Nobody's Right If Everybody's Wrong

What a field day for the heat / A thousand people in the street
Singin' songs and a-carryin' signs / Mostly sayin' hooray for our side.
-- Buffalo Springfield

The comedian Jonathan Winters used to do a bit about a baseball pitcher's thought process while trying to outfox the hitter. He keeps going one step ahead on what the hitter is expecting. The marvelous exercise in circular logic ends predictably with the ball landing somewhere in the distant seats.

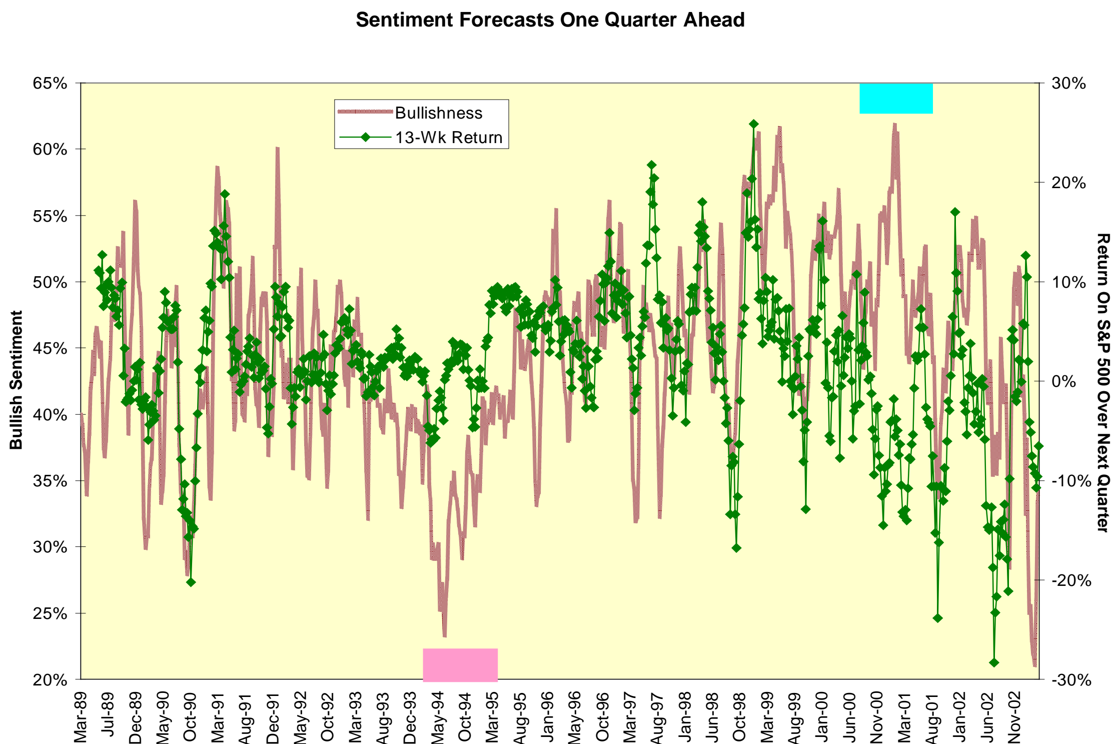
We may be approaching such a point in market analysis; sentiment commonly is used as a negative indicator, and everyone now has a rule for what to do when the VIX or the put/call ratio hit a certain levels. All of this is difficult to reconcile with the commonly held - but actually quite absurd - belief that markets somehow reflect wisdom deeper than the combined ignorance of participants therein.

Let's make three strong statements:

1. Sentiment is a surprisingly good indicator of market direction, as seen in the chart below
2. If the underlying economic value of any market changes, the market can move quickly and powerfully in that direction. There's a name for this condition: "Trend"
3. Markets do not and cannot forecast. They only can measure conditions prevailing in the here and now. Two parties can agree on a price for a time distant that protects their underlying economics but conforms to neither side's forecast. Where is the forecast content in this so-called reservation price?

