What Is "The Master Sentiment Indicator" (MSI)

The Master Sentiment Indicator, or MSI, is an investor sentiment indicator made by combining nine, well-tested sentiment indicators into one. The MSI is based on the theory of contrary opinion and is designed to signal the start of bull and bear markets. It is not a short-term indicator.

Why Investor Sentiment Is So Important

It's not economic data itself but how investors react to it that drives stock prices. Up to 50% or more of an asset's price, either up or down, can be driven by the emotions of fear and greed alone. So, the Sentiment King doesn't analyze the economic picture; we analyze what investors are doing and thinking about it. Measuring investor sentiment and investor expectations is the great, unexplored area of investing.

Warren Buffett said: "A simple rule dictates my buying: Be fearful when others are greedy and be greedy when others are fearful." Notice he didn't mention "interest rates" or "earnings", just emotions. With investing, no matter what the economic outlook, you must buy when things look bleak and sell and walk away when the future looks bright. This contrary activity is what makes investing so hard and the Sentiment King is dedicated to helping investors do this.

The Theory of Contrary Opinion

The theory of contrary opinion is easy to state. It says prices will move opposite to what investors expect when "too many" investors have that expectation. The key is knowing when there are "too many." I want to emphasize this last point: The theory applies only when those expectations have reached an extreme. Notice that the theory does not consider the general economic situation. It simply states that the necessary and sufficient condition for a major market top or bottom is the existence of an extreme level of bullish or bearish sentiment.

The MSI

The MSI is updated every Saturday, it is not a daily indicator. The Sentiment King calculates an appropriate moving average for each of the nine indicators that we believe represents investor expectations for the long term. We then combined all nine indicators into oner using a proprietary procedure. We then graph the total on the Sentiment King Red and Green Zone ranking scale. These show when investor expectations are at extremes.

Any one sentiment indicator can become distorted but the combination of all nine produces very reliable sentiment readings. More information on the Sentiment King's Red and Green zone "Ranking Scale" is found on page 14 of this report on the "Theory of Contrary Opinion."

The next eleven pages graph the history of the MS asnd each indicator, from 2007 to present. The last section explains the theory of contrary opinion and our experience with it.

The Nine Components of the MSI

May 10, 2024

Components of the MSI

	SK Rank	Total Puts/Calls	Equity Puts/Calls	COT S&P500 E-mini	ProShares Bear/Bull Buying	NAAIM	Stock Survey	Nasdaq Survey	AAII Sentiment	Investors Intelligence	MSI
Extreme	-10										
Bearishness	-9										
	-8										
	-7										
	-6										
	-5										
	-4	X									
	-3		X								
	-2					X					
	-1										
Neutral	0										
	+1										
	+2										
	+3										
	+4				X				X		
	+5							X			X
	+6										
	+7										
	+8									X	
Extreme	+9			X			X				
Bullishness	+10										

The Components of the MSI

1. Total Puts/Calls
2. Equity Puts/Calls
3. COT S&P500 E-mini
4. ProShare Bear/Bull Buying
5. NAAIM
6. Hulbert Stock Survey
7. Hulbert Nasdaq Survey
8. AAII Sentiment
9. Investors Intelligence

On the left is the list of the nine sentiment indicators that make up the MSI. They are also listed in the top row of the table above going from the left to the right. Each is explained in the subsequent pages.

On the left column of the table is the SK ranking scale, which goes from -10 at the top to +10 at the bottom. Also shaded are the Red and Green Zones at the extremes of a large wide neutral area. These zones indicate when an indicator is reaching an extreme reading. There is no sudden demarcation but a graduated level.

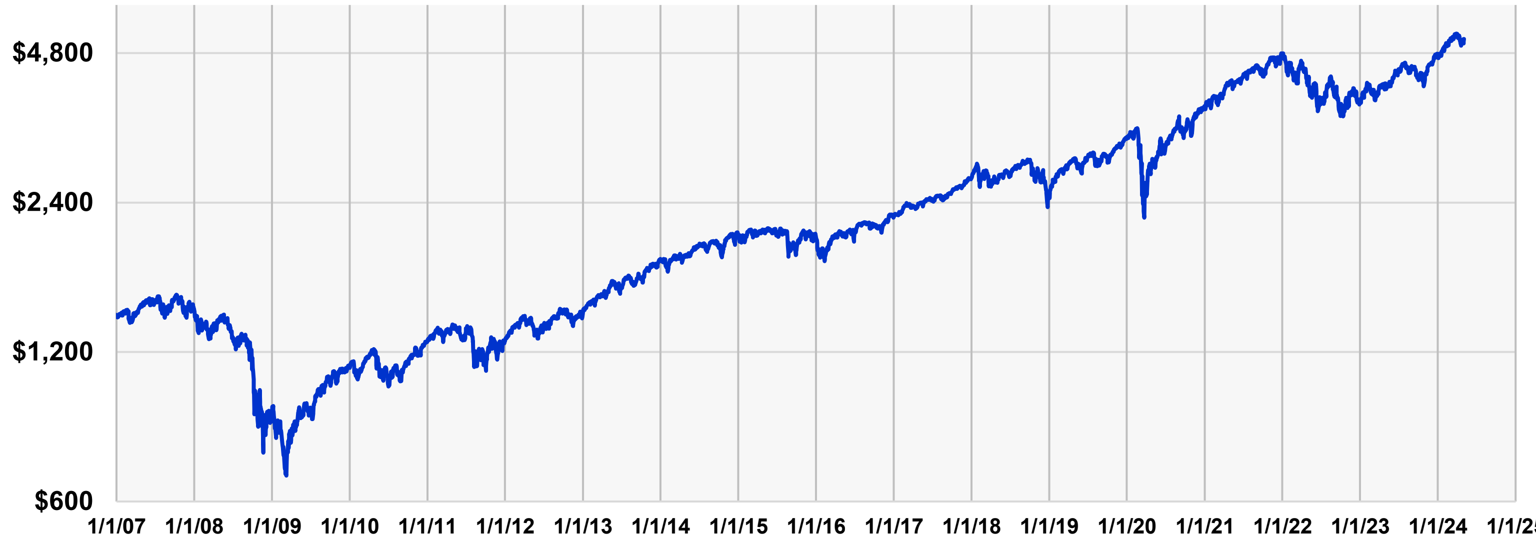
On the far-right column is the master sentiment indicator, which is made from the nine indicators. Each of the nine indicators that go into making the MSI is given a weighting in proportion to the square of its current ranking. This gives an indicator with extreme readings slightly more importance in the composite than those with neutral zone readings.

The next page charts the history of the MSI back to 2007.

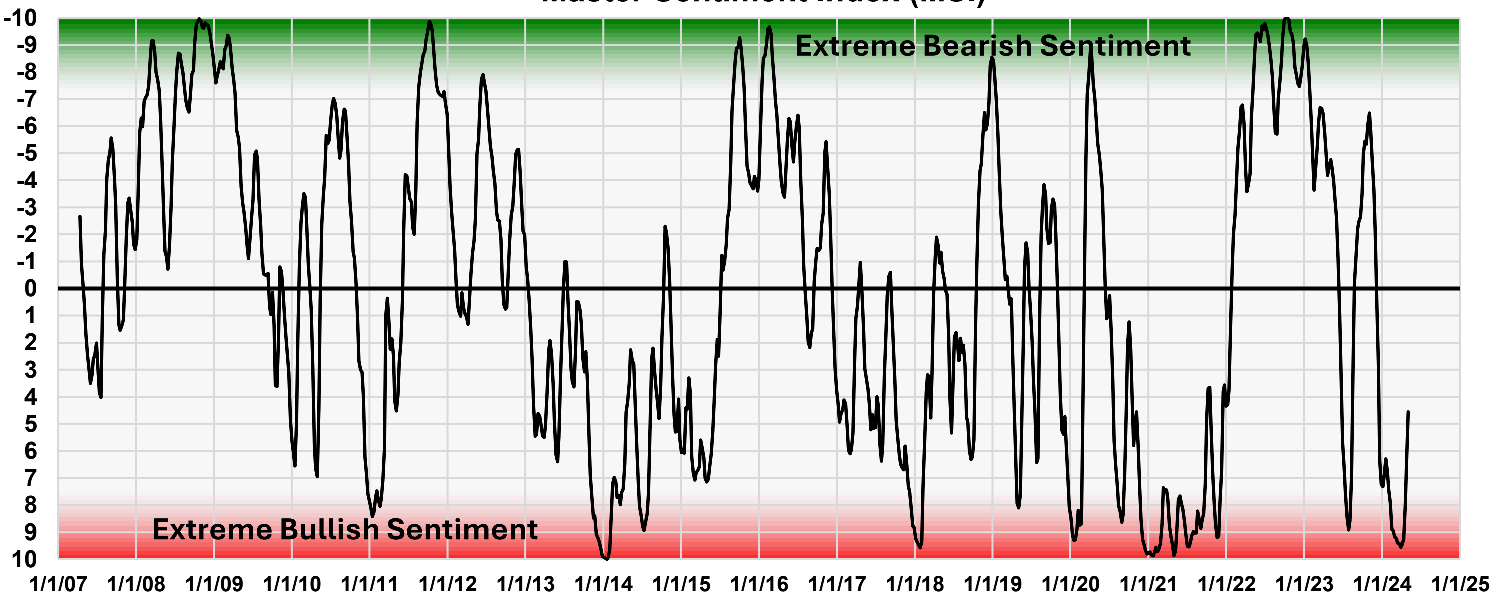
May 3, 2024

SPX
2007 - 2024

Sentiment King



Master Sentiment Index (MSI)



