May 15, 2015

What Is the AAII Sentiment Indicator Telling Us?

The AAII Investor Sentiment Survey is a weekly survey of individual investors measuring their percentage level of Bullish, Neutral and Bearish sentiment on the stock market for the next six months. Survey respondents are AAII members. The AAII Investor Sentiment Survey is widely followed and published weekly in Barron’s next to the Delta Market Sentiment Indicator (MSI) in the Market Laboratory – Indicators section of the paper (the Delta MSI is also available on-line at Barron’s at http://online.barrons.com/public/page/delta-tactical.html). In addition to Barron’s, a great way to have regular access to the AAII indicator is to join AAII. With membership, you are able to download detailed historical data and view the current reading and have access to educational material and thought leaders in the investment industry.

What caught our attention this past week was a report that the percentage of AAII Bullish respondents has declined for 5 consecutive weeks and is now at 26.7%. At the start of 2015, the bullish sentiment was 51.7%. What does this mean? Is it predictive of stock market performance for the rest of the year?

Shown below is a chart of the AAII percentage bullish survey response from July 1987 through this past week.
Our observations are as follows:

- **Box 1**: From 1987 through 1993, generally survey respondents were more bearish than they have been since. During the past 28 years, almost all bullish readings have fallen in the range of 20% to 60%. Virtually all readings below the 20% level occurred earlier than 1994. 1990 was a particularly low sentiment year with the all-time low reading during the week of November 16, 1990 at 12%. The S&P 500 returns for 1987 through 1993 in order from 1987 forward were 5.3%, 16.6%, 31.7%, -3.1%, 30.5%, 7.6% and 10.1%. The cumulative growth of the S&P 500 during these years was 120.7%. The average annual return was 13.5%. The worst calendar year was -3.1%. In hindsight and based on actual market performance, it is somewhat hard to see why bullishness was depressed during this period.

- **Boxes 2 & 3**: Generally readings above the 60% level are infrequent. They occurred in two periods with Boxes 2 and 3 on the chart above. Box 2 shows high levels of bullishness in 2000 and 2001. The all-time high reading was during the week of January 6, 2000 at 75%. The S&P 500 declined -9.1% and -11.9% in these years respectively. The NASDAQ performed substantially worse as the technology stocks collapsed. On the other hand, Box 3 shows a high level of bullishness (>60%) clustered in 2003 and 2004 when the market advanced by 26.7% and 10.9%. These two periods are contradictory in terms of their correlation to market direction.
Box 4: Since mid 2005, almost all AAII sentiment has been range bound within the 20% - 60% band. This is somewhat surprising as the bear market of 2008-2009 was stressful and caused the CBOE volatility index (VIX) to an extreme reading of 89. It is possible that after 28 years of historic bull and bear markets, investors are becoming less reactive on a sentiment level to the stock market.

Some followers of AAII bullish sentiment believe the indicator is contrarian and most predictive when it reaches extreme levels. The theory is that when bullishness is at a low level, you should buy and when almost all investors are bullish, you should sell. The last reading of bullish sentiment below the 20% level was at the start of April 2013. In 2013 and 2014, the S&P 500 was up 32.4% and 13.6%.

Intuitively, this makes sense. But, the data above suggests this is not always the case with the AAII indicator and may provide mixed signals. Additionally, we have seen far fewer extreme readings (>60%, <20%) since mid 2005 giving us lower confidence that AAII sentiment is unified.

A Closer Look

In taking a closer look at the data, more subtle information appears to surface. Namely, investors may confuse the business cycle with the stock market cycle. The most extreme readings of bearishness (low bullishness and high bearish sentiment also measured by AAII) almost all occurred in 1990. From July 1990 to March 1991, there was a recession. The other period of frequent bearishness measured by the differential between bullish and bearish sentiment occurred in 2008. The Great Recession began in December 2007 and ended in June 2009. The current five consecutive week downtrend in AAII sentiment may simply be a reflection of declining economic fundamental strength (e.g., 1Q GDP growth of 0.2%). Conversely, four of the 10 highest readings of bullishness measured by the differential between bullish and bearish sentiment occurred in 2000.

