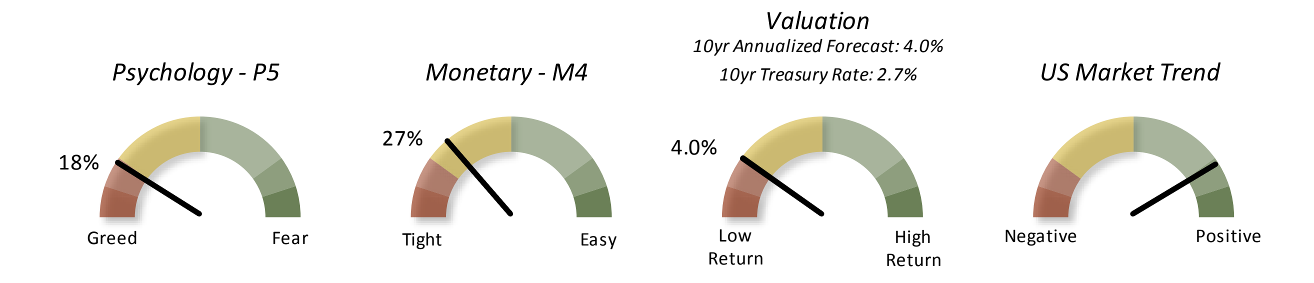
Cypress CAPITAL

Cypress Market Outlook

By Mark T Dodson, CFA



Recommended Equity Exposure: 70% of Maximum Allocation

Market Trend Analyzers	Phase
Domestic Equities	*Investment Phase: 70% Invested*
International Equities	*Trading Phase: Short Term Trend Positive*
Real Estate	*Investment Phase: Maximum Exposure*
Commodities	*Trading Phase: No Exposure*

Monetary

Components	Condition
Exchange Rates	*Neutral*
GDP	*Positive*
Inflation	*Neutral*
Interest Rate Spreads	*Negative*
Interest Rates	*Neutral*
Lending & Leverage	*Neutral*
Monetary Aggregates	*Neutral*
Velocity	*Negative*

Valuation

Components	Level
10Yr Annl Equity Return Forecast	4.0%
10Yr Treasury Note Yield	2.7%
5Yr Annl Valueline App Potential Forecast	7.2%

Psychology

Components	Condition
Bank Sentiment	*Neutral*
Flow of Funds	*Positive*
Fund Flows	*Negative*
Insider Sentiment	*Neutral*
Leveraged Investments	*Negative*
Option Activity	*Neutral*
Surveys	*Neutral*
Consumer Confidence	*Negative*
Technical Indicators	*Positive*
Trading Data	*Neutral*
Volatility	*Neutral*

Model Summary

Investor psychology has dropped to the bottom quintile of readings. In a market that has not hit new highs, that's a level at which a bear market rally would traditionally begin to run into headwinds. All the indicators that were giving green lights on Christmas Eve have reversed course.

Stock market pundits celebrated the 10-year anniversary of the bull market over the weekend – which is confirmation of the optimism that we are seeing inside our psychology composite. It's presumptuous and overconfident considering the market peaked last year. If bear markets like to make fools of most of us, that's the kind of story that is right out of the bear market playbook. They are stories that will have to be retracted should the market fail to make new highs.

Monetary conditions are unchanged. The slope of the yield curve has continued to grow shallower, and the lagged effect that the curve has on markets and the economy has yet to make its full impact. Monetary base is now shrinking faster than any time since the crash of 1937 (and the Great Depression before that), as a result of the Fed's quantitative tightening. Both will keep monetary conditions from improving much even if other categories improved substantially, and the composite is more likely to worsen throughout the year rather than improve.

Recent headlines from labor markets, some of which are leading indicators, have begun to give more cautious signs. This month, the NFIB Small Business Survey showed that the percentage of small businesses citing labor costs as their biggest problem reached a record high.

The bullish evidence here relies on breadth, momentum & price trend. The bottom line is that we don't have enough evidence to rule out a move higher, but we still lean toward the bear rally case. We believe that any rally higher will ultimately prove to be short term gains that are later forfeited – a speculative momentum rally. They can be un-nerving if you are sitting on too much cash, but they are also dangerous. Stocks do not have a margin of safety, and the warnings coming key long-term indicators suggest you should hedge your bets. The Q4 decline was not a rebuilding of the wall of worry. If it reset the clock on sentiment, current readings suggest that sentiment rally is played out. We have officially entered the most vulnerable period of the rally off the December lows.

