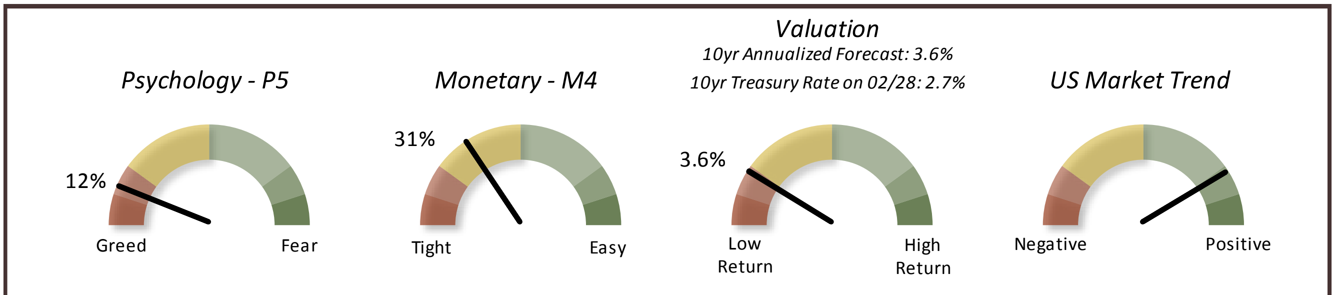
Cypress Market Outlook

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*

Psychology

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

Valuation

Components	Level
10Yr Annl Equity Return Forecast	3.6%
10Yr Treasury Note Yield	2.7%
5Yr Annl Valueline App Potential Forecast	6.1%

Model Summary

Psychology dropped to the 12th percentile and is knocking on the door of the worst 10% of readings – the decile reserved for the most euphoric market periods. For the first time in quite some time, the bank sentiment category has dropped into negative territory, which in this case is more of a clue that the economy has been slowing rather than investor enthusiasm for stocks. Consumer Confidence and fund flow data have also weighed down the composite over the last four weeks. This extreme is coming as we are within a few weeks of wrapping up the most seasonally strong November to April period of the election cycle.

The monetary composite improved modestly this week on decreases in corporate bond yields; however, the big news this week on the monetary front was the yield curve inversion. It's also the curve that has traditionally been our preferred method for measuring the curve – the 10Yr Note minus the T-Bill yield. This is the third yield curve inversion of my career, and this is the third time I've witnessed some incredible displays of analytical gymnastics to dismiss it.

When the yield curve is steep, market pros like to use it to as evidence for their bullish position, and all things equal, we'd agree there. When it inverts, gurus come up with some feats of data mining, smart turns of a phrase or narratives on why its outdated, why despite its incredible track record across a range of economies for as long as we've had financial markets that it doesn't matter this time. Most are intelligent, compelling pieces of work, and while we agree that it's good to question and poke holes in one's beliefs and framework, it's also consistent that advice givers have a strong tendency to use tools like this when it fits the narrative but to find reasons to dismiss it when it doesn't.

There is nothing magical about the yield curve inverting. The act itself doesn't cause anything, and it doesn't mean that markets will implode tomorrow. It's also not too helpful to draw lines on some level of inversion or shallow curve to say that's the only time an investor should have concern. The yield curve is simply a signpost – of where we are in the cycle.

> *"Invariably, investors who disregard where they stand in cycles are bound to suffer serious consequences" - Howard Marks*[i]

Yield curves invert in economies that have been running too hot, where markets are overvalued, and over-confident investors are all in on risk and growth. The impulse is to dismiss it, because it challenges the prevailing economic narrative and often occurs before we're ready, when we think a cycle still has room to accelerate or power through. Overconfidence only becomes self-evident to us in hindsight. It's more than coincidence that Lyft's IPO, the biggest money losing IPO in history in terms of earnings, is occurring the same week that the yield curve has inverted. The bottom line is that yield curves invert in markets where the chance of a bear market is higher than normal.

