Dear Scott,

Market Fears Spike: S&P 500 has Worst Week in Two Years
The market runs on fear and greed. After having run up a bit, it's particularly easily spooked by troublesome world events, such as:
- Argentina's debt default becoming an insurance credit event.
- Portuguese banking scandal: massive losses & insolvency.
- Ukraine vs Crimean separatists with Putin's military backing.
- The Israeli / Hamas conflict grows a ceasefires crumble.
- Sunni Insurgents, al-Qaeda, and Kurds battle for Iraq (oil).
- Ebola virus patients brought to America. Is that really safe?

When the consensus is that the market is at least somewhat overbought and world events seem precarious, professional traders often hope to reduce portfolio risk in the event additional troublesome incidents occur over the weekend by selling some of their recent winners on Friday and re-entering the market on Monday.

But, that was last week. On Monday confidence had at least partially returned. It seems the debt problems will be renegotiated with little effect on the world, the first Ebola patient arrived to properly secured facilities without incident, the market isn't too worried over who controls oil in Iraq anymore because of the US energy boom, the Gaza conflict is nothing new, and the Crimean problem will likely not escalate because the Europeans are too dependent on Russian energy to play hard ball. The expectation expressed by some professional traders Monday morning on CNBC was that the "buy the dip" crowd would likely show up later in the day. And (surprise), they did.

While there are many market moving events that are unpredictable, statistically it can be shown that it is better to ignore events in the short term to avoid selling low only to watch the market rebound, thus locking in whipsaw losses. For more discussion on this, see: The "Faster Response" False Dilemma.

In any case, this terrible "worst week in two years" may look big on the 6-Month chart above, but it's hardly visible on the 6-Year chart, and the StormGuard Indicator also suggests the market is far from having a serious problem. While many, including me, might be critical about economic policy and regulation that may have thrown cold water on the economic recovery, perhaps this restrained recovery has naturally fostered a more stable market with fewer serious sell-off corrections. Something to chew on …

Master Strategy Update & Addition
A few months ago we introduced the Master Strategy concept. It
enables you to implement a multi-layer Strategy-of-Strategies in a single Strategy slot for much less than it would cost to build it yourself. Today we are announcing both an upgrade and an addition to the family of Master Strategies.

The **Master SOS ETF Power Mix Strategy** was significantly upgraded from four to six underlying ETF Strategies with an improvement in their behavior to more smoothly hand off trend leadership from one Strategy to another. If you had this Master Strategy in your account, you will find that your personal copy of the Strategy was automatically updated when we formalized the changes to the official Master Strategy. See more information here.

The **Master SOS Ultra Ultra (3x) Strategy** was recently added and includes three underlying Strategies. Currently there are not too many 3x ETFs, but this is a good start. CAUTION! This Strategy is not for the timid. Not only does it have three times the short term volatility of other general ETF Strategies, but some of its ETFs are fairly thinly traded. We highly recommend its use only as small part of an overall portfolio in order to blunt the possible sting of its high short-term volatility. See more information here.

**Is the Market Overvalued? ... Continued.**

In July's news letter you may recall the S&P 500 P/E Ratio chart (at right) with me pondering claims by some analysts that the market is quite overvalued. My conclusion from this chart (in vacation-beer-BBQ mode) was "naa - that can't be true!"

That prompted a very interesting reply from Dale Van Metre, Ph.D., CRPC, of Ameriprise, who was featured in June's newsletter regarding his recently published article entitled *Defensive Position Rotation: Achieving Financial Goals with Less Volatility*. Dale says, "the S&P 500 P/E ratio is not a good measure because it is not correlated with anything that matters. The current S&P 500 P/E is low because E (earnings) is 70% above its long term mean for reasons that are not sustainable. When E falls to its historical level people will wonder why S&P 500 P/E was so unreliable in telling us we were not in a bubble." Dale further provide links to two very interesting professional articles.

1.) John Hussman's [July 7, 2014 Weekly Market Comment](https://www.hussmanfunds.com/blog/weekly_market_comments.php) contains a chart of Capitalization/GDP vs Subsequent S&P 500 10-yr Total Return (right) and he comments that "The ratio of market capitalization to GDP, presented on an inverted scale, is beyond every point in history except for the final quarter of 1999 and the first two quarters of 2000." According to the chart, the S&P 500 will average a negative 1.5% return per year over the next 10 years.

While this is a very concerning outlook, there is more than one way to produce that result. For example: (1) The market could double over a period of eight years, and then drop by 67% over two years, (2) the market could first drop by 67% and then double over a period of
eight years, (3) the market could just go into the doldrums and lose 1.5% per year, or (4) numerous other variants.

But these possibilities cannot all be equally likely. While the chart indicates that the 10-year average returns from 2007 to 2017 will be about 1%, we have already logged returns through mid 2014 averaging 6.4% per year. To make this come out right over the next 2.5 years, the S&P 500 would have to lose about 14% per year. This will indeed be interesting to watch!

2.) Doug Short's July 1, 2014 Advisor Perspective illustrates that the P/E10 closely tracks the real (inflation-adjusted) price of the S&P Composite. The P/E10 is Doug Short's preferred abbreviation for the 10-year average of "real" (inflation-adjusted) earnings popularized by Nobel laureate Robert Shiller who refers to it as the Cyclically Adjusted Price Earnings Ratio, or CAPE.

Doug notes that "After dropping to 13.3 in March 2009, the ratio rebounded to an interim high of 23.5 in February of 2011 and then hovered in the 20-to-21 range. The latest ratio is at a new interim high -- the highest since December 2007. The ratio in the chart is doubly smoothed (10-year average of earnings and monthly averages of daily closing prices for the index)."

My conclusion is quite simple. I agree with Dale that these additional measures do indicate that the S&P 500 is actually much more overvalued than it would appear by examining the ordinary P/E ratio. That said, if indeed earnings have been pumped high by the Federal Reserve's Quantitative Easing (QE) program, then have we admitted that it really is different this time — at least until QE really does come to an end?

From a practical standpoint (1) I wonder if the last 5 years of data plotted in blue in the PE/10 chart would have given a sufficient clue that the market was in grave danger in 2008, and (2) I believe that the very long time constants used in smoothing the chart data would reduce its utility to use by investors with similarly very long trading time constants — 10-years is way too long for use with SectorSurfer.

Whether QE makes things different this time or not, in the end the market will either go much higher before it rolls over — or not. Fortunately, SectorSurfer will be paying attention to what "the market is actually doing" versus what the gurus say "the market should be doing" — which Dale and I agree makes all the difference.

Surf Well and Prosper,

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