The MSI

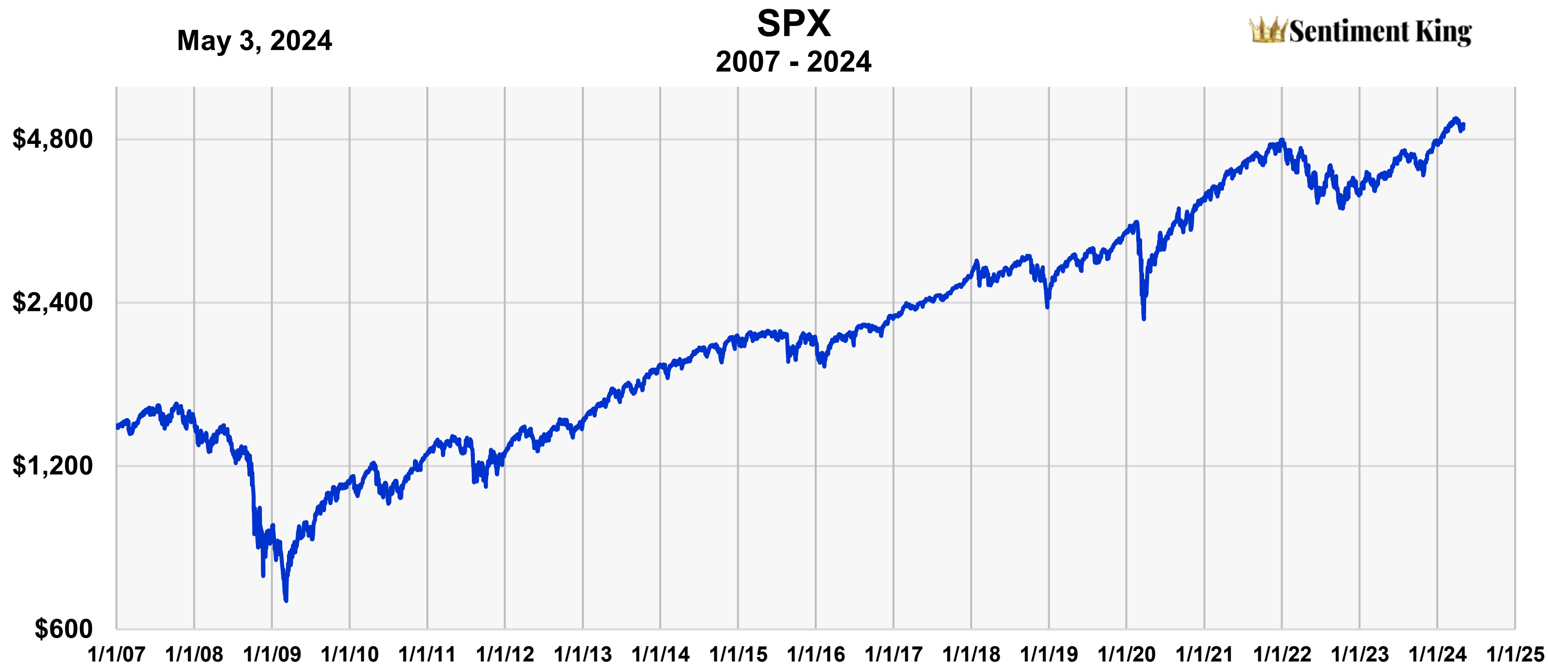
The above is the MSI (Master Sentiment Indicator), which is a composite sentiment indicator made from the nine, well-known indicators shown on the left. All but one have histories back to 2007, or earlier, and are explained and graphed in the following pages.

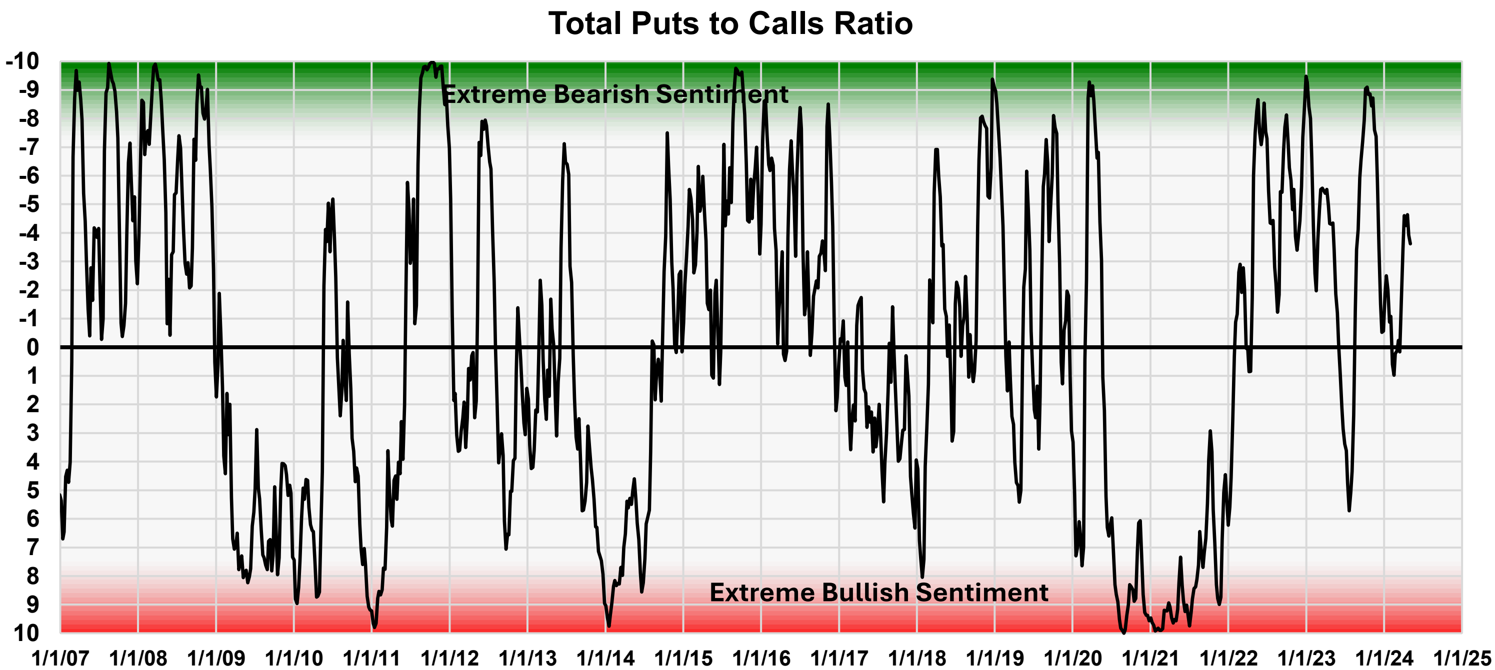
The MSI is long-term and helps find the start of bull and bear markets. As you can see it only gives Red and Green Zone signals every few years. When applying contrary opinion, experience has taught us that using a composite indicator is more reliable than using just one or two sentiment indicators.

Each of the nine indicators that go into making the MSI is given a weighting in proportion to the square of its current ranking. This gives an indicator with extreme readings slightly more importance in the composite than those with neutral zone readings.

The MSI has a good record of indicating the start of bull markets, slightly less so for bear markets. That's because market tops and bottoms are different. Bear markets usually end suddenly and at a particular moment. Bull market tops are spread out over time, forming a fan formation, with various sectors peaking at different times. The actual top is often hard to define.

May 3, 2024





Total Puts to Calls Ratio

Puts and calls are options with "calls" basically being bets stock prices will rise, and "puts" being bets they will decline. There's a lot more to options than this, but it will suffice for our purposes. Measuring how many puts versus calls investors are buying can tell us a lot about what they expect stock prices to do. “Too many” put purchases compared to calls means they expect prices to go down, and vice versa.

The puts to calls ratio was developed by market technician Martin Zweig in a Barron's article in late 1971. I remember the article causing quite a buzz, since it presented a second way to measure investor expectations like the very popular short-selling indicators.

The total puts and calls ratio includes option purchases in all categories. We form a time weighted moving average of about 20 days of the daily puts to calls ratio. This gives more mathematical importance to recent ratios than earlier ratios. We then compare the moving average against historic norms to rank the ratio on the SK ranking scale.

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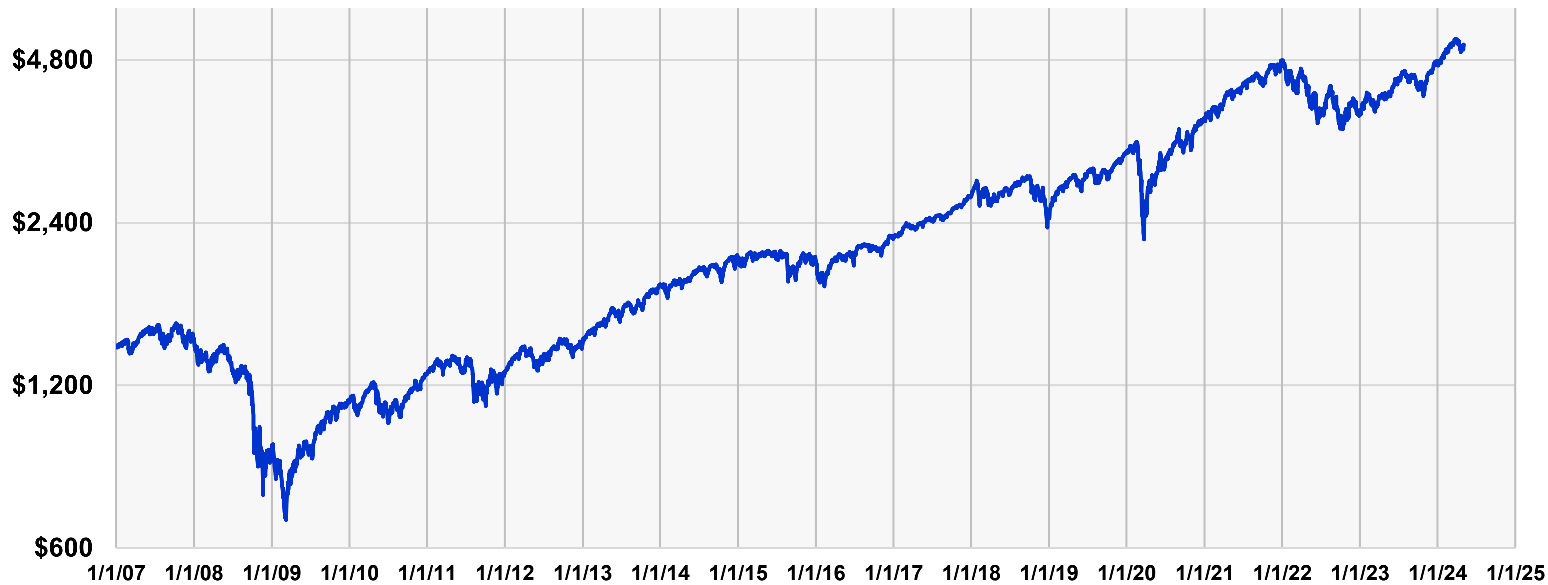
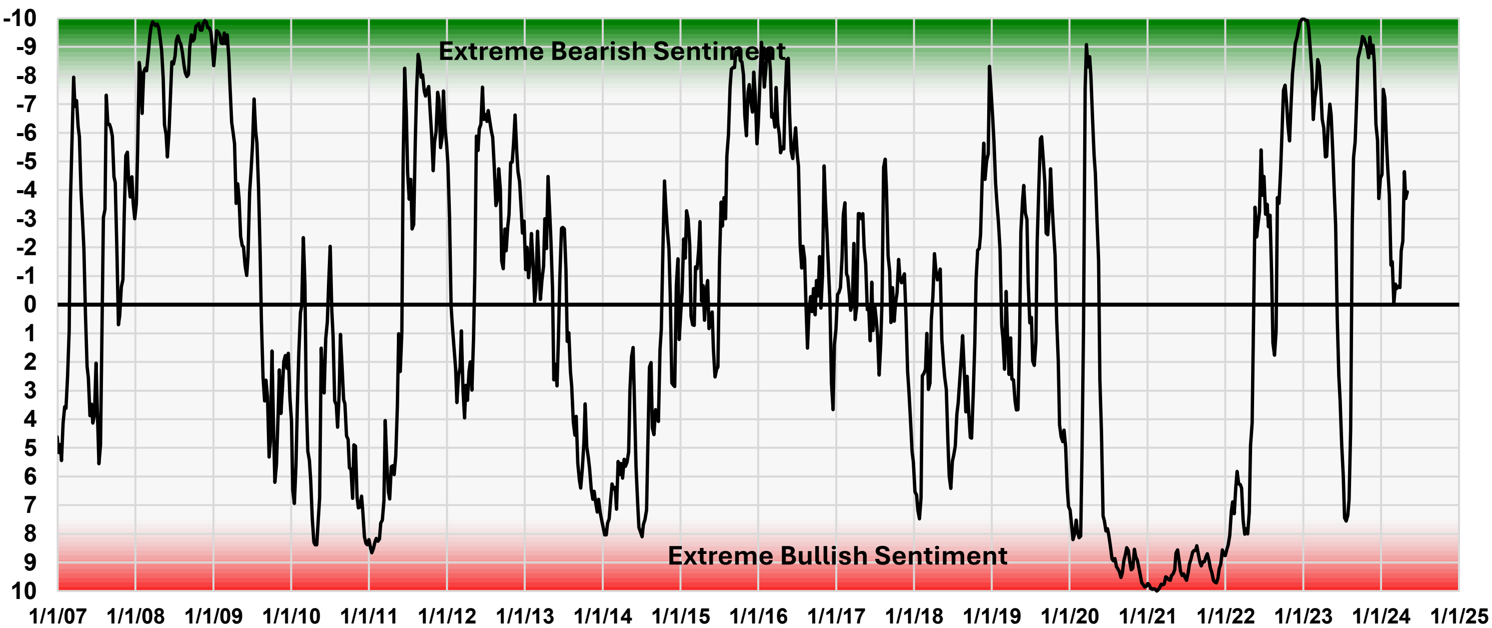
Sentiment King



