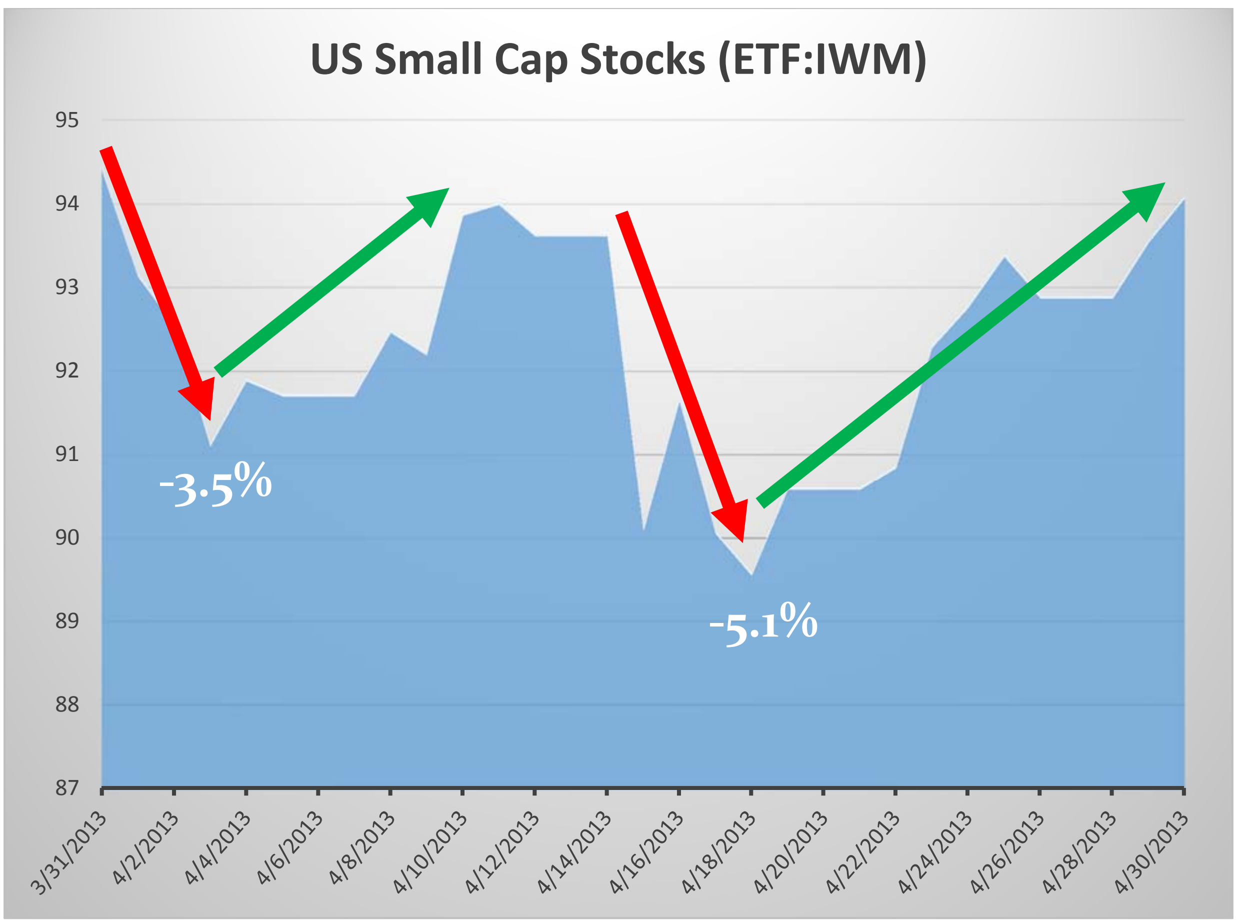
You're Never Alone With a Schizophrenic

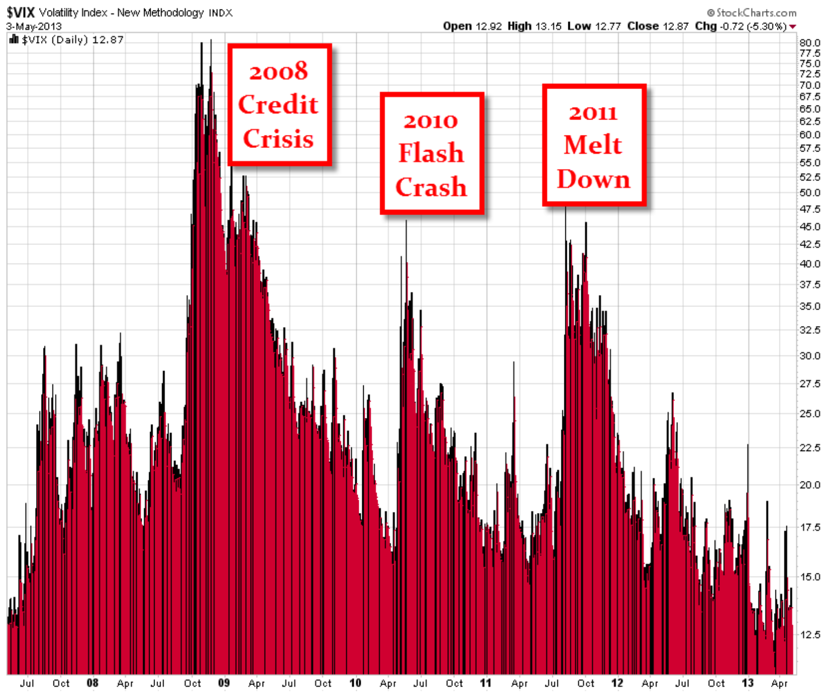
Readers who know me well are aware of my love affair with classic rock and blues music. As the markets gave us a rollercoaster ride in the month of April, I was drawn back to 1979 and borrowed the title for this piece from an album by Ian Hunter*. There were four things that brought on that bipolar feeling in April. First was a rollercoaster ride in the equity markets. Second was the violent volatility of volatility. Third, we saw stocks hovering at new highs while interest rates were trending lower – something that ain't usually the case. Fourth, with stocks near their all-time highs, the number of individual stocks trading above their recent averages has actually been declining – what we call a negative divergence in market breadth.

Rollercoaster Ride: Using US small cap stocks as an example, you can see on the chart below that they dropped 3.5% in the first three days of April, got back about even, then dropped 5% mid-month and climbed back up to end the month just shy of where they started. That's what I call manic indecision – a lot of gyration but no real progress.

