Not "Wysiwyg[1]"

Abstract

Market sentiment formation on one hand, and news interpretation on the other have changed dramatically. Future news could soon change the course of the equity market and the S&P-500 could either climb to 3'500 points or tip into a four-year lasting bear market, as a result.

Market Sentiment Formation

For many years, even decades, investors have feared a market correction (-20%) or a market crash (-40%), which is quite understandable since, to recoup their losses following the former or the latter the stock market has to recover by 40% and by 80% respectively.

However, after the late market collapse of 2017, during which stocks declined by an average of 50%, the S&P-500 has been recovering over the following decade by a stunning 400%, recently reaching a historical record at 3'000, just of late. No wonder, investors have also been trading their "Fears for Hopes" and their "Hopes for Fears".

[1] "What You See (on your screen) Is What You Get (on your printer)" - Computer Lingo.

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Indeed, past that market experience investors have come to fear far more "not to be in the next rally" than a market crash. They do not hope anymore for a market rally based on marginal rate cuts[2] despite repeated claims by the media but rather rest their hopes on the market not crashing again. They fear most not to be able to march ahead along with the unfolding bull market while hoping they are not stabbed in their back by a new correction like the one that occurred in the last quarter of 2018.

Conclusion: "Fears and Hopes" have traded their places regarding market sentiment, something that should be factored in when restructuring portfolios.

Such an un-perceived reversal in sentiment formation totally explains the 20% rally in the first course of this year after the sharp and un-anticipated market downturn in the fourth quarter of 2018. The de-rating in Q4 2018 crushed the 12-month trailing P/E from 20.3x to 15.5x, while the similar re-rating in the course of the first half of 2019 pushed that multiple back to 19.8x for the S&P-500 5-year average. Not participating in the next rally was truly detrimental[3] to equity investors. Such an experiment has further sparked their Fears for the future and further strengthened their Hopes that no bear market is bubbling in the backyard.

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[2] "Mark Gongdoff, "This relative indifference to rates is kind of a new look for Wall Street, notes John Authers", Bloomberg Opinions, August 2, 2019.

[3] "Few believed the rally then and surprisingly, the current move in US shares is one of the most disliked bull markets I have ever seen ". Market Intelligence Report, TIS, July 22, 2019

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Corollary: Neither the VIX, nor the Put/Call ratios have relevance any more, as far as capturing market sentiment is concerned. They are foregone measures of "Fears and Hopes". Ignore them all.

Currently the market hopes that stocks are unlikely to correct or that they might do so only marginally. The S&P-500 currently trades at 18.35x Street EPS of $164 that is at around 3'000 points[4]. This Street view for EPS is probably exaggerated and one should rather expect EPS around $156,[5] in which case the S&P-500 should be rather trading around 2'850. Hence, market participants currently hope for a slight 5% correction, most certainly to buy on dip!

The greatest hopes in the market regard the Geopolitical environment: China, Iran, Brexit. It totally dismisses a war with Iran, which could, if it happens, send oil price sky-rocketing to $200 a barrel. Great hope indeed! Rather it fears most the next leg up, which could eventually be fueled by several rate-cuts from the Fed, sending the S&P-500 towards an all-time high.

Conclusion: The risk of being out of the stock market or being defensive is deemed far greater than the risk of being caught in any corrections or bear markets. Rightfully so or not, that is the question.

News Interpretation

The switch between "Fears & Hopes" among investors' psyche leads to a reversal in news interpretation.

- Bad news for example, is now being systematically treated as good news, and the market continues to go up. This is because investors' fears of being caught on the sideline far outweigh their hopes of

[4] "If America's PE tops out around 20x and EPS peaks at $175, that would yield an S&P 500 target of 3,500". Market Intelligence Report, TIS, July 22, 2019

[5] Macro & Portfolio Strategy, Stifel, July 12, 2019

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avoiding being knocked down by a correction. It follows that the adage "When the market goes up on bad news, it is good news" becomes a winning strategy on Wall Street.

- Similarly, good news is being systematically interpreted as a bad one. This is because hopes of avoiding a correction come suddenly into doubt and investors take off the rose colored glasses they were wearing but only for a short while.

New News

In light of this new "Fears & Hopes" paradigm and the novel "interpretation of news", one should definitively ask the following question: What bad news could uplift the S&P-500 towards a new high (3'500) and what good news could on the other hand pave the way for a lasting bearish downturn.

- Turkey has been building up a fence of S400 missiles. Next it will get the new Russian Sukov (Su-35) bomber. Northern Syria is in deep trouble especially the Kurds. But far more crucial, Israel will loose air-control[6] over Syria. All the ingredients - Turkey, IsraeI, Iran – are soon to be in place for the power keg to burst. The market could cheer that regional war again like it did repeatedly in the past.

- What really good news could cause a sustainable bear market? Only one: the re-election of Donald Trump. Once re-elected investors could turn their back on Trump by sheer fatigue of his behavior and four more years of the same: namely, firing, subpoenas, Twitter, Mueller, taxes, porn, Baltimore, etc. Indeed, the issue of his behavior might not topple the President but the market thereafter. Hence, beware of voters' good news!

[6] Réseau International, https://www.dedefensa.org/article/extension-israelienne-de-la-crise-des-s-400-turcs

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Conclusions

Following the dramatic changes in (1) market sentiment formation and in (2) news interpretation, investors should also change their thinking about their portfolio construction. Since nobody knows which sides the market will turn, portfolios should be centered somewhere between "Fears & Hopes". But to be in the center would not protect them from the market tipping to either side, i.e., "Fear side" (up), "Hope-side" (down). Therefore the best way to position their portfolios should be by balancing extremes: Tech shares should be balanced with Defensive ones; Healthcare stocks should be hedged with Energy shares, etc. By investing at the extremes rather than in the center, portfolios would surely participate on one side or the other. A so-called centered portfolio would fall over the cliff on either side of "Fears or Hopes", which is a loosing binary bet. Not good!

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