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DOMINANT CYCLES IN INVESTMENT MANAGERS' EXPOSURE TO U.S. EQUITY MARKETS INDICATE IMPENDING TURNAROUND

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ABSTRACT

The importance of analyzing sentiment cycles of active money managers plays a critical role in assessing financial risk. Dominant cycles in the National Association of Active Investment Managers Exposure Index have been identified with high correlation over the past 15 years. The current state of the dominant cycles indicates a possible reversal for U.S. equity markets.

The Importance of Sentiment Cycles

In 1949, investing legend Benjamin Graham eloquently characterized the cyclical nature of financial markets in his book "The Intelligent Investor":

"The market is a pendulum that forever swings between unsustainable optimism and unjustified pessimism."

Normally, social mood waxes and wanes positively and negatively. Thus, sentiment waxes and wanes in the form of dynamic cycles. Mood refers to a feeling, emotion, or attitude about something, and, of course, it can have a range of values. Whenever mood is related to corporations or the economy, the character of events will unfold in the related financial assets. Fear and despondency represent one extreme, while thrill and euphoria characterize the other end of the spectrum.

Cycles are the important structure because sentiment does not jump rapidly from one state to another. A change of mood requires time; therefore, sentiment moves in dynamic cycles or waves.The challenge is to spot and predict the extreme turning points observed at market tops ("Maximum Financial Risk" - Euphoria) and at markets lows ("Maximum Financial Opportunity" - Panic).

If you have data sets that provide raw "mood" information related to financial assets on the one hand, and on the other hand have cyclic tools that can decipher and track dominant cycles, we are able to provide supporting market analysis to adjust your active investment risk.

Against this background, a cycle analysis of the NAAIM Exposure Index was performed. The NAAIM Exposure Index represents the average exposure of active investment managers to the U.S. equity markets. A value above 100 indicates leveraged long positions. The raw data of this publicly available index is not predictive in nature. However, the exposure index provides insights into the actual risk management of investment managers. In the case that cycles are found in that dataset, it will allow a prediction of future exposure and risk management efforts of that group.

Our performed cycle analysis for the entire NAAIM dataset revealed two dominant cycles: cycles with a length of 73 and 184 weeks. Both cycles were added to a superposition wave, which simply combines both cycles in terms of their phase, amplitude, and length into one combined wave (**Chart 1**).

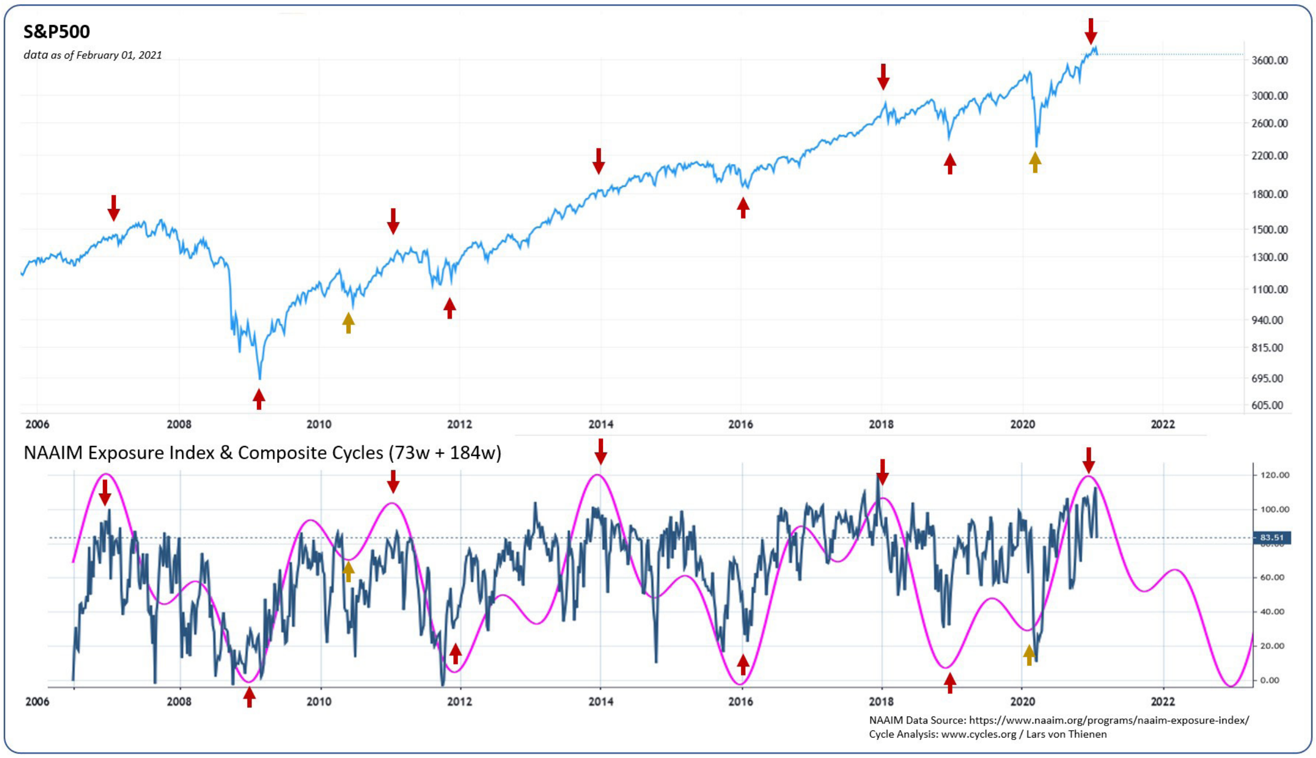

Chart 1: Superposition Composite Cycle (73w + 184w) in the NAAIM Exposure Index, S&P500 Index, Data as of Feb. 1 2021

The composite cycle shown is significant because >90% turning points from the exposure index composite cycle correlate with important market reversals. The composite cycle indicated:

- 2007-2009 17-month bear market during the financial crisis
- 2009 market low
- Short-lived bear market between May and October 2011, which was indicated by the high of the sentiment cycle just before Black Monday on Aug. 8, 2011, when the U.S. was downgraded
- 2014-2015 period began with an indicated sentiment cycle top and resulted in a sideways moving market
- 2016 sentiment cycle low, which indcated the start of a truly remarkable year for financial markets
- Predicting the end of the boom in early 2018, with 2018 being a worse year for financial assets. Since January 2, 2018, the S&P has fallen 8% until year end
- Pointing to the start of the next market upswing beginning in early 2019, indicated by the low of the composite cycle. With a gain of +60% to date since the indicated December 2018 composite cycle low.

Today, at the time of writing, we have reached the next projected composite cycle high for the NAAIM Exposure Index.

Based on the dominant cycle composite analysis of investment managers' exposure to the U.S. equity markets shown, the current cycle top and past correlations suggest a trend reversal in U.S. equity markets is imminent.

AUTHOR INFORMATION

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Mr. von Thienen is founder and CEO of a German-based IT management company. He develops algorithms and software for cycle detection at whentotrade.com and has published two books on cycle analysis. He is a Member of the Board of the Foundation for the Study of Cycles. Appointed by the Minister of Justice, von Thienen has served as a commercial judge for over a decade in Germany. Von Thienen is based in Germany.

REFERENCES

- NAAIM Exposure Index: https://www.naaim.org/programs/naaim-exposure-index/
- Cycles App: https://cycles.org/