Market Outlook

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MRI Highlights - AAII bears surge. Yield curve hits new depths.

Market Risk Index improved but remains above 80 in defensive territory. Psychology edged closer to climbing out of the bottom decile of readings. The market timing associated with these psychology extremes has been good, with each breach of the bottom decile warning of each distinct market peak since 2018 – January and October 2018 as well as May and July 2019. The 2019 summer rally peaked within days of our report highlighting both weakening breadth and the extreme psychology readings. Investor sentiment is tracing out a pattern that is consistent with a long process of topping, sharing most in common with the topping over the 1998-2000 period.

For traders looking for short-term insights from sentiment, the only indicator in our psychology basket to hit an extreme is the AAII survey, and it was substantial. There was a sharp increase in bearishness in that survey – hitting levels that tend to come at or near short term bottoms. The last time that the weekly spread was this wide between the bulls and bears was during the December 2018 decline. In that case, stocks bottomed two weeks later. So far that indicator stands alone. Even put/call ratios have yet to register the same kind of readings we saw back at the June bottom.

We'd caution investors about reading too much into the AAII survey as a measure of the long-term wall of worry. It fluctuates a lot in response to short term market moves. The survey can reach high levels of bearishness early, often, and throughout a bear market. It's better used paired with the AAII's monthly allocation survey to see how individual investors are positioned to gauge the wall of worry. The most recent allocation survey revealed that cash allocations were sitting near all-time lows, and the spread between investor stock and cash allocations suggest complacency. If AAII members are nervous, they are nervous about holding too much in equities. The last time AAII members were this nervous and holding a comparable amount of equities was in May 2007. That presented a very short-lived opportunity, and the sentiment survey would go on to register a comparable bull minus bear spread another eight instances during the 2008 bear market.

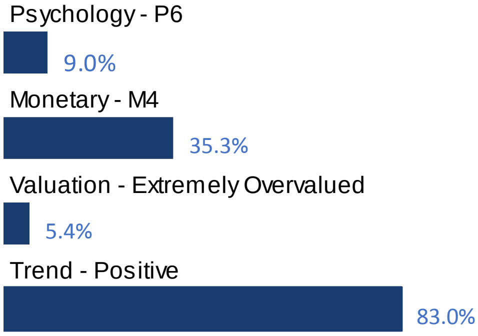
Monetary conditions dropped slightly, as the yield curve inversion reached a new cycle low. The monetary composite continues to be cushioned by falling bond yields and muted inflation pressures,

Market Risk Index

Elevated

83.4%

Category Percentiles



Biggest Psychology Influences

Flow of Funds	Positive
Leveraged Investments	Negative
Investment Surveys	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%

Price Trends

US Equities	Positive
Intl Equities	Cautious
REITs	Positive
Broad Commodities	Negative

Market Risk Index scales from 0 to 100%. Higher readings correspond with higher risk markets. Scores below 25% are bullish. Scores between 25-75% are neutral, and scores above 75% are markets vulnerable to major drawdowns.

notably benign PPI readings and a weak CRB Raw Industrials index. The latter are two-edged swords, because weakness there can also be early recession warnings. The Fed's tightening cycle broke the bourgeoning inflationary trend, but the delicate balancing act is doing so without harming confidence and causing recession.

Both the yield curve and our velocity indicators will be a headwind for markets and the economy going well into 2020. The idea of a mid-cycle adjustment should quickly fade into the rear-view mirror, as this turns into the beginning of an easing cycle. Global central banks have begun an easing cycle with India and then Thailand unexpectedly cutting rates. Philippines and Peru have also lowered rates. China set their official Yuan target slightly above 7 to the US dollar - the weakest level since 2008.

