Perspective: Black Swan - Mitigate and Vaccinate

Mar 23, 2020

A Black Swan Event

The market is indeed in the midst of a Black Swan event of epic proportions. Black Swan events are defined as rare, unpredictable, and beyond the realm of normal expectations. The market's fall from its high on February 19th to bear market territory was the fastest on record. It was about 3x faster than 1929, 4x faster than 1987 and 6x faster than 1990 – the three prior record holders. Just as the Coronavirus caught healthcare professionals without therapeutics or vaccines, so also did this never-before-seen Black Swan catch algorithms and investors unprepared.

What's different this time compared to the H1N1 virus of 2010, which had no adverse effect on the stock market, but infected 60.8 million and killed 12,469 in the United States (according to the CDC)? Although I'm sure there are other factors, the two that most catch my attention are (1) the rise of AI algorithms digesting media articles, drawing conclusions, and racing to sell before others; and (2) the government shutdown of many portions of the economy. Together they've created downward market pressures like we've never seen before.

S&P 500 Index - 6 mo.

Why StormGuard Did Not Trigger

StormGuard Armor is designed to do three things:

1. Avoid <u>protracted</u> bear markets by automatically switching to a strategy of defensive funds.
2. Avoid locking in sharp drops, which most often snap back, by having a modicum of patience.
3. Avoid whipsaw losses associated with medium-term drops that don't become bear markets.

The "rainbow chart" (right) described in the March 6th Newsletter clearly

Bear Market Exit Methods

illustrates the significance of avoiding short-term and emotional responses to market drops, including the use of stop-loss orders. Investing is a game of odds, not of certainty. The rainbow chart makes the point that it is better to be right than to be early.

StormGuard Armor was specifically designed to trigger only at ***month-end*** because the trend signals have the highest quality at that time. <u>The unprecedented character of this Black Swan event provides cause for re-examining the rules of StormGuard Armor to ensure that it is prepared to make a suitable decision at the end of the month.</u>

Black Swan Special Situation
The accelerated decline to bear market territory in just a matter of days occurred faster than StormGuard could possibly trigger, and it put the market into an exceedingly oversold position. In past decades, the Delta MSI (chart right) has signaled a significant market rally whenever the Delta indicator got below 10% (as it did in late 2018). Today, the Delta indicator stands at -62.4%, lower than at any prior time other than the 2009 market bottom (see SG-Armor Indicators chart, right) and indicates the market is in a very oversold condition.
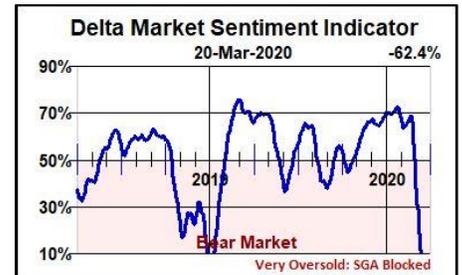
Black Swan Mitigation Plan
The Coronavirus Black Swan is already here and has already taken markets down swiftly. Our task in the short term is to mitigate the Black Swan's long-term damage. While a rough ride may be unpleasant, permanent damage can only occur if there are whipsaw losses. Months from now, portfolios that suffered whipsaw losses will be fired in favor of employing those that managed to mitigate losses. <u>Thus, StormGuard Armor will incorporate a new rule that prevents it from triggering at month end if the Delta indicator was below zero at any time in the prior month.</u> The canceled trigger can be seen in the chart (below right) with a new descriptive footnote at the bottom.

Black Swan Vaccine?
It is said, "that which doesn't kill you makes you stronger." Good news… we now have the DNA sequence for government-induced Black Swan events and have already begun work on a few algorithmic vaccines. We

(click to see on SG charts page

SG-Armor Indicators (30 years
(click to enlarge)

SG-Armor Black Swan Mitigatic
(click to see on SG charts page

believe it's more likely than not that future virus scares will be driven by similar government and market forces. We'll be ready.

Signal Override?

Occasionally, I have been asked about the wisdom of overriding trade signals. Here is what to consider: Our algorithms only examine market data. The system has no direct knowledge of events in the news. If you believe that you have event-knowledge that is not already assimilated into market prices, then it is not unreasonable to consider overriding the buy or sell recommendation of the system.

May the markets be with us,

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