ClarkCapital MANAGEMENT GROUP

Navigator® Global Opportunity

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December 31, 2013 - Market Commentary

Resisting Sentiment's Siren Song

Executive Summary

- U.S. Equity sentiment has hit bullish optimistic extremes over the last 30 days. Although sentiment indicators are not very accurate market timing tools, they do indicate the market psychology is ripe for a significant correction.
- The S&P 500 monthly chart continues to show an accelerating, unsustainable rate of price increases.
- With frothy sentiment, the probability of a fast multi-week down trend is increasing.
- Although the first and second quarters have significant risk for a correction, this does not necessarily negate the probability of the emergence of a longer term secular bull market.

"If anyone unwarily draws in too close and hears the singing of the Sirens, his wife and children will never welcome him home again. Therefore pass these Sirens by, and stop your men's ears with wax that none of them may hear."

Homer, The Odyssey (Book XII)

Sentiment of the crowd is a very powerful force in markets, as it pushes market psychology to extremes. Let's look at some of the current extreme sentiment measures for the U.S. equity markets:

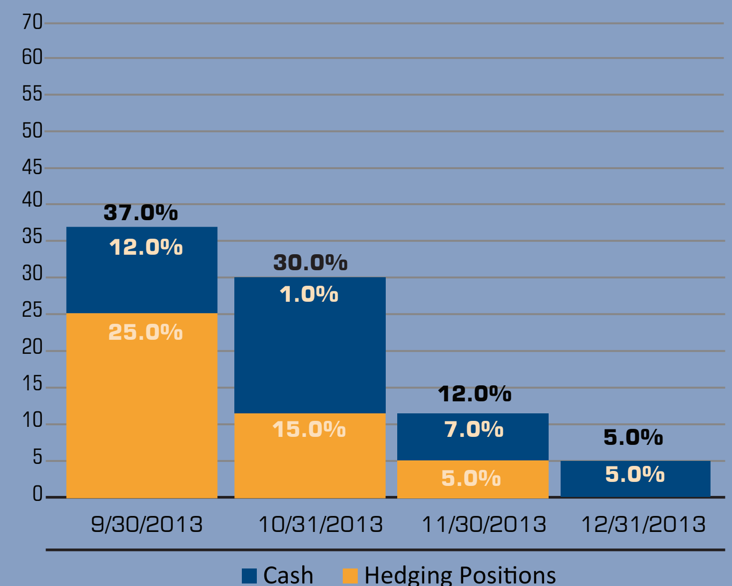
- The Daily Sentiment Index for the S&P 500 futures (trade-futures.com) has hit 93% bulls twice this quarter, a rare occurrence. This indicates short term extreme bullish sentiment amongst S&P 500 (SPX) futures traders;
- The Investors Intelligence Advisor Survey has registered 114 consecutive weeks of "bullish plurality," meaning bulls outnumbering bears.
- Likewise, individual retail investors are not bearish, as measured by the American Association of Individual Investor's Survey. In a recent survey, bulls outnumbered bears by 36.5% — the second highest extreme reading in seven years.
- Continuing extreme lows in the CBOE Put/Call ratios, as well as in the ISEE Call/Put ratios, are indicating reduced levels of hedging activity.

Target Allocations (as of 12/31/2013)

US EQUITY		**65.0%**
SPY	SPDR S&P 500 ETF	40.0%
DIA	SPDR DJ INDUSTRIAL AVERAGE ETF TRUST	20.0%
QQQ	POWERSHARES QQQ TRUST	5.0%
SECTORS		**6.0%**
XLE	ENERGY SELECT SECTOR SPDR FUND	3.0%
XME	S&P METALS & MINING INDEX	3.0%
INTERNATIONAL EQUITY		**24.0%**
EZU	ISHARE EMU INDEX	10.0%
EWA	ISHARES AUSTRALIA	5.0%
VWO	VANGUARD EMERGING MARKETS	5.0%
EIDO	ISHARES MSCI INDONESIA MARKET INDEX	2.0%
HAO	GUGGENHEIM CHINA SMALL CAP ETF	2.0%
CASH		**5.0%**

This is not a recommendation to buy or sell any particular security. Please see attached disclosures.