Equity Puts to Calls Ratio



Equity Puts to Calls Ratio

While the total puts and calls ratio includes option purchases in all categories, the equity ratio is the ratio of puts and calls of individual stocks only. While both ratios are valuable, experience has taught us that the equity puts and calls ratio is slightly more reliable. However, we include both indicators in the MSI because we feel both ratios are valuable tools into what investors expect the market to do. We are alert to monitor whether the recent creation of daily options will distort the ratio making it more difficult to compare the current ratio with past extremes.

The equity puts to calls ratio data is provided daily by the CBOE after the market close. Just like with total puts and calls, we form the same time weighted moving average of the equity puts to calls ratio. This gives more importance to recent ratios than earlier ratios in the moving average. We then compare the moving average against historic norms to rank the ratio on the SK ranking scale.

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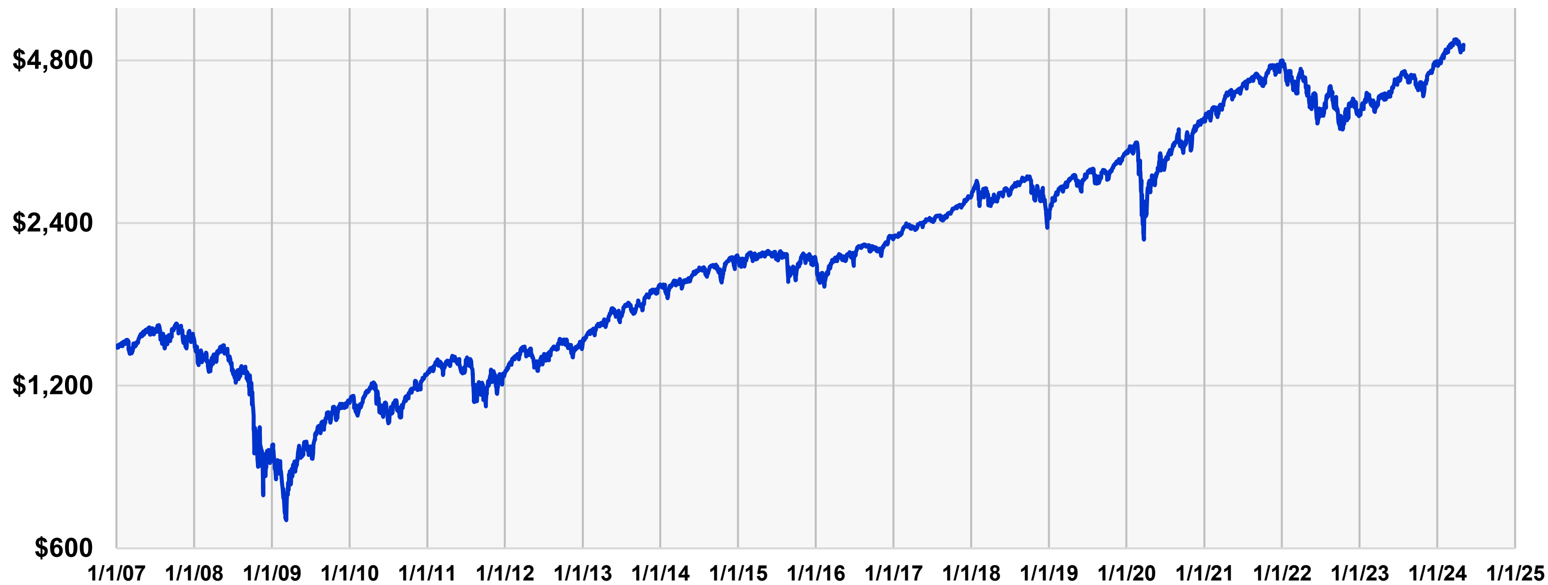

Money Managers Short S&P 500 E-mini

The Money Managers COT Data – S&P 500 E-mini

Every week the CME reports investment positions of five different classes of futures traders in the S&P 500 futures. They are dealers, asset money managers, leveraged traders, reportable and nonreportable traders. The most informative investor class to follow are the asset money managers.

One would think (hope) that asset managers would be more “long” than “short” the market at the bottom, and less “short” than “long” at the market top. However, history shows the opposite is true. This makes the long and short positions of money managers in the S&P 500 futures a wonderful contrary opinion indicator.

We form a three-week moving average of the number of contracts asset managers are long versus short S&P 500 futures. History determines what ratios represents extremes in market expectations during past bull and bear markets. We then graph the three-week average on our SK ranking scale.

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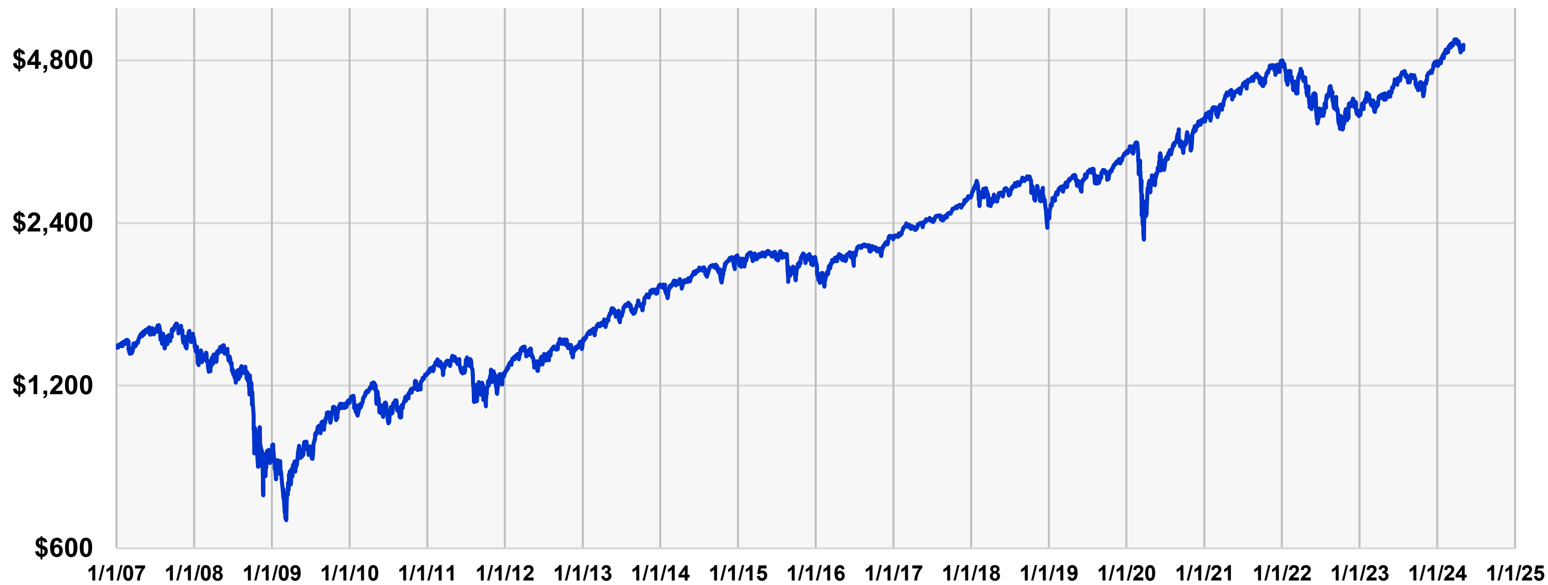
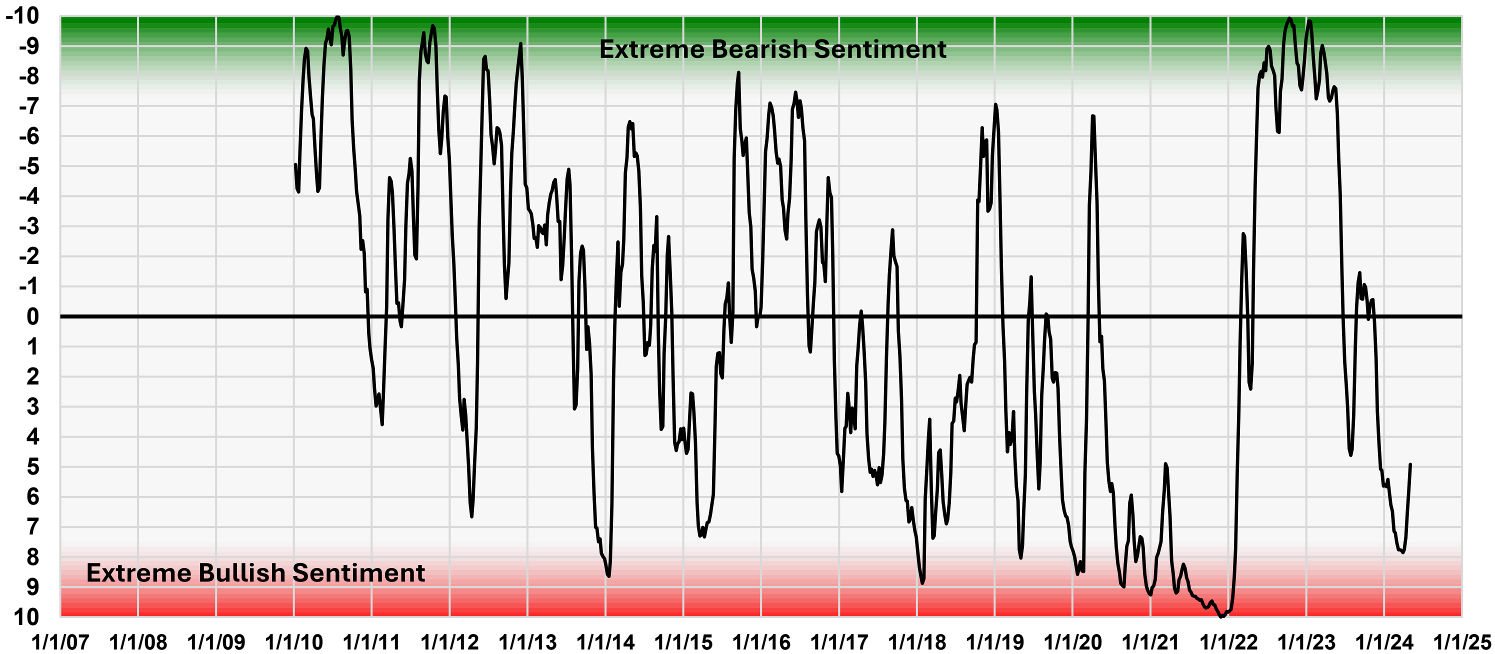