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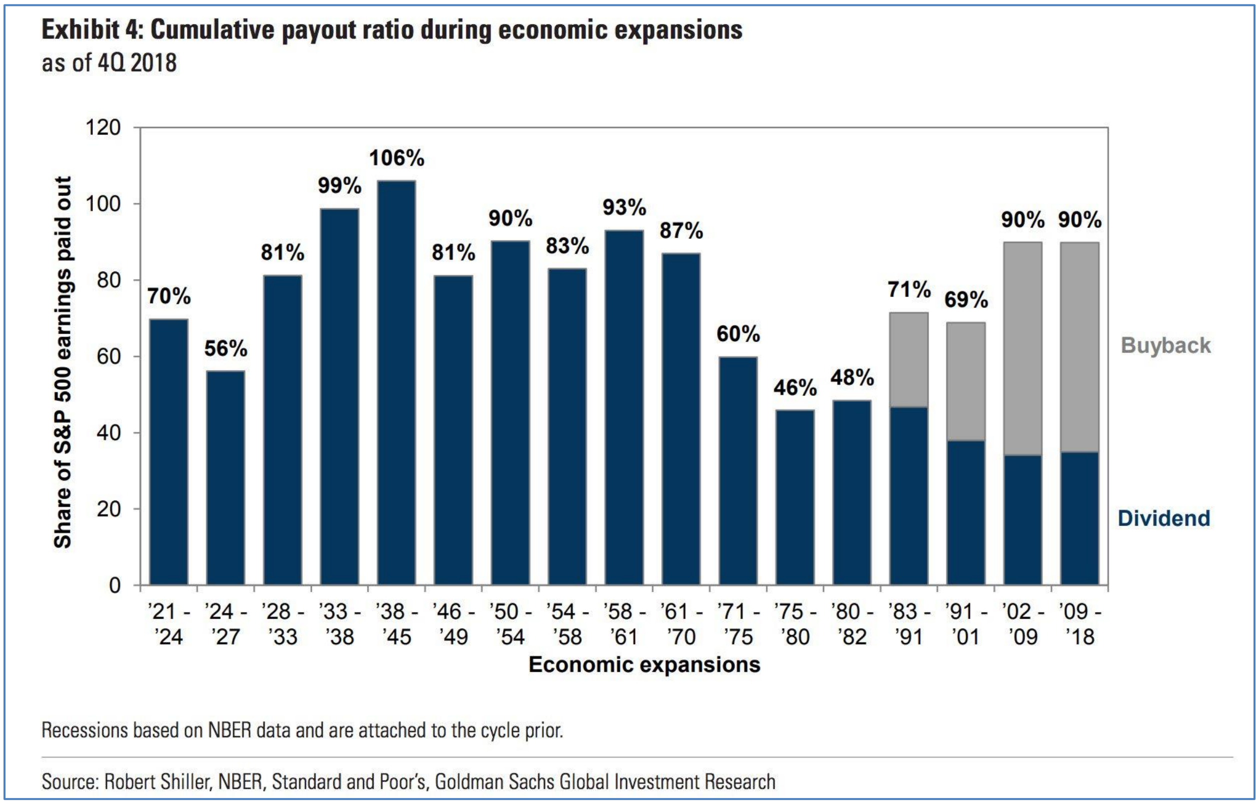
Special note – over the next couple of weeks, we will be rolling out a new website as well as introducing the Market Risk Index, which will distill all the indicators and factors in our model into a single number. That number will give you a quick way to determine whether the readings from our baskets of market indicators is a bullish, bearish, or neutral outlook. We'll send another announcement before we make the switch.