Defensive Positions (Last Four Months)



Asset allocation may vary and the targets shown will be affected by market conditions, account guidelines or restrictions.

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- Ned Davis Research's Weekly and Daily Sentiment Indices, which are weighted composites of multiple sentiment measures, are hitting extremely optimistic levels.

Remember that sentiment indicators are not necessarily accurate market timing tools, and extreme readings can continue for up to six months before a major correction occurs. More importantly, they do indicate the market psychology is ripe for a significant correction.

In our last commentary in early October, we noted the possibility that the S&P 500 (SPX) had been in distribution since the May 22nd 2013 high; that was unless the September 19th high (1729) was convincingly exceeded (meaning no false breakouts). In late October, the SPX did in fact move above the September high (1729) and consolidated above that September high until early November. Our analysis indicated it would not be a false breakout; and the May-September period was in effect a consolidation for another leg up. Thereupon, we eliminated our hedges in November, keeping only marginal cash positions in November to the present. After that, the index never traded below that 1729 high. See "Defensive Positions" on the previous page.

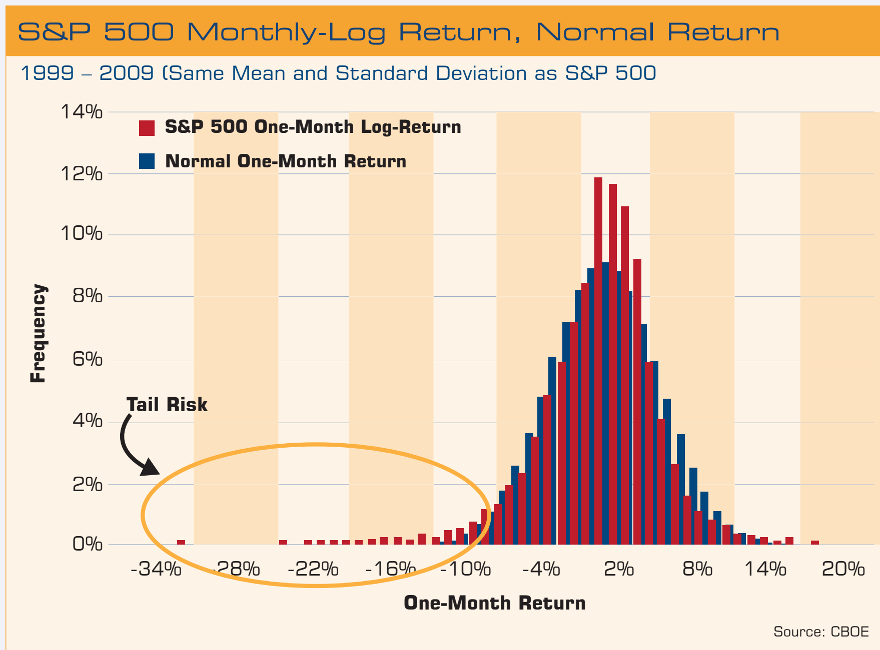

Figure 1

Following this takeoff in mid-November, the bears retreated into deep hibernation, covering hedges to preserve capital. However, the market ecosystem needs bears, as bears with short positions become the natural buyers in a down trending market. Remember the old market adage: up trends begin with short covering. Over the last 13 months, short positions have been squeezed so repeatedly, so relentlessly, so systematically that bears have by and large given up.

Consequently, the lack of hedging activity can lead to fast hard corrections. As mentioned above, the existence of hedges (shorts) represents a cushion in market downturns. This observation is more than anecdotal; it is statistically registering in a little noticed index compiled by the CBOE called SKEW.

SKEW is a statistical term describing the symmetry of normally distributed S&P 500 returns around its mean. (For those who wish to delve into the details of SPX SKEW see www.cboe.com/micro/skew/introduction.aspx.) SKEW is an indicator that measures perceived tail risk, the circled area in Figure 1. The VIX is a proxy for the standard deviation of the "normally distributed" S&P 500.

