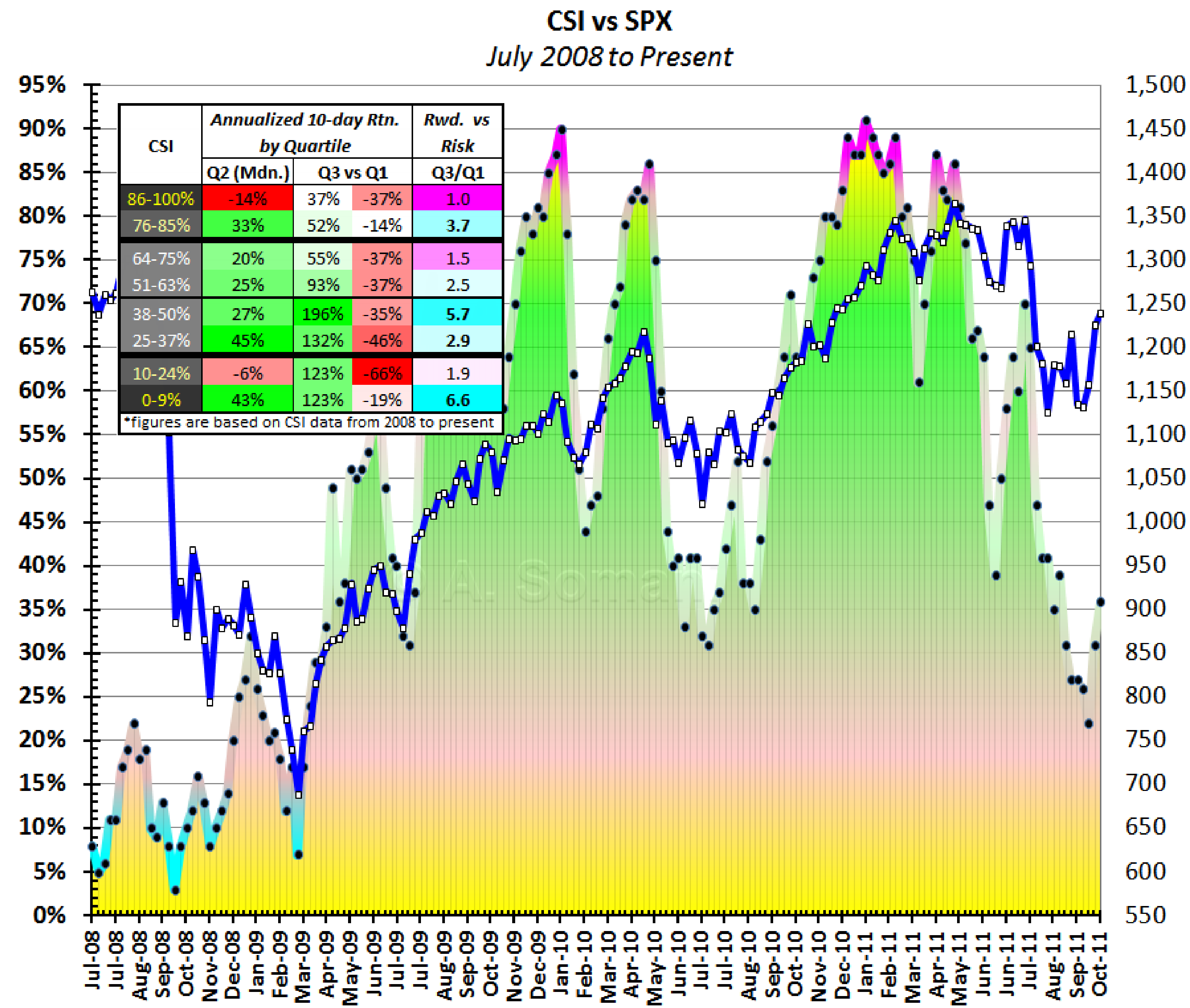
Crowd Sentiment Index (CSI) for US Equities

