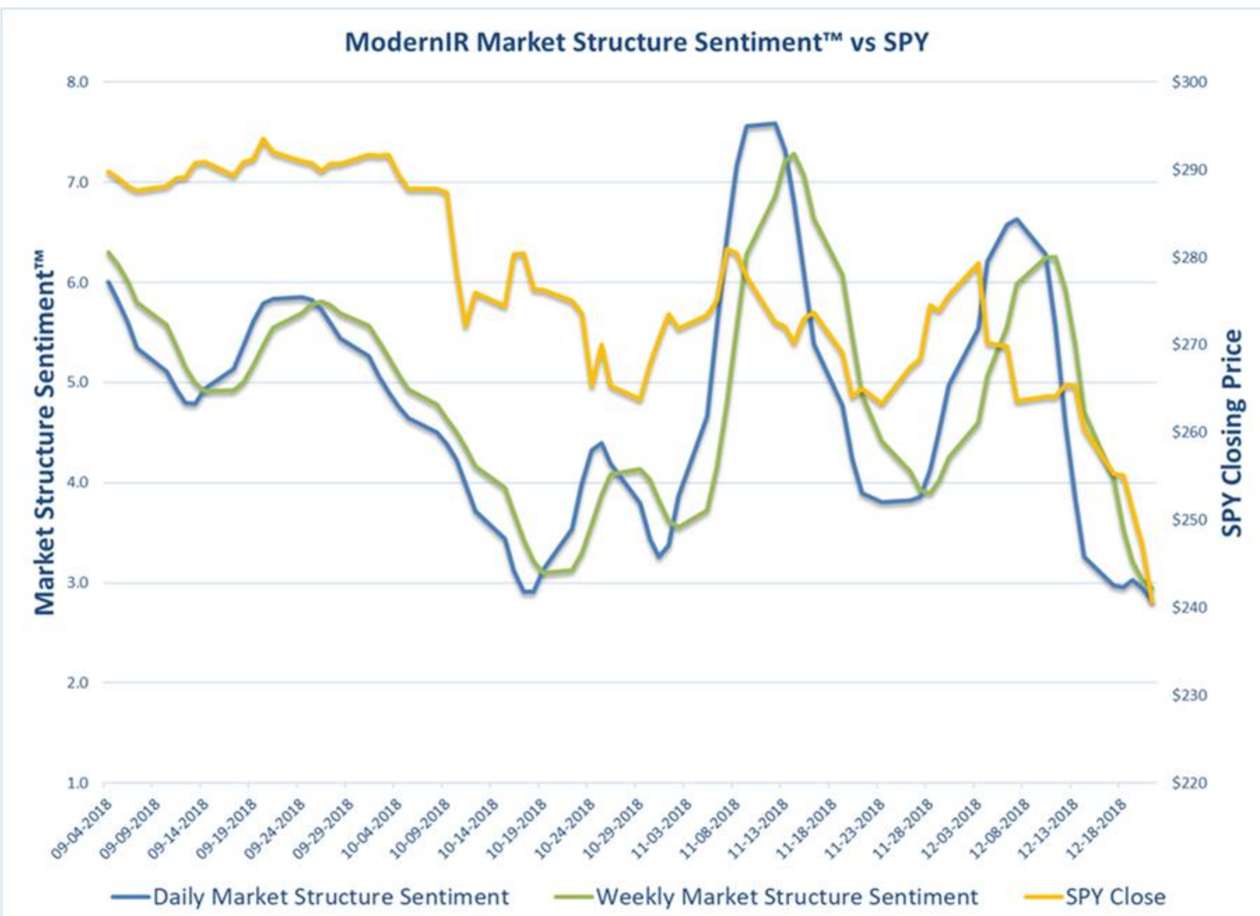
All,

Why the coal from the market in our Christmas stockings? We said we expected the market to decline into December options expirations, and then surge. Did our model fail?

The market will make fools of any who say "this is what will happen tomorrow," but no, our model didn't fail. Rather than bottoming by Dec 19, Market Structure Sentiment has continued falling. The volatile daily reading did hit a trough Dec 19, ticking up a few basis points Dec 20 – and then it fell again Dec 21.

Market Structure Sentiment isn't mass psychology but how machines set prices. There are two kinds of trades: Marketable and Nonmarketable. The former want to be the best bid to buy or offer to sell and they must by rule be automated so they can move fluidly to the "top of the book," the best price. Nonmarketable trades are not similarly governed. Market Structure Sentiment meters whether marketable orders have bottomed or topped or mean-reverted, in effect.



