

# Monthly Market Risk Report

For the Month of May 2015

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Estate Counselors, LLC monitors a number of forward looking economic indicators in an effort to identify when the risks of a market bubble or adverse economic conditions are increasing. If those indicators suggest there is an unusually high risk that a market bubble has formed or that a recession is on the horizon, then we may recommend to our clients that they consider investing in option contracts that are intended to increase in value should either a bubble pop or a recession take hold.

The following is a list of indexes tracked by Estate Counselors, LLC and their current forecast. Based on the data below it appears that:

Economic Risk is **LOW**

Market Risk is **ELEVATED**

Hidden Markov Model (HMM) indicates that the equity markets are currently in a **BULL MARKET** trend

Many domestic economic indicators have remained soft since last month's report, although they collectively point to an economy that is expanding, albeit slowly. Notably, however, steady growth in payrolls has been seen during 2015. U.S. equity prices recently broke out to the upside after trading within a range for 5 months, and their valuations continue to remain somewhat inflated by historical measures. Also consistent with last month's report, uncertainty remains in the markets as participants attempt to anticipate the timing of an interest rate hike by the Federal Reserve, although the most recent FOMC minutes indicated that a hike will not occur in June. Considering the data in this month's report, we are comfortable with the positioning of our clients' portfolios and accordingly, no additional hedging measures are being recommended for our clients' accounts at this time.

## A. ECONOMIC INDICATORS

- I. **Capital Spectator's U.S. Economic Trend Index (ETI).** ETI is a diffusion index that measures the percentage of 14 leading and coincident indicators that are trending positive for economic growth. More specifically, a diffusion index represents the percentage of the variables that are positive. Accordingly, if all of the

indexes included in ETI were positive, the value of the ETI index would be 1.0 or 100%. If 7 of the 14 variables were positive, the value of the ETI index would be 0.50 or 50%.

This index is typically released mid-month based on data for the prior month. As of May 20<sup>th</sup>, the ETI index reading was **88.1%**. Higher readings equate with more indicators signaling that the economy is expanding; lower readings imply a weaker economy, with levels below 50% signaling a high probability that a recession has started. ETI registered the same as last month, and it continues to indicate that economic expansion has cooled off. However, the reading remains well above the danger zone that would indicate a high probability of a recession beginning.

One month ago: 88.1%  
Two months ago: 92.9%

- 2. Capital Spectator's U.S. Economic Momentum Index (EMI).** EMI is the monthly median percentage change for the 14 indicators that comprise the ETI. EMI is based on the median rather than the average (i.e., the mean) of these indexes because the mean is subject to outlier numbers, which can mislead us as to the true average. The median, by contrast, is immune to extremes because it reflects the middle point for a batch of numbers.

As is the case with the ETI, this index is typically released mid-month based on data for the prior month. As of May 20<sup>th</sup>, the EMI index reading decreased to **5.6%**. Near zero and below zero readings are indicative of recessions, usually with a slight lead time relative to the start dates, as determined by the National Bureau of Economic Research. Although EMI has decreased again in May, it is still above the level that would indicate that business cycle risk and the probability of a recession is looming.

One month ago: 6.4%  
Two months ago: 7.9%

- 3. Capital Spectator's Macro-Markets Risk Index (MMRI).** MMRI measures the daily median change of U.S. stock, bond, and oil prices. Because this information is available in real time, with continuous updates, prices have an edge over conventional economic statistics, which are published with a lag of a month or more. In addition, unlike published indexes, the market data on which MMRI is based is not adjusted. Accordingly MMRI is intended for use as a supplement for developing perspective on the current month's economic profile until a complete data set is published.

If MMRI falls under 0%, that would suggest that recession risk is elevated. By contrast, readings above 0% imply that the markets are anticipating/forecasting economic growth. As of May 12<sup>th</sup>, the MMRI index reading is **6.7%**. MMRI has contracted since the April reading, but it continues to indicate that the economy is expanding and remains above the level that would suggest a recession is imminent.

One month ago: 8.0%  
Two months ago: 6.8%

4. **Chicago Fed National Activity Index (CFNAI).** The CFNAI is a weighted average of 85 existing monthly national economic indicators. It is constructed to have an average value of zero and a standard deviation of one. Since economic activity tends toward trend growth over time, a positive reading corresponds to growth above trend and a negative reading corresponds to growth below trend. Research has found that the CFNAI provides a useful gauge on current and future economic activity and inflation in the U.S. The index's three month moving average provides a more consistent picture of national economic growth and is therefore used by Estate Counselors, LLC instead of the volatile monthly numbers.

When the three month moving average moves below -0.70 following a period of economic expansion, there is an increasing likelihood that a recession has begun. Conversely, when the three month moving average is above 0.70 after a period of economic contraction, there is an increasing likelihood that a recession has ended. The three-month moving average for the month of April registered **-0.23**. The CFNAI indicates that economic activity has now been running below its trend line for the past three months, although it still is not to the point that would indicate that a recession is likely.

One month ago: -0.27  
Two months ago: -0.08

## **B. MARKET VALUATION INDICATORS**

- I. **Bullish Percent Index (BPI).** BPI is a popular market breadth indicator that is calculated by dividing the number of stocks in a given group (an exchange, an industry, etc.) that are currently trading with Point and Figure buy signals, by the total number of stocks in that group. For example, if 2,100 stocks signal buy and 700 signal sell, the value of the NYSE Bullish Percent Index is 75.

