FINANCIAL PREPAREDNESS

"One of life's most painful moments comes when we must admit that we didn't do our homework, that we are not prepared." ~ Merlin Olsen

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The Great Cashout

Recently this article caught my eye. A number of Very Smart Money (as in privy to deep inside information) stockholders have been selling a lot of shares, two of them for the first time *ever*. Corporate insiders are generally Smart Money, though they tend to be early, probably because (1) due to SEC regulations, they can sell only during certain windows and (2) a market can stay irrational for longer than short sellers can stay solvent.

Also, "Many of the sales were made according to 10b5-1 trading plans...[which] are created in advance so that shares are automatically sold...at a specific date or when the stock hits a certain price." But the most notable sales were not part of such a plan.

Now, to be fair, there are a number of reasons why insiders would sell that has nothing to do with their assessment of the stock's valuation, including to pay for expenses, to take advantage of relatively low tax rates or to reduce unsystematic risk.

Let's start with Mark Zuckerberg, CEO of Meta Platforms (one of the Magnificent 7 stocks), which currently comprises 2.55% of the S&P 500 Index. He has sold shares every month since last November (his first sale since Nov. 2021), for a cumulative total of about 3,820,508 shares, which at the current price is worth just shy of $1.9 billion. Wait, what? Why is he selling one of the Mag7 stocks? Surely he must realize the vast potential of AI?

Maybe he needs some cash for his underground bunker, or to rig the 2024 election.

Then there's Jamie Dimon, CEO of JPMorgan Chase, who recently sold $150 million of stock—his first sale since he became CEO 18 years ago. Maybe he plans to retire soon (and possibly run for President; although he's the consummate insider, lately he sounds relatively reasonable). Or maybe he sold because 12.6% of his bank's "fortress balance sheet" ($171 billion) is exposed to commercial real estate.

Another reason for his sale may be reflected in an obscure indicator known as XLF Component Correlation, which "shows the correlation among members of the [financials] sector. During times of panic, investors tend to buy or sell 'everything' together, no matter their individual merits, so correlation rises. The higher it goes, the more we're seeing groupthink, which tends to happen at times of extreme pessimism, and is thus usually a positive for stocks going forward. When conditions are calm and investors become complacent, they trade stocks on their own merits, and correlation drops. That tends to lead to below-average returns for the Sector going forward." Recently the correlation plummeted to its current .4879, the lowest since January 2007 (just before the Great Financial Crisis).

Next is Amazon (another Mag7 member and 3.66% of the S&P 500 Index) founder Jeff Bezos. He has sold some shares over the years, but his $8.5 billion sale in February absolutely dwarfs all previous sales. Is he a closet Luddite? Does he not understand how AI is going to revolutionize society? Maybe his new trophy wife is high maintenance so he needs a little extra cash?

Then there's Leon Black, the co-founder and former CEO of investment manager Apollo Global Management, so he's Very Smart Money. He just sold stock ($172.8 million) for the first time ever.

Finally there's Warren Buffett, who is sitting on a record $168 billion cash hoard, presumably because he can't find good value. He's not right about everything, but he does get major market calls right. I remember when he warned about speculative excess during the Dot Com bubble. The Buffett Indicator indicates that the U.S. stock market is currently significantly overvalued.

Let's look at insider selling in certain sectors. The Corporate Insider Velocity (4-week rate of change for insider buys minus insider sells) for the health care sector has plummeted from 133 last September to -60.4 today, the lowest (most bearish) reading since 2013.

Recently, the insider buy/sell ratio in the consumer discretionary sector was at the lowest level (other than during 2021) going back to 2010. And the insider buy/sell ratio for the energy sector was at the lowest level going back to 2010.

So if some of the Smart and Very Smart Money is raising cash, what are the Dumb Money masses doing right now? The savings rate (which would help fuel any stock price increases) is at 3.8%--close to the lowest since at least 2016, while credit card debt (and the average card interest rate) are at record highs. Hardship withdrawals from 401(k) plans are at a record high, and "about 40% of individuals who dipped into their 401(k) last year did so to avoid foreclosure." Not only do consumers not have any money to invest in financial assets, it will take years to dig out of the debt hole they're in.

The mutual fund cash level is at a record (going back to 1955) low of 1.9%. Since mutual funds generally need to keep some cash on hand to meet redemptions, there is virtually no cash left to propel stock prices higher. The NAAIM Exposure Index (a measure of equity exposure for active money managers) is currently very high at 95%, leaving almost no cushion and no *optionality* in the event of a stock market crash.

Mom & Pop investors are ALL IN despite the risks. Equities as a percentage of total non-financial assets for U.S. households was 36.2% at the end of 2023 (the most recent figure available), close to the record (going back to 1952) high of 37.7% set at the end of 2021.

One month ago, the SKEW Index—which measures the risk of a "black swan" type of event in equities within the next 30 days—set a record (going back to 1990) high. At the same time, the PE/VIX Spread set a record (going back to 1990) high. This "shows the spread between the forward price/earnings multiple on the S&P 500 and the VIX volatility gauge. The higher it is, the more investors are willing to value stocks while not suffering the consequences of high volatility, which tends to lead to poor future returns."

The Small Spec Index Position--which shows the net position of small (Dumb Money) traders in stock index futures—made an enormous surge during the last year and is now just shy of the record high set in early January.

Penny stock dollar volume has been very high since the end of 2020, and with only a few exceptions (including the peak of the Dot Com bubble), is currently the highest it has ever been (going back to 1995). Investors trade more (risky, no yield) penny stocks when they feel confident. Following the Dot Com bubble and the Great Financial Crisis, penny stock volume was very low.

So what could go wrong? If you typed that question into ChatGPT, I think it would answer, "Nothing! Come on in, the ether's fine!" Actually, my editor did pose the question to ChatGPT; here's the response:

"Several factors could lead to problems or volatility in the stock market [my emphasis is in italics]:

Economic downturns: *Recessions* or economic slowdowns can lead to reduced corporate earnings, which can in turn cause stock prices to decline.

Political instability: Uncertainty related to government policies, *elections*, or *geopolitical tensions* can affect investor confidence and lead to market volatility.

Corporate scandals: Instances of *fraud, accounting irregularities, or unethical behavior* by companies can shake investor trust and lead to sell-offs in affected stocks.

Interest rate changes: Central bank decisions to *raise* or lower interest rates can influence borrowing costs, consumer spending, and corporate profits, impacting stock prices.

Market bubbles: *Speculative bubbles can occur when asset prices rise far beyond their intrinsic values, eventually leading to sharp corrections or crashes when the bubble bursts.*

Natural disasters: Events like earthquakes, hurricanes, or *pandemics* can disrupt economic activity, leading to market downturns.

Technology failures: Malfunctions or *cyberattacks on trading systems and infrastructure* can disrupt market operations and cause panic selling.

Black swan events: Unexpected and rare events, such as terrorist attacks or major natural disasters, can have unpredictable effects on the stock market.

It's important for investors to be aware of these risks and to diversify their portfolios to mitigate potential losses."

Hmm. Maybe I should reconsider my decision to use a margin loan to buy call options on the Mag7 or Nvidia?

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