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- **Bulls Keep Runnin'**
- **Signs Of Excess**
- **I've Seen This Before**
- **10 Commandments Of Trading**
- **Market & Sector Analysis**
- **401k Plan Manager**

Bulls Keep Runnin'

Let's start with a quick update [from last week.](#)

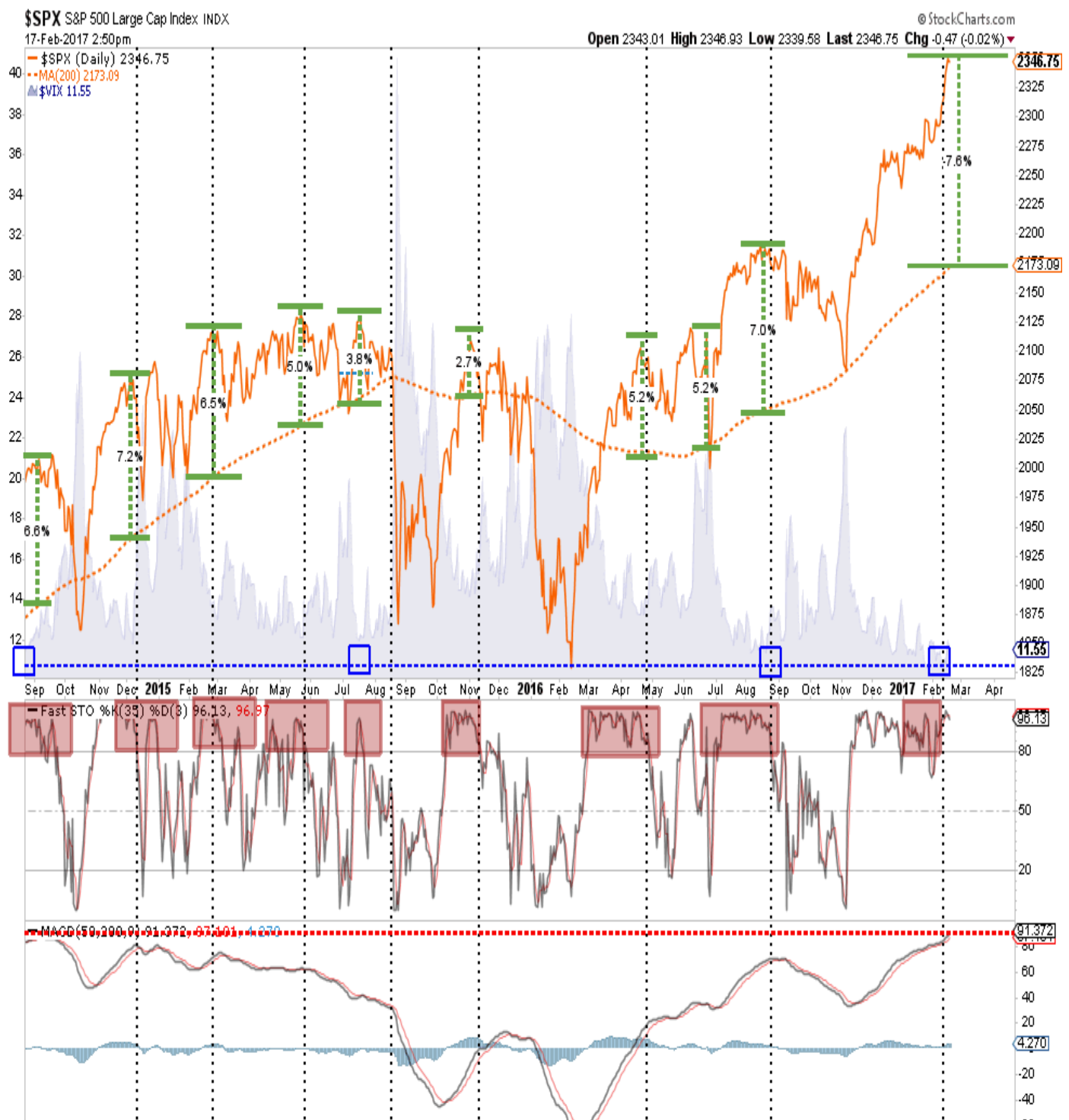
"Since the beginning of January, the markets have remained in a very low volatility sideways trading pattern as shown in the chart below. However, this past week all three indices broke out to the upside with the Dow moving above 20,000 and the S&P 500 surging above the 2,300 mark."



"There are plenty of bullish supports currently that warrant keeping portfolios exposed to equity risk currently:

- The bullish trend remains intact as noted by the red dashed line in the first chart above.
- The NYSE Advance/Decline remains bullish
- The number of stocks on bullish buy signals remains bullish
- The number of stocks above their 50 and 200 DMA's is rising.
- Bullish confidence is high
- Volatility remains low"

This past week, as President Trump reiterated that a "terrific tax cut" package was forthcoming, stocks rocketed higher earlier in the week and attempts to sell off on Thursday and Friday were quite muted. **While the "bullish backdrop" clearly remains, there is ample evidence to reduce overweight equity positions and refrain from making new purchases currently.** As shown in the chart below, the deviation in the price of the S&P 500 from its underlying 50 & 200 day moving averages, bottom two indicators, are currently at extreme levels. **At these levels, a pull back or correction has been a common occurrence.**



A correction can happen in one of two forms:

1. *The price of the index begins to trade in a sideways pattern for a couple of weeks which allows the underlying moving average to catch up with the price, OR;*
2. *The price corrects to, or beyond, the underlying average.*•

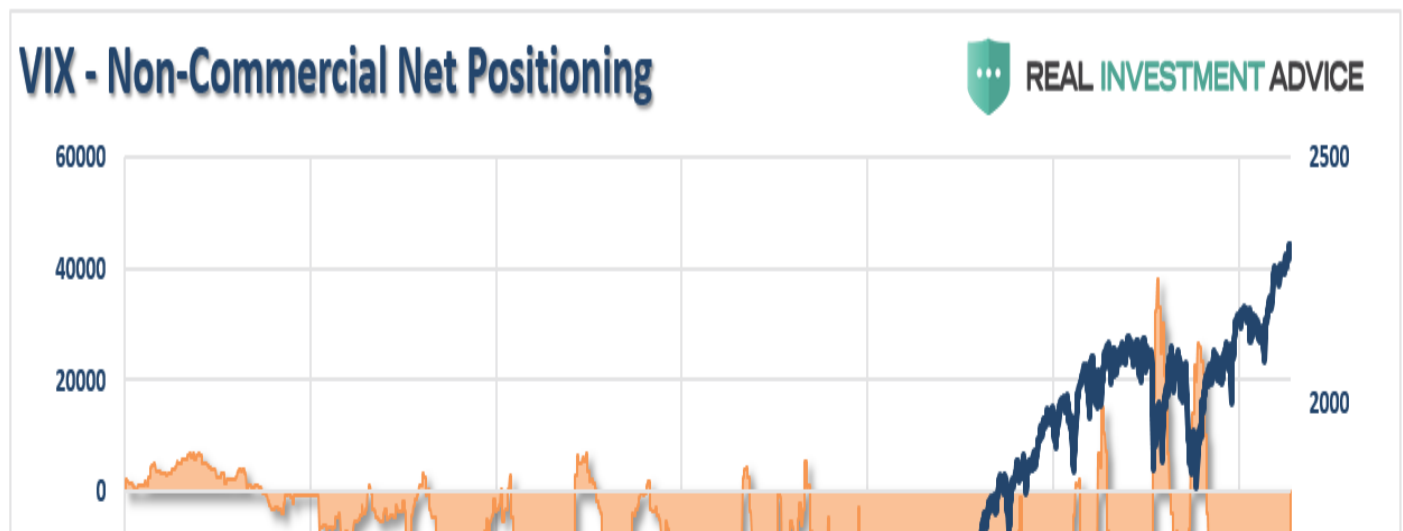
While a sideways correction is entirely possible, it generally rarely happens. Most likely, a correction would entail a price reversion towards 2175 to 2200. Given the market finds support at these levels, investors should be afforded a better entry point to add exposure. **However, a violation of those levels would suggest a deeper correction is in the making. I am temporarily holding off adding new equity positions to portfolios currently until the risk/reward opportunity becomes a bit more favorable. However, with portfolios nearly fully allocated at this juncture my bigger concern is focused on the numerator of the risk/reward equation.**•

