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Quantitative & Strategy

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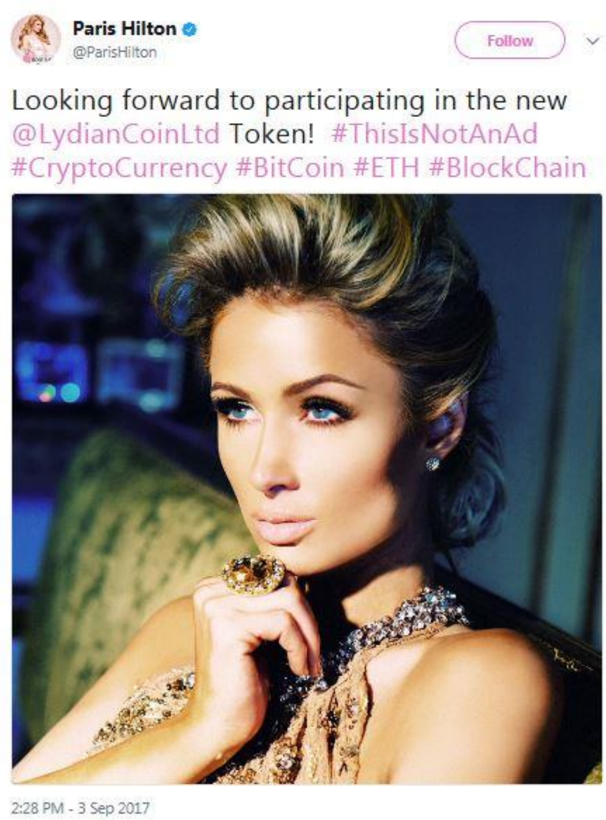
WHAT YOU DON'T SEE AT MARKET BOTTOMS: PARIS HILTON EDITION

Highlights

It is said that while bottoms are events, tops are processes. Translated, markets bottom out when panic sets in; therefore, they can be more easily identifiable. By contrast, market tops form when a series of conditions converge, 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 fourth report in a series of the "things you don't see at market bottoms", where we are seeing widespread signs of investor euphoria.



Interested readers can review the reports in the first two editions in this series, *What You Don't See At Market Bottoms*, *What You Don't See At Market Bottoms: Euphoria and Wild Claims* and *What You Don`t See At Market Bottoms: No Fear Edition*.

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?* and *The Music Is Still Playing, Should You Keep Dancing*). Nevertheless, psychology is becoming a little frothy, which represents the pre-condition for a major top.

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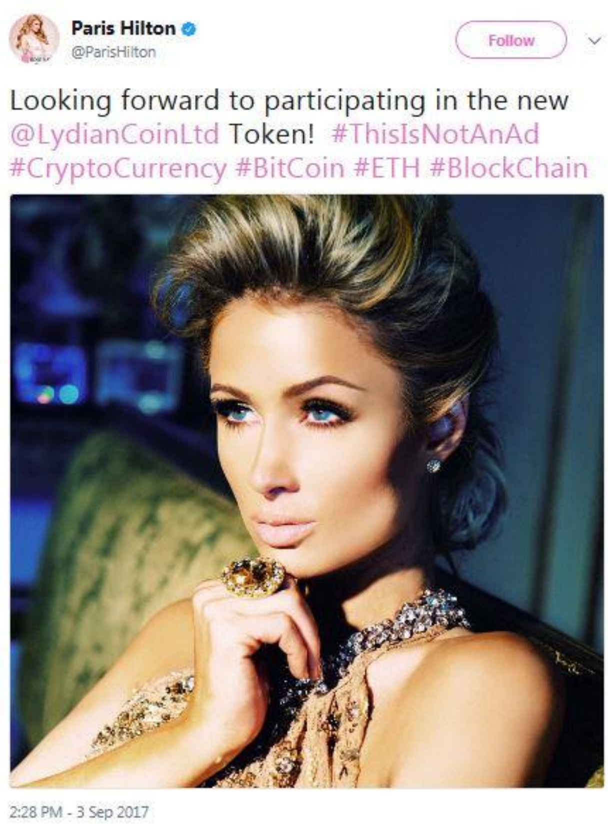
Cryptocurrency Mania

No doubt many investors have heard about the parabolic rise in the value of many cryptocurrencies. Now there is a gold rush to cash in on Initial Coin Offerings, otherwise known as ICOs.

Now Paris Hilton, the woman who is known for…being famous, has gotten into the act.

