



US

The Way You Make Me Feel: Sentiment's Message

Investors remain cautious despite bullish positioning, as rotations curb speculation while record margin debt and high equity allocations raise longer-term risks.

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Key takeaways

- Investor sentiment is unusually split: subdued surveys contrast with elevated stock allocations, persistent ETF inflows, and record margin debt, so the market is not yet showing a uniformly euphoric extreme.
- Recent speculative excess has been unwound mainly through sharp rotations—especially in artificial intelligence (AI)-related industries—rather than a broad index decline, creating the potential for reflexive rallies (sharp, short-lived market rebounds occurring after a period of heavy selling or a deep correction) in beaten-down market leaders.
- Longer-term risks remain elevated: near-record household equity exposure and surging leverage have historically pointed to weaker forward returns, while the economy's growing reliance on the stock-market wealth effect raises the stakes of a potential prolonged downturn.

The equity market has continued to defy gravity this year amidst a stop-and-start war in the Middle East, questions over how the Federal Reserve plans to tackle inflation, and a 19-year high in 30-year Treasury bond yields. Considering the persistent nature of geopolitical and policy-related stress, the S&P 500's high single-digit return year-to-date looks respectable. It has made for an interesting investor sentiment backdrop: while investors have continued to pile into the market via strong ETF flows and high margin debt balances, they have done so reluctantly as attitudes have been more subdued.

Typically, when behavioral (e.g., ETF flows, margin debt, real money positioning, etc.) and attitudinal (e.g., surveys, sentiment indexes, etc.) sentiment congregate in one extreme, they provide contrarian signals for the stock market. We aren't yet seeing that dynamic today, given there is still a gap between the behavioral and attitudinal sentiment metrics we track. More recently, some of the froth in the former has been wrung out, driven by the significant unwind in industries that became central to the AI momentum trade (semiconductors and memory chips, to name a few).

That shows up clearly in the ETF Speculation Index from our friends at Ned Davis Research (NDR). The index compares assets in leveraged long ETFs versus those in inverse ETFs, so it's a good behavioral gauge of investor optimism. As you can see in the chart below, the index had recently been in extreme optimism territory but has reversed sharply into extreme pessimism territory in a matter of two weeks—triggering what NDR calls a "buy signal." We are not market timers, nor are we recommending you buy or sell, but we point this out to say that given momentum's severe washout of late, investors shouldn't be surprised by strong, reflexive rallies in some AI mega caps.

Strong momentum reversal



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NDR ETF Speculation Index is the ratio of total assets in leveraged long U.S. Equity ETFs to all inverse U.S. Equity ETFs. The ratio is smoothed by 7 days and then normalized using a 63-day z-score (a z-score measures exactly how many standard deviations a specific data point is above or below the average of a data set). Buy signals are generated when the Index first crosses below -1.2 and sell signals are generated when the index first crosses above 1.4.

Indexes are unmanaged, do not incur management fees, costs and expenses and cannot be invested in directly. **Past performance is no guarantee of future results.**
For illustrative purposes only.

As we mentioned, investor attitudes have not been consistent with their behavior this year. Shown below are two components of the weekly American Association of Individual Investors (AAII) Sentiment Survey: the percentage of respondents saying they are bullish or bearish on stocks. We like to look at the spread between the two and right now not only is it negative, it's nowhere near prior periods that were consistent with major market tops.