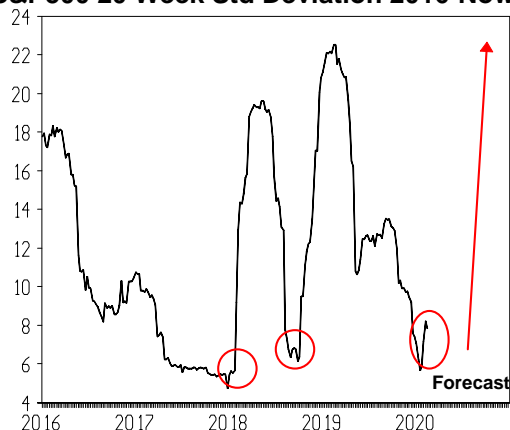


## A Stock Market Volatility Surge is Coming

S&P500 20 Week Std Deviation 2016-Now



Model forecasts for every stock market volatility measure point strongly higher. That includes realized volatility (20 day and 20 week standard deviations) and implied volatility (VIX, VXN, VXX). Bigger daily and weekly stock index percentage swings should soon develop.

The last two times weekly S&P500 volatility was at a low level and had a strong upward model forecast like this were Jan 2018 (before the VIX termination) and Oct 2018, before the S&P500 index declined by -20% from its Sept 2018 peak to its Dec 24, 2018 low (see chart).

**The low stock market volatility environment of the of the past four months has bred complacency.** Typically markets drift higher on low volatility (small daily percentage changes), luring investors into complacency until the market makes a top. Daily percentage swings typically increase around a top in the market and then surge during a

sell-off. Paradoxically that means markets can have big daily percentage gains as they sell off, because the daily percentage declines are bigger or outnumber the daily gains. Most of the biggest percentage declines and advances have occurred during major bear markets like 1929-1932 and 2007-2009.

**The mindset for managing higher volatility is the furthest thing from consensus sentiment at the moment.** If our forecast of sustained higher volatility ahead is correct, now is an ideal time to buy put options and the VXX volatility etf. The VIX got to 50 back in February 2018 volatility explosion, it's currently 15. The VIX broke above its 200 day average two weeks ago, a potentially bullish development for volatility. If this is a major long-term top in the stock market (our hypothesis), there is a high probability the VIX will exceed that 50 peak.

**The VXX volatility etf could triple in such a scenario.** Keep in mind the VXX is the instrument market manipulators use to kite the stock market. Their short positions are the fuel that can make the VXX soar in a stock market selloff. The recent rip-roaring rally in Tesla stock (+331% since last June) shows what can happen in a short squeeze. TSLA was probably the most-shortest major stock before its huge rally. VXX is vulnerable to a short squeeze.

**Federal Reserve credit has had no change since Dec 25th, 7 weeks ago.** The Fed Repo/TBill operations peaked last year, the Fed has no current monetary stimulus operations. The surge in the stock market this year is pure speculation and momentum from last year's Q4 Fed operations.

The contrast between the giddy stock market and the situation on the ground is unprecedented. The Chinese lockdown comes on top of a long-term downturn in cyclical alpha and upturn in defensive alpha that has been in place for years.

Sector rotation is the heart of the stock market, it's a X-Ray of the underlying health of the market and economy. The deterioration in S&P500 cyclical alpha is prolonged and extreme. The significant dates and percentage alpha since the last business cycle bottom are: Materials -41% (Apr 2011), industrials -14% (Dec 2016), financials -13% (Feb 2018) and consumer discretionary -7% (July 2019). The economically-sensitive cyclical sectors of the S&P500 have been declining in alpha terms for YEARS. The turning points came long ago.

Likewise, S&P500 defensive sectors bottomed in relative terms YEARS ago. The significant dates and percentage alpha for defensive sectors since their long-term cycle turning points are: Utilities +19% (Jun 2018), real estate +10% (Oct 2018) and consumer staples +8% (Jun 2018). The gold stock group (GDX our favorite defensive investment) has +39% alpha since a relative bottom vs the S&P500 (Sep 2018).

This bifurcated alpha performance (cyclicals down, defensives up) has tracked the decline in the US business cycle (now a record 127 months long). The current global economic downturn triggered by the Chinese virus lock down comes ON TOP of the longstanding cyclical alpha slump. It's probably a coup de grâce for the global business cycle and corporate profits. *The current terminal rush into tech stocks is reminiscent of someone with a serious heart condition gobbling down ice cream and egg yokes while he is being wheeled into the hospital.*

*With volatility forecast to surge, the recommended strategy is to aggressively sell and short brief flash-in-the-pan stock market rallies, buy longer-dated put options and buy the VXX.* Overweight defensive sectors, buy the GDX gold stock etf and TLT TBond etf. Cyclicals remain a top sell, short and underweight recommendation: Automotive, retailers, machinery, steel, industrials, banks and brokers. Our #1 short industry group recommendation is semiconductors, the most cyclical tech group and the one that is currently most inflated. **Short SMH and the semi stocks on P6.**

## Come On In, The Water's Fine



**D**anger lurks beneath the stock market's placid surface, while the consensus swims unconcerned. The Chinese quarantine shutdown should soon begin to affect global supply chains. There's no mystery about this, companies will soon run out of components sourced from mothballed Chinese factories (see press clips). That should have a domino effect on global manufacturing, which is already choking. Case in point: Apple just announced a revenue warning on this very subject.

US industrial production went negative yoy four months ago (September 2019) and retains a downward model forecast. German industrial production went negative yoy 13 months ago (Nov 2018), retains a downward model forecast and is falling at a hyper-recessionary -7% annual rate. Note that this is BEFORE the Chinese virus factory shutdowns feed through into the global economy. The world economy is on the brink of a major recession.