Charting Trends

Quote of the Week

"Cycles have more potential to wreak havoc the further they progress from that midpoint – i.e., the greater the aberrations or excesses. If the swing toward one extreme goes further, the swing back is likely to be more violent, and the more damage is likely to be done, as actions encouraged by the cycle's operation at an extreme prove unsuitable for life elsewhere in the cycle." – Howard Marks

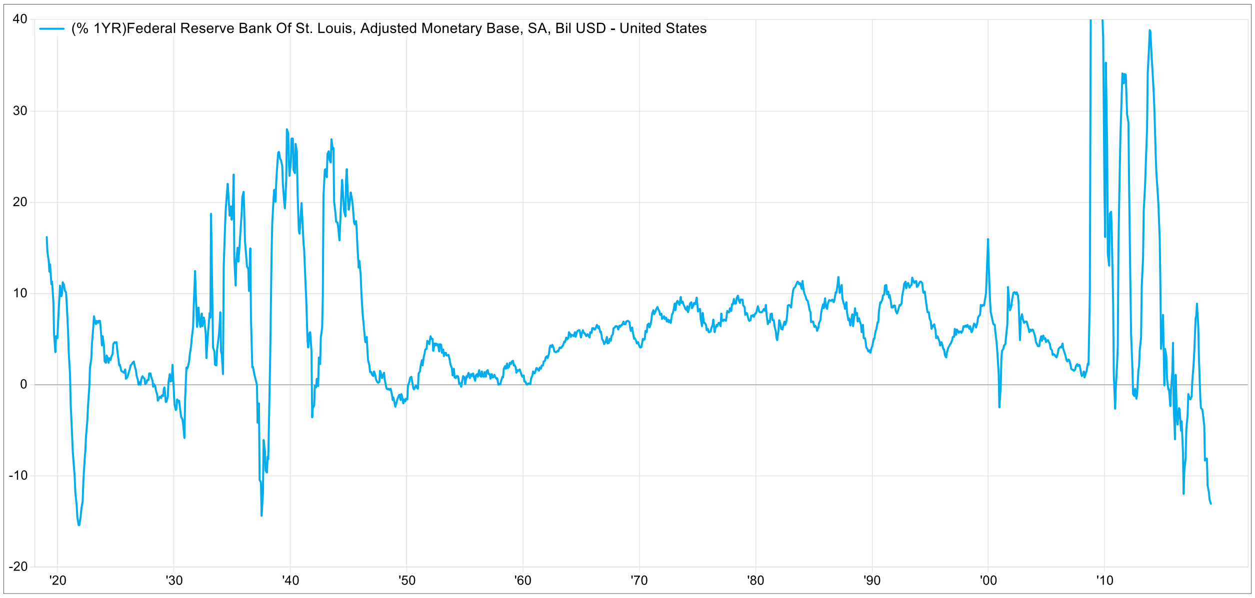
Chart – Factoring Buybacks, Payout Ratios are at 90%



Source: Holger Zschaepitz

Chart – Monetary Base Growth Slowest Since 1937

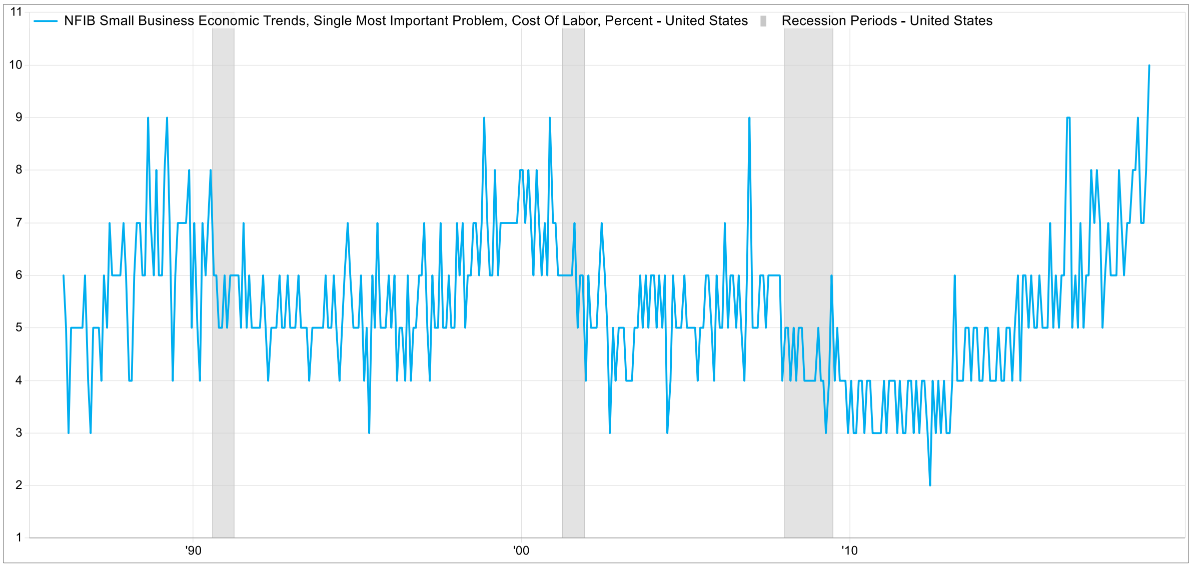
Monetary base is the monetary aggregate that the Fed directly controls. The declines here are a result of quantitative tightening. The volatility in the growth rate of monetary base over the last 10 years is unlike anything since the Great Depression era.



