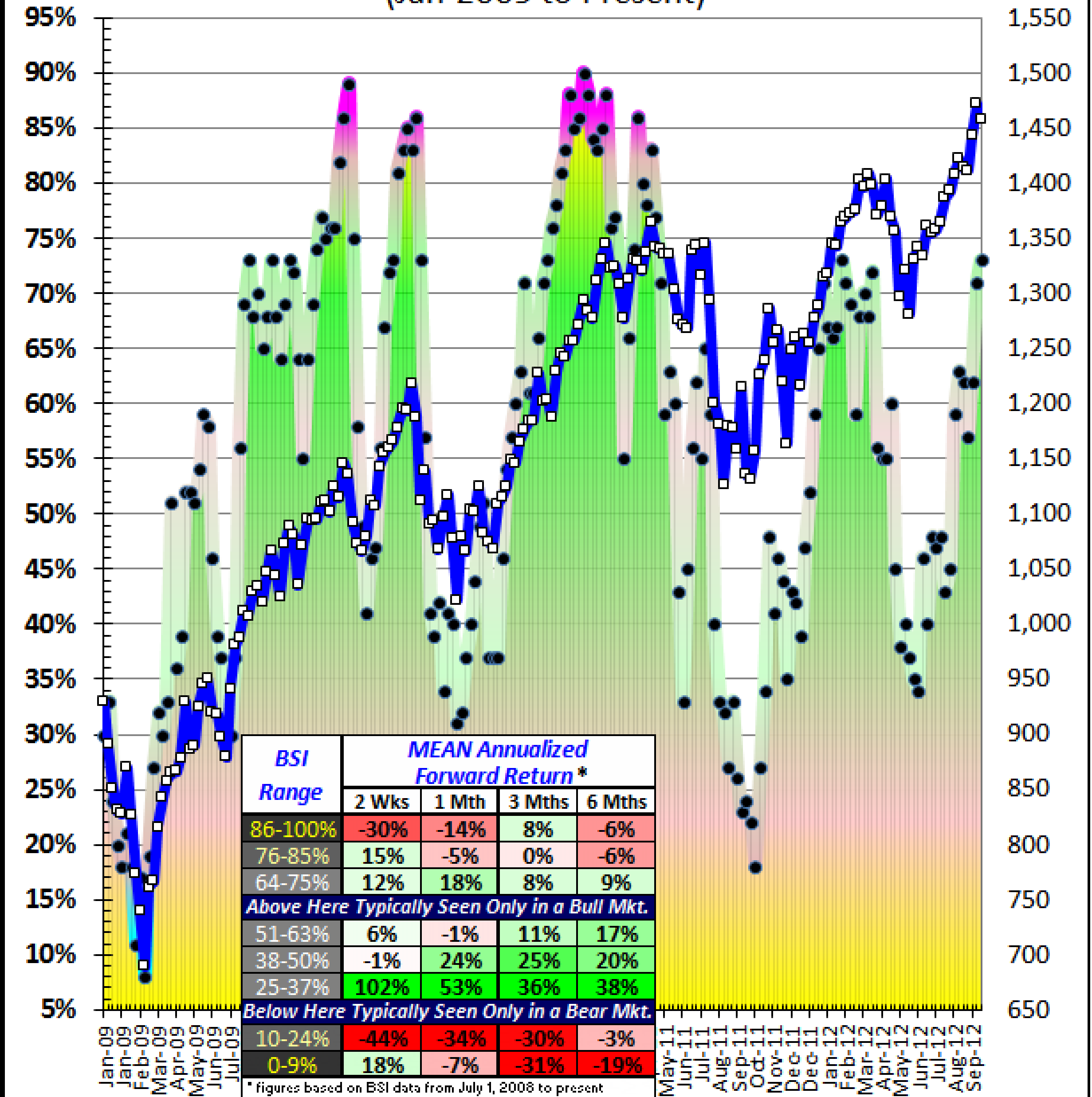
Bullish Sentiment Index (BSI) for US Equities