Exhibit 1: The Paris Hilton Lydian Coin Tweet



Source: Twitter

What exactly is the Lydian Coin? FT Alphaville explains:

> *Lydian Coin is from a company called Gravity4, whose chairman and chief executive, Gurbaksh Chahal, pleaded guilty in 2014 to misdemeanour battery charges of domestic violence.*
>
> *The digital advertising business claims to be "the world's first A.I. big data marketing cloud" and is raising $100m (!!!) through the sale of Lydian "tokens" to finance the development of… well, nothing really:*
>
> > *100% of the proceeds raised by the sale of Lydian tokens will be held by LydianCoin Pte. (in fiat currency or cryptocurrency, as financial, security, and other considerations may demand) as reserves against the cost of services to be performed for Lydian token holders upon negotiation of the token back to Lydian.*
>
> *If the whitepaper is to be believed, the whole idea here is that people will pay for Lydian tokens and use them to buy advertising campaigns from LydianCoin, which in turn licences its technology, products and services from Gravity4. The money won't be used for anything. It will just sit there, covering the enormous balance sheet liability this ICO will create for LydianCoin.*

In other words, the Lydian Coin is nothing more than a gift card for services that you could have bought with ordinary money:

> *We've often talked about how ICOs are like buying funfair tickets for a funfair that hasn't been built yet. This is like buying tokens for rides at a funfair when you could just use your money to pay for the rides directly. All that's really happening here is people are paying for services in advance of receiving them, like purchasing a giftcard.*

Not to be outdone, hedge fund manager, author and venture capitalist, James Altucher, has now moved to the Dark Side, and he is now flogging cryto-currencies.

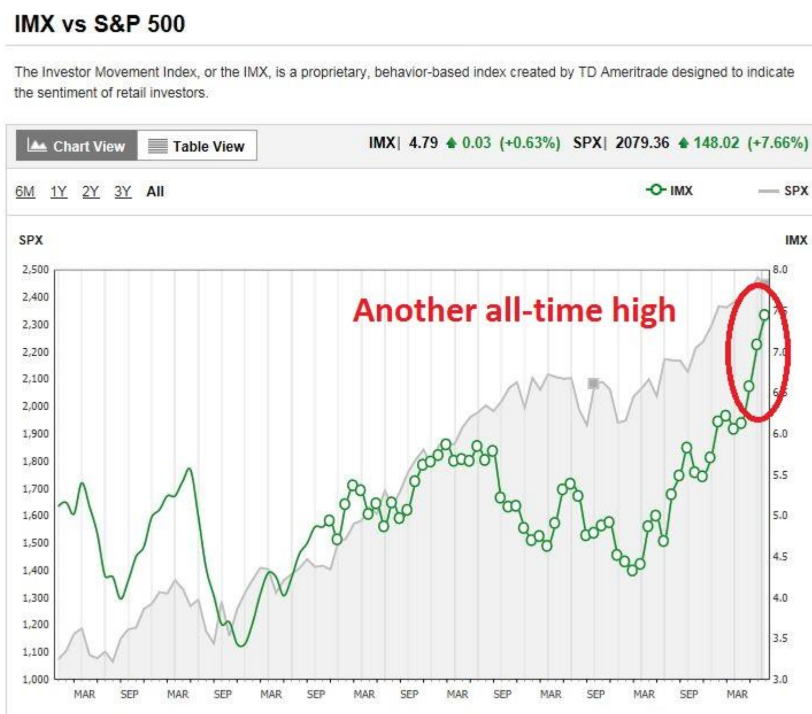
Exhibit 2: James Altucher Now a Spokesman for Cryto-currencies

Source: Facebook Ads

Retail Investor Mania

An update of the Investors Movement Index from TD Ameritrade, which measures Ameritrade client bullishness, shows that readings have reached another all-time high.

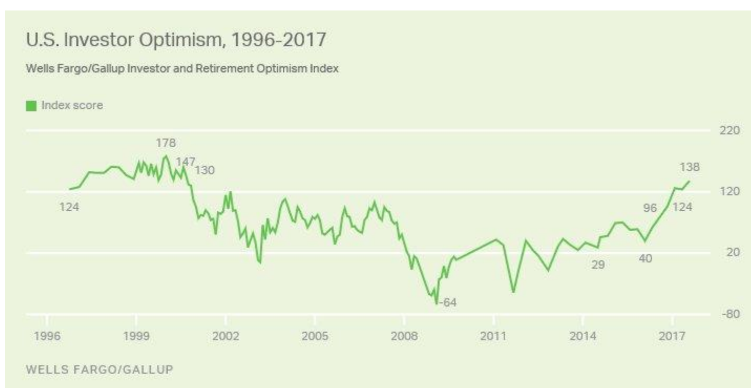
Exhibit 3: TD Ameritrade Retail Sentiment Hits Another All-Time High



Source: TD-Ameritrade

The Wells Fargo/Gallup investor optimism poll provides a longer term perspective. This poll shows investor confidence at a 17-year high.