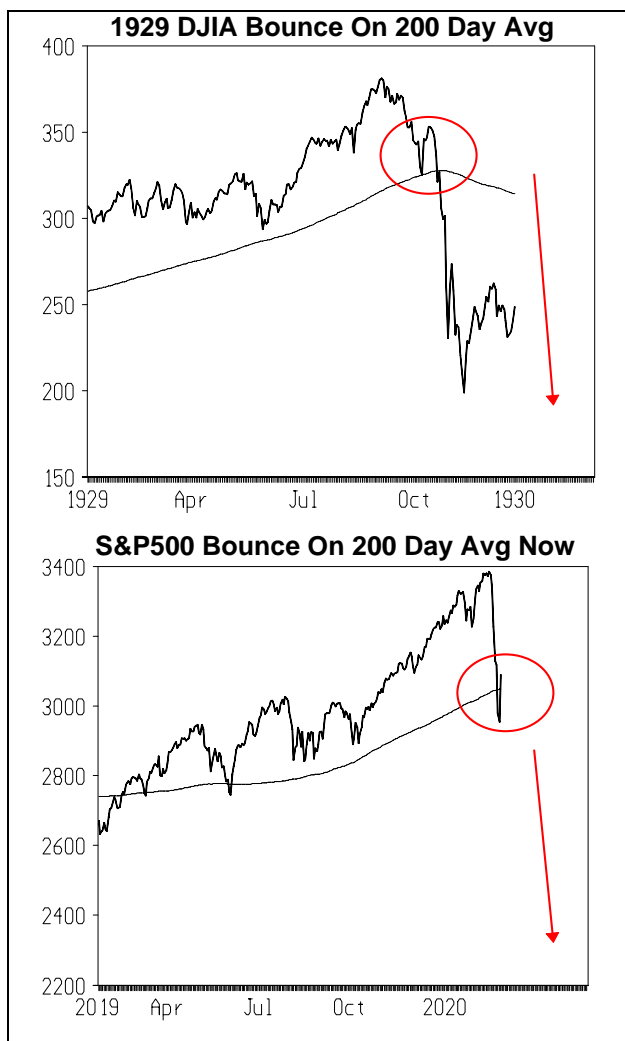
You wouldn't know that from looking at European industrial stocks, the Eurostoxx Industrial Goods and Services hit a new high relative to the index two weeks ago. That is completely and utterly nuts, with European industrial production falling off a cliff for the past 13 months. Take advantage of the European stock market's inefficiency. Industrials are the new #1 sell and short recommendation in Europe, with a major downward model forecast. There's a sector ETF for Stoxx ETFs, also sell and short Siemens, ABB, Atlas Copco, Sandvik, Maersk, Deutsche Post, SKF Group, Thyssenkrupp, Capita Group and Rolls Royce. US industrials also have a downward forecast and a sell and short recommendation: The XLI etf, machinery (MTW, PCAR, CAT, AGCO, CMI, DE, ITT), electrical equipment (AYI, ENS, ROK, AME), air freight (UPS, EXPD, FDX, AAWW), airlines (CEA, UAL, ALK, AAL, ALGT), distributors (WCC, GWW, GPC), truckers (R, CHRW, JBHT, WERN, KNX, YRCW) and industrial conglomerates (MMM, EMR, JCI, GE).

Global banks and financials should get hit from the approaching recession (Belkin Report: Jan 13 Sell and Short Financials). The S&P financial sector has -4% alpha ytd, it's barely up on the year and way behind the index. Sell and short money center banks (JPM, C, BAC), regional banks (ZION, CMA, WFC, BK, USB, HBAN, FITB, STT), brokers (GS, SCHW), asset managers (BEN, CG, APO, GLRE, AMG), European banks (Standard Chartered, Bankia, Barclays, RBS, Caixabank, Banco Sabadell, BPER Banca, Lloyds, HSBC, Akbank, Garanti Bank, Intesa Sanpaolo, Unicredit, BNP Paribas, Credit Agricole) and most of all - emerging market banks (BSBR, SHG, KB, IDCBY, HDB, ITUB, BBD, CICHY). Our emerging market bank ADR index is down -9% ytd, that is -13% alpha in two months and it has a major downward forecast. Emerging markets don't have the phony central bank support network to defy gravity. Most emerging markets are also exposed in a big way to China. Short them.

And the grand prize for the best performing US or European sector ytd? **EUROPEAN UTILITIES +12% alpha, +16% absolute**. What? On a sector level, European utilities have outperformed everything including the US tech sector by a mile (+6% more alpha than US tech). Let's just think about that for a minute. Mom & Pop and institutional investors think it's a glorious bull market and are loaded up on tech. Meanwhile, the best-performing global sector is lowly defensive European utilities, which no one likes. The market is going risk-off beneath the surface, the financial press isn't reporting it and investors are missing it. Another piece of that puzzle is US REITs, the S&P real estate sector was up 5% last week (+3% alpha). REITs are probably starting to do what European utilities started doing six weeks ago (adding major alpha). **Our model has a major outperform forecast for defensive sectors in the US and Europe, it is not too late to get on board**. In the US, overweight real estate (XLRE), utilities (XLU) and staples (XLP). The European telecom sector is really depressed and at a relative low, this is a great entry point to overweight European telecom (Orange, Deutsche Telekom, Telefonica).

A similar recommendation goes at the macro level: Buy the defensive asset (Tbonds TLT, gold and gold stocks GDx) and sell and short stock indexes, especially semiconductors (SMH). Stock market volatility should soon erupt, this is probably a great entry point to buy VXX, the volatility ETF which remains close to its recent lows.

## Beware of the 200 Day Average Bounce



US stock indexes traded down to their 200 day averages last week and today they bounced on it. This pattern is most evident for the S&P500 (see bottom chart). A bounce around the 200 day average is a reasonable expectation. Market participants and algos who have been successfully long for 10 years probably see this as a classic buying opportunity at a key technical level.

We have the opposite view. The US stock market has been ignoring the global economic downturn that started way before the coronavirus surfaced. COVID-19 has simply accelerated the global economic bloodbath (see press clips). Companies will soon be warning of revenue and earnings shortfalls and brokers will be downgrading stocks and the market like crazy. Our model forecast points down for global stock indexes, both intermediate and long term. *Our view is this is a major long-term stock market top and prices will have a major extended decline.*

The best example of a 200 day average bounce that fizzled is the 1929 DJIA (see top chart). That market top ended an era (the Roaring 20s). The 1920's mood in the market and society made a 180 degree reversal as the stock market crashed. Things that seemed perfectly normal beforehand (speculation, euphoria) became anathema. We're probably setting up for a similar mood change. Having carefully studied the 1929 stock market top and its aftermath, *we suspect current market excesses exceed those of 1929.* The liquidation of speculative bubble positions should drive equity prices much lower for a long time.