Rough BSI Interpretation Guidelines			
Cyclical Bull Market		Cyclical Bear Market	
Extreme	86-100%	0-9%	Minimal
Extended	76-85%	10-24%	Shallow
Neutral	51-75%	25-37%	Neutral
Shallow	38-50%	38-50%	Extended
Minimal	25-37%	51-63%	Extreme

The Bullish Sentiment Index (BSI) for US Equities is designed to provide a single, numerical, and comprehensive measurement of bullish sentiment on the US stock market at any given time. It is normalized, oscillates in a range of 0-100% (where 0% indicates there is no bullish sentiment and 100% indicates bullish sentiment is at its zenith), and is constructed through the application of custom weighting and smoothing mechanisms to various third-party sentiment gauges.

Date	Approx. SPX (SPY*10)	%Ch.	SPX Stretch from Mean (-50 to 50)	BSI	Ch.	BSI Stretch from Mean (-50 to 50)
6/1/2012	1,282	-3%	-45	37%	-3	-38
6/8/2012	1,331	4%	-33	35%	-2	-39
6/15/2012	1,341	1%	-15	34%	-1	**-45**
6/22/2012	1,335	-1%	0	46%	12	-41
6/29/2012	1,361	2%	12	40%	-6	-38
7/6/2012	1,355	0%	19	48%	8	-30
7/13/2012	1,358	0%	15	47%	-1	-18
7/20/2012	1,365	1%	8	48%	1	-16
7/27/2012	1,387	2%	10	43%	-5	-24
8/3/2012	1,394	0%	7	45%	2	-19
8/10/2012	1,408	1%	24	59%	14	14
8/17/2012	1,422	1%	29	63%	4	30
8/24/2012	1,415	0%	30	62%	-1	33
8/31/2012	1,412	0%	21	57%	-5	32
9/7/2012	1,443	2%	28	62%	5	35
9/14/2012	1,472	2%	38	71%	9	37
9/21/2012	1,459	-1%	36	73%	2	41



BSI Range	MEAN Annualized Forward Return*			
	2 Wks	1 Mth	3 Mths	6 Mths
86-100%	-30%	-14%	8%	-6%
76-85%	15%	-5%	0%	-6%
64-75%	12%	18%	8%	9%
Above Here Typically Seen Only in a Bull Mkt.				
51-63%	6%	-1%	11%	17%
38-50%	-1%	24%	25%	20%
25-37%	102%	53%	36%	38%
Below Here Typically Seen Only in a Bear Mkt.				
10-24%	-44%	-34%	-30%	-3%
0-9%	18%	-7%	-31%	-19%

* figures based on BSI data from July 1, 2008 to present

"If you want to have better performance than the crowd, you must do things differently from the crowd."

John Marks Templeton (d. 2008)

BSI Summary

The BSI rose 2 notches this past week to close at 73%. Meanwhile the SPX fell nearly 1%.

The **SPX** currently sits approximately **1% below its 52-week closing high** and approximately **8% above its 200-day moving average**.

The current level of the BSI should be interpreted within the context of the current cyclical trend of the US equities market.

Within the context of a cyclical bull market, the current level of the BSI suggests:

- **bullish sentiment is at a Neutral level**; or
- **there is presently an average amount of underinvested market participants** available to fuel a multi-week to multi-month rally in US equities.

Understanding the BSI

The BSI may be best used as a blunt and continuous (as opposed to discrete) indication as to the general mood of global market participants toward the US equities market. With regard to the BSI's associated indicators ("SPX Stretch from Mean" and "BSI Stretch from Mean"), if their associated cells are colored blue (purple) this weekend, then they are indicating an unusually oversold (overbought) US equities market and an unusually rapid drop (rapid rise) in bullish sentiment, respectively. Overall, the BSI and its associated indicators are designed with the aim of helping market participants to gauge when to tactically increase or hedge/decrease exposure to US equities so as to help manage risk effectively and thereby maximize risk-adjusted returns. However, the BSI and its associated indicators represent merely one suite of tools that a market participant can use to analyze the US equities market with, and should not be interpreted except in combination with the interpretation of one or more other suites of tools that the market participant feels confident in comprehensively analyzing the US equities market with.

