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## HedgeFolios Strategy Advisory

# Reducing Exposure Ahead of a Volatile New Year

12-28-2024

### Our Current View:

In our December 20 trading services (two days after the big market plunge on December 18), we explained to our members,

The natural reaction now for the **short term** is for money managers and retail investors to consider bargain hunting. **That shouldn't last very long because cash levels are so low.**

In addition, the swamp creatures in Washington still have a month to sabotage the incoming administration. Anything can happen, including a lot of unpleasant surprises.

Our rule is that when the risk/reward is about 50-50, we prefer to **have low exposure or stay on the sidelines** until the fog clears.

We also showed a number of charts that had become **oversold**, which is why we said the **next shorter term move should be up. That may be brief.**

We got that short-term bounce over the next 4 trading days. However, on Friday (December 27) we once again saw another onslaught of selling. Now it looks like a technical bounce is over, meaning that **a larger decline is a higher probability.**

Of course, Friday's market action should not be a reason to make an investment decision. However, it was the second-to-last full day of trading this year. For us, that is a reason to make some important decisions.

As we wrote in our December 8 **HedgeFolios Strategy Advisory**, we expected a year-end rally but said it would be isolated to the **winners/leaders**, including the Mag 7, AI, and tech stocks. Those are the areas that have held up well all December and have outperformed the broader market during the recent volatility.

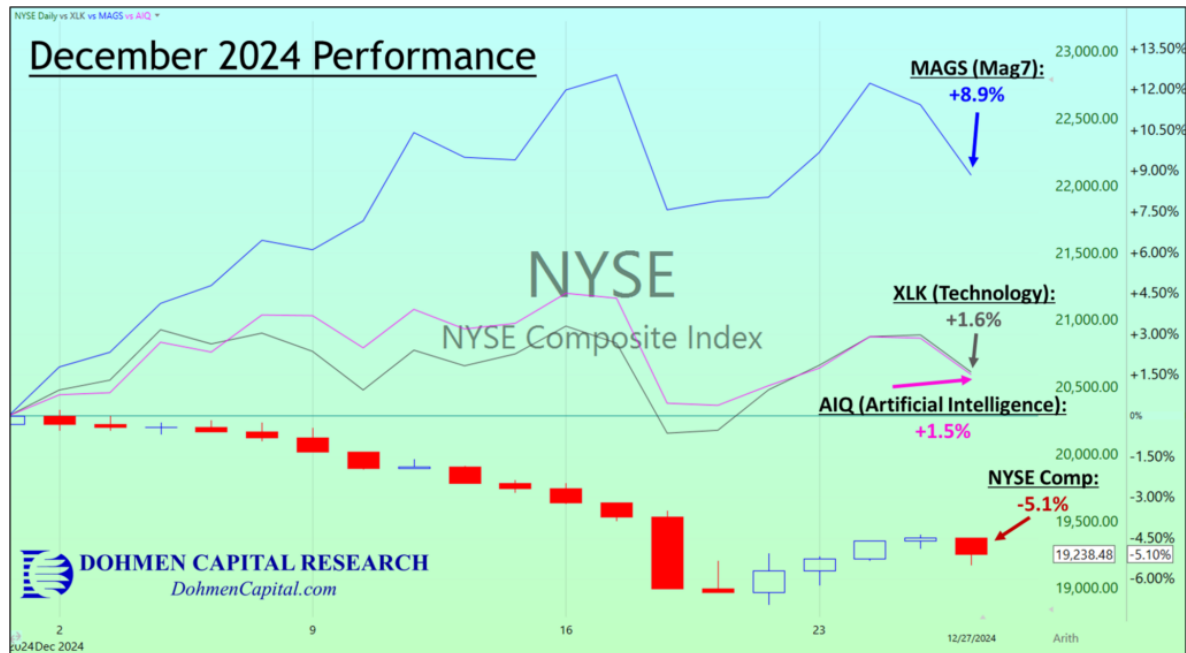
Meanwhile, the majority of analysts and money managers had expected a broad strong year-end rally. It did NOT materialize, and the market strength did not broaden out.

We can see this on the daily comparison chart below showing the December performance for the Mag 7 stocks, AI stocks, Tech Stocks, and the broader market represented by the NYSE Comp. Here are

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their returns:

- MAGS (Mag 7, blue line) = +8.9%
- XLK (Technology, grey line) = +1.6%
- AIQ (AI stocks, pink line) = +1.5%
- NYSE (broad market, candlesticks) = -5.1%



We explained in our last two **Wellington Letters** that investors of all types had record long positions in stocks and call options. At the same time, cash levels were at lows by a number of measures, meaning **there was not enough fuel for a prolonged market rally.**

While these record positions are not exact timing measures, it gives us a measure of vulnerability of the market. With optimism at the highest in decades because of the election outcome and the plans of the newly elected administration, things were at levels that couldn't get better. When they can't get any better, then even small negatives can shake up the markets.

