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Sentiment Survey

A Logical Look At An Emotional Market

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Executive Summary

- **The US Stock Market: Near To Intermediate Term Bullish.** The latest data shows that both retail and professional investors are extremely pessimistic about the direction of the US stock market, if not terrified that prices will move to new 2011 lows. History tells us that this is precisely when investors should be *looking for opportunity*. **These data suggest that US equity prices are likely to rise into year end**, and could extend their gains into Q1 2012.
- **US Treasury Prices: Near To Intermediate Term Bearish.** Historic bullish extremes on long dated US Treasury prices by retail futures traders, brokerage and advisory firms. and futures options traders, amid favorable investor sentiment for a bottom to emerge in the Japanese stock market, all indicate **ideal investor sentiment for a 1-2 quarter bottom to emerge in benchmark US interest rates during Q4 2011**.
- **The US Dollar: Near To Intermediate Term Bearish.** The latest data from both retail and professional trend followers indicate **favorable conditions for a decline in the US Dollar Index that extends through at least year end and potentially into early 2012**, and suggests that an important peak may already be in place in the greenback at the early October highs.
- **Commodity Prices and The Energy Sector: Near To Intermediate Term Bullish.** Historic most bearish extremes by three different types of investor in the CRB Index, copper prices and crude oil prices suggest **favorable conditions for an upcoming 1-2 quarter rebound in commodity prices**, one which could have a positive effect on US equity prices.

US Stock Market: Current Extreme In Pessimism Has Historically Preceded 1-2 Quarter Market Advances

In our July 27th Sentiment Survey we discussed *".. favorable conditions for the late June advance in the US stock market...to lead into a more intermediate term decline -- perhaps by early to mid August "*

The bellwether S&P 500 actually began to decline as our July report was being written, dropping by 203 points or -16% between July 27th and August 9th before stabilizing and essentially trading sideways since then.

In today's report we display and discuss the latest investor sentiment data according to retail futures traders, mutual fund investors, Registered Investment Advisors (RIAs) , and brokerage and advisory firms -- all which indicate **favorable *if not ideal* investor sentiment for a one to several month advance to emerge in the US stock market**.

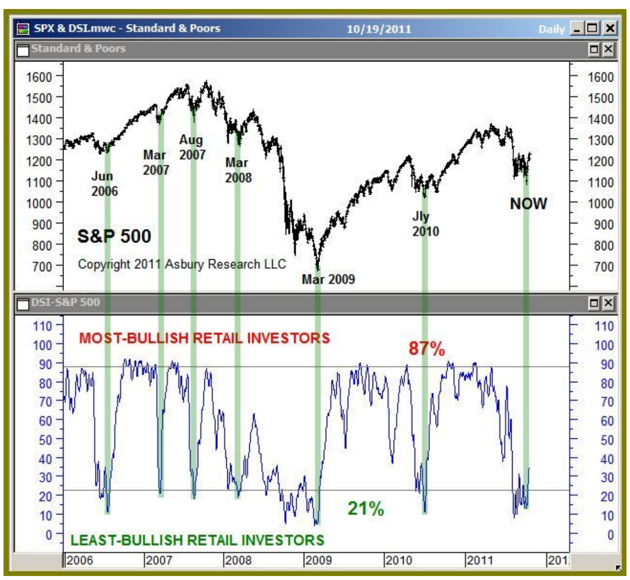

Chart 1

Chart 1 measures investor sentiment according to the **retail futures trader** via a daily survey of these investors' *bullishness* on the S&P 500. since 2006, which is plotted by the blue line in the lower panel. A daily bar chart of the S&P 500 (SPX) appears in the upper panel.

The green highlights show that these trend followers, who are notorious for being the most bullish at market tops and least bullish at market bottoms, are current just starting to rise from an historic *least bullish* extreme (of just 21% bullish or less) that had previously either coincided with or immediately led every one to several month *rise* in the S&P 500 in recent history -- during both bullish and bearish trends alike. As a contrary indicator, <u>these data are near to intermediate term bullish for the US stock market</u>.