Of course no market period is exactly like any other and overlaying market charts on top of each other usually doesn't work. But the pattern of major speculative bubble tops is similar (DJIA 1929, Nikkei 1989, Nasdaq 2000, S&P500 2007). Expect the current stock index bounce to fizzle out after a few days and turn into a bigger drop. We recommend selling and shorting this bounce. Our longer-term multi-

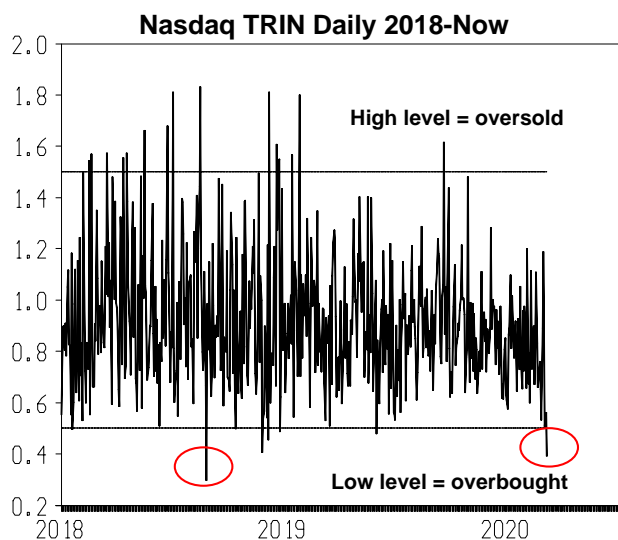
year downside target is the 200 month average, which is down -45% for the S&P500, -43% for the DJIA and -62% for the Nasdaq 100. The 200 month average is the level reached at the bottom of the 2000-2002 and 2007-2009 bear markets.

In the meantime, there are attractive trades and positions that should provide gains, or at least alpha. For instance long TBonds. The TLT TBond etf was up 5% last week while the S&P500 was down -11% for net alpha of +16%. We still strongly recommend shifting out of stocks into Treasuries, buy TLT/short S&P500. Bond-like equity market proxies (utilities, REITs, and consumer staples sectors) should handily outperform the S&P500. These are recommended for long-only funds but do not expect absolute gains, just positive alpha. Hedge funds can convert that alpha into absolute gains through pair trades such as long XLU/short XLF, long XLP/short XLK, long XLRE/short XLY, etc. Gold and gold stocks remain a top long recommendation, despite last week's turbulence. The VXX volatility etf remains a top long, it was up +53% last week.

If you are a hedge fund looking for short ideas, the model forecast has suggestions. Financials have a weaker forecast and with interest rates dropping like an anvil, financials stand to lose. Last week our money center bank group (top 10 short on P6) was down -16%, -5% more than the index. It's probably safe to say nobody else is telling you to short C, BAC and JPM, we are. Junk bonds have finally started to crater and junk bond (aka private equity) asset manager stocks are extremely elevated and are recommended shorts (APO, BX, KKR, CG). European banks are a top short recommendation. French, Italian and Spanish banks are recommended shorts (see P7 for specific names). Semiconductor stocks are in the stratosphere and are probably headed for major revenue and earnings hits. Short SMH and the semi stocks listed on P6. Cyclical should be shorted: Autos, auto components, airlines, machinery, steel and European industrials (P7).

The coronavirus has accelerated the existing global economic downturn. Stock markets decline during business cycle contractions because revenues and earnings collapse. Use every opportunity to sell and short vulnerable stocks during brief market bounces. Volatility should continue to rise, with big daily percentage swings, both up and down. Sell the big rallies.

## The Nasdaq is More Overbought Now Than It Was At The Top



**B**ubbles die hard. The Nasdaq and S&P500 hit their all time highs on Feb 19th (three weeks ago) and are down ~18% from those levels. Despite the price carnage, a measure of Nasdaq bullishness (TRIN) hit a new 19-month record today.

Investopedia definition of TRIN “*What Is the Arms Index (TRIN)? The Arms Index, also called the Short-Term Trading Index (TRIN) is a technical analysis indicator that compares the number of advancing and declining stocks (AD Ratio) to advancing and declining volume (AD volume). It is used to gauge overall market sentiment. It does this by generating overbought and oversold levels, which indicate when the index (and the majority of stocks in it) will change direction.*”

Basically, TRIN shows sentiment by measuring relative volume going into advancing vs. declining issues. At market tops everyone usually wants to buy and TRIN levels are very low. At market bottoms everyone capitulates and TRIN is very high (for a number of days). TRIN levels below 1 show greed and TRIN levels above 1 show fear. Overbought extremes are below 0.5 and oversold extremes are above 1.5 (see chart).

Today's Nasdaq TRIN reading was .39, the lowest since Aug 27, 2018 (right before the late-2018 stock market sell-off, see chart). The 3 day moving average of Nasdaq TRIN is .49 and the 10 day moving average is .71. These are all extremely low levels that scream utter complacency. It is absolutely bizarre to see such TRIN readings after a major market collapse. The inference is: *Bubble People are buying Nasdaq stocks with complete abandon as the market collapses. This is NOT how stock market declines typically end.* High TRIN levels develop when massive volume goes into declining issues. Expect to see major Nasdaq selling capitulation with big TRIN numbers before the current decline concludes.

**Bottom line? Nasdaq investors didn't get the memo: The bull market is over.** They are nonchalantly buying the -18% dip in the midst of a bear market. This shouldn't last. Expect to see major capitulation (with massively high TRIN levels) before this first phase of the stock market decline concludes. Short Nasdaq ETFs and stocks on brief bounces (SMH, QQQ, PSJ, FANG stocks, software stocks, etc.).

**Financials:** The XLF S&P financial sector ETF is down -27% from its Feb 14th peak. It remains a top short and negative alpha forecast recommendation. Securities brokers (XBD index, MS, GS, SCHW, R.J.F. etc.) are new top short recommendations. Stock market carnage is likely to affect securities brokers with unforeseen losses through exposure to failing hedge funds and arcane bull market leveraged bets gone sour. Short brokers, banks, credit cards, European banks and emerging market banks on brief bounces.

