## Crowd Sentiment Index (CSI) for US Equities

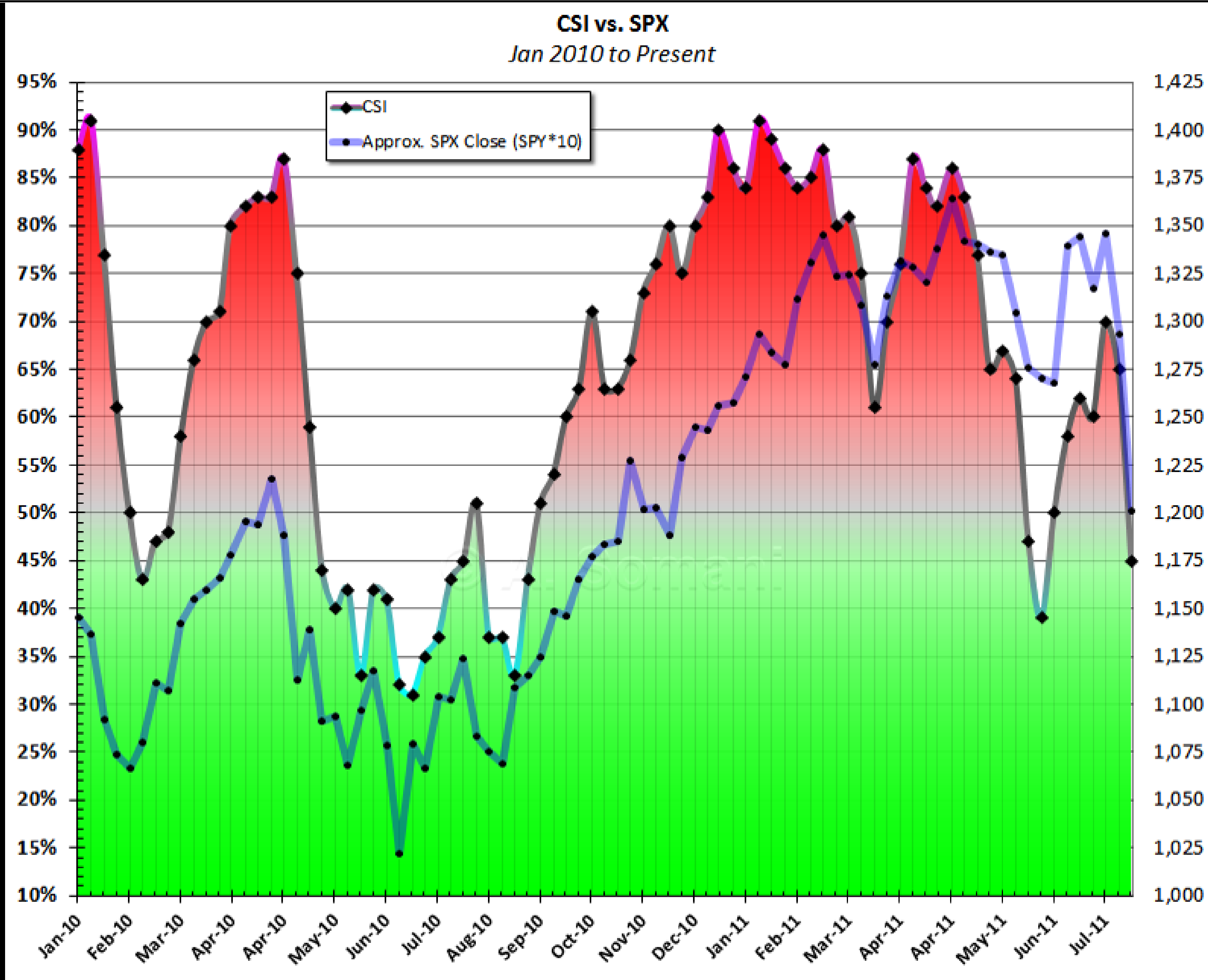
Imprecise CSI Interpretation Guidelines

| | 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% |

*The Crowd Sentiment Index (CSI) for US Equities is a normalized and smoothed composite of investor sentiment on the US stock market derived from various daily and weekly sentiment guages produced by third-parties.*