Exhibit 4: Wells Fargo/Gallup Investor Confidence At A 17-Year High



Source: Gallup

Former Target Manager Starts Hedge Fund

We present this story in the New York Times, which speaks for itself:

> *Each morning, at the market's open, Seth M. Golden, a former logistics manager at a Target store, fires up the computer in his home office in northern Florida and does what he has done for years: Put on bets that Wall Street's index of volatility, the VIX, will keep falling.*
>
> *It has been a lucrative strategy as the so-called fear gauge has been, outside of the occasional spike, largely fearless — confounding experts by sloping persistently downward and in the process making Mr. Golden a multimillionaire.*

Seth Golden's trading strategy has been…well…golden:

> *Mr. Golden, who is 40, lives in a suburb of Ocala, Fla. Since he has been shorting VIX, he says his net worth has gone to $12 million from $500,000 in about five years.*

The vol shorting strategy has been so successful that he is starting a hedge fund:

> *Now, he is starting a hedge fund dedicated to wagering against the VIX. Investors, he says, have been pounding on his door to get in early, offering him $100 million for starters.*

David Merkel, former actuary turned portfolio manager, had these sensible but sobering words of caution for volatility traders:

> *It is like the credit cycle in many ways. There are two ways to get killed playing credit. One is to speculate that defaults are going to happen and overdo going short credit during the bull phase. The other is to be a foolish yield-seeker going into the bear phase.*
>
> *So it is for people waiting for volatility to spike — they die the death of one thousand cuts. Then there are those that are short volatility because it pays off when volatility is low. When the spike happens, many will skinned; most won't recover what they put in.*
>
> *It is tough to time the market, whether it is equity, equity volatility, or credit. Doesn't matter much if you are a professional or amateur. That said, it is far better to play with simpler and cleaner investments, and adjust your risk posture between 0-100% equities, rather than cross-hedge with equity volatility products.*
>
> *Again, this is one where people are very used to selling every spike in volatility. It has been a winning strategy so far. Remember that when enough people do that, the system changes, and it means in a real crisis, volatility will go higher than ever before, and stay higher longer. The markets abhor free riders, and disasters tend to occur in such a way that the most dumb money gets gored.*
>
> *Again, when the big volatility spike hits, remember, I warned you. Also, for those playing long on volatility and buying protection on credit default — this has been a long credit cycle, and may go longer. Do you have enough wherewithal to survive a longer bull phase?*

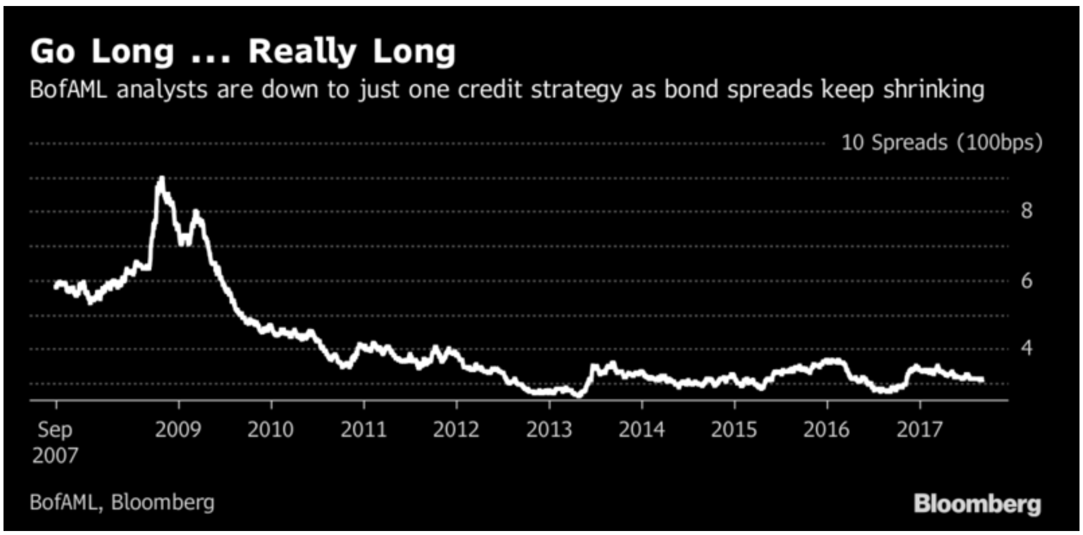
It's like picking up pennies in front of a steamroller. Use some leverage, and you start to make substantial money.

