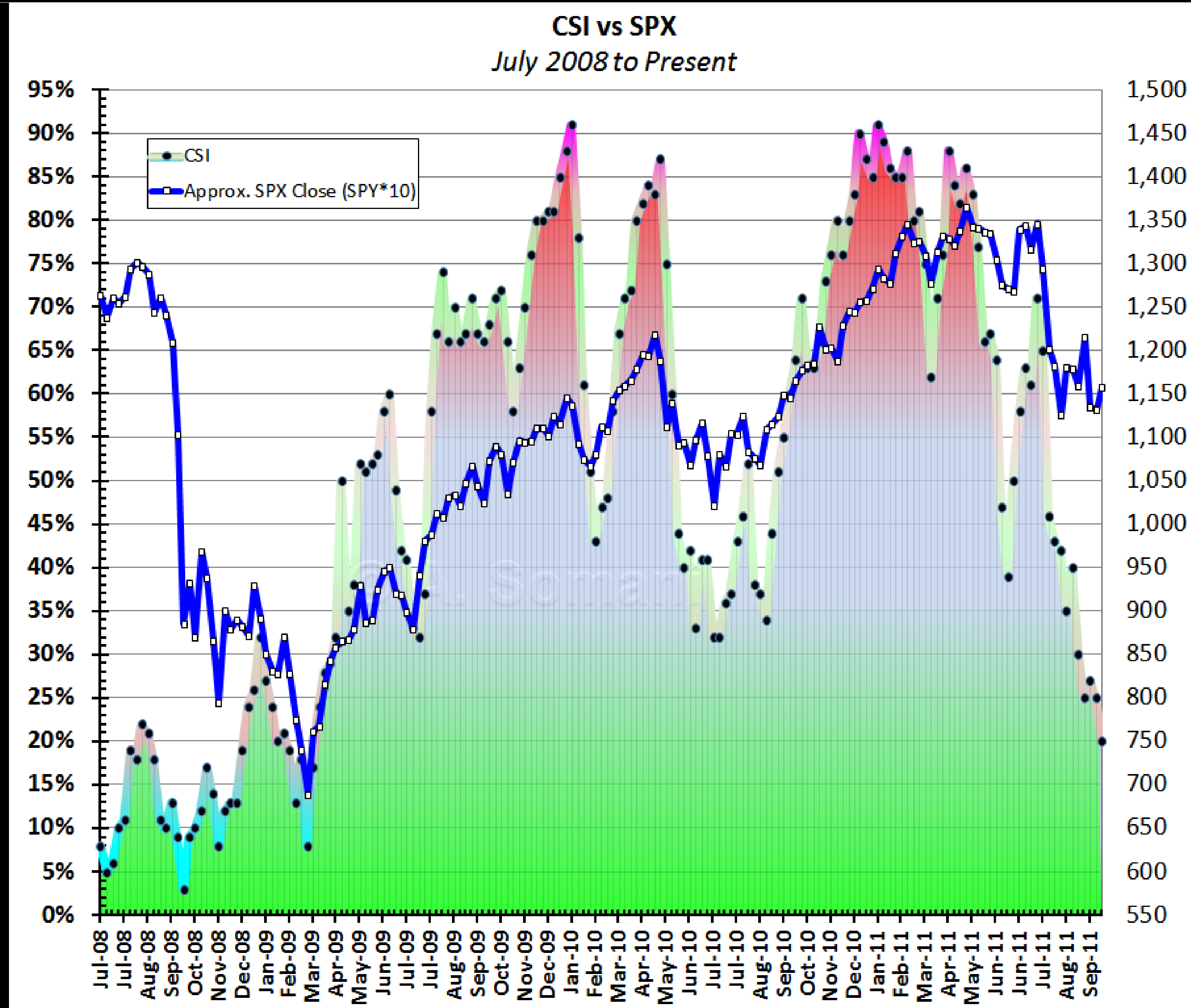
Crowd Sentiment Index (CSI) for US Equities

The Crowd Sentiment Index (CSI) for US Equities is a smoothed and normalized composite of crowd sentiment (ranking from 0-100%) on the US stock market that is derived from various daily and weekly sentiment guages prepared externally by third parties.

Imprecise CSI Interpretation Guidelines

	Bull Mkt.	*Bear Mkt.*
Extreme	86-100%	0-8%
Overweighted	71-85%	9-18%
Neutral	56-70%	19-29%
Overweighted	46-55%	30-38%
Extreme	27-45%	39-56%

Date	Approx. SPX Close (SPY*10)	%Ch.	CSI	Ch.
7/15/2011	1,317	-2%	61%	-2
7/22/2011	1,346	2%	71%	10
7/29/2011	1,293	-4%	65%	-6
8/5/2011	1,201	**-7%**	46%	**-19**
8/12/2011	1,181	-2%	43%	-3
8/19/2011	1,126	**-5%**	42%	-1
8/26/2011	1,180	**5%**	35%	-7
9/2/2011	1,179	0%	40%	5
9/9/2011	1,159	-2%	30%	-10
9/16/2011	1,215	**5%**	25%	-5
9/23/2011	1,135	**-7%**	27%	2
9/30/2011	1,132	0%	25%	-2
10/7/2011	1,157	2%	20%	-5



Comments and Opinions from the CSI Editor

Some Observations on Sentiment

- The CSI declined 500 basis points this past week to drop to 20%, despite an ~ 2% rally in the SPX. Over the past couple of weeks, the SPX has more than held its own – yet, the CSI continues to deteriorate. At this time, I would be cautious on assuming that any price strength that goes unconfirmed or largely unconfirmed by the CSI for more than 2-3 weeks will strengthen (or even sustain itself).