| Date | Approx. SPX Close (SPY*10) | %Ch. | CSI | Ch. |
|---|---|---|---|---|
| 5/20/2011 | 1,336 | 0% | 65% | **-12** |
| 5/27/2011 | 1,335 | 0% | 67% | 2 |
| 6/3/2011 | 1,304 | -2% | 64% | -3 |
| 6/10/2011 | 1,276 | -2% | 47% | **-17** |
| 6/17/2011 | 1,271 | 0% | 39% | -8 |
| 6/24/2011 | 1,268 | 0% | 50% | 11 |
| 7/1/2011 | 1,339 | **6%** | 58% | 8 |
| 7/8/2011 | 1,344 | 0% | 62% | 4 |
| 7/15/2011 | 1,317 | -2% | 60% | -2 |
| 7/22/2011 | 1,346 | 2% | 70% | 10 |
| 7/29/2011 | 1,293 | -4% | 65% | -5 |
| 8/5/2011 | 1,201 | **-7%** | 45% | **-20** |





**Opinionated CSI-related Commentary from an Always-learning Market Student**
*Before starting this week's commentary, it's worth remembering that a number of traders and investors are understandably concerned about how S&P futures may open this evening. Some of these people have been fearing Mondays that come after tumultuous weeks for a long time, in fact (at least since the Black Monday crash in 1987). These fears have actually allowed Monday to become one of the stronger performing days of the week since 1987. Anyway, no one knows how markets will react for certain but I want to note that the news of the S&P downgrade of the US's bond rating on Friday appears to be mostly priced into the market or is at least far from coming out of the blue, if only judging from the after-hours ETF price reactions following the announcement [which were ultimately not significant in any major market, including the SPX (SPY), gold (GLD), and long-term treasury bonds (TLT)]. The reactions make sense because rumors of a soon-to-come downgrade had been coming down the grapevine throughout last week and were well known across Wall Street trading desks by Friday.*

*I also want to remind readers of the FOMC meeting coming up on Tuesday as being a potential bright spot for bulls and potential rally catalyst – if a new stimulus program is announced or hints (subtle or otherwise) of a new or upcoming stimulus program (probably different from QE1 and QE2) are made, for example. The possibility of such statements coming about may be considered low but should not be dismissed, in my opinion – especially as the current economic slowdown is expected to continue into year-end (at least if the Fed does not intervene), conditions now are not that different from when QE2 was last announced, and a new easing program is still possible based on the last set of Fed minutes. Strangely (especially in light of Japan's recent intervention in its currency markets to weaken the Yen, and the downgrade of the US's bond rating by S&P), I do not see much discussion this weekend about the meeting – and I view that as a positive.*

It may come as no surprise that a multi-sigma (in this case, 7%) decline in the SPX this past week has led to one of the largest point drops in the CSI in years. It has moved from neutral territory at the end of last week into just barely extremely bullish territory at the end of this week (though still above its June low of 39%), within the context of a cyclical bull market (assuming we still are in a cyclical bull market, and I believe that this is still a more than valid assumption for the time being – but, respect those who feel differently, as always). A glance at the various price and breadth metrics I monitor regularly shows just how unusual the market is acting. From exceptionally multi-day and multi-week overbought levels in early July, the SPX, in less than one month, has hit multi-day and multi-week oversold levels not seen since late June of last year (mere days before the low of 2010) – and prior to that, early March 2009 and early Oct. 2008. As you will note, tremendous multi-week rallies unfolded when the market got this oversold in the past, though the number of occurrences from which to establish this point are understandably low. As an example of the type of oversold levels I'm seeing, the SPX had over 450 new 20-day lows (out of 500 possible) on Friday and 0 new 20-day highs. I have not seen a reading like this since the crux of the financial crisis in 2008. Likewise for the S&P Oscillator, which is well into double-digit territory and now below last year's lowest reading (matched this past Thursday).

