Market Outlook

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Highlights

The Market Risk Index has had several weeks in a row of modest improvement, almost all due to improvements in investor sentiment. The psychology composite was able to break out of the bottom decile of readings for the first time since April. That move to the bottom decile that we first reported in late April was almost immediately met by a halt in the market's post-Christmas Eve advance.

Readings from the psychology composite still fall in the excessive enthusiasm category, and the short-term improvement we saw in indicators like put/call ratios have abruptly reversed back to neutral territory after the sharp one-week bounce in the large cap stock indices. The AAII survey readings are in excellent shape, but it's survey cousin, the Investor's Intelligence sentiment survey still shows excessive optimism. The best periods for taking more risk in markets based upon sentiment surveys comes when readings from both surveys confirm one another.

Meanwhile on the market breadth front, the High Low Logic index has gone from a minor sell signal to a major one, the same level that we hit back in the fall of 2018. Those readings mean that an unusual number of both new highs and new lows are occurring simultaneously – indicating lack of uniformity in the underlying market. The activity in highs and lows has nailed the market internals and inflection points in risk-taking, while traditional breadth metrics that focus on advancing and declining stocks have given false senses of security for technicians for some time now.

Monetary conditions will continue to be challenging for several months, as the yield curve has moved forcefully into inverted territory this spring. The tightening cycle may have seemed like a mild one given the ending level of interest rates, but the traditional interest rate view completely ignores the unprecedented central bank stimulus we have witnessed this cycle. Viewed through the lens of "shadow rates", which account for the effects of QE, and the picture of this tightening cycle changes to arguably one of the most aggressive ever. The bond market is strongly implying that a Fed rate cut is coming soon, and Treasury bill yields have already fallen 20 basis points below the

Market Risk Index

Elevated

77.1%

Category Percentiles

Psychology

11.5%

Monetary

45.2%

Valuation

5.0%

Trend

87.4%

Biggest Psychology Influences

Option Activity	Positive
Leveraged Investments	Negative
Consumer Confidence	Negative
Technical Indicators	Negative

Biggest Monetary Influences

Change in Interest Rates	Positive
Yield Curve	Negative
Velocity	Negative

Valuation

7-10 Year Rtn Forecast	3.2%
10Yr Treas Yield (on 4/30)	2.5%

Price Trends

US Equities	Positive
Intl Equities	Cautious
REITs	Positive
Commodities	Negative

Fed Funds rate. Unfortunately, the lesson from market history on what happens after the first rate cut at the completion of a Fed tightening cycle in an economy with full employment and an inverted yield curve isn't favorable for bulls.

The market appears particularly vulnerable here. April's non-confirmed highs by the broad-cap weighted indices looks more like a quintessential market topping pattern. Every day without a broader set of new highs becomes problematic for a bull market that has relied mostly on momentum for several months. Investors who prefer a margin of safety in equity investing should feel content to sit with some extra capital on the sidelines.

Chart – High Low Logic Gives Major Sell Signal

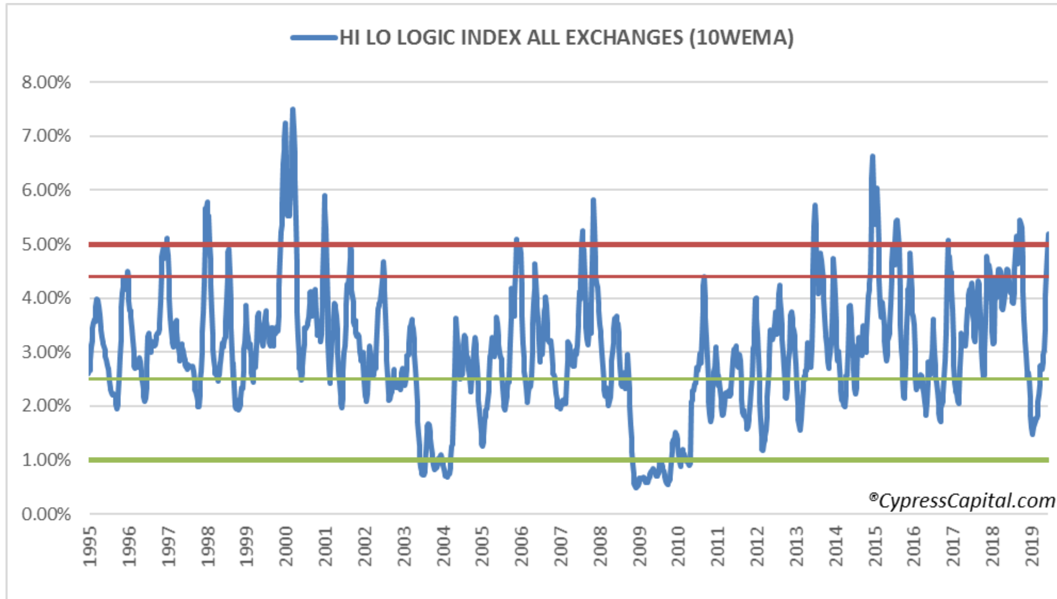
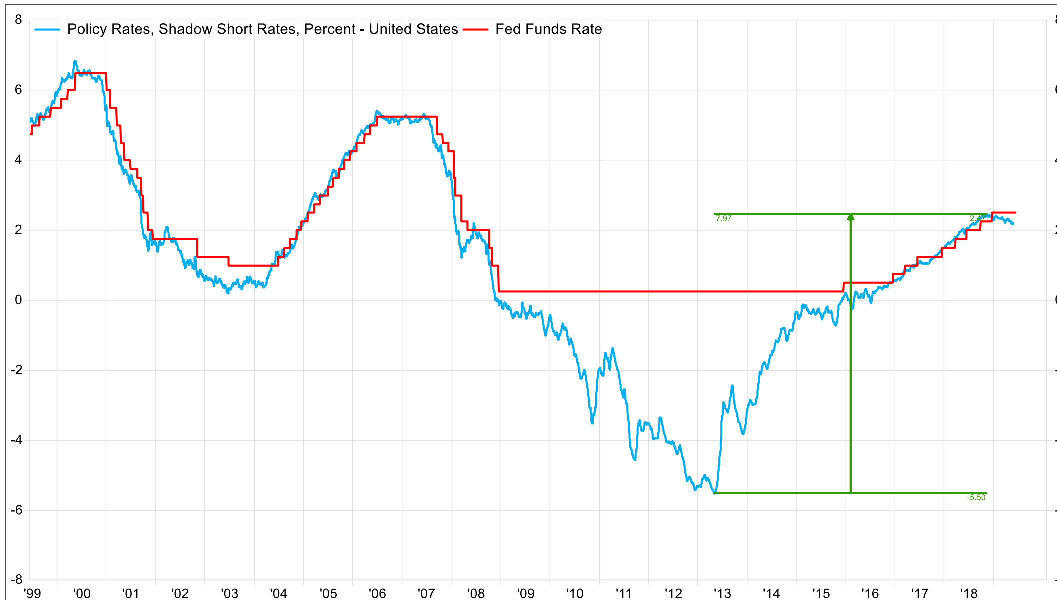


Chart – Shadow Rates Imply Nearly an 800 Basis Point Tightening Cycle



Source: Factset, Bank of New Zealand

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