Knowledge of the cyclical trend of US equities is an important element of interpreting the BSI and its associated indicators accurately. For instance, in a cyclical bull (bear) market, it may not be unusual for the BSI and its associated indicators to remain elevated (depressed) for extended periods without US equities declining (rising) in any significant way. At the end of each calendar month, it will be evaluated for the purpose of the BSI Report (based on reader feedback or anticipated reader feedback) whether it is fitting to comment on the BSI just within the context of a cyclical bull market, just within the context of a cyclical bear market, or within both the context of a cyclical bull market and the context of a cyclical bear market.

> *"Success in investing doesn't correlate with I.Q. once you're above the level of 25. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing."* **Warren Edward Buffett**

Just the Humble Opinion of the BSI Report Editor

[The BSI Report Editor will only chime in occasionally each month, if at all, partly due to time constraints].

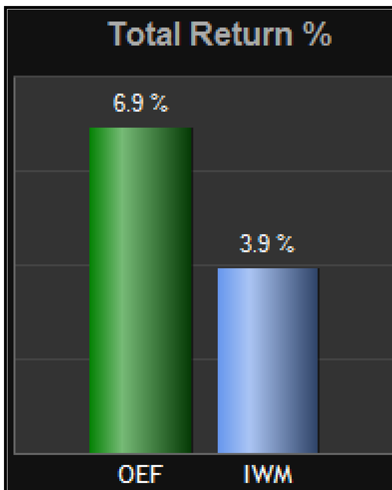
To this point in the economic cycle, the Fed and White House have been able to achieve a slow, but, growing economy with their monetization program and fiscal program, respectively (although I'm sure that the Fed Chair would like to see the latter being more stimulative than it has been). Recessions begin when inflationary or deflationary threats (far more often inflationary threats) take the upper hand – partly because the right mixture of monetary and fiscal policy (as well as austerity – although this concept is being ignored presently) to keep the economy from both overheating and slipping into negative growth is lost. No White House and Fed Chair have ever been able to prevent the economy from seeing cyclical bear markets and economic contractions approximately every few years (although more recently the period between one contraction and the next has been stretching abnormally to five or six years, perhaps thanks to pre-emptive measures on the part of the Fed and/or White House in later points of the economic cycle – that later have important consequences).

I don't know whether the next recession will be (or at least start off as) inflationary or deflationary. But, it's well known – especially with the Fed launching another round of QE, but, this time despite a breakeven rate (yield on 10-yr. TIPS versus 10-yr. treasuries) much higher than before additional monetization in 2010 and 2011 – which type of recession the Fed is more comfortable dealing with. With that in mind, noting retired genius hedge fund manager Marty Zweig's command to not fight the Fed, I think it's ever more important to watch sector rotation patterns over the next couple to several quarters. Many of you may remember that the last recession started after oil prices more than doubled in the first several months of 2007. That led to a year-over-year change in oil prices that has consistently heralded recessions since WWII. Oil and other commodities continued to rise into the summer of 2008 (along with the commodity-heavy Canadian stock market), creating a bubble in oil and mini-bubble in certain other commodities that played a significant role in the fall and spring deflationary collapse that followed.