Signs Of Excess

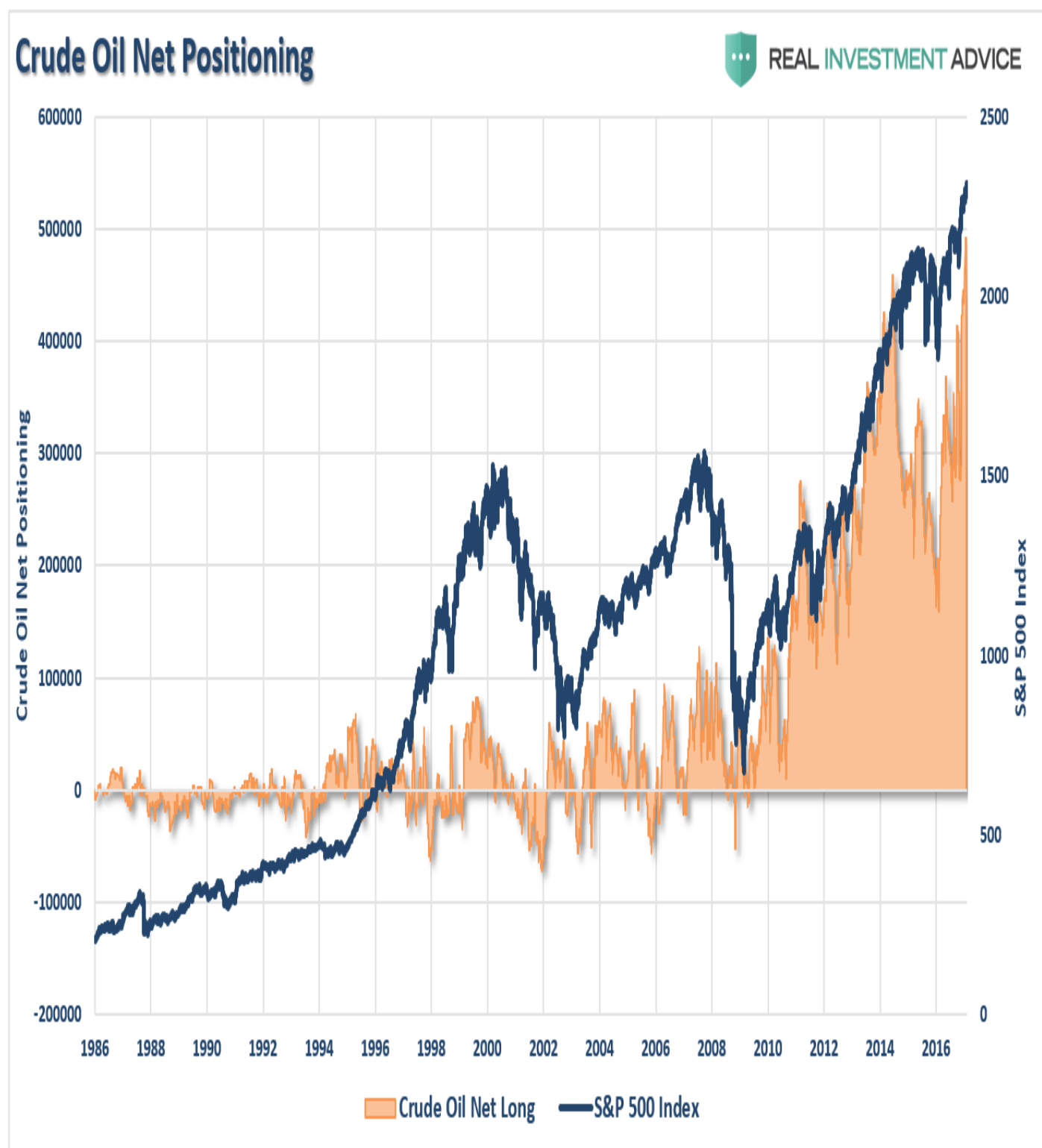
It isn't just price extensions of the market that is currently concerning but the underlying excesses as well. [On Tuesday, I reviewed](#) the COT (Commitment Of Traders) data which is exceptionally important data as it is the **sole source of the actual holdings of the three key commodity-trading groups, namely:**

- **Commercial Traders:** *this group consists of traders that use futures contracts for hedging purposes and whose positions exceed the reporting levels of the CFTC. These traders are usually involved with the production and/or processing of the underlying commodity.*
- **Non-Commercial Traders:** *this group consists of traders that don't use futures contracts for hedging and whose positions exceed the CFTC reporting levels. They are typically large traders such as clearinghouses, futures commission merchants, foreign brokers, etc.*
- **Small Traders:** *the positions of these traders do not exceed the CFTC reporting levels, and as the name implies, these are usually small traders.*

The data we are interested in is the second group of Non-Commercial Traders. This is the group that speculates on where they believe the market is headed. **While you would expect these individuals to be *?smarter?* than retail investors, we find they are just as subject to human fallacy and *?herd mentality?* as everyone else.** Therefore, as shown in the series of charts below, we can take a look at their current net positioning (*long contracts minus short contracts*) to gauge excessive bullishness or bearishness. **With the exception of the 10-Year Treasury which I have compared to interest rates, the others have been compared to the S&P 500.** The extreme net-short positioning on the volatility index suggests there will be a rapid unwinding of positions given the right catalyst. **As you will note, reversals of net-short VIX positioning has previously resulted in short to intermediate term declines.**



