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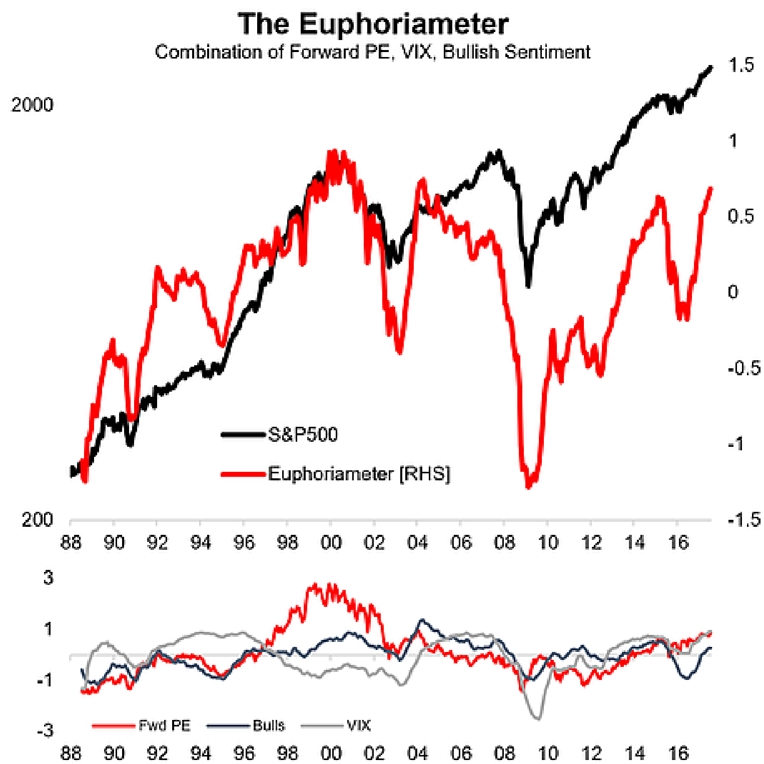
WHAT YOU DON'T SEE AT MARKET BOTTOMS: NO FEAR EDITION

Highlights

It is said that while bottoms are events, tops are processes. Translated, markets bottom out when panic sets in, and therefore they can be more easily identifiable. By contrast, market tops form when a series of conditions come together, but not necessarily all at the same time.

We have stated that while we don't believe the stock market has made its final cyclical top, we are in the late stages of a bull market (see *Four Steps, Where's the Stumble?*). Nevertheless, psychology is becoming a little frothy, which represents the pre-condition for a major top.

As a result, we are publishing a third report in a series of the "things you don't see at market bottoms", where we are seeing widespread signs of investor fearlessness.



Interested readers can review the reports in the first two editions in this series, *What You Don't See At Market Bottoms* and *What You Don't See At Market Bottoms: Euphoria and Wild Claims*.