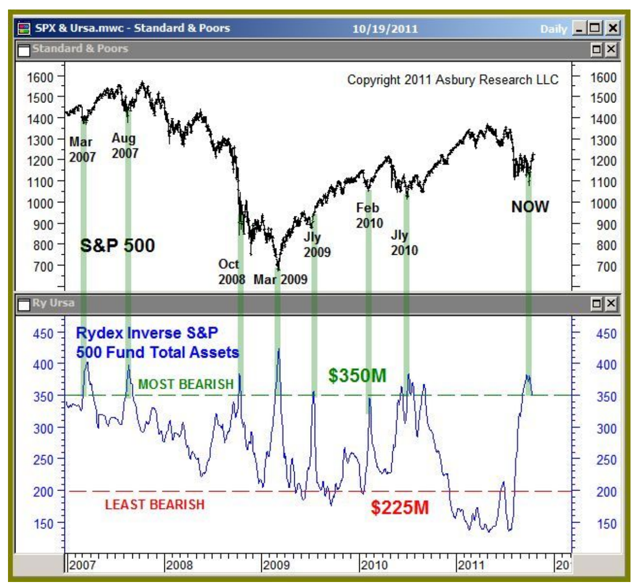

Chart 2

Chart 2 measures investor sentiment according to **mutual fund investors** via the daily assets invested in the **Rydex Inverse S&P 500 (formerly Ursa)**

Fund since 2007, which is plotted by the blue line in the lower panel. A daily bar chart of the S&P 500 appears in the upper panel.

The green highlights on the chart show that the assets invested in the fund are *just starting to retract from* an historic high extreme of $350 million, indicating *an extreme in bearishness by investors* on the S&P 500 that had previously coincided with every important *bottom* in SPX in recent history. This is another contrary indicator that indicates these investors are *convinced* that the US broad market is headed lower from here. History tells us that this is precisely when investors should be *buying*, not selling.

Chart 3 measures investor sentiment according to relatively small , active **Registered Investment Advisors (RIAs)** via **The National Association of American Investment Managers' (NAAIM) Weekly Survey of Manager Sentiment**, which is plotted since its inception in July 2006 by the blue line in the lower panel. A weekly chart of the S&P 500 appears in the upper panel.

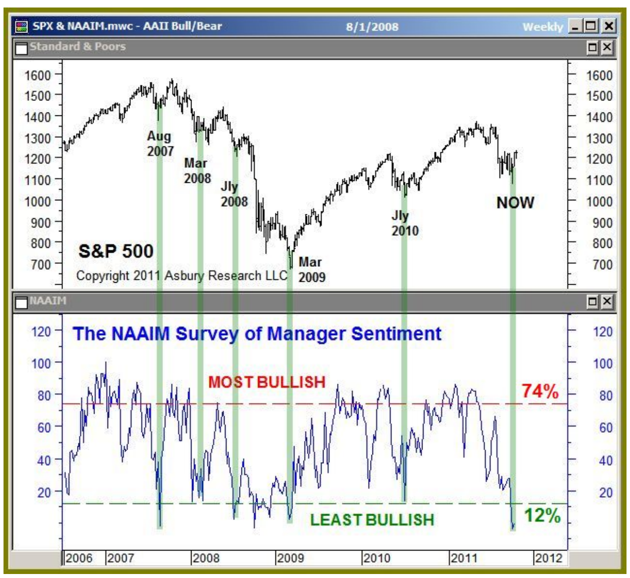

Chart 3

The green highlights on the chart show that these intermediate term-oriented professional trend followers are currently buried at an historic *least bullish* extreme of less than 12% bullish, and that previous similar extremes have coincided with every significant *bottom* in the US stock market in recent history -- regardless of trend direction.

Chart 4 measures investor sentiment according to the more intermediate term investment horizon of **brokerage and advisory firms** via the **Market Vane Survey**, which polls the collective day-to-day *bullishness* of these firms on a variety of different assets including the US stock market. The chart displays the survey as it pertains to the NASDAQ 100 (NDX) in the lower panel (blue line), with a daily bar chart of NDX in the upper panel.

Chart 4

The colored highlights in the lower panel define *most bullish* (63% bullish or more, red) and *least bullish* (46% bullish or less, green) extremes in this survey since 2004. The green vertical highlights between both panels show that these professional trend followers are currently bouncing off of an historic *least bullish* extreme which has previously coincided with or immediately led what have been the most important bottom in the US broad market index during this 7-year period. This is yet another instance of an extreme in pessimism, this time from a group of intermediate to long term trend followers, that has historically preceded multi-month *bottoms* in the US stock market.