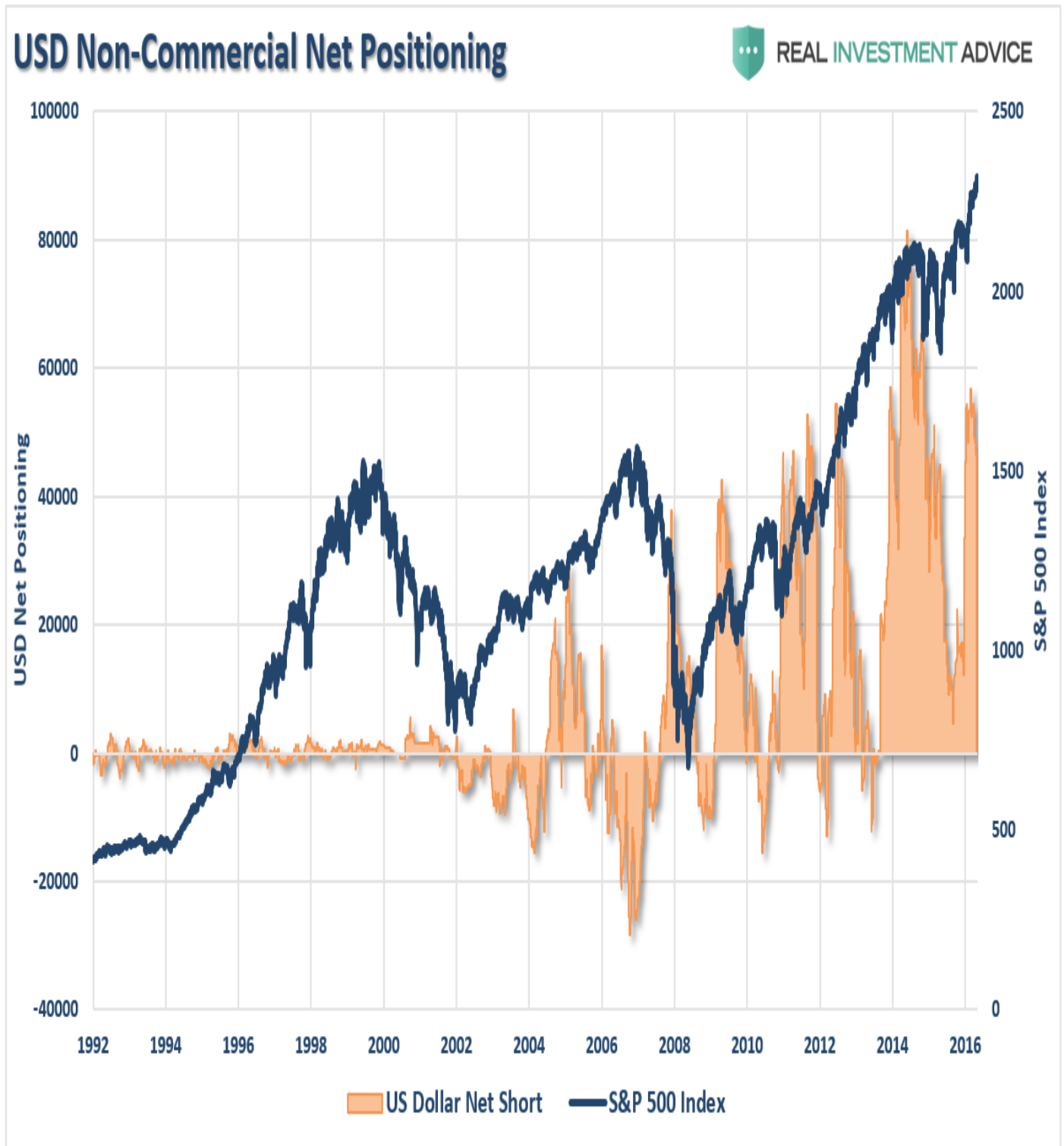
Crude oil positioning is also highly correlated to overall movements of the S&P 500 index. **With crude traders currently more "long" than at any other point in history, a reversal will likely coincide with both a reversal in the S&P 500 and oil prices being pushed back towards \$40/bbl.**



While oil prices could certainly fall below \$40/bbl for a variety of reasons, the recent bottoming of oil prices will likely favor some support around that level. Given the extreme long positioning on oil, a reversion of that trade will likely coincide with a "risk off" move in the broader markets as well. **If you are overweighted energy currently, the data suggests a rebalancing of the risk is likely advisable.**



The same goes for the US Dollar. While net positioning is not at historic extremes, it is at levels which would coincide with a short to intermediate-term correction in the S&P 500.



Of course, as I have previously discussed, there are also signs of excess in:

1. [Leverage - both in margin and corporate debt.](#)
2. [Bullish Sentiment](#)
3. [Valuations](#)
4. [The "High-Yield" Chase](#)
5. [Market Capitalization Ratios](#)

Currently, there is an implicit disregard for fundamentals. Of course, such disregard has historically been a hallmark of poor future returns for investors.

Seen This Before

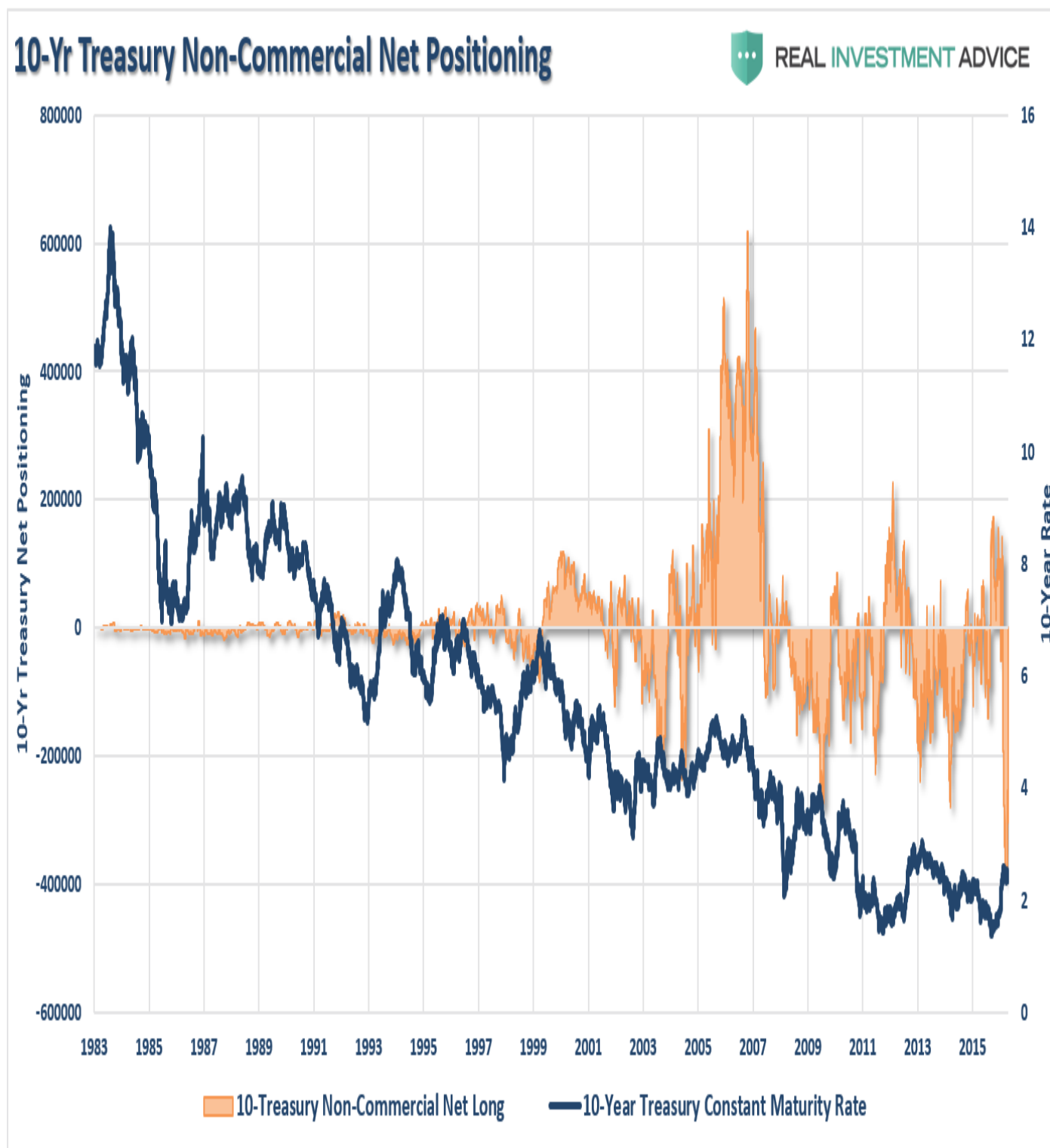
In both previous bull market peaks we find, as measured as a percentage change from the previous bottom to the current level, the following:

- **CORE INFLATION** rose 11.7% and 7.1% just prior to the recession. **Currently, Core CPI is up 11.1%**
- **GDP GROWTH** picked up by 7.5% and 5.1% just prior to the recession. **Currently, GDP is up 6.8%**
- **EMPLOYMENT** was up from lows by 9.1% and 8.6%. **Currently, Employment is up 19.0%**
- **INTEREST RATES** rose 50.8% and 51% from lows. **Currently, Rates are up 87.9%**

As we saw just prior to the beginning of the previous two recessions, such a bump is not uncommon as the impact of rising inflation and interest rates trip of the economy. **Given the extreme speculative positioning in oil longs, short bonds, and short VIX, as discussed yesterday, it won't take much to send market participants scrambling for the exits.** While I am NOT suggesting that we are about to have the next great market crash tomorrow, the current sensation of *?Deja Vu?* might just be worth paying attention to.



The most interesting setup currently for investors, is the massive net-short position on US Treasury Bonds. Given the aggressive leveraging in the markets above, a reversal in the S&P 500 will likely send money rushing into bonds for "safety." That rush will fuel a short-covering spree in bonds forcing yields towards 1.5% or lower. •



This is an area that I am looking at adding more of into portfolios to hedge the long-equity bias currently. •

Babson's 10-Commandments of Trading

My colleague, Mark Yusko, just recently penned his 4th-quarter market review which is well worth reading in its entirety. However, buried inside of it was this terrific bit of insight from Roger

Babson.

"Roger Babson's success as an investor, and in running his investment research firm was, to some large degree, based on his unique (some might say unorthodox) beliefs in how markets functioned. Babson was quoted as saying, **?Don't look for society to give you permission to be yourself,?** and his willingness to **start an investment business based on a theory that many dismissed as something akin to astrology was notable (particularly because it ended up working).** During his time at M.I.T., Babson became interested in Newton's third law and posited a theory that the business cycle was driven in part by the interplay between human participants and gravity. Over the course of his career Babson researched and developed Newton's theory and came to the conclusion that economic variables (and even the stock market itself) could be explained by the gravitational forces of the earth. Working with M.I.T. Professor of Engineering George F. Swain, Babson applied the concept of actions and reactions to classical economics, which led to the development of the Babsonchart of Economic Indicators. **The Babsonchart was designed to not only assess current economic, business and investment conditions, but to predict future conditions as well.** Having amassed a meaningful fortune himself, Babson expanded his business information business into wealth management after the Financial Panic of 1907 and utilized the Babsonchart to counsel on when it was wise to be in the markets or out of the markets (one of the first tactical allocation services). Babson had concluded that there was a better way to manage wealth, saying,

?More people should learn to tell their dollars where to go instead of asking them where they went.?

Babson thought it was important to just begin his wealth management effort with his own capital because he believed that, **?people would rather be shown how valuable you are, not told.?** Actions always speak louder than words, and Roger Babson was always a man of action. As a disciple of Newton, Babson drew strength from the construct of **?actions and reactions,?** so whenever an endeavor in Babson's life ended, a new one immediately began to take its place. Babson had an amazing ability to never be discouraged by setbacks. One of his mantras was, **?When we are flat on our backs there is no way to look but up.?** Perhaps his greatest strength, however, was his willingness to take chances and to rebound when the risks at the time perceived by others seemed to overwhelm the likelihood of a successful outcome."

Babson developed his own list of **?Ten Commandments of Investing?** that he encouraged his readers and clients to follow:

1. **Keep speculation and investments separate.** This is a very important concept that is often lost on market participants. We describe it as the Three Bucket Rule. Everyone should have three buckets in their portfolio:
 - **The Liquidity Bucket** (10% to 15% to cover lifestyle costs),•
 - **The Stay Rich Bucket** (70% to 80% that is diversified, long-term investments,) and;
 - **The Get Rich Bucket** (10% to 15% for speculation, we joke this is for the stock tips and friends & family deals, unfortunately, you will likely lose it all, so keep it small).
2. **Don't be fooled by a name.** Make sure you know what you are buying as names can be deceiving. For example, the Blue Chip Growth Fund in my 401(k) that turned out to be **?the Blue Chips of the future?** and was actually small-cap growth instead of large-cap core.
3. **Be wary of new promotions.** If a financial services firm is selling you something new, it is likely that they have figured out how to package up an old idea with higher fees for themselves.

4. **Give due consideration to market ability.** Be honest with yourself about how much time you are willing to commit to investing and whether you have the knowledge, temperament and discipline to be an effective investor.
5. **Don't buy without proper facts.** Do your homework and never (ever) buy a stock tip. Always remember there is someone on the other side of every transaction who has done at least as much diligence and research as you have.
6. **Safeguard purchases through diversification.** Concentrated portfolios make you rich (or poor) and diversified portfolios keep you rich. How do you create a small fortune? Start with a large fortune and stay concentrated.
7. **Don't try to diversify by buying different securities of the same company.** Single company risk is a very dangerous game (that said, over the past 80 years there have been some developments in capital structure arbitrage which make this rule a little less absolute).
8. **Small companies should be carefully scrutinized.** Back in Babson's time this was a really big deal as the small companies that went public were dicey at best, and fraudulent at worst. With the increased regulatory burden placed on public companies today, there is somewhat less risk, but small-caps are still very volatile and should be handled with extra care.
9. **Buy adequate security, not super abundance.** Investing is about taking intelligent risks. You must take risk in order to make an adequate return, but you only want to take the risks where you are adequately compensated.
10. **Choose your dealer and buy outright (i.e., don't buy on margin.)** Leverage is a tool. It can be used to amplify the returns of any assets, but the danger of margin is you are leveraging leveraged assets, which can lead to problems. The real danger is leverage can't make a bad investment good, but it can make a good investment bad through forced selling at inopportune times

?I repeat what I said at this time last year and the year before, that sooner or later a crash is coming which will take down the leading stocks and cause a decline of 60 to 80 points in the Dow Jones Barometer. Fair weather cannot always continue. The Economic Cycle is in progress today as it was in the past. The Federal Reserve System has put the banks in a strong position, but it has not changed human nature. More people are borrowing and speculating today than ever in our history. Sooner or later a crash is coming and it may be terrific. Wise are those investors who now get out of debt and reef their sails. This does not mean selling all you have, but it does mean paying up your loans and avoiding margin speculation. Sooner or later the stock market boom will collapse like the Florida boom. Some day the time is coming when the market will begin to slide off, sellers will exceed buyers, and paper profits will begin to disappear. Then there will immediately be a stampede to save what paper profits then exist.? - Roger Babson, September 5th, 1929.

