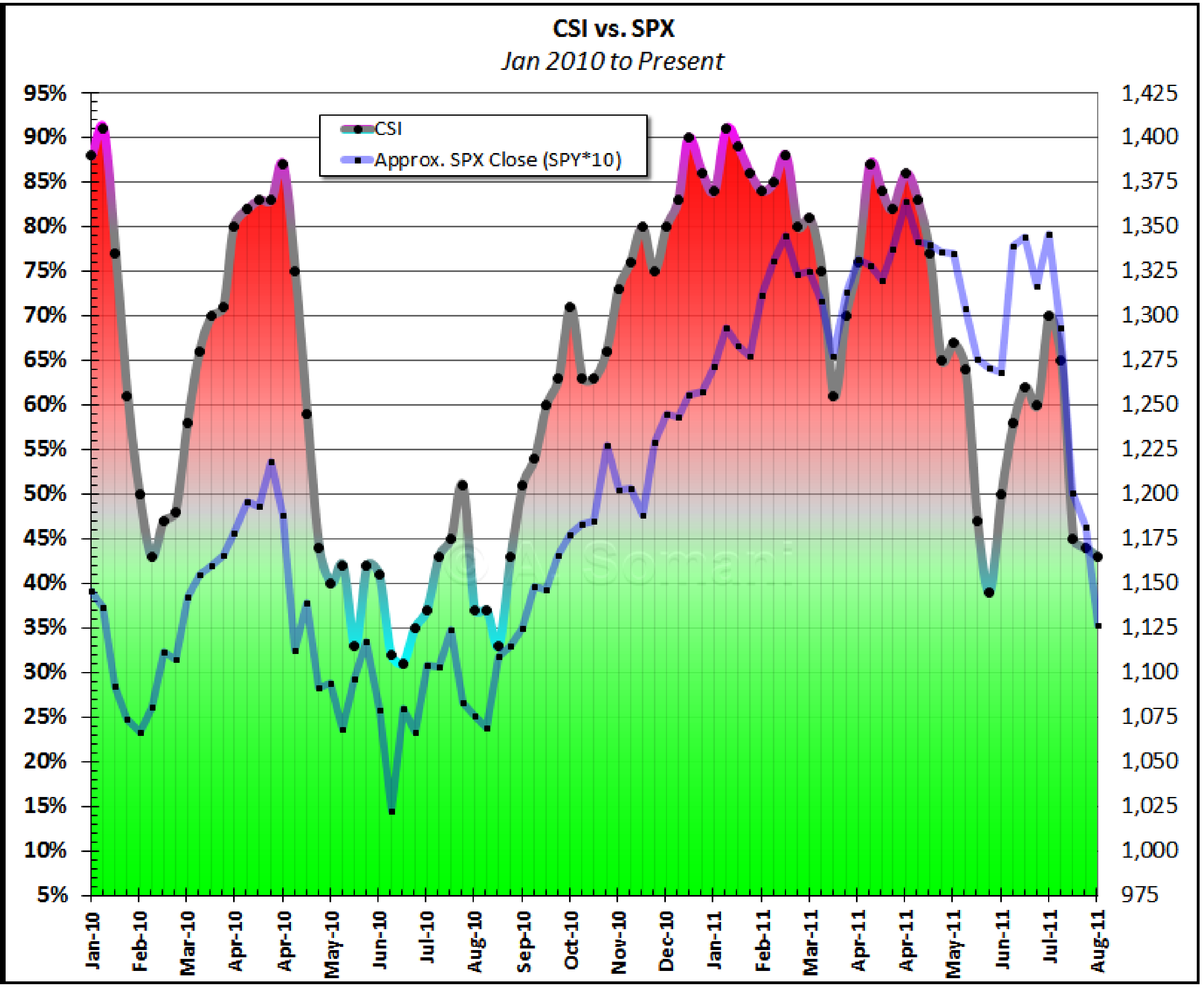
Crowd Sentiment Index (CSI) for US Equities

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 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.

Date	Approx. SPX Close (SPY*10)	%Ch.	CSI	Ch.
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**
8/12/2011	1,181	-2%	44%	-1
8/19/2011	1,126	**-5%**	43%	-1



Opinionated CSI-related Commentary from an Always-learning Market Student

An ~5% fall in the SPX this past week was not enough to push the CSI lower. Overall, it is certainly not a positive that the SPX has fallen an additional ~6% or so over the past two weeks without the CSI moving meaningfully lower. There is a clear underlying stubborn bullishness in the sentiment numbers I'm getting despite the potential of a new cyclical bear market having started, particularly from newsletter writers who are increasingly looking for a multi-week to multi-month rally regardless of the status of the current cyclical trend. The caveat to this concern is that the CSI is still in what is normally an extreme level on the downside for a cyclical bull market environment. In other words, if the SPX is still in a cyclical bull market, further downside in the CSI may not be warranted and a multi-week rally (probably of 10%+) is imminent. On the other hand, it is worth pointing out that the CSI fell to the low 30s last summer before the SPX bottomed out, and investors seem to have been more scared back then as compared to now – despite the fact that it is now less likely the Fed will be coming to the rescue like it did in late August last year, and the decline in economic confidence and the severity of the economic slowdown this year is more severe than last year. Also, if the SPX is in fact now in a cyclical bear market, the CSI can easily fall to much lower levels before the first multi-week bear market rally launches. For example, when the last cyclical bull market in the SPX ended in Oct. 2007, it took another quarter (all the way to early Feb. 2008) and CSI numbers below 19% before the first multi-week rally of the 2007-09 cyclical bear market launched.