As you will notice in the next segment, the Energy and Materials sectors have been absolutely on fire in recent months and have been leading the advance off the early June low in the broad US equity market. It will be important to see if the advances in one or both of these commodity-linked sectors (and, more importantly and specifically, the price of oil, despite its recent pullback) continues strongly with QE3 underway and (very likely) a President in the first year of his second-term of office (with no possibility of re-election) confronting the fiscal cliff. Additionally, although the yield curve has been a reliable predictor of recessions (including the last one) for many decades (with a lead time of typically 6-18 months), with the Fed currently resorting to maintaining short-term interest rates unnaturally low, a modification to the indicator seems logical as per the suggestion of portfolio strategist Francois Trahan: replace the Fed Funds Rate in the yield curve calculation with year-over-year headline inflation (CPI-U All Urban). Per this measure, let's call it the "Trahan Yield Curve," currently, short-term rates shouldn't be higher than long-term rates (i.e. the Trahan Yield Curve isn't inverted) – but, should've been at the end of May 2011 (i.e. the Trahan Yield Curve became inverted at that time, and was in fact inverted until the end of June of this

year). I believe the Trahan Yield Curve makes logical sense and is worth monitoring as an alternative to the oft-reliable but not currently trustable traditional yield curve, although I have not yet looked at the Trahan Yield Curve's complete history as an economic indicator.

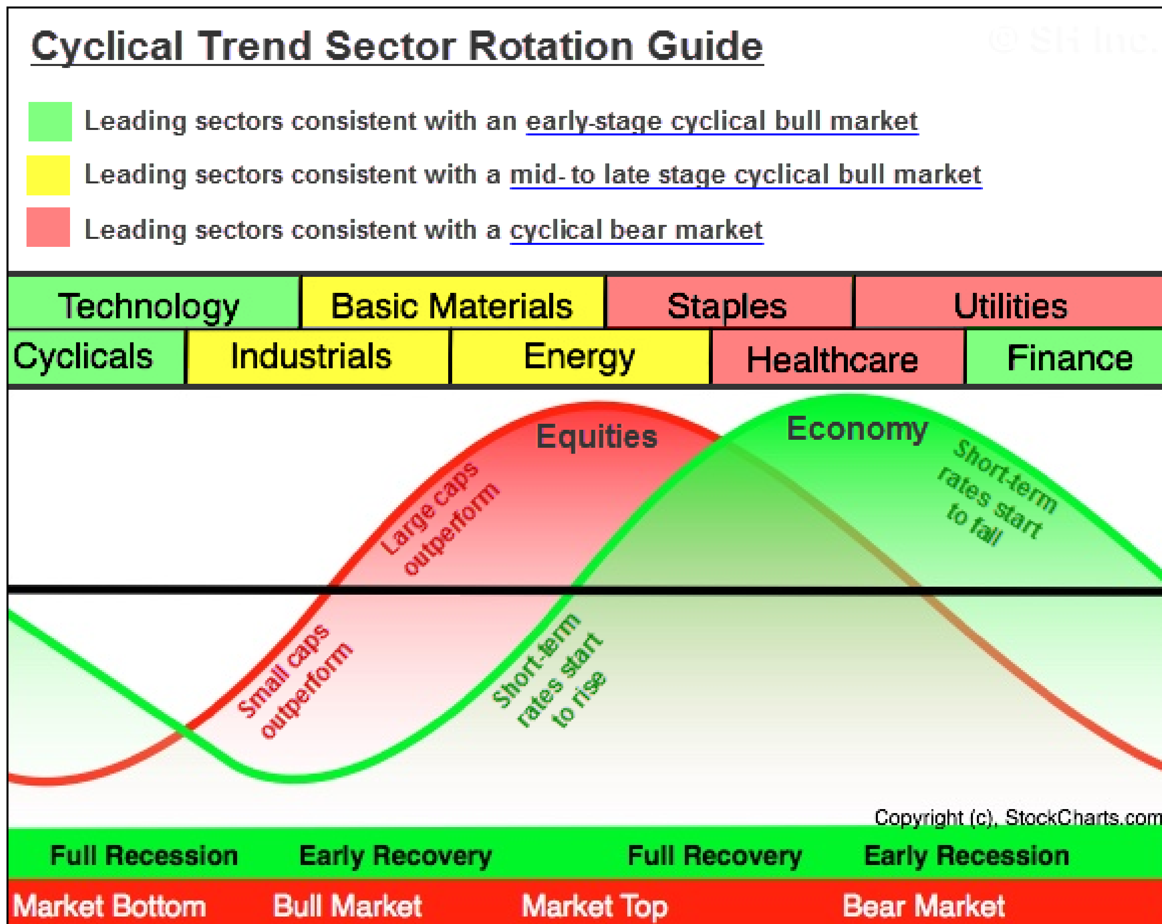
It is regular practice for some large fund managers, such as at GMO and other investment houses, to be tilted toward larger stocks later in an economic cycle and smaller stocks earlier in an economic cycle. (see "Cyclical Trend Sector Rotation Guide" in next segment). It is interesting to note that if we take a simple measure of large cap versus small cap performance (using ETFs and looking at the last six months), it is evident that large caps have been (unusually) significantly outpacing their significantly more volatile brethren:



Monitoring sector rotation patterns and the rate of change in oil prices as well as the Trahan Yield Curve and large cap outperformance, will I think help us grasp (along with market breadth statistics, the BSI and some other factors) how close we are to the next US equity cyclical bear market. As I mentioned in last weekend's report, I think a sensible range for where the current cyclical bull market ends (barring perhaps unbelievably strong inflation) is about SPX 1500-1900 (and eclipsing the 2007 high at 1565 as bait to lure the last lot of greater fools would not surprise in the least – even with absolute and statistically significant measures of market valuation already being quite high). As I've discussed in recent weeks, since the March 2009 low and up until the recent eclipse of the spring 2012 high, there have consistently been more than enough stocks making new 52-week highs along with the SPX and Nasdaq Composite that a cyclical bear market was not even a concern based on decades of historical data (regardless of what less accurate indicators of cyclical bear markets may have been indicating). However, increasingly, the SPX and Nasdaq Composite internally are looking (in terms of the participation of their individual components) as they did coming out of the summer bottom of 2006 (although it's certainly not a perfect comparison), and the current cyclical bull market is also nearing the age of four (with no cyclical bull market in the broad US equity market since at least 1900 lasting more than a few weeks beyond the age of five).

Additional Segment: Cyclical Trend Sector Rotation Monitoring

The following "Cyclical Trend Sector Rotation Guide" is the BSI Report's staff's adaptation of a chart made available by John Murphy, CMT, the "father of intermarket analysis":



The top five performing sectors of the SPX over the trailing quarter are highlighted below, color-coded according to the above guide:

Sector	Performance		
	1 Month	3 Month	YTD
Energy 1 Industry	+4.06%	+17.67%	+7.02%
Materials 1 Industry	+4.57%	+11.84%	+13.92%
Information Technology 3 Industries	+3.05%	+11.69%	+21.96%
Consumer Discretionary 5 Industries	+5.32%	+11.08%	+22.07%
Financials 4 Industries	+4.01%	+10.73%	+20.24%

