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Market Facts

When Sentiment Fails

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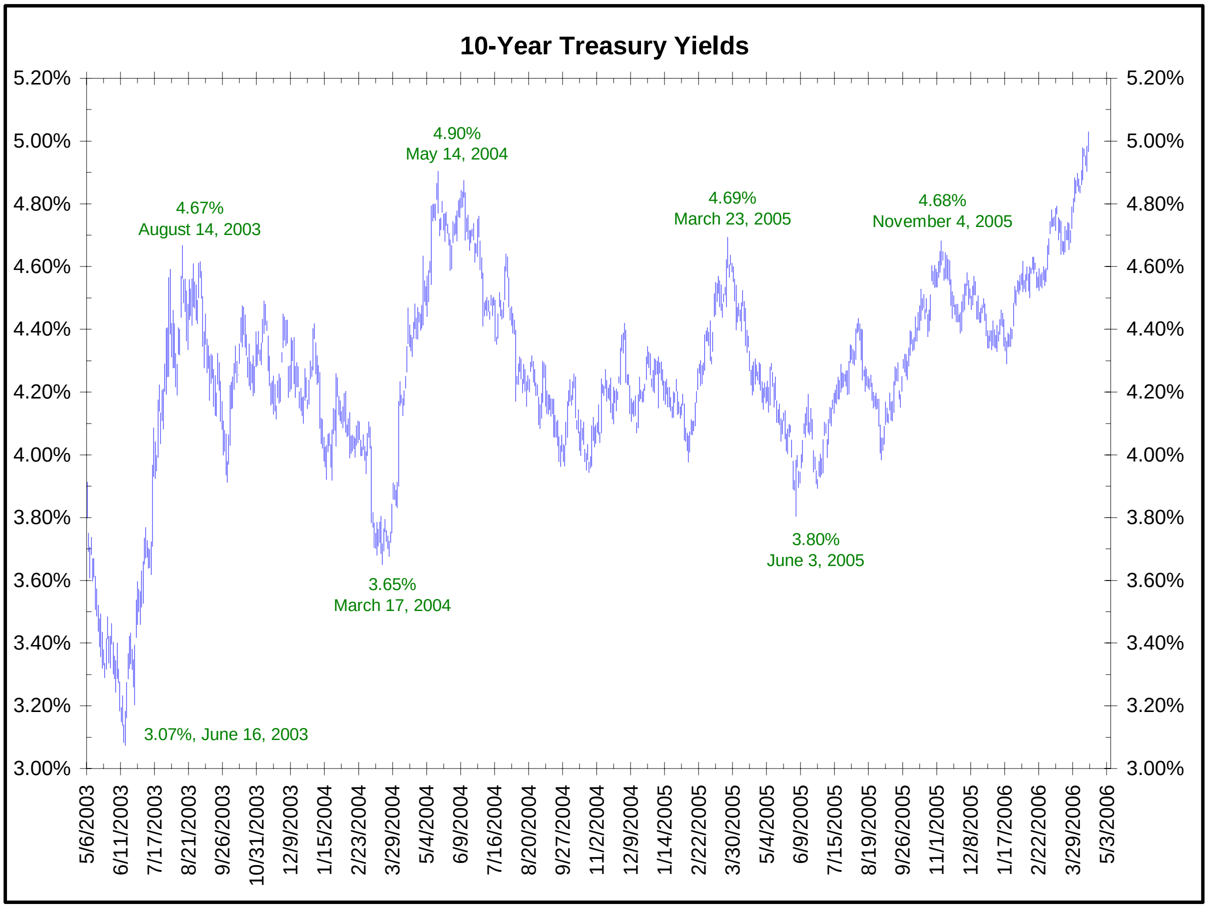
Earlier today the 10-year yield broke above 5.00% for the first time since June 2002. This marks a clear breakout of the range that has been in force over the last few years (see the chart below). During this stretch of time, the opinions of most long-term money (i.e., the ISI and J.P. Morgan surveys) have been decidedly bearish. Everyone from economists to primary dealers and portfolio managers has been short bonds just waiting for the inevitable rise in yields from their 40-year lows set in 2003. After frustration in 2004 and 2005, this patience is being rewarded in 2006.