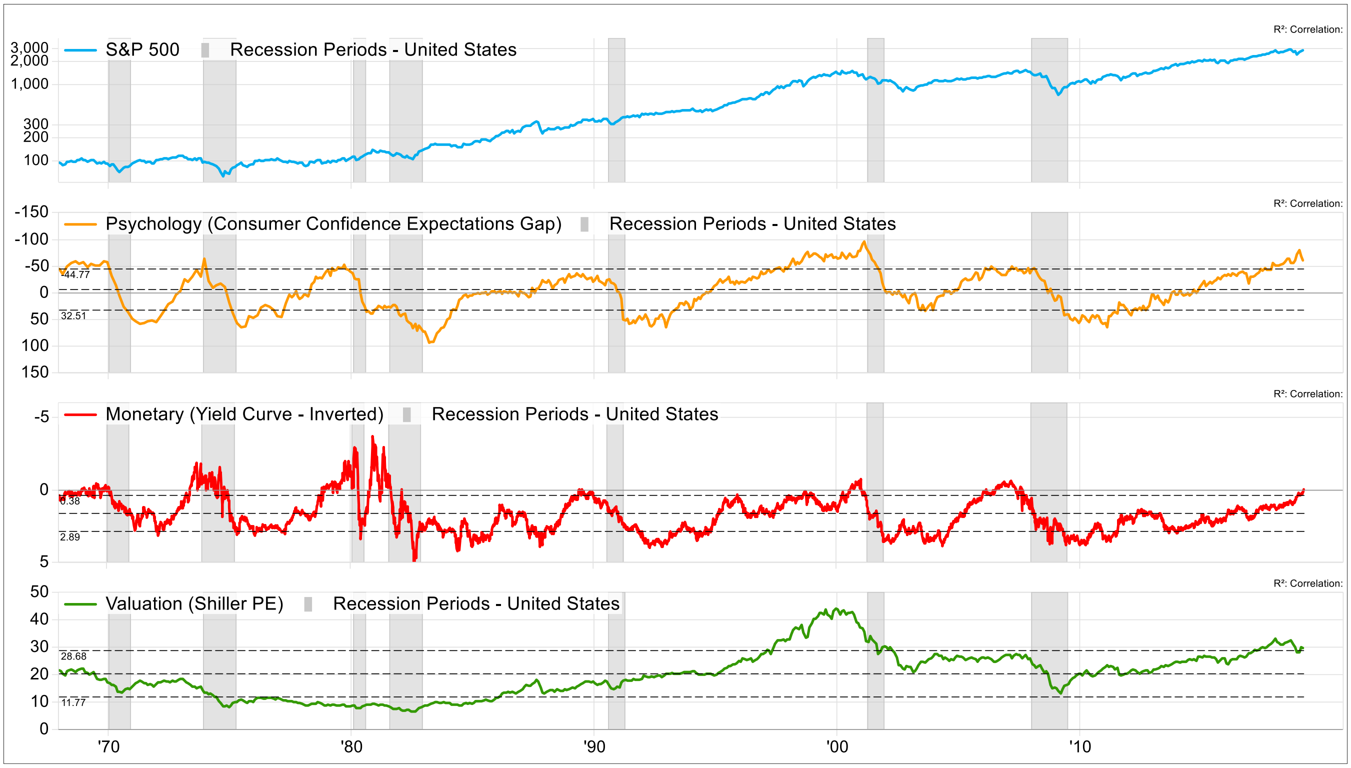
Unfortunately, the incentives for prognosticators are built to make all or nothing, bold calls. There's comfort in being part of the crowd, and there are rewards for gurus who make claims boldly. It's a game of garnering attention, and there is little repercussion for making calls that encourage taking too much risk. This causes many opinions that dismiss signs of elevated risk. While it's great when that advice encourages investors to stick to an investment plan during difficult times, at other times that advice can be a dis-service to investors.

Investors don't have to play that game. One great difference is that markets allow you to size your bets. Investors don't have to make a binary decision of being a bear or a bull – there is a range of bets that you can make with your allocation based upon your conviction. With an inversion of the yield curve, valuations and consumer confidence near all-time highs, unemployment at generational lows, doesn't it make sense to follow Howard Mark's advice and regard where we are in the cycle? Doesn't it make sense to exercise some discipline and patience in your allocation to back off the risk taking before investors make a complete mad dash for the exits? We think so.

