HedgeFolios Strategy Advisory

“Speculative Fever at Record Highs”

12-9-2020

Our Current View:

November was superb for equities as all the major indices raced to new all-time highs. Powered by newfound vaccine optimism and the Fed’s now-quiet injection of billions of dollars into the financial system, inflows into stocks hit record highs as investors pulled out of safe havens, like bonds and gold. In fact, money has been flowing into some of the more speculative areas of the markets in droves.

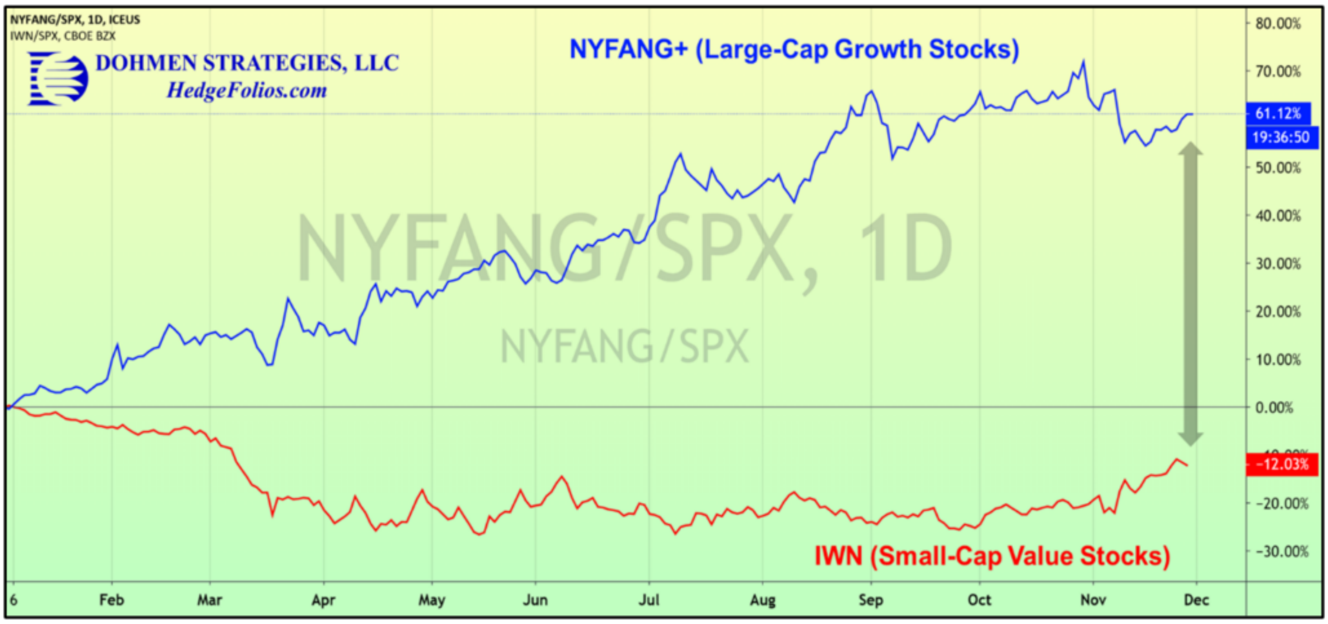
It is important to understand that speculative fever goes through different stages. To us, it looks like we are now in the final, “ridiculous” stage. Today’s IPO of Doordash (DASH), a food delivery firm with no earnings, could be the final indicator of that. The stock **soared a huge 70%** from its IPO price when it debuted today (12/9/2020).

C3.ai, an artificial intelligence technology company, also with no earnings, had its first day of trading as well, under the symbol AI. After trading was temporarily halted midday due to the huge run-up in price, the stock closed with one-day **gains of over 120%.**

With some of the speculative areas of the markets running hot, in our HedgeFolios, we try to identify the sectors of the market that are outperforming and monitor changes in rotation, which is a critical element of our active investing strategy.

Over the past several weeks, the markets have seen the leaders and laggards of the summer rally swap roles. Now, instead of high-flying tech stocks driving the markets higher, it has been small, cyclical companies leading the way.

Below, we show the relative year-to-date performance of the NYFANG+ (blue line, representing the popular mega-cap growth tech stocks) and the IWN (red line, representing small-cap value stocks), compared with the performance of the S&P 500.