What You Don't See at Market Bottoms

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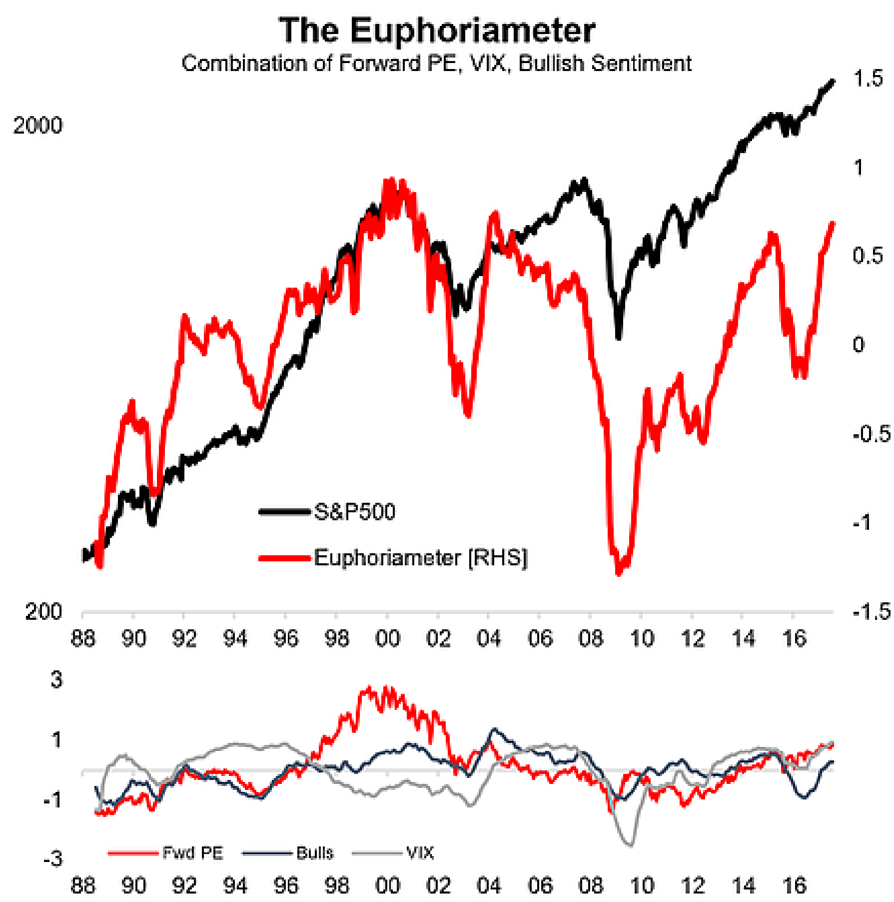
We have stated that while we don't believe the stock market has made its final cyclical top, we are in the late stages of a bull market (see *Four Steps, Where's the Stumble?*). Nevertheless, psychology is becoming a little frothy, which represents the pre-condition for a major top.

As a result, we are publishing another report in a series of "things you don't see at market bottoms". Numerous readings indicate that any semblance of investor fear has gone out the window. An update of the Euphoriameter from Topdown Charts shows that it has reached a new recovery high for this market cycle.

Exhibit 1: Euphoriameter



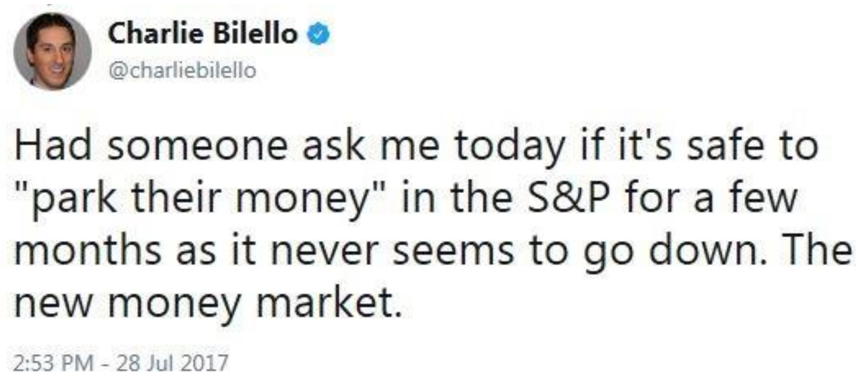
Source: Topdown Charts, Datastream

There are plenty of other examples of investor fearlessness.

Equities as the New Money Market

This tweet from Charlie Bilello is self-explanatory.

Exhibit 2: The New Money Market



Source: Twitter

[Shudder]

Then there was this *ahem* enticing ad that came across our desk.