Merrill Lynch Credit Analysts Down to One Idea

You know that a market is extended when sell-side analysts run out of ideas. After a relentless search for yield, BAML credit analysts have become exhausted. Bloomberg reported that they are down to one idea for fixed income investors:

> *Years of record-breaking new issuance combined with risk premiums that continue to narrow amid a seemingly insatiable appetite for credit, have resulted in what can only be described as a case of "sell-side block" for investment strategists at Bank of America Merrill Lynch.*
>
> *In a note published on Wednesday, the team said it was "down to one" strategy in global credit: "just long U.S. investment grade." The bank closed out a recommendation to buy exposure to junk-rated European company debt while shorting the region's investment-grade bonds through two of the credit indexes in the Markit iTraxx family.*

Exhibit 5: Cash Allocation Levels at Levels Last Seen at the NASDAQ Top

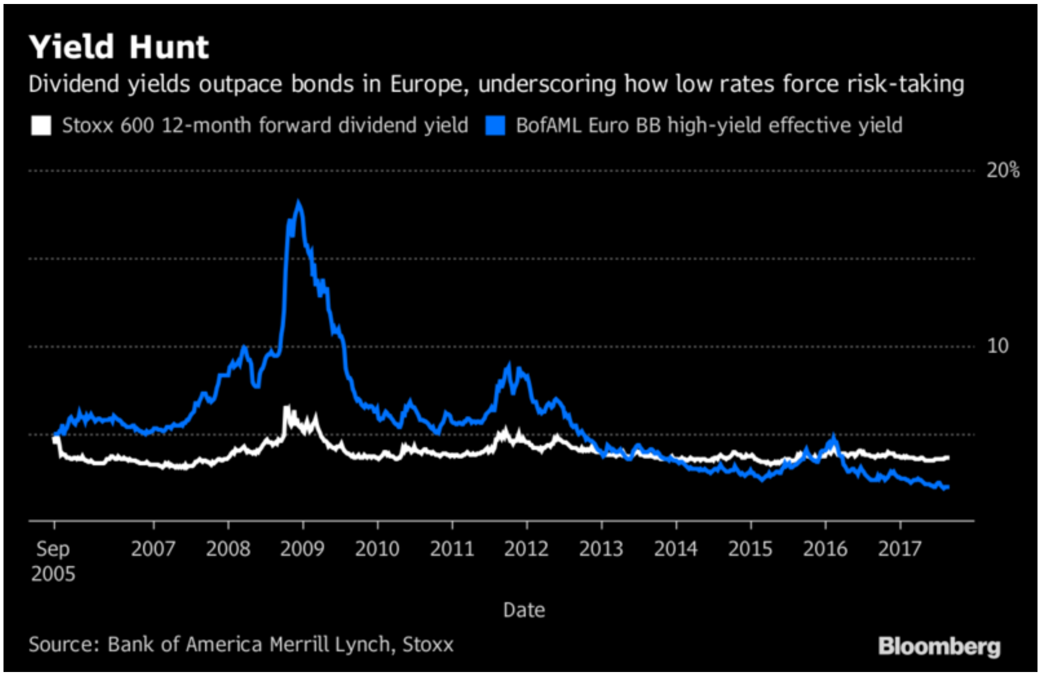


Source: American Association of Individual Investors, Dana Lyons

In a related comment about the search for yield, CNBC reported that Goldman Sachs CEO Lloyd Blankenfein expressed his unease about the general state of risk appetite in an interview at a European banking conference:

> *When yields on corporate bonds are lower than dividends on stocks that unnerves me. The biggest problem, the anxiety that people have, is non-specific to what asset we are pointing to but the general feeling that things have been going up for too long.*

Exhibit 6: STOXX 600 Dividend Yield Lower than Corporate Bonds



Source: FactSet Information Systems

Investors, Be Prepared!