Source: Factset

Charts – Labor Cost Becoming A Concern of Small Businesses

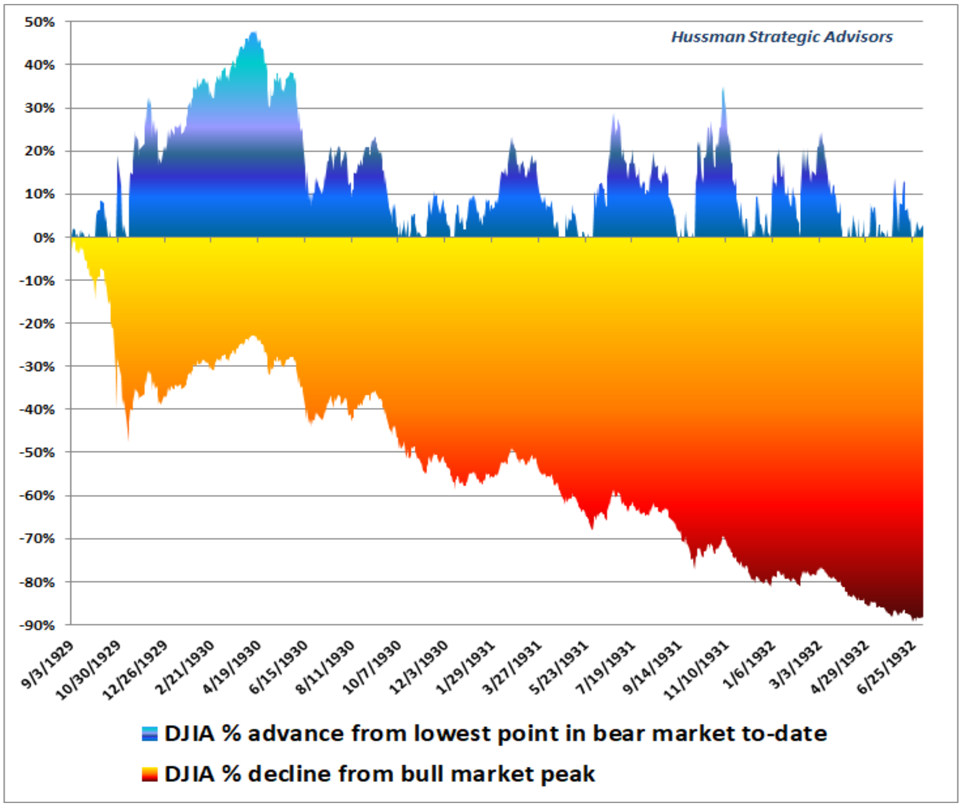
Percentage of small businesses who said that labor costs are their single most important problem has reached a record high. Spikes in this obscure survey question have been good long leading indicator.