I mentioned last week that the late April top in the SPX earlier this year was missing one or more of the classical breadth-based markers of a cyclical bull market top that have marked virtually all cyclical bull market tops since at least 1929. Unfortunately, it is increasingly likely that such markers are proving to not be as reliable as they have been in the past if recent (and ongoing) extremes we are seeing, in both the correlation between individual stocks as well as the use of ETFs and index futures (at least for the S&P 500, but, also, for example, for the Nasdaq 100), continue. Such extremes in "basket trading" are resulting in what were previously 2-3+ standard deviation breadth moves occurring much more often than in the past (a recent Bespoke Investments blog post is relevant in this regard). Thus, research needs to be completed to determine just how much less useful breadth extremes from a given popular (or somewhat popular) index may be as compared to in past years. Given what I'm stating, however, you can see that I'm quite open to the possibility that a cyclical bull market top could occur (as it may have in late April) without any (at least significant or notable) warnings from one or more of the classical breadth-based markers of cyclical bull market tops that I had discussed last week. In the case of such a possibility, I would want the evidence of a cyclical bear market having started to be quite compelling, of course – and it is becoming increasingly so, I must admit.

The weakness of the bounce we have seen in the SPX following its Monday Aug. 8th capitulation low, which was just a hair's width (~7 points) from reaching the minimum target I had suggested of SPX 1215, is disappointing. Normally, we would have seen a rally following the Monday Aug. 8th capitulation low that also would have lasted at least a couple of weeks, especially coming off the degree of oversold levels that were present beforehand. If we combine the weakness of the bounce (which really represents a lack of institutional interest in stocks, despite the SPX having closed more than two standard deviations from its 200-day moving average), with the lack of a meaningful further drop in the CSI this week, along with the fact that it appears unlikely the SPX will not see a significantly further move lower at some point over the next 52 weeks barring the SPX currently being in a 1987-type scenario (see this excerpt from Bespoke Investments shared by Cobra at Cobra's Market View, for example) – then it seems a move down to at least the SPX 1000-1020 level is just a matter of time (this is the natural Fibonacci extension zone one would expect to see hit if the S&P 500 futures materially breach their 1070-75 support level). The lack of a hint of, or introduction of, a new monetary easing program on Friday this week by the Fed (at Jackson Hole), may seal the coffin (as Chris Puplava eloquently notes in his latest article), on what are already (I would argue) 65-70% odds that a cyclical bear market is now underway. Let's remember, though, that the Fed could enormously increase the odds (which I would say are currently 30-35%) of what we have been seeing as being simply a crash within cyclical bull market, by a rather huge amount – if they wish to, and if the market is accepting of whatever new monetary easing program the Fed proposes (which they may not be if the monetary easing program is too similar in structure to QE1 and QE2). Lakshman Achuthan, head of the Economic Cycle Research Institute (ECRI), has been adamant since the beginning of the year that G7 and major emerging market economies would see a summer slowdown (potentially leading to a recession – as every recession begins with an economic slowdown) that would last at least until the end of this year. So far, he has been (as he has usually been in the past) right on the money, and it is difficult to see the global economy not to continue to slow down, at least barring Fed-led monetary intervention.

As you may have surmised by this point, effectively, I have three main market scenarios on my mind currently:

1. The SPX is still in a cyclical bull market and is in the process of making an important low, right near the low from earlier this month, and a large 10%+ rally is imminent, en route to eventual new highs.
2. The SPX has begun a cyclical bear market but is in the process of making an important low, right near the low from earlier this month, and a large 10%+ rally is imminent, to be followed by another leg down in the coming months to at least SPX 1000-1020.
3. The SPX has begun a cyclical bear market and any bounce we see in the coming days will be marginal (perhaps 2-3% in size) and should be shorted because a

failed re-test of this month’s lows is imminent, as the SPX has a date with the 1000-1020 level within the coming several trading days (including even as early as sometime this week, if only to apparently attempt to force the Fed’s hands).

Of these scenarios, I think #3, unfortunately, has the highest odds. Were it not for more investor bearishness being evident in the CSI, especially given the market decline over the last couple of weeks, I would give scenario #2 the highest odds. The edge of #3 over #2 is not huge, though. And, scenario #1, though unlikely, is still possible, especially if the SPX can hold its own until this Friday and the Fed also hints at or introduces a new monetary easing program that the market is accepting of.

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.*

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