1.1 Market First - Fundamental Analysis

Chapter 1: Market First Introduction

A Critical Consideration

Novice chess players know the basic moves and they focus on their game plan. They are oblivious to what their opponent is doing and they are quickly mated. The market is your opponent. It doesn't care about your game plan; it has its own agenda. You need to reveal it and then use that knowledge to your advantage.

More than 75% of all stocks follow the market. This is the most important piece of the trading puzzle. If you get the market right, your probability of success increases dramatically. If you get it wrong, the odds are against you.

Proper market analysis is the most important piece to the trading puzzle.

What You'll Learn

Our market analysis starts with a longer-term fundamental analysis and we describe it in detail. We need to know the macro forces that are driving the market and we need to be aware of key events that might impact price. Next, we will perform technical analysis on a long-term and a short-term basis to form our market opinion. We describe the indicators and the methods we use in detail. This forecast drives all of our trading decisions and we need to get it right.

In this section you'll learn how to form a market opinion.

Chapter 2: Long Term Market Fundamental Analysis

What is fundamental analysis?

Fundamental analysis evaluates the surrounding business environment. These elements impact corporate revenues and profits and that makes them relevant to the market. This type of analysis is a cornerstone of investment research and focuses on evaluating various aspects of a company's underlying business environment to determine its intrinsic value and potential for growth. Fundamental analysis involves analyzing a wide range of factors, including the company's financial health, management team, industry trends, economic conditions, and competitive landscape.

Why is fundamental analysis important?

Large institutions monitor these elements and they have research teams that help them determine the long-term risks and rewards to bottom line corporate profits. It stands to reason that a robust economy with low borrowing costs, a low corporate tax rate and minimal regulation would be good for profits. Asset Managers monitor the conditions and they rotate in and out of sectors based on fundamental analysis. Sharp market corrections and long-term rallies are driven by fundamentals so they are important. We trade based on technical analysis, but it is important to know the catalysts behind the moves.

Why do I use fundamental analysis for the market and not for individual stocks?

I define a trader as someone who does not hold a position for more than three months so the fundamentals for a company are fairly stable and less relevant in the context of my trade duration. You need to use fundamental analysis for stocks if you are a longer term investor. You need to know the company's products, competition, intellectual property, lawsuits, clinical trials, regulatory environment, profit margins, revenues, supply chains, guidance and anything else that will impact the macro business operations and/or profits. The fundamentals for a corporation can change on a quarterly basis, but in general they are fairly stable. Institutions spend billions of dollars a year on stock fundamental analysis and it is the basis for their asset allocation. When they rotate in/out of stocks they leave a trail of bread crumbs that is revealed through allocation. When they rotate in/out of stocks they leave a trail of bread crumbs that is revealed through technical analysis. That is why I only use technical analysis for stocks. Longer term market fundamentals can remain constant for years and then change rapidly. These macro shifts can spark big market moves so it's important to always keep an eye on the macro backdrop.

How long can macro market fundamentals remain constant?

The massive market rally from the 2009 – 2021 can be explained by extreme central bank money printing which resulted in suppressed bond yields and low credit risk. In this instance the macro conditions did not change for a decade. Long-term fundamentals do not typically change overnight and there is a gradual transition. However, a Black Swan event like Covid-19 sparked the largest market decline since the Great Depression and it blind-sided many traders.

What are the most important fundamental elements?

At any point in time, the predominant fundamentals can change. For instance, during the 2000 "tech bubble" it was valuations. In 2008 it was credit. In 2016 it was political and we saw violent swings based on Presidential tweets. In 2020 it was Covid-19 and its economic impact. In 2022 there was inflation that forced the Fed to tighten. The most relevant fundamental element changes over time. Here's what you need to keep an eye on.

Chapter 3: Corporate Earnings

Introduction

According to most analysts, the market is driven by earnings and interest rates.

Corporate earnings drive the market and that is why it is listed as the first market fundamental. All of the other fundamentals impact corporate earnings, but the bottom line is the bottom line. If companies are making a lot of money the market will go higher. If companies are losing money or making money at a slower rate then the market will go down.

Earnings Season

Typically the market bid is strong ahead of earnings season. When I started my career all eyes were on "Big Blue" and IBM would set the tone for earnings season. The leadership has changed, but the concept is the same. Watch mega cap tech earnings reactions and you will be able to determine the general state of same. Watch mega cap tech earnings reactions and you will be able to determine the general state of quarterly earnings. AMZN, AAPL, GOOG and MSFT account for more than 20% of the S&P 500 and these earnings will impact the market. Once these tech giants have reported, some of the "air" is let out of the balloon.

There are a few bell-weather stocks to watch for large industries. INTC is losing its luster, but in the past it used to set the tone for the semi-conductor industry. FedEx is considered an economic bell weather because it indicates the demand for shipping and analysts watch the company's guidance.

I will cover this in the stock section, but some stocks have a tendency to rally into earnings announcements. We track this tendency and we structure bullish put spreads around it. When it comes to individual stocks, we trade before the number and after the number, but we never hold over the number. This will also be discussed in greater detail.

The impact of earnings on the overall market is monumental. In terms of longer term market fundamentals, we do not need to know the specifics for each company, we need to gauge the overall performance.

FactSet is a great one-stop resource for this information. They post the results free, but on a delayed basis. This link will give you the macro fundamental information you need regarding earnings.