**Positive Alpha Opportunities:** In the past week, S&P utilities (XLU) have +8% alpha, consumer staples (XLP) have +7% alpha, REITs (XLRE) have +4% alpha, gold stocks (GDX) have +11% alpha and TBonds (TLT) have +22% alpha. These all remain top model outperform (alpha) recommendations. Long only funds should overweight utilities, consumer staples, REITs, gold stocks and Treasuries. Hedge funds should be able to harvest absolute gains through market neutral pair trades like Long utilities/short financials (XLU/XLF), long staples/short tech (XLP/XLK), etc. The same theme applies to stock selection, see P6 and P7 for specific overweight/underweight stock recommendations.

The virus scare serves as a catalyst for a global economic contraction that was already underway. Obviously airlines, hotels, casinos, etc. are vulnerable to major business slowdowns. Several other groups that haven't been hit as hard may also prove to be vulnerable. Restaurants and retailers could soon get hit by consumer aversion to public exposure, see P6 for specific stock short prospects. The biggest overowned sector that doesn't yet reflect the global economic downturn is technology. Tech stocks are vulnerable to supply chain disruptions and collapsing consumer demand. This dovetails with the Nasdaq overbought TRIN reading described above. Short tech stocks on brief bounces.

## Covering Shorts and Going Long For A Bounce



We're closing all our stock market short positions and going long for a bounce. This is strictly a strategic short-term bounce scenario. The DJIA is down -19% since last week's report (-32% from its Feb 12 all time high). We've looked at major stock market collapse patterns and this one is probably close to a near-term trading bottom.

This report only comes out every week, a lot can happen between reports. While stock markets could easily go down another 10% or so (plus or minus 10% moves are happening almost every day), the probability is that stock indexes are close to a major low of the first waterfall decline. Some type of meaningful bounce is likely.

Bearishness has reached a feverish extreme. All the Wall Street geniuses like Goldman Sachs who told you at the beginning of the year that the US economy was fine and stocks will continue higher are exposed as massively wrong and are now bearish. CTA's are short stock indexes (they

were long at the top). This has the potential for a short squeeze.

Coronavirus paranoia is probably at a peak. This is not the Black Death plague that will wipe out 50% of humanity. Obviously it's dangerous for the elderly and those with underlying health conditions. The stock market has now reacted to this risk and it is probably relatively priced in (for now).

***The Federal Reserve's complete capitulation on interest rates (to zero) and QE is a landmark event that is probably not yet reflected in the stock market.*** Today we had the third-biggest percentage daily decline in US stock market history, after the Fed's policy reversal (DJIA -13%). This probably came from forced selling due to margin liquidation related to last week's big market decline. We expect to see the Fed's new credit expansion put a temporary floor under the stock market and set the stage for a bounce.

To be absolutely clear, our long-term forecast for the stock market remains down and this is probably not the ultimate bottom. However, the environment has completely changed from *buy and hold* to *trade the major swings*. Not day-trading, but trade major percentage moves that are too big to stay short or long through if you are on the wrong side of the market. This is obviously tricky business and difficult to say the least. Our objective is to help you not get caught short at the bottom of a waterfall decline and get your gonads squeezed off.

Just take a look at the accompanying chart of the S&P500. It has gone down in a straight line for 18 trading sessions (-30% from its peak). My boss (the Vice Chairman) at Salomon Brothers used to say: *'Nothing goes straight down except a limp d\*\*k.'* Bear markets go down in a zigzag pattern, interrupted by rip-off-your-face rallies that defy logic. Yes, the global economy is going into a recession (we have forecast that repeatedly). Yes, corporate earnings are going to collapse. Yes, unemployment is going to rise. Yes, all these quarantines will have a major impact on consumer spending, consumer confidence and consumer discretionary stocks like restaurants, retailers, autos, etc. But stock indexes could have a major bounce in the face of that bad news. *The S&P500 has hit our 200 week avg downside target and should bounce (see chart).*

In terms of sector and industry group rotation, our first recommendation remains gold mining stocks (GDX etf). The Fed's policy reversal should prove to be beneficial for gold and gold miners. Physical gold has traded down to its 200 day average, a likely support zone. If you are wondering where the Fed's new QE program is likely to go, gold and gold mining stocks should be prime beneficiaries. They have been liquidated recently, probably as a side-effect of margin calls on unrelated hedge fund positions. We don't have the impression that gold assets are a major holding of hedge funds. The recent liquidation has probably cleared the decks for a recovery rally. Take a look at physical silver, it hit \$12/ounce today, an 11 year low. This is probably an aberration from someone's margin call and is a gift buying opportunity in the face of a new Fed credit expansion.

Consumer staples is the current top S&P sector recommendation. Food, beverages, household products, food and drug retailers, etc. should outperform the index. It makes sense given the current environment. Treasury bonds remain a long recommendation.

We look for a bear-market bounce over the next month or so. Shorts could get squeezed. Don't assume it's off to the races again, probably just a major bounce in a downtrend. We're closing our long volatility position (VXX etf) which is up +348% in the past month and we're going short VXX. The market has probably transitioned from a passive long to an opportunistic trading vehicle where you should pick your entry and exit points for long and short positions. For now we are closing shorts and going long for a bounce, with the objective of capturing gains on the long side and going short again from a higher level.

## Stock Market Bounce Ahead



US and global stock indexes should be on the cusp of a huge rebound rally. The Fed has unleashed the Kraken with its new QE infinity and zero interest rate policy. With the S&P500 down -34%, DJIA down -37% and Russell 2000 down -41% from their recent highs, the stage should be set for a massive-bounce back rally. This is probably an excellent entry point to go long stock indexes for a bounce.

Confirmation of this scenario can be found in the model's group rotation forecast. Defensive utilities and REITs are removed as outperform prospects, while FANG and tech groups switch from underperform to outperform prospects.

**FANG is interesting because it has somehow become a defensive stock group** that is somewhat insulated from the current coronavirus phobia. Amazon and Netflix in particular should benefit from shelter-in-place refugees ordering online

rather than shopping and watching movies and shows at home rather than at movie theaters. Semiconductors, software, social media and communication equipment are all new outperform prospects, after a big sell-off.

**Goldman Sachs is hilariously wrong.** They loved the stock market at the top early this year and hate it now at the bottom. They've squandered their reputation and influence. If the S&P500 rallies by 30%, Goldman will be forced to cover their sell-stocks recommendation at a much higher level. Bye Bye Kostin and Hatzius.

