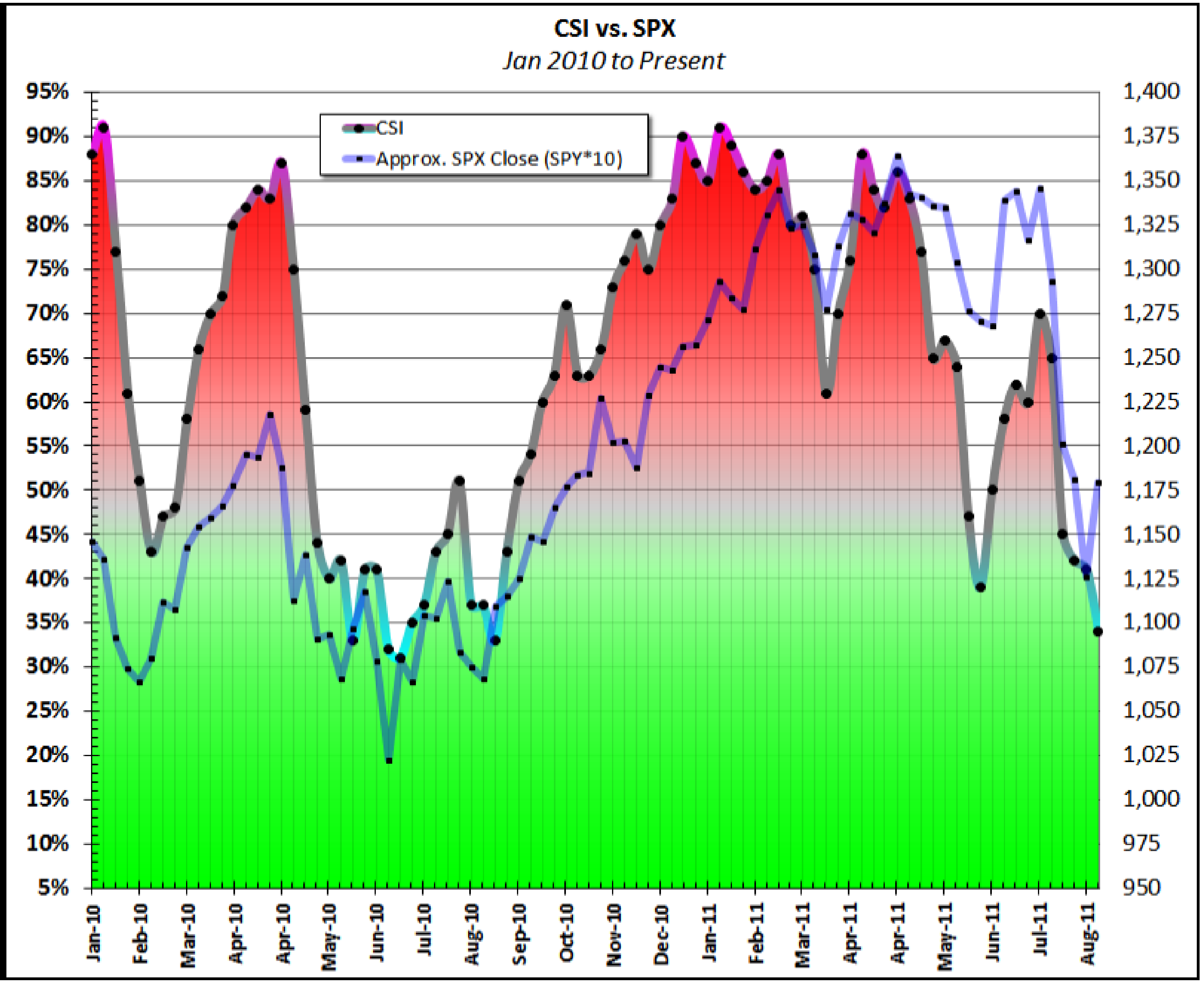
Crowd Sentiment Index (CSI) for US Equities