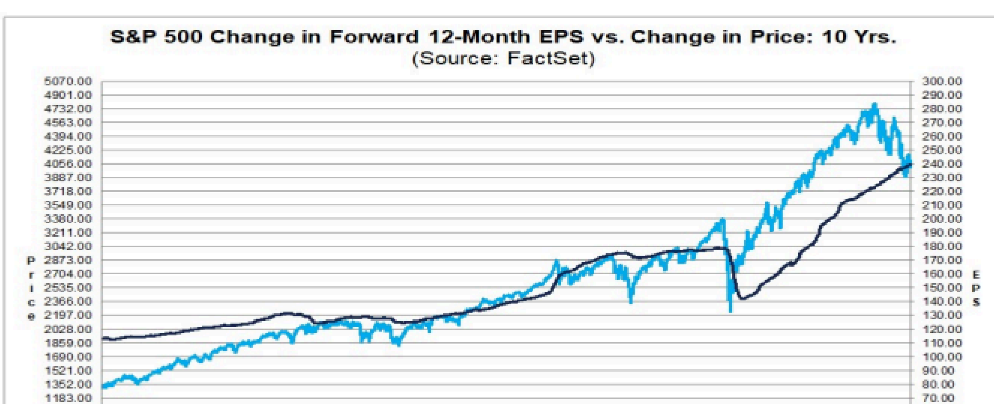
EARNINGS INSIGHT

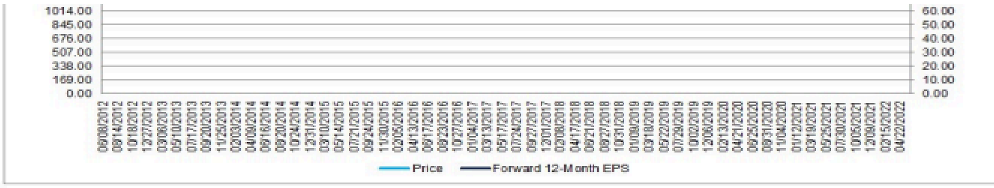
FACTSET ⟩ SEE THE ADVANTAGE

June 10, 2022

Key Metrics

- **Earnings Growth:** For Q2 2022, the estimated earnings growth rate for the S&P 500 is 4.0%. If 4.0% is the actual growth rate for the quarter, it will mark the lowest earnings growth rate reported by the index since Q4 2020 (3.8%).
- **Earnings Revisions:** On March 31, the estimated earnings growth rate for Q2 2022 was 5.9%. Seven sectors are expected to report lower earnings today (compared to March 31) due to downward revisions to EPS estimates.
- **Earnings Guidance:** For Q2 2022, 71 S&P 500 companies have issued negative EPS guidance and 31 S&P 500 companies have issued positive EPS guidance.
- **Valuation:** The forward 12-month P/E ratio for the S&P 500 is 16.8. This P/E ratio is below the 5-year average (18.6) and below the 10-year average (16.9).
- **Earnings Scorecard:** For Q2 2022 (with 2 S&P 500 companies reporting actual results), 1 S&P 500 company has reported a positive EPS surprise and 2 S&P 500 companies have reported a positive revenue surprise.





Fact Set earnings recap

Chapter 4: Interest Rates

A decade of loose monetary policy has resulted in a parabolic market rally.

Introduction

Interest rates are largely controlled by central banks. The Federal Reserve (US), the European Central Bank (ECB), The People's Bank of China (PBOC) and the Bank of Japan (BOJ) are the largest central banks in the world. More than 60% of all known central bank foreign exchange reserves are US dollar denominated and the International Monetary Fund (IMF) considers the US dollar to be the global reserve currency. Consequently, the Federal Reserve (Fed) is at the top of list when it comes to longer term interest rate analysis. The Federal Open Market Committee (FOMC) meets eight times a year to determine monetary policy. These are major market events.

Interest rates impact corporate borrowing costs and consequently they impact profits. Interest rates also impact consumer borrowing/spending and that in turn impacts economic activity. Interest rates also make fixed income investments (bonds) more/less attractive on a relative basis and that has an impact on the demand for stocks.

What You Need To Know

This is some of the driest and least significant information in the minds of young traders because they only know the loose monetary policy of the last decade. Interest rates on the US 10-year Treasury are at historic lows (2%) and that is half the 100-year average. Central banks around the globe are keeping their foot on the gas pedal, but that began to change in 2022.

I don't want to get into the politics of whether the Federal Reserve is needed, but in theory the Fed's role is to smooth out economic cycles so that we don't have big booms and busts. When the economy is robust and signs of inflation start to surface, they tighten (interest rate hike). When the economy is struggling, they ease (interest rate cut).

The Fed has its foot glued to the gas pedal and as of this writing (6/9/22) they are preparing for a swift and steady dose of tightening. They have grossly underestimated inflation and their hand is forced.

I mentioned earlier that interest rates impact borrowing costs. Let's first take a look at the market impact of low interest rates at the corporate level. Companies can issue cheap debt (bond offering) and they can use the proceeds for capital expenditures (plant and equipment). This is good because they are creating more jobs and that is good for the economy. They can also use the proceeds to buy back shares of stock. Unfortunately, this is how most companies have spent the proceeds. In the last decade, the number of shares outstanding has been reduced by 50%. This has been a huge reason for the market rally in the last 10 years. More cash from central bank money printing is chasing fewer shares of stock so naturally the price of the shares goes up. With fewer shares outstanding, the earnings per share (EPS) also go up and the company did not have to lift a finger.

After a decade of loose monetary policy, consumer borrowing is at record levels ($4 trillion+) and consumer spending is also at record levels. Lower interest rates stimulated economic growth, but at what cost? During the Covid-19 pandemic most households had no savings and they could not go a few weeks without a paycheck. The government approved $8+ trillion in stimulus to prevent an economic collapse. I will discuss this in greater detail in the Credit section.

In terms of investment alternatives, stocks have been the only game in town the last 10 years. Banks pay .1% (if that) for savings accounts and the US Treasury yield on 10-Year bonds is lower than the inflation rate. This means that bond investors are generating negative real returns (yield minus inflation). This is forcing investors (even retirees who need to be conservative) to own stocks to generate a reasonable rate of return.

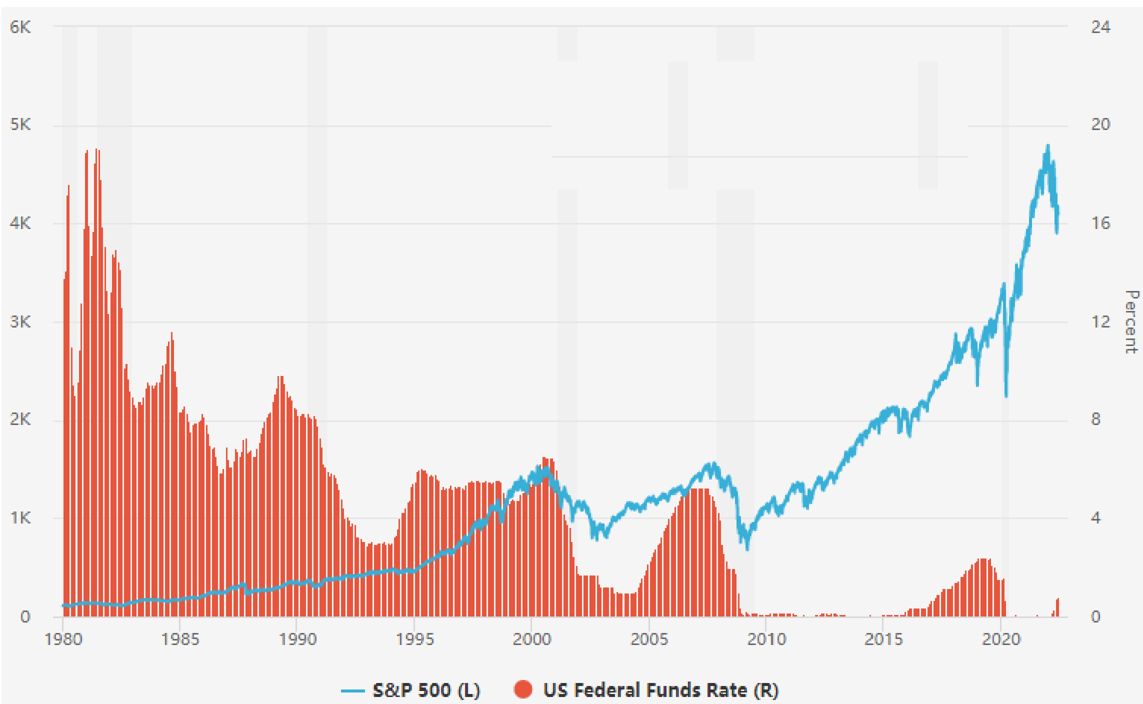
So we know that low interest rates and loose monetary policy are good for the market. Are higher interest rates bad for the market? Regardless of why the Fed is tightening, the market is addicted to easy money and it reacts negatively to the first rate hikes. Asset Managers fear that the tightening will stifle economic growth and they sell stocks (reduce risk) during the early stages of tightening. The last time the Fed hiked interest rates was December 2015. Market volatility was relatively high the six months preceding the rate hike and six months after the first rate hike the market had retraced 15%. So far in 2022 the Fed has raised rates .75% and they plan to hike at least another 1% by the end of summer. The market has corrected more than 20% with tech stocks taking the brunt of the blow.