Exhibit 3: Use Option Trading To Earn Income

Source: Google Ads

[Double shudder]

A Kid's Market

Mark Hulbert recently wrote that we are now in a "kid's market", where the "kids" with no fear are making all the money:

> *The concept of a "kids market" was introduced by Adam Smith, the pseudonymous author, in his classic book from the late 1960s entitled "The Money Game." He used that phrase to refer to an investment environment in which the advisers and traders making the most money are those too young to remember the last bear market.*
>
> *That would certainly appear to be the case today. The 2007-2009 financial crisis and bear market is now more than eight years in the past. Anyone younger than in their mid-30s probably wasn't even out of college or graduate school during that bear market, and therefore has little or no direct investment experience of a*

severe bear market. Their attitudes toward downside risk are entirely different from those of us who lived through that crisis, the bursting of the internet bubble, or other bloodbaths of investment history…

Consider the investment newsletters I monitor with the best risk-adjusted returns over the trailing 30 years (Investment Quality Trends, edited by Kelley Wright) and trailing 20 years (The Buyback Letter, edited by David Fried). Both of these ranking periods are long enough to encompass not just one but at least two severe bear markets. And neither of these top performers is currently recommending Amazon, Facebook or Netflix.

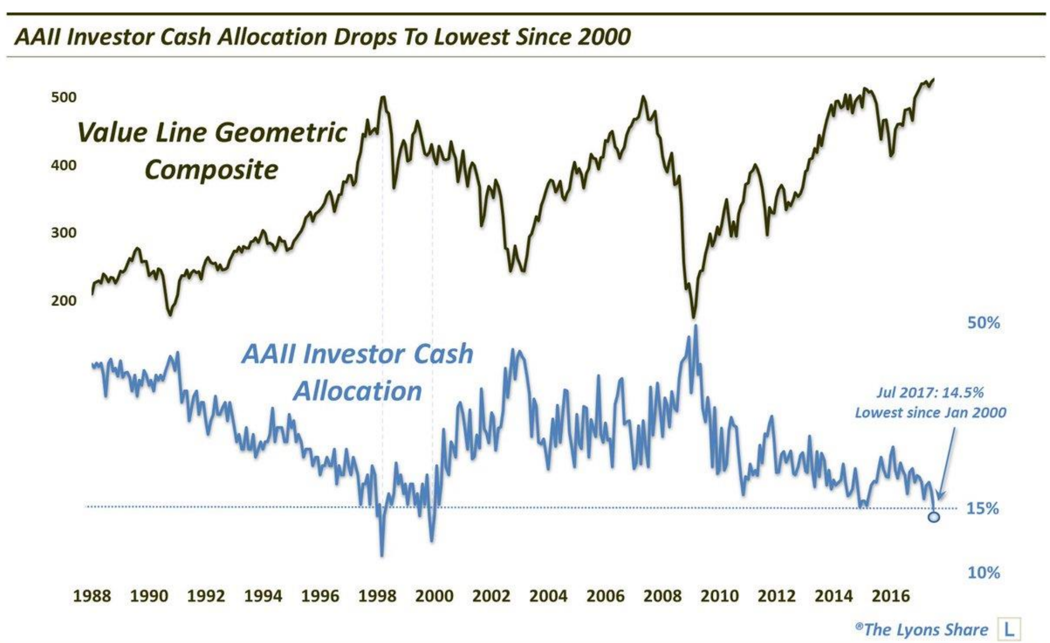
To be sure, kids markets can remain that way for some time. Eventually, however, the kids will encounter a bear market and, in the process, become older and wiser like the rest of us.

As another example of the "kids' market", Marketwatch reported on a survey indicating that millennials are far more bullish on equities than their elders:

*According to a quarterly investment survey from E*Trade Financial, nearly a third of millennial investors—defined as ones between the ages of 25 and 34—are planning to move out of cash and into new positions over the coming six months. By comparison, only 19% of Generation X investors (aged 35-54) are planning such a change to their portfolio, while 9% of investors above the age of 55 are planning to buy in.*

In addition, the AAII's asset allocation survey, which reports on what AAII members are actually doing in their portfolio rather than the volatile weekly sentiment survey, shows that cash allocations have reached a 17.5-year low, or the NASDAQ top. To be sure, the survey also reported that equity allocations edged down from a 12-year high, but readings are still ahead of levels seen at the start of the Great Financial Crisis.

