June 6, 2014

Cavernous disconnect between ***irrational complacency & fat-tail Risk***

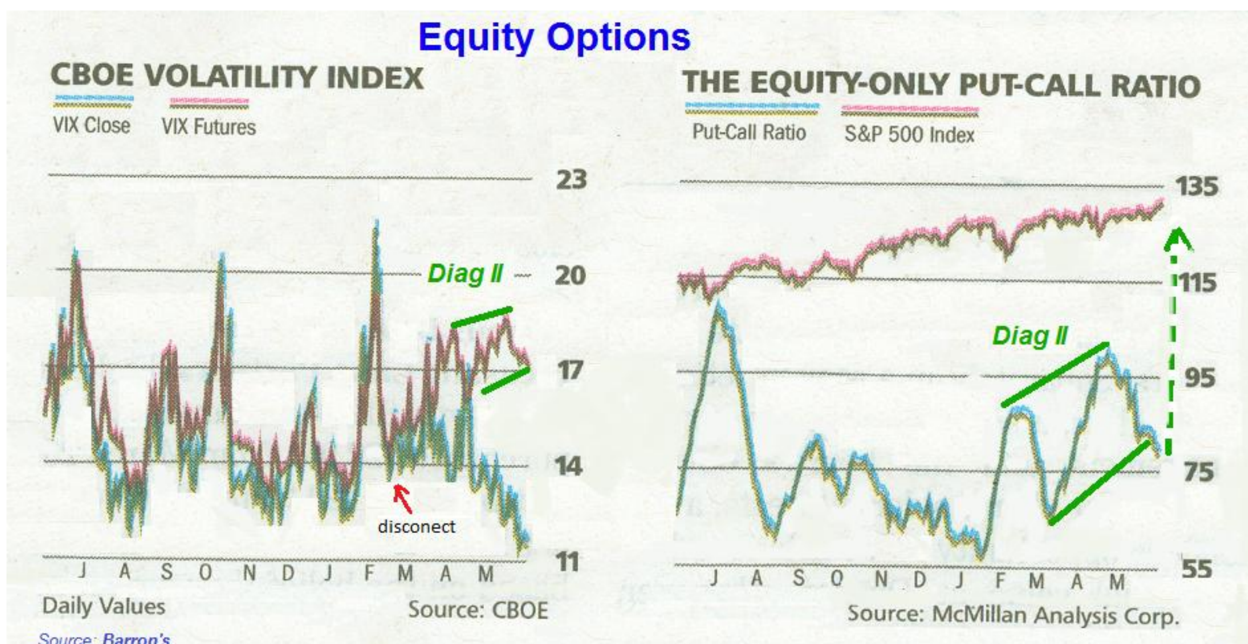
With the Market hitting new ***"highs"*** ***reversing into a plunge,*** even as the $VIX remains in the sewer, there's a cavernous disconnect between *irrationally, complacent gullibility* and the *Black Swan* right around the corner. Rather than batting down the hatches in preparation for turbulent weather, investors persist in linearly projecting low-volatility and higher stock prices into infinity. The last time the $VIX fell to the current gutter- level was in February 2007, ***on the eve of the credit crisis*****,** just prior to the onset of the plunge which culminated in the 2009 trough.

The ***calm before the storm*** is a repeating pattern in all of nature.

While I initially thought the $VIX futures were being manipulated to support the market, the charts below prove otherwise. Only the most naïve investors have become ***irrationally complacent*** & credulous of the Fed's omnipotence. Meanwhile, professional investors continue to price Volatility far more realistically in the *$VIX* Futures. The *Diag II* however, shows a *degree of hesitancy,* which typically accompany this pattern.

Launching pad for explosive upside in the VIX

On the right you see the Equity-only *Put/Call Ratio* in green, tracing a *Diag II*, to indicate the ***launching pad for an explosive upside in volatility,*** concurrent with by a surge in the demand for Puts, used to protect against losses in *"long"* portfolios.



Fat Tail Market Risk - *Market Volatility will soon Spike*

In aggregate, the two equity option charts provide a far more accurate measure of ***Fat Tail Risk*** the supposedly *low-probability, extreme outliers in the bell-shaped curve,* which extend far beyond our financial paradigm. Add to that an Elliott spin, and you've got a preview of the future. Prior to March 2014 on the left, you that the CBOE $VIX index

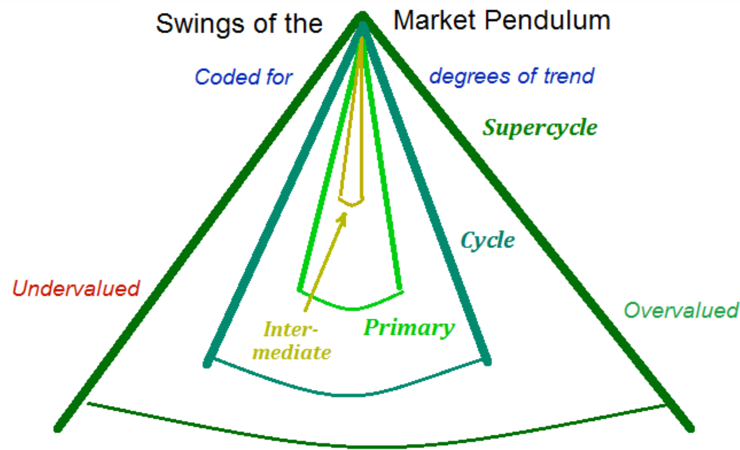
and the VIX Futures closely tracked one another. Since then, the Futures employed by sophisticated professionals, have traced a positively-sloped *Diag II,* while the $VIX index has slipped into the gutter. Any way you look at it, ***Market Volatility will soon Spike***. In effect, there's a terrific arbitrage opportunity simply buying *highly undervalued* ***TVIX***, the Volatility ETN. No need to *short the VIX Futures*, which are just a bit less undervalued, and due to SPIKE likewise.

