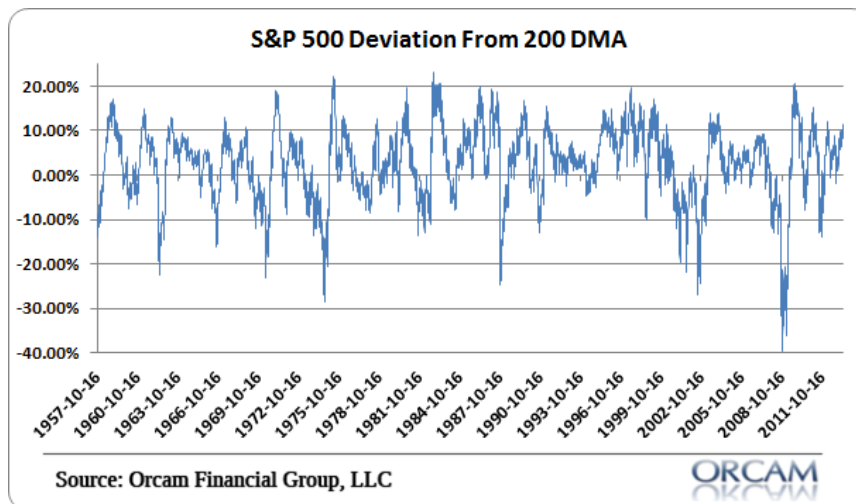




The Teflon Market

Does Mean Reversion Exist in a Teflon Environment?

One of the few guarantees in the markets is the existence of mean reversion. It's not always predictable, but it is unavoidable on some timeframe. It's important to consider a potential mean reversion when the market is at extremes like it is today. For instance, the chart below shows the S&P 500's % deviation from its 200 day moving average. The current reading of 12.5% or higher is something that only occurs about 10% of the time the market is open. So we're in a highly unusual environment.



But that doesn't mean a reversion to the mean is necessarily right in front of us. In fact, of the 33 instances where the market first reached the 12.5% deviation level it was negative just seven times three months afterwards. The data is a bit less convincing in the

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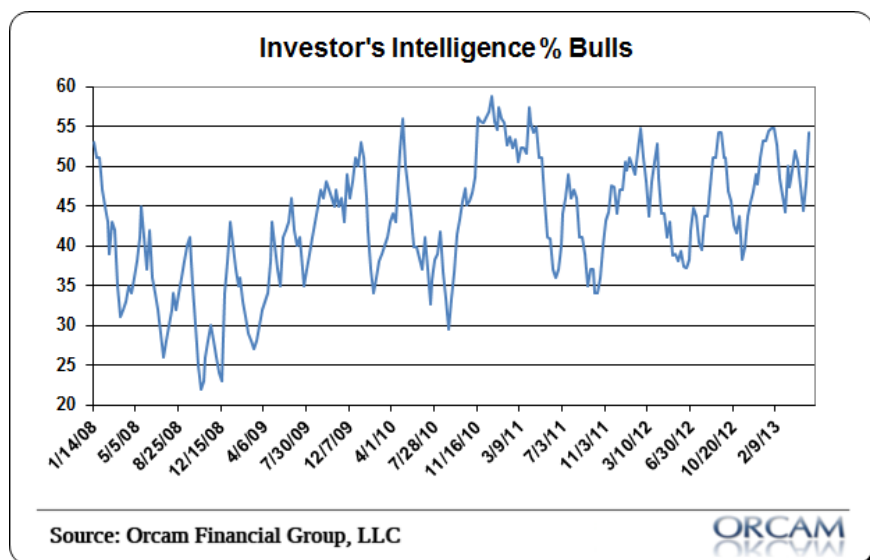
**The appearance of a
Teflon market is
surely an illusion—or
is it?**

near-term though not by much. Of those thirty three instances the market was down just ten times one month afterwards. The average returns are also overwhelmingly positive. On a one month basis the S&P 500 has historically traded 0.42% higher one month following the 12.5% deviation level while it was higher by 3.01% three months after.

That data surprised me as I would have expected it to show something a bit more negative. Instead, it seems to confirm the old saying “a trend is your friend”. Of course, this data isn’t bullet proof and thirty three data points hardly make a highly reliable data set, but it does provide some interesting historical perspective. It makes me feel a bit better about my bullish strategic view of the market though worse about the tactical view.

That said, I still think my strategic/tactical balance remains the prudent way to approach this type of a market. I think we have to approach this environment as its own totally unique data point because of the extraordinary influence that Quantitative Easing and market psychology appear to be having on price action. And I still believe that it’s prudent to remain strategically bullish (cyclically bullish) and tactically (short-term) bearish. Mr. Market has a tendency to be rather manic and sentiment readings are now overwhelmingly bullish (as they have been). The data point that really jumps out is the Investor’s Intelligence poll of investment managers which is now in nosebleed territory once again. In the past 5 years this has occurred just 6 times and the market has averaged a 0.2% return 3 months in advance. Bear in mind that’s during a raging bull market advance so this sentiment reading has tended to coincide with a market that is psychologically stretched.

Of course, the last time we saw this reading was back in January of this year and the market has advanced in a nearly straight line since then, but that’s Mr. Market for you. Clearly, he’s taking his meds at present and feeling awfully good about himself. And while mean reversion might not be a guarantee this remains an environment in which



investors should be overweight the core strategic piece of a portfolio while also using the tactical piece to remain somewhat cautious.

As I've long stated, the core strategic piece remains quite bullish based on my expectations for continued modest economic growth and low risk of recession. But this is not the type of market I feel comfortable being exposed to a 100% equity position. Therefore, I would continue to remain bullish on a strategic basis and more bearish on a tactical basis. If Mr. Market decides he doesn't like what he sees we're likely to see the air come out of this market quite quickly. I wouldn't bet aggressively on that scenario, but given the uncertainty regarding the end of QE and the embedded psychological put surrounding QE I think that remains a wise approach.

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