Conclusion and Investment Implications

The data in **Charts 1-4**, which represent both retail and professional investors that invest within a variety of different time frames from short to long term, show that *trend following investors* -- which is the common denominator between all of them -- are extremely pessimistic about the US stock market, if not terrified that prices will go even lower.

History tells us, via these data, that this extreme in pessimism is precisely when investors should be *looking for opportunity*, rather than a rock to hide under. **Assuming that history repeats, these data suggest that US equity prices are likely to rise into at least year end, and potentially into early 2012.**

US Treasury Prices: Historic Extremes in Sentiment On US Treasuries, Japanese Equities Suggest An Upcoming 1-2 Quarter Decline Amid Rising US Interest Rates

We are particularly interested in the direction of US interest rates right now because of the steadily-tightening positive correlation between the yield of the US 10-Year Treasury Note and the S&P 500 over the past year, as shown in **Chart 1** below.

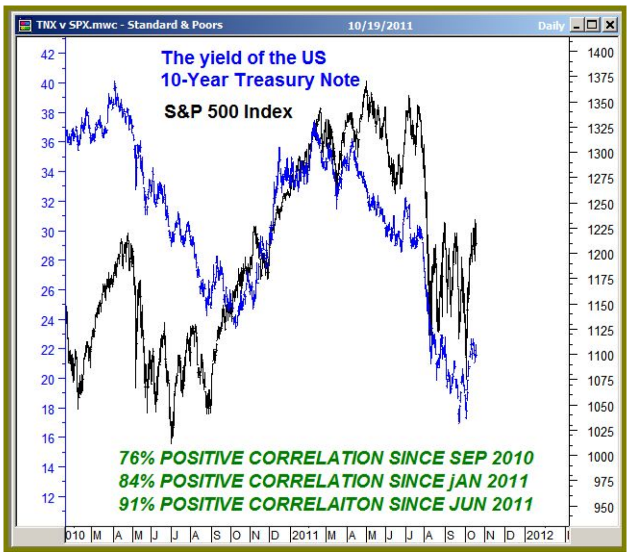

Chart 1

The relationship exists because of investors' tendency to look outside of the stock market itself for clues to upcoming market direction, including US interest rates and crude oil prices, particularly when the economy is weak or stock prices are declining.

Per the correlation, **we view the current alignment of investor sentiment data on US interest rates as another indirect indication of upcoming US stock market direction**.

Chart 1 (next column) measures investor sentiment according to a daily survey of **retail futures trader** *bullishness* on the US 30-year T-Bond since 2005, which is plotted by the blue line in the lower panel. A daily bar chart of the CBOT T-Bond appears in the upper panel.

The red highlights on the chart show that these investors are currently retracting from a September *most bullish* extreme of 88% bullish or greater, an extreme that has previously coincided with or immediately led what have arguably been <u>the</u> most important *peaks* in long dated US Treasury prices in recent history.

Chart 2

Also note that, although the blue line in the lower panel has recently declined out of *most bullish* territory, it is nowhere near the opposite least bullish extremes (green highlights) that have coincided with important market *bottoms* during this period. <u>This suggests that the late September decline in Treasury prices is still in its early stages.</u>

Chart 3 (next page) measures investor sentiment on the long bond according to the **Market Vane Survey**, which polls the daily level of *investor bullishness* by **brokerage and advisory firms** -- which tend to operate within a more intermediate to long term investment horizon than the near term-oriented futures traders shown in **Chart 2**.

Just like **Chart 2**, though, the red highlights on **Chart 3** show that these professional trend followers are also *just starting to retract* from previous most bullish extremes on long dated US Treasury prices, which have previously coincided with or led every important *top* in the T-Bond contract during the past decade.

Chart 3

Because these investors operate within a longer term time frame, these data suggest a more *intermediate to long term* negative bias than the previous chart -- and the potential for rising benchmark US interest rates into the first quarter to first half of 2012.

Chart 4 (next column) measures investor sentiment according to **futures options traders** via the **T-Bond Put/Call Ratio**, which is plotted by the blue line in the lower panel. A daily bar chart of the CBOT T-Bond appears in the upper panel.