The crash began just a few weeks later...on October 29th, 1929.



BLACK

Make no mistake. The bulls clearly remain in charge of the market currently. Just don't fall into the "complacency trap" that such will always be the case. •This is why having some method of managing risk is critical to long-term investment success.

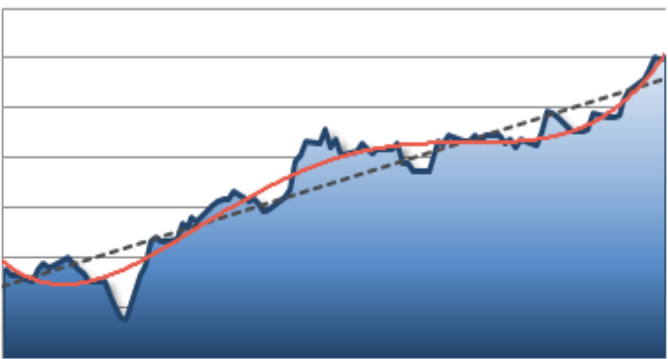
#PortfolioHedgesMatter

Market & Sector Analysis

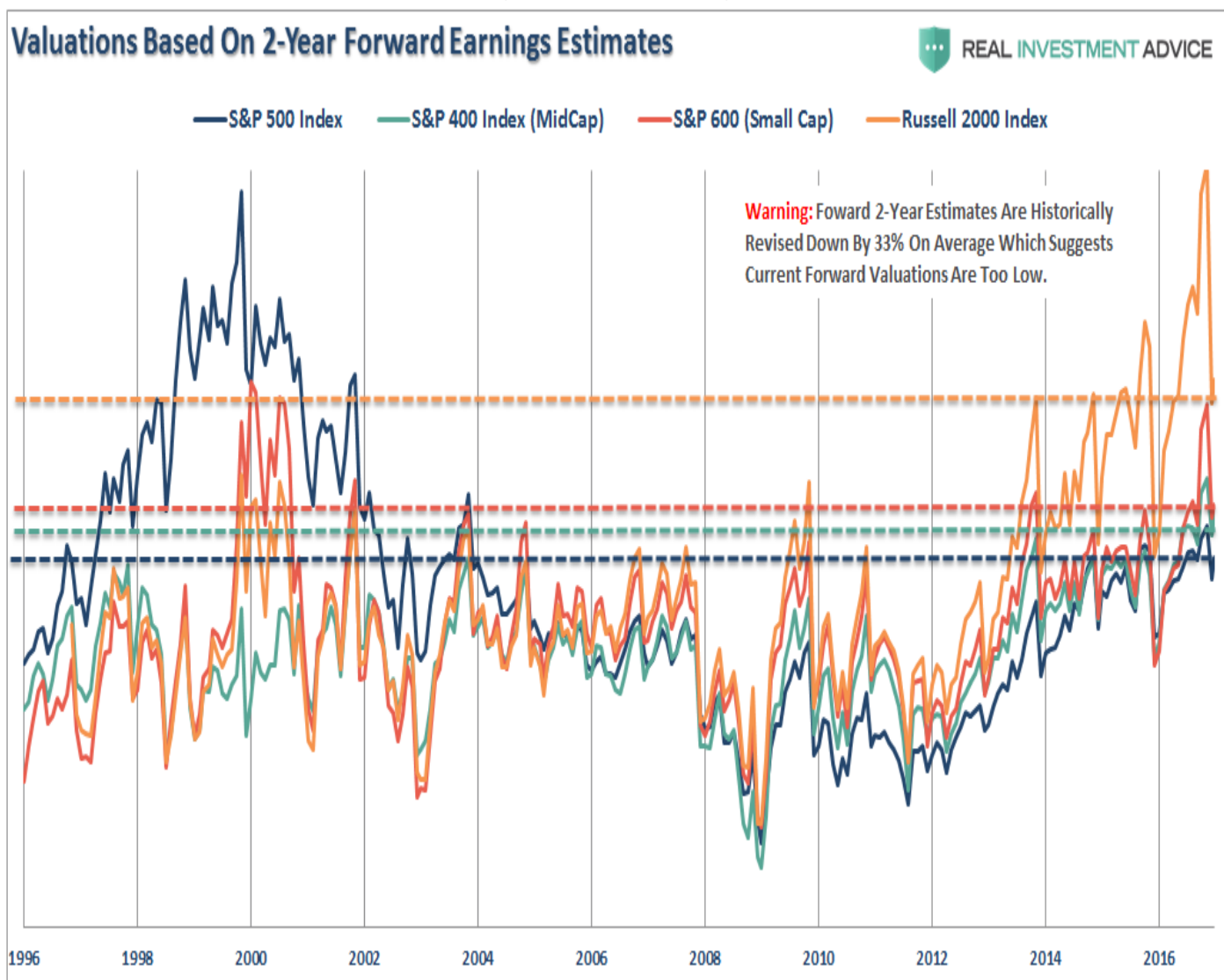
Data Analysis Of The Market & Sectors For Traders

S&P 500 Tear Sheet

The "Tear Sheet" below is a "reference sheet" provide some historical context to markets, sectors, etc. and looking for deviations from historical extremes. If you have any suggestions or additions you would like to see, [send me an email](#).

3 Month SPY Price								SPY RISK INFO					
								Item	T 2-Yr	T 1-Yr.	YTD	% Diff YTD/T1-YR	
								Price Return	11.89%	21.88%	5.17%	(76.37%)	
								Max Drawdown	-15.32%	-6.53%	-1.48%	-77.39%	
								Sharpe	0.59	1.20	1.20	0.00	
								Sortino	1.10	1.42	1.42	0.00	
								Volatility	11.93	10.21	10.21	0.00	
								Daily VaR-5%	(18.50)	6.77	0.98	(0.85)	
								Mnthly VaR-5%	(12.47)	(4.33)	(4.33)	0.00	
S&P 500 Fundamental Analysis								S&P 500 Market Cap Analysis					
Item	2 years ago	1 year ago	Current	1 Yr % Change	5 Year High	5 year Low	% From High	% From Low	Item	12-M Ago	Current	% Chg	
Dividend Yield	1.93%	2.17%	1.91%	(13.31%)	2.20%	1.83%	(12.87%)	4.67%	Shares	2,505.3	2,631.2	5.03%	
P/E Ratio	18.48	16.61	20.12	17.44%	41.89	18.44	(52.0%)	9.14%	Sales	56,060	56,317	0.46%	
P/S Ratio	2.63	2.62	3.28	20.32%	3.19	1.79	3.13%	83.94%	SPS	22.4	21.4	(4.35%)	
P/B Ratio	3.13	2.99	3.55	15.73%	3.38	2.30	5.09%	54.72%	Earnings	7,482	7,412	(0.94%)	
ROE	15.24%	15.59%	15.60%	0.09%	16.12%	15.01%	(3.23%)	3.95%	EPS TTM	3.5	3.5	1.30%	
ROA	2.89%	2.92%	2.79%	(4.45%)	2.99%	2.79%	(6.62%)	0.00%	Dividend	1.3	1.3	4.87%	
S&P 500 Asset Allocation													
Sector	1 Year Price Return	Weight	Beta	P/E	P/E High-5yr (Mo.)	P/E Low-5Yr (Mo.)	P/E % From Peak	ROE	DIV. YIELD	TTM Earnings Yield	Current Forward Earnings	Forward PE	
Energy	18.41%	6.97%	1.19	119.47	153.13	11.45	(22.0%)	3.0%	2.7%	0.74%	2.05	28.89	
Materials	23.56%	2.85%	1.40	20.05	54.34	11.91	(63.1%)	17.5%	2.1%	4.92%	3.87	17.63	
Industrials	25.05%	10.26%	1.07	19.41	25.01	12.50	(22.4%)	17.7%	2.1%	5.21%	4.02	17.85	
Discretionary	19.84%	12.20%	1.08	21.24	61.71	16.28	(65.6%)	22.5%	1.4%	4.69%	3.69	18.85	
Staples	6.15%	9.30%	0.62	21.31	25.37	15.08	(16.0%)	23.2%	2.6%	4.64%	3.50	19.37	
Health Care	9.51%	13.79%	0.94	16.66	28.59	11.16	(41.7%)	25.4%	1.7%	5.96%	5.26	14.79	
Financials	42.24%	14.82%	1.31	16.43	24.94	9.50	(34.1%)	8.5%	1.6%	6.04%	4.18	13.91	
Technology	29.47%	21.44%	1.23	22.13	74.60	16.56	(70.3%)	26.0%	1.2%	4.60%	4.00	20.21	
Telecom	5.05%	2.38%	0.50	13.69	26.08	12.64	(47.5%)	20.6%	4.7%	7.24%	2.95	13.73	

