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HOW YOU FEEL MATTERS

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A quote attributed originally to Baron Rothschild suggests that you should be a buyer of stocks when “there's blood in the streets.” This harsh reference is recognition that acting counter to strongly negative market sentiment often is wise.

Be it overwhelmingly negative sentiment or the reverse, recognizing prevailing market sentiment can be important.

Following the U.S. presidential election, the equity market experienced a robust rally. Nothing economically suddenly changed to justify the market’s move. There was no international event to propel stock prices higher. A renewed sense of optimism was the only substantive change, which underscored that how investors feel has much more to do with how the equity market acts than most numbers-only investors would like to admit.

There is some validity in the premise that the market’s post-election surge merely brought stocks prices to levels that pre-election concerns would not allow. However, going from a guarded view to a much more upbeat stance drove some sectors to levels typical financial analysis would not suggest were justified – all on the back of much improved sentiment.

Gauging sentiment is difficult, particularly when you attempt to quantify it. But there are several widely followed efforts to do just this.

The oldest market sentiment gauge is compiled by Investors Intelligence, a major provider of research and technical analysis. Each week for the last 54 years Investors Intelligence has released a survey of investment professionals that measures their collective views of the equity market. The report’s bullish, bearish and neutral percentages offer a snapshot of how these investment participants feel about the market’s prospects.

Similarly, the American Association of Individual Investors (AAII) offers the weekly result of a survey the group conducts of thousands of individual investors. The AAII survey compiles bullish, bearish and correction percentages. Historic survey data go as far as early as July 1987.

Interestingly it is somewhat counter-intuitive that these measures are useful in exactly the opposite way their results would suggest, which makes them potentially useful as contrarian indicators.

Rising sentiment measured as the bullish percentage in both measures is a good sign until it reaches an extreme. Conversely, a declining bullish percentage is useful in confirming a trend until it reaches an extremely low level.

Determining what level of extreme reading offers a clearly investable signal represents a problem in both measures. Often this becomes a matter of interpretation rather than a specific level of bullish or bearish sentiment.

Two examples stand out when considering extremes as measured by the AAII survey.
On January 6, 2000, the AAII bullish percent set an all-time high of 75.00%. The S&P 500 that day was 1403.45. By March 12, 2003, the S&P 500 had fallen 43.79% to 788.90. In the four weeks prior to the March low, the AAII bullish percent ranged from 21.90% to 34.30%. From the March market low and the low bullish percent reading, as illustrated by the chart on the left (courtesy of Stockcharts.com) the S&P rallied for a 47.45% gain by March 2004.

And then there is the reverse.

March 5, 2009 the AAII bearish percent reached its highest level ever at 70.27%. One day later, the S&P 500 hit its intraday low at 666.79 before embarking on a rally that by April 29, 2011 sent the S&P 500 105% higher to 1370.58.

Another example of excessively bearish sentiment presaged a significant market upturn.

On January 14, 2016 the AAII percentage of investors with a bullish market bias reached its lowest level (17.9%) in more than five years. The bullish percent at that time had been at or below 17.9 only 17 times out of 1540 possible weekly readings. In every prior instance, the S&P 500 had a gain three and six months after the bullish percent reached 17.9 or less. The average three-month gain was 6.30%. The average six-month gain was 14.00%. The S&P 500 January 14 last year was 1878.93. Six months later it was 2036.09, up 8.36%. By January 11 this year, the S&P 500 was 20.99% above the January 14, 2016 level.

At times the actual bullish or bearish percentages do not tell the whole story. The spread between the two also can be useful. For example, the spread between the two percentages might more clearly illustrate prevailing sentiment. In January 2000 and August 1987 this spread was heavily slanted toward the bullish side – just before the market had a major decline. Multiple times late in 2008 and into 2009 this spread was lopsidedly slanted toward the bearish side - not long before the market embarked on a major upturn.

An August 4, 2017 Janney Investment Strategy report, “Corrections– Cause and Opportunity”, detailed eight factors that can forewarn of a possible market pullback or full correction. One of the eight – excessively positive sentiment – noted that, “When the vast majority of investors exhibit no market concern, a reversal in sentiment can shove stocks down.” The most recent sentiment data, however, are far from showing excessively bullish sentiment. In fact, they are closer to the exact opposite.

Bullish sentiment in the August 24, 2017 AAII sentiment survey fell 6.1 percentage points to 28.1% for the lowest reading since June 1. The bearish percent rose 5.5 points to 38.3%. Perhaps more importantly, the combination of either a bearish and neutral market views was nearly three-quarters of all respondents.

Assessing sentiment clearly is an art, not a science. Stock market sentiment measures are subject to a range of interpretations, but they nonetheless offer useful guides as to the market’s collective view. It is a mistake to assign a single point of any sentiment measure as a spot to take action. However, paying attention to ranges is worthwhile. It also is important to remember that the market sentiment approaching an extreme level, either too positive or too negative, may signal that the current market trend may be about to change.