The VIX, which is the 30 day implied volatility of the SPX, may not fully capture the perceived risk of the SPX in some market environments. In this regard, SKEW complements the VIX as a risk measure, telling us how the market prices another "area" of risk (i.e. tail risk.) The higher "tail risk" is, then the higher the SKEW Index. An excerpt from the above CBOE web site states it clearly:

> VIX captures the first layer of perceived risk, as it tells how far on average the S&P 500 log-return is likely to stray on either side of its mean, including the risky downside. Once this is gauged, SKEW catches the additional layer of risk implied by the left tail of the distribution. Perceived tail risk increases when market participants increase their probability of a catastrophic market decline, what has come to be called a "black swan."

There is generally a low correlation between variations in the VIX and SKEW. High values of SKEW occur in conjunction with both high and low values of VIX. High SKEW values accompanying high VIX values are infrequent however.

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The probable cause is that when the VIX spikes during periods of crashing stock prices, a repeat crash (from accompanying high SKEW) may not be viewed as likely. This high VIX/high SKEW event did occur during the Long Term Capital Crisis in 1998. Therefore, it appears to us that meaningful signals come from high SKEW values in conjunction to low VIX values — where risk unrevealed by the VIX is indicated by the SKEW.

With the above as background, on December 20th, 2013, the SKEW indicator gave us its second most extreme reading (143.20) in its 23 year history (data begins in January 1990.) This occurred with a low VIX reading of 13.79 (which implies less than a 4% expected move in the SPX over the next 30 days). The VIX tells us there is limited expected volatility in the next 30 days (<4%), but the SKEW tells us there is a significant probability of a tail risk event. Prior extreme highs were on March 16, 2006 (142.02), October 16, 1998 (146.22), and June 21, 1990 (142.57). With the exception of the previously noted 1998 Long Term Capital Crisis reading, the two other extreme readings were both accompanied by a low VIX and were quickly followed by declines of 20% (1990) and 8% (2006). Figure 2 shows the S&P 500 at prior highs of the SKEW over the last four years.

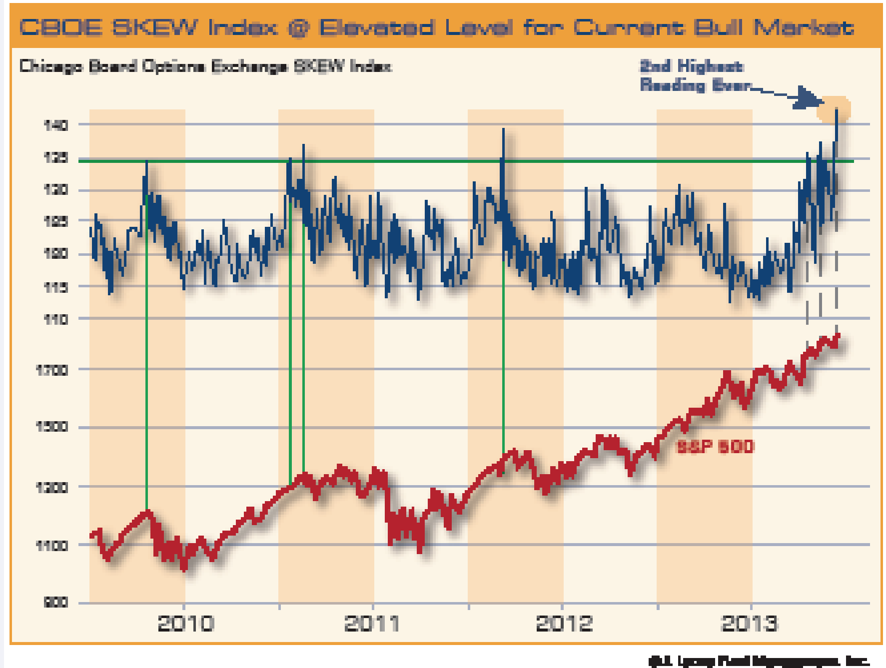

Figure 2

Please understand that all the data points discussed above, when viewed in isolation, are insignificant. However, when viewed together, in their cumulative evidentiary weight, they paint what we believe is a high risk market mosaic. We understand the trend is still intact, but the trend is extended in price as well as time.