The rightmost red vertical highlight on the chart shows that the ratio is currently declining from its highest level in more than a decade, indicating *an extreme in investor complacency or optimism*, but still remains up at historic extremes that have coincided with the most important peaks in the T-Bond contract since 2005.

These data suggest that Treasury prices are currently vulnerable to a decline that is similar in importance to those other instances at similar extremes highlighted in red on the chart.

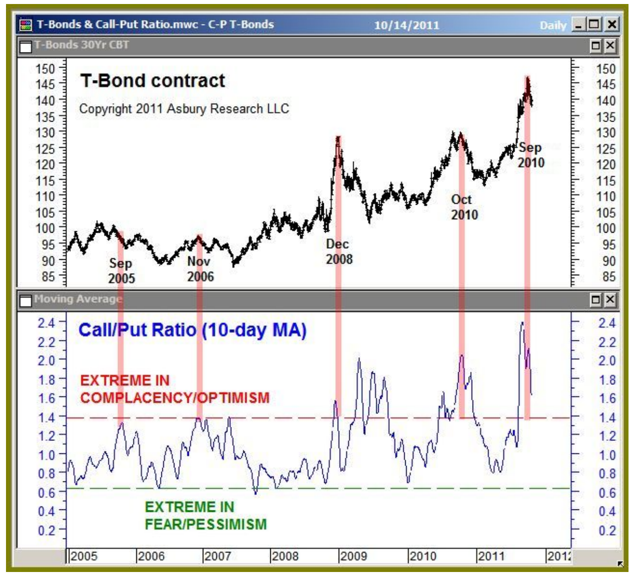

Chart 4

Chart 5

Chart 5 displays a daily bar chart of the Japanese Nikkei 225 Index since 2005 in the upper panel, with the same daily survey of **retail futures trader** bullishness shown in **Chart 2** -- *this time on the Nikkei* -- in the lower panel. The blue line and rightmost green vertical highlight on the chart show that these traders are currently rising away from an historic *least bullish* extreme of just 22% bullish or less, which has previously coincided with every important *bottom* in the Japanese index in recent history.

This chart is germane to US interest rates is because of the tight and stable long term *positive correlation* between the Nikkei 225 and the yield of the US 10-Year Treasury Note over the past decade, as shown in **Chart 6**.

Chart 6

The relationship exists because the US is a major purchaser of Japanese goods. Thus, during a strong US economy during which US interest rates are rising, the US buys more goods from Japan which helps to buoy their stock market.

Per the correlation, an upcoming rise in the Japanese stock market, as **Chart 5** suggests is likely, should coincide with *a rise in benchmark US interest rates* as long dated US Treasury prices *decline*.

Conclusion and Investment Implications

Historic bullish extremes on long dated US Treasury prices by retail futures traders, brokerage and advisory firms. and futures options traders, amid favorable investor sentiment for a bottom to emerge in the Japanese stock market, all indicate **ideal investor sentiment for a 1-2 quarter bottom to emerge in benchmark US interest rates during Q4 2011**.

The US Dollar: Latest Data Suggest Favorable Conditions For A 1-2 Quarter Peak

In our July 27th Sentiment Survey we said: *"...favorable investor sentiment (exists) for the mid July decline in the US Dollar to continue on a week-to-week basis, but also suggest that the May lows are unlikely to be appreciably broken before at least a 1-2 month corrective rebound emerges."*

Since that report the US Dollar Index essentially drifted sideways through late August -- hovering *just above* the May lows -- before a 6.34 point, +9% rally emerged between August 29th and October 4th.

In today's report we display and discuss the latest investor sentiment data according to notorious trend-following retail futures traders, mutual fund investors and brokerage and advisory firms -- all which suggest that **a one to several month peak is in place in the greenback (particularly versus Europe) at the early October highs**.

(NOTE: The US Dollar Index is comprised of six component currencies: the euro, Japanese yen, British pound, Canadian dollar, Swedish krona and Swiss franc and is 77% weighted towards Europe. The Japanese yen comprises just 14% of this index.)

Chart 1 (next column) measures investor sentiment in the US currency according to a daily survey of **retail futures trader** *bullishness* on the US Dollar Index since 2005. A corresponding daily bar chart of the index appears in the upper panel.

