Sample Client Report from February 2017

Quick Summary: The market advance should continue, most likely into Q2 2017 before a more important top is likely. Currently, sentiment extremes show early signs of froth, which is an important concern. But market breadth remains strong, with no toxic divergences in the picture at this time. I expect the market to continue grinding higher, with more modest gains likely before we see a top. With the market as overextended as it is, a 4-7 percent pullback could occur at any time, even without a divergence sell signal.

As the market advances, investors heavily committed to equities should consider paring back exposure. If sentiment extremes increase further, or divergences appear, then a more aggressive reduction in equities would make sense. If sentiment increases to dangerous levels , and toxic divergences come into play, then a significant reduction in equities would be my recommendation. And for trading strategies, the risk-reward for shorting the market would become an attractive option.

For those who want more details, please read further.

Conditions Today: The market is clearly overextended, but refuses to give ground. The "Trump rally" is based largely on a new perception of increased growth and better earnings for 2017-18, the result of deregulation and lower taxes. As a result, Wall Street continues to raise estimates for future earnings of individual stocks, as well as leading indexes like the SPX and NDX. And as a consequence, PE multiples have actually dropped over the past few weeks, even as the market has steadily advanced.

What is the Lethal Triad Saying? We are currently getting mixed signals.

Breadth: On the one hand, breadth has remained strong since the election. The majority of market sectors have participated in the rally, reaching new highs last week. And the leading index components have moved in lock step with the averages, thus negating any toxic divergences at this time. As you know, weakness in the large-cap internals is a prerequisite for such toxic divergences.

Sentiment: On the other hand, gauges of sentiment and speculation have been increasing, particularly since December 2016. And some sentiment indicators are now approaching "lethal" territory, telling us that froth is beginning to take hold. Of note, a number of media commentators and market letters that were previously bearish have now thrown in the towel. As such, the setup for an important intermediate top is starting to fall into place.

Valuations: Some valuation measures are getting long in the tooth, particularly in technology. Using a proprietary model of 500 tech stocks, my latest readings show the price to sales ratio at around 3.20. This is close to levels last seen in early 2000 (dot.com bubble). But at the market peak in March 2000, historical spikes close to 5.0 were seen. And semiconductors registered a price to sales ratio of close to 10.0. Today, we are well below such record extremes.

And with earnings estimates being raised significantly, PE ratios based on future earnings expectations remain in the 21-22 area, well below the readings of 28-35 seen in 2000.

Market Prospects from Here: the SPX is now up 89 consecutive days without a 1% down day. And leading technology indexes are up 13 straight days, a new record since 1926. (For this calculation, other index simulations were performed.) This is a pretty good definition of "overextension".

With the rubber band stretched to this extraordinary degree, something has got to give. And the odds strongly favor a 4-7% type pullback at any time. Such a retracement would be normal and healthy, and would likely extend the advance for now. No divergences are needed for such a moderate decline.

With current breadth as strong as it is, the odds of a severe correction or bear market (e.g. 15-20 percent or more) remain small. But with sentiment showing early signs of more dangerous froth, even moderate divergences could trigger a lesser 8-13 percent pullback. I am currently tracking sentiment and breadth in parallel, with the divergence element by far the more important of the two.

The odds currently favor the market continuing to grind higher, with technology and NDX leading the way. But given the high sentiment numbers, I do not see much upside from here. Gains of 4-8 percent are still possible before we see a more important top. I will update you on any changes in the all-important divergence patterns.

Below I show examples of selected daily divergence screens, as well as sentiment indicators that are beginning to show signs of froth.

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CHART ANALYSIS

The SPX advance-decline line is fully in gear with the SPX index itself. Breadth remains strong.

The NDX advance-decline line is fully in gear with the SPX index itself. Breadth remains strong.

The XLK advance-decline line is fully in gear with the XLK ETF itself. Breadth remains strong.

BUT

Media (And Oval Office) exuberance for stocks is now increasing. Former bears are now flipping to the bullish side. This is not a good sign.