Sentimental Forecasts

While markets do not forecast, it is not true that the opinions of professionals are collectively worthless. It is just that they operate with a lag. The best fit I have been able to determine is that bullish sentiment (Investors Intelligence prior to December 2002, American Association of Individual Investors thereafter) leads the return on the S&P 500 by thirteen weeks, or one calendar quarter.

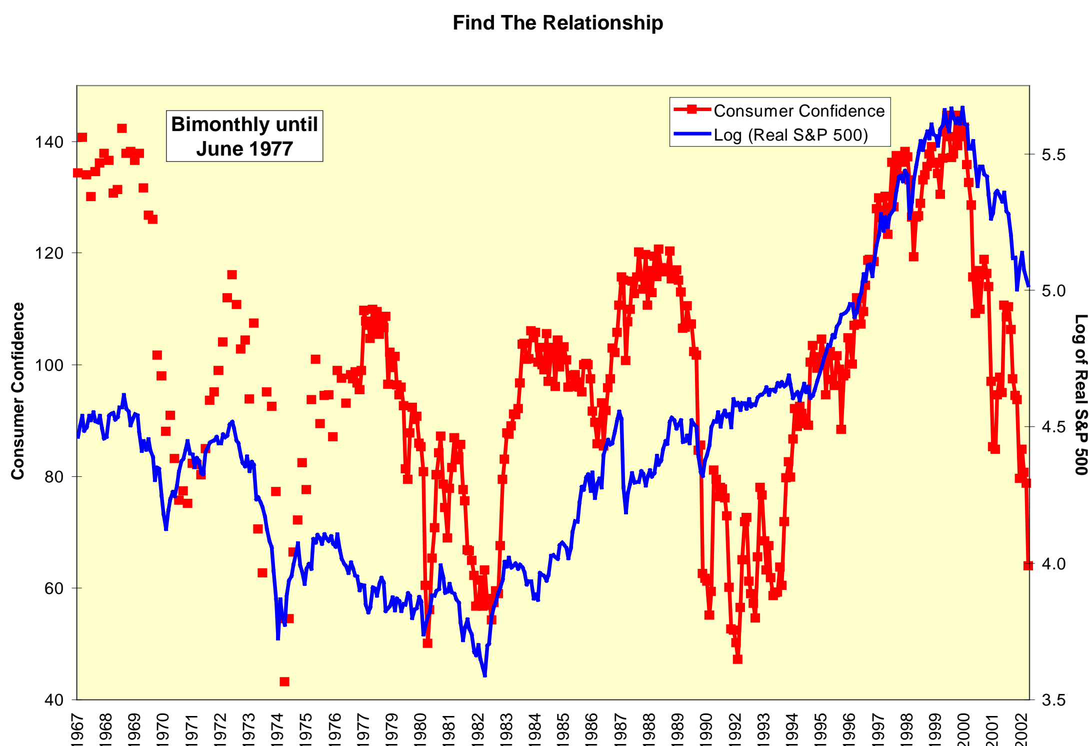


For those of you inclined to snarl that market pundits have been too bullish since the bear market began, you are correct over certain intervals, especially from the September 2000 through July 2001 period marked on the chart. On the other hand, the fearless forecasters fretted mightily during the Fed's 1994 series of rate hikes; this period preceded the eruption of the late 1990s bull market of blessed memory.

In both instances the priestly class appeared to be ascribing greater powers to Federal Reserve actions than The Powers That Were deserved. No surprise here over the respective outcomes.

A Consuming Passion

Consumer confidence as reported by the Conference Board, a number that recently has acquired market-moving status, has been far more of a cipher for stocks over long periods of time. A large plunge during and after the first Persian Gulf War did little to derail a slow advance in real equity prices. Conversely, a sharp jump in confidence in 1994 had no market impact.



Stocks and confidence tracked each other closely during the late 1990s bull market, but once the market broke, confidence has broken much further and faster even though the recession has been relatively mild, unemployment has not exceeded 6.0% and housing prices have strengthened. So, as the bartender said to the horse who just walked in, "Why the long face?"

