Brief Observations: Distinctions Matter

November 13, 2017
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Brief Observations

Last week, the uniformity of market internals shifted to an unfavorable condition. This classification is based on current, observable market conditions. Historically, our measures of internals have shifted about twice a year, on average. We can't rule out a fresh shift back to more favorable conditions, or a resumption of speculative pressures, but we'll take that evidence as it arrives. While our immediate market outlook has been rather neutral in recent months, the combination of offensive valuations, extreme "overvalued, overbought, overbullish" conditions, and unfavorable market internals shifts us back to a negative market outlook. Still, the potential downside risk of the market over the completion of this cycle is so deep that it's probably sufficient to maintain tail-risk hedges and index put option strike prices a few percent below current market levels.

Our primary measures of market internals reflect the behavior of broad range of individual stocks, industries, sectors, and security types, including debt securities of varying creditworthiness. We would characterize last week's shift as "early deterioration" because the key feature isn't the depth of the weakness, but instead the *uniformity* of that deterioration (which has historically been more important). This deterioration can also be observed in a variety of standard measures, including the recent spike in junk bond yields, three consecutive weeks of negative market breadth and negative net volume (advancing volume minus declining volume), weak participation featuring more than 40% of U.S. stocks falling below their respective 200-day averages, and internal dispersion featuring numerous stocks hitting both 52-week highs and 52-week lows despite record highs in the major indices.

Because robust speculation tends to be rather indiscriminate, we view deterioration in the uniformity of market internals as a reflection of a subtle shift toward risk-aversion among investors. In hypervalued markets characterized by extreme "overvalued, overbought, overbullish" conditions, these shifts are often associated with steep market losses.

Distinctions matter

I continue to observe a great deal of misunderstanding around our investment approach. It's best to clarify this confusion before it's too late. Our challenge in the advancing half-cycle since 2009 was that we relied too heavily "overvalued, overbought, overbullish" features of market action. Though we fully anticipated the market collapse of 2007-2009, the resulting credit strains and employment losses were wholly outside of post-war experience, which prompted my insistence on stress-testing our methods against Depression-era data. One of the features of the resulting classification methods was that they prioritized "overvalued, overbought, overbullish" syndromes *ahead* of our measures of market internals, because of their reliability in prior cycles across history.

This cycle has been "different" in the sense that zero interest rate policy, as well as post-election enthusiasm, has encouraged continued speculation despite the most extreme "overvalued, overbought, overbullish" syndromes on record. Nearly all of the adaptations we've introduced to our approach in recent years have been *to restore the pre-2009 priority we placed on the uniformity of market internals*. That process was painfully incremental, and it's admittedly small comfort that we were being good Bayesians (updating our "priors" in the face of outcomes that conflicted with information from a century of prior market cycles). Still, those who imagine that our key valuation measures have become less reliable, or that we are ignoring "technical" factors, or monetary factors, or price behavior here simply misunderstand the actual issue that we needed to address.

We are entirely sympathetic to the idea that valuations are often*temporarily* irrelevant when investors are in a sufficiently speculative mood. We fully concede that our over-reliance on "overvalued, overbought, overbullish" features of market action was our Achilles Heel in an environment where zero-interest rates and post-election enthusiasm encouraged continued yield-seeking speculation. Most importantly, we've adapted in a way that avoids "hard-negative" market outlooks in periods where the uniformity of market internals is favorable (reflecting a preference of investors toward speculation rather than risk-aversion).

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Yet notice that none of those considerations apply once overvaluation is *joined* by unfavorable market internals. A century of market evidence demonstrates that the U.S. stocks have lost substantial value in periods where market internals have been unfavorable. Indeed, when unfavorable internals have emerged in the presence of overvalued, overbought, overbullish conditions, the S&P 500 has lost value, on average, *even during the advancing half-cycle since 2009*.

Distinctions matter. While reliable valuation measures are extremely useful indications of 10-12 year S&P 500 total returns, and of potential market losses over the completion of the market cycle, they are often useless over shorter segments of the market cycle when investors are highly inclined to speculate.

While overvalued, overbought, overbullish syndromes have historically been useful warnings of impending air-pockets, panics, and crashes, we've adapted to the fact that these syndromes have also been rather useless in the face of zero-interest rate policy and post-election enthusiasm that has encouraged continued speculation.

The key lesson, though, isn't to ignore valuations, or even "overvalued, overbought, overbullish" syndromes. The key lesson is to attend more explicitly to market internals, which are the most direct measure we've found to gauge the inclination of investors toward speculation or risk-aversion. Once deteriorating market internals *join* overvaluation, that overvaluation can suddenly matter with a vengeance. Once deteriorating market internals *join* extreme overvalued, overbought, overbullish syndromes, those syndromes can suddenly matter with a vengeance.

Understanding those distinctions will be essential in navigating the completion of this cycle, and those that follow.

A historically-informed approach is important, because we continue to see investors focused on far less reliable distinctions. For example, investors should understand that since 2009, a substantially larger portion of the cumulative gain in the S&P 500 has occurred in weeks that the index was *below* its 200-day moving average than in weeks when the index was above its 200-day moving average. Likewise, the S&P 500 has experienced net losses in periods since 2009 when the ISM Purchasing Managers Index was at or above current levels.

In a market that we continue to expect to lose more than -60% over the completion of this cycle, and where we estimate potential losses closer to -70% for many valuation deciles, the failure to make evidence-based distinctions may be ruinous for many investors. In particular, investors seem to imagine that they will be able to get out once the market breaks below, say, its 200-day moving average. More likely, at the point prices reach that level, those same investors will find it impossible to sell, insisting instead that the oversold dip should be bought. If you study prior bear market declines day-by-day, you'll find that the intermittent rallies and plunges have a psychological effect that encourages poorly-timed vacillation between trend-following strategies and competing swing-trading ones. The highly volatile spikes typically encourage investors to buy dips too early, panic when they spike even lower, then get sucked back in on fast, furious upward spikes that then fail spectacularly.

I remain convinced that historically-informed discipline is the proper approach. For our part, the adaptations we've made have restored our pre-2009 prioritization of market internals. Though extreme "overvalued, overbought, overbullish" conditions have historically been enough to warn of impending market losses, this time has been different, and we're open to the possibility that the change is permanent. The lesson of the recent half-cycle is about the ability of zero interest rates to encourage speculation (and maintain favorable market internals) long after extreme overvalued, overbought, overbullish conditions emerge. But distinctions matter. Once the uniformity of market internals – the most reliable measure of *speculation itself* – is knocked away, those extremes are still likely to matter with a vengeance.

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