Diag II - ***the most bullish of all price patterns***

For those who are not familiar with the *Diag II*, it heralds the beginning of a long move, in either direction. This *bullish Diag II* in the *$VIX* confirms the nascent ***Supercycle* Bull Market*** in *Volatility*, opposite *free-falling* Stock Market of the *same magnitude*. These ***key forecasting patterns*** are prominently labeled in the *Big Picture Wave Count* since 1900. For a detailed explanation of the *Diag II*, follow this link.

Market Volatility will soon be much higher

As you well know, the market never reaches its destination via the shortest, straight-line trajectory, it prefers the *scenic route*, keeping time with the *Market Pendulum's swing to & fro* to opposite extremes in valuation. Such pendulums, concurrently operating at all degrees of magnitude, exemplify ***waves human herding emotion*** as shifts from ***risk-on to risk-off, & back again***. ***Up shifts in magnitude always come as a big surprise for the linearly minded. The herd concurrently underestimates Volatility & undervalues the $VIX & $TVIX.***



Volatility is "playing dead"; first a lower degree fractal-plunge

According to B of A Merrill Lynch Surveys, Hedge funds are ***net short***, while the *short position* in small-cap Russell 2000 is the *highest in two years*, *longs* in the NASDAQ are at a one-year low. Cash levels among fund managers are high and ***volatility is "playing dead".*** Only an idiot could conclude a ***"Melt-up"*** from this scenario, on the other hand there's too much anticipation of the *"Plunge",* for this to be the *"Big One*". As we showed previously, this will likely be a lower degree ***fractal***, the *warm-up act* to prepare us for the main event.

GDP ***contracting*** in a tail-spin

Just last week we learned that the economy contracted ***1%*** in the 1stQ, rather than the initial GDP estimate of 0.1% *growth. Just as virtually no one expected interest rates to plunge since January, currently nobody expects GDP to remain at the 1stQ's lows, much less* ***shrink dramatically*** *from there*. ***We do,*** in fact we have been emphatically asserting an inevitable ***GDP contraction*** for many months.

Note the ***plunging volume*** above, a market that continues rising on ***decreasing volume*** is *illusory,* ***characteristic of <u>terminal</u> upsides. There are fewer & fewer buyers left,*** *when there's no one left to buy, the Market DIVES!*

Elliott's foremost contribution: *degrees of trend*

Perhaps Elliott's foremost contribution to understanding the market is this concept of ***relative magnitude.*** Just as earthquakes are ranked on the ***Richter scale***, by numbers from 1-10 to represent severity on a ***log scale,*** *where each ascending number represents* ***10x*** *the previous in its destructive potential.* Similarly, Elliott's waves ascend in ***<u>semi-log</u> scale to represent <u>twice</u> the capital destruction as one degree of trend lower*** in Wave ***C*** ended 2009, and ***4x*** Wave ***A*** ended 2002.

****Supercycle*** is the highest degree of magnitude for the last 200 years, for the sake of comparison, it is *Super-sized,* like the Cokes sold at 7-11 *bigger than your head*. Like all Elliott patterns ***Supercycle*** degree sub-divides into 5 ***Cycle waves***. In the chart below, you get a perspective for what this means.

Like ***Supercycle Wave (II),*** which culminated in the Great Depression, ***Supercycle Wave (IV)*** *in principle*, corrects the longest Bull Market in History from 1932. However *in practice,* the only segment which unfolded at ***Supercycle degree*** spanned 1982 to 2000. Logically the longest Bull Market must be followed by a commensurate Bear Market ***"correction".*** By *Elliott's guideline,* ***the most likely extent of any correction is the previous 4th wave of one lesser degree***.

In magnitude hierarchy, ***Supercycle*** is *twice* the magnitude as ***Cycle degree***, ***Cycle degree*** is *twice* the magnitude as ***Primary Degree,*** and ***Primary Degree,*** is *twice* the magnitude as ***intermediate degree.*** In the long-term chart since 1900 below, these degrees of trend remain color-coded for facility of comprehension.

Supercycle Wave (I) ended 1906.

Supercycle Wave (II) completed in 1932

Supercycle Wave (III) concluded in 2000

Supercycle Wave (IV) will likely endure 26 ± 6 years from 2000, with the ***(A)-wave*** troughing near ***Dow 572***, to *widen the price channel* & accommodate ***Grand Supercycle degree,*** will make its first appearance in 200 years as ***Grand Supercycle [III],*** tagged onto the end of ***Supercycle (IV),*** just as ***Supercycle (III)*** began with the culmination of ***Cycle IV***, marked **C** below in 1978.

Cycle Wave IV is a fractal of Supercycle (IV) in process

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