The chart below shows valuations for the S&P 500, 400, 600 and Russell 2000 based on FORWARD 2-Year Estimates. **For example, the latest reading for the S&P 500 P/E ratio is based on the current price divided by 2018 earnings estimates.** Currently, with the exception of the S&P 500, all other indices are trading at or near the highest levels since the "dot.com" crash.



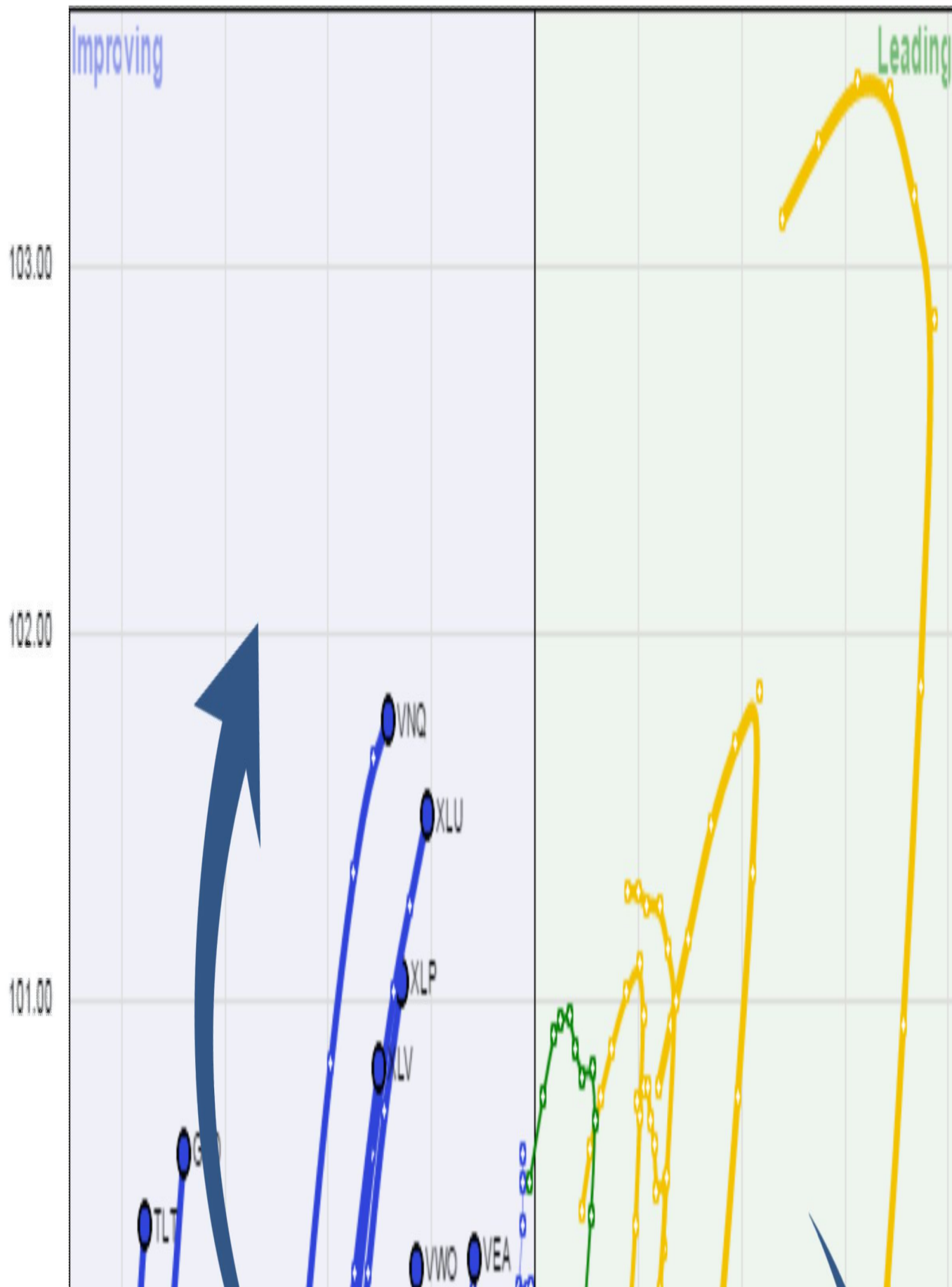
Sector Analysis

The Rotation Is Now Accelerating Over the last couple of months, I have been discussing the coming rotation of the "risk on" versus the "risk off" sectors in the market. [As I noted \(with a video\) at the beginning of the year](#), these rotations usually are early indicators of a "risk off" transition and provide opportunities for investors. Here is the rotation chart from January 5th.



As you can see, that rotation has continued to accelerate since then as expected.

Portfolio Note:•Two weeks ago I made two adjustments to the model below so it will align more closely with our actual portfolio allocations. I have swapped IDV for VEA and added VWO. Due to the weight of our portfolio hedges in portfolios currently, we are using a position in IWM as a proxy for MDY and SLY. **Portfolios reside at our maximum portfolio equity weightings including hedges currently.**•



This rotation is still likely early in its movement. **As noted previously, when the "Trump exuberance trade" reached its peak post-election, the rotation trade became very obvious.** As noted at the beginning of this missive, from a historical viewpoint corrections in the month of February tend to amass towards the end of the month. In other words, don't let this week's rally fool you. It is historically very well aligned with normal early February advances. **The "risk off" trade is likely telling us something more important. Technology, Discretionary, Industrials, Staples, Utilities, Health Care and Financials continue to push highs. Energy continued to struggle after breaking its 50-dma. Basic Materials lagged but held its ground. Notably, watch Utilities as the 50-dma is heading back up suggesting a cross of the 50-200 dma is likely. The same goes for Staples and Healthcare.**



