Topping Markets

10 June 2013
DJIA: 15,238

So far, the year has been rewarding for most equity holders. Recently the Dow Jones Industrial Average, the S&P 500 and the small-cap Russell 2000 each set all-time record highs. Is this likely to continue? We don’t think so, our research now suggests this is a time for caution for stock investors.

For the past 40 years our research team has analyzed stocks and bonds. Each weekend, our team calculates and then tracks a group of proprietary risk indicators, some leading and some coincident. A shift in the stock indicators from negative to positive, such as occurred in the fall of 2012, is a signal to buy stocks and expand equity positions. Likewise, shifts from positive to negative, as at present, indicate we are in a higher risk area for stocks. Experience has taught us it is prudent to reduce equities.

Aside from the negative trend in our indicators, other factors trouble us. For example, post-election years are notorious for their volatility. Since 1928, post-election years have suffered the lowest annual returns and the highest levels of volatility (standard deviation) in the four year election cycle.

We also examine the behavior of the firms themselves, believing they have better insight than most outsiders. In fact, we consider this activity to be done by the “smart money.” What have they been doing? While announcements of share buybacks receive considerable favorable media attention, the data tell a different story. Recently, twice as many companies were offering additional shares [selling] to the public as were buying back shares. This suggests many companies may believe their stock is overpriced.

Market topping actions are often prolonged. How do we identify the turning point? While not infallible, one important gauge is frequently found in sentiment shifts. During a rising market it is normal to see rising levels of optimism. Danger usually occurs when optimism has been high and begins to reverse.

Unfortunately, we note signs of this today. Investors Intelligence tracks the opinions of many professional advisors, who were recently the most bullish since the spring of 2011. Now their bullishness has begun to reverse, we recently had one of the largest two week declines since 2010. Data from the American Association of Individual Investors (AAII) is even more pronounced. After heady readings just a few weeks ago, the AAII survey now shows more bears than bulls.

These factors are combined with others such as heavy selling by corporate insiders, little conviction and weak volume on recent rallies, high valuation levels for stocks when measured against long term gages such as the Cyclically Adjusted Earnings. Of course, all of this is confirmed with our weekly indicators, a preponderance of which are now bearish. This is a time for caution, when it is prudent to trim equity levels.

David W. James, CFA
Frank James, Ph.D.
Trent Dysert, Assistant Portfolio Manager
Barry James, CFA, CIC