While the business cycle is an important driver of stock valuations, stocks are a forward looking discounting mechanism and may not trade in lock-step with the business cycle. Often, while the economy is mired in recession and economic conditions feel miserable, stocks trade higher. When the economy is booming along, stocks may begin to decline as they anticipate the next downturn. Investors’ feelings about how the stock market will behave over the next six months based on current main-street economic conditions may not be a good basis to accurately predict future market direction.

No indicator is perfect. The AAII indicator is an interesting measure of investor sentiment and may be useful in formulating a disciplined opinion about future stock valuations. We pay attention from the perspective of wanting to know what people are thinking. We find it mildly bullish that investor sentiment is currently below the long-term
average as it suggests there is no irrational exuberance. *Bull markets climb a wall of worry.*

Investor feelings about economic conditions are interesting, but not directly what we care about. What we care about is where the stock market is going in the future. Stock prices are the summation of all known information by all investors. They are forward looking. They are a direct expression of what investors are placing hard money investments on regarding the future.

If we want to know where stock prices are going, one of the most direct and objective measures of this are stock prices. This is what the **Delta Market Sentiment Indicator (MSI)** measures. We record the daily price history on a proprietary set of roughly 3,600 equally weighted stocks. We compare the price history to a moving average crossover level that provides an important threshold for the predictive transition point between bullish and bearish sentiment.

Because the Delta MSI is based on stock price action and not investors feelings about economic conditions, it should catch a trend change even if the economy is in a recession. During bullish economic times, it is designed to sell stocks if the market is indicating a negative inflection point in the foreseeable future.

There are times when price based market indicators can whipsaw between bullish and bearish signals. So can indicators based on investor feelings about economic conditions. At some level, whipsaw signals are the price one pays to avoid the next major downturn.

Another way to measure future stock price action is relative strength. Assets showing strong appreciation relative to other assets often are reflecting improving fundamentals matched with rising investor interest and fund flows. Assets declining in price often reflect declining fundamentals and falling investor interest. Price trends often have persistence as changing fundamentals usually to not occur overnight and investors often are slow to recognize the underlying change. Many of Delta’s strategies use relative prices to make rules-based decisions about which assets to own. These types of strategies are less subject to whipsaw trades.

Feel free to give us a call anytime if you would like to discuss the relative merits of sentiment indicators and relative strength rotational strategies. Because of the slow pace of advance of the stock market since November 7 when the MSI turned Bullish for this cycle and the steady rise of the moving average, the MSI is converging with current stock prices. Currently, the indicator is bullish/neutral. For the indicator to provide bullish signals in the coming weeks, the stock market will have to appreciate. We see this as an excellent time to invest as new money should either appreciate or the MSI provides a tight stop-loss in the event the bullish cycle ends.
Delta Market Sentiment Indicator (MSI) as seen in Barron’s

MARKET SENTIMENT IS  
BULLISH  
THIS WEEK’S NUMBER IS  
48.2

Our technical number decreased this week from 48.6 to 48.2

INDICATOR STATISTICS

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Value</th>
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<tbody>
<tr>
<td>Consecutive Bullish Weeks:</td>
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<tr>
<td>Cycle Inception Date:</td>
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<tr>
<td>Range:</td>
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<td>Mean:</td>
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<tr>
<td>NASDAQ YTD:</td>
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*From marketslack.com current week

Delta Market Sentiment Indicator Over the Past Year

The Delta Wealth Accelerator website is www.deltawealthaccelerator.com.

As always, if you have any questions or any interest in our tactical strategies and our wealth management solutions, please give us a call at (415) 249-6337 or email us at info@deltaim.com.

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