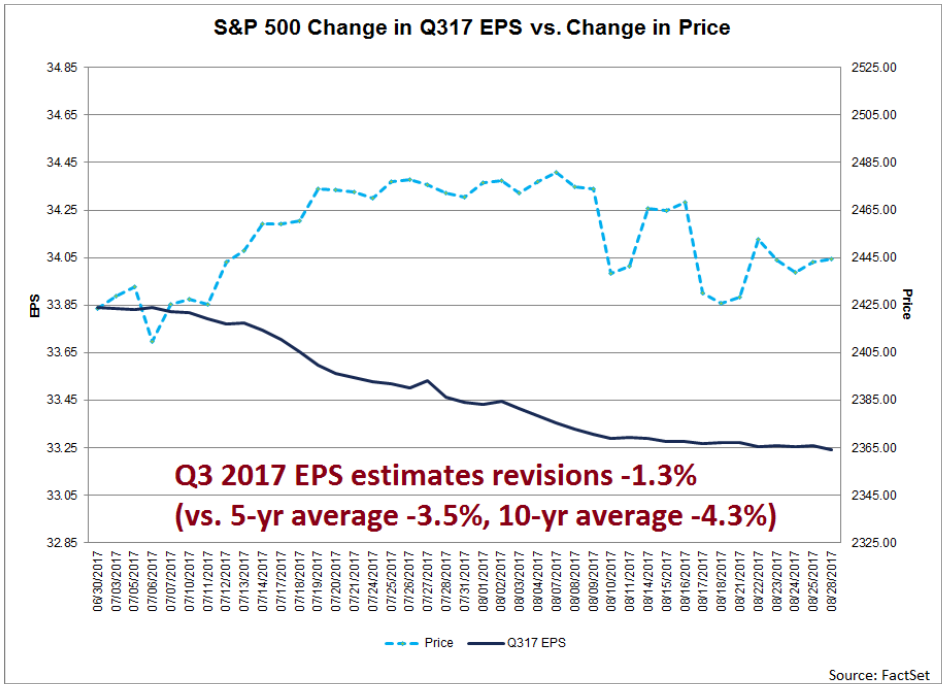
For now, we believe the frothy excess that we have cited in this and past reports represents a "this will not end well" narrative without an obvious bearish trigger. However, sentiment doesn't function well as precise market timing tools.

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 in 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. As seasoned investors know, Street analysts tend be overly optimistic in their EPS estimates and they revise downward as the actual reporting period approaches. The latest analysis from John Butters at FactSet shows that Q3/17 EPS estimates are being revised downward much more slowly than the historical experience, which is bullish.

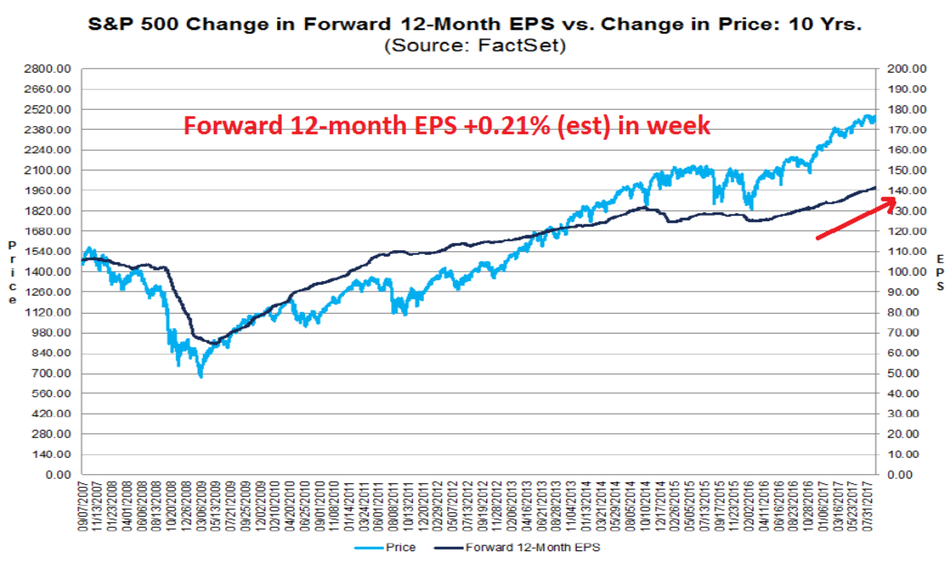
Exhibit 7: Q3 EPS Estimate Revisions Better than Average



Source: FactSet Information Systems

As well, the forward 12-month EPS is still rising, which is another indicator of Street optimism.

Exhibit 8: Forward 12-month EPS Still Rising



Source: FactSet Information Systems

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.

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