Ratio of ProShare Bear/Bull Buying



PROSHARE Bear/Bull Buying Ratio

The ProShare fund family has 140 ETFs that invest in exotic ways, including the use of leverage and going short the market. By comparing buying in long versus short funds provides a unique way to measure what traders expect the market to do.

History shows that traders buy more "short" funds at market lows and fewer "short" funds at market tops, just the opposite of what one would want. This makes it a good contrary opinion indicator very much like the old odd lot and member short selling indicators of the 1970s and 80s.

While some of these funds were started in 2006, it took to 2010 for the situation to stabilize with enough assets in both type funds to produce meaningful ratios that could be compared against historic norms. Because of its obvious usefulness we included it in the MSI starting in 2010.

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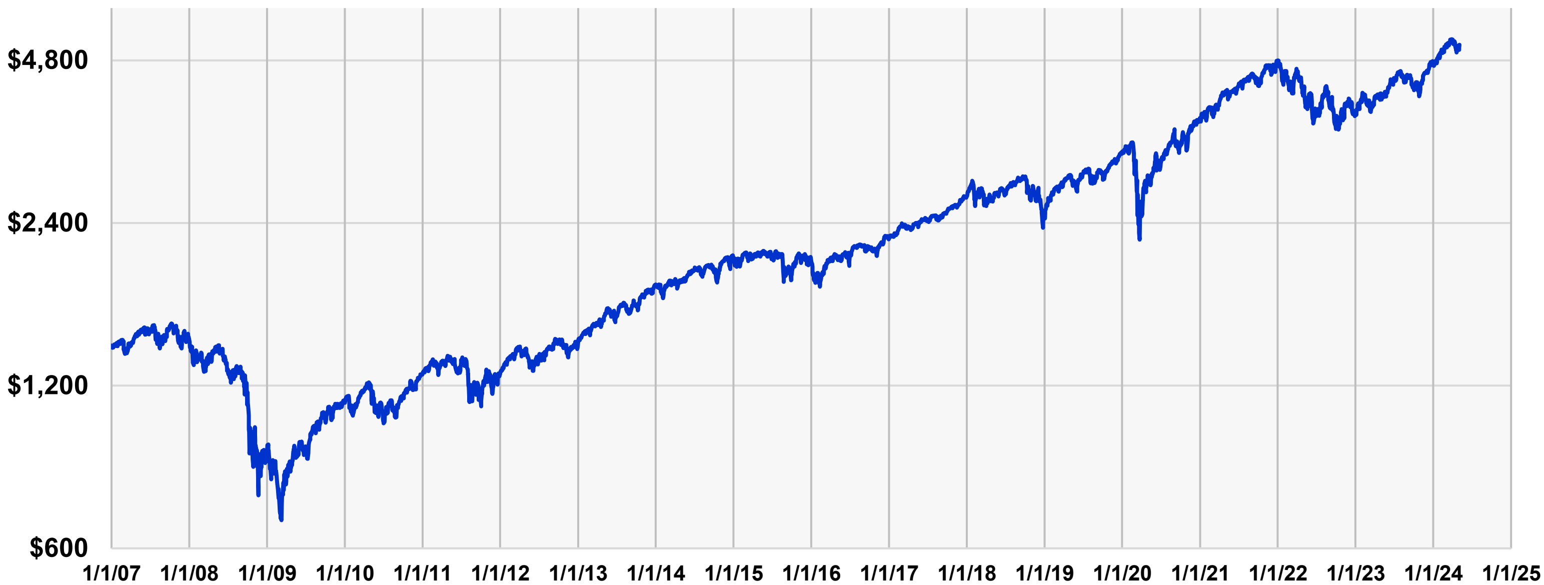
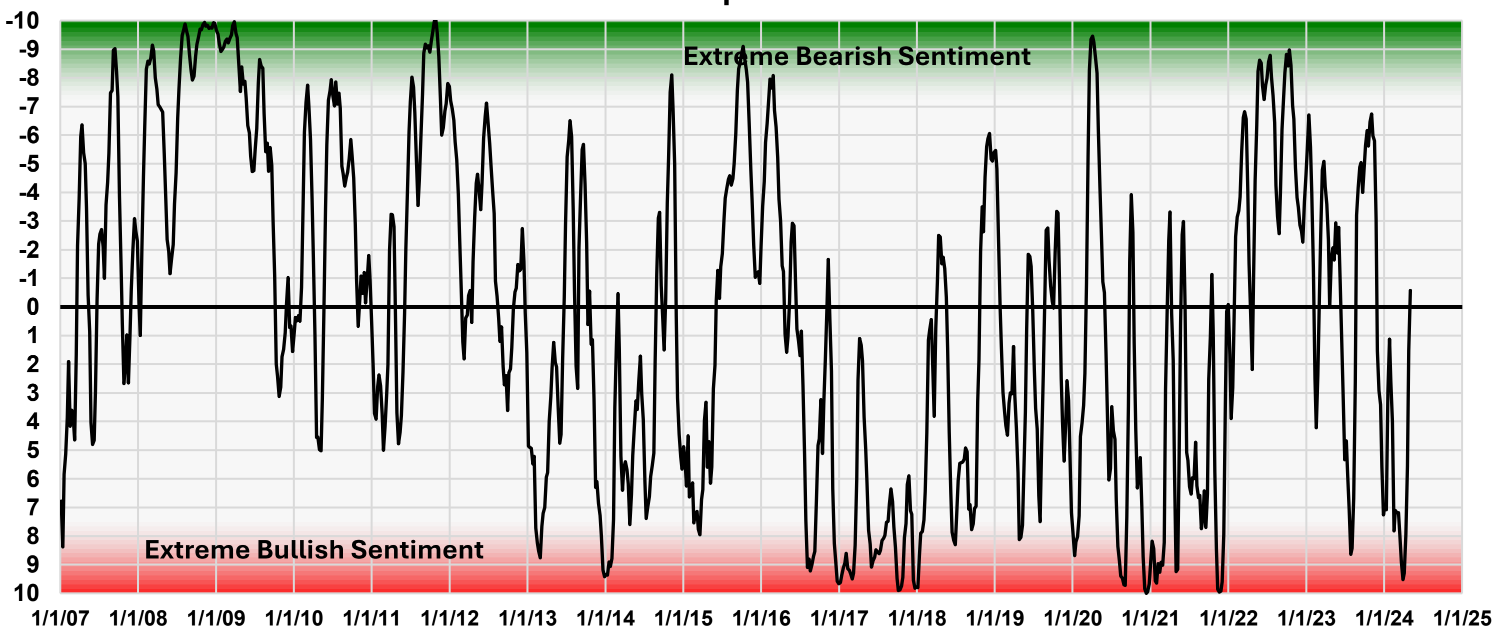


NAAIM Exposure Index



The NAAIM Investment Exposure

The National Association of Active Investment Managers (NAAIM) was formed in 1989. Every week members are asked to provide a number which represents their overall equity exposure every Wednesday. Responses are tallied and averaged to provide the average long (or short) position of all NAAIM managers, as a group. This is called the investment exposure number.

History shows that active managers have the highest equity exposure at market tops and the lowest exposure at market lows. This makes it a wonderful contrary opinion indicator. We form a three-week moving average of the exposure index and graphic on our sentiment king red grim ranking scale, which is graphed above. The raw data to form the index is found at https://naaim.org/programs/naaim-exposure-index/.