Charting Trends

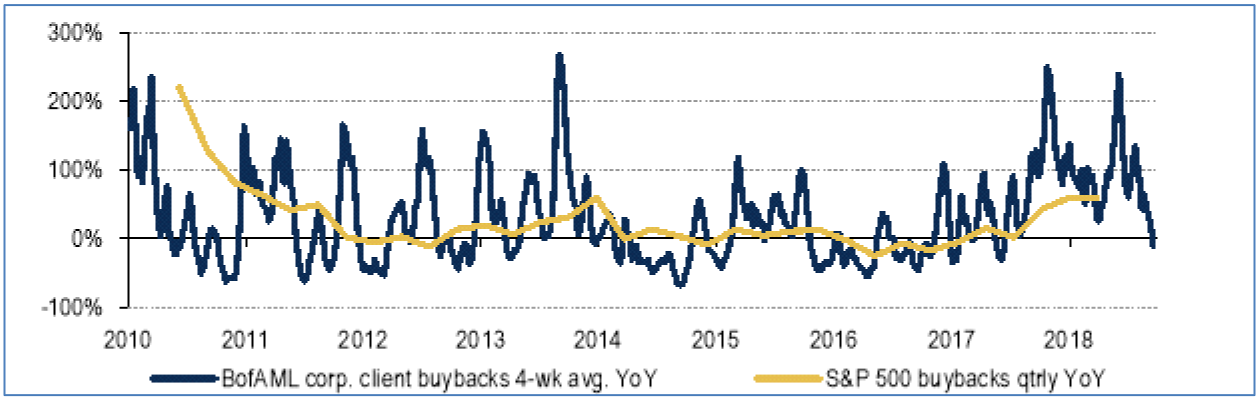
Chart – Regarding Where We Stand in the Cycle

The yield curve, consumer confidence, and PE ratios all give clues.