Source: Factset, WSJ, The Pain Report

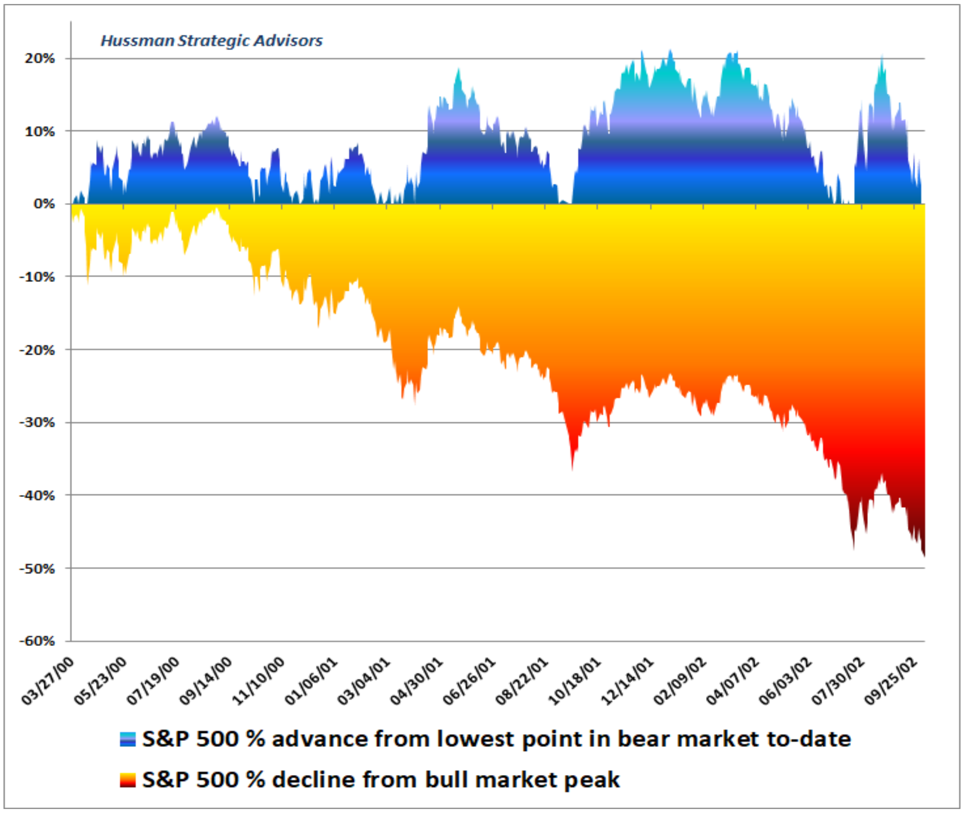
Charts – Quantifying Great Depression Bear Market Rallies

These next three charts are from John Hussman's most recent piece, and they are a fantastic illustration of how powerful bear market rallies are within a bear market – almost cruelly so. The blue regions signify the rallies within a broader bear. A 20% move higher within a bear market is not uncommon, making it difficult to officially rule that a bear market is over until the market reaches new highs.