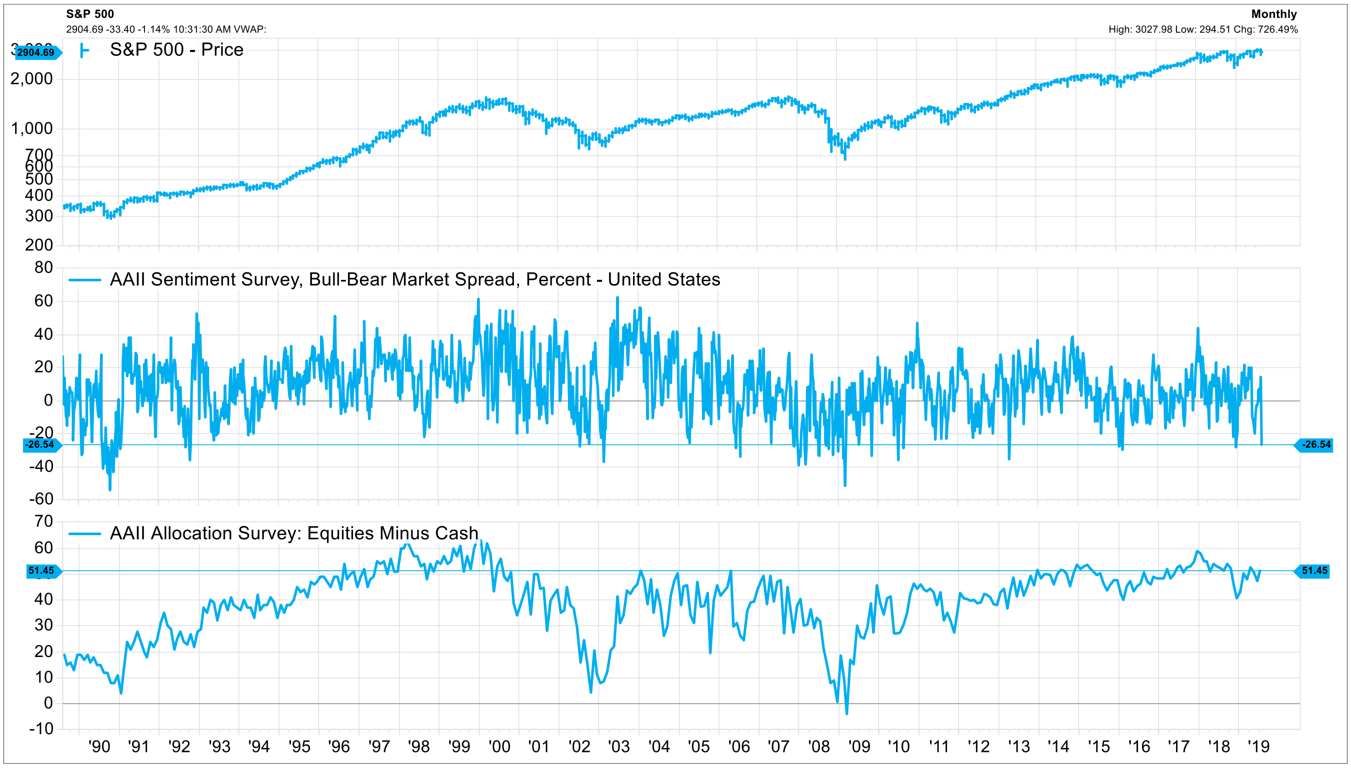
The trade war has had a notable impact on manufacturing and corporate investment, while services (less reliant on trade) have been steadier. Before tariffs were enacted, there was a surge in shipments and stockpiling of inventories as importers sought to avoid tariffs, likely helping to inflate economic growth in the short-term. Corporate investment in stock buybacks hasn't been phased though, as Goldman Sachs reported a surge in activity on its buyback desk during the Monday decline. With over $15 trillion in negative yielding debt in global markets around the world and an ongoing trade war, both the resilience of US equities and the confidence of investors has been impressive. We believe that buybacks have made the difference, but it has come at the expense of corporate balance sheets. Corporate payouts in buybacks and dividends are higher than corporate cash flow, and corporate debt has surged.

Price trends were damaged over the course of the last week, although not enough to harm the Market Risk Index. Big caps are still beautiful from the perspective of the price trend; however, the price trend for small cap stocks is in a downturn. This is the first time the trend for small and large cap stocks have been out of sync since 1999. The balance sheet of the average small cap stock no longer has the firepower to support aggressive buybacks here.

The price trend for broad commodities turned negative this week, but the price trend for gold remains positive. We initiated a position in gold back in June. We also trimmed reduced our position in Long Term Treasuries this week. While our bond momentum gauge is still positive, it has hit overbought levels that have marked a good time to lock in some profits historically more often than not. Overall, our equity allocation remains around 60% of our maximum as MRI suggests the margin of safety offered by equities is too narrow.