The red highlights show that these traders are just starting to retract from a multi-year most bullish extreme of 80% or higher. one that had previously coincided with or immediately led what have been the most important *peaks* in the US currency in recent history.

As a contrary indicator, this "too bullish" extreme by these trend followers indicates favorable investor sentiment for another similarly-important top to emerge in the US currency this month, if one is not already in place at the early October highs.

Chart 1

Chart 2

Chart 2 measures investor sentiment according to **mutual fund investors** via the **Rydex US Dollar**

Ratio, which is plotted since 2010 by the blue line in the lower panel. The Rydex US Dollar Ratio is the total assets invested in the Rydex Weakening Dollar 2x Strategy Fund (RYSBX) *divided by* the total assets invested in the Rydex Strengthening Dollar 2x Strategy Fund (RYWBX), a daily measure of *bearishness* on the US currency by the trend-following, retail investors that typically invest in these funds. A corresponding daily bar chart of the US Dollar Index appears in the upper panel.

The red highlights on the chart show that these investors are currently starting to move away from historic *least bearish* extremes that have previously coincided with every near to intermediate term *peak* in the US currency during the past two years.

Accordingly, these data suggest that the October decline in the US Dollar Index is the beginning of a multi-month decline in the US currency that -- assuming that history repeats -- could extend through year end.

Chart 3 (next column) measures investor sentiment on the US Dollar according to the more intermediate to long term investment horizon of **brokerage and advisory firms** via the **Market Vane Survey**. This daily survey, which is plotted by the blue line in the lower panel, indicates the collective *bullishness* of these professional trend followers on the US currency since 2000. A daily bar chart of the US Dollar Index appears in the upper panel.

The colored highlights in the lower panel define *most bullish* (58% to 76% bullish, red) and *least bullish* (21% bullish or less, green) extremes in this survey during the past decade. The rightmost red vertical highlight between both panels shows that these investors have just started to pull back from previous *most bullish* extremes which, according to the pattern during the past decade, indicates favorable sentiment for another major top to emerge in the US currency this month -- one that is similar in significance to those that emerged in June 2010, November 2008 and November 2005.

Chart 3

Conclusion and Investment Implications

Three different types of retail and professional trend followers, which invest in both near term (monthly) and intermediate term (quarterly) time frames, are all just starting to retract from previous bullish extremes on the greenback that have historically coincided with important *peaks* in the US Dollar Index. **The current data suggests that another similarly-significant peak in the greenback may already be in place at the early October highs, and is amid favorable sentiment to extend at least through year end and potentially into Q1 2012.**

Commodity Prices & The Energy Sector: Favorable Sentiment For 1-2 Quarter Rebound

In a weak global economy, identifying an upcoming rebound in key commodity prices can indicate an increase in demand that can have an equally positive effect on US equity prices. This dynamic can be seen in the *positive correlation* between US stock indexes and economically-sensitive crude oil and copper prices.

In today's report we display and discuss three different investor sentiment data series that pertain to crude oil, copper and the CRB Index -- all which suggest **favorable sentiment for a significant rise in commodity prices during Q4 2011 and potentially into early 2012**.

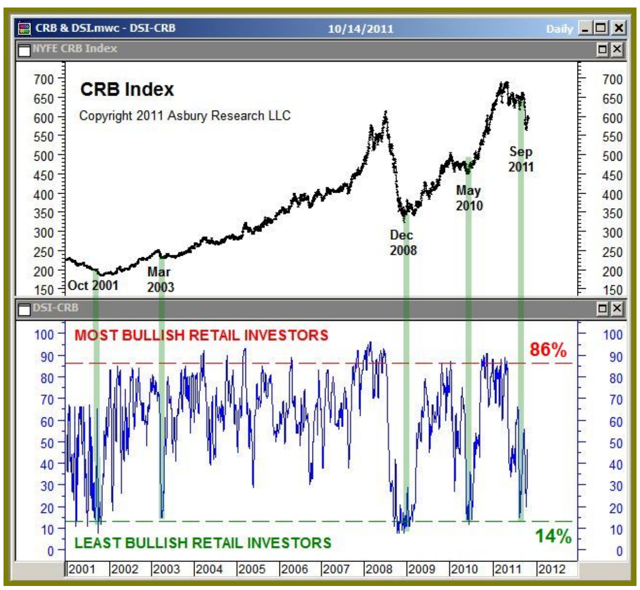

Chart 1

The blue line in the lower panel of **Chart 1** plots daily investor bullishness on **the CRB Index** over the past decade according to a daily survey of **retail futures traders**. A corresponding daily bar chart of the CRB Index appears in the upper panel.

