HedgeFolios Strategy Advisory

"Don't Fall for the 'Buy the Dip' Trap"

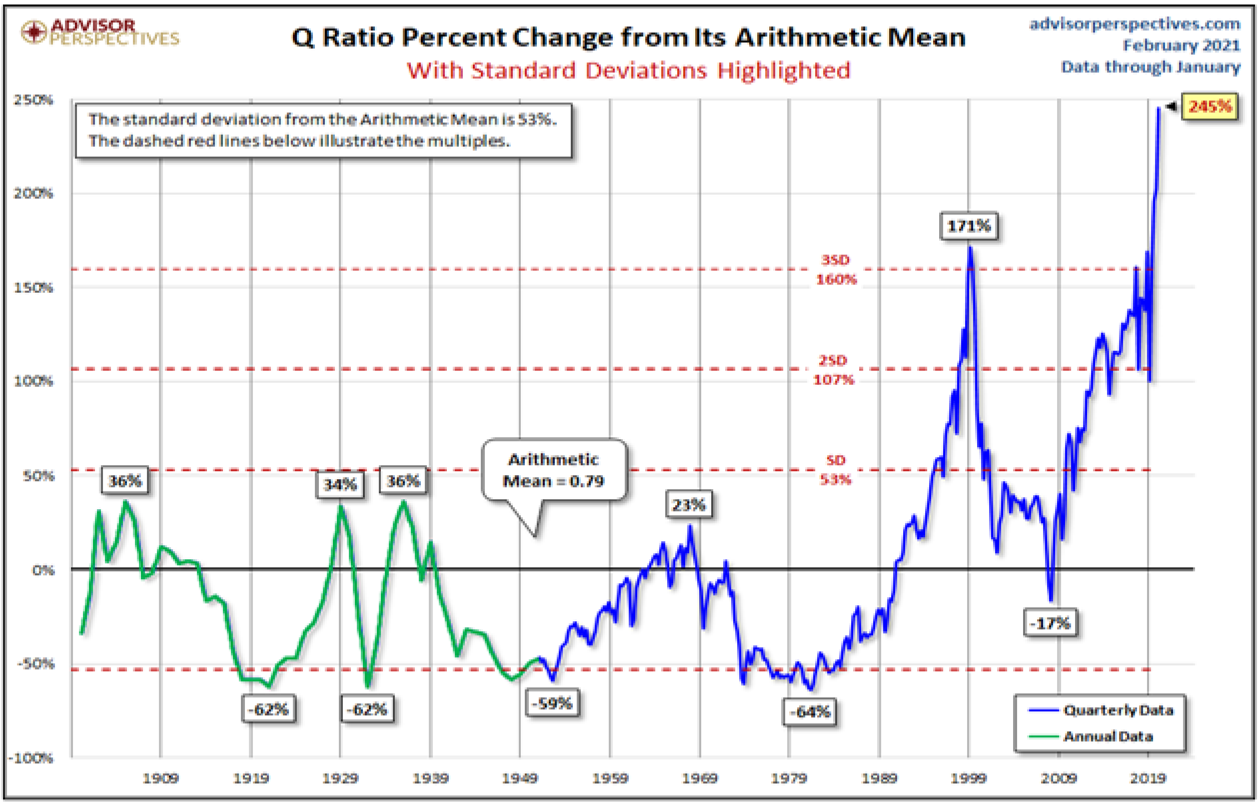
2-23-2021

Our Current View

So far, the trillions of dollars in new stimulus from the Fed and the Treasury have done their job of keeping the stock market trudging higher. Vaccine mania and now the "reopening" narrative have added fuel to the fire, confirming our belief that markets would start the year off strong, as investors prepared for "life after COVID-19."

