DOHMEN STRATEGIES, LLC
Creators of HedgeFolios

HedgeFolios Strategy Advisory

"The Fake Bull Market of 2018"

9-13-2018

While the financial media has been hyping "**the longest bull market in history,**" we are focused on the big question **whether the rally of the last seven months is still a bull market, or merely a secondary rally** after the real top that occurred at the end of January.

In our ***Wellington Letter***, we have stated the characteristics of such a "secondary rally". One characteristic is when **rising prices occur on declining volume**, which is what we have had (see chart below). Another is that **much of the rally is not due to investment buying**, but by other factors.

One of these factors is **short covering,** i.e. traders closing out short positions while stocks with high short positions are manipulated upward. That's exactly what we have seen.

Another factor is that the **number of new highs** made by individual stocks is very small.

But the **biggest factor this year is buybacks** of stocks by companies wanting to boost their earnings per share by reducing the number of shares outstanding. This is **plain financial engineering.**

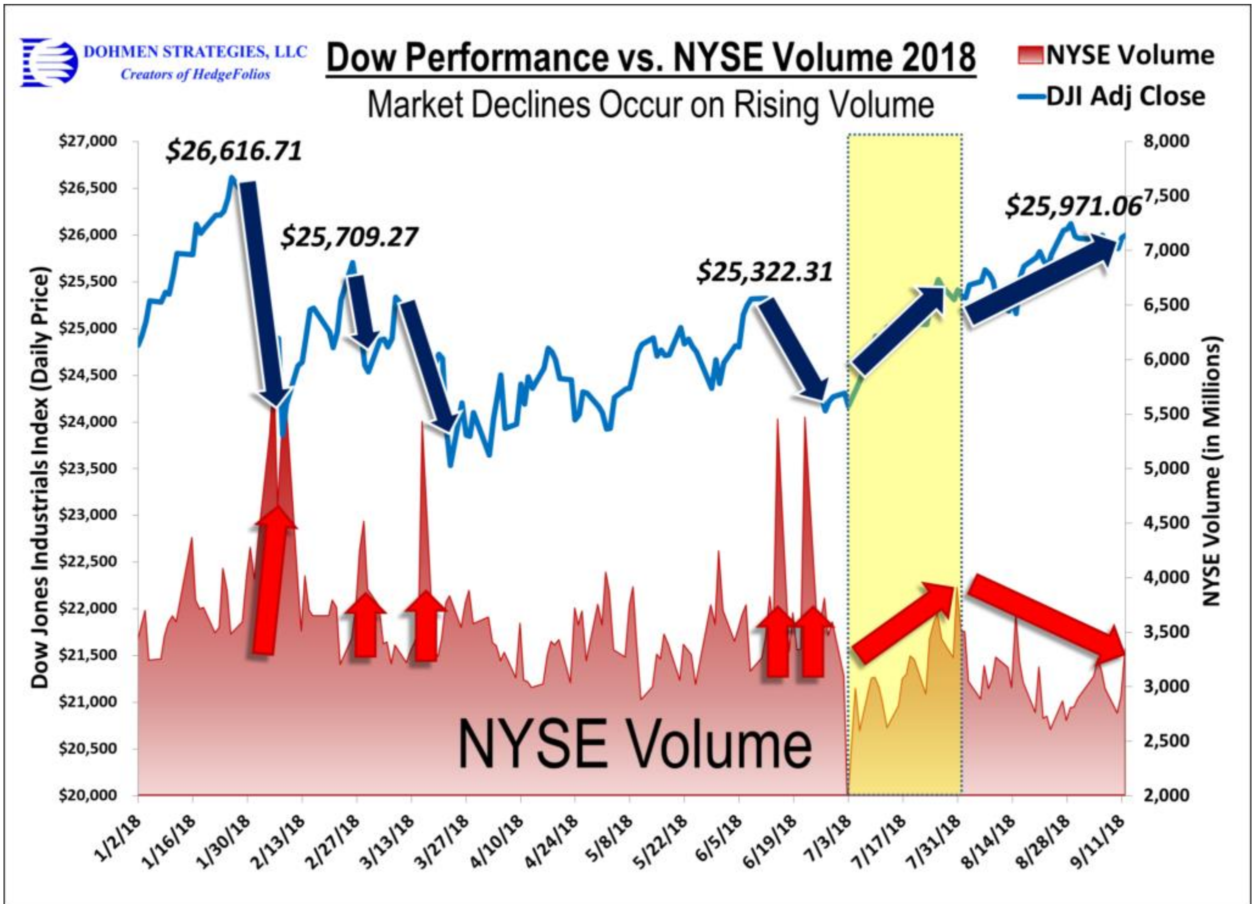
Let's take a look at some of the details to support the above:

Hedge funds, which are usually considered to be the smartest investors, on average are actually down since beginning of the year whereas the S&P 500 index is up. This is unusual.

According to Goldman (GS), a basket of the 50 Russell 3000 stocks with market caps greater than $1 billion, and **the largest outstanding short interest as a share of float, has outperformed the S&P 500 by 14 percentage points YTD (+21% vs. +7%).**

There we can see the **rally this year has been a "short-squeeze."** Contrary to investment buying, a short-covering rally eventually fades when most shorts are gone.

How do we know it was not investment buying? There was **declining volume when the market was up, and rising volume when the indices declined**. Here is the chart that shows this pattern, comparing the DJI Price (30 large-cap stocks) to the volume of the NYSE Composite Index (more than 2000 stocks). There was one exception to this pattern, which took place in July. However, the pattern resumed at the beginning of August.