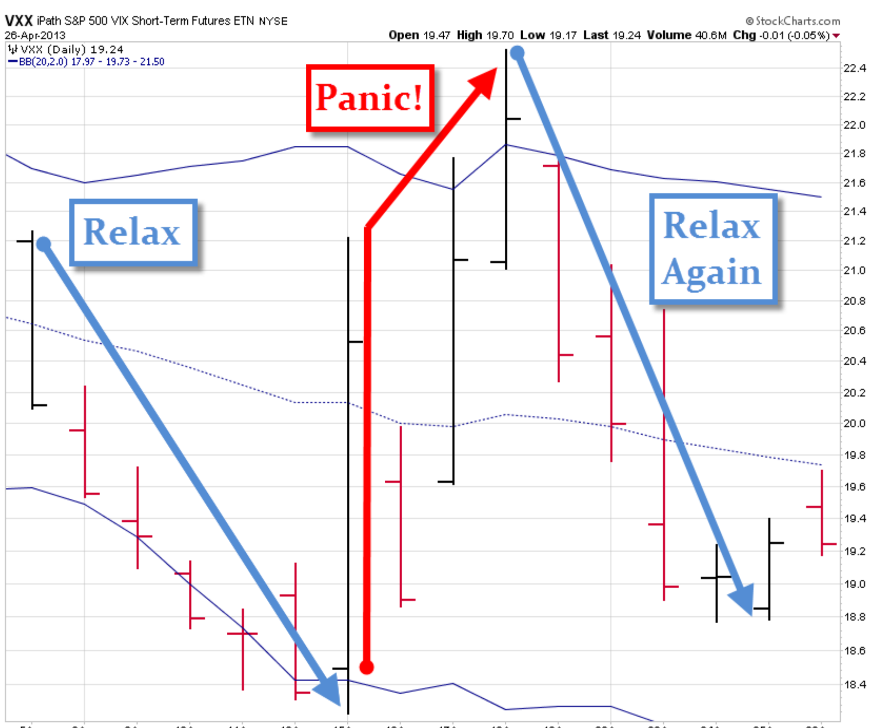


*Best remembered (at least by those of a certain age) for his band Mott the Hoople and the songs *All the Young Dudes, All the Way From Memphis,* and *Cleveland Rocks.*

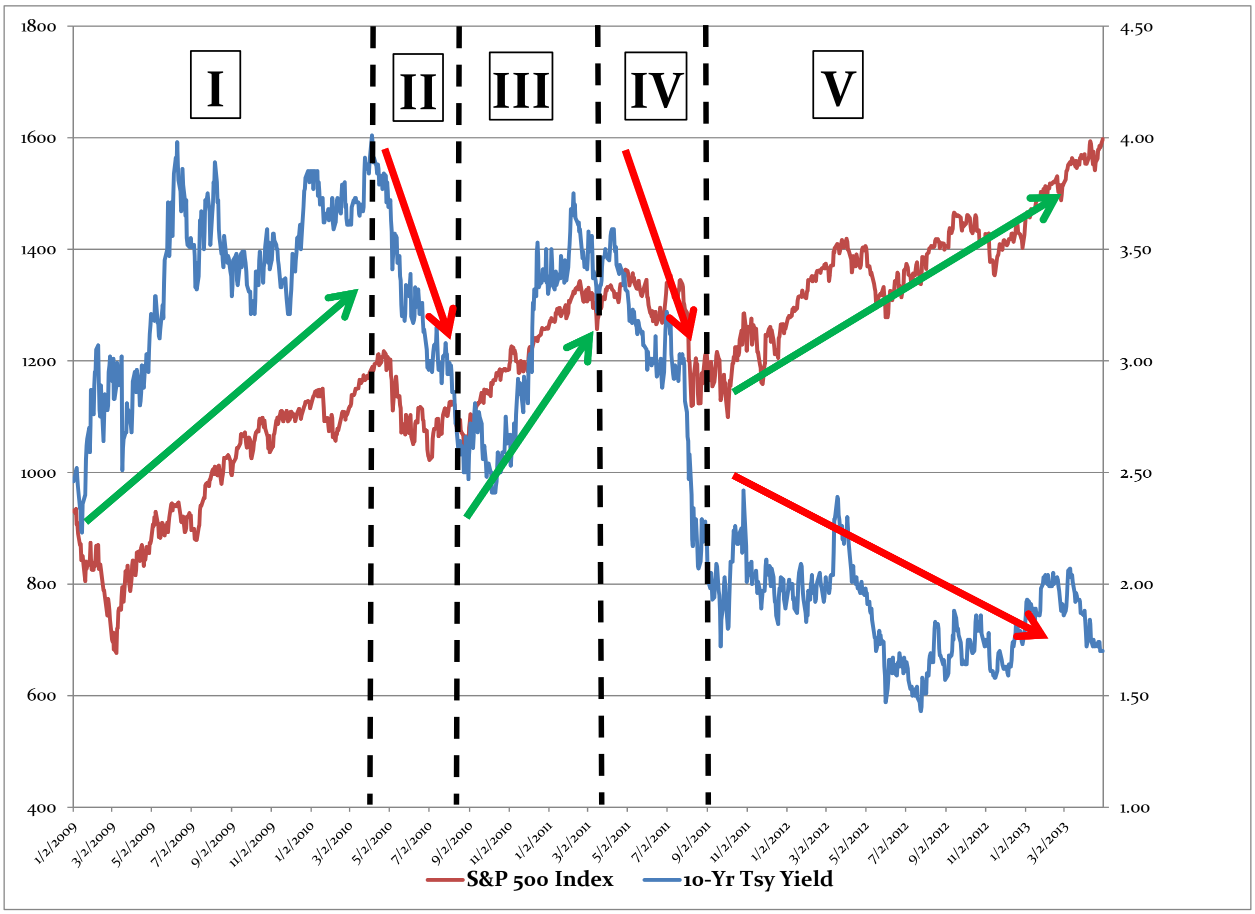
Volatility of Volatility: The second schizophrenic behavior we saw in April was in a popular measure of market emotion known as the VIX (for volatility index). But before we look at April, it's important to note that current levels of "fear" are very low compared with what we've experienced since the credit crisis in 2008. Where the VIX is currently in the teens, we saw it peak above 80 at the height of the panic in 2008 and reach up into the 40's during the Flash Crash in May 2010 and the Europe-related melt-down in August of 2011. By comparison, today's market is much less fearful – downright complacent in the opinion of some analysts.