After a number of months, Asset Managers are able to gauge the economic impact of the rate hikes. They can also gauge the Fed's tenor. Gradually tightening over a period of years with a strong economic backdrop has produced big market rallies historically. Remember, one of the Fed's reasons for hiking rates is to fend off inflation. What if they have to hike because of inflation and not because of economic growth?

The market also tends to rise during periods of inflation. However, real returns (percentage gain for the S&P 500 less the inflation rate) are lower than it is during periods of normal inflation (2-3%).

Loose monetary policy has played a role in the massive market rally the last 10 years. It provides a safety net because the system is flush with cash and credit risk is low. Investors and corporations (share buy backs) have flocked into stocks and market volatility has been near historic lows.

Short-term traders need to be aware of the FOMC statement/minutes. They are released during market hours and they produce large market swings.



Parabolic Market Rally After Decade of "Loose Money"

Chapter 5: Credit

The threat of a credit crisis is the biggest fundamental market threat and it can lead to prolonged market declines.

Introduction

Stable credit conditions are critically important to the market. Economic cycles, interest rate hikes, political unrest/wars and all of the other bearish events in the last hundred years have come and gone. However, a full blown credit crisis can last for generations and we barely escaped one in 2008-2009. Credit is the oil that lubricates the global financial system and without it the engine locks up.

Central banks are financial institutions that have the power to print money, control lending and set interest rates for a nation. In the United States it is called the Federal Reserve or the Fed. The central bank supervises commercial banks which in turn control lending to individuals and businesses. There is one central bank for each country and the currency has value to the degree that investors trust the country's willingness and ability to repay debt.

The United States has never defaulted on any of its debt obligations. The IMF (International Monetary Fund) considers the US dollar to be the global reserve currency and 60% of all international exchange reserves are dollar denominated.

I don't want to get too far into the weeds on this topic because it gets complicated and as short-term traders we don't need that level of granularity. All we really need to know is the source of the market selling and if it is credit related, we will know that a deep and sustained market decline is possible. Towards the end of the article I will show you the "canaries in the coalmine".

A Brief History

In its first 230 years the United States amassed $2 trillion in debt. In the last 20 years that has increased 15 fold to over $30 trillion. On a national level there are structural issues (obligations) and demographics (aging population) that will impact the credit worthiness of the US. The obligations include Social Security, Medicare and interest payments on our national debt. These are called mandatory expenses and as a percentage of tax revenue they account for 65% of the budget (31% of the budget in 1962).

"Baby Boomers" are retiring at an accelerated pace and that is a double edged sword. Instead of a worker paying into Social Security and Medicare you have someone who is drawing those benefits. I was going to cite more statistics, but let me stop here. Reports from the Congressional Budget Office (CBO) are publicly available and you can sift through them. In the next 10 years the mandatory expenses for the US will reach 100% of the budget and there will not be any money left for all of the other things that the government spends money on. This is akin to the consumer who has accumulated so much debt that their income no longer covers the interest payment on that debt.

Unfortunately, this problem spreads far beyond the national level. It is unconstitutional for states to run

Unfortunately, this problem spreads far beyond the national level. It is unconstitutional for states to run deficits, but they do. The largest states (New York, California and Illinois) have massive structural debt issues and their bonds have a “junk” rating. Municipalities have similar issues. Our founders knew that the credit worthiness of our nation would be compromised if states were allowed to run deficits. The chain is only as strong as the weakest link.

Conditions Today

Consumer credit in the US has reached record levels and it stands at $4 trillion dollars. The majority of workers are so financially stretched (no savings to cover expenses and debt obligations) that they can’t go a month without a paycheck. Consequently, the US government conducted “helicopter drops” in 2020/2021 to the tune of $8 trillion. This stimulus kept the house of cards from imploding during a viral pandemic (Covid-19). This is not sustainable and we should all hope the next new virus does not surface anytime soon.

With all of the issues I have already cited, know that on a relative basis, the US has a better balance sheet than many other developed nations. From 2010 – 2013 I closely monitored PIIGS (Portugal, Ireland, Italy, Greece and Spain) bond auctions and interest rates. The bond yields were jumping and the credit worthiness of each sovereign was in question. No worries, the ECB guaranteed those obligations. This did not go over well with Eurozone nations who had practiced fiscally responsible. Those countries did not want to bail out Greece and they wanted collateralized loans (asset backed – i.e. the Parthenon). Eventually, the more stable EU member nations saw the light and they agreed to the bailouts. The ECB was losing face and the demand for Eurodollars was low. Banks wanted dollars and not Euros. In an act of desperation, the US backed the Eurodollar through currency swaps. In essence, Americans were backing Greece. You might not even be aware of this and some of you might not care. Fed officials know that if the ECB fails the global “House of Cards” will come tumbling down.

A Shared World Problem

I could go right down the list of the largest developed nations. Some are slightly better off than others, but in general debt is spiraling out of control across the spectrum (national, state, municipal and consumer).

China has enjoyed hyper growth for decades, certainly they have money. The Communist leaders have tremendous wealth and their actions speak louder than words. For years they have been reducing their US bond holdings and they are instead purchasing working assets (shipping ports, mineral rights, real estate) with all of the “funny money” they have accumulated. They know that these assets will have value. This wealth is separate from the PBOC.

China’s central bank (PBOC), regional banks and provincial debt (municipal) is unknown, but I have seen estimates in the $7 trillion range in 2020. Decades of hyper-growth breeds excess and excess breeds bad lending practices. China’s shadow banking industry (unregulated lending) is estimated to be greater than $20 trillion. If these loans fail, it would make our financial crisis in 2008-2009 look like a cake walk. We are trillion. If these loans fail, it would make our financial crisis in 2008-2009 look like a cake walk. We are currently seeing Chinese real estate developer loan defaults. Could this be the start of a credit crisis?

How long can this charade last?

It is impossible to say and that is why I trade what is in front of me and not what I think is going to happen. As long as everyone (global central banks) “plays nice in the sandbox”, they can all continue to print money within “acceptable” limits. As I have already pointed out, the central banks are intertwined and when one goes, they all go. At some point one of the central banks will overstep their bounds.

It’s not a matter of if a global credit crisis will happen; it is a matter of when it will happen. This is fifth grade math and anyone who bothers to look at the numbers will reach the same conclusion.

Why is this information not publicized?

Predicting a global credit crisis is as popular as forecasting that the sun will explode. Until you are right you will look like an idiot for predicting a credit crisis. When it actually happens, no one will care that you got it right – they will be too worried about how they will survive the event.