(Note: The CRB Index is an un-weighted geometric average of 17 commodity futures contracts that includes energy, grains, industrials like copper and cotton, livestock, precious metals, and "soft" commodities like coffee and sugar. It is often seen by investors as a bellwether of market-based inflation.)

The green vertical highlights between both panels show that these trend followers -- who are notorious for being *incorrectly positioned at market extremes* -- are currently hovering just above a September *least bullish* extreme of just 14% bullish that has previously either coincided with or led the most significant *bottoms in commodity prices* during past decade.

Assuming that history repeats, this extreme in sentiment suggests that another similarly-important bottom in commodity prices is emerging now.

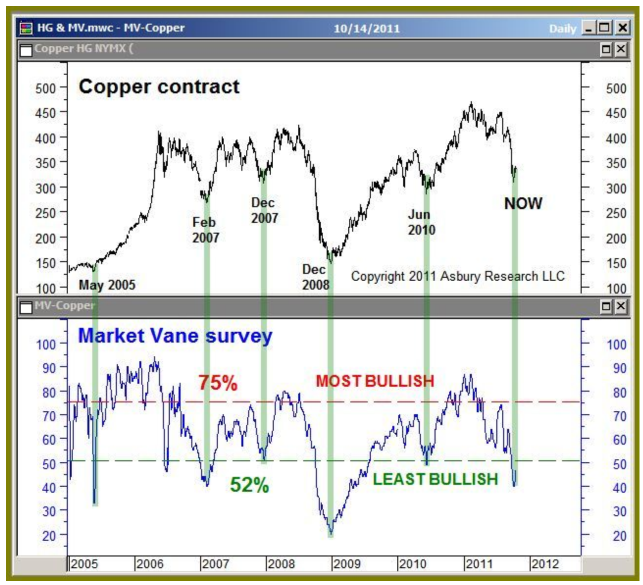

Chart 2

Chart 2 measures investor sentiment on **copper prices** since 2005 according to the more intermediate to long term investment horizon of **brokerage and advisory firms** via the daily **Market Vane Survey**, which is plotted by the blue line in the lower panel. A corresponding daily bar chart of COMEX copper appears in the upper panel.

The blue line and rightmost green vertical highlight shows that that investor sentiment appears to be stabilizing and reversing direction from historic *least bullish* extremes of 52% bullish or less, a place from which the most important *bottoms* in copper prices during the past 7 years have emerged.

As long as investor sentiment continues to become increasingly bullish from here, we will view this as the potential starting point of another rise in copper prices that is similar in importance to those others highlighted in green on the chart.

Chart 3 shows the relationship between copper prices and the US stock market via COMEX copper (red line) and the Dow Jones Transportation Index (black line) since 2000.

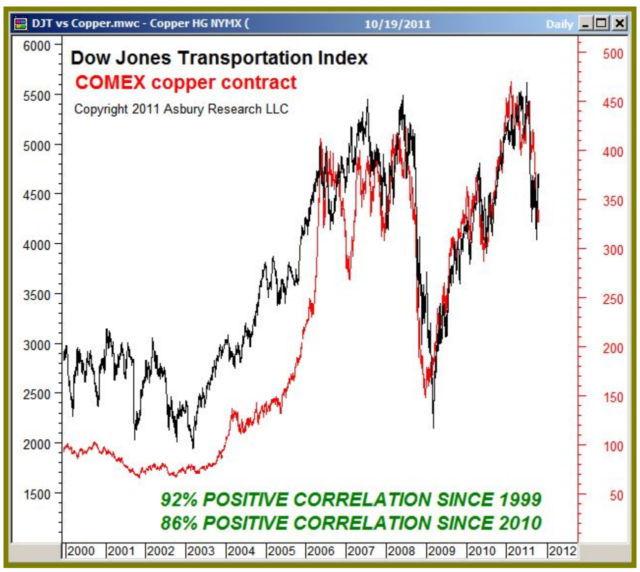

Chart 3

Assuming that this tight and stable long term positive correlation does not suddenly disappear overnight, we would expect a rebound in copper prices to coincide with a rebound in the Dow Transports -- as well as in the broader US stock market.