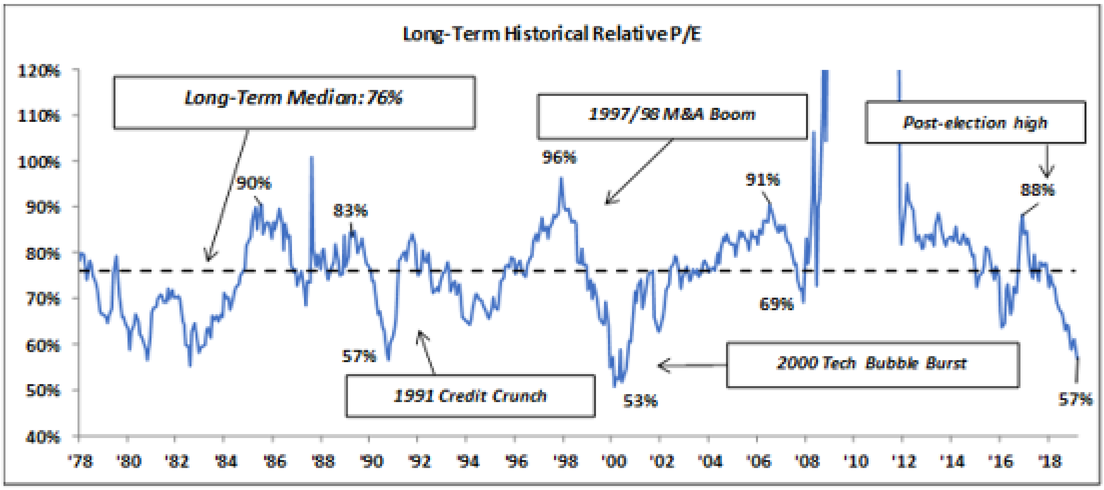
Source: Factset

Chart – The Pace of Buybacks Has Been Slowing



HT: Robin Wigglesworth

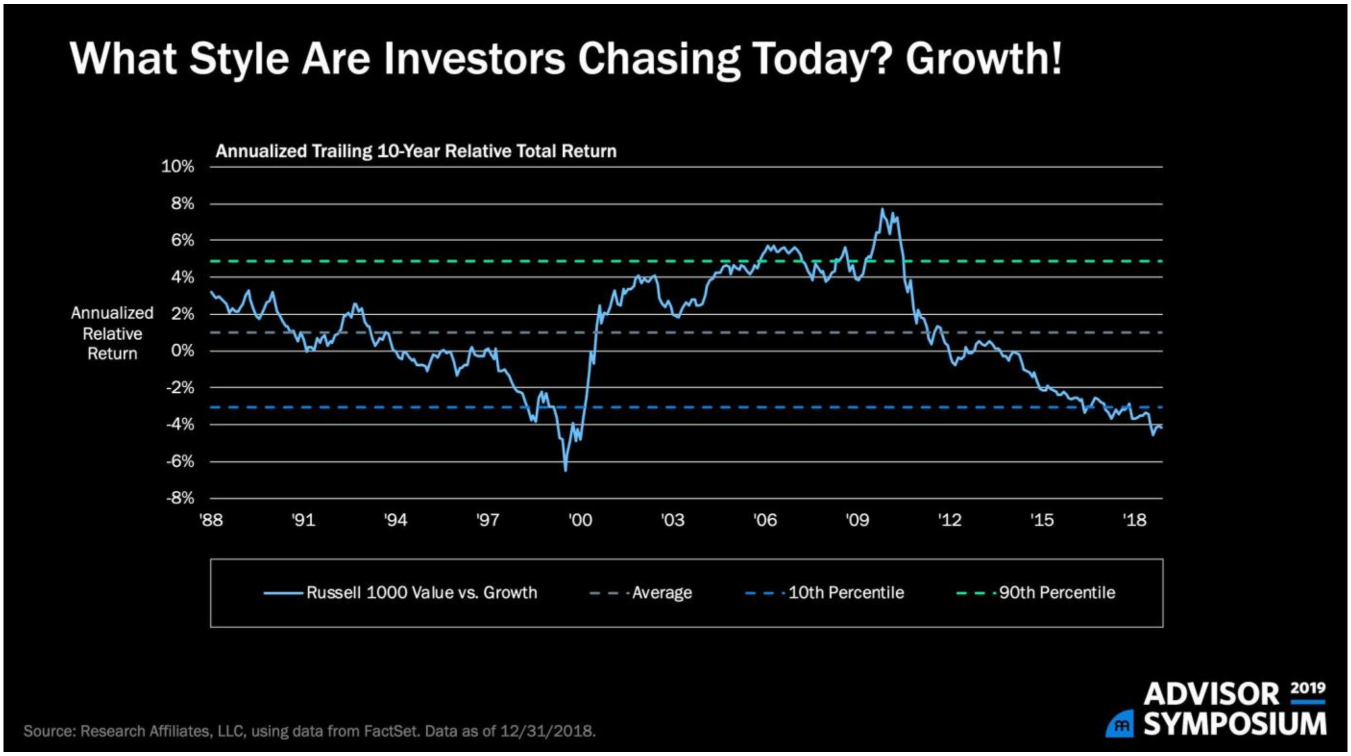
Chart – Dovish Fed Announcement Sent Bank Stocks to Lowest Relative PEs since Tech Bubble Burst