The politician who wants to adjust Social Security or Medicare never gets elected, so we are all at fault. We hear about the unsustainability of Social Security and Medicare and we still keep voting for idiots who want to kick the can down the road to our children. When you are running for office, you can’t compete with Santa Claus.

How will we know when a global credit crisis is happening?

First of all it is important to know that much of the credit risk shifted from the private sector (banks) to the sovereign level (central banks) in the last 20 years. Central banks are the lender of last resort. In the US, bank balance sheets are in decent shape and I don’t see that as an issue domestically. A financial crisis that starts at the bank level would be a big warning sign, but that will quickly get soaked up by the central banks. When you start hearing about bank bailouts by central banks, you know that it is getting serious. The Eurozone has already gone through that process and ECB is allowing European banks to pledge “junk” as collateral. Unlike the Fed, the ECB did not force banks to write-down bad debt because they were worried that too many banks would collapse. Japan used this tactic in the 1990’s under the notion that time would solve the problem. Their market has still not recovered to those highs in in the last 30 years. The ECB has executed a bank bailout without any headlines by allowing them to pledge junk. Most investors don’t realize the significance.

How do we trade a credit crisis?

If the credit crisis can be contained to the private sector (banks failures) the market declines will be severe and there will be plenty of shorting opportunities. The drops will be furious and the central banks will fight desperately to stop contagion. During the 2008-2009 I remember the Fed announcing interest rate cuts just before quadruple witching to screw the maximum number of shorts and to get the maximum market impact when they were forced to cover. Those were some massive market rallies on the eve of options expiration. As long as the credit crisis does not spread to the central bank level, they will “pull another rabbit out of their hat” and avoid the “big one”.

How to know if the credit crisis gets to the central bank level?

Sovereign bond auctions are the “tell”. Nations have to constantly reissue debt to finance expenses. In the US, our average duration on $30 trillion of debt is four years so there are constant bond auctions. When the demand for those sovereign bonds is low, the interest rates shoot higher. If those yields get into the high single digits, you know it is serious.

Are there any safe havens?

When this spreads to a sovereign level, it can happen in weeks or in some cases even days. It is hard to say to what degree central banks will agree to back each other. If you think that you will simply cash out the millions you make (from your shorts) in your trading account, it is not going to happen. Banks and brokerage firms will be locked down. When they fail, your deposits are only guaranteed to a certain amount. Physical gold would be of value to the extent that someone is willing to accept it in exchange for goods/services. For those of you who feel like gold will go up when everything is tanking, that is not how it works. Gold retains its value better than other assets, but it is an asset and eventually investors sell anything they have of value and that includes gold.

If by chance you figure out a way to retain some of your wealth, your best investment will be lead and barbed wire. You will need it when your neighbors see that your lights are still on.

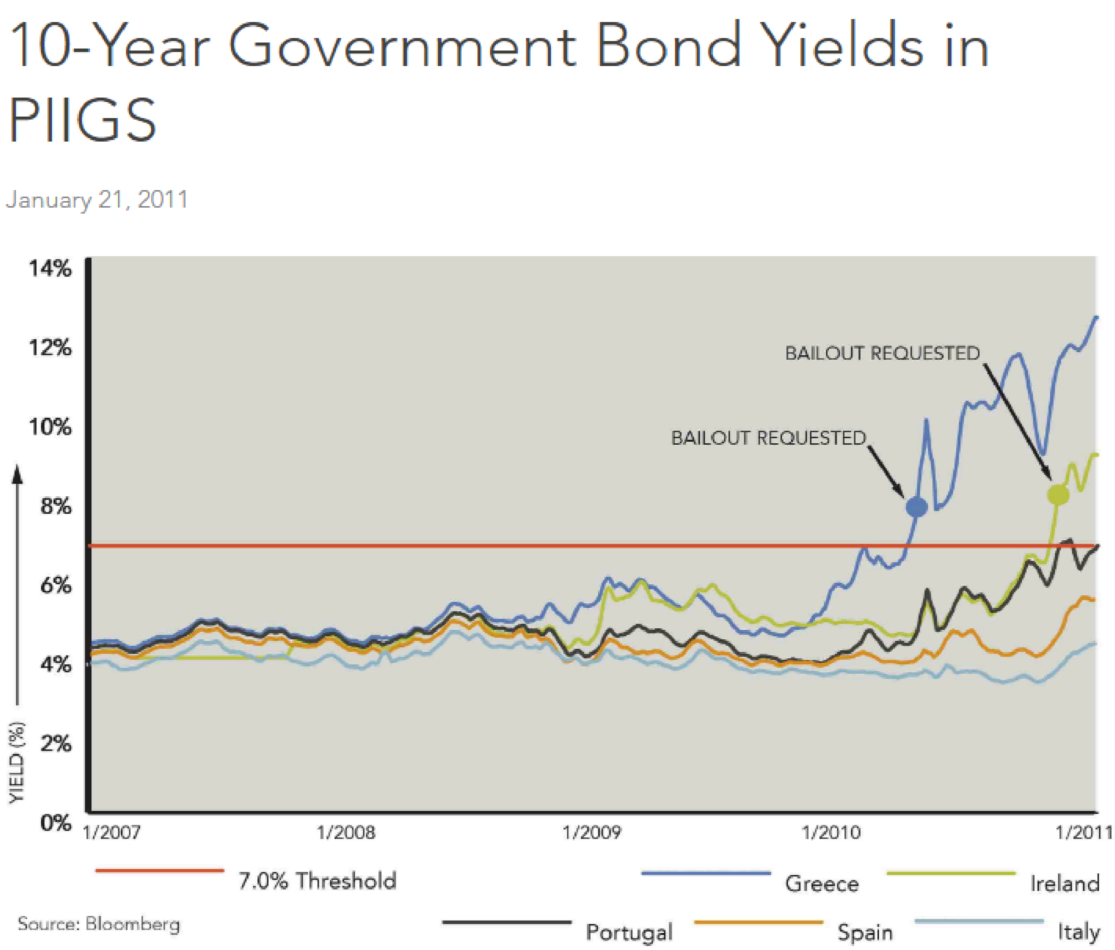
In previous sovereign defaults, the country typically seizes assets. A new currency is issued and people are able to keep a fixed dollar amount of their total deposits (i.e. the first $100,000) and there there is a “hair cut” on the balance (i.e. you can keep 10% of the deposits above $100,000). If this happens on a global basis, it could take years for the dust to settle and for commerce/transactions to return to normal.

Why did you write this depressing section?

This is depressing and I’ve watched this storm brewing for the last decade. As long as there is no credit crisis, assume that every market decline is temporary and that it will eventually lead to a buying opportunity. If the credit crisis does not escalate to the sovereign level and if central banks all support each other, perhaps you will get to enjoy your riches from the shorting opportunity and this charade can continue for a decade longer.

Is there any investment that will increase in value during a global credit crisis?

