

# Monthly Market Risk Report

For the Month of February, 2017

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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 **MODERATE**.

Hybrid Markov Index (HMI) indicates that the equity markets are currently in a **BULL MARKET** trend. (A more detailed discussion of HMI can be found later in this Report.)

Estate Counselors' Equity Hedge Index (ECHI) is signaling **HEDGE OFF**. (Please see below for a description of ECHI.)

The 10 Year Treasury note yield has receded to 2.40%, which is in the middle of a range it's been in post-election. As has been the case for many months, stock market valuation indicators continue to suggest that equities are overvalued, however tax cuts and corporate deregulation are continuing to impress upon and improve the economic outlook. Despite stocks trading at all-time highs, economic data, low volatility and market momentum suggest the equity markets may have further near-term upside. At this time, we continue to recommend following the course being charted by the investment strategies we have developed over the past several years with the benefit of our internal research as well as the scholarly research of others and our own rigorous back testing.

As of today, Estate Counselors, LLC's Hedge Index ("ECHI") is signaling Hedge Off and we have no immediate intention of recommending acquiring put options in our clients' accounts. However, if the stock markets continue to move higher, we may recommend implementing a hedge in our clients' accounts.

## A. ECONOMIC INDICATORS

1. **Capital Spectator's U.S. Economic Trend Index (ETI).** ETI rose this month, and its reading continues to indicate that there is a low probability of a recession beginning.

As of February 19<sup>th</sup>, the ETI index reading was **81.0%**. 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.

One month ago: 76.2%  
Two months ago: 76.2%

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%. 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. This index is typically released mid-month based on data for the prior month.

2. **Capital Spectator's U.S. Economic Momentum Index (EMI).** EMI spiked over a point higher this month and continues to indicate recession risk is low.

As of February 19<sup>th</sup>, the EMI index reading is **3.9%**. 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.

One month ago: 2.8%  
Two months ago: 2.7%

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.

3. **Capital Spectator's Macro-Markets Risk Index (MMRI).** The most recent MMRI signal suggests that business risk remains low and decreased again over the past month.

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. MMRI has risen over the past several weeks to **12.3%** as of February 19<sup>th</sup>.

One month ago: 11.8%  
Two months ago: 6.3%

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.

4. **Chicago Fed National Activity Index (CFNAI).** The three-month moving average for the month of January registered **-0.03**. The index has been improving as of late and remains above the -0.70 level that would signal the onset of a recession.

One month ago: -0.14  
Two months ago: -0.14

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 trends toward 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.

**B. MARKET VALUATION INDICATORS**

- 1. Bullish Percent Index (BPI).** BPI indicates that stocks have remained slightly in overvalued territory.

As of February 23<sup>rd</sup>, the BPI for the NYSE index is **72.10%**. 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.

One month ago: 72.22%  
 Two months ago: 70.01%

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.

- 2. CAPE Ratio.** The CAPE ratio indicates stocks are valued well above their historical average.

Cape on 2/23/17	Median	Mean	High	Above Average	Neutral	Low
Cape	16.05	16.71	25.1+	22.5-25	17.5-22.4	<17.4

One month ago: 28.48  
 Two months ago: 27.91

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 16.71, while its historical high is 44.2.

- 3. Total Market Cap of the U.S. Stock Market to GDP.** The Total Market Cap to GDP ratio increased from the prior month and remains in “significantly overvalued” territory, as defined by gurufocus.com. At this level, gurufocus.com states that the stock market is currently likely to return -0.9% per year, including dividends.

	Market Cap to GDP on 2-23-17	Median	Mean	High	Above Average	Neutral	Low
Market Cap to GDP %	131.0%	68.83	75.89%	115+	90.1%-115%	50.1%-90%	<50%

One month ago: 128.9%  
Two months ago: 126.8%

The Total Market Cap to GDP ratio 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.

4. **Tobin's Q.** Tobin's Q has increased from the prior month and continues to suggest that stocks are at above average valuations.

	Tobins Q on 2/1/17	Median	Mean	High	Above Average	Neutral	Low
Tobin's Q	1.02	0.76	0.68	0.90+	0.75-0.90	0.65-0.70	<0.65

One month ago: 1.01  
Two months ago: 1.04

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.

5. **S&P Earnings Yield.** This measure indicates that stock valuations have increased while high yield bond valuations have decreased since last month.

As of February 23<sup>rd</sup>, the S&P 500 earnings yield is 3.77% while the yield on high yield bonds is 6.01%. This amounts to a spread of +2.24%. The spread has increased as stock prices have rallied as corporate earnings increased.

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.

	<u>S&amp;P</u>	<u>Bonds</u>	<u>Spread</u>
One month ago:	3.88%	6.07%	+2.19%
Two months ago:	3.85%	6.20%	+2.35%

### C. Hybrid Markov Index (HMI)

The Hybrid Markov Index switched from Bear market regime to Bull market regime in June 2016. Since then, the index has consistently indicated a Bull market and the recent gains posted by the S&P 500 have further reduced the possibility of the market slipping into a Bear regime. As of February 23<sup>rd</sup>, the HMI output is **Bull**.

One month ago: Bull  
Two months ago: Bull

*Please note that Estate Counselors, LLC has adopted a unique hybrid version of the Hidden Markov Model (HMM).* The HMM is an econometric tool that estimates the probability of a Bear market using trailing S&P 500 1-year returns (calculated monthly). Our proprietary HMI is an extension of a HMM Model that also utilizes 60-day and 200-day Moving Average crossover on the S&P 500 Index to generate binary "Bull" or "Bear" signals. The crossover of 60-day and 200-day moving averages of the S&P 500 Index is used to identify the probable end of the Bear regime after HMM issues a Bear market signal.

### D. ECHI

ECHI is currently signaling **Hedge Off**.

The Estate Counselors, LLC Hedge Index (ECHI) was developed to provide an empirical signal for when a hedge on equities should be established due to an impending market decline. ECHI is a composite risk index that draws on the output of the Crash Risk Index (CRI) which is an equal-weighted mix of ten indicators developed by Jim Picerno of The Capital Spectator, drawing on a diverse range of U.S. equity and bond market factors. It provides a daily measure of risk for evaluating the potential for a near-term market correction/crash. **2 of the 10 SMRI signals are currently active.** If 5 or more of the SMRI indicators signals are active, ECHI signals high market risk ("Hedge On"). Once ECHI is triggered it will continue to signal Hedge On until less than 5 SMRI signals are active.

### **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.multpl.com/s-p-500-earnings-yield>.

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**Important Disclosures:** The information and statistics in this Market Risk Report have been obtained from sources we believe to be reliable but are not guaranteed by us to be accurate or complete. Any and all earnings, projections, and estimates assume certain conditions and industry developments, which are subject to change. The opinions stated are those of Estate Counselors, LLC, but are not intended to be a substitute for personal investment advice. Services provided by Estate Counselors, LLC do not constitute legal services and are not being provided by Willms, S.C. law firm. Communications between Estate Counselors, LLC and its clients are therefore not covered by the attorney-client privilege, and as a result may be discoverable by third parties. All such communications are, however, covered by Estate Counselors, LLC's privacy policy, a copy of which is available on request. Thank you.

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