A highly regarded, **big hedge fund manager lost around 19% in his fund this year because of bets on the short side**. Many of the shorts apparently were in the FAANG stocks. That's Facebook, Apple, Amazon, Netflix, and Google.

Bloomberg reported that **bearish investors, mostly hedge funds we assume, have shorted about $37 billion worth of FAANG stocks, up 42% from a year ago**. The increase in short sellers is due to the over-valuations in these stocks. The shorts experienced great pain.

What happened? These stocks accounted for the vast majority of the NASDAQ Composite's advance this year. The short sellers got killed, but drove the market up when they had to buy their way out.

The market plunge usually occurs when the short-sellers have given up on their bearish case and eventually close out their shorts. They were right, but they were

too early. There is a saying, “the markets can stay irrational longer than most investors can stay liquid.”

But Hedge funds also buy big positions when they like the stock. This year they loved Facebook (FB). They held huge bullish positions in Facebook. About 30% of hedge funds owned the stock. Then the stock plunged, wiping out about $150 billion of value. Hedge funds were bleeding.

A Big Transition:

Now we are seeing the well-known stocks that had excellent gains, faltering. The shorts are out, which means that there is little support under these stocks. We have already seen severe plunges in some, like Facebook. We believe the rest will follow.

No one talks about it, but **many very well-known stocks are already in bear markets** if you accept the definition of a 20% or more decline. The table below has 15 such firms based on their declines from their peak this year that are **now in bear markets.**

Those are some big and important firms (with the exception of Snap). This supports our case that **global markets are already in bear markets and the U.S. market needs to be watched closely.**

The **U.S. markets have been stronger** because of the new policies in Washington, such as tax cuts and big reductions of superfluous regulations, producing a stronger U.S. economy.

Interestingly, these declines are being ignored by the analysts. **Note that these stocks are in a variety of industries. We think that markets around the world are either in bear markets or on their way.**

Major Firms in Bear Markets *in 2018*
(as of 9/13/2018)

#	Name	Ticker	Date of 2018 High	High Price	*Current Price*	Decline %
1	General Mills	GIS	1/25/2018	$60.69	*$45.64*	*-22%*
2	Tyson Foods	TSN	1/9/2018	$82.51	*$63.50*	*-23%*
3	General Motors	GM	1/16/2018	$45.52	*$36.36*	*-25%*
4	Tesla	TSLA	8/7/2018	$387.46	*$303.15*	*-25%*
5	Facebook	FB	7/25/2018	$218.62	*$177.64*	*-26%*
6	Kraft Heinz Co.	KHC	1/17/2018	$80.67	*$58.22*	*-26%*
7	Dollar Tree	DLTR	1/31/2018	$116.65	*$84.41*	*-28%*
8	MGM	MGM	1/29/2018	$38.41	*$28.88*	*-28%*
9	Ford	F	1/16/2018	$13.48	*$9.70*	*-30%*
10	Symantec Corp	SYMC	1/9/2018	$29.73	*$20.20*	*-33%*
11	American Airlines	AAL	1/16/2018	$59.08	*$40.40*	*-33%*
12	Avis	CAR	3/20/2018	$50.88	*$32.18*	*-34%*
13	General Electric	GE	1/11/2018	$19.39	*$12.77*	*-34%*
14	U.S. Steel Corp	X	3/1/2018	$47.64	*$29.41*	*-40%*
15	Snap	SNAP	2/7/2018	$21.22	*$11.08*	*-56%*

Warning Flags:

The **small, individual investor has finally plunged into the stock market this year, after ignoring stocks for 9 years. We consider that a big warning.** They usually buy near tops and sell near bottoms, using their emotions as an investment timing tool. This is a very bad idea!

We see the gathering of storm clouds on the horizon. In fact, we see many "cockroaches" surfacing for the global financial markets. They will not resolve themselves, even if the US stock markets act as if everything is wonderful.

Most important, we see the **growing emerging markets problems,** which we have warned about since last year.

But there are many other huge problems still not being discussed in the media, similar to 2007-2008. They will finally surface for all to see when big damage has already been done to stocks.

Currently, only **10 of the 500 stocks** in the S&P 500 account for **20% of the index's capitalization**.

Only **50 stocks make up half of the capitalization**. Here you can see how easily the index can be manipulated by just moving a few stocks.

Even more interesting, **only 2 stocks**, Amazon and Apple account for over **50% of the NASDAQ's gains** this year.

When moves get this narrow, something we don't recall ever seeing, the **warning flags are flying for us.**

Our HedgeFolios:

We are now positioned very defensively as you know. We don't want to be the last investors to the exit. Those who have liquidity and cash equivalents at the bottom of a deep decline will be able to pick up some great bargains. Contrary to what you hear on TV, **cash is *not* trash**.

In the fall of 2008, the predecessor of HedgeFolios, Private Portfolios, advised to buy a number of **inverse ETFs in order to profit from a substantial plunge we had forecast**. Those who followed that advice had the chance to **make big profits** (an average of an amazing 72% in 6 weeks in 5 leveraged, inverse ETFs) as the vast **majority of investors lost a big part of their wealth**.

As a reminder to our valued members: The three model HedgeFolios that have the ability to utilize inverse ETF's include the Opportunistic, Global Equity, and Income portfolios.

The other two, Global Conservative and U.S. Conservative, will not hold inverse ETF's but instead distribute their allocations among more defensive sectors, treasuries, and cash equivalents.

There is no guarantee that we will be right in our bearishness at this time, however, all the **technical factors are lining up**. And for the final piece of bearishness, buybacks of stocks will temporarily stop on September 15. That **removes the biggest source of buying this year.**

Wishing you all the best,

Bert Dohmen and team