Chart 4 measures investor sentiment in the Energy Sector since 2005 according to **ETF investors** via our own **Rydex Energy Ratio** (blue line, lower panel), which is the total assets invested in the Rydex Energy *plus* Energy Services Funds *divided by* the total assets invested in *all* Rydex sector funds. A corresponding daily bar chart of the iShares Energy Sector SPDR ETF (XLE) appears in the upper panel.

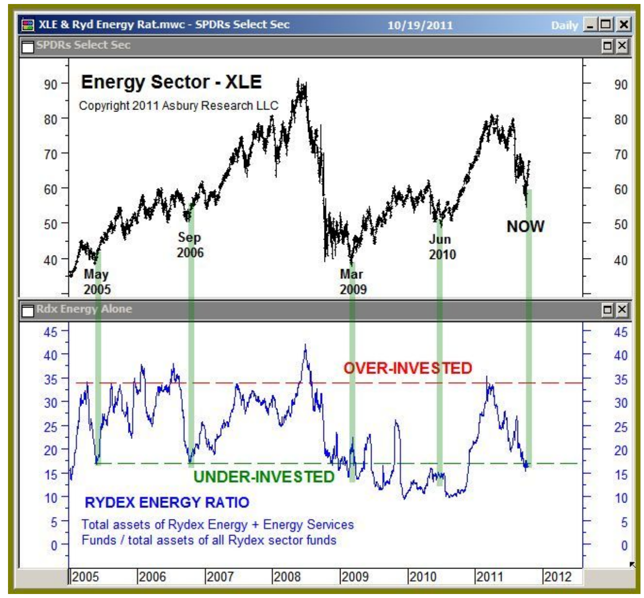

Chart 4

The green highlights on the chart show that our Ratio has reached a multi-year *under-invested* extreme that had previously coincided with what have been the most important bottoms in XLE in recent history.

Considering the tight and stable long term *positive correlation* between XLE and the NYMEX crude oil contract (not shown) since the XLE's inception in late 1998, and the more recent *positive correlation* between crude oil prices and the S&P 500 since the US stock market peaked in October 2007 as shown in **Chart 5** (next page), we would view a rebound in XLE and crude oil prices as also being indirectly positive for the US stock market.

Conclusion and Investment Implications

Historic most bearish extremes by three different types of investor in the CRB Index, copper prices and crude oil prices -- the latter two which are positively correlated to the US stock market, suggest favorable conditions for an upcoming rebound in commodity prices -- that could also have a positive effect on US equity prices.

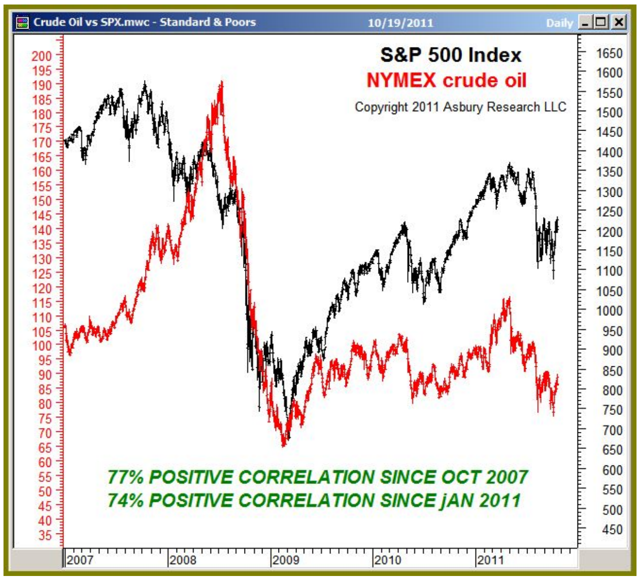

Chart 5

These data suggest the potential for an economic demand-driven rise in both commodity and US stock market that has the potential to extend into early 2012.