Exhibit 4: Cash Allocation Levels at Levels Last Seen at the NASDAQ Top



Source: American Association of Individual Investors, Dana Lyons

Booming "Client Engagement"

The rise in retail investor appetite is exemplified by the comments that accompanied the financial results from Schwab, indicating that account openings are the strongest in 17 years, or since the NASDAQ market top:

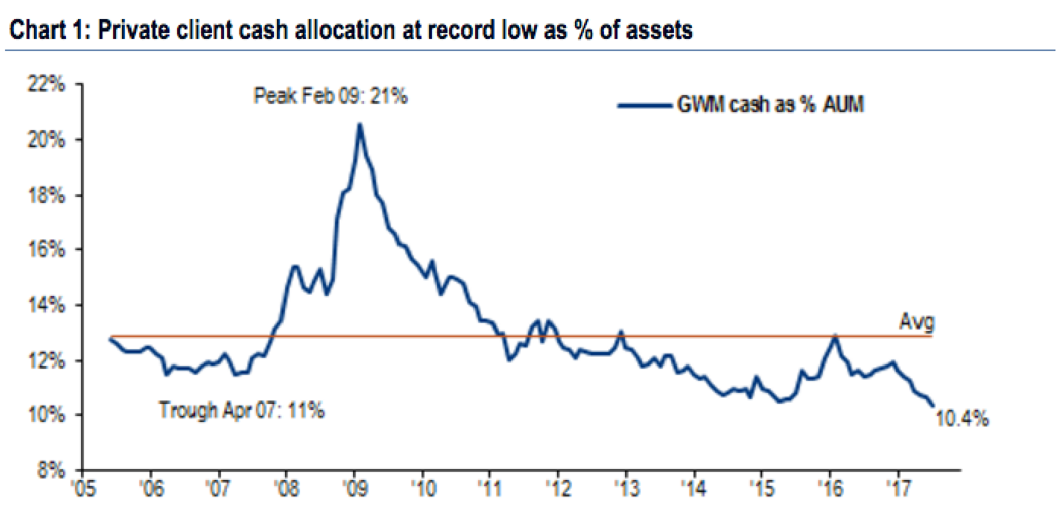
> *Strong client engagement and demand for our contemporary approach to wealth management have led to business momentum that ranks among the most powerful in Schwab's history. Equity markets touched all-time highs during the second quarter, volatility remained largely contained, short-term interest rates rose further, and clients benefited from the full extent of the strategic pricing moves we announced in February. Against this backdrop, clients opened more than 350,000 new brokerage accounts during the second quarter, bringing year-to-date new accounts to 719,000—up 34% from a year ago and our strongest first half total in seventeen years.*

These comments are consistent with our previous report about the comments from TD Ameritrade CEO Tim Hockey about "investor engagement" and "asset gathering":

> *Investor engagement has been resilient. High trading volumes despite ongoing volatility. We're seeing very, very healthy trends and new funded account growth, and asset inflows from both new and existing accounts. Asset gathering itself is a quarterly record, and we've already met our previous fiscal year record for net new assets with nearly a quarter yet to go.*

These comments about client and investor engagement are consistent with the BAML observation that private client cash is at all-time lows.