Given how much cash has come out of the market recently (not just from retail investors, as indicated last week, but also hedge funds and especially proprietary traders who came out of the market prior to the debt ceiling deadline, who are still hoarding cash, and who are looking for their next opportunity), as well as sentiment that (though not yet very extreme) is starting to get wildly negative (with new suggestions of a coming recession across numerous financial publications this weekend), and extreme short-term and intermediate-term oversold conditions, what can we expect? I would suggest:

1. A multi-week rally of some kind should be prepared for – probably at least back to the major pivot that is SPX 1250, if not at least to the 200-day moving average above it at about 1285. Even at the start of a cyclical bear markets (should we be starting one, which I do not feel at this time), a sharp countertrend rally to test the 200-day moving average (from below it) is common.
2. Extremes in price and breadth behavior that have been occurring since Thursday typically cannot be maintained for long (less than 10 trading days) without a rally starting, judging from recent history. I think the closest recent example would be the final days of June and early days of July in 2010. I would hazard to guess that we will see the market make a multi-week low this week or early next (if it did not on an intraday basis on Friday) and begin a multi-week rally that eventually takes the SPX to at least one of the two levels I mentioned, and more likely at least to the higher of the two.

3. There is of course a good chance that any low made this week or next, even if it does lead to a multi-week rally, will eventually get tested at least once more – probably weeks after the completion of said rally.

As one can see from past similar cases of extreme oversold conditions that I have pointed out above, it appears very risky to be short right now. At the same time, those interested in getting long should be prepared for quicker and sharper drops the longer this decline continues. This is because when a market fails to respond to oversold conditions that get more and more extreme, traders and investors get more and more worried, and falls steepen – until panic ensues and an eventual climax is reached.

In any case, I have a small sneaking suspicion that, as unexpected as it may be, Friday, with its intraday low at **1168**, just might have marked the price low before the next multi-week rally, but we will have to wait and see. The reason I think it may have is due to the price action. Friday allowed for a test of the 62% Fibonacci retracement of the rally from late August to the recent May top, and also had price reach past the measured move target for a head-and-shoulders pattern (at least based on the rules of Thomas Bulkowski, who I consider an excellent resource when it comes to chart patterns). Friday also formed the type of spinning top candle you normally see near a swing low, and enabled a weekly close above the typical lower boundary for a cyclical bull market that I described in last week's commentary (the lower of the 20-month moving average and the level corresponding to two standard deviations below the 200-day moving average). I think it is important to continue to keep an eye on this lower boundary and see if it holds the way it has in many past cyclical bull markets where corrections got this large this quickly.

Before ending this week's commentary, I think it is worth noting that stocks are the cheapest they have been versus bonds since Oct. 2008 in terms of yield differential, and this fact may put a floor below stock prices and cap on long-term bond prices in the coming weeks, if not earlier (barring a new crisis of some kind). The S&P downgrade of US bonds on Friday does not help the case for owning US bonds over US stocks, either. Our friend, Mr. Whaley, of Witter & Lester in beautiful Huntsville, Alabama, who I have referenced before, made a poignant comment in his Wednesday commentary this past week that I would like to share:

> *I can't get over the fact with the market at 1260 and trailing earnings of $83.19, the current earnings yield is 6.6% as compared to a five year Treasury Note of 1.2%. The Bears will argue that trailing earnings will not hold water going forward and certainly no one can say for certain. But even if you trim the earnings yield to 5.0%, it is still much higher than any return you can obtain across the 30 year yield curve. Even, the S&P dividend yield (2.1%) is higher than the Five Year Note yield.*