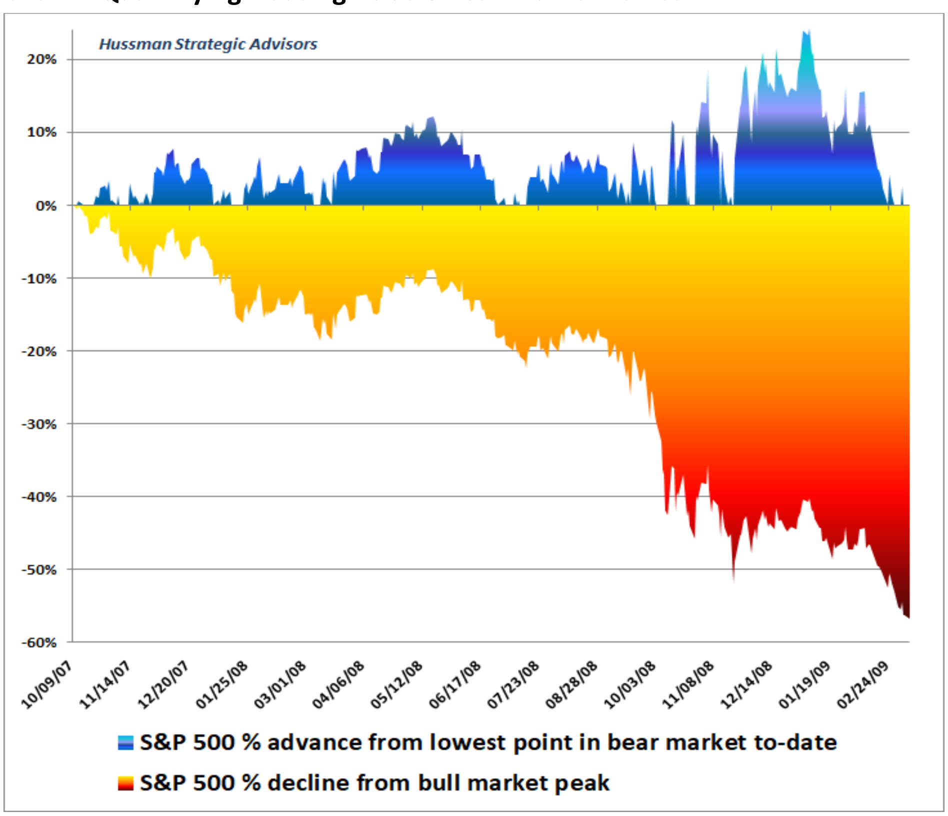
Source: John Hussman

Chart – Quantifying Tech Bubble Bear Market Rallies



Source: John Hussman

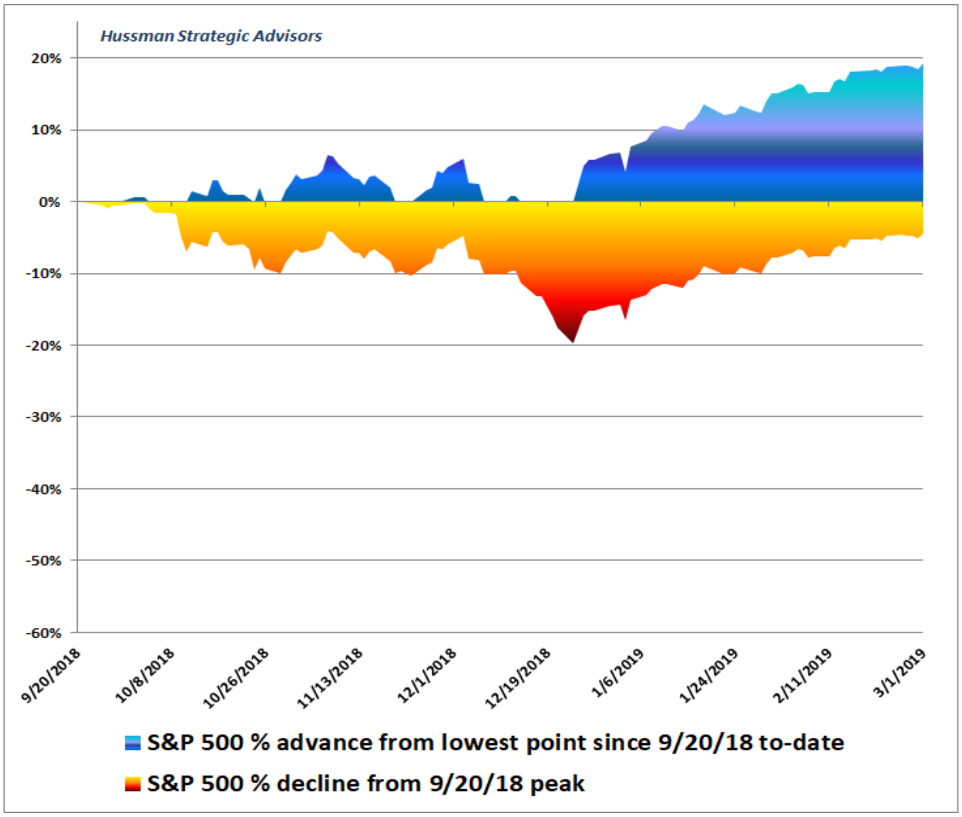
Chart – Quantifying Housing Bubble Bear Market Rallies



Source: John Hussman

Chart – Present Day Drawdown and Rally

The rally off the lows isn't unusual in terms of magnitude or duration, but it looks more persistent and steadier than the other examples. That's likely fueling the abrupt shift in investor psychology back to enthusiasm, as most investors are already concluding that what we have experienced was a correction, and it's in the rear-view mirror.



Source: John Hussman

Thanks for reading.

Mark

Company Purpose

To positively alter the course of others' lives.