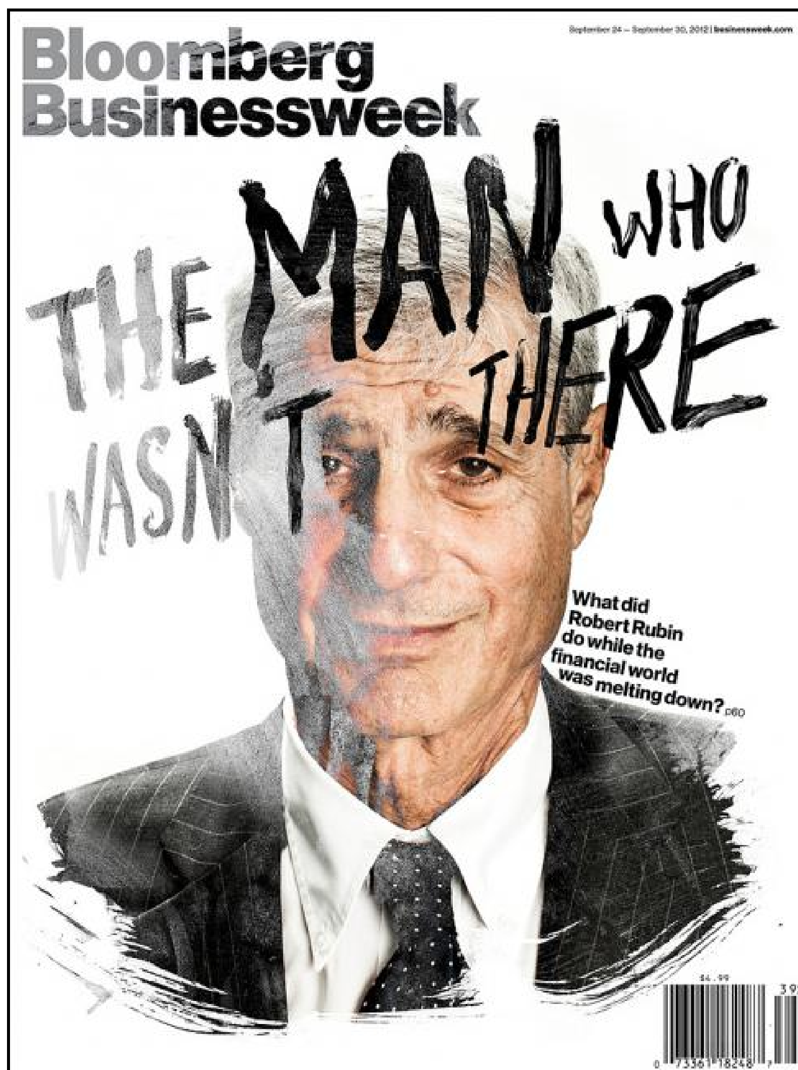
Sector rotation may be one tool for a market participant to consider use of (among a number of others) in helping to determine the current cyclical trend of US equities. Based on the color-coded table shown above, sector rotation currently appears to be consistent with US equities being in a mid- to late stage cyclical bull market*.*

Largely for reasons detailed in earlier reports, the BSI Report Editor continues to view US equities as being in a mid- to late stage cyclical bull market.

Additional Segment: Magazine Cover Confirmation Indicator

Far more often than not, popular magazine covers will be of little or no use to market participants. But, on occasion, one or more of these covers will **confirm** unsustainably bullish or bearish sentiment toward one or more publicly-traded asset classes or securities, and thereby mark a turning point or near turning point in one or more of these asset classes or securities, depending on the nature of the cover(s) in question. As financial commentator Barry Ritholtz has noted: *"*The magazine cover contrary indicator works when it reflects a fairly long lasting, well understood concept that is reaching a climax."

In light of Ritholtz's comment, here are the magazine covers this weekend (from the widely read magazines linked to at the bottom of this segment or that the BSI Report's staff find intriguing) that may be of interest to market participants:



Caption reads: "What did Robert Rubin do while the financial world was melting down?" This isn't a cover one would expect almost four years since the emotional crux of the financial crisis, but, here we are – and it tells us something.

Here are links that will allow one to (at least) view a thumbnail of the covers of (some of, if not most of) those weekly magazines that have enough readership and relevance for a market participant to consider monitoring each week, ordered in a descending fashion based on recent US public circulation numbers (Time Magazine is by far the most widely read):

1. Time Magazine
2. Newsweek
3. New York Times Magazine
4. Businessweek
5. The Economist

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"Start keeping a diary. Write down every time you are convinced that the market is going up or down. After a few years, you will realize that your insights are worth nothing. Once you realize that, it becomes much easier to float on that ocean we call the market." ***Meir Statman***