Exhibit 5: BAML Private Client Cash at All-Time Lows

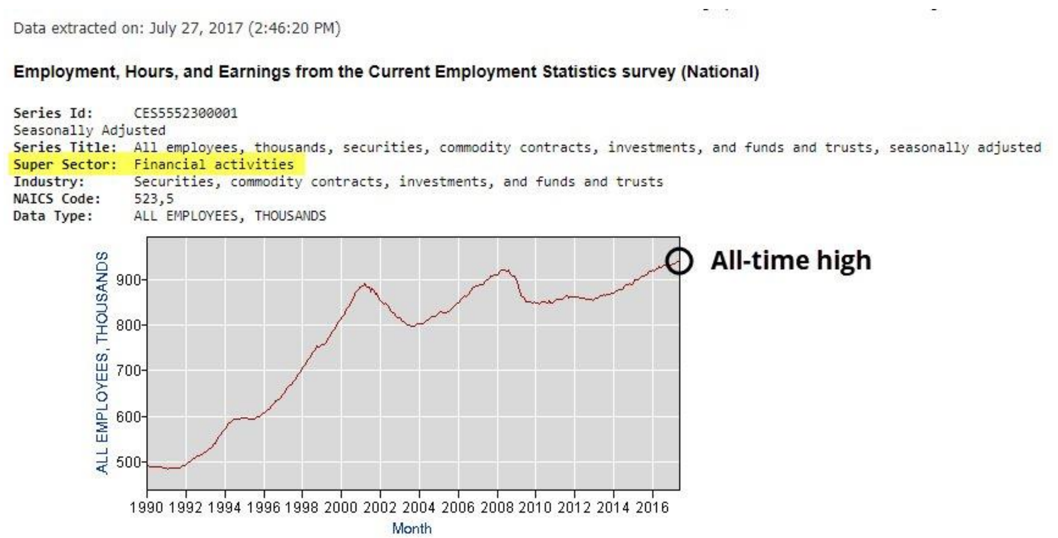


Source: Bank of America Merrill Lynch

Surging Street Employment

As a result of the retail boom, securities industry employment has risen to a new high.

Exhibit 6: Securities Industry Employment at All-Time High



Source: Sentiment Trader

No Fear in Credit Markets

The heightened appetite for risk has spread to the credit markets as well. Bloomberg recently pointed out that yield spreads in credit markets have become so tight that the rule of thumb of a bond coupon falling below a company's leverage is being violated:

> *Bond buyers have a rule of thumb that says be wary when the coupon on a new debt sale slips below the issuer's leverage. It's an indicator that investors aren't being paid enough for the risk they're taking on.*
>
> *This adage is being tested anew amid a bubble-like market, as issuers wear down buyers with deals that they'd spurn in almost any other era. One recent example is July's $500 million sale from HD Supply Waterworks. The water and wastewater company priced the debt beneath its 6.3 level of leverage, which measures debt as a multiple of earnings.*
>
> *Not only did the sale go through, but demand allowed HD Supply to boost it from $475 million and pay even less interest than initially asked, finishing at 6.125 percent.*

In a recent interview, Howard Marks cited the Argentina 100-year bond issue as well as the Netflix 10-year bond with a 3.625% coupon as signs of market froth (click here for video). Marks expressed concern about the maximum upside of 3.625% for a growth company like Netflix.

As a frame of reference, the latest statistics from Morningstar shows the NFLX interest coverage to be 2.8, and a debt-to-equity ratio of 5.3 — well above the 3.625% coupon.