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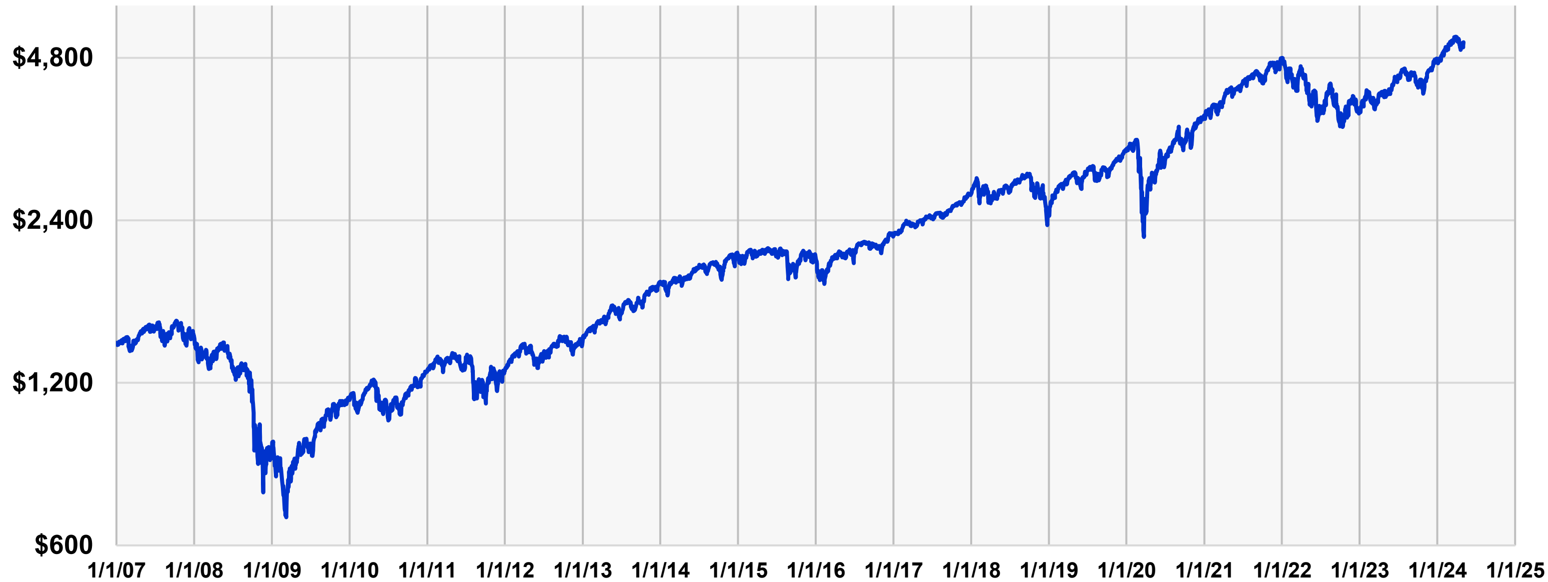
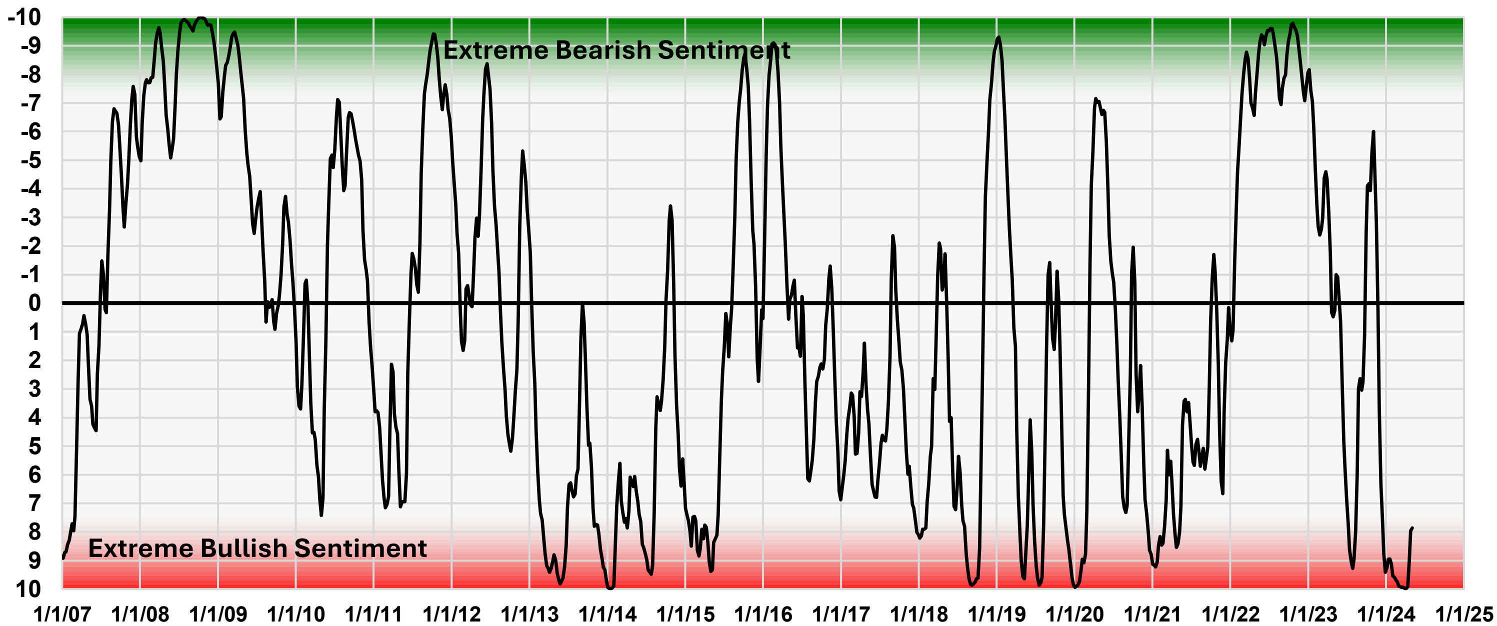
Sentiment King