Market Structure Sentiment accurately predicted the top in September, and the bottom -- nearly the same as now – in October. Then correlation became woozy like a drunk. That means Risk Mgmt – counterparty positions meant to mitigate exposure – were failing. The data showed massive patterns related to the wholesale market for Exchange Traded Funds.

There are two markets for ETFs, wholesale and retail. It's contrary to Regulation National Market System, which requires all stocks to trade at a single best price, and it makes possible the "arbitrage mechanism" on which ETFs are built. Isn't it interesting that the way ETFs became the greatest modern investment phenomenon was by exempting them from rules governing everything else?

The wholesale market as we've explained repeatedly lacks transparency. While there is a published "basket" of collateral for creating and redeeming stocks, only a handful of brokers and market-makers see it – and nobody but the ETF sponsors know what's actually in that basket. What are they taking for collateral?

We've contended that the collateral market for ETFs – which according to the Investment Company Institute was over $3.7 TRILLION just through October this year, or about $400 BILLION per month – is undercapitalized. We think it's substituted, sampled, borrowed. We said the risk if our theory is correct is magnified downside if the market goes into a prolonged decline.

Why? Because if collateral devalues, those using collateral for transactions need more of it at the same time their trading strategies are becoming more challenging. So they have to sell things they didn't intend to. They chase short-term directional trading opportunities to offset losses. They may withdraw from making markets in less-liquid stocks – like Financials, Energy stocks, and small-caps.

I think our concerns about ETFs were validated in this increasingly bearish market correction. **But what's now hitting stocks is human nature.** Rational people tend to delay responding to downturns because they're not objective, and because business media is awash in the early part of market downturns with pundits declaiming the superiority of doing nothing.

As the impact of failing ETF collateral compounded – and this is typical too in these cycles – the next wave washing through business media is a repeating cycle of pundits talking about all the reasons for fear: tariffs, global economic weakness, geopolitical instability, slowing US growth, recession fears, and so on.

It sort of follows the crisis cycle: Denial, Anger, Depression, Bargaining, Acceptance. The second wave of pundits is the Anger phase.

Depression arrived this past week ahead of Christmas. Marketwide, Active Investment led, up 2.2%, followed by Fast Trading. **When there is small behavioral change and big price declines, that's a panic at the disco.** It means money is taking the market price over limit orders. It's a flight to the exits. The full angst of losses that have now compounded to in some cases more than 40%.

Here's the irony: Fast Traders were out in front, leading most of the eleven industrial sectors. They had covered last week. They were poised to front-run a surge into options expirations. Instead they were trampled by Active money bolting for the fire escape. Human nature, unlike math, is unpredictable. So Fast Traders reversed and shorted anew and down we went.

What strikes me is that had the public known the problem was structural rather than fundamental, would we have had this correction at all?

What's ahead? If it's the end of the bull market, a lot more misery. I don't think we've seen anywhere near the potential for catastrophic damage that ETF inflation in equities has the potential to inflict. But by the same token, looking at Sentiment right above on the graph, it's bottomed again. Technicians – and I'm not one – would call it a double-dip.

A plus to me is that the distortions caused by Risk Mgmt have washed out, evident in how Sentiment and SPY, the S&P 500 ETF, are aligned again. I think we'll get a surge following Christmas, the one that should have happened last week, and maybe one more down leg in January. If so, that'll be Bargaining. Acceptance will be a return to normalcy that calms nerves and volatility (running at 3.6% daily for the past 50 trading days, a staggering amount that the VIX and beta belie, and 4.5% the five trading days ended Dec 21).

But we don't know. Behavioral volatility jumped over 12% Friday, a signal that risk lingers and sits on the precipice of becoming endemic.

Through what's happened since the end of September, our forecasts and predictive behavioral reads have performed admirably **(REMINDER: Act by Dec 31 to save on our new Sector Insights – out today again – or by Jan 15 at the latest to continue receiving them)**. They tell us what weather lies ahead in markets near-term. So we'll keep you apprised, informed and in front of your executives and boards. In the worst storms, what calms nerves is knowledge and preparation – and we'll bring both to bear for you.

And on that note, enjoy the holiday season. We in the capital markets regardless of any current misery remain among the world's most privileged people. A new year lies ahead, full of new vistas. We'll see you there.

Best wishes,

Tim Quast
President
ModernNetworks *IR* LLC