Exhibit 7: Netflix Profitability and Leverage Ratios

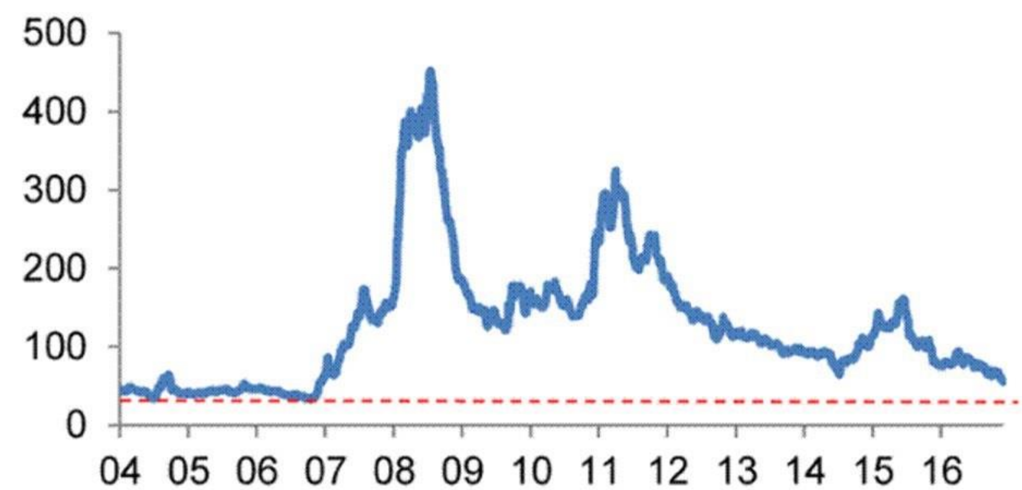
Profitability	2007-12	2008-12	2009-12	2010-12	2011-12	2012-12	2013-12	2014-12	2015-12	2016-12	TTM
Tax Rate %	39.95	36.86	39.72	39.91	37.10	43.73	34.30	23.63	13.56	28.34	11.07
Net Margin %	5.55	6.08	6.94	7.44	7.06	0.48	2.57	4.85	1.81	2.11	3.55
Asset Turnover (Average)	1.92	2.16	2.57	2.60	1.58	1.03	0.93	0.88	0.79	0.74	0.72
Return on Assets %	10.66	13.13	17.86	19.36	11.16	0.49	2.40	4.28	1.42	1.57	2.58
Financial Leverage (Average)	1.50	1.78	3.41	3.38	4.77	5.33	4.06	3.80	4.59	5.07	5.31
Return on Equity %	15.85	21.35	42.42	65.75	48.47	2.47	10.82	16.72	6.01	7.61	13.10
Return on Invested Capital %	12.96	17.92	28.10	35.38	30.10	2.73	8.83	13.39	6.46	5.53	8.84
Interest Coverage	—	—	30.68	14.64	18.95	2.53	6.87	7.56	2.07	2.74	2.80

Source: Morningstar

The increase in risk appetite is not just confined to the U.S. In Europe, corporate bond spreads have fallen to 10-year lows, propelled by ECB quantitative easing bond purchase programs that have created a shortage of euro-denominated bonds.

Exhibit 8: Europe Parties Like It's 2007

Figure 1: € iBoxx Corp OAS, bps



Source: Citi Research, Markit

5x Leverage ETPs

That's enough. We don't have time to talk anymore, we are heading back into the party and to trade the new 5x leverage ETPs.