- The overwhelming majority of price- and breadth-based models I use to identify cyclical trend changes in the SPX have triggered by this point, suggesting a cyclical bear market is clearly underway. Until I see at least one of these models trigger again, I will assume US stocks are in a cyclical bear market.

- Within the context of a cyclical bear market, the current level of the CSI may be interpreted as neutral. As Schaeffer's Research writes in their *Monday Morning Outlook* this week: "…as far as the II and AAII polls go -- while bearish, they're still not as bearish as they were at the March 2009 bottom. This suggests panic could still lead to climactic selling, and another substantial decline."

- Based on CSI readings that occurred during the 2007-09 cyclical bear market, it would be of no surprise if the CSI once again needs to get to 8% or below before a sizeable bear market rally emerges (or the cyclical bear market concludes):

What the CSI is Like at Bear Market Bottoms

Wk. of CSI Trough	*CSI Trough*	*SPX at CSI Trough*	*Date of SPX Trough*	*SPX Trough*
3/14/08	4%	1275	3/17/08	1257
7/11/08	5%	1225	7/15/08	1200
10/10/08	3%	840	10/10/08	840
11/21/08	8%	741	11/21/08	741
3/6/09	8%	667	3/6/09	667

What Bear Market Rallies are Like (Continuation of Prior Table)

Date of SPX Trough	*SPX Trough*	*Date of SPX Peak*	*SPX Peak*	*% Rise in SPX*	*Decline Retrac.*	*Wks.*
3/17/08	1257	5/19/08	1440	15%	50%	13
7/15/08	1200	8/11/08	1313	9%	50%	5
10/10/08	840	10/14/08	1044	24%	38%	1
11/21/08	741	1/6/09	935	26%	62%	9
3/6/09	667					

Some Observations on the Cyclical Price Trend

- According to Sam Stovall of S&P: *"In 80 percent of all the times since 1945 that the S&P has fallen by 15 percent or more, it has morphed into a new bear market."*

- The visible price destruction on the daily, weekly, and monthly charts of the SPX, topped off with a second lower quarterly close (which is rare in a cyclical bull market), significant deterioration in what were leading growth stocks, and a recession call (based on what the NBER would date as a recession) from the highly reputable ECRI, puts the odds of late April / early May marking a cyclical peak in the SPX at very high odds, in my opinion.

- Prominent parties that have their own proprietary and highly accurate recession-predicting models apart from the ECRI, including economist and star portfolio strategist Francois Trahan of Wolfe Trahan, and respected portfolio manager Chris Puplava of PFS Group, appear to agree with the ECRI's recession call.

- A sustainable increase in 10-year treasury yields and junk bonds and/or commodities, and/or the onset of significant new monetary easing (including QE3 or its equivalent), alongside a visible trough in the ECRI's Weekly Leading Index (or a new forecast of a recovery by the ECRI), can be at least some of what is expected to mark the bottom of the cyclical bear market or current decline in the SPX.
    - I find it hard to believe that the Fed will not significantly increase its monetary easing policies at some point within the next seven months, if the ECRI is indeed correct about the US heading into recession (or being in one now).

- I would advise caution (to myself firstly, and to readers, secondly) in comparing present market breadth statistics on the major US indices against seemingly comparable market breadth statistics collected prior to the last 2-3 years (if not prior to the last 12 months), in arriving at an opinion on the current market condition (relevant market breadth statistics in this regard include: advancers, decliners, up volume, down volume – and possibly even new highs and new lows). The reason I say this is that the amount of historical extremes we are seeing in market breadth statistics on the major US indices, currently, is unprecedented and appears surreal or unnatural (eg. see here). The cause for most of these extremes may stem from presently relatively high correlation and co-movement between individual issues, resulting from the rapidly increasing use of ETFs that has occurred over the past few years.

