Continue to Embrace the Fear

Fear is a Good Thing

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Fear is a powerful and dangerous emotion.

We usually think of fear as a bad thing. But when you can understand the irrational thinking that causes fear you can often use it to your advantage. This is, in my opinion, one of the advantages of forming a very strict rules based & automated approach to portfolio management. Although I approach the markets from a rather complex understanding I actually funnel my conclusions into a series of neat and simple rules. One of those rules is adhering to the idea that the emotional responses of other investors should not alter my strategic view of the markets, but allows me to take advantage of potential tactical moves.

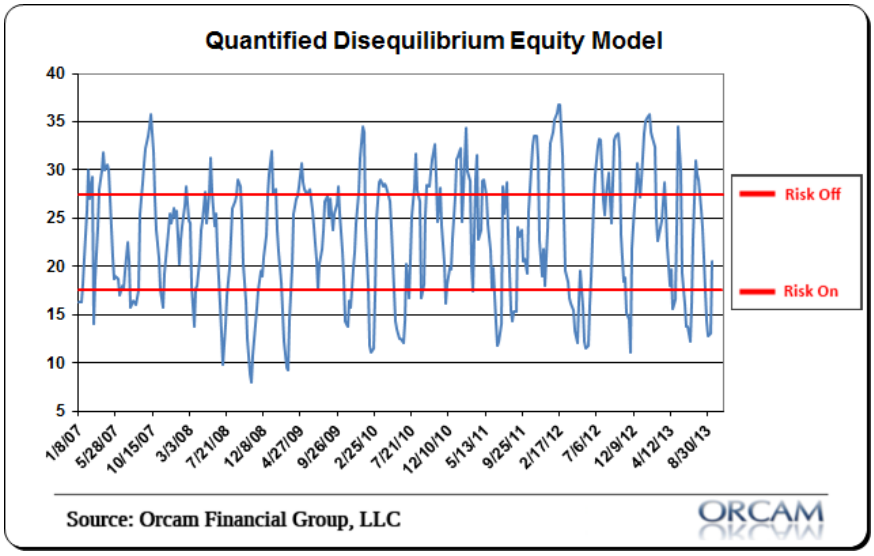
2 weeks ago I mentioned that the Syrian conflict, the debt ceiling, taper and the other fears in the market were likely overblown and that the fear should be embraced. The S&P 500 is up a quick 3.5% in the last 2 weeks as these fears were indeed proved to be overblown and the market is now in a self-correcting phase where investors are realizing that the big picture story hasn't really changed all that much.

It's helpful to put this emotional response in some sort of perspective. The chart at the right shows the Volatility Index which shows the

implied volatility of the S&P 500. Now, you have to be careful with this index because it doesn't only imply negative volatility, but also implies positive volatility. But it often spikes when fears of future expected negative volatility spike. You just have to interpret the change in the index as it pertains to the current market environment. Clearly, the recent rise in the index was due to expected fears of future negative volatility so options traders were protecting themselves against this potential change in the market. And if you have some capability of model for trading into the fear then you can decipher when the risk/reward favors the bold.

And we witnessed something that has become all too commonplace in recent years. The VIX spikes and then traders realize that nothing has really changed. Of course, the key to knowing whether the VIX spikes matter is being able to differentiate between a benign spike and an even when it truly is "different this time". I believe we can model the high probability of an outlier event by using the Orcam Recession Index because extreme economic fragility tends to coincide with extreme market fragility. As I've shown in the past, every single 30%+ decline in the market in the last 40 years has occurred within a recession. So, from a risk management perspective we can substantially hedge our risks if we can make a credible bet that there is a recession on the horizon. And as the Recession Index has shown consistently now for 5 years, the risk of recession is not present.

That said, the VIX is still elevated. The fear is still out there. At 14.3 the VIX is still consistent with an environment where portfolio managers are still overly cautious. And that means the path of least resistance remains on the upside. This is also confirmed by the QD model which is nowhere near a "risk off"



reading at present. The latest reading of 20.5 is a bit more neutral, but still consistent with more bullish positioning. Based on my estimates we're likely to remain in a "risk on" mode for several more weeks at a minimum.

In short, continue to embrace the fear!

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