As of May 21<sup>st</sup>, the BPI for the NYSE index is **63.40%**. When the percentage of bullish stocks within a particular index is 70% or higher, the index is considered to be overvalued. When the index is below 30, stocks are considered to be oversold. The BPI receded since last month's reading but it still suggests that equities are trading near the high end of a fairly valued range.

One month ago: 67.56%  
 Two months ago: 62.55%

- CAPE Ratio.** CAPE is a modified form of the PE ratio of the S&P 500 as determined by Robert Schiller. CAPE is simply the S&P 500 index's current price divided by the 10-year average of trailing earnings, adjusted for inflation. A high CAPE reading may be evidence that stock prices are inflated. The long term average of this ratio is 16.59, while its historical high is 44.2.

Cape on 5/21/15	Median	Mean	High	Above Average	Neutral	Low
Cape	15.95	16.61	25.1+	22.5-25	17.5-22.4	<17.4

The CAPE ratio suggests that stock prices continue to remain inflated, as they have been for many months.

One month ago: 27.42  
 Two months ago: 27.77

- Total Market Cap of the U.S. Stock Market to GDP.** This statistic is an indicator of whether the stock market is fairly valued. It compares how much money is invested in the market relative to GDP, which is closely tied to corporate profits. A high reading would be an indication that equity prices are inflated.

Market Cap to GDP on 5-20-15	Median	Mean	High	Above Average	Neutral	Low
Market Cap to GDP %	68.83	75.89%	115+	90.1%-115%	50.1%-90%	<50%

The Total Market Cap to GDP ratio increased since last month and it continues to suggest that U.S. stocks are significantly overvalued. It should be noted, however, that this metric compares current market conditions to historical GDP, which is itself a lagging indicator.

One month ago: 125.7%  
Two months ago: 125.9%

4. **Tobin's Q.** This statistic is calculated by dividing Total Market Value (as represented by the Wilshire 5000) by the Total Asset Value. A low Q (between 0 and 1) means the cost of the assets of companies included in the Wilshire 5000 is greater than the combined value of their stock. In that event the stock market is undervalued. Conversely, a high Q (greater than 1) implies that the stock price of all Wilshire 5000 companies exceeds the replacement cost of the assets of those companies. A Tobin's Q that significantly exceeds its historic average of 0.68 is a potential indicator of an equity market bubble.

Tobins Q on 5/1/15	Median	Mean	High	Above Average	Neutral	Low
Tobin's Q	1.12%	0.76	0.68	0.90+	0.75-0.90	0.65-0.70 <0.65

Tobin's Q increased slightly since last month, although it is lower than two months ago. It continues to suggest that stock prices are overvalued.

One month ago: 1.11  
Two months ago: 1.13

5. **S&P Earnings Yield.** This statistic is the inverse of the S&P 500's P/E ratio (trailing 12 month earnings divided by index price). It can be used to compare equity valuations with the yield on bonds. If the S&P earning's yield is higher than the yield on high yield bonds, then that is an indication that stocks represent a better value than their closest fixed-income equivalent.

As of May 21<sup>st</sup>, the S&P 500 earnings yield is 4.80% while the yield on high yield bonds is 5.78%. This amounts to a spread of +0.98%. Stock yields have decreased over the past month while bond yields increased, causing the spread between stocks and high yield bonds to increase. Both stock and bond yields have decreased since the prior month with bond yields decreasing slightly more, causing the spread to narrow. However, this measure still indicates that stocks are overvalued when compared to high yield bonds.

	<u>S&amp;P</u>	<u>Bonds</u>	<u>Spread</u>
One month ago:	4.85%	5.84%	+0.99%
Two months ago:	5.04%	5.79%	+0.75%

**C. Hidden Markov Model (HMM)**

A Hidden Markov Model is an econometric tool for representing probability distributions over sequences of observations. It measures the probability of a bull or bear market. It uses trailing S&P 500 1 year returns (calculated monthly) and the previous month's probability of a bull market as inputs and then generates the current probability of a bull or bear market as an output. HMM outputs above 75% indicate a high probability of a current bull market. If the HMM output is below 25%, it is an indicator of a high probability of a bear market. As of May 20<sup>th</sup>, the HMM output is **91.49%**. The probability that stocks will remain in a bull market has again decreased since the prior month but it continues to indicate that the probability that stocks will remain in a bull market is high.

One month ago: 92.15%  
Two months ago: 93.88%

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**END NOTES**

- The latest ETI reading can be found at <http://www.capitalspectator.com/>.
  - The latest EMI reading can also be found at <http://www.capitalspectator.com/>.
  - The latest MMRI reading can also be found at <http://www.capitalspectator.com/>.
  - A reading of the bullish percent index for the NYSE can be found at <http://stockcharts.com/h-sc/ui> using the symbol \$BPNYA.
  - The most recent CAPE reading can be found at <http://ycharts.com/indicators/pe10>.
  - A current reading of total market cap to GDP can be found at <http://www.gurufocus.com/stock-market-valuations.php>.
  - Tobins Q can be found at <http://www.advisorperspectives.com/dshort/updates/Q-Ratio-and-Market-Valuation.php>.
  - The current S&P earnings yield can be found at <http://www.mutpl.com/s-p-500-earnings-yield>.
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