Market Outlook

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Highlights

Market Risk Index climbed above 80 this week on drops in all three of our counter-cyclical categories. To get above 80 in a market where prices are in an uptrend, it means you have the most pronounced investor enthusiasm for buying overvalued stocks in an economy vulnerable to recession. There are only a handful of market environments in the last fifty years with conditions that manage to score an MRI above 80, and they are a who's who of euphoric markets. In some, the market rolled over immediately. In others, like the 1998-2000 period and today, the euphoria persisted as markets continued to defy economic reality for a time. There is no free lunch, and the further the market moves from the mean, the more painful the reversion.

In 1998-2000, it was a euphoria that built over the Internet. In this one, in addition to a boost from the most monetary intervention in the history of the Fed ever, there's also link between sentiment and politics with Gallup showing a link between high consumer confidence and partisan leanings. The bull market has also been prolonged by a late cycle surge in corporate buybacks as a direct result of the historic corporate tax cut passed in 2017. It's managed to help cap-weighted US equities continue to advance a year and a half after global equities peaked and provided cover for a trade war that has provided a hurdle of uncertainty for global economic growth. The buyback phenomenon is largely a US one, and there's a direct tie to buybacks and a clear deterioration of corporate balance sheets this cycle.

Market Risk Index

Elevated

80.2%

Category Percentiles

Psychology - P5

10.7%

Monetary - M4

38.8%

Valuation - Extremely Overvalued

5.4%

Trend - Positive

94.8%

Biggest Psychology Influences	
Low Volatility	Positive
Leveraged Investments	Negative
Option Activity	Negative
Consumer Confidence	Negative

Biggest Monetary Influences	
Falling Corporate Bond Yields	Positive
Yield Curve	Negative
Velocity	Negative

Valuation	
7-10 Year Rtn Forecast	3.4%
10Yr Treas Yield (on 5/31)	2.1%

Investor psychology has again moved to such extremes that it's likely we will see a breach of the bottom 10% of readings in the next couple of weeks, and with that a likely end to this summer's rally. This week, the sentiment surveys category, which was the category that pinpointed beginning of the summer rally, has flipped back to negative after the Investor's Intelligence survey revealed a spike in bullishness. The spread between bulls and bears on that survey is now around 2 standard deviations above its mean.

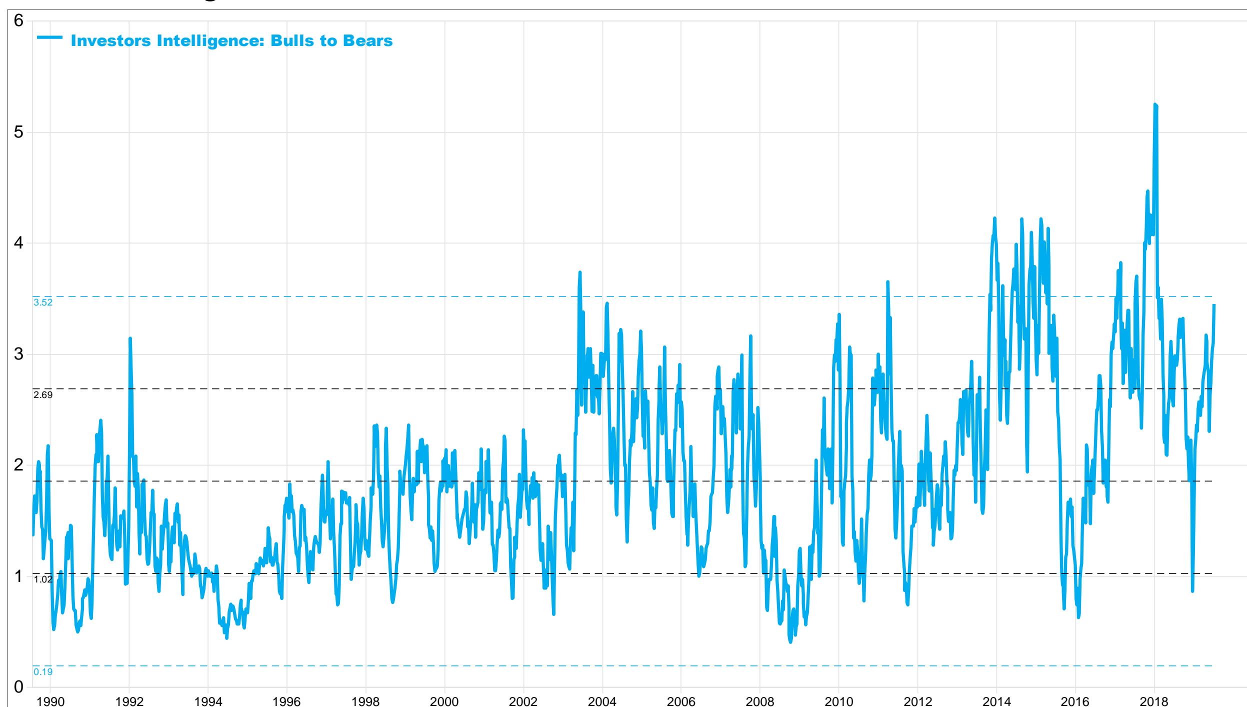
Valuations have dropped back to the 5th percentile. Our scoring here goes back more than 100 years, meaning, this market falls into the worst 5% of valuations in modern US stock market history. What people like to call unpredictable, black swans in markets aren't really that. They become probable, almost predictable events

when viewed through the lens of stock market valuation. Helpful tools for measuring risk in equity markets abound, but they require long term patience and thinking, and investors ignore them when they don't fit their narrative. Investing is supposed to be an exercise in long term thinking, where investors build these long term 30-year financial plans only to make shifts in an out of investments and strategies based upon short term performance and volatility.

On the monetary front, the acceleration in the growth in M2 and MZM monetary aggregates continues, and this is occurring as the inverted yield curve is making initial efforts at re-steepening. These are classic monetary signs of a rollover from a peak in economic enthusiasm. Steepening curves and an acceleration in the growth of money often coincide with shifts to more volatile markets and periods where complacent investors begin to review their previous notions of how much risk they can stomach. We may measure this with lots of time series and statistics, but all of it is a simply a change in the prevailing mood of investors. It means that investors mindsets will soon shift to one whose pre-occupation with participation will soon give way to preservation.

A Fed rate cut this month is a forgone conclusion, a forecast for 2019 that we were reluctant to put in print late last year when that opinion was far from consensus. The challenge for the Fed was to break inflation pressures that were building (they've succeeded here), but without causing late cycle, extreme confidence to roll over. A rate cut this month is about maintaining confidence – maintaining investor confidence that it was OK to bid up stock prices to the worst valuations since 1999. That strikes us as an absurd and impossible task for monetary policy. At best, it's a patch in a leaking dam.

Investor's Intelligence: Bulls to Bears Ratio



Source: Factset

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