Stock Survey

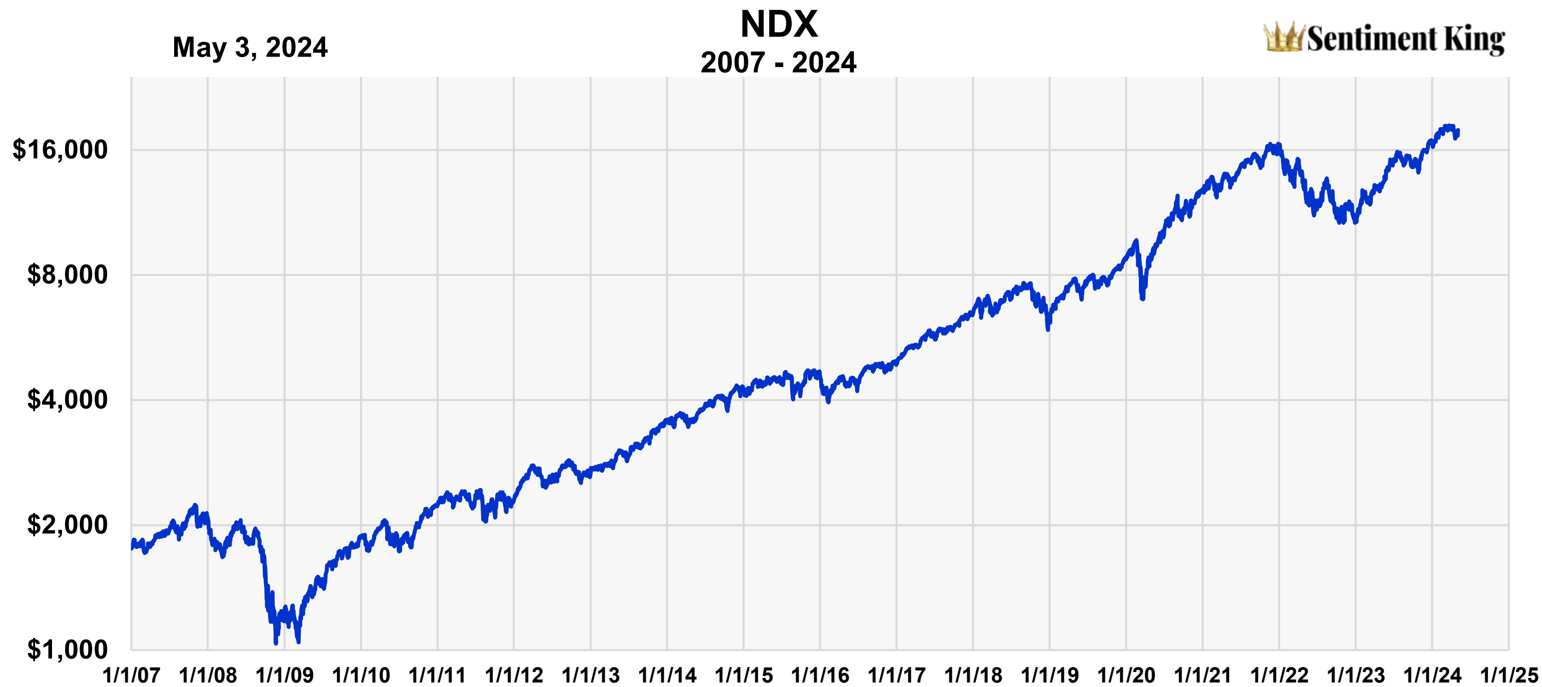


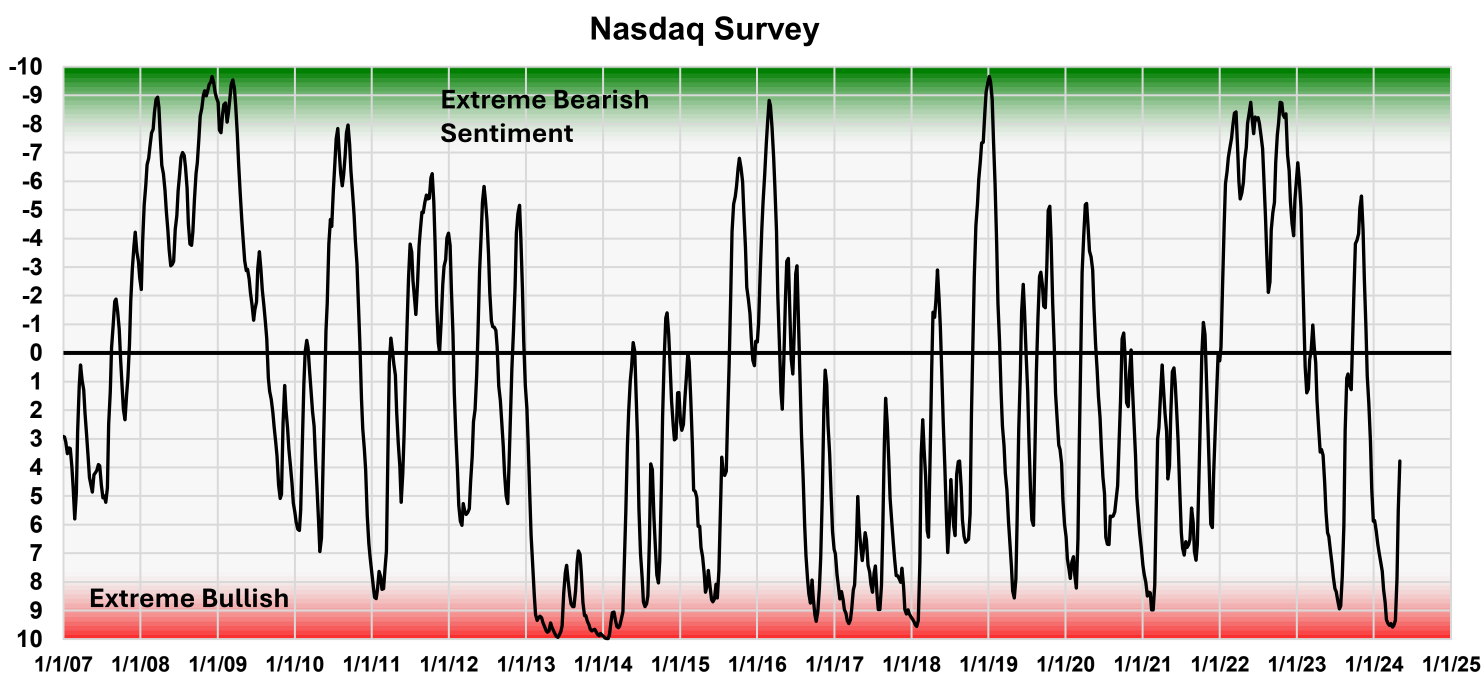
The Stock Survey

In the 1990s Mark Hulbert created his now-famous Hulbert Sentiment Indices, which he has updated daily ever since. For those who do their own research and want daily sentiment information, we highly recommend Mark's service https://hulbertratings.com/.

His surveys separate newsletter writers into those who write about the general stock market and those who specialize in speculative NASDAQ stocks. Because of this he publishes two distinct surveys – the stock survey and the Nasdaq survey.

We take his daily data of the stock survey and form a long-term moving average to obtain what we believe is a long-term perspective. We then graph this moving average on our SK ranking scale shown in the chart above. It's easy to see the close correlation of our long-term ranking of Mark's daily sentiment numbers with major bull and bear markets.





The Nasdaq Survey

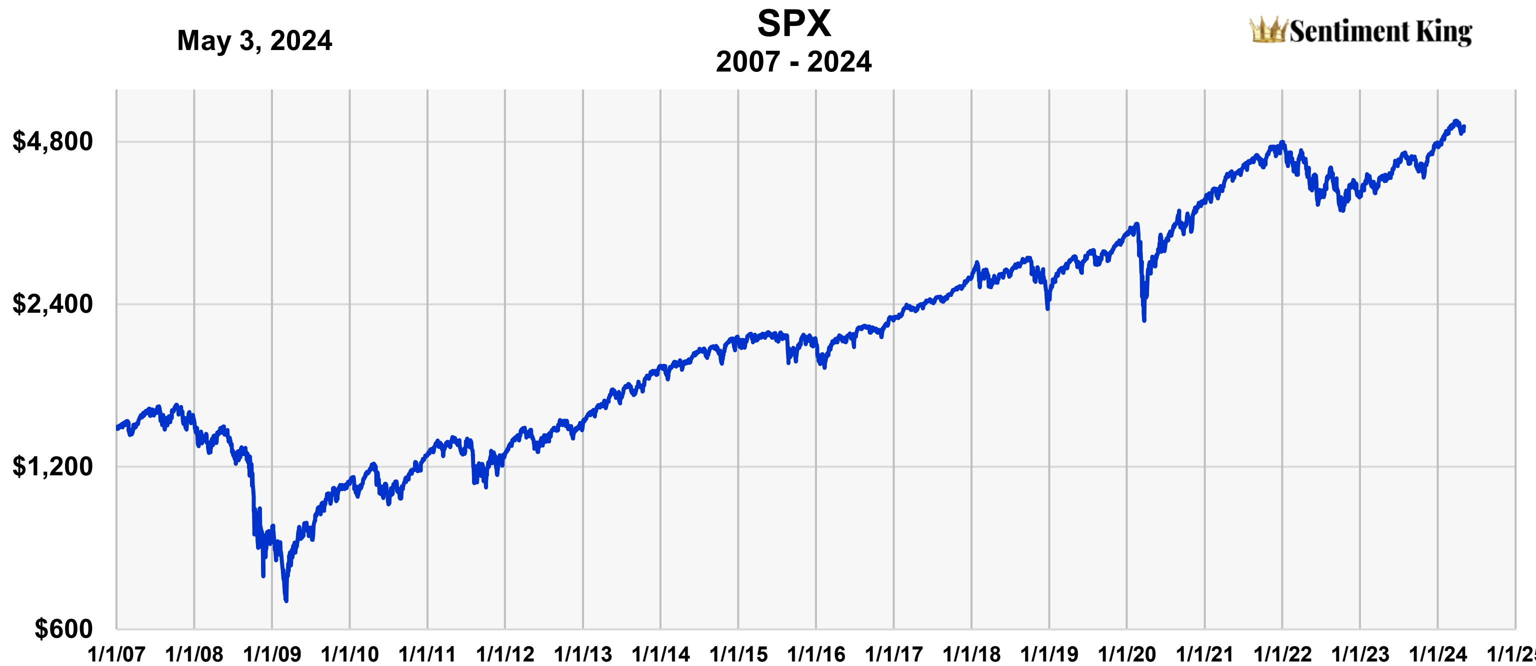
As we wrote on the previous page, Mark Hulbert separates newsletter writers into those who follow NASDAQ stocks and those who follow all stocks. He subtracts the number who are bearish from those who are bullish in each category.

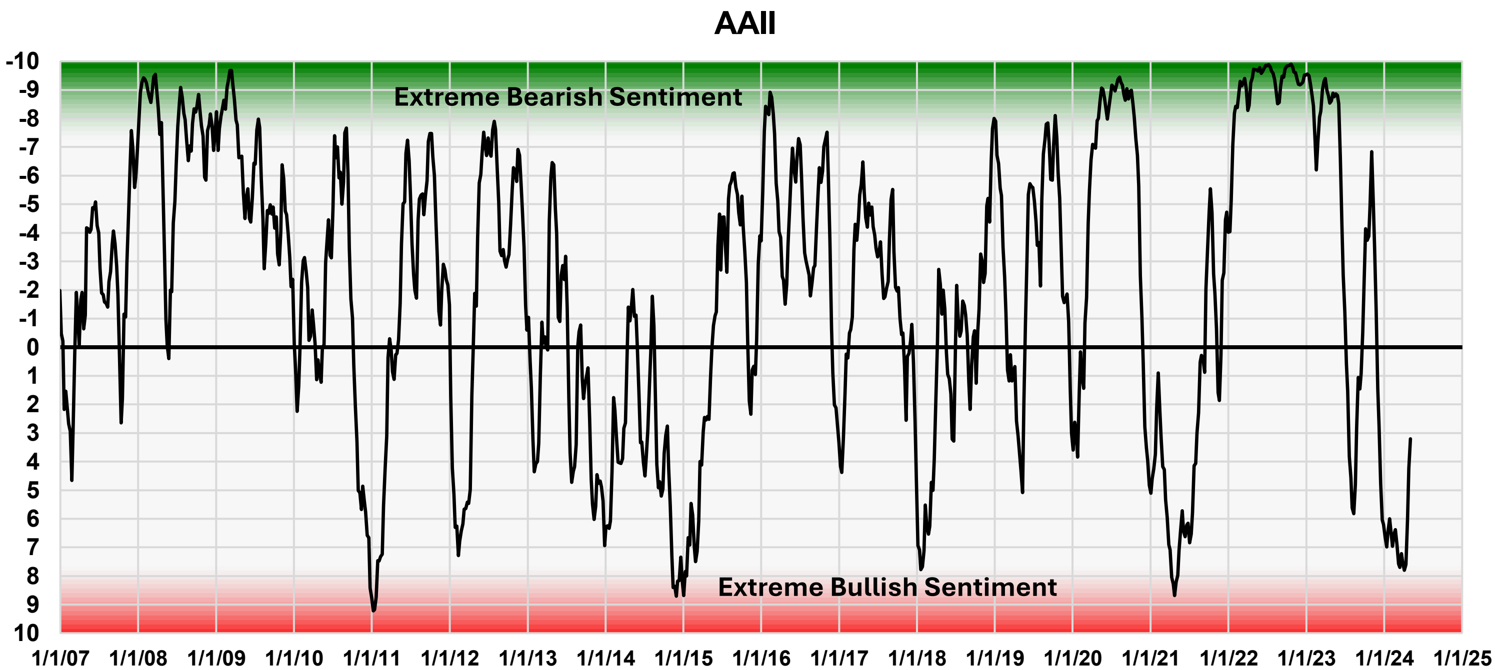
Like with the stock survey, we take the daily Nasdaq survey and calculate an appropriate moving average to get a long-term perspective. We then graph this moving average on our SK ranking scale shown in the chart above.

It's easy to see the close correlation of this long-term metric with major bull and bear markets. While both the stock survey and NASDAQ survey have good histories, we tend to favor the NASDAQ survey as slightly more insightful.