Our Theory of Credit and Liquidity, established in 1977, suggests that money supply and demand are far more important indicators than the earnings and dividend yields circulated by analysts on financial TV. Our theory has a much better track record. In 2020, the U.S. M1 Money Supply, which typically has slow and steady growth from year to year, ***rose by an astounding 70%.***

As a result, **money is flowing into asset prices, creating what could easily be called the most overvalued market in history.** Consider the chart below from Advisor Perspectives, which shows the stock market's "Q-ratio," measuring the ratio of the stock market's value to the replacement value of its firms:



At the height of the dot-com bubble (see 1999 on chart), the Q-ratio reached a peak of 171%, meaning stocks were trading close to twice the amount of value that would be necessary to replace their assets. During the dot-com crash, that 171% premium was entirely wiped out. Today's measure, a 245% premium of stock's market value, puts even that extreme to shame.

The incredible overvaluations, coupled with a lack of short-sellers, mean that any upcoming correction is likely to be more severe and longer-lasting. It means the markets are sensitive.

Yesterday, February 22nd, we saw what could be the first stages of a big correction, as the NASDAQ had its worst single-day decline since January 27th. Today, that decline was extended.

"Buy the dip" is now the rallying cry from Wall Street. We wrote during the late January decline that it was a conditioning test, to get traditional money managers and investors conditioned to "dips." When the real plunge finally starts, these people will continue to buy the dips. They will be buying all the way down, giving the HFT firms plenty of profits by short-selling.

In yesterday's issues of our short-term trading services, the *Smarter Stock Trader* and *Fearless ETF Trader*, we wrote:

Raise cash positions. The NASDAQ led the plunge today. Broad indices were not affected much. However, the NASDAQ could trigger additional selling, which could quickly turn into an avalanche. Our work suggests that March should be a weak month for the stock market. Reduce exposure.

Our decision was confirmed in today's trading after tech stocks took another major hit. The speculators have had a rough start to their week.

In today's session, the NASDAQ Composite dropped down to support at its recent swing low from January 29th, shown on its daily chart below:

The index, however, is now more than 5% off its all-time high set on February 16th. We do not expect support to hold for long, as the heightened volatility we've seen over the past few days will likely lead big price swings in the days ahead. Don't let the rebounds fool you.

While the selling is currently most concentrated in the tech sector, we believe too much exposure to any stocks in this environment could be risky. In the event of an investor panic, anything and everything will be sold.

Take a look at one of the most speculative areas of the market, cryptocurrencies. Over the past *two weeks*, Bitcoin was surging to new record highs every day. But just in the past *two days*, Bitcoin crashed more than $13,500 from its high on Friday to its low today. That's a 23% plunge! This is another important signal that money is quickly moving from more aggressive "risk-on" areas into ones that are considered more defensive and "risk-off".

Two "risk-off" areas of the market that are catching a bid are the precious metals sector and commodity indices, which still look very good after today's roller-coaster. The latter was even up at the close. We can conclude that our forecasts over the past several months of rising inflation over the next several years will yield great opportunities, but also affect other sectors adversely.

Our HedgeFolios

Much like we recommended in our short-term trading services, we believe the best move now is to **raise cash**. The big selling we're seeing in the tech sector could easily spread to other parts of the market, and volatility tends to bring about more volatility.

In each of our 5 HedgeFolios, we've significantly increased our cash allocations to around 40-45% by shedding exposure to our higher-risk positions in the tech and clean energy sectors. In particular, we've exited all positions in the ARK family of funds, which have become overcrowded and are very sensitive to high-flying stocks like Tesla, which is long overdue for a sizeable double-digit correction.

In our Global Equity, Global Conservative, and U.S. Conservative portfolios, we've increased our exposure to the Invesco DB Commodity Index Tracking Fund (DBC), which tracks the performance of a diverse basket of commodity futures. Commodities stand to benefit nicely from rising inflation expectations and will nonetheless do well even if the "reopening" story plays out.

Our Conclusion

The "reopening" narrative will keep the public positive for a bit longer and keep them from selling. It is a great plan. We ask: isn't the reopening already factored into today's prices?

Therefore, we could very well likely see stocks trade higher over the next several days, ahead of the next plunge. However, we caution; don't fall into the trap.

The bulls have run out of gas. How many times can money managers buy stocks because of a vaccine, a reopening, and a dismal excuse for an economic recovery?

Wishing you successful investing,

Bert Dohmen and team