**Gold and gold stocks are ideally situated to lead the rebound rally.** The Fed's monetary mayhem should feed directly into rising gold and gold mining stock prices. The GDX gold stock etf is the #1 position in the portfolio and gold stocks are the #1 recommendation on the P6 industry group page. Since last week's report, the GDX is up +31% and the S&P500 is down -6% for an astounding +37% GDX alpha in one week. That outperformance is just starting in the model forecast and the GDX has barely broken out yet. Buy GDX and the gold stocks listed on P6 on brief pullbacks.

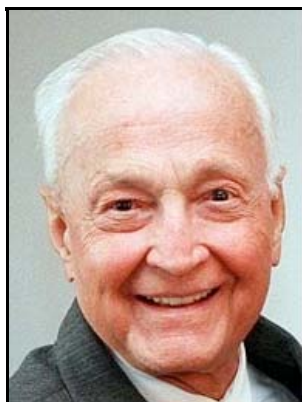
**Take a look at last week's recommended forecast outperform and underperform list.** While gold stocks were up +31%, many stocks on our top 10 group sell list were down -30% to -50% (COF -38%, DFS -51%, ADS -44%, SYF -44%, GS -22%, MS -21%, C -25% TEN -51%, SUP -37%, MTOR -30%, MOD -38%, MGA -36%, UAL -41%, SAVE -42%, JBLU -36%, ALK -38%, AAL -28%, ATI -38%, KKR -25%, BX -19%, APO -25%, F -23%, FCAU -37%, etc.). While we've never seen so many shorts on anyone's list down that much in a week, this behavior is probably climactic. But we're leaving financials and cyclicals on the underperform list. Specialty retailers and restaurants also appear vulnerable, they came into this sell-off overowned and elevated and have had only had a few weeks of liquidation. So there are still plenty of sell ideas with alpha potential for shorts even in the forecast rising market.

**The VXX volatility ETF probably topped last Wednesday at the 69 level.** It closed today at 51, down -26% from its peak. We added VXX as a short last week (after being long VXX during its +348% gain over the past month). Falling volatility is a bullish confirmation signal for the stock market.

**US TBonds remain a long (TLT etf).** With the Fed buying, US TBonds should hold up for now, but soaring deficit spending is obviously a big negative down the road. We will monitor this position closely. All other global bond long positions are closed out.

**To summarize: We've switched from short to long on stock indexes after capturing most of the -30% decline this year.** The Fed's QE should add rocket fuel for a major stock market rebound. A reasonable bear market bounce could take the S&P500 up 30% or more, the 3000 level would make a nice right shoulder for a huge head and shoulders top (see chart). Defensive sectors are removed as outperform prospects and tech becomes a top long and outperform prospect, especially FANG. Gold and gold stocks should fly on the Fed's monetary capitulation. The GDX and gold stocks listed on P6 remain the #1 long recommendation.

## ***Buy At The Point Of Maximum Pessimism***



"The time of maximum pessimism is the best time to buy and the time of maximum optimism is the best time to sell."

John Templeton

Stock markets currently reflect John Templeton's famous maxim: *Buy at the point of maximum pessimism*. The news is obviously dreadful. The virus scare has shut down vast swathes of the global economy and left corporations quivering and people sheltering at home, temporarily without jobs and wondering how they will pay their bills. You would have to be nuts to be bullish, right?

**Not according to Templeton.** With the S&P500 down -34% from peak to trough (3386 on Feb 19th to 2237 on Mar 23rd) the false optimism that permeated investment sentiment early this year has been obliterated. The stage should be set for a

stock market bounce.

The S&P500 20 day annualized standard deviation is currently 95% (its average is 15%). We were long volatility (VXX) before the crash (S&P500 20 day standard deviation was 6% in January). The VXX etf rallied by 419% from its low on Jan 16th to its peak on Mar 18th. We are now short VXX and it is down -30% from its Mar 18th peak. What this means is volatility is being squeezed out of the stock market. The forced liquidation that generated those 10% daily market swings is over. The S&P500 is likely to calm down and creep higher.

US stock indexes are having a bounce around their 200 week averages. This is a normal expectation. We turned from bearish to bullish two weeks ago. The S&P500 was up +10% last week. That is probably a bigger percentage weekly move than will happen now. Our forecast is for a continued stock market bounce on lower volatility and smaller percentage moves. Our general target for this rally is around the 3000 level, another 15%-20% higher for the S&P500 and other US indexes. Stock indexes could rally back toward their 200 day averages. That level is almost 30% higher for European indexes like the DAX, CAC40 and FTSE. That is too much of a rally to endure if you are short or too much to miss for long-only investors. It would be a year's worth of gains in a less-volatile environment.

*What sectors, groups and stocks are likely to lead the forecast rally?* We've changed in most of our group rotation forecast. Gold stocks remain the top outperform recommendation, the Fed's credit expansion should keep gold prices rising and benefit gold miners. But tech has moved onto the outperform list. FANG stocks are actually defensive in the current environment (as opposed to airlines, hotels, restaurants and retailers). Semiconductors are a fresh long recommendation. Software has become a outperform recommendation, many high-flying software stocks are down -40% from their February peaks. Social media and communication equipment stocks are also fresh long recommendations. After tech comes health care and consumer staples, both sectors have obvious appeal in the current lockdown. Utilities and REITs are no longer on the outperform list.

*What sectors are likely to underperform?* Financials. Banks, brokers, asset managers and insurance stocks have an underperform forecast. Zero interest rates are negative for financials, as are widening credit spreads. For example, the Stoxx European bank supersector was down -6% today with the Stoxx index up +1%, for negative alpha of -7% in one day. Banks remain our top sell recommendation in Europe and the US.

*After financials, cyclicals have the next weakest forecast.* Autos, airlines, restaurants, hotels, retailers, machinery and industrials are underperform prospects. New additions to the weaker forecast list this week are retail REITs and mortgage REITs, which obviously have problems.

