Strategy Update—Too Much of a Good Thing?

I am travelling in Asia for the next 9 days so please pardon the brevity of updates here. I'll be back on the regular schedule in early February.

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Long Story Short—The surge to S&P 1,500 begins to look a bit frothy….

The equity market appears to be coming around to the realization that the global economy and the US economy are in a bit better shape than most presume. Recent jobless claims data are hitting post-recession lows and this morning's PMI report showed a very strong reading of 56.1 in the USA. It's very clear that the odds of a recession in the near-term are extremely low. But the market doesn't always perfectly rhyme with the economy so we have to begin to wonder if the recent rally is totally justified.

Let's look at some of the facts. The S&P 500 is up 12 of the last 17 sessions and 7 sessions in a row. The first 24 days of the year have the S&P up 5.2% (as of my writing the S&P is touching 1,500). That's an annualized return of 79%. The S&P averages a real return of 6.7%. Investors are universally bullish, whether it be small investors or institutional managers (smart money). Technicals are starting to look incredibly fragile with many of the indices beginning to make parabolic moves higher. The QD model remains in a "risk off" reading.

While my strategic (longer-term) position remains quite bullish, I am growing increasingly concerned about this market in the near-term. I am moving from a cautious tactical positioning to a bearish position. That means I am comfortable shorting indices at this level. While I am by no means expecting a huge market sell-off I am concerned that equity investors are now beginning to price in something more than a mere muddle through economic environment. The risks to the market will not become obvious until everyone has realized them, but we're not

In the business of predicting every zig and zag in the market. We are in the business of understanding the macro drivers impacting portfolio composition and managing the risks AROUND the zigs and zags of the market.

Equity investors have clearly come around to the bullish cyclical position I've long maintained, but we have to remember that the market is ultimately the summation of the decisions of its participants. At present, the participants are almost universally expecting a positive market environment going forward and in doing so they have created an unusual market environment in which prices become compressed due to this optimism. Rather than seeing a natural pricing process where the market zigs and zags higher (or lower) we are seeing optimism drive prices to somewhat irrational levels. So, instead of an average 6.7% return panning out over the course of 12 months we're seeing a huge time compression here where most of that is priced in over the course of a few weeks. I don't think a positive equity market return is unwarranted in 2013, but I do think that the current trend is not only unsustainable, but likely irrational.

* Bear in mind, shorting is not appropriate for everyone and can be extremely risky. As a tactical component this sort of strategy should **never** make up the majority of your portfolio and should instead be used to hedge and smooth a large core component. Anyone who shorts the market permanently WILL lose and should realize that shorting is nothing more than a moderately aggressive bearish posture and not a sustainable long-term money making strategy. In addition, we have to consider the reality that all of this current optimism could lead to even more optimism, but as risk managers we're not in the business or riding trends. We are in the business of attempting to smooth out trends.

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