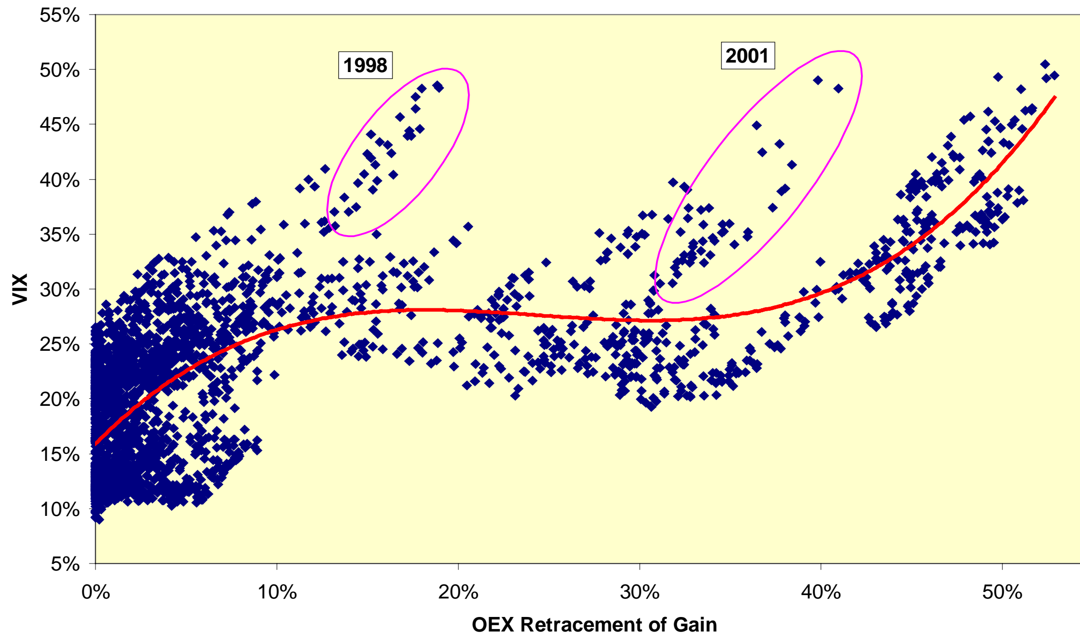
The answer, I believe, lies in a collective sense of remorse, the notion that we had something awfully good going, got greedy, and now will have to pay the piper for an indefinite period. After three years of being promised that happy days will be here again, we just don't buy it anymore. This shattering of confidence will take a long time to repair; it took a decade to get from Vietnam and Watergate to Reagan's Morning in America.

Tension And Regret

In my former life as a commodity research maven I used to publish what I called tension indices that captured more aspects of a market than price alone. For commodities with active forward curves, such as crude oil and natural gas, I used a combination of a trend oscillator, the relationship between implied and historic volatility and the shape of the forward curve as measured by the convenience yield. For short-term interest rates and currencies, I replaced the convenience yield with ratio of forward rates to horizon rates.

Stock indices presented another challenge: Stocks do not have a forward curve, and I can tell you that this has been a very difficult concept for stock traders to grasp in regard to single stock futures. The expectational variable for

stocks is contained in the price itself. I solved, or thought I solved per the discussion below, this problem by modeling the relationship between volatility, represented by the VIX, as a function of retracement of gain.



The relationship, as seen in the trend curve, is cubic. As the market hovers around its last new high, the VIX remains low. The big jumps in the VIX that occur in the first major declines to new lows are highlighted. The combinations on the right of high volatility and large retracements of gain are from July and October 2002.

What is clear to me at this juncture is that retracement of gain, which captured behavior well in the bull market, is insufficient in explaining current sentiment and equity tension. Who still measures the decline in their net wealth from March 2000 anymore? If you do, get over it. You might as well weep for the glory days of the Roman Empire.

I had hoped to complete a new statistical measure incorporating a time attenuation factor and a proximity-to-most-recent-low factor for this article. Talk about being unrealistic! Watch this space around the start of the baseball season for a new pitch that no one will expect.