We have argued that one of the reasons that the market has trended sideways is that long-term investors have all already placed their bets, and have been sitting on their hands. In this void, we have argued that yield movements have been dominated by the short-term traders.

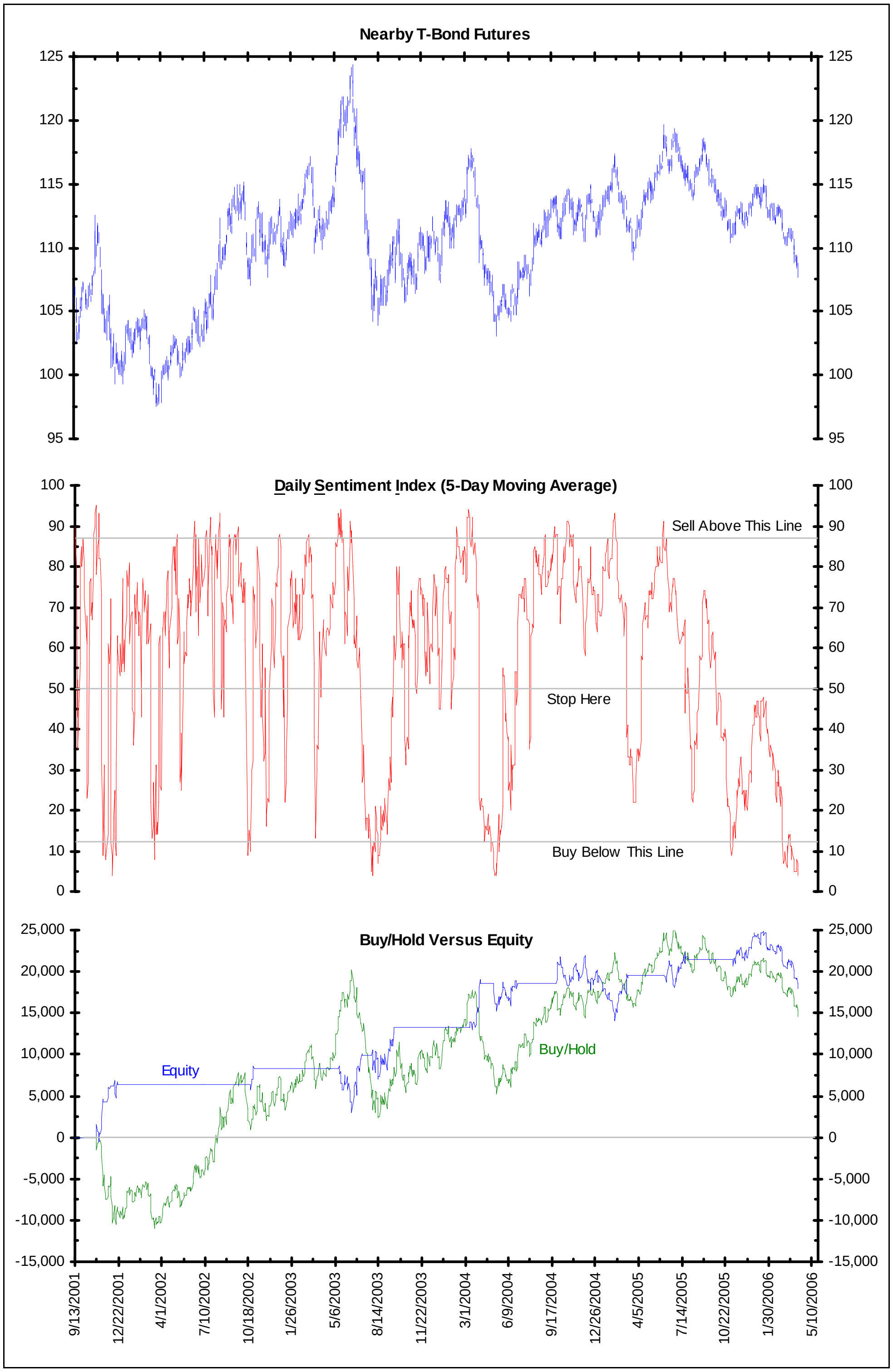
One of the better ways to gauge the opinions and general trading patterns of these short-term traders is through contrarian indicators such as MBH Commodities' **D**aily **S**entiment **I**ndex (DSI). This index is created by surveying retail futures traders whether they are bullish or bearish on a given market. The results then are expressed as a percentage of traders who are bullish.