Having said that, we see a distinct mood swing when we zoom in on the activity in April. Looking at VXX (a tradeable relative of the VIX), we see three distinct swings moving from relaxed to panicked and back to relaxed. The magnitude of these swings was enormous. The first was down 14% in 7 days (500% annualized). Then we went up 16% in 4 days (1000% annualized). Finally, we went down 16% in 5 days (800% annualized). Now that's what I call rock and roll!! The market may be calm relative to the major panics of recent years, but traders seem to be on guard and on edge – ready to move and move fast.

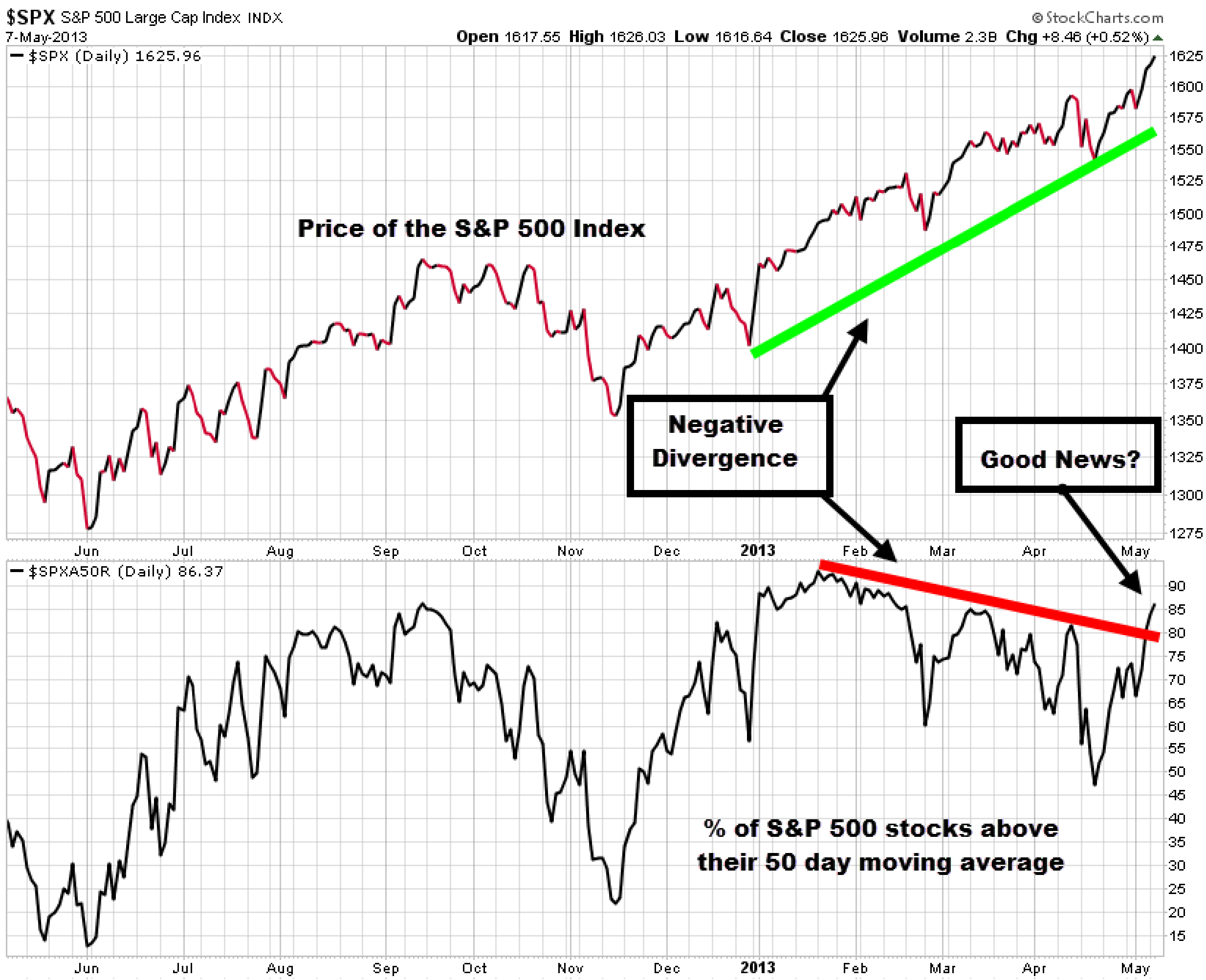


Stock Prices and Interest Rates: Under normal circumstances, stock prices and bond yields move in the same general direction. The logic is that if investors are making money in stocks, they are less interested in bonds and yields need to rise to make bonds more attractive. On the other side, when stock prices are going down, investors are more likely to seek refuge in bonds and this will push yields down as bond prices are bid higher. The chart below shows this relationship since January 2009. What's interesting is that this correlation has gone astray since the last low point for stocks last November. We've seen a rally in both stocks and bonds over this time frame. This suggests that investors are moving more as two camps rather than one herd. We would expect one of the arrows to change direction but we don't know which one or when it will happen.



Negative Divergence in the S&P 500: When most people talk about the stock market, they refer to the Dow, the S&P 500, the Nasdaq Composite and maybe some favorite individual stocks. One of the things I keep an eye on is how many stocks are in sync with the market trend. As an example, when the S&P 500 is moving higher and trading above its 50-day moving average (50 dma), I want to know how many of the 500 stocks in the index are also trading above their own 50 dma. If the index is moving higher, we'd like to see an increase in stocks above their 50 dma as confirmation of broad participation in the rally. As shown on the chart below, this year's move higher in the

S&P 500 has actually seen a decrease in the number of stocks trading above their 50 dma. This is what we call a negative divergence. The rally we've seen so far in May could be resolving this divergence in favor of the bulls as the number of S&P 500 stocks trading above their 50 dma has broken out above the negative trend line shown in the chart below.



Conclusions? From the lows of October 2011, we have experienced a strong rally in equity markets – especially in the U.S. Every pullback has proven to be a buying opportunity. Skeptics have pointed to a worsening European economy, China slowdown, subpar U.S. recovery and global addiction to monetary easing. The markets have responded with a great big "SO WHAT?" Professional money managers need to be invested to avoid career risk. Individual investors have been kicking themselves for not jumping in earlier. Cash is truly trash. We are in a self-reinforcing phase where the market will keep going up until we run out of people compelled to buy. No one knows when that will happen. But it would be wise to watch closely and have an exit strategy.