Donald J. Trump
@realDonaldTrump

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Stock market hits new high with longest winning streak in decades. Great level of confidence and optimism - even before tax plan rollout!

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5:34 AM - 16 Feb 2017

Chastising noted bear John Hussman

Of Pessimism and Pride

by: Lawrence Hamtil on Friday, February 17, 2017

Should Stocks Be Worth More Now Than They Used To Be?

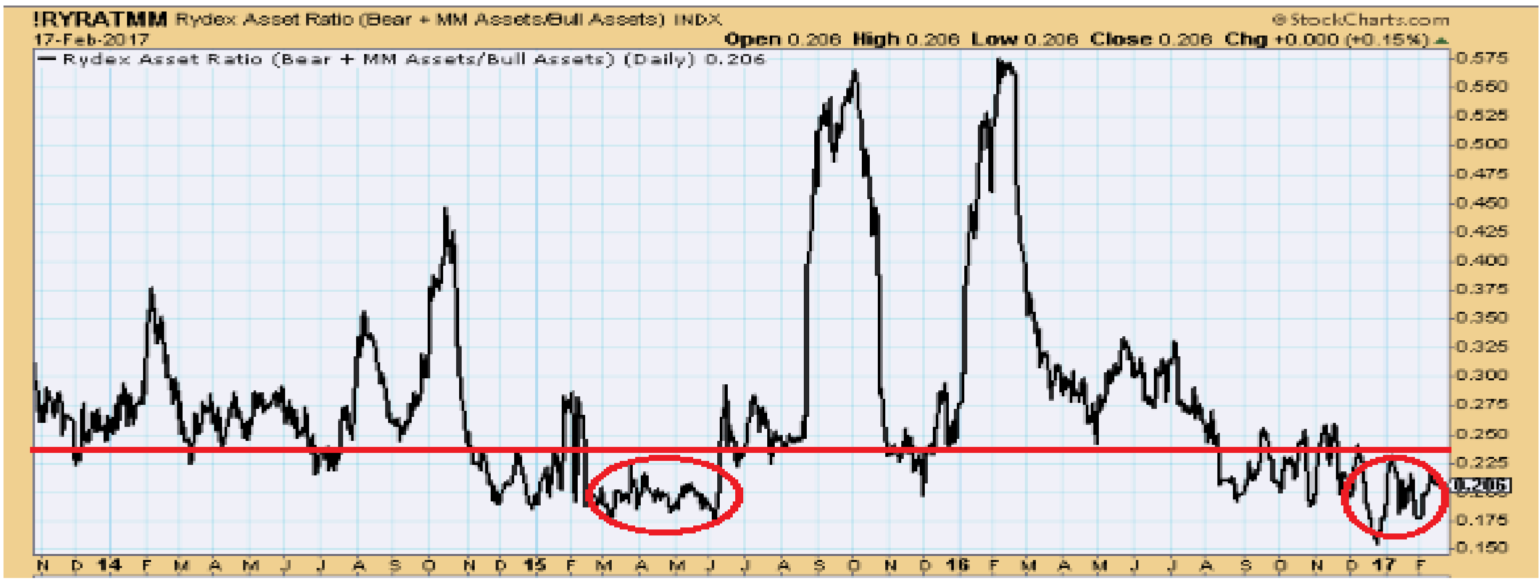
Posted February 13, 2017 by Michael Batnick

Stock markets are doing so much winning, investors are thinking Nasdaq 6,000

Published: Feb 17, 2017 4:01 p.m. ET

Indicators of lethal speculation are steadily increasing, and are now approaching the danger zone. This is a potential setup for a significant intermediate top within the next few months.

The Rydex Asset Ratio is showing early signs of froth. This is an advance warning of a potential top ahead. The amount of time spent below the red threshold line is important here. Readings are now comparable to 2015.



And the SentimenTrader Composite of indicators (over 50) showing excessive optimism is now exceeding levels seen before the 2015 top.

% Showing Excess Optimism