We recommend being opportunistically long currently. Forced liquidation of leveraged positions has probably created a temporary selling climax. The Fed and US government's new stimulus programs have likely put a floor under stock indexes and set the stage for a rebound. The news is obviously terrible, but Templeton's advice stands, *"buy at the point of maximum pessimism."* Longer-term we are not so sanguine, paradoxically we look for rising investor confidence to spot the potential next top in stock prices: *"The point of maximum optimism is the best time to sell."* We'll let you know when the forecast changes.

## Market Instability



Federal Reserve Financial Stability Report Nov 8, 2021 *“Asset prices remain vulnerable to significant declines should investor risk sentiment deteriorate, progress on containing the virus disappoint, or the economic recovery stall.”*

The Federal Reserve is speaking out of both sides of its mouth. Today the Fed warned *“Asset prices remain vulnerable to significant declines should investor risk sentiment deteriorate,”* while last week Fed Chairman Powell in his press conference did everything in his power to encourage investors and thus keep the bubble he created going.

**The Fed is playing a dangerous game.** If you have been around a few cycles you have seen speculative bubbles come and go. The 2000 tech bubble peak was followed by a major loss of wealth and an economic slump. Likewise for the Oct 2007 credit crisis bubble peak. Likewise for the June 2015 Chinese stock market bubble peak. These bubbles were all inflated by previous short-sighted central bank stimulus programs. The aftermath was disastrous for investors.

**The risk in the current US speculative bubble is best illustrated by the S&P500 price/sales chart above.** There’s never been anything like the current elevated price/sales ratio. It’s almost twice as extreme as it was in 2000 or 2007. At 3.2, the current S&P price/sales ratio is at a never-seen extreme, twice its 1.6 long-term average. Rationalizing it by saying ‘TINA’ (There Is No Alternative when interest rates are so low) proves the point: The Fed has created a monumental speculative bubble with its zero interest rate policy and QE monetary policy.

**Obviously investors have had to play the game until now.** But remember what Citibank CEO Chuck Prince said in July 2007: *“When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.”* That quote epitomized an era and cost Prince his career, he resigned under pressure on November 4th, 2007.

**“We’re still dancing” has been resurrected as a theme song for portfolio managers and individual investors in this current cycle.** The pressure to conform is relentless. Individual investors have gone ape-shit crazy with Robinhood accounts and equity fund inflows. Likewise for corporations which are buying their own shares with abandon in share buyback programs.

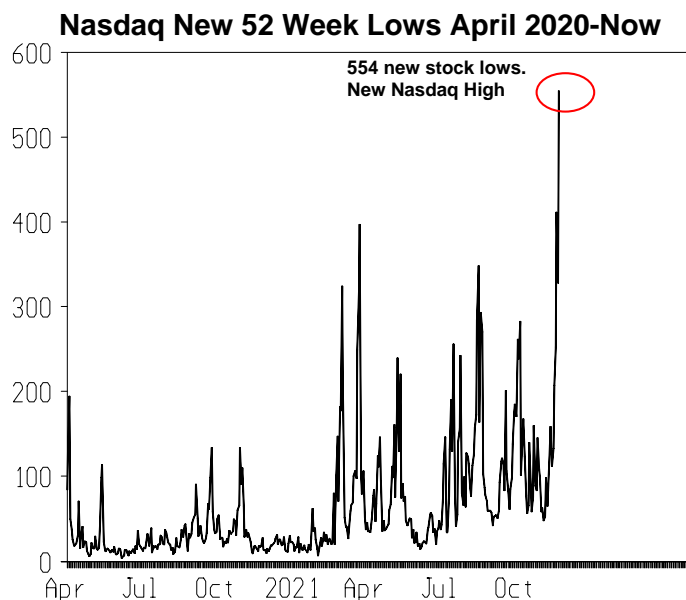
**While the latest stock market surge over the past month caught us by surprise, we are emphatically not dancing.** The short-term model forecast looks for a major cycle stock market top. Bullish sentiment is vulnerable to a major reversal.

**Stock market volatility (VIX and stock index 20 day standard deviation) is probably at a major cycle low.** Single stock call option buying is a previously unheard-of level and volatility selling by the still-dancing crowd has smashed the VIX down relentlessly, but the VIX appears to have bottomed three days ago and has an upward forecast. There appears to be a huge short position in volatility which is vulnerable to a major short-squeeze. When volatility surges, the stock market tanks.

**We recommend heeding the Fed’s latest financial stability warning about the risk of significant asset price declines.** A reversal in market sentiment and a rise in volatility could soon torpedo investors’ best-laid plans which currently seem to be counting on a year-end stock market rally. Take advantage of ebullient sentiment and reduce risk in your portfolio to the bare minimum.



## Bubble Trouble



You've heard numerous theories about why this time is different, overvaluation doesn't matter, year-end rally, there is no alternative (TINA), individual investors keep buying the market, central banks won't raise interest rates for another year, etc.

**Meanwhile there has been a major deterioration in sector & group rotation and stock market breadth** (advance declines and new high/lows). Today when the Nasdaq briefly hit a new high before reversing and closing -1% lower, there were 554 new 52 week Nasdaq lows and just 213 new 52 week highs (see chart). Notice more than twice as many new one year lows as new highs on a new intraday Nasdaq index high. That's an astounding divergence that indicates what is really happening beneath the surface of the stock market: Many stocks are declining and are down big already.

**A similar divergence is taking place in advance/decline indicators.** For the last four days there have been almost

twice as many Nasdaq declining stocks as advancing stocks: Today 3038 stocks down, 1705 up.

**Individual investors are foaming at the mouth bullish, buying one week call options on FANG stocks.** Two weeks ago the AAll individual investor survey showed twice as many bulls as bears (48% vs. 24%). The little guy is all in.

**This appears to be a major speculative bubble top, similar to those of 1929 or 1987.** We've modeled those events (along with other major stock market tops) and the current Nasdaq index shares their pattern.

**Looking beneath the surface, stock investors have been squeezing into a smaller and smaller subset of stocks** like MSFT, AAPL, TSLA, etc. Meanwhile even high profile cloud software stocks have been tanking. Today the CLOU cloud software etf was down -3.4% and is down -10% from its Nov 4th peak. Cloud software stocks remain a top short recommendation.

**The rot is spreading into financial and consumer discretionary stocks.** We added securities brokers and credit card stocks as shorts several weeks ago. Our credit card stock group is down -10% from its Sep 24th peak. The XBD securities broker index is down -4% from its Nov 3rd peak. Money center banks, regional banks, asset managers and European banks are added as new shorts this week. Financials were previously long and outperform recommendations.