We have often shown the chart of the NYSE COMPOSITE because it is very broad and therefore not affected by manipulations as much as the S&P 500 or DJI.

The 2-day chart below shows the decline since the start of December. **It was the largest decline for the NYSE Comp since 2023.** Therefore, you can see there was no year-end broad market rally as most analysts expected.

Note that on the 2-day chart that the sharp December decline had a normal technical bounce last week, right to the resistance at the lower line of the Dohmen Deviation Channel (blue diagonal lines). Now it is turning lower. This is a bearish pattern.



The 2 day chart of the ETF for small cap stocks, IWM, below had a sharp decline in December as it **fell over 8%**. The bounce last week went exactly up to resistance (upper red horizontal line) and was rejected, turning lower on Friday.

One day doesn't make a trend, but so far it looks like the December plunge could be the start of something worse.



**CONCLUSION:** When the opposite of the widely expected occurs, it is an important signal to consider being a contrarian. Because the masses are still bullish, the winning investors early next year are likely to be on the opposite side.

We have been very cautious during this time, contrary to most investors, and have pointed out that **cash will be important.**• Warren Buffett is reported to have had over a **record \$325 BILLION** in cash in his Berkshire vehicle.

**POTENTIAL PULLBACK TRIGGERS:** On Friday we heard analysts say that it was just a normal market pullback and there was **nothing to worry about.**• If they are fully invested with customer money, what else can they say?

**One convenient trigger for a shocking market decline would be a plunge in bitcoin and the crypto firm stocks.** The big, highly leveraged firms like Coinbase (COIN) and MICROSTRATEGY (MSTR) are very vulnerable to margin calls they can't meet. The latter is said to have a huge 4 to 1 leverage.

If any group, such as the enemies of the incoming administration, **wants to cause a stock market crash**, the demise of any of these two firms could be a very good trigger.

A market plunge or crash would change the current positive sentiment for the economy and markets overnight. Money would leave the equity markets, especially when the margin calls go out and investors can't come up with the cash. Some may even lose their house.

The propaganda news TV would say that investors disagree with the Trump agenda.

In a margin call crisis, everything that can be sold is sold, even conservative stocks, along with gold and silver. The **risk/reward** ratio of leveraged investors is now extremely high.

Always ask yourself, if you had the cash for all the stocks or ETFs you hold now, would you buy them tomorrow? Or would you say **no**• because the risk is too high. If **no**• is your answer, you should be selling.

Given the potential, but uncertain dangers, **we prefer to err on the side of the worst case, especially heading into the seasonally volatile period of the new year.**

The December stock market weakness, which had no obvious reason, could be the **prelude.**• The sudden weakness of Bitcoin the past two weeks, in spite of maximum hype for this computer entry masquerading as an **asset,**• is very suspicious. At the time of this writing **Bitcoin is down roughly 13%** from its December 17 intraday high.

Having said all that, there is still **no guarantee** that our **worst case scenario**• will be correct. There never is a guarantee. But being cautious certainly lets us sleep at night.

There is an old saying, **sell down to the sleeping point.**• We believe that many investors now are overextended and perhaps not sleeping well.

Watching the guests and analysts on financial TV, do you see or hear any bears? It has become an extinct species. That is a bearish signal.

Interesting is that TESLA (TSLA), the MAGS ETF, and other major stocks made a December top the same day as Bitcoin. Yet, many stock market indices made their tops a couple weeks earlier.

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We have often written that bitcoin is a good gauge of “speculation” and “risk appetite” for stock market participants. And right now it is giving warning signs.

Our HedgeFolios:

Over the past two weeks we have reduced our exposure to the markets by quite a bit. At first, we sold roughly half of our allocations to most of the ETFs we hold across all 5 models. Then, on Friday (December 27) we exited a few of the positions that looked most vulnerable or had weaker rebounds off the December 18 bottom.

We also sold half of our current allocation to long-term Treasury bonds via the TLT on Friday as this position has not acted as we originally expected. We had thought that T-bonds would rally as long term interest rates should have declined. That didn’t happen.

With the reduced allocations and positions the past two weeks, we greatly increased our cash on hand and now have between **59%-68% cash** in our 5 models. Our low exposure and high cash should help members sleep easier at night knowing the volatile period of early January is right around the corner.

Our Conclusion:

Periods of great uncertainty happen. The markets have been in one of those for the past several months because of the events around the election.

During such times, it is important **not** to be fully invested. The clouds will eventually clear. Our longer-term bet is still on the new incoming White House “team.” But the saboteurs of their agenda will be active.

The big market plunge, with the DJI down more than 1,100 points on December 18, looks like the start of something worse. The technical bounces of some indices have been weak.

We hope all our members had a Merry Christmas and happy holidays!

We wish you an early “Happy New Year,” one we hope is filled with health, happiness, and prosperity,

Bert Dohmen and Dion Dohmen