At the risk of getting philosophical – yes. Regardless of when or how this plays out, there is something that you can do right now. Take care of yourself. Your health is priceless and I suspect that when you need healthcare the most it might not be there for you. There is no downside to this advice. Work out and eat healthy. This investment will always pay off. Shift your focus away from material goods and spend time building your spiritual and personal relationships. A credit crisis can't strip you of these and you will be rich.



Spikes in sovereign interest rates are a warning that credit issues are looming

Chapter 6: Economic Reports

It’s important to know which data points the market cares about and to know the release dates.

Introduction

Let me add a little spice to an otherwise dry topic. The scene is the US 30-year bond pit on the CBOT, the most liquid futures contract in the world. This is where I started my career in 1989. It was the only futures pit that was open during economic releases (8:30 AM ET). The stock market would not open for another hour and the S&P 500 was closed as well. I’ve been to rock concerts and sporting events and they pale in comparison to this spectacle. Fortunes were made and lost in minutes and the paramedics were on hand. This is the mind set of a pit trader as they prepare for the release of the Unemployment Report:

Well, I made it in on time and I knew we were going to be packed in here like sardines. I can lift my feet off of the floor today. If this fat fu__er next to me gets in my way, I’m going to stick that pig with my pencil. This is the only game in town and if you want to trade the jobs report you have to come through me. It just got quiet, so it’s time to watch the wire. In a few seconds all hell is going to break loose. I’ll take some blows, but I’ll get my share in. This has been a rough week and I need to make some damn money. That breakfast burrito is not sitting well and I’m going to make these guys suffer. Time to do battle… ding, ding, ding, ding.

–The mental state of a floor trader before a big number.

The Trading Floor

In general, economic releases are backwards looking. If they are materially different from what was expected, they can spark swift reactions, but in general they are fairly benign. Here are some of the economic releases I pay attention to.

Unemployment Report

The Unemployment Report is released on the first Friday of the month and it helps us gauge employment. Although Wall Street considers this to the “grand daddy” of all economic releases, I don’t. First of all, the jobs report relies on government employees to process applications and to accurately report data… enough said. It is filled with seasonal adjustments and adjustments to the releases in prior months. If someone is unemployed for 6 months the government conveniently drops them from the number under the assumption that they are not looking for work. This number is buried in the labor participation rate and it has been steadily declining (more people not working) for decades. If a major holiday falls in the month when the jobs report is released there are sure to be adjustments. Analysts believe this is because people want to enjoy the holiday and they postpone filing for unemployment benefits. I don’t trust this number and fortunately I don’t need to. I just trade the reaction.

There is one component I do track when inflation is running hot and it is **Hourly Wages**. A number in the .3% range is normal, but a number in the .6% or higher range is “hot”. This is the largest input cost for employers and it is fundamentally relevant.

Initial Jobless Claims

Initial Jobless Claims reports are released weekly (Thursday morning) and they are timely. I like to track the 4-week moving average and it is a good indication of how the Unemployment Report will come in.

ADP (Automated Data Processing) is a publicly traded company that processes payroll checks for small and medium sized companies. They report how many paychecks were “cut” the previous month and it is released two days before the Unemployment Report. I find this to be a much more accurate reflection of the labor market. There are no seasonal adjustments or judgements on who is employed, who wants to be employed and who is unemployed. It is a raw number (how many checks did we “cut” the previous month) and I love the simplicity of it. There is no political agenda and there have been allegations of data manipulation for the jobs report before elections.

ISM Manufacturing Index & ISM Services Index

ISM Manufacturing Index and ISM Non-Manufacturing Index (aka ISM Services) are reported during the week of the Unemployment Report. I like these economic data points because they are timely. These are surveys, and as such they measure current conditions. They are released 30 minutes after trading starts and you need to be aware of the release dates because they can have a market impact. Since 80% of our economic activity is generated in the service sector, I tend to put more weight on ISM Services.

China is the second largest economy in the world and at some point they will be the largest economy. After decades of hyper-growth, I pay close attention to what is happening in China. They account for 30% of the world's manufacturing and they are considered the "global growth engine". China does not publish a Flash PMI (Purchasing Managers Index) so I have to gauge their activity using other data points. I watch the trade balance numbers and I want to see the percentage increase/decrease in imports/exports. If the imports are decreasing it could signal a slowdown. China also releases its GDP, Industrial Production and Retail Sales in the middle of the month. At the end of the month they release the official PMI.

CPI, PPI, and PCE

Consumer Price Index (CPI), Producer Price Index (PPI) and the Personal Consumption Expenditures Index (PCE) are inflation gauges. These data releases can be insignificant for decades, but when inflation is a concern, you want to be aware of these releases. Right now (6/10/22) inflation is running hot and you want to be aware of these releases so that your swing trades do not get blindsided.

Retail Sales

Retail Sales is an economic release that allows us to gauge the health of the consumer. If retail sales are in the 3% range, spending is normal.

Conclusion

There are many facets to trading and awareness is near the top of the list. The objective is not to anticipate how the number will come out or to guess the market reaction. Knowing these data points and the trends provides you with context as you put the longer term market moves into perspective. Once the number is released, I monitor the reaction and I follow the money. If the reaction was substantial, I make a mental note of it and I know that the market deems it to be important. When I am planning my week, I look at the upcoming releases and I note where the "speedbumps" might come into play. If I feel the number has the potential to "surprise", I will adjust my overnight risk accordingly.

Chapter 7: Politics

We have the best politicians money can buy – both parties!

Introduction

Politics influence the market and it is my least favorite topic to discuss. I don't allow anyone in my chat room to talk politics. Our country is divided and the chat room is a sanctuary where we can escape from it.

Corporate tax policies, regulations, foreign affairs, economic sanctions, the budget, stimulus and the debt ceiling all impact the market.

Corporate tax policies

Corporate tax policies shape corporate profitability and investor sentiment. Changes in tax rates and regulations can directly affect companies' bottom lines, influencing their investment decisions, hiring practices, and capital allocation strategies. Corporate tax reforms have broad implications for market valuations. Investors adjust their expectations for earnings and cash flows in response to changes in tax liabilities.

Regulatory Environments

Regulatory environments also exert significant influence on the market, particularly in industries subject to stringent oversight such as finance, healthcare, and energy. Shifts in regulatory frameworks can impact companies' operating costs, market access, and competitive dynamics, thereby influencing investor perceptions of risk and reward.

Foreign Affairs

Foreign affairs and economic sanctions introduce geopolitical risks that can disrupt global trade, supply chains, and investment flows. Tensions between countries or regions can lead to market volatility as investors assess the potential implications for trade relations, resource availability, and geopolitical stability.

Federal Budget

Federal Budget

Government budgets and fiscal stimulus measures have both direct and indirect effects on the market. Budgetary decisions impact government spending priorities, infrastructure investments, and social welfare programs, all of which can influence economic growth and corporate performance. Fiscal stimulus measures, such as tax cuts or infrastructure spending, can stimulate economic activity and drive market sentiment.

Debt Ceiling

The debt ceiling, or the statutory limit on government borrowing, is a critical consideration for financial markets. Failure to raise the debt ceiling can trigger uncertainty about the government's ability to meet its financial obligations, potentially leading to credit rating downgrades, higher borrowing costs, and market turmoil. Debates and negotiations surrounding the debt ceiling can be significant for investor confidence and market stability.

