The Blumenthal Viewpoint

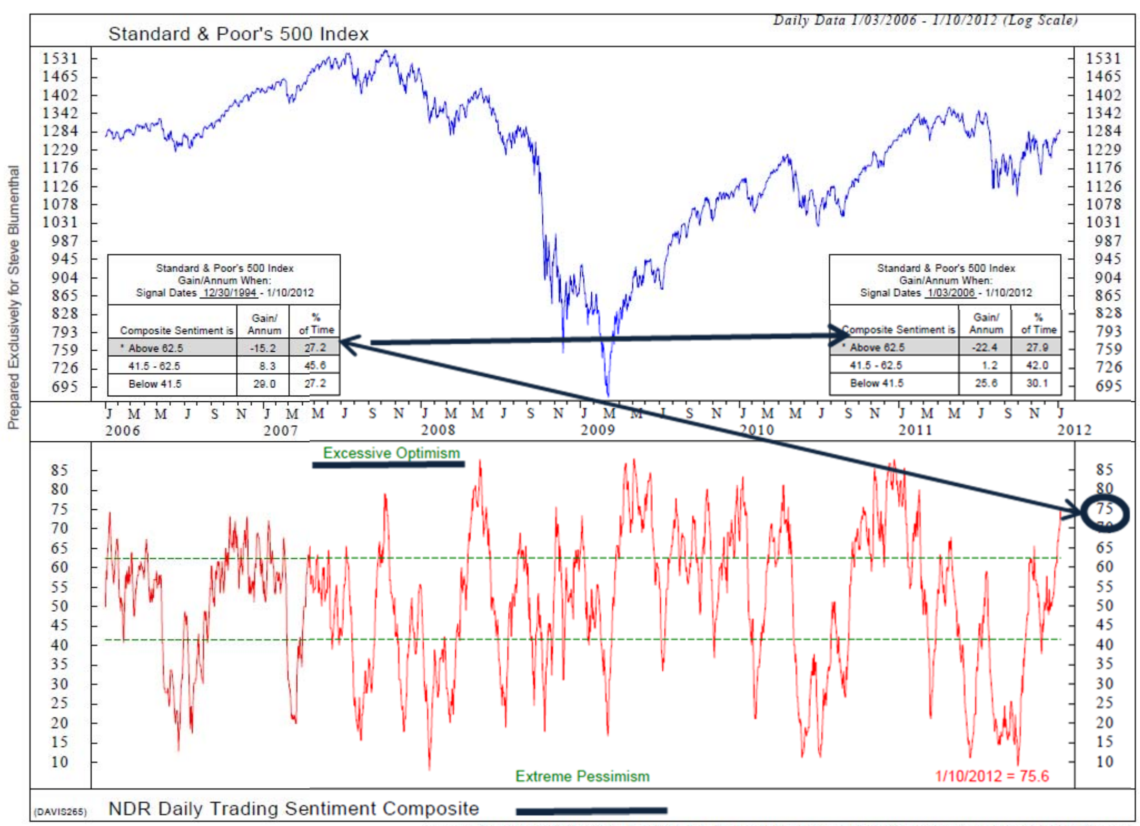
January 11, 2012

Excessive Optimism - Investor Sentiment and Chart Resistance:

The following discussion focuses on the long-term equity portion of an investor's total portfolio and the need to hedge that exposure from time to time given the fundamental risks in the system today. Following the wisdom of Sir John Templeton, the idea is to sell (or hedge) when everyone else is buying and to buy (remove hedge) when everyone else is selling.

As you can see below, investor sentiment has again reached the Excessive Optimism zone. The arrows point to the Performance of the S&P 500 Index when readings exceed the upper dotted green line. The box on the left dates from 1994 to January 10, 2012. The box on the right dates from 2006 through January 10, 2012. (source: NDR 1-10-12)

Clearly, the odds do not favor buying equities when sentiment is in the Excessive Optimism zone.