Exhibit 9: 5x Leverage ETPs

Short & Leverage ETPs (31 product(s) available)   Export

Name	Type	Gearing	Expiry	Bid*	Ask*	Intraday Perf	+/- Spot	EPIC
SG FTSE 100 x5 Daily Short (GBP)	Daily Short	5x	11/05/2027	£ 79.960 (c)	£ 80.210 (c)	-1.77%	+0.48%	5SFT
SG Euro Stoxx 50 x5 Daily Long (GBP)	Daily Long	5x	12/03/2025	£ 50.210 (c)	£ 50.420 (c)	+5.31%	+1.24%	EU5L
SG Euro Stoxx 50 x5 Daily Short (GBP)	Daily Short	5x	12/03/2025	£ 15.985 (c)	£ 16.055 (c)	-5.88%	+1.24%	EU5S
SG FTSE 100 x3 Daily Long (GBP)	Daily Long	3x	28/07/2025	£ 141.380 (c)	£ 141.730 (c)	+1.09%	+0.49%	UKL3
SG FTSE 100 x3 Daily Short (GBP)	Daily Short	3x	28/07/2025	£ 42.230 (c)	£ 42.340 (c)	-1.05%	+0.49%	UKS3
SG FTSE 100 x2 Daily Long	Daily Long	2x	11/05/2027	£ 107.420 (c)	£ 107.560 (c)	+0.73%	+0.48%	2LFT
SG FTSE 100 x2 Daily Short	Daily Short	2x	11/05/2027	£ 92.010 (c)	£ 92.130 (c)	-0.71%	+0.48%	2SFT
SG Gold x3 Daily Long GBP	Daily Long	3x	11/05/2027	£ 104.420 (c)	£ 104.750 (c)	-2.10%	-3.08%	3LAU
SG Gold x3 Daily Short (GBP)	Daily Long	3x	11/05/2027	£ 92.870 (c)	£ 93.150 (c)	+3.63%	+3.09%	3SAU
SG Gold x5 Daily Long (GBP)	Daily Long	5x	19/05/2025	£ 84.330 (c)	£ 85.830 (c)	-4.04%	-5.13%	5GOL
SG Gold x5 Daily Long (USD)	Daily Long	5x	19/05/2025	$ 70.240 (c)	$ 71.490 (c)	-4.71%	-5.13%	5GUL
SG Gold x5 Daily Short (GBP)	Daily Short	5x	19/05/2025	£ 50.160 (c)	£ 50.930 (c)	+5.62%	+5.15%	5GOS
SG Gold x5 Daily Short (USD)	Daily Short	5x	19/05/2025	$ 41.760 (c)	$ 42.400 (c)	+4.79%	+5.15%	5GUS
SG DAX x5 Daily Long (GBP)	Daily Long	5x	12/03/2025	£ 52.590 (c)	£ 52.810 (c)	+5.10%	+1.20%	5DEL
SG DAX x5 Daily Short (GBP)	Daily Short	5x	12/03/2025	£ 16.375 (c)	£ 16.445 (c)	-5.65%	+1.20%	5DES
SG Silver x5 Daily Long (GBP)	Daily Long	5x	19/05/2025	£ 22.695 (c)	£ 23.040 (c)	-11.11%	-11.98%	5SIL
SG Silver x5 Daily Short (GBP)	Daily Short	5x	19/05/2025	£ 22.445 (c)	£ 22.790 (c)	+12.33%	+12.06%	5SIS
SG Natural Gas x3 Daily Long (GBP)	Daily Long	3x	28/07/2025	£ 4.429 (c)	£ 4.508 (c)	-2.53%	-3.20%	NGL3
SG Natural Gas x3 Daily Short (GBP)	Daily Short	3x	28/07/2025	£ 138.090 (c)	£ 140.540 (c)	+4.38%	+3.23%	NGS3
SG WTI x3 Daily Short (GBP)	Daily Long	3x	11/05/2027	£ 73.000 (c)	£ 73.230 (c)	+3.40%	+2.54%	3SWO
SG WTI x3 Daily Long (GBP)	Daily Long	3x	11/05/2027	£ 113.320 (c)	£ 113.670 (c)	-1.70%	-2.61%	3LWO
SG WTI Long x5 Daily Long (GBP)	Daily Long	5x	05/03/2026	£ 40.180 (c)	£ 41.000 (c)	-3.62%	-4.40%	5WTI
SG WTI Oil x5 Daily Short (GBP)	Daily Short	5x	19/05/2025	£ 12.175 (c)	£ 12.425 (c)	+5.35%	+4.19%	5OIS
SG WTI Oil x5 Daily Short (USD)	Daily Short	5x	19/05/2025	$ 10.135 (c)	$ 10.345 (c)	+4.30%	+4.19%	5OUS
SG FTSE 100 x5 Daily Long (GBP)	Daily Long	5x	12/03/2025	£ 113.010 (c)	£ 113.470 (c)	+1.82%	+0.49%	5UKL
SG EURUSD x5 Daily Long	Daily Long	5x	24/09/2025	$ 117.130 (c)	$ 117.550 (c)	-5.06%	-5.40%	LEU5
SG GBPUSD x5 Daily Long	Daily Long	5x	24/09/2025	$ 31.870 (c)	$ 31.990 (c)	-3.90%	-4.14%	LGB5
SG JPYUSD x5 Daily Long	Daily Long	5x	24/09/2025	$ 134.630 (c)	$ 135.310 (c)	-3.09%	-3.46%	LJP5
SG EURUSD x5 Daily Short	Daily Short	5x	24/09/2025	$ 57.070 (c)	$ 57.280 (c)	+5.10%	+5.41%	SEU5
SG GBPUSD x5 Daily Short	Daily Short	5x	24/09/2025	$ 151.400 (c)	$ 151.940 (c)	+3.86%	+4.14%	SGB5
SG JPYUSD x5 Daily Short	Daily Short	5x	24/09/2025	$ 39.380 (c)	$ 39.590 (c)	+3.12%	+3.45%	SJP5

Source: Societe Generale U.K.