Data based on 17 large cap bank stocks

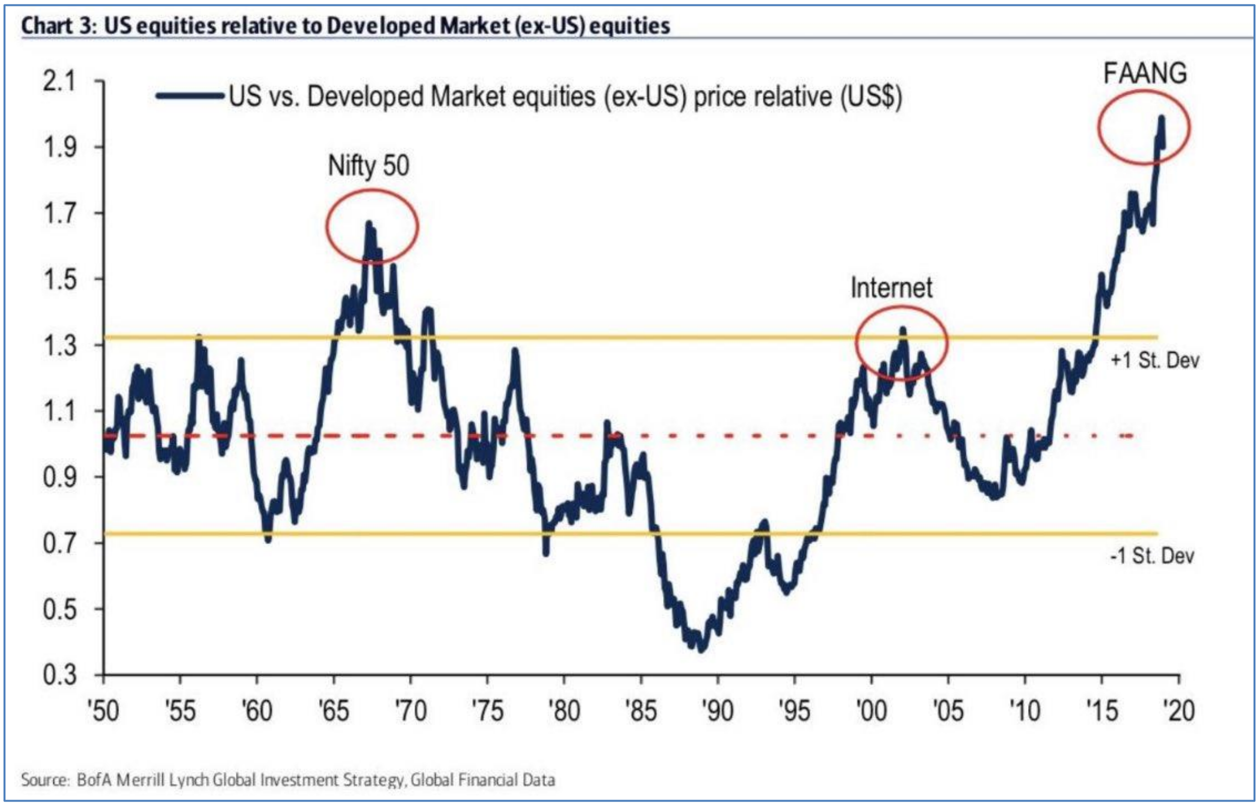
Source: Bernstein

Chart – Value Stocks Worst Stretch of Underperformance since the Dot Com Bubble



HT: Tobias Carlisle

Chart – FAANG Era Propels US vs Intl Performance to Record Levels



HT: Jessie Felder

Chart – Fed Rate Cut Odds Now Exceed 75%

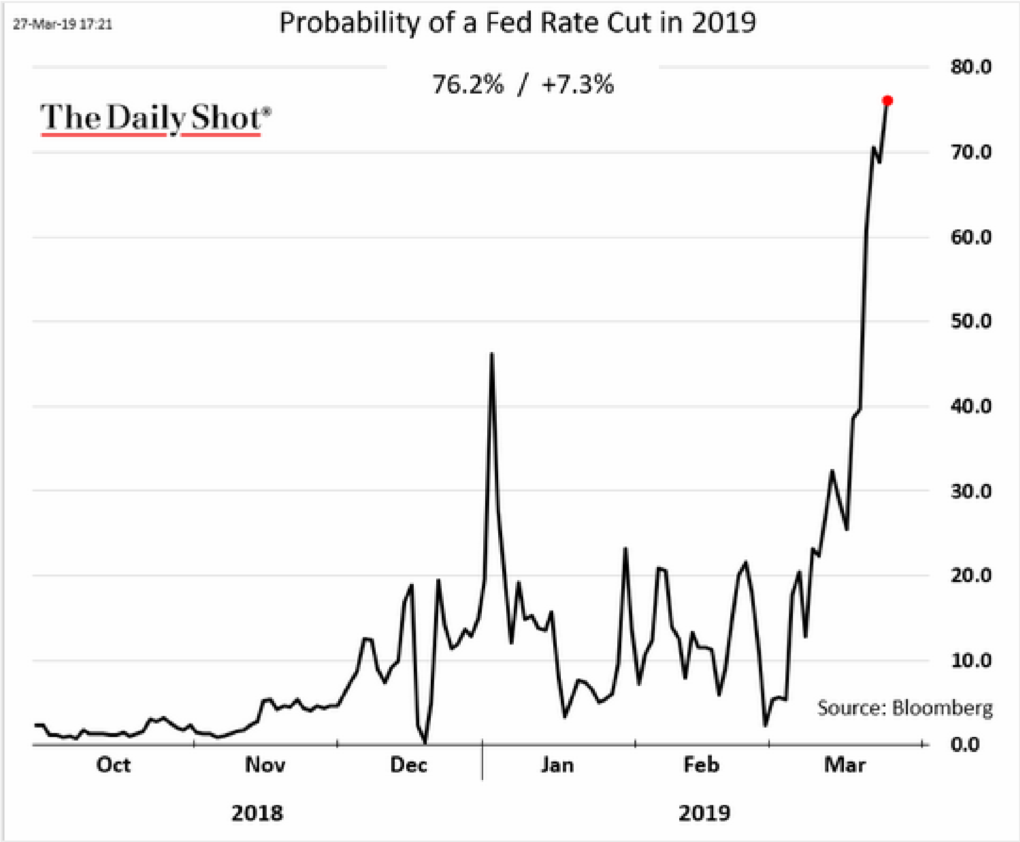
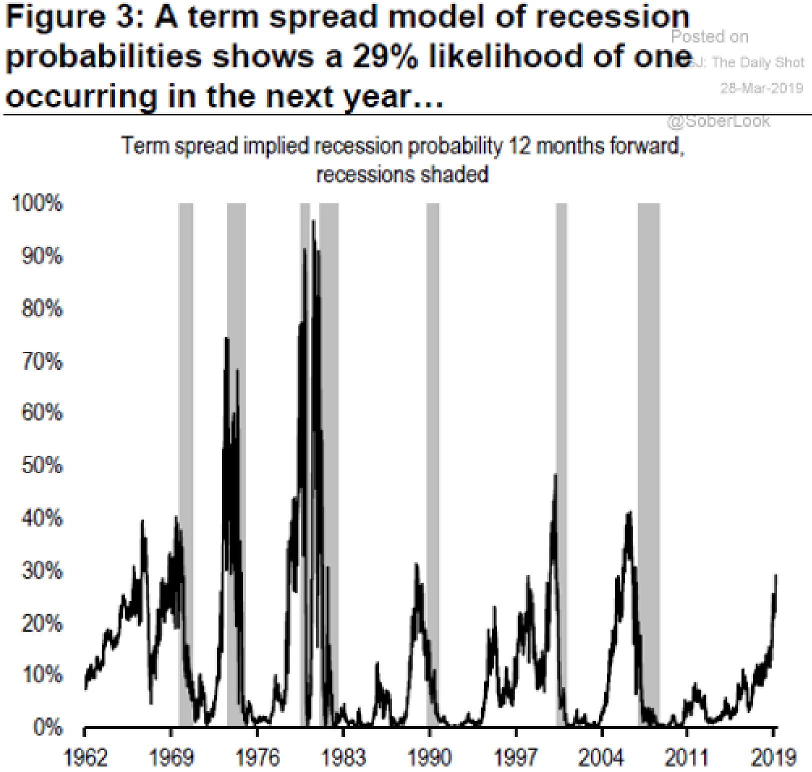