Testing the DSI

How effective was following short-term traders in the last few years? The chart below attempts to illustrate.

The top panel shows the price of T-bond futures since September 2001, while the middle panel shows the 5-day moving average of its DSI. A simple trading system was then created in which bonds were sold whenever this 5-day moving average went above 87.5% (7/8) or bought whenever it went below 12.5% (1/8). In both cases the position in bonds was closed out once the 5-day moving average of its DSI returned to 50%. The blue line on the bottom panel of this chart shows the equity created by using this strategy. The green line shows what an investor would have made by simply using a buy/hold strategy.



At first glance the equity created from the DSI strategy described above might not appear to be that much better than the simple buy/hold strategy. However, as the table below points out, an investor's money is only tied up in this trade 38.55% of the time since September 2001 using the DSI strategy. In the 61.45% of the time in which the DSI did not trigger a trade, this money could be invested elsewhere, adding even more to the overall equity line. Looking at it another way, an investor's money is only at risk 38.55% of the time using the DSI strategy, as opposed to having it invested the entire time using the buy/hold strategy.

Also adding to the impressive track record of the DSI strategy is that over 90% of the trades triggered since September 2001 have been winners. Only the current open position, were it to be closed out prematurely, would create a loss.

Bond Futures DSI Test

Date Range - September 11, 2001 to April 7, 2006
Sell when 5 Day DSI is above 87.5% (7/8)
Buy when 5 Day DSI is below 12.5% (1/8)
Exit Trade when 5 Day DSI crosses 50%

Total Trades	% Winners	Buy/Hold	Total Profits	% Time Invested	Largest DrawDown
11	90.90%	14,593.75	17,933.80	38.55%	7,875.00

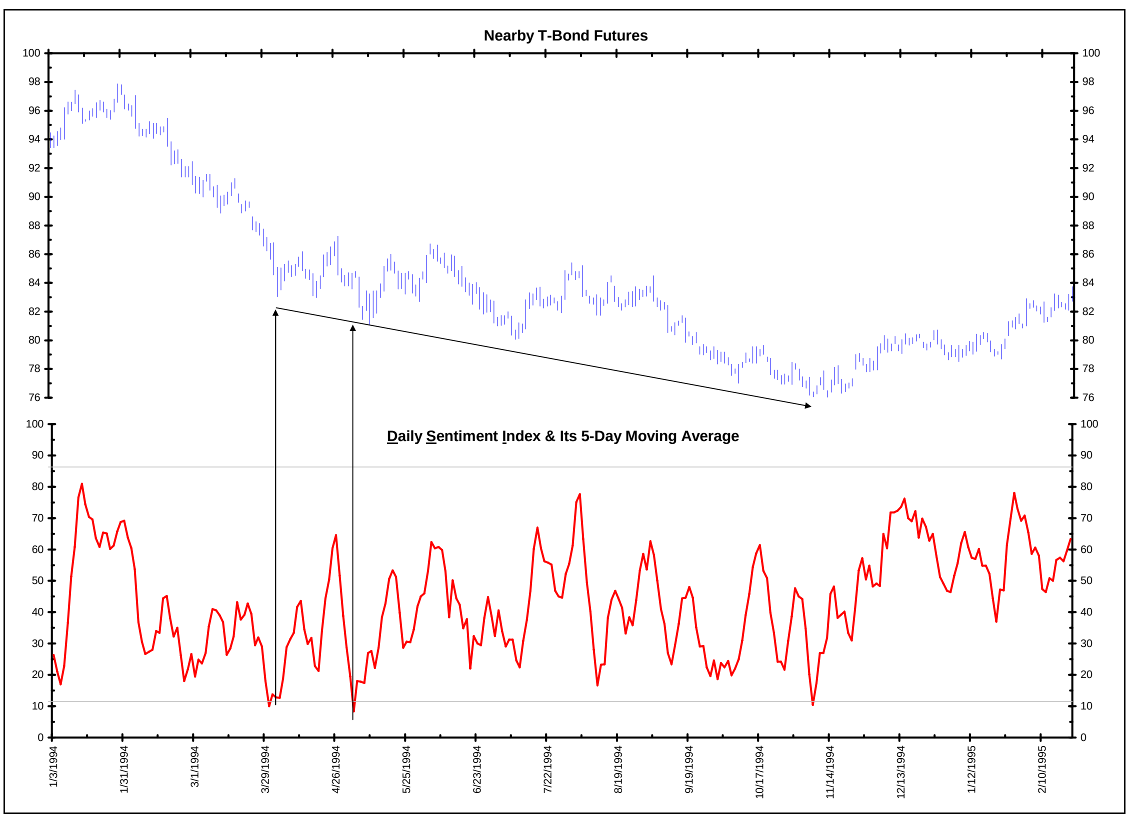
Largest Drawdown	**7,875.00**	**2/9/2005**	(Sell)
Current Drawdown	**6,968.75**	**4/7/2006**	(Buy)