Some Other Market Observations

- To this point, I have intentionally kept inter-market analysis out of the CSI Report, even though I'm a big fan of it – especially when economic confidence is low and the economy is in a tough spot. I will end this practice now. The US Dollar Index and long-term Treasury bonds (and yields) continue to be leading indicators of risk appetite, and every reader may want to keep a keen eye on them. One could argue that the recent strength in the stock market has much to do with the 'breather' that the US Dollar Index needs (and appears to be taking – see *All Eyes on the USD* section of Chris Puplava's latest article), en route to what will likely be higher prices for it in the coming weeks and months (a cyclical rally that will likely end sometime next year), albeit within the context of a secular downtrend. Bearish sentiment on the Euro (i.e. EUR/USD) has gotten extended recently, after all. Additionally, gold and silver have yet to show noticeable strength concurrent with recent US Dollar Index weakness (unlike equities), and this may be yet another hint that the US Dollar Index is just taking a breather before further gains in the coming weeks and months. It will be interesting to see whether weakness in gold and silver continues despite the overwhelming bearishness that exists on these two markets. If yes, it would be a warning sign that liquidity may be evaporating from financial markets in much the same way it did in 2008.

- Earnings season is fast approaching. Generally, earnings seasons that occur near 52-week lows in the SPX are bullish, as analyst and investor expectations tend to be relatively low and positive earnings surprises tend to be more likely, as a result. However, given that Q3 earnings estimates have probably not considered the possibility of a recession having started in Q3 (as few traditional economists regard the risk of recession as particularly high, at this time), negative earnings surprises would not come as a shock, and would be typical of what you would see concurrent with or prior to heading into a recession.
    - Although not statistically significant, it may be worth noting that poorly returning earnings seasons have been coming in streaks in the past few years, as sell-side research analysts tend to take multiple quarters to appropriately adjust their expectations on the companies they cover when these companies are not meeting estimates. A repeat would mean another down earnings season for stocks.

- As Tom DeMark pointed out in his interesting interview with Bloomberg this past week, the similarities between the current cyclical bear market and last cyclical bear market are rather stunning (to this point!). Take, for example, this visual view of it from Also Sprach Analyst (blowup here). If the SPX continues to repeat history, it should be en route to tacking on further gains (as much as another ~9%, based on the March 2008 rally) on through to early January. But, how likely really is this, especially after so many are now noticing the similarities between the current cyclical bear market and the last cyclical bear market?

- John Paulson's main fund ("Advantage Plus") at his hedge fund appears to be down a whopping and hard-to-believe 47%. That means redemption requests, which I understand will need to be filed by his clients with him before the end of Oct., could force Paulson to liquidate potentially even billions of dollars' worth of his various holdings before 2011 is out – with larger and more liquid holdings (presumably financials and gold) likely to take the biggest hit.

Market Scenarios to Consider for the Coming Weeks

I'm not a market forecaster and don't believe one needs to even remotely accurately forecast the market to be successful in trading it or investing in it. However, I feel that it's useful to have some different market scenarios for the coming weeks on one's mind (sometimes to partly assist in trade planning and/or risk management), and then consider if market action is confirming or denying them.

#	Scenario	Guesstimated Probability	Notes
1	SPX fails to definitively close above 1205 before heading lower to re-test its Oct. 4 intraday low.	50%	A re-test of the Oct. 4 intraday low will probably lead to a definitive break of said low – eventually, if not immediately.
2	SPX fails to definitively close above 1235-65 before heading lower to re-test its Oct. 4 intraday low.	35%	A re-test of the Oct. 4 intraday low will probably lead to a definitive break of said low – eventually, if not immediately.
3	SPX definitively closes above 1265 before continuing higher without a re-test of its Oct. 4 intraday low, or before heading lower to re-test its Oct. 4 intraday low.	15%	Admittedly, there are analysts that I very much respect, such as Jim Stack and Wayne Whaley, that still believe US equities are in a cyclical bull market. I am willing to leave the door open to the *possibility* of a continuing cyclical bull market at least until the SPX makes a definitive close below its Oct. 4 intraday low.

There is no doubt that oversold conditions have been piling up in equities over the past few months and could fuel a large cyclical bear market rally at any time (indeed, the SPX may have begun such a rally on Tuesday this past week). However, I would like to see the CSI hit lower levels before being more confident in, say, a 5-12 week rally of 10% or more. I would not bet too strongly on the latest rally not continuing, especially if SPX 1170 is definitively closed above, given that the SPX has now closed lower in 5 of the past 6 months. But, right now, I get the feeling that the intraday (and probably closing) low for 2011 has not yet arrived.

Cautionary Note on Interpretation: *The Crowd Sentiment Index (CSI) for US Equities is perhaps best used as a blunt and continuous (as opposed to discrete) indication as to the general market mood toward US equities, which can help a contrarian trader or investor to decide when to increase or hedge/decrease US equities exposure so as to help manage risk effectively and thereby maximize risk-adjusted returns. In a cyclical bull market, it is not unusual for the CSI to remain elevated for extended periods without the market declining in any significant way. Conversely, in cyclical bear markets, it is not unusual for the CSI to remain depressed for extended periods without the market rising in any significant way. Furthermore, the CSI is merely one tool a trader or investor can use to analyze markets, and should not be interpreted except in combination with the message being delivered by a suite of other tools the trader or investor feels confident in analyzing markets with.*