**Hotels and restaurants are top short recommendations.** Our restaurant group is down -11% from its April 30th peak (-23% alpha with the S&P500 up 12% since then). Our hotel group is down -9% in the past three weeks and hotels & leisure stocks remain a top short recommendation.

**Why would hotels, restaurants and leisure stocks decline? INFLATION.** It's a bad omen about the US consumer. As the CNBC press clip illustrates, "88% of Americans are worried about inflation. Here's where they're planning to cut back. Many are planning to cut back their spending when it comes to eating out, upgrading their technology devices, buying clothes and traveling. The poll by Country Financial, conducted between Oct. 22 and 25, found that many Americans do plan to cut back their spending. Of the 1,031 adults ages 18 and up surveyed, 48% said they plan to reduce their spending on restaurant meals and takeout."

**Our model changed on the dollar last week, we're now long the US dollar.** That is a risk-off position with negative implications for emerging markets.

**This economic cycle has been warped by excessive stimulus.** The stock market momentum thrust that began 20 months ago (April 2020) has run its course. The time to buy was then, the time to sell is now. Central banks and politicians are doing everything in their power to keep the stock market game going, but the stock market is deteriorating beneath the surface. It's a tug-of-war between market forces and central-bank-inspired investor exuberance. Sentiment should break and volatility should surge. Look out below.

## Internal Disintegration



The stock market is melting from within. If you look only at the S&P500 or Nasdaq, it looks like no big deal so far: S&P500 -2%, Nasdaq 100 -4% from recent all time highs (Nov 18-19, two weeks ago). Ditto for Europe: DAX -5%, FTSEMIB -4% from their all time highs (Nov 15-17, two weeks ago).

**But look through a microscope and it gets gruesome.** The cloud software ETF at the top of our sell list on P5 is down -16% from its Nov 4th peak. Cloud software stocks (a major holding of hedge funds and momentum funds) are down huge from their recent peaks (FSLY -72%, ZM -67%, DOCU -56%, RNG -56%, COUP -54%, DOMO -48%, SPLK -47%, PLTR -46%, CTXS -44%, TWLO -43%, SQ -34%, CRWD -31%, MNMT -30%, AVLR -29%, OKTA -26%, VEEV -26%, PTC -26%, PAYC -24%, TEAM -24%, etc.).

**These cloud software stocks deserve to go down, many are unprofitable and still sport price/sales ratios above 14**, four times the S&P500 all time high price sales ratio of 3.2, which is twice its long term average of 1.6. Investors rationalized nosebleed valuations because of *growth*. The *growth* justification for cloud stocks is being annihilated. Of course cloud stocks are going down because someone is dumping them. That's a pattern to keep before your eyes: What investors own the most of and is the most overvalued is disintegrating.

**It's not just cloud stocks. Mega cap FAANGT stocks are also getting dumped.** Facebook (FB) is down -17% from its September peak. Tesla (TSLA) is down -18% from its Nov 4th peak. Netflix (NFLX) is down -12% from its Nov 17th peak, Amazon (AMZN) is down -8% from its July peak. The FANG etf (FDN) long recommended on P5 is down -12% from its Sept 7th peak.

**But hope springs eternal. As the press clips illustrate, investors poured \$10bn into equity funds as the market went down last week.** Today Bloomberg reported inflows of \$2.6bn into Nasdaq 100 QQQ etfs. See image above left.

**Is buying the dip a valid strategy at this point in the market cycle**, or has investor psychology been warped beyond repair by Federal Reserve monetary policy? If it's the latter case, then it's a fool's game. So far stocks have been going down on INFLOWS. What happens when the tables turn, investors get cold feet and inflows turn into OUTFLOWS?

**Our model forecast points down for stock indexes. This looks like an epic top.** You won't hear that from Wall Street, Bloomberg, CNBC, FT or the WSJ. They are still pushing higher stock index targets for next year and *stocks to buy now*. Telling investors to sell or short doesn't win friends in the investment world.

**Here are our recommendations based on the model forecast** - the same model that recommended selling and shorting cloud software stocks. We're not looking for popularity, we're following a model forecast and hoping to help clients avoid losses and even profit from a bear market.

**Long-only funds:** Reduce equity exposure to the minimum. Sell into brief rallies. Shift out of tech, communication services, financial and consumer discretionary stocks into utilities, staples and REITs. Buy puts.

**Hedge funds:** Get out of tech. Raise short exposure. Short software, FAANGT, internet, social media, securities brokers, asset managers, solar and EVs. Buy puts.

**Global funds:** Sell and short global stock indexes and emerging markets. Shift out of tech into utilities, food & beverages, personal goods and real estate. Shift out of stocks into government bonds. Buy puts.

**Asset allocators:** Shift out of stocks into government bonds.

**The forecast for volatility points up.** That implies bigger daily percentage swings (both up and down), which can be confusing. The natural instinct for long investors is to be relieved when the stock market bounces and to be upset when it declines (buy high and sell low). We advise the opposite - sell and short into brief market bounces and avoid selling in the hole. A bear market could drive stock indexes much lower. The objective is to not get hurt by a major decline and be able to re-deploy into stocks when nobody wants to touch them after a big decline.

## Sector Rotation is Risk Off

S&P Sector	Alpha	Since
Utilities	+6%	Nov 8
Staples	+5%	Nov 19
REITs	+5%	Sep 6
Health Care	+3%	Nov 25
Comm Serv	-14%	Sep 1
Financials	-7%	Oct 22
Cons Disc	-5%	Nov 22

By now it should be clear that only a few mega-cap stocks have held the US market aloft. Last week the S&P500 hit a new high just 0.2% above its previous Nov 18th high, primarily due to AAPL (which was up 11% on the week) and MSFT (which was up 6% on the week). Every sector except tech underperformed the S&P500 last week.

**Meanwhile in a strange paradox, our tech stock shorts have been working in both relative and absolute terms** (cloud software, internet and social media). CLOU, the cloud software ETF is down -16% since Nov 4th (for -25% alpha). FDN, the internet FANG eff is down -11% since Sep 7th (for -14% alpha) and SOCL, the social media ETF is down -20% since Sep 7th (for -23% alpha). So while news headlines

and brokers focus on *'the strong market'* stocks are melting down underneath. You know this if you have a diversified long portfolio because your stocks probably aren't matching index performance.