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%	0-9%
Alarming	76-85%	10-24%
Neutral	51-75%	25-37%
Alarming	38-50%	38-50%
Extreme	25-37%	51-63%

Date	Approx. SPX Close (SPY*10)	%Ch.	CSI	Ch.
7/1/2011	1,339	6%	58%	8
7/8/2011	1,344	0%	64%	6
7/15/2011	1,317	-2%	60%	-4
7/22/2011	1,346	2%	70%	10
7/29/2011	1,293	-4%	65%	-5
8/5/2011	1,201	-7%	47%	-18
8/12/2011	1,181	-2%	41%	-6
8/19/2011	1,126	-5%	41%	0
8/26/2011	1,180	5%	35%	-6
9/2/2011	1,179	0%	39%	4
9/9/2011	1,159	-2%	31%	-8
9/16/2011	1,215	5%	27%	-4
9/23/2011	1,135	-7%	27%	0
9/30/2011	1,132	0%	26%	-1
10/7/2011	1,157	2%	22%	-4
10/14/2011	1,226	6%	31%	9
10/21/2011	1,240	1%	36%	5



CSI	Annualized 10-day Rtn. by Quartile			Rwd. vs Risk
	Q2 (Mdn.)	Q3 vs Q1		Q3/Q1
86-100%	-14%	37%	-37%	1.0
76-85%	33%	52%	-14%	3.7
64-75%	20%	55%	-37%	1.5
51-63%	25%	93%	-37%	2.5
38-50%	27%	196%	-35%	5.7
25-37%	45%	132%	-46%	2.9
10-24%	-6%	123%	-66%	1.9
0-9%	43%	123%	-19%	6.6

*figures are based on CSI data from 2008 to present

Observations and Opinions from the CSI Editor

You may notice two changes in the CSI this week:

- Past measurements of the CSI have changed a bit, but not significantly. This is due to modifying the smoothing component for one of the sentiment surveys that goes into the CSI Report in order to enhance its signal-to-noise ratio.
- I've added a box in the *CSI vs SPX* chart showing the annualized 10-day forward SPX return at each zone of the CSI. It is important to remember that this box is only based on CSI data going back to the beginning of 2008 and does not adjust reported returns for the specific cyclical trend or volatility level of the SPX at any given time. Nevertheless, some observations can readily be made. For example: when the CSI is in the 10-24% or 86-100% zones, returns 10 days forward tend to be unattractive and reward-to-risk tends to be poor. On the other hand, when the CSI is in the 0-9% zone, reward-to-risk looking 10 days forward tends to be particularly favorable.

Some Observations and Opinions on Sentiment

- The CSI increased by 500 basis points this past week to 36% – creating a second week of confirmation of the SPX advance since the Oct. 4th low. The CSI appears to have formed an important low two weeks ago, therefore, at 22% – a level rarely seen in cyclical bull markets but unusually high for a major low in a cyclical bear market, interestingly enough.

- Within the context of a cyclical bear market, the current level of the CSI is neutral. Considering that the market may be in the midst of a cyclical bear market rally, a neutral CSI indicates the rally could easily have further to go before completing but is likely close to half complete if not more than half complete.

- Within the context of a cyclical bull market, the current level of the CSI is extremely bullish and suggests there is a lot of room for higher prices in the current rally, as many of those who may buy into the current rally have yet to do so.
    - Although the CSI dipped to 22% on Oct. 7th, which is outside the normal band of values the CSI operates within in a cyclical bull market, this deviation from the norm is quite small and does not tell us much (if anything) about the cyclical trend of US equities.

Some Observations and Opinions on the Cyclical Price Trend

- While there remains strong evidence that US stocks are in a new cyclical bear market, the evidence for a continuing cyclical bull market has grown somewhat this week: persistently positive breadth activity (including a complex configuration now appearing on the upper half of the McClellan Oscillator, for example), continuing indications of a multi-month top and possibly a multi-year top in long-term treasuries, as well as new weakness in the USD Index which is now in a battle to stay above major support around its 200-day moving average.

