speed at which interest rates rise. This is precisely why the Bear Market Symbol should refer to a Strategy, such as SSS1 (a reference your Strategy #1) that can evaluate multiple candidate funds and select only the currently best performing one to own each time StormGuard triggers.

The best performing Bear Market fund types are as follows: (1) long term treasuries, such as VUSTX and TLT-, (2) aggregate bond indexes, such as AGG- and PTTRX, (3) an inverted stock index such as SH-, and (4) gold bullion, such as GLD-. While it's easy to make

Failed Interest Rate Predictions

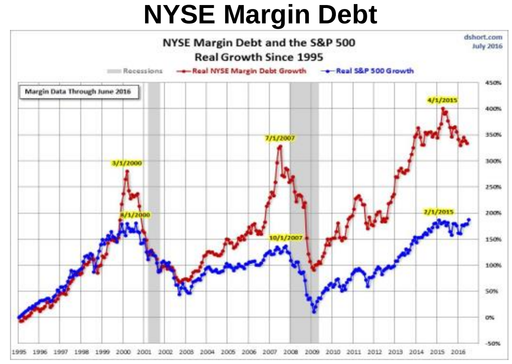


Click to Enlarge

Velocity of M2 Money Stock

Click to Enlarge

NYSE Margin Debt



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Interest Rates vs. 10yr Treasuries

Time Interval		Interest Rate		Rate Change	VUSTX Return
From	To	From	To	Per Year	Per Year
1989	1994	9.8%	3.0%	-1.4%	13.10%
1994	1995	3.0%	6.0%	3.0%	-7.70%
1995	2001	6.0%	7.0%	0.2%	10.50%
2001	2004	7.0%	1.0%	-2.0%	8.10%
2004	2007	1.0%	5.2%	1.4%	5.20%
2007	2008	5.2%	0.3%	-5.0%	7.40%
2008	2016	0.2%	0.4%	0.0%	7.50%

Click to Enlarge

Bear Market Strategies with treasury and bond funds, the inverse S&P and gold funds tend to have problematic sharp reversals that can often reduce Strategy performance. However, since treasury and bond funds may become quite unattractive when interest rates start rising, it's still important to find a way to enable the inverse S&P and gold to participate. Fortunately, they are tamed when owned together in a 50/50 portfolio split. To simplify experimentation, I have created the **new artificial symbol SHGD-** which is composed of 50% SH- (short S&P 500) and 50% GLD- (gold bullion). We'll explore this in detail next month. Until then, please experiment creatively!

Advanced Bear Market Strategies
Streamed Live September 6th, 7PM PST

[Click for Event Details.]

Sept 6th Meetup: High Performance Integrated Bear Market Strategies
If you want to improve the bear market performance of your Strategies to ensure you are fully prepared for the next market crash, then you need to attend this live online seminar. We will cover all of the basic concepts of StormGuard-Armor, Bear Symbols, Extended Symbols, and most importantly, the construction of integrated high performance Bear Market Strategies that explores combinations of numerous fund types said to be safe havens during bear markets. We'll see what works ... and what's just a bunch of hooey. See Details.

Speaking Engagement Calendar.
Please come and see one of these seminar presentations if you are in the neighborhood. Alternatively, ask your AAII Chapter or Investment Group leader to schedule a presentation. Live Webinar presentations for smaller investment clubs and groups are welcomed.

Seminar Titles: "True Sector Rotation Made Practical, and Addressing the 7 Faces of Risk"
This is a fast-paced detailed seminar that will cover SectorSurfer basics, Forward Walk Progressive Tuning, Strategy-of-Strategies, and how to make Low Drawdown Portfolios.

- **Seattle, WA: Momentum Investing Meetup Group - Sept, 6 at 7:00 PM - Streamed Live**
- **St. Louis, MO: AAII Chapter - September 8, 2016**
- **Sacramento, CA: AAII Chapter - September 20, 2016, 7 PM**
- **San Jose, CA: SectorSurfer User Group - September 21, 2016, 6PM, Advanced Topics**
- **Phoenix, AZ: AAII Chapter - October 15, 2016**

Surf Well and Prosper,

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Additional Resources

SectorSurfer Live Forum
By the Seattle SectorSurfers Meetup Group

The SectorSurfer Live Forum provides Internet-streamed access to the Seattle SectorSurfers Momentum Investing Meetup Group so everyone can attend the presentations and discussions hosted by Chief SectorSurfer. Click HERE

SectorSurfer Users Group
Join the Conversation

The SectorSurfer Users Group is an online Google Groups Forum created by Joe Gruender of San Jose, CA to provide a platform for exchanging strategies, ideas and learning from the experience of other SectorSurfers. Click HERE

SectorSurfer University
Learn to Change the Game

Investment professional Richard Erkes created SectorSurfer University to provide everyone the opportunity to learn how to use SectorSurfer to improve investment portfolio performance while simultaneously reducing investment costs. Click HERE

ALPHADROID STRATEGIES
Professional Help - Change the Game

Bryan Sullivan founded AlphaDroid Strategies to provide True Sector Rotation and StormGuard technology to financial advisors in a framework that helps them manage high performance portfolios for their clients. Click HERE