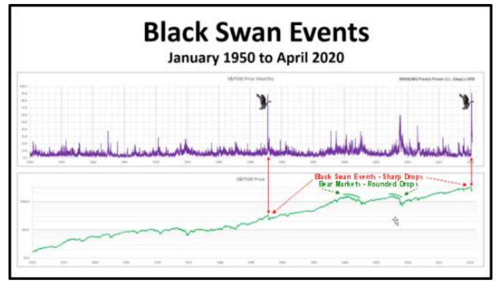
Perspective: L-U-V that Rebound? Black Swan Vaccination!

May 15, 2020

Black Swan Events – Rare and Brutal

The 70-year charts of the S&P 500 market index and the market's volatility (right) illustrate the rarity of Black Swan events and their difference in character from ordinary bear markets. The March 2020 market crash fits the Black Swan definition of "rare, unpredictable, and beyond the realm of normal expectations." The only thing close in volatility over the chart's period was the 1987 Black Monday market crash. Both events are characterized by extremely sharp drops during a bull market. Conversely, ordinary bear markets are characterized by a much slower roll-off that picks up steam and typically bottoms with a comparatively sharp reversal.

(click to enlarge)



Market Recovery Shape?

Pundits have been debating about the shape of the market recovery for at least two months. The S&P500 chart (right) looks an awful lot like a V-bottom that has paused. Given how deeply oversold the market became and the swift supportive response from Congress and the FED, a sharp rebound was to be expected. Subsequently retesting that low (a W-shaped recovery) is unlikely given the FED's massive liquidity injection and the $3 trillion stimulus bill passed by Congress. Furthermore, the Federal Government has implemented "Operation Warp Speed" for developing a Covid-19 vaccine that mitigates regulatory hurdles and jump starts the production of a few hundred million doses. If I were a betting man, I would bet that this elevator is going back to the top floor, and I would want to be on it.

S&P 500 Index - 6 Months

Bad Breadth is a Good Thing!

Although random punctuated events that shock markets must be endured, they do lead to new trends that can be profitably traded.

Whether the market further recovers along an ***L***, ***U***, or ***V***-shaped path is almost irrelevant – the elevator is definitely going back to the top floor with a new set of winners and losers. When there's is a big difference between the winning and losing sectors in a rising market, the market is said to have bad breadth. However, bad breadth is precisely the fuel that enables momentum strategies to outperform the market. Focus on the sectors – both ***V*** (winners) and ***L*** (losers) shaped recoveries are present. The question is not whether to get on the elevator, but rather which sector elevator has the most attractive bad breadth.

What the Market Indicators Say

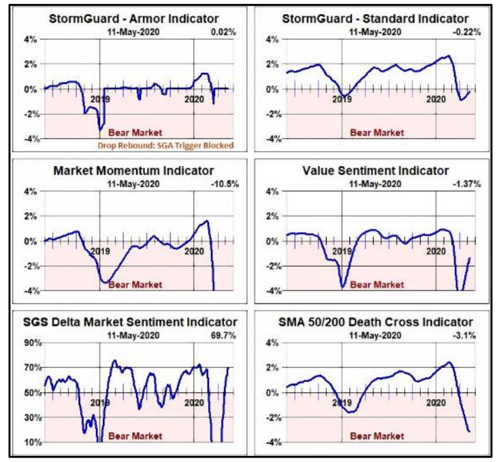
In the March 23 Newsletter**,** I wrote that StormGuard-Armor did not trigger for the Black Swan because it is designed to (1) avoid protracted bear markets by automatically switching to a strategy of defensive funds, (2) avoid locking in sharp drops, which most often snap back, by having a modicum of patience, (3) avoid whipsaw losses associated with medium-term drops that don't become bear markets, and (4) trigger only at ***month-end*** because the trend signals have the highest quality at that time. The market's excessively steep decline quickly put it into an oversold condition – which logically blocks StormGuard-Armor from triggering and producing a sell signal.

A survey of the Market Indicator charts (right) shows that: (a) the SG-Standard indicator will probably reach positive territory later in May, (b) the SG-Market Momentum indicator of high volume trading sentiment is still quite negative, but is starting to rise, (c) the SG-Value Sentiment indicator of new highs/lows is headed strongly higher and may reach positive territory at about month end, (d) the faster response SGS Delta Market Sentiment Indicator has now gone from very negative (oversold) to a strong momentum indication, and just for fun (e) the well-known Death Cross indicator crossed into SELL territory at the very bottom of the market and looks like it won't be back until August at the earliest. Ugh.

StormGuard-Armor Status - What's Next?

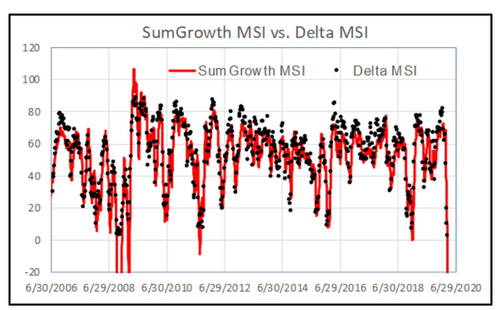
StormGuard-Armor's triggering remains blocked for 20 market days from the last instance of the oversold condition (about 18 market days ago). However, it can be (and has been) extended by an additional 40 market days when there also has been a sufficiently sharp rebound. However,

Market Indicators
(click to enlarge)



Note: The SGS Delta Market Sentiment Indicator is our own close approximation of published Delta Market Sentiment Indicator and is based on the daily return DEMA of the dividend adjusted Russell 3000 index. Financial Advisor Peter Lingane of Lafayette, CA recently produced the below comparison chart and reports: "The algorithm was fit to 26 months of Delta data in Feb 2016. The qualitative fit is excellent. 84% of the comparisons are out of sample. The Delta MSI is constrained to the range 0-100; the SGS algorithm is not. Delta writes "When the indicator falls below 10, the market usually delivers strong positive results over the next twelve to eighteen months."