- In the CSI Report, my nature has more recently been (partly due to my concern about unreliable market breadth figures as a result of the increasing dominance of ETF and futures trading) to lay preference to market price action and the macro picture as opposed to market breadth. These three elements are not the only elements I use to analyze US equities but they are perhaps the most important ones. The former two elements indicate (and have been indicating for several weeks – since at least the end of Aug. if not the end of July) that the cyclical trend for the SPX is down. However, market breadth (the third element mentioned above) has favored what we've been seeing being no more than a cyclical bull market correction. Recall, for instance, what I asserted in the Aug. 12th CSI Report: *none of three special breadth-based signatures of a cyclical bull market top have yet appeared this year – despite the fact that at least one of these signatures has preceded, or coincided with, the day of every cyclical bull market top since at least 1929*. In fact, information strongly linked to one of these signatures was recently discussed by Mark Hulbert, in a column many of you have probably already read.
    - Personally, in the interests of maintaining a flexible and adaptive approach to the market (which is a necessary ingredient to trading and investing success, in my opinion), I *remain* open to either possibility: a new cyclical bear market off the May top or a continuing cyclical bull market off the March 2009 lows. This is largely why I have been writing in recent weeks that I remain "open to the *possibility* of a cyclical bull market at least until a definitive break of the Oct. low" while favoring (sometimes strongly) a bearish outlook due to negative market price action and a negative macro picture.
    - Price action in many sectors and leading growth stocks remains poor and V-shaped, not having consolidated or changed enough to warrant a positive stance on it, in my opinion. This is unlike last August (before a major bullish continuation move), when the market of stocks looked much healthier. Consider that about 75% of common stocks in the NYSE still remain below *both* their 150- and 200-day moving averages. For the SPX, this figure is 60% – all while the VIX continues to hold above 30 (despite Friday's SPX breakout). But, with the macro picture improving somewhat [with continuing weakness in long-term treasuries, new weakness in the USD Index, an uptick in economic indicators (especially the Philly Fed), etc.] I think it is appropriate to adopt a more neutral (less bearish) outlook on the cyclical trend of the SPX. As Chris Puplava wrote on Friday: *"Given*

the weight of the evidence is more balanced, making large bullish or bearish bets appears unwise at this time."

- In my opinion, it is critical for the bearish case, on a macro level, that the US Dollar Index (USD Index) hold above its crucial support area around the 200-day moving average.

A definitive break of this crucial support area would be a major event for both bulls and bears (a major boon for the former and major detriment for the latter). If there is going to be a definitive break of this crucial support area, I would expect it would not come on the first attempt but on a second or third attempt. Currently, the USD Index is in the midst of making a multi-day (possibly even multi-week) low and starting a rally (and I suspect we will see it begin this coming week). The quality of this rally (coming off the support area above) will be important to monitor as a gauge for what may be in the future of US equities.

  - A sturdy new leg up in the USD Index has a strong chance of leading to an eventual re-test (if not break) in the SPX of its Oct. 4th low – while a lower high, rollover and new leg down in the USD Index has a strong chance of leading to an eventual re-test (if not break) in the SPX of its May 2nd high.

- 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."*
  - Further: *"Since 1945, when the S&P 500 has dropped at least 20% [from intraday high to intraday low] but less than 40%, the index has taken an average of 11 months to hit bottom and another 14 months [for a total of 25 months] to get back to its previous peak."*
  - Cyclical bull markets in US equities last an average (both mean and median) of near 2.5 years, based on data going back to the early 1900s,

and have a mean rise of 99%. In May, the age of the cyclical bull market off the March 2009 low was just a bit over 2 years and it had risen 96%. In other words, if the cyclical bull market off the 2009 lows did not end back in May of this year, it is worth remembering that that it is more (probably much more) than half complete (as Paul Desmond of Lowry's concluded back in July).

- This week saw a rebound in the Bloomberg Comfort Index. The cyclical trend of the Index appears to remain down, however, which is unusual unless US equities topped back in May. Normally, the Index negatively diverges from the SPX at cyclical bull market tops, including at the 2000 and 2007 tops.

- The Smart Money Flow Index hit a new 52-week high this week for the first time since late July, which is unusual unless US equities are in a continuing cyclical bull market off the March 2009 lows. Normally, the Index negatively diverges from the SPX at cyclical bull market tops and positively diverges from the SPX at cyclical bear market bottoms.
  - The strength in this Index combined with the substantial relative strength in the Nasdaq 100 (a riskier and more volatile index than the SPX) is quite bullish and one of the centerpieces of the argument for US equities being in a continuing cyclical bull market, in my opinion.

- The ECRI made a recession call at the end of Sept., leaving no wiggling room in their announcement and putting their reputation on the line.
  - This past week, the Weekly Leading Index (WLI) of the ECRI continued to decline, despite the recent advance in the stock market. As Chris Puplava indicates in his Oct. 14th article, when a WLI bottom does not precede or coincide with an important multi-week bottom in the SPX, traders and investors should question whether that bottom in the SPX will really last.
  - The WLI is now approaching last year's low. What is different this time is that while ECRI co-founder Lakshman Achuthan did not make a recession call last year, he has been indicating since the end of September that a new recession (based on the NBER definition) has either started or about to begin.

- Here is a neat point of fact (especially as some of those so adamant on a cyclical bull market now were equally adamant on one in March 2008), given how closely price action in US equities has been mirroring the 2007-09 cyclical bear market in recent months:

  > *Consider that the last two times Achuthan [co-founder of the ECRI] leveraged his cycle research to make an out-of-*

consensus recession call were March 2001 and March 2008. After the first, the S&P 500 rose 14% to its 10-month average in May before falling 32% over the next 16 months. After the second, the S&P 500 rose 9.8% to its 10-month average in May before collapsing by 42% over the next nine months.

Let me add that the impact of the 10-month moving average (very close to the 200-day moving average on a daily chart, which is currently at about SPX 1275) is not surprising, given what growth stock investor extraordinaire Mike Scott mentioned last week: *"I went back and looked at the following bear markets: 1969-1970, 1973-1974, 1981-1982, 2000-2003, 2007-2009...The one theme that is constant in all of these past markets is that there was an initial wave down followed by a bear market flag structure that rallied to the 200 day moving average before rolling over into wave 2 down. In one case the bear flag is more of a sideways consolidation (73-74)."*

  - If the SPX reaches its 200-day moving average in the coming weeks (which seems probable, notwithstanding a likely significant retracement in the coming several trading days), it will be critical to monitor how it reacts around this average to get a sense of what's coming up for US equities.

- 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 over the past few years (including recently) is unprecedented and appears unnatural (eg. see here and here). The cause for most of these extremes may stem from historical extremes in correlation and co-movement between individual securities, resulting from the rapidly increasing use of ETFs and equity futures that has occurred over the past few years.

Some Other Observations and Opinions

- As you can see, Q3 earnings estimates have been revised down significantly coming into Q3, and the question is really whether estimates have been lowered enough by the sell-side to ensure another quarter of a substantial beat rate. If companies are now still not able to beat estimates at a pace consistent with recent quarters (where close to 65% of companies have been beating estimates), it would be a definite sore spot for bulls, in my opinion.

  - The majority of earnings reports will be coming this week and next, and the 'success' of the earnings season or lack thereof is still too early to conclude upon right now. But, so far, it has been a generally positive earnings season.

- It is unusual, given the price thrust that occurred in the first several days off the Oct. 4th low, for the SPX not to continue higher, for the most part, for several more weeks. If US equities are in a cyclical bear market, a rally of 5-12 weeks off a quarterly low (like Oct. 4th) is entirely normal. A rally significantly longer than this (closer to 15-18 weeks) can be expected in a continuing cyclical bull market, however. These are only general rules, of course, and exceptions will certainly occur. Currently, the rally is about 3 weeks old.

- Gold and silver have yet to show noticeable strength concurrent with recent USD Index weakness (unlike equities), and this may be a hint that the USD Index is just taking a (now extended) breather before further gains in the coming weeks and months. In my experience, gold and silver tend to slightly lead changes in the USD Index (although not always). It will be interesting to see whether weakness in gold and silver continues despite the positive secular trend and overwhelming bearishness that exists on these two markets. If yes, it could be part of a warning sign that liquidity is evaporating from financial markets in much the same way it did in 2008.

- Headline risk continues to remain high. How the market reacts to any news coming out of Europe, especially this weekend through maybe the middle of this coming week, is difficult to predict – particularly when one isn't sure what the news that comes out will be like. Any news can obviously have a significant impact on the direction of the market, as large players adjust their time and liquidity preferences in accordance with what they're seeing. Although European finance ministers are focusing on protecting the banks in their respective countries, and likely see that as their top priority, it is worth noting what Jeffrey Gundlach (star bond manager at DoubleLine Capital) has basically said: there will be a big loss coming out of Europe somewhere, we just don't know where yet. Much of Greece's debt will apparently need to be written down or defaulted upon at some point (likely before the end of next year, if not now) – and how this is handled by EU finance ministers and the ECB is critical.

Some 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. Many of the successful traders and investors that I've come across in my brief experience as a market participant believe in responding to the market rather than trying to forecast it. After all:

> Traders and investors can be divided into two groups: those who focus on *predicting markets and being right* and those who focus on *making money and protecting capital*. As a general rule, the second group is always much more successful than the first because it cares about one thing only: <u>the correct play now</u>. What was thought yesterday, said yesterday, and done yesterday, is old news.

That said, it can be 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 new information (including market action) is confirming or denying them. Therefore, I present some scenarios below that I am considering for the coming weeks, but that are certainly subject to change as new information becomes available and is obtained.

#	Market Scenario	Guesstimated Probability	Notes
1	SPX reaches but fails to definitively break 1275-1295 before heading lower to re-test its Oct. 4th low.	40%	A re-test of the Oct. 4th intraday low will probably lead to a definitive break of said low – eventually, if not immediately.
2	SPX reaches but fails to definitively break 1250-1260 before heading lower to re-test its Oct. 4th low.	15%	A re-test of the Oct. 4th intraday low will probably lead to a definitive break of said low – eventually, if not immediately.
3	SPX fails to definitively break this past week's high (~ SPX 1240) before heading lower to re-test its Oct. 4th low.	7.5%	The high headline risk, especially this weekend, means one has to consider this scenario as a possibility.
4	SPX definitively breaks above 1295.	37.5%	As mentioned earlier in the report, the cyclical outlook has become somewhat more balanced due to improvements

			in the macro picture (although the macro picture could be significantly impacted this weekend). Accordingly, the probability behind the bullish case has grown.

A Sperandeo 1-2-3 trend change has formed on the SPX weekly chart, which indicates a high probability minimum target of the1250-60 level. Additionally, the fact that the SPX has definitively broken above SPX 1225 resistance with only a very minor 23.6% Fibonacci retracement, suggests the 200-day moving average (at ~ SPX 1275) is a high probability minimum target for the current rally, based on my understanding of Fibonacci extensions.

If the USD Index makes a multi-day (possibly multi-week) low this week (as it appears it will), US equities may go sideways at best and see a significant retracement at worst. The latter would not be a surprise, actually (given how stretched the SPX is on a short-term basis and the need for the McClellan Oscillator to soon unwind back down toward its zero line, for instance).

Significant support for the SPX in this rally lies at 1195-1205 as well as around the 50-day moving average (SPX 1175-85).

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.*