HOLD ON AS VOLATILITY CONTINUES

Just understanding where we are helps to make sense of some of the volatility in the market and the drivers of the seemingly relentless bearish pressure. These are the most dangerous markets since 2008.

These note extracts from Convergex put this into a perspective we find compelling and accurate. The notes are prepared by Nicholas Colas, chief market strategist at Convergex, a global brokerage company based in New York. Rather than rewrite these notes we bring readers the relevant extracts. Our additions are in bold italics.

When it comes to understanding the fashion of the market, banks are the new crude oil. Last year we watched the plummeting price of crude. We argued over how much the U.S. consumer would spend of their gas pump windfalls. And worried over the U.S. oil economy.

Those were simpler times.

The European banks are now the centre of the global capital markets' handwringing. And the answers aren't as easy there as just finding a low on crude prices. The leap of faith required to embrace European/U.S. bank stocks is vast, spanning every topic that can theoretically touch the global financial system. That includes:

- the current level of Chinese foreign exchange reserves (last week's worry point)
- the financial condition of oil producing countries from Saudi Arabia to Venezuela ***(and Russia. Economic collapse here will have political consequences and consequences for the growth of terrorism as stable states fail)***
- and the chance for the global tsunami of negative interest rates to reach U.S. shores either from the west or (more likely) east.

With volatility picking up, it pays to remember the old poker rule: you don't play your cards, you play the people at the table. And since I know about as much about poker as I do about fashion, I only have one point here. Doing the fundamental work on any stock right now is only part of the investment process.

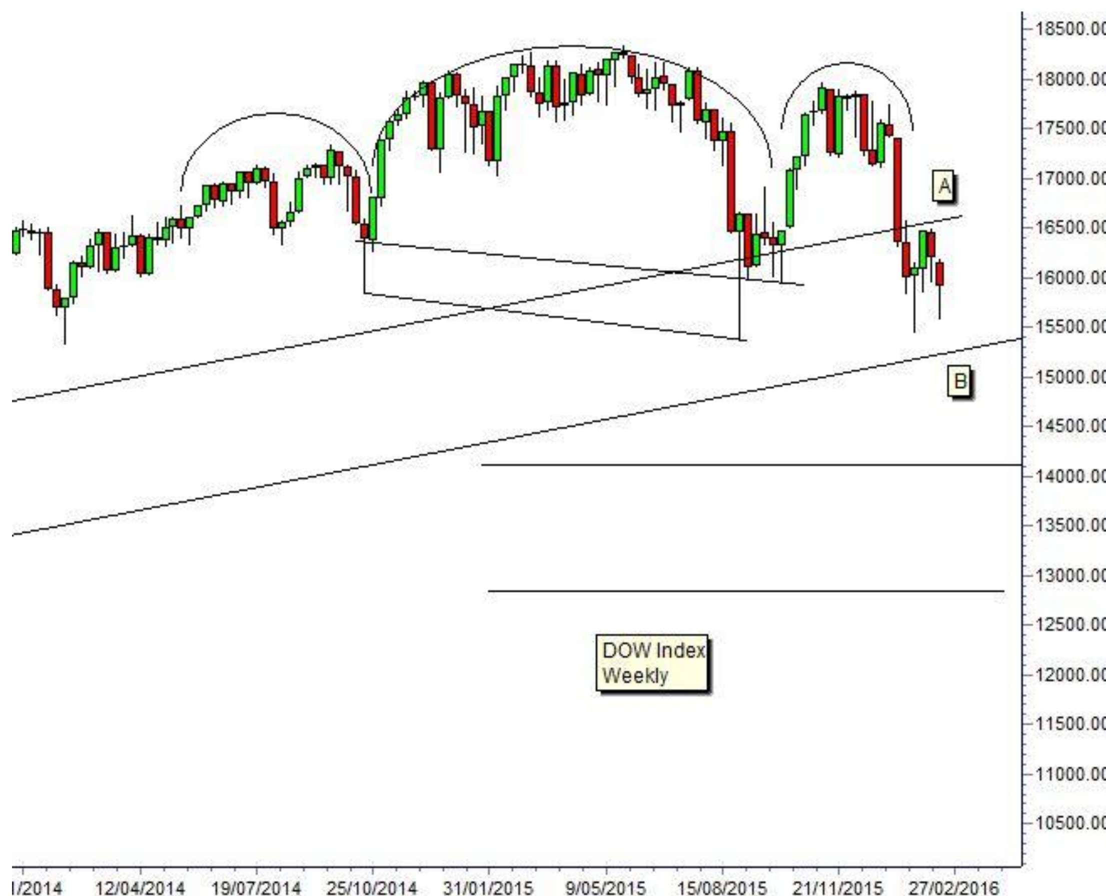
More important is scaling into the right entry point, and that means identifying a near term low for global equities. After all, if that low isn't somewhere near current levels then we may have larger problems. ***(We are bringing readers articles on managing entries and setting better stops)***