From the broader index positioning: Small Caps, REIT's, Mid Caps, and Dividend Stocks bounced off their respective 50-dmas **BUT are all extremely extended above their longer-term moving averages suggesting a higher degree of risk.** Emerging and International markets got a lift from the weakening dollar which prompted an increase in International weightings in portfolios two weeks ago from a trading perspective. These areas are also extremely overbought currently as well. **Caution is advised.** Like Utilities, Staples and Healthcare above, **watch REIT's where the 50-dma is about to cross above the 200-dma which should provide for additional support for the sector.**



The table below shows thoughts on specific actions related to the current market environment.●

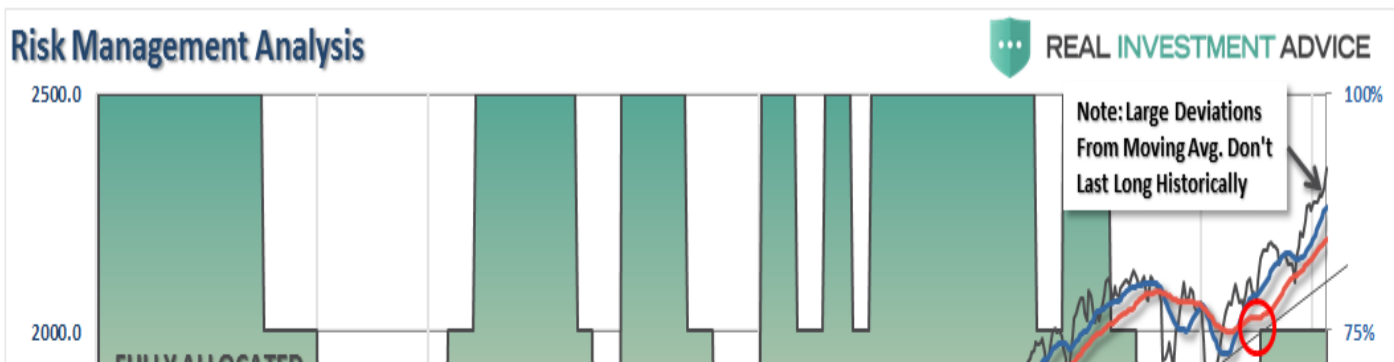
(These are not recommendations or solicitations to take any action. This is for informational purposes only related to market extremes and contrarian positioning within portfolios. Use at your own risk and peril.)

	Over Bought / Sold	50/200 DMA	Trend	Action	Notes
XLY	OB	Positive	Positive	Hold	Improving
XLK	OB	Positive	Positive	Take Profits	Extreme Overbought/Weakening
XLI	OB	Positive	Positive	Take Profits	Overbought/Weakening
XLB	OB	Positive	Positive	Take Profits	Extreme Overbought/Weakening
XLE	OS	Positive	Positive	Warning	Broke 50-dma
XLP	OB	Negative	Improving	Hold	Added To Portfolio - Hold
XLV	OB	Improving	Improving	Hold	Added To Portfolio - Hold
XLU	OB	Improving	Improving	Hold	Added To Portfolio - Hold
XLF	OB	Positive	Positive	Take Profits	Overbought/Weakening
\$SML	Declining	Positive	Positive	Take Profits	Overbought/Weakening
EEM	OB	Positive	Positive	Hold	Dollar / Rate Risks
EFA	OB	Positive	Positive	Hold	Added To Portfolio - Trade Only
GLD	OB	Negative	Negative	Sell	Overbought/Target \$120
IDV	OB	Positive	Positive	Reduce	Dollar/Rate Risks
MDY	OB	Positive	Positive	Hold	Added To Portfolio - Trade Only
SDY	Declining	Positive	Positive	Hold	Weakening
TLT	Declining	Negative	Negative	Hold	Added To Portfolio - Hedge
VNQ	Declining	Improving	Improving	Hold	Added To Portfolio - Hedge

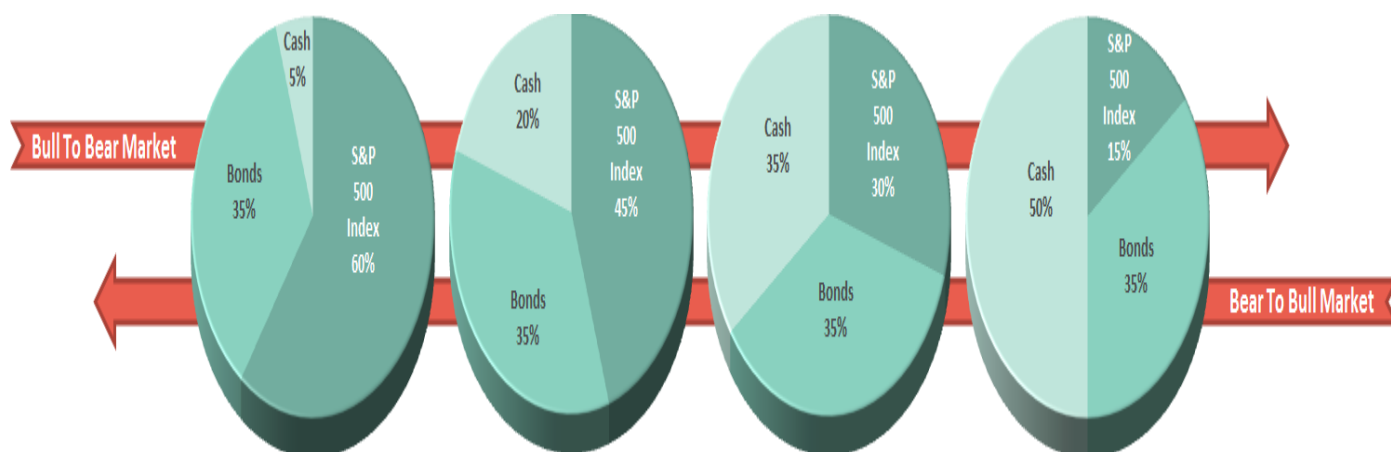
Portfolio Update: Ten●weeks ago, as suggested, we hedged our long-equity positions with deeply out-of-favor sectors of the market (*Bonds, REITs, Staples, Utilities, Health Care and Staples*) which have continued to perform well in reducing overall portfolio volatility risk. As noted two weeks ago, we added two new positions from a "Trading" perspective only: **IWM - Russell 2000 and VEA - International** The short-term bullish trend and technical setup required an increase in equity risk in portfolios. **However, all positions●maintain very tight trailing stops as the mid to longer-term dynamics of the market continue to remain very unfavorable.**●No new additions to equity are currently recommended as risk/reward remains unfavorably balanced going into next week. **Rebalancing remains●strongly advised.**

THE REAL 401k PLAN MANAGER

The Real 401k Plan Manager - A Conservative Strategy For Long-Term Investors



There are 4-steps to allocation changes based on 25% reduction increments. As noted in the chart above a 100% allocation level is equal to 60% stocks. I never advocate being 100% out of the market as it is far too difficult to reverse course when the market changes from a negative to a positive trend. Emotions keep us from taking the correct action.



Markets Push Extremes, But Bulls Remain In Charge

As I noted last week:

*"While, in retrospect, I should have increased the 401k model allocation to 100% at the beginning of the year, **the risk/reward setup for an incremental increase in exposure simply has not been justifiable given the limitations that exist in 401k plans as it relates to trading limitations.**"*

A correction back to short-term supports around •2200-2250 on the S&P 500 would likely be a "buyable" trading level. **As noted in the chart above, the current extension above the moving average will likely be corrected sooner rather than later.** Such a correction will relieve some of the extreme overbought conditions that currently exist and allow for additional risk exposure in portfolios if needed.