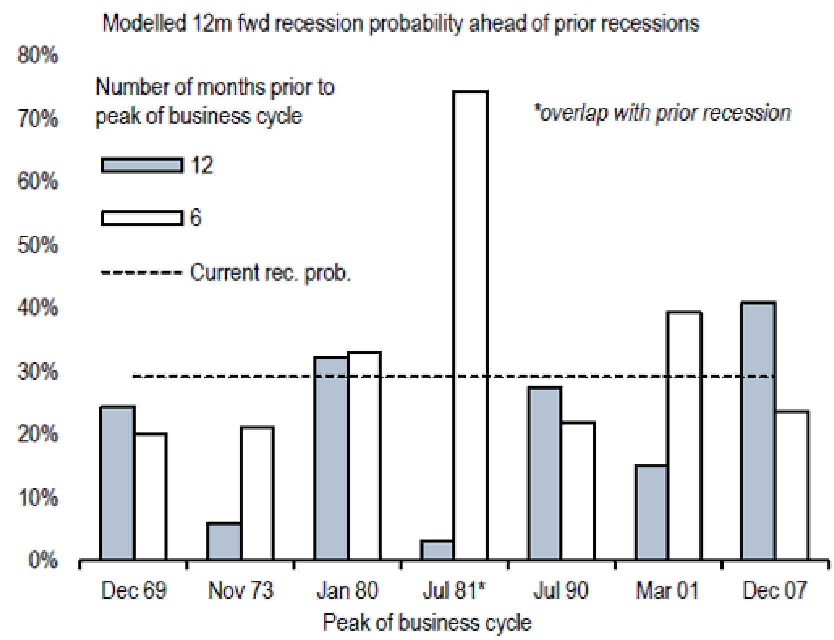
Chart – Yield Curve & Recession Odds

Figure 3: A term spread model of recession probabilities shows a 29% likelihood of one occurring in the next year…



Source: Refinitiv, Credit Suisse research

Figure 4: …this level of probability has seen a recession a year out on 5 out of the last 7 occasions



Source: Refinitiv, Credit Suisse research

Source: WSJ

Thanks for reading.

Mark

Company Purpose

To positively alter the course of others' lives.

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[i] *H/T: John Hussman for the quote*