May 3, 2024

Sentiment King



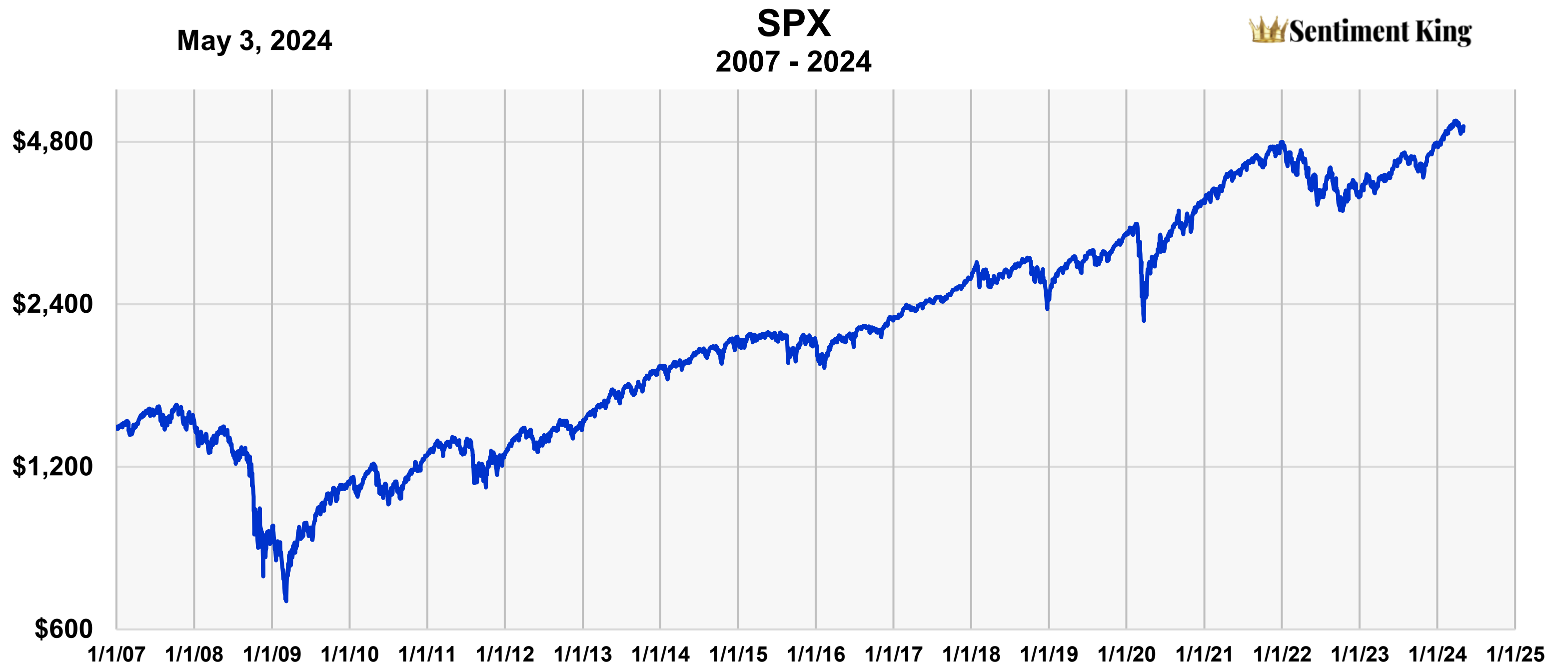


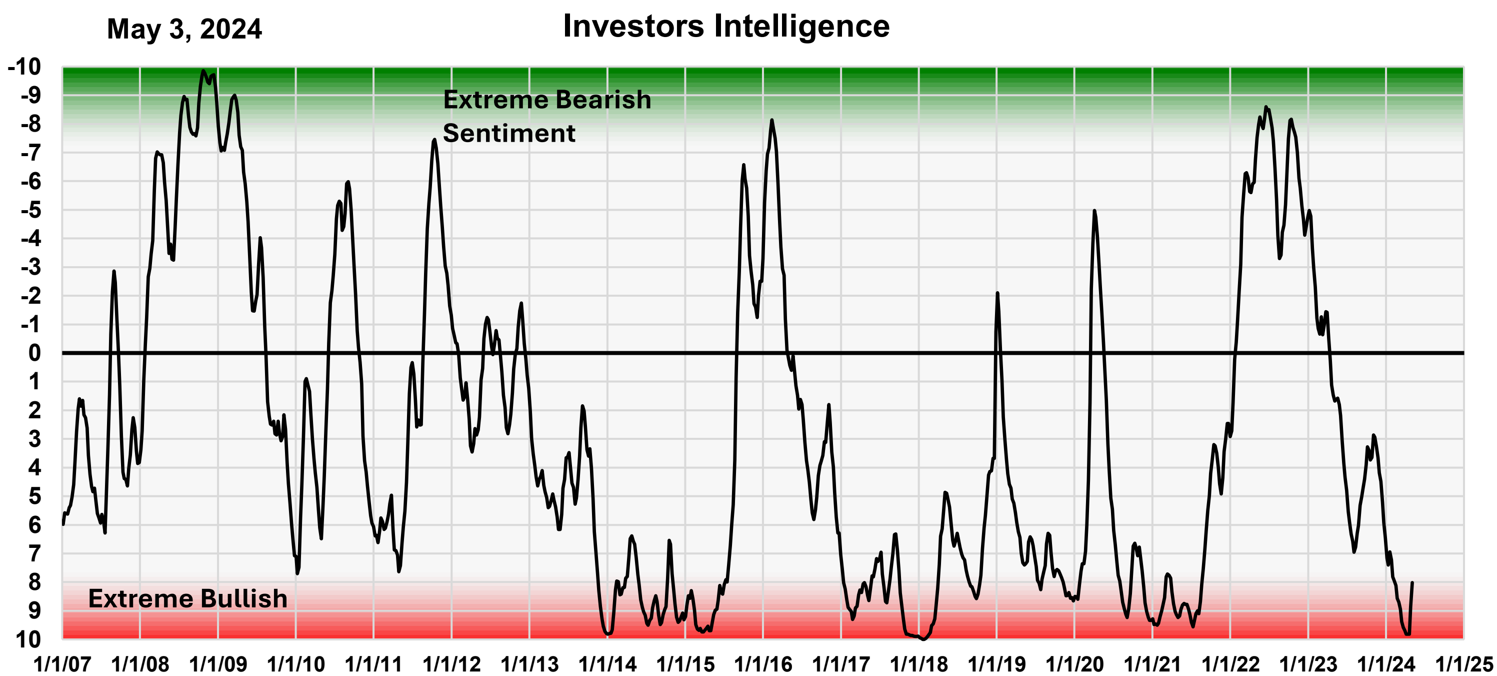
AAII

The information in italics below is compiled from the American Association of Individual Investor's website https://www.aaii.com/sentiment-survey:

"Each week, we ask AAII members a simple question: Do you feel the direction of the stock market over the next six months will be up (bullish), no change (neutral) or down (bearish)? The AAII Investor Sentiment Survey is conducted each week from Thursday 12:01 a.m. until Wednesday at 11:59 p.m.

Like many investment surveys, the AAII survey makes a wonderful contrary opinion indicator. We take the weekly, bullish, bearish and correction numbers and form a time weighted moving average to provide a long-term perspective. We then rank this moving average on our SK ranking scale, which is graphed above.





The Investors Intelligence Newsletter Writer Survey

The Investors Intelligence survey of newsletter writers was started in 1963, twenty years before the American Association of Individual Investor survey. This makes it the granddaddy of all contrary opinion indicators. Investors Intelligence is now owned by Chartcraft. The raw data to do your own research can be purchased at the following website: https://www.investorsintelligence.com

They publish the percentage of newsletter writers who are bullish, bearish, or expecting a correction on a weekly basis. The famous Barron's editor Alan Abelson referred to it constantly in the 1970s and 80s when trading the market based on contrary opinion was the only effective way for many to make money.

We form a time-weighted, moving average of these weekly values, to obtain the long-term perspective we are looking for. We then graph this long-term moving average on the Sentiment King Red and Green ranking scale. This is the graph shown above.

The Theory of Contrary Opinion and How To Apply It

The Theory of Contrary Opinion

The theory of contrary opinion is very simple to state: When "too many" investors think stock prices will advance, they usually decline. Likewise, when "too many" think prices will decline, they advance. In other words, prices will move opposite to what investors expect when "too many" investors have that expectation. The key is knowing when there are "too many."

I want to emphasize this last point: The theory applies only when those expectations have reached an extreme. Notice that the theory does not consider the general economic situation. It simply states that *the necessary and sufficient condition for a major market top or bottom is the existence of an extreme level of bullish or bearish sentiment.*

When applying the theory, one cannot guess when there are "too many"; you must have indicators that measure it. Then you must also have a history that covers numerous bull and bear markets that shows when an indicator has signaled "too many" in the past. An indicator might show two bulls for every bear, but this could be a normal ratio for that indicator and "too many" is a ratio of 4 to 1.

Why the Theory Works

Contrary opinion as a theory was first defined by Humphrey Neill in his 1954 book, *The Art of Contrary Thinking*, but I'm sure it was known before that. For example, in Edwin Lefevre's book, *Reminiscences of a Stock Operator*, written over 100 years ago, there is the statement, "Always buy when complete demoralization has set in."

The usual explanation of why the theory works is this. If everyone is bullish, investors have already purchased so even with more good news there are few buyers left to push prices higher. The advance is "exhausted" so just a little profit taking will reverse things and move prices lower.

On the other hand, if everyone is bearish, they have already sold. So, even with more bad news, there are few sellers left to push prices lower. The market is "washed out." So just a little buying by bargain hunters will move prices higher.

This is a good explanation, but it doesn't account for everything. For example, I have seen markets that went through a small sideways correction after a big advance, which culminated with almost everyone expecting prices to decline even further. Yet, the number of possible sellers after such a small correction couldn't possibly be exhausted like at the end of a bear market.

Until we get a better explanation, however, this one will suffice.

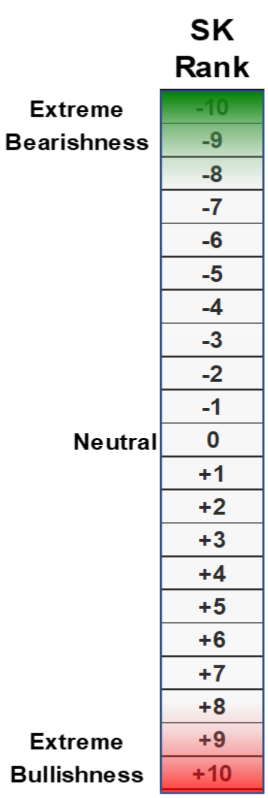
How Investor Expectations are Measured

The methods for measuring investor expectations fall into two categories. The first category attempts to discover what investors expect by measuring their investment activity. The second category measures what investors or advisors expect by polling them to get their outlook on the market.