The IWN, which has outperformed the S&P 500 by more than 13% over the past 3 months, is now closing the huge divergence that emerged over the summer, meaning the best opportunities on the long side could likely come from these smaller value stocks if the rally continues.

The big question, of course, is whether the rally will continue. With stocks racing higher than ever, many investors are feeling that a correction is overdue. In environments like these, however, rallies can often persist longer than most investors expect.

All four of the major indices – the S&P 500, NASDAQ Composite, Dow, and Russell 2000, have surged to record highs. The only source of technical resistance standing in the way of the broader market is the January high for the VALUG index, shown below:

In today's trading (12/9/2020), the VALUG stopped just shy of this resistance level, only a few points away from setting a new high for 2020. That is strong resistance. Now we have to see how strong a pullback could be and how long it could last.

Trading volume and exuberance continue to persist, but those can change quickly. If the VALUG breaks out higher, there will be little in the way of technical resistance to stop the broader market from continuing to advance.

It is more important than ever, however, for investors to stay on their toes in environments like these. **Excessive stock enthusiasm has led to new record highs on many indicators lately**, which have gone even higher than they were at prior important tops, such as the bubble of 1999-2000. This is a warning signal that **the market is getting frothy.**

One indicator showing this enthusiasm is short interest in the S&P 500. As shown on the 18-month chart below, short interest in the SPX has totally evaporated and now at its lowest level in years:

By itself, low short interest does not forecast an immediate decline. In fact, in environments like this one, stocks can continue to rise for a while even as bearish indicators begin to pile up.

However, with fewer traders taking the short side, any decline would not get support from short covering. No one can forecast the end of a trend ahead of time, we can only try to determine when it is ready to start through technical analysis.

Gold prices, on the other hand, are looking entirely different than equity prices. After sustaining some rough losses since the top in August, we are now seeing a turnaround in the market which could be the start of a new leg higher. We show the daily chart for gold futures below:

After a steady rise over the past few days, the futures price has climbed back above important resistance from the September and October lows (blue dashed line). Moreover, the rejection of the money flow indicator (green line, bottom of chart) from "oversold territory" is also a signal that the prevailing downtrend may have concluded with the bottom on November 30th. Thus, Gold and silver are now looking attractive.

Having exposure to gold can be very useful when stocks have mild to moderate declines, as it is considered a "safe haven." However, it is important to recall that this does not apply during a sharp plunge or crisis, when investors sell anything and everything to raise cash.

CONCLUSION: The stock market is definitely becoming frothy, with sentiment indicators reaching bullish extremes. The technicals on the charts of the major indices, however, remain bullish and suggest that the upside may continue for a little while longer. For the past several weeks, we have said in our Wellington Letter that the rally is likely to go to January. That, of course, is not a guarantee that it will.

Our HedgeFolios:

Since our last Strategy Advisory, we sold XME, the SPDR Metals & Mining ETF, from all our HedgeFolios and replaced it with exposure to GDX and SIL, which track gold and silver miners, respectively.

The XME has exposure to both the precious and industrial metals mining industry, the latter of which is showing signs of weakness. By buying GDX and SIL, we aim to take advantage of the ongoing upside reversal in the precious metals markets.

We also took a new position in GMF, the SPDR Emerging Asia & Pacific ETF, in our Global Equity HedgeFolio. Emerging markets have not only been one of the strongest performing sectors in the

DOHMEN STRATEGIES, LLC

market but are also one of the least crowded.

Finally, we added ARKK to all five of our HedgeFolios. With the broader market signaling potential new opportunities on the upside, this very-well managed active ETF is looking very attractive, offering exposure to some of the leading tech and biotech firms.

Our Conclusion:

We still see signs of speculative juices flowing. Money seems to want to get into the market before year-end. That way, customer statements of money managers don't show that they were too careful.

Right now, charts and technicals are now giving much better clues than the fundamentals. We will stay alert heading into the New Year as January could bring lots of turmoil. Keep that in mind in your investment plans, as the higher the major indices go, the more vulnerable they become to a stiff correction.

When everyone is plunging in, it's usually a good idea to have an exit strategy to implement when the "sell signals" appear. For now, however, we remain confident that the markets have more upside ahead of them through year-end. As always, we will watch it closely for you.

Wishing you successful investing into the New Year,

Bert Dohmen and team