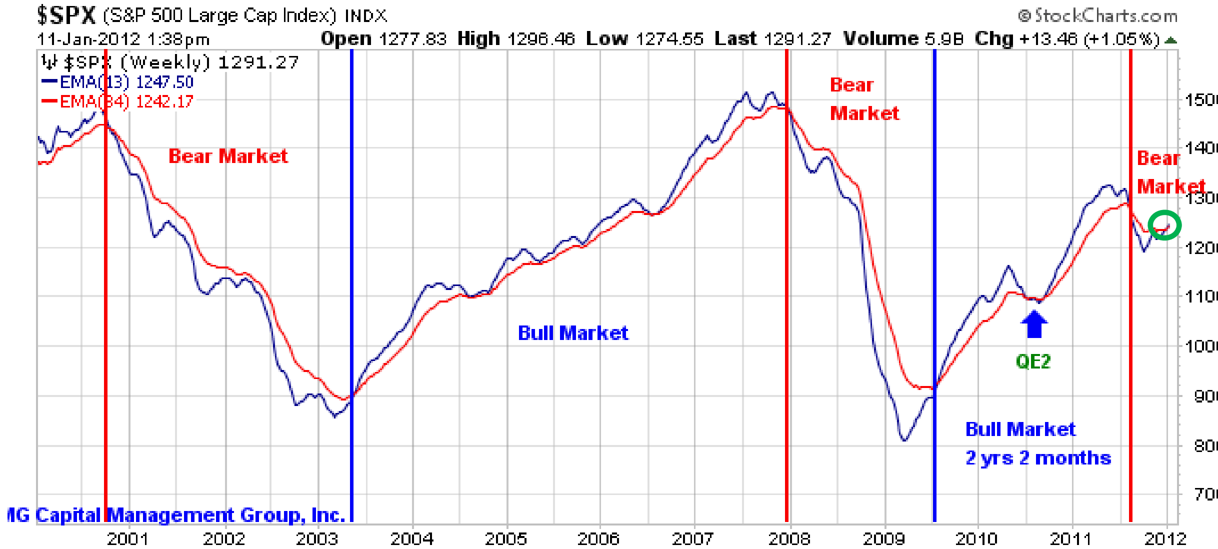


For me, when sentiment reaches Excessive Optimism and the market reaches important resistance (see yellow highlighted area in the next chart), it is time to focus on protecting long-term biased equity exposure. 1300 to 1360 marks the immediate overhead resistance. The market closed yesterday at 1296.

The S&P 500 Index could certainly move higher. 1360 is a reasonable probability. However, given the long-term secular bear market environment, I continue to favor using extreme sentiment readings as a guide to put on and take off risk protection. I believe buying put options is the most cost-effective way to risk protect. A collar put strategy is a cost-effective solution. Other options include adding a position in an inverse ETF. Talk to your investment advisor. I believe the risk discussion is important given the systemic risk in the system today.
The secular bear market began in 2000. You will note from the above sentiment chart that there are just a few times each year that sentiment reaches the Excessive Optimism zone. The point here is that protection needs to be put in place just two to three times each year; however, patience and discipline are required. Please remember that not every trade will be correct. Think of this in terms of portfolio insurance. I favor taking the protection off when sentiment reaches the Extreme Pessimism zone.

A point of clarity: I do not believe there is a need to hedge or risk protect your tactical/alternative investment positions. They should purposely serve as a risk diversifier within your total portfolio structure with the goal to enhance your overall returns and reduce your total portfolio risk.

Cyclical bear turning to cyclical bull? The next chart serves as a pretty good guide to identify the shorter-term cyclical bull and bear periods that have occurred since the beginning of the bear market in March 2000. I have labeled the periods ‘Bear’ and ‘Bull’. Note how, most recently, the 13 week EMA line (blue) has crossed above the slower 34 week EMA line (Red). This could indicate the beginning of another cyclical bull period (within what I continue to believe is an overall longer-term secular bear market cycle). It is not yet conclusive (green circle).



Finally, I find it helpful to look back at the overall trend in the market. The S&P 500 Index reached a high of 1575 in 2000 and again in 2007 (just prior to the global credit crisis / great recession). Today, the S&P is near 1300. Secular bear markets are frustrating and painful. I see nothing to change my risk management focus. Here is an S&P chart dating back to 1999.

With kindest regards,

Steve

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