Conclusion

If you want to know how policy is going to impact the market, just follow the investment portfolio of your favorite Congressman. They can still legally pass legislation and trade ahead of the news. You could also follow stocks with relative strength. Remember, it tells us what the "smart money" is doing.

Before you get too riled up by the image, Republicans and Democrats are equally guilty. This was just an easy image to find.

Nancy Pelosi makes millions off tech stocks – and scoffs at push to ban congressional trades

By Lydia Moynihan and Theo Wayt — January 7, 2022 | 9:42pm | Updated

Congress can trade based on insider information

Chapter 8: Black Swans

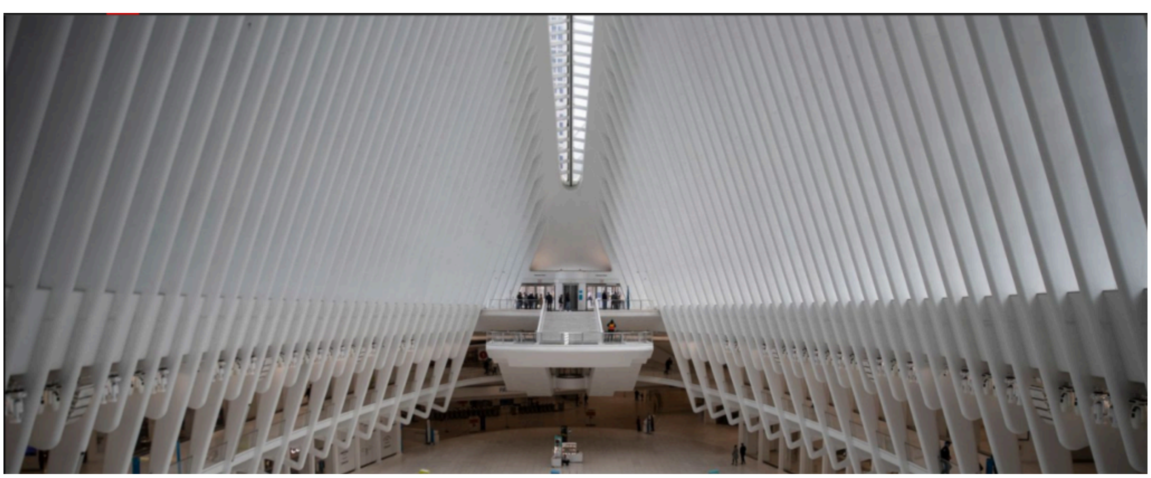
These events catch investors completely off guard and they can't be predicted.

Introduction

A **Black Swan** event is something that catches traders completely off guard. The market is an efficient pricing mechanism and these events are not priced in. In my 30 years I have only seen a few of these. One was 9/11, another was the "Flash Crash" and the third was Covid-19.

In contrast, the .com tech bubble and 2008-2009 financial crashes were NOT black swans. Both were predictable given stock valuations and lending practices.

There are few ways to prepare for Black Swans and they do wreak havoc on the market. In all three cases the market dropped suddenly and it recovered quickly. The market was only closed a few days for 9/11 and it bounced right back. The "Flash Crash" lasted a day and the Covid-19 drop only lasted a couple of months.



The Oculus transportation hub in New York is empty during the Covid-19 lockdown.

Chapter 9: Foreign Markets

The US accounts for 40% of the world's market capitalization.

A Trader's Perspective

Overseas markets can set the tone for the US markets. I give them a quick glance to see if they are going to provide a head wind or a tail wind before I start my trading day. If there is a major overnight move in the S&P 500 I will investigate if the move was tied to a foreign event or a news item.

China is the second largest economy in the world, followed by Japan. Consequently, I weigh Asian markets more heavily. I do monitor China's Purchasing Manager Indices (PMI), GDP, trade balance (imports/exports) and retail sales releases.

I can observe European markets during our trading hours and I will give them a quick glance during the day. ECB monetary policy is important and I am aware of their actions.

I look at daily charts for foreign markets once a week to see how they compare to the S&P 500. Overseas markets are not a major part of my fundamental analysis.

It is important to note global exchange holidays because they will often lead to a dull trading session in the US.

In January of 2020, I read about a new virus in China. Analysts were discounting the news, but I read about empty highways during the Chinese New Year and I knew this could manifest into something big. I kept apprised of the developments and when the S&P 500 cracked in February of 2020, I was ready for the drop.

In 2021, China's market had fallen more than 20% from its high when our market was making a new all-time high. If China is the global growth engine, why were these two markets moving in opposite directions? We are seeing strains in China's real estate market and the largest property development company is defaulting on interest payments. Could this be a sign that global economic conditions are faltering?

Conclusion

Global fundamental analysis may not impact your trading very often, but if something major is happening, time spent on this research could prevent you from getting blindsided.

The US accounts for 45% of the world's market capitalization and it has the best liquidity. It dictates what happens around the globe. It is the market I trade and it is where I focus my fundamental research.

% of World Stock Market Cap by Country*

Country	% World	Since '16 Election	10 Years Ago	Chg Since Election	10-Yr Chg
United States	**40.01**	**36.53**	**32.34**	**3.48**	**7.67**
Japan	7.59	7.79	8.02	-0.20	-0.42
China	7.51	10.21	4.03	-2.70	3.47
Hong Kong	6.51	6.28	5.56	0.23	0.94
United Kingdom	4.49	4.57	6.83	-0.08	-2.34
France	3.23	2.89	4.44	0.34	-1.20
Germany	2.91	2.78	3.62	0.12	-0.72
India	2.83	2.57	2.23	0.26	0.60
Canada	2.81	2.94	3.66	-0.13	-0.85
Switzerland	2.03	2.16	2.24	-0.13	-0.21
South Korea	1.97	1.94	1.58	0.03	0.39
Australia	1.72	1.78	2.42	-0.05	-0.70
Taiwan	1.48	1.50	1.33	-0.01	0.16
Sweden	0.97	0.98	0.94	-0.02	0.02
Spain	0.94	0.98	1.72	-0.04	-0.78
Brazil	0.90	1.19	2.57	-0.29	-1.66
Italy	0.84	0.75	1.74	0.09	-0.90
Netherlands	0.79	0.73	0.80	0.06	0.00
Russia	0.70	0.77	1.45	-0.07	-0.75
Thailand	0.65	0.63	0.31	0.02	0.33
Singapore	0.64	0.73	0.82	-0.09	-0.18
Saudi Arabia	0.62	0.61	0.96	0.02	-0.34
South Africa	0.62	0.67	0.79	-0.05	-0.17
Indonesia	0.58	0.69	0.37	-0.11	0.20
Denmark	0.57	0.53	0.53	0.04	0.04
Malaysia	0.55	0.59	0.49	-0.04	0.06
Belgium	0.54	0.65	0.58	-0.10	-0.03

