

## Getting sentimental

By Tom Stevenson, 2 September 2009

### **Investor sentiment is a useful guide to future market movements but it is difficult to read.**

The mood of investors can provide a useful contrary indicator of where the market is heading. When most people around you are excited about the outlook for financial assets, it's often a good time to rein in your own enthusiasm. By the same token, universal gloom is generally a good sign that markets are close to the bottom.

Of course, it's rarely that simple. If it were, investment would be a lot easier and more profitable than it actually is. The reality is that markets can stay over-optimistic or too gloomy for long periods, defying the independent thinkers who end up calling the top or bottom too early. It is possible that we are at such a moment in the sentiment cycle now.



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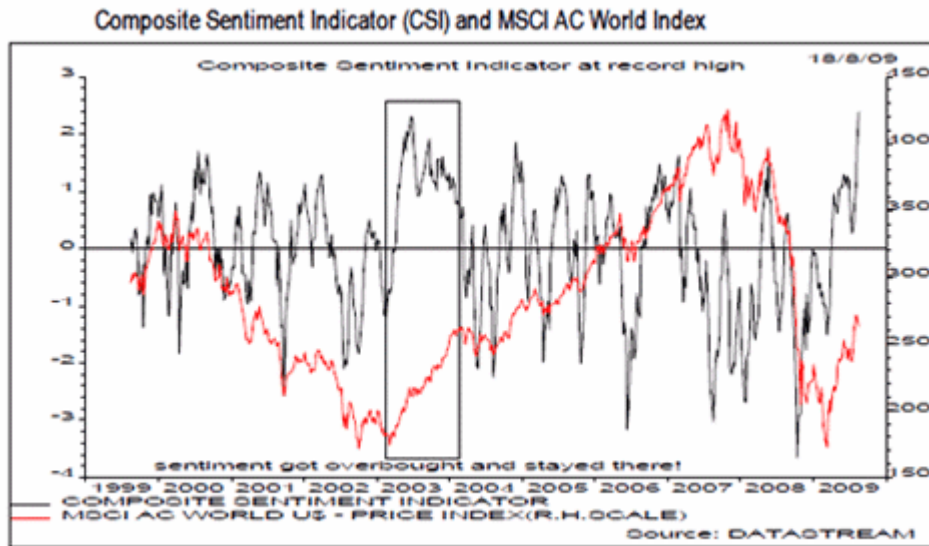
The consensus wisdom says September is a dangerous month for stock markets and history suggests that the autumn is both prone to underperformance and vulnerable to market slumps. Because of this, sentiment has taken a decided turn for the worse since the end of the holiday season and there has been a rash of headlines about the possibility of an autumn market correction.

A recent survey of investors expectations had more than a quarter of those polled "expecting a correction".

In a way, this new mood of caution is only to be expected because the market has enjoyed a spectacular run since the March low. The MSCI World index has risen by around 55% in six months, a V-shaped market recovery if ever there were one.

But the new mood is notable also for the contrast it represents to the enthusiasm most investors were demonstrating throughout the summer months. That same investor survey described just over 50% of the investors questioned as bulls and less than a fifth as bears. That is the lowest reading since near the top of the market in 2007.

At Fidelity we have a composite sentiment indicator, which is derived from a number of inputs such as the ratio of directors selling their company's shares to those buying, expectations of market volatility and market momentum. As the chart below shows, it recently stood at a record high level, indicating that the market had become very "overbought" during the recent rally.



Note: The CSI is based on four one year normalised inputs: VIX, US director sell/buy ratio, AAll survey and 1 month momentum.

On its own that indicator, together with the new mood of caution since the return to work, might argue for a reduced exposure to the market. But a glance at recent history shows that over-reacting to a spike in sentiment can be an expensive mistake.

The last time that the sentiment indicator was this high was in the early stages of the recovery from the 2000-2003 bear market. Sentiment spiked higher and stayed high throughout the first leg of the 2003-2007 bull market. Investors would have kicked themselves if they had jumped ship too early back then just because the market looked “overbought”.

Another point to make about sentiment indicators is that they are rather better at flagging market low points than market highs. In other words, investors should take more notice of very negative sentiment than very positive. It seems that extreme pessimism is less often justified by the facts than extreme optimism.

One further element of confusion this week was the market’s reaction to the latest crop of economic data. Purchasing managers indices in both China and the US provided further evidence of a pick-up in manufacturing activity with healthy order books adding to the good news. A couple of months ago that would have been cheered by investors but in the new mood of caution it prompted a significant market slide on Tuesday.

All of this conflicting sentiment is an argument for standing back from the market’s mood swings unless they are telling you something very significant like the blind enthusiasm at the top of the dot.com bubble or the antipathy displayed by almost all investors at the bottom of the market in March.

The alternative, which many investors will prefer, is to ignore the noise of sentiment altogether and to invest steadily throughout the emotional rollercoaster. That way, they will avoid becoming swept up by investors’ excitement at the top and won’t be discouraged by the prevailing mood of despair at the bottom.

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