I continue to suggest using this current extension•to as an opportunity to clean up portfolios.(Use guidelines noted [previously.](#))

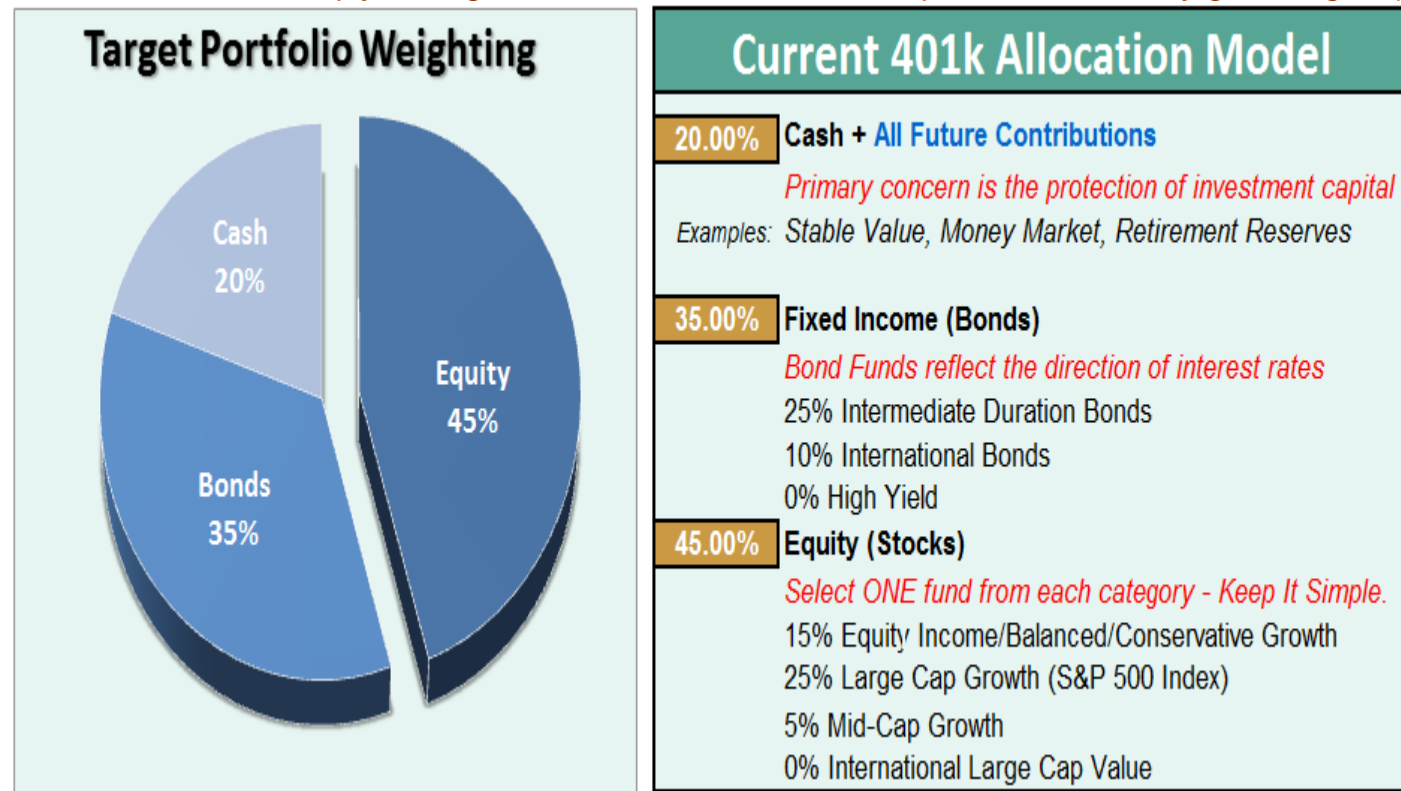
1. Tighten up stop-loss levels to current support levels for each position.
2. Hedge portfolios against major market declines.
3. Take profits in positions that have been big winners
4. Sell laggards and losers
5. Raise cash and rebalance portfolios to target weightings.

If we can get a correction that resolves the overbought, extended and excessively bullish backdrop to the markets currently, I WILL increase the allocation model to 100%. •For now, we will wait and let the markets tell us what it wants to do next. If you need help after reading the alert; don?t hesitate to [contact me.](#)

Current 401-k Allocation Model

The 401k plan allocation plan below follows the K.I.S.S. principal. By keeping the allocation

extremely simplified it allows for better control of the allocation and a closer tracking to the benchmark objective over time. *(If you want to make it more complicated you can, however, statistics show that simply adding more funds does not increase performance to any great degree.)*



401k Choice Matching List

The list below shows sample 401k plan funds for each major category. In reality, the majority of funds all track their indices fairly closely. Therefore, if you don't see your exact fund listed, look for a fund that is similar in nature.

Common 401K Plan Holdings By Class

Cash	Stable Value	Equity	
	Money Market	Large Cap	Vanguard Total Stock Market
Fixed Income	Retirement Savings Trust		Vanguard S&P 500 Index
	Fidelity MIP Fund		Vanguard Capital Opportunities
	G-Fund		Vanguard PrimeCap
	Short Term Bond		Vanguard Growth Index
			Fidelity Magellan
	Pimco Total Return		Fidelity Large Cap Growth
	Pimco Real Return		Fidelity Blue Chip
	Pimco Investment Grade Bond		Fidelity Capital Appreciation
	Vanguard Intermediate Bond		Dodge & Cox Stock
	Vanguard Total Bond Market		Hartford Capital Appreciation
	Babson Bond Fund		American Funds AMCAP
	Lord Abbett Income		American Funds Growth Fund Of America
	Fidelity Corporate Bond		Oakmark Growth Fund
	Western Asset Mortgage Backed Bond		C-Fund (Common Assets)
	Blackrock Total Return		ALL TARGET DATE FUNDS 2020 or Later
	Blackrock Intermediate Bond		
	American Funds Bond Fund Of America	Balanced Funds	Vanguard Balanced Index
	Dodge & Cox Income Fund		Vanguard Wellington Fund
	Doubleline Total Return		Vanguard Windsor Fund
	F-Fund		Vanguard Asset Allocation
International			Fidelity Balanced Fund
	American Funds Capital World G&I		Fidelity Equity Income
	Vanguard Total International Index		Fidelity Growth & Income
	Blackrock Global Allocation Fund		American Funds Balanced
	Fidelity International Growth Fund		American Funds Income Fund
	Dodge & Cox International		ALL TARGET DATE FUNDS 2020 or Sooner
	Invesco International Core Equity		
	Goldman Sachs International Growth Opp.	Small/Mid Cap	Vanguard Mid Cap Growth
<p>The above represents a selection of some of the most common funds found in 401k plans. <u>If you do not see your SPECIFIC fund listed simply choose one that closely resembles the examples herein.</u> All funds perform relatively similarly within their respective fund classes.</p>			Fidelity Mid Cap Growth
			Artisan Mid Cap
			Goldman Sachs Growth Opportunities
			Harbor Mid Cap Growth
			Goldman Sachs Small/Mid Cap Opp.
			Fidelity Low Price Stock Fund
			Columbia Acorn US
			Federated Kaufman Small Cap
			Invesco Small Cap