One way to do that is to look at the correlation between various asset classes and industry groups. The basic idea is simple: risk assets ***like stocks*** bottom when everyone wants to rush to the sidelines at the same time. That's when average correlations for the 10 sectors of the S&P 500 relative to the overall market go to +90%, for example. ***(this is when every stock, good, bad, stocks in strong uptrends, all trend down. This correlation amongst the behaviour of the large cap stocks is exacerbated by Exchange Traded Funds trading)***

Since 2009 this has only happened in mid 2010, late 2011 and September 2015. All were great short term entry points (2015, very short term as it turns out), so we consider asset price correlations a useful market "Tell".

We aren't at a near term bottom yet for U.S. stocks. That's what the correlation data seems to show, anyway. Average sector price correlations (Tech, Utilities, Financials, etc) are just 86.9% over the last month relative to the S&P

500. While that is high relative to long run patterns (50% was normal in the 1990s, for example) it is very close to the 2009-current average of 83.8%. Back in September 2015, the average correlation was 92.1% - over one standard deviation from the average since the Financial Crisis. At current readings we are barely half a standard deviation from the average.



(The Weekly Dow chart shows our downside targets. It's updated from the notes in the January 8 issue of the newsletter.)

As far as what sectors will have to see higher price correlations in order to signal a near term bottom, the key groups are Health Care (82.9% trailing 30 day correlation) and Energy (81.4%). For the former, which has underperformed the broad market in the last month by 300 basis points, a tighter correlation might bring some better returns. By contrast, Energy has been outperforming the S&P 500 in February so a closer link to the S&P 500 would be less welcome.

As for the industry groups that already have a high degree of correlation to the overall market, no surprise that Technology (96.2%) and Financials (95.6%) lead the way. That banks and brokers would lead the market makes sense given our earlier comments, but why Technology? The simple answer seems to be that asset managers are taking risk out of their portfolios at the moment, and tech stocks have higher price volatility than most groups. So out they go, even if there's no fundamental connection between an online retailer or advertising company and the health of large European banks.

The only other correlation data series worth a mention this month is the relationship of gold prices to equity markets. The structural price correlation over time should be zero, since one is a physical asset and other is financial in nature. Over the last month, however, the correlation of gold to the S&P 500 has been negative 46.3%. No surprise, therefore, that gold was up over 3% at various points today as the U.S. equity market declined.

Contrary to the old saying about stocks, gold often takes the elevator up and the stairs down. Upside moves are sharp, the pullbacks dull and grinding. And, as you can imagine, gold and stocks pass each other as each takes its own method of conveyance up or down. Since the Financial Crisis the two assets have waved at each other a few times while taking these opposing journeys. You can guess the most notable dates, which include late 2011 and now, along with April 2013 and March 2014 when gold was simply underperforming.

By that measure – that gold is so dramatically negatively correlated to stocks – we must be approaching a low for equities at some point fairly soon. We'll wait for sector correlations to reach +90% before we ring that bell, however.

There are three parts to the solution. The first part is to wait until there are clear signals of a market bottom and trend reversal. That's covered in our weekly Index notes.

The second part is to move to short term trading of indexes and equities using CFDs. This leverages the returns and reduces the time frame. It is active trading and requires free time during market hours. We know this does not suit many of our readers who are part time traders.

The third part of the solution is to shift attention to different leveraged markets which trade outside of Singapore working hours. That's the FX market and its one of the reasons for our 18 month focus on developing suitable techniques for trading these markets.