Investors, Be Prepared!

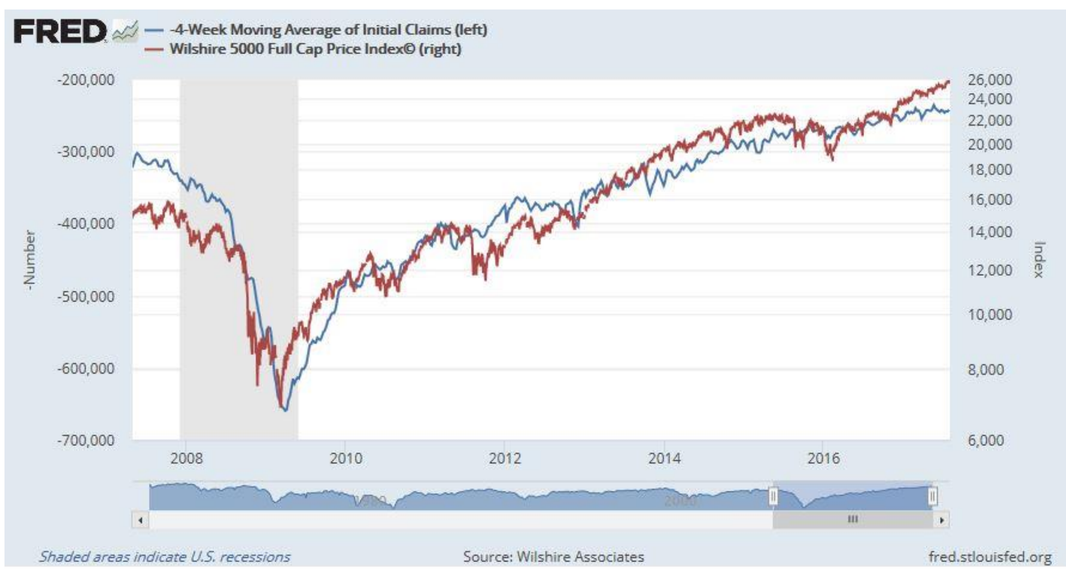
For now, we believe the frothy excess that we have cited in this and past reports represents a "this will not end well" narrative without an obvious bearish trigger. However, sentiment doesn't function well as precise market timing tools.

There are several ways for investors to position themselves in this environment of heightened risk. Balanced fund investors may wish to re-balance the portfolio policy weights from a risk-on profile. Equities have outperformed bonds for several quarters and investors with balanced fund mandates will have seen their equity weights naturally drift upward. Re-balancing back to policy weight can be viewed as a prudent course of action.

Investors with equity-only mandates may also wish to take steps to prepare for a possible recession in the next 1–2 years by avoiding stocks with high bankruptcy risk. Managers can still outperform by avoiding the losers under a recessionary scenario. We have conducted a full study of our bankruptcy analysis on the non-financial stocks in the S&P/TSX Composite and the Russell 3000. Clients who would like a copy please contact Ed Pennock at (647) 287-6800 or by email at ed@pennockideahub.com.

For traders, the nowcast of short-term indicators remain bullish. The following chart shows the 4-week average of initial jobless claims and the S&P 500. The two data series has shown a remarkable inverse correlation during this expansion cycle.

Exhibit 10: Initial Jobless Claims and Wilshire 5000



Source: FRED, Federal Reserve Bank of St. Louis

We reiterate our belief that this is not the top of the equity market (see our recent report, *Four Steps, Where's the Stumble?*). Nevertheless, investors should be aware of the risks of an environment in which sentiment has become increasingly frothy without regard of the risks involved.

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