The length of time since any significant correction is glaring in terms of historical norms, as shown in Table 1.

Likewise, monthly price momentum is continuing to accelerate at an unsustainable pace; we publish again the updated monthly S&P 500 chart (Figure 3, following page) from our last commentary, showing three ascending trend lines.

Finally, it is important to keep in perspective that the scenario we're laying out here is a high probability case for a short to intermediate term correction. It is not a long term bearish call. However, after reviewing the above statistics of our current trend, especially those relating to sentiment, we believe one should see the wisdom of moving away from the crowd towards a more defensive posture at some point in the future. To accomplish this, we utilize a set of trend criteria to give us warnings of a negative change in trend. Of course this means we may appear to move early into a defensive posture, but risk management demands it.

Table 1: S&P 500: Number of Days Before the Start of 5%,10%, and 20% Corrections

Mean Market Days without Correction

from 1/3/1928 to 1/3/2014

	5% Corrections	10% Corrections	20% Corrections
Secular Bulls	84	331	1105
Secular Bears	31	91	486
All Periods	49	161	635
Current Case	133	565	1214

Source: Ned Davis Research

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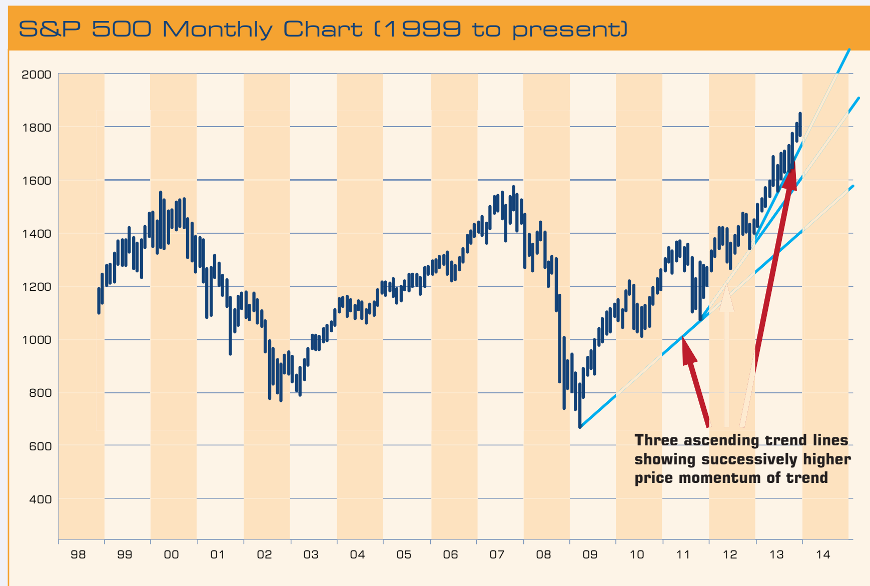

Figure 3

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The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 75% of U.S. equities.

The Dow Jones Industrial Average is a stock market index that shows how 30 large publicly owned companies based in the U.S. have traded during a standard trading session in the stock market.

The NASDAQ Index is a market-weighted index of all common stocks listed on the NASDAQ exchange.

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performers of developed markets outside the U.S. and Canada.

The MSCI World Index is a freefloat-adjusted market capitalization index that is designed to measure global developed market equity performance.

The MSCI World Index ex. U.S. is a freefloat-adjusted market capitalization index that is designed to measure global developed market equity performance excluding the U.S.

The MSCI Emerging Markets Index is a freefloat-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

The MSCI All Country Europe is a freefloat-adjusted market capitalization index that is designed to measure the performance of European equity markets.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index.

The Russell 3000® Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

The VIX Index is a forward looking index of market risk which shows expectation of volatility over the coming 30 days.

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