SGS vs-Delta MSI (click to enlarge)

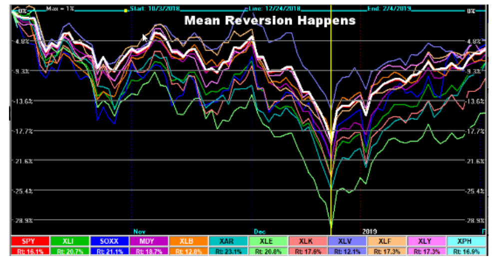


StormGuard-Armor will be allowed to trigger during these 40 days if all three main components of StormGuard-Armor begin declining.

Black Swan Mitigation #1 – No Bottom Selling

As reported in the [March 23 Newsletter], once the Black Swan caused markets to quickly become oversold, action was immediately required to prevent permanent whipsaw loss damage. Thus, StormGuard-Armor incorporated a new rule to prevent selling at month-end if the SGS Delta MSI indicator was below zero (indicating an oversold condition) at any time in the prior month. One should buy when there is blood in the streets, not sell. The canceled trigger can be seen in the StormGuard-Armor chart (above right).

Mean Reversion Example
(click to enlarge)



Black Swan Mitigation #2 – Employ Mean Reversion

Ordinary momentum indicators would suggest that funds that have fallen the least have the strongest momentum and relative strength. However, the opposite is actually more often true after a particularly sharp or large decline. This principle is well-known as [mean reversion]. In March, we implemented this principle in our momentum algorithm: In the first month after an oversold condition, the momentum algorithm now works in reverse by selecting the fund that recently fell the most. The Mean Reversion Example chart (above right) illustrates this principle in the December 2019 oversold event when comparing the fall and rebound of XLE to that of XLV. The Sector Nectar chart (right) illustrates the success of employing this mitigation principle in a momentum strategy.

Sector Nectar Rebound
(click to enlarge)

Bull-Rider Bear-Fighter 6-Month Checkup

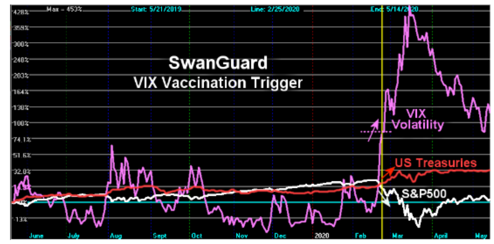
The relative performance of the Bull-Rider Bear-Fighter Index (BRBF) is charted (right) relative to the S&P500 Index and a few reference funds. Although the BRBF holds 80% equities and 20% bonds, it has managed to outperform every one of them. The Pacer TrendPilot fund was included to illustrate the consequences of employing a simplistic bull/bear market indicator that inherently produces whipsaw losses for intermediate-duration market drops. The Berkshire Hathaway fund was included because I was surprised to see that Merlyn's magic has been doing better than the legendary Warren Buffet's magic.

6-mo. Performance
Bull-Rider Bear-Fighter
See Also: [BRBF Index Info]

Black Swan Vaccination – SwanGuard Preview

Like the CDC and numerous biotech companies, we have been working feverishly (so to speak) to quickly develop (1) mitigation therapeutics for this Coronavirus Black Swan, and (2) a preventative vaccine for future Black Swans … now that we have its fingerprints and DNA. Will the medical community, media, and politicians react similarly to the next scary virus that comes along? We think so.

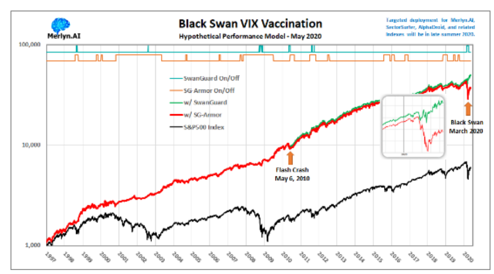
Black Swan
VIX Vaccination Trigger
(click to enlarge)



The VIX Vaccination Trigger chart (right) illustrates the sharp and extreme reaction of the VIX market volatility index to the Black Swan event. It is further confirmed by a notable initial decline in stocks and notable initial advance in US Treasuries. The SwanGuard algorithm will augment StormGuard. SwanGuard will be able to trigger at any time during the month (not just at month-end). Upon triggering, SwanGuard will immediately trade into the extreme safety of US Treasuries. As volatility later subsides, it will turn control over to StormGuard.

The SwanGuard Model chart (right) illustrates how SwanGuard is expected to behave when applied to the S&P500 utilizing StormGuard-Armor. If StormGuard-Armor is already triggered, SwanGuard will be ignored. Over the 25 years modeled, there are only two instances where SwanGuard takes control. The first one follows the May 2010 "flash crash," which spooked the market for a few months, and the second one is the much more serious March 2020 Black Swan event. In this model, SwanGuard employs the TLH long-term treasuries ETF through the first week of April and then reverts back to the S&P500.

SwanGuard Model
Integrated Black Swan Vaccination
(click to enlarge)



By late summer we expect to complete the SwanGuard VIX Vaccination integration and deployment for our SectorSurfer and AlphaDroid platforms, and for our published Merlyn.AI Indexes. Keep an eye out for subsequent Newsletters that will let everyone know when SwanGuard has been fully deployed and ready to take action against the next Black Swan's arrival.

May the markets be with you,

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