Trade	Type	InDate	InPrice	OutDate	OutPrice	Profit	CumProfit
1	Sell	11/1/2001	93.41	11/16/2001	89.09	4,312.50	4,265.63
2	Buy	11/27/2001	85.62	12/4/2001	87.66	2,031.25	6,250.01
3	Buy	12/12/2001	84.31	12/24/2001	84.44	125.00	6,328.14
4	Buy	10/22/2002	94.75	10/31/2002	96.69	1,937.50	8,218.77
5	Sell	5/15/2003	108.19	7/8/2003	106.44	1,750.00	9,921.90
6	Buy	7/30/2003	98.41	9/18/2003	101.84	3,437.50	13,312.53
7	Sell	3/11/2004	110.78	4/6/2004	105.41	5,375.00	18,640.66
8	Buy	5/5/2004	101.97	6/30/2004	102	31.25	18,625.04
9	Sell	9/28/2004	111.09	3/11/2005	110.16	937.50	19,515.67
10	Sell	6/6/2005	117.12	7/27/2005	115.12	2,000.00	21,468.80
11	Buy	11/9/2005	111.41	*4/7/2006*	*107.875*	*-3535.00*	*17,933.80*

When DSI Fails

The chart and table above show that the DSI has had a great track record of predicting movements in the bond market since September 2001. Now that it appears to be failing (nothing works forever), what does it mean?

We have argued that when a sentiment indicator fails, it is still useful information. Typically the market is undergoing a "transition in trend." An illustration is the 1994 bond market below.



After the short-term crowd turned bearish in 1994, the bond market still declined for another eight months. Sentiment never turned positive, although it did to get to neutral a few times. In this case, another larger trend was developing via selling from groups not included in the survey of short-term traders. In this case it was a “global margin call” among leverage speculators and the selling did not subside until the bond market suffered its worst total return year since 1927.

A similar case could be developing now. Selling from a group **away from** the well understood bearish crowd could be underway and the results are a new major downtrend for the first time in four years. Right now this group is not apparent, but it will be overtime.

Conclusion

In our **conference call** last week, we said:

> *I wanted to make the case in this conference call that we are not ready to join the chorus right now and say that long-term interest rates are going to head higher. If we are wrong, and they are about to head higher from here, then what we have found in looking at sentiment statistics and a lot of other things is that, if the bond market is to break out – and let’s define a “breakout” as well above the June 2004 low, so let’s say 5% yield; get a couple of days’ close above 5% yield – and that is on the 10-year yield, which is at 4.88% right now – then it is not too late. Historically when a market breaks out it doesn’t go for another six more basis points, stall, and then retrench. It goes for 30 or 50 or 70 basis points and then it stalls and retrenches. Breakouts tend to be meaningful and significant. So I would bet that we are at the top of the range right now. If we are not, and the market wants to continue to move higher, then there is still a longer way to go in this market. It is not just, “Let’s short the market and capture the next five basis points.” There is a lot more to go from here.*

Unless bond prices bottom right now, it looks like this market is transitioning to a new major downtrend. The reasons and implications will be explored in upcoming writings.

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