**So what are you supposed to do: Sell everything else and buy AAPL and MSFT? Definitely not.**

**The secret story that no one else seems to have noticed is that defensive sectors and stocks are outperforming.** They turned the corner in November. S&P utilities have +6% alpha since Nov 8th, consumer staples have +5% alpha since Nov 19th, REITs have +5% alpha since Sep 6th, health care has +3% alpha since Nov 25th.

**Our model forecast suggests this is just the beginning of a sustained period of outperformance for defensive sectors** utilities, staples, real estate and health care. For long market exposure, buy and overweight these sectors.

**Conversely, popular cyclical sectors have quietly left the bubble party.** Communication services has -14% alpha since Sep 1st, financials have -7% alpha since Oct 22nd and consumer discretionary has -5% alpha since Nov 22nd.

**Our model forecast suggests this is just the beginning of a sustained period of underperformance for the popular sectors** communication services, consumer discretionary and financials. Sell, underweight and short them.

**Hedge funds might notice the extreme dispersion between outperforming and underperforming sectors and establish market neutral sector ETF pair trades** such as long XLU/short XLF (utilities/financials) or long XLP/short XLY (consumer staples/consumer discretionary). These trades go against consensus positioning. Financials and consumer discretionary stocks are popular and widely owned, while nobody seems to like utilities and staples. So this could be a major pain trade for the consensus.

**Turning to individual stocks, for outperformance the model likes big defensive stocks** like PG, CHD, HSY, PEP, CVS, NI, ED, CCI and UNH.

**For sells, shorts and underperformance the model likes software stocks** like TEAM, NET, HUBS; big cap stocks like TSLA, NFLX, NVDA, AMD, brokers like JEF, GS, MS, PIPR, banks like C, SIVB and asset managers like GROW, GBL, KKR and BX.

**Retailers appear to have just turned the corner after an undeserved rally and are recommended sells and shorts:** M, DDS, TGT, JWN and WSM.

**Solar and EV stocks are fresh recommended shorts, led by TSLA.**

**The cap-weighted S&P tech sector (XLK) is deceptive,** it looks strong thanks to AAPL and MSFT, but many individual tech stocks and groups are already in liquidation.

**What can you say about a stock market that is jerked around by algorithmic trading and retail flows while so many sectors, groups and stocks are headed south? It's an epic top.** Sell and short into brief snapback rallies (like last week's), shift into defensive sectors and don't get hurt in a market selloff.

## Epic Top

### Global Index of Stock Indexes Monthly 2018-Now



**G**lobal stock markets had a huge rally off the March 2020 virus selloff lows, on the back of massive monetary and fiscal stimulus. That momentum thrust is over. The stimulus created blowback in the form of excessive inflation. Authorities have no choice except to reverse course and withdraw stimulus.

**The Fed is tapering QE and preparing for rate hikes next year.** The Bank of England (BOE) is the first major central bank to raise interest rates (Dec 16). Emerging market banks in Russia, Mexico, Chile, Costa Rica, Pakistan, Hungary and Armenia also just raised interest rates. Global monetary policy is tightening.

**Somebody forgot to tell US investors who keep pouring money into equity ETFs.** The psychology of throwing money at stock persists, despite the fact that most stocks stopped going up months

ago.

**Our global stock index (index of indexes) stands at the same level as it did in May, seven months ago (see chart).** US indexes have been slightly stronger, but our US index of indexes stands at the same level as it did in August, four months ago. Since August there has been \$125bn of equity ETF buying, with -\$73bn of equity mutual fund selling for net buying of \$52bn (Refinitiv data). Much buying, no progress.

**Investor psychology is sticky, still obsessed with stimulus that is going to be withdrawn.** The Fed has done its best to encourage this mindset by delaying tapering and rate hikes because they know when investors start selling, the wealth effect the Fed has nurtured will turn negative and the economy will choke.

**Viewed from this perspective, the stock market has been transformed into an intentionally-created speculative bubble.** But sentiment is fragile. Bubbles don't continue forever.

**Obviously someone is selling. Beneath the surface of the US stock market, many popular ETFs and stocks are down big from their 2021 peaks:** ARKK Innovation Fund -40%, TAN solar -40%, SOCL social media -33%, Bitcoin -33%, Tesla -27%, XRT retailers -18%, EEM emerging markets -18%, CLOU cloud software -18%, FB -15%, FDN FANG internet -13%, IWM Russell 2000 -12%, KBE bank -11%, GVIP Goldman hedge fund VIP -9%.

**That is with the S&P500 down just -3% and the Nasdaq down -6% from their 2021 peaks.** Popular groups and stocks are down much more. Some widely touted and overowned cloud software stocks are down 10-20 times as much as the S&P500: ZM -54%, DOCU -52%, PLTR -49%, SQ -43%, etc.

**The overall picture is a sick market with many stocks down big already,** 69% of Nasdaq stocks are already below their 200 day averages (Reuters press clip). Both the Nasdaq and S&P500 are still 5% above their 200 day averages. Indexes are now probably poised to follow their weak members lower.

**Investment Recommendations: Reduce long exposure to the minimum allowed in your investment mandate.** Raise cash by selling into brief snapback rallies. Hedge funds should raise short exposure to the maximum allowed, with shorts focused on tech, consumer discretionary, financials and communication services. Asset allocators should shift out of stocks into government bonds.

**A major alpha opportunity exists in defensive sectors:** Utilities, consumer staples, REITs and health care. As discussed in last week's report, these bottomed in relative terms to the index, mostly in November. They have added big relative gains in the past two weeks, From their lows utilities and REITs are +8%, staples +7% and health care +6%. The upward relative move for defensive sectors is just starting in the model forecast, this is the time to participate in this move. For long exposure, switch out of tech, consumer discretionary and financials into defensive sectors. The same goes for European EuroStoxx sector rotation.

**As for stock indexes, the model forecast suggests this is an epic top on the order of March 2000 or October 2007.** Sell and short into brief bounces. Happy holidays, no report next week. The next report will be Jan 3rd.