Mexico	0.49	0.56	0.80	-0.06	-0.31
Norway	0.42	0.36	0.71	0.06	-0.29
Finland	0.35	0.32	0.55	0.03	-0.20
Chile	0.34	0.34	0.40	-0.01	-0.06
Phillipines	0.33	0.38	0.15	-0.05	0.19
U.A.E	0.31	0.33	0.40	-0.02	-0.09
Israel	0.22	0.23	0.34	0.00	-0.11
Poland	0.21	0.21	0.35	0.00	-0.13

**Bloomberg Market Cap Indices*

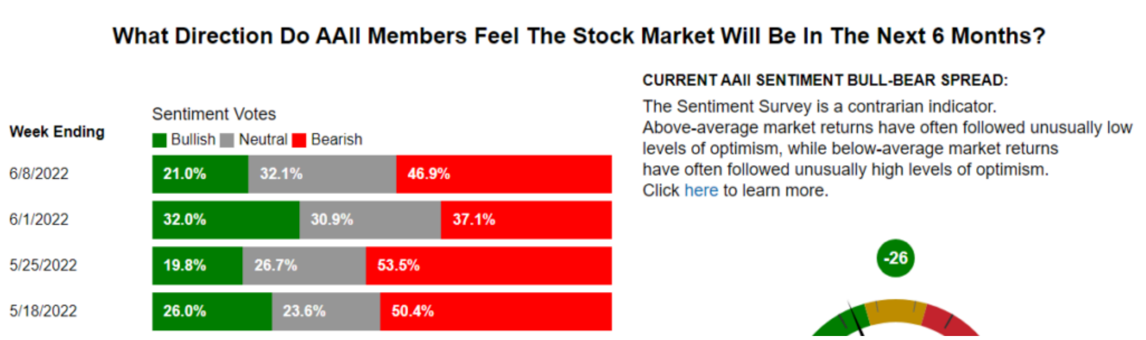
Chapter 10: Bullish And Bearish Sentiment

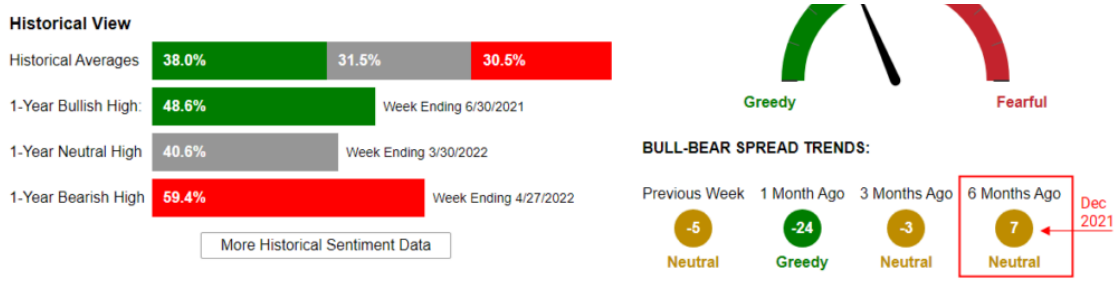
These contrarian indicators attempt to predict reversals based on the mood of retail traders.

Many indicators have been created to reflect the mood of retail investors. I will discuss a few of them, but I have not found much value in their predictive power. Markets can stay overbought or oversold for long periods of time and the 1OP indicator is much more accurate than these sentiment indicators. Even then, 1OP simply tells us when a reversal is likely. We adjust our positions, but we do not take trades simply based on one indicator. Picking "tops" or "bottoms" is a great way to destroy your account. We do not predict these moves, we wait for price action to tell us that a reversal is underway.

Sentiment Polls

Bullish and bearish sentiment polls are taken by the American Association of Individual Investors (AAII). You can view the change in sentiment here. These are polls and we do not know who the respondents are, if they are acting on their mood or how these polls have performed historically. Their website currently shows that the sentiment 6 months ago was neutral and the S&P 500 has fallen 20% (bear market) in that time.





AAII Sentiment Indicator

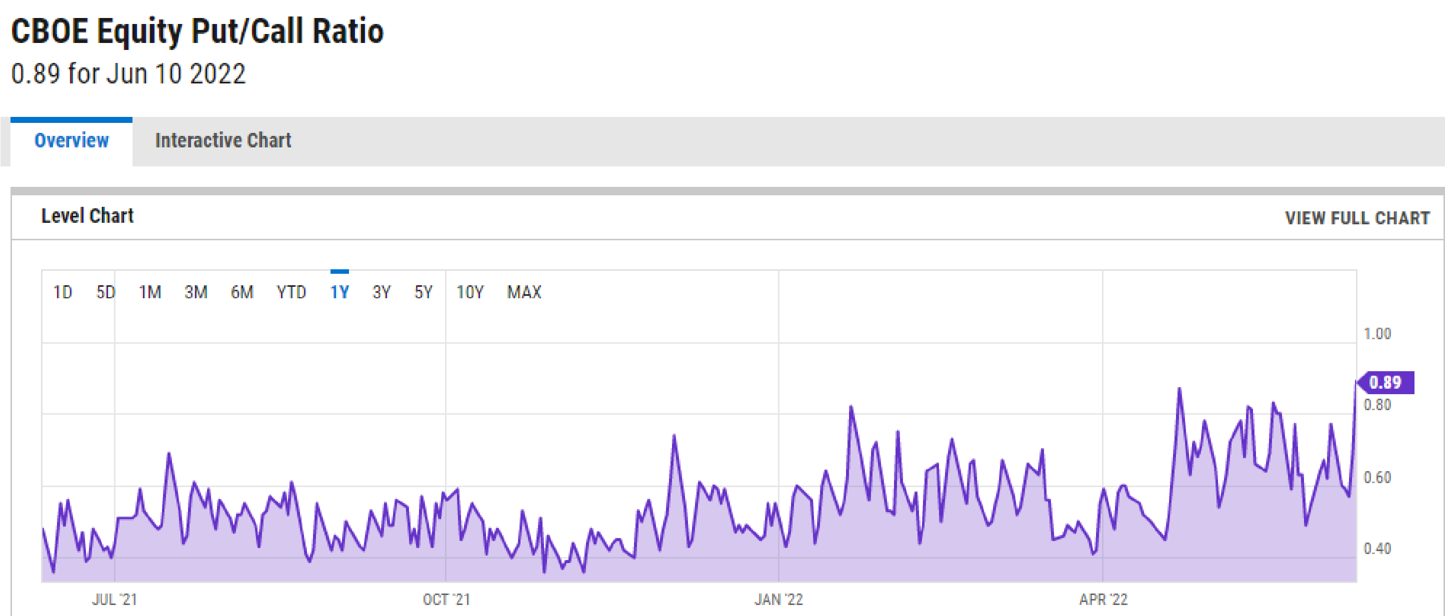
VIX Index

The VIX Index is a calculation designed to produce a measure of constant, 30-day expected volatility of the U.S. stock market, derived from real-time, mid-quote prices of S&P 500® Index (SPX℠) call and put options. It does have some utility and I discuss it in greater detail in the Market – Short-term – Technical section of this course. As a contrary indicator, a low VIX would signal complacency and the expectations for a market correction would be low. If you used this as a sign that a market top was forming you would have lost all of your money in the last decade. Option implied volatilities continued to make new historic lows as the market surged higher. I have found that huge spikes above 40 are fairly reliable in predicting market support levels, but you still need price confirmation. To reach those levels, the market has to make a very swift and deep drop. Out of all of the sentiment indicators, VIX has the most utility.

