THRASHER ANALYTICS

Market Update

Something new I'm starting is sending out a letter (almost) every week. I'll continue to be doing my full length analysis and commentary that you're used to getting on a bi-weekly basis but on the other weeks I'll be sending a note like this one, which provides an update to the models, sentiment, and a brief market update.

In addition to the above mentioned additional commentary, I'll also be including the below 'snapshot' in each email to provide quick access to the models and key market data.

Sector Rotation: November	
Real Estate	XLRE
Utilities	XLU
Health Care	XLV

Notable Breadth Data:	
SPX >50MA	69.40%
SPX >200MA	70.40%
Industries >50MA	87.70%
Nasdaq >50MA	60.50%
Nasdaq >200MA	47.80%

Fixed Income Rotation: Q4	
Junk Bond	JNK
Aggr Bond	AGG

Index & Sector Adaptive Trend Models	Up Trend	Down Trend
SPX	X	
QQQ	X	
IWM	X	
XLF	X	
XLY	X	
XLK	X	
XLV	X	
XLU	X	
XLP	X	
XLI	X	
XLRE	X	
XLE		X
XLB	X	

Daily Sentiment Index	% Bullish
S&P 500	80
Nasdaq 100	82
Nikkei	87
VIX	17
10yr Treasury	51
5yr Treasury	47
CRB Index	64
Gold	53
U.S. Dollar	42

*Green<20% Red>80%

<u>*The Good*</u>

In my last letter I noted the concern I had with the poor market participation (breadth), highlighting several charts that showed the divergences and lack of broad strength while the main indices were making new highs. I'm encouraged that over the last week of trading, breadth has greatly improved. On Saturday (yesterday) I dug deeper into the breadth data, looking at not only individual stocks but at sub-industry groups as well - finding that more stocks have strengthened, joining the trend higher of the major index.The list of SPX stocks hitting new 6-month highs is slowly growing and still not to a level that would be most ideal, but the improvement is nonetheless a positive and worth noting.

The improvement being made internationally is also bullish. While The new high list is primarily made up of smaller country exchanges, France remains the only major market (of the top MSCI EAFE constituents) to have broken out, the others are doing their best to hitch their train on the expanding int'l strength being displayed right now. Zooming in, semiconductors hold the greatest focus for me, having broken out as discussed last week, dipping this past week to test the breakout point (in the SOX index) and holding strong to move back to finish the week at a fresh high. We also had improvement in small cap stocks last week as well, with IWM attempting to breakout of the upper-end of its 2019 range.

We've also now entered the bullish period of market seasonality. The only caveat being that pre-election years have seen some rough price action in November that eventually gets smoothed out in December. But broadly speaking, November and December have been bullish months for U.S. equities.

<u>*The Bad*</u>

The biggest concern I have rests with volatility and sentiment. A topic I may expand on in a public blog post is the idea that there are two major types of downside risks within the market - at least in the context of what drives the change in trend. First is broad market breakdown, which can be measured by narrowing breadth. This is the major type of market development that has historically lead to double-digit declines in equities, as we saw in Q4 of last year and more severe in 2007. I wrote quite a bit about this in Q3 and Q4 of last year, feeling quite alone ringing the bell that the internals of the market were not showing the same level of strength as the indices. This was during a time where the market had become complacent that we could ride higher on the backs of FAANG and all would be alright. They were wrong and stocks dropped by 20% to close out 2019.

So as I was saying, the first major risk to a trend change is a decline in breadth, (which currently has improved in today's market). The second is sentiment and volatility. It's my belief that volatility is the ultimate gauge of market sentiment, which is why I spend such a great deal of time focused on it. Volatility (the VIX and other VIX-like gauges) measure the expectation of future price swings - i.e. their sentiment towards the market. Typically we see excess in sentiment when volatility gets under-priced, which I measure in relation to Volatility of the VIX (VVIX) as well as the overall shape of the VIX futures curve, its a sign of excessive bullishness as the market begins to discount the idea of heightened volatility. This is something we have in the market right now, with spot VIX currently sitting more than 3 points below 3-month volatility. There hasn't been as much of a discount to spot volatility as there is now since October '18 or early January '18.

We can also see excessive sentiment in the Daily Sentiment Index. When the DSI gets north of 80% bullish (Friday we were at 80% for SPX and 82% for Nasdaq), an above-average level of bullishness is flowing through Wall Street. A third method of measure excessive sentiment is focusing on price itself. Specifically, when price moves too far too fast in a short period of time. When price gets pushed north of 5% above its 50-day MA, as we saw in January 2019, it's often attributed not to economic or fundamental undertones but overly bullish sentiment. Right now we have two of these conditions - excessive DSI readings and overly-discounted volatility.

In fact, the latest COT data for the VIX shows the percent of open interest by non-professional traders has *short volatility contracts than just before the massive spike in the VIX that took place in early 2018. Pair that with the 17% bullish DSI score and we have ourselves a major short-term market risk.*

What's this mean going forward? Good news! History is on the side of the VIX bears with regards to a spike in volatility this week. I tweeted over the week asking how many times people thought volatility had spiked after it hit a new 3-month low. It's commonly believed that a "low" VIX is what acts as the kindling for it to spike higher. That's just not true. In fact only three times since 1990 has the VIX hit a 3-month low and risen by at least 50% within the following week. The three dates were December 2014, February 2013, and October 1997. Historically we see VIX bottom and slowly begin to grind higher before it spikes. Here's two recent examples... Q4 of last year I wrote a blog post on August 6th warning of the rise in volatility. The VIX bottomed two days later and slowly moved higher but didn't "spike" under early October. The same thing can be seen in January 2018 before the VIX-plositon that collapsed the short VIX ETF (XIV). The VIX bottomed January 3rd but didn't "spike" until February 5th. We can't know the exact path volatility will take but through my analysis and the Volatility Risk Trigger, I think there's a large risk that we have begun to setup for a material move higher in volatility.

The Conclusion
How's this pair with the bullish breadth development? In my view, there's a short-term risk of a 5-10% decline in equities but because breadth has improved the potential move is less likely to be a repeat of Q4 '19 with stocks moving 20% lower and more likely to be a normal market correction, providing a possible dip buying opportunity into year-end. Because it's been so rare for the VIX to spike off a 3-month low within the following week, I don't think we're at a major risk of seeing a large vol move this week - that is unless something out of D.C. or some 'tail event' takes place - in which case all bets are off. But if we get a "normal" market week, I'll be looking for other data points to guide my bias, which I'll of course share in these letters, to where the risks light and the guide path we may take in the markets.

Okay that's all I have for tonight. This stream of consciousness turned out to be much longer than I intended but I hope it gives you a good view into where we are within the equity market right now. Going forward I don't plan to write this month in my off-week commentary I promise!

Best Regards,
Andrew Thrasher, CMT

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