As we've stated before, indicators of investor expectations only have meaning when they reach extreme values. In between extremes they have little meaning and the technician must let the market move forward until they do. As a rule, always assume the primary trend is intact until sentiment indicators have reached sentiment readings as established by history.

This is a useful guide that will help you stay with the major price trend. The primary error a market technician will make when using contrary opinion indicators is "forming" a market opinion and acting on it when none is there. Have patience. The second is to justify or ignore extreme readings. The Sentiment King's Red and Green Zone ranking scale was designed to help with these issues.

The Red Zone, Green Zone and Neutral Zone Ranking



A moving average of an indicator is calculated - one we believe measures a long-term view for that indicator. Historical values of this moving average are then used to establish where the current moving average ranks against historic norms. A minimum ten-year history is required for this, one that covers multiple bull and bear market. The current value is then positioned on a scale from +10 to -10, each incremental number representing a 5% change in its historical position.

This ranking method makes it possible to put different type indicators – such as the puts to calls ratio and the percent of bullish advisors – on the same scale. It allows us to combine different indicators into one, which we call the Master Sentiment Indicator. All the graphs in the report show this ranking of the indicator, not the indicator itself.

Red zone readings are +8 and above. It means our moving average calculation is in the highest 10% of all readings. Readings of -8 or less are Green Zone readings, meaning it's currently in the lowest 10% of our moving average calculation. There's no sudden demarcation line but a gradual fade in as you can see in the color scheme.

The large area in between, which we call the neutral zone, is just that – the indicator is neutral. The current ranking might indicate more bulls than bears, or vice versa, but it's not enough to have meaning. Only extreme values have meaning.

CONTRARY OPINION IN PRACTICE

Using Contrary Opinion to Help Find Tops and Bottoms of Bull and Bear Markets

When I first began studying the market in 1971, I believed that contrary opinion was useful only for finding the tops and bottoms of bull and bear markets. I thought the best approach was to wait for an extreme reading in sentiment to signal the start of a movement (whether up or down) and then wait for the opposite extreme to signal the end of the movement.

Notice there is no consideration for the economic picture. It just requires "extremes" in investor expectations when forecasting bull and bear markets. I still believe this but have discovered the theory has other valuable applications to trading.

The 2022 Bear Market Low

Following this principle made finding the low of the 2022 bear market rather easy.

Beginning in August of 2022, through twenty articles we wrote for Seeking Alpha, we noted the extreme levels of bearish sentiment in numerous contrary opinion indicators. We continuously wrote they all indicated the end of the bear market. Some readers listened; most didn't and generally replied that the start of a bull market was impossible because of a coming recession. One of our articles directly addressed this conflict. On August 31st, 2022, we wrote:

"We are at a unique moment in time to test an important concept.

What's more important when determining market direction - the negative economic factors everyone thinks will drive prices lower, or the statistical fact that so many people believe prices are headed lower? After 50 years of market study, I say it's the latter. In any event we will all learn something important very soon."

We all did learn something important, as the theory proved itself once again. Unfortunately, most investors waited on the sidelines and missed the main thrust of the subsequent bull market.

Bull and Bear Markets are Different

Contrary opinion works better at finding bear market lows than the tops of bull markets. The primary reason is because there is a difference between bull and bear markets. They have different characteristics. They are not opposites or mirror images of one another. You can demonstrate this difference by flipping a chart upside down and taking away the price scale. An experienced trader can easily tell the chart is upside down by the chart patterns. They aren't vertically symmetric

Bear markets usually end suddenly with different sectors bottoming around the same time. The ending of Bull markets are spread out over time, with various sectors peaking at different times, forming a fan formation. There seems to be a topping process that takes time, as much as a year or more. This makes determining an exact topping moment difficult because it's not well defined. While an index might have an exact peak, there are often really two or three tops where different sectors peak.

Because of this difference you'll often find bullish sentiment going to extremes two or three times during a bull market top as different sectors peak at different times. At bear market lows you seldom get bearish sentiment reaching extremes more than twice.

The 1994 to 1999 "Wall of Worry"

At a client seminar in December of 1994, I pulled out the Investor's Intelligence chart which showed the largest amount of bearish sentiment since the 1987 crash. In the video of the event, I say a major advance is imminent, so they should stay put with their stock investments. I explained contrary opinion to them, much as I have here. After the bull market started, we religiously updated the Investor's Intelligence readings every six months at client seminars.

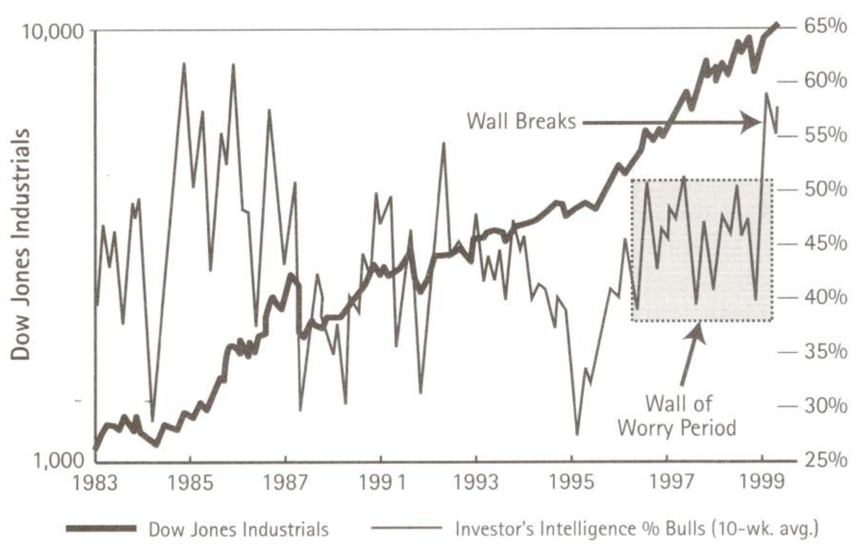
As we did, we noted no swing toward the type of extreme bullish sentiment readings that would indicate a market top. In fact, the bullish readings stayed very muted, and they were accompanied by magazine articles illustrated with pictures of bears, in which many analysts argued that the market was overvalued and ready for a correction.

To us these naysayers represented the well-known "wall of worry" that accompanies almost every advancing market. It was a unique moment and highly unusual to have such a clear "wall of worry" carry this far into an advance. So, we just stayed bullish for the entire four-year rise, waiting for extremely bullish sentiment, and in this case, it worked very well. The wall eventually "fell" in 1999.

I mentioned this in my book published in 2000, which included the chart diagrammed below. The chart shows the four-year, "wall of worry" from 1994 to 1999 and what we said about it. You can see the wall finally breaking in 1999, just before the start of the dotcom bear market.

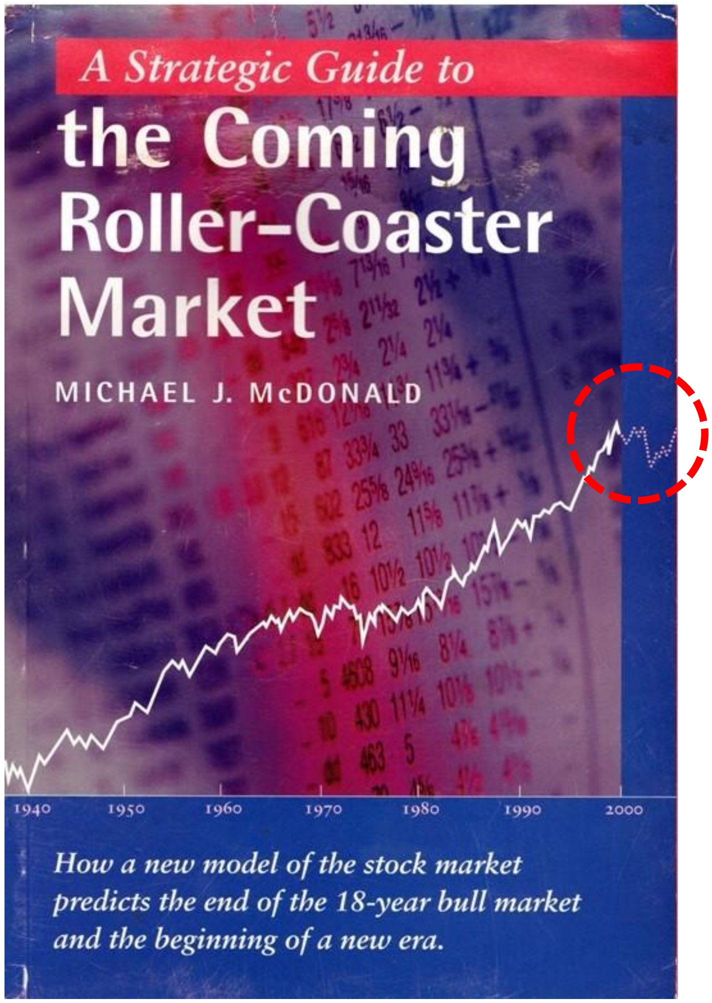
118 OF BABES, O'BUCS, AND CONTRARY OPINION

FIGURE 5.8 The wall of worry. It is an old cliché that markets continue to rise against a wall of worry and doubt. You could actually see this cliché in action from 1994 to 1999 by watching the guru index, Investor's Intelligence. Bullish sentiment refused to rise above 50% until the beginning of 1999, when the wall finally broke.



Calling the Top of the Dot-Comm Bull Market in 2000

The crowning achievement of contrary opinion was the calling of the top of the 18-year bull market and the dot comm bubble. We were so certain about this forecast; we actually wrote a book on it. The forecast was based completely on investor psychology and sentiment; there was little if any mention of economic factors. We memorialized the forecast on the cover of the book, which is shown below.



The new era was forecast to be a trading range market, which we also put on the cover. I've circled it in red. The stock market complied as it went effectively sideways from 2000 to 2010 with two major bear markets separated by a four-year bull market.

The timing was almost perfect as the book was published three months from the market top of the eighteen-year bull market, but this was really luck. The book was purchased by Wiley and Sons and renamed "Predict Market Swings with Technical Analysis." As far as we know, it was the only book to forecast the end of the dot comm price bubble in the year it occurred.

Is it a High-Level Consolidation or the Topping Process Before a Major Decline?

There are other ways to apply the theory. For example, I have found that contrary opinion is very useful at determining whether the market is going through a high-level consolidation before moving higher or is moving sideways prior to a major decline.