10-year Chart of VIX

Put/Call Ratios

Put/Call ratios divide the open interest for puts by the number of calls. This measures the number of contracts, so a large open interest of out of the money puts would mask a large number of at the money calls. To compensate for this another indicator called the dollar weighted put/call ratio was created. It divides the dollar value of put open interest by the dollar value of call open interest. The issue of put/call ratios is that we don't know who is buying the puts or calls and what the overall strategy is. Sentiment indicators attempt to measure retail orders on the notion that the "little guy" is always wrong. How do we know who the buyer is? We also don't know the intentions of the options trader. If a large institution buys puts for portfolio protection is that bearish? The bottom line is that I have not found any predictive value in this indicator. I have included a 3 year chart below.



3-year chart of the put/call ratio

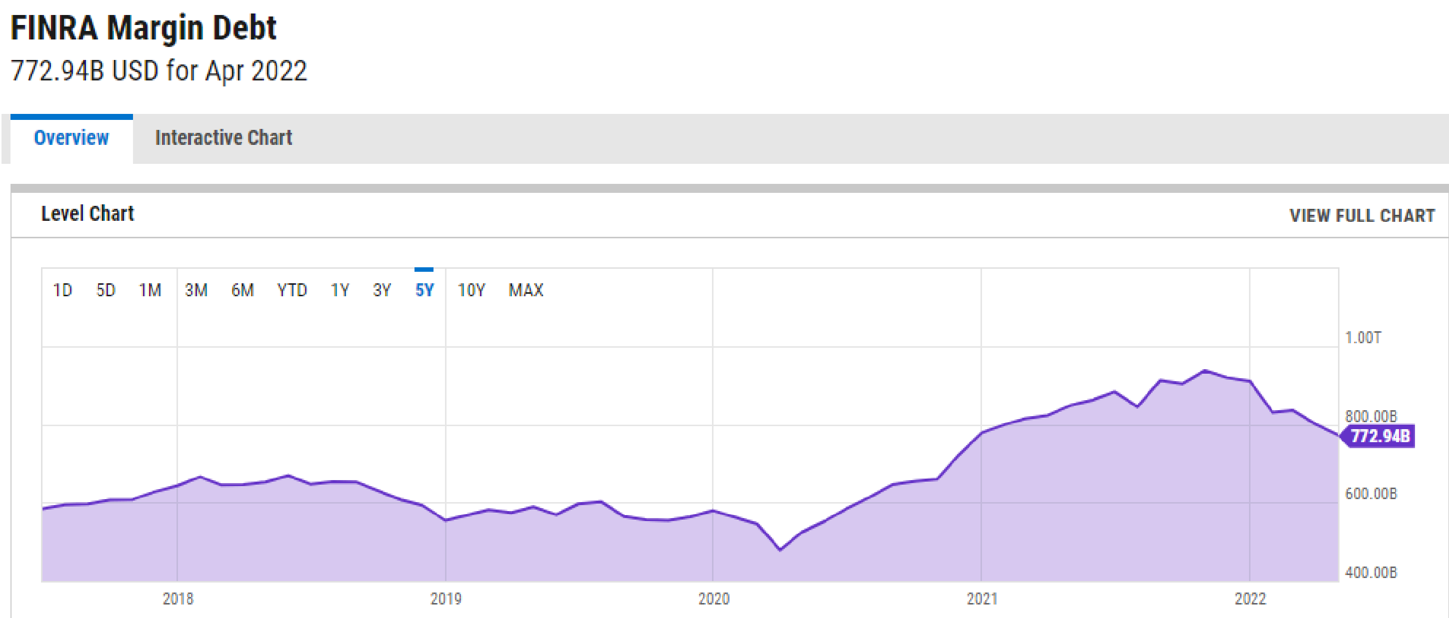
Margin Balances

Margin Balances are calculated by FINRA (Financial Industry Regulatory Authority) at the end of each month and they do reflect retail trader sentiment.

Member firms (brokers) carrying margin accounts for customers are required to submit, on a settlement date basis, as of the last business day of the month, the following customer information:

- the total of all debit balances in securities margin accounts; and
- the total of all free credit balances in all cash accounts and all securities margin accounts.

The data is calculated monthly so there is a slight lag. As you can see in the chart below the margin debt hit a low during the March 2020 market low. When the market drops, some of the selling is because of fear and low during the March 2020 market low. When the market drops, some of the selling is because of fear and some of it is to satisfy margin calls. You can also see that margin debt was extremely high in December of 2022 which was a market high. This data does have some merit and it can be used as a confirming indicator. The market price action in November and December were also indicating that a top was forming.



5-year chart of margin balances

Mutual Fund Flows

Mutual fund flows are also a sign of retail sentiment, but I find very little value in this information. The mutual funds report their balances at the end of the month so the data is old. When investors sell the mutual fund (outflow) the fund has to sell its holdings immediately. This information is instantly reflected in the price of stocks and the S&P 500 index. We do not have to wait a month for this data, we can see it in the price action immediately.

Gauging Institutional Sentiment

I am more interested in gauging institutional sentiment than I am retail sentiment. My goal is to follow the "smart money". I do this by watching sector rotation and relative strength/relative weakness help us identify asset allocation. When money is flowing out of high growth stocks and into safer stocks (consumer staples, utilities, and healthcare) it is a sign of "risk off" and we can expect market weakness. When money is flowing out of the safer stocks and into high growth tech stocks, it is a sign of confidence and the market is likely to move higher. In June 2020 the QQQ (Nasdaq 100 tech ETF) made a new all-time high after the Covid-19 crash. The SPY (S&P 500 depository receipts) did not make a new all-time high for another two months (August 2020). This was a sign of confidence on the part of Asset Managers. In November 2021, the QQQ made a new all-time high and it never reached that point again. The SPY did not make a new all-time high for another two months (January 2022) and it was

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a sign that money was rotating out of high growth stocks. Since then the SPY has dropped more than 20%.

Sector rotation helps us gauge institutional sentiment

Conclusion

In conclusion, these sentiment indicators for retail investors are interesting, but not trade worthy. The collection methods and the timeliness make them inferior to watching sector rotation and the 1OP indicator. It is fine to reduce your directional exposure when we have warning signs, but we do not predict market tops and bottoms. We only trade reversals when we have price confirmation.

Chapter 11: Conclusion

Market fundamentals help us understand the prominent forces that are driving price.

Awareness is Key

Awareness is what distinguishes excellent traders. The more you know, the less likely you are to be blindsided. You don't have to become an economist to understand the fundamental influences that are in play, but you do need to spend at least a few hours each week on this research. Know the dominant macro forces and plan your trading around scheduled events that could have a market impact. The goal of this first section was to teach you the most important long-term market fundamentals. The rest of the course will be focused on technical analysis.