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.
6/10/2011	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%	42%	-3
8/19/2011	1,126	**-5%**	41%	-1
8/26/2011	1,180	**5%**	34%	-7



Opinionated CSI-related Commentary from an Always-learning Market Student
Despite a significant climb in the SPX this week, of about 5%, the CSI fell by 7 points to 34%, within the context of what looks to be a cyclical bear market (especially given Mr. Bernanke's statement on Friday) but may still be a cyclical bull market. It is a pretty rare occurrence to see a sizeable drop in the CSI in the same week as a strong market rise. Fortunately, as might be expected, such an event is more often a good omen than a bad one, as it normally reflects a rally coming out of a multi-week low that is being viewed with serious skepticism and worry, and, therefore, is a rally that has further to go. Additionally, at 34%, the CSI suggests that market participants are (finally!) approaching a level of pessimism that rivals that of last summer, when the broader market environment actually looked better than it does today (in my opinion, at least) but when the terror of 2008 was more freshly remembered than it is presently (though it is still currently remembered well, I'm sure).

Last week, I laid on the table the three scenarios for the SPX that seemed most likely to me for the coming weeks:

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).*

My favored scenario was #3, followed not far behind by #2, with limited consideration to #1 (especially if the Fed didn't 'deliver the goods' at Jackson Hole, which it didn't). Well, as Turnaround Tuesday's follow-through day in equities made clear this past week, I really should have favored #2 the most. The SPX is already halfway to achieving the 10%+ rise my scenario considers, after all. But, is it really that simple? No, it isn't. Why is that? The problem is that, although the rally that began earlier this month saw follow-through last week, and the decline in the CSI this week is a good omen for further gains to come over the next several trading days (perhaps even 3-7 weeks), one needs to remember that the current market environment is highly news sensitive and (especially without QE in place) economically fragile. There is a deluge of economic data coming out this week, much of which is likely to be pretty terrible – and very possibly quite worse than what has been priced into the SPX, as it stands currently. As such, though I absolutely believe (for now) that scenario #2 is at least somewhat more likely than a modified version of scenario #3 (a version of scenario #3 where the bounce is more than the 2-3% I wrote, and closer to 5-8%), anyone who is concerned about preserving their capital really needs to be prepared for the modified version of scenario #3, just in case. If (modified) scenario #3 comes to the forefront, the SPX may only very briefly trade slightly above 1200 in the coming days (and maybe not even), before aiming itself toward a re-test of this month's low. This is an important point, especially for anyone out there who might be trying to liquidate or hedge some or all of their portfolio (perhaps at or above SPX 1200, for example), due to wanting to avoid a possible ongoing cyclical bear market. It is worth remembering, also, that even if the SPX is still in a cyclical bull market, a re-test of this month's low at some point in the coming months should be prepared for.

Unsurprisingly, the Fed did not hint at a new easing program on Friday at Jackson Hole, and it is apparent that the condition of the stock market and economy will need to deteriorate further for Mr. Bernanke to be compelled to act in a substantive way as he did last year [I say substantive because the Fed is still doing (smaller) POMO operations and still keeping short-term rates very low]. It is still, of course, totally unclear to me as to how much of the cyclical bull market off the 2009 lows was due to genuine demand and desire to own equities and how much was due to Fed-led monetary intervention and the resulting domino effect of such intervention. Impossible to know, I suppose, for a variety of reasons (including that it might be impossible to totally separate demand for equities from prevailing monetary policy, as the two are, in many cases, intertwined). But, I can say that the SPX did not show an ability to sustain rallies when QE1 ended and, so far, has not shown an ability to sustain rallies since QE2 ended. What's that saying again? Right: "Fool me once, shame on you. Fool me twice, shame on me." Regardless of your opinion about the current cyclical trend of US equities, you may wish to keep a watchful eye on the SPX's 20-month moving average and if the SPX can close above it at month-end (on Wednesday). Historically, monthly closes below this average (which is currently at SPX 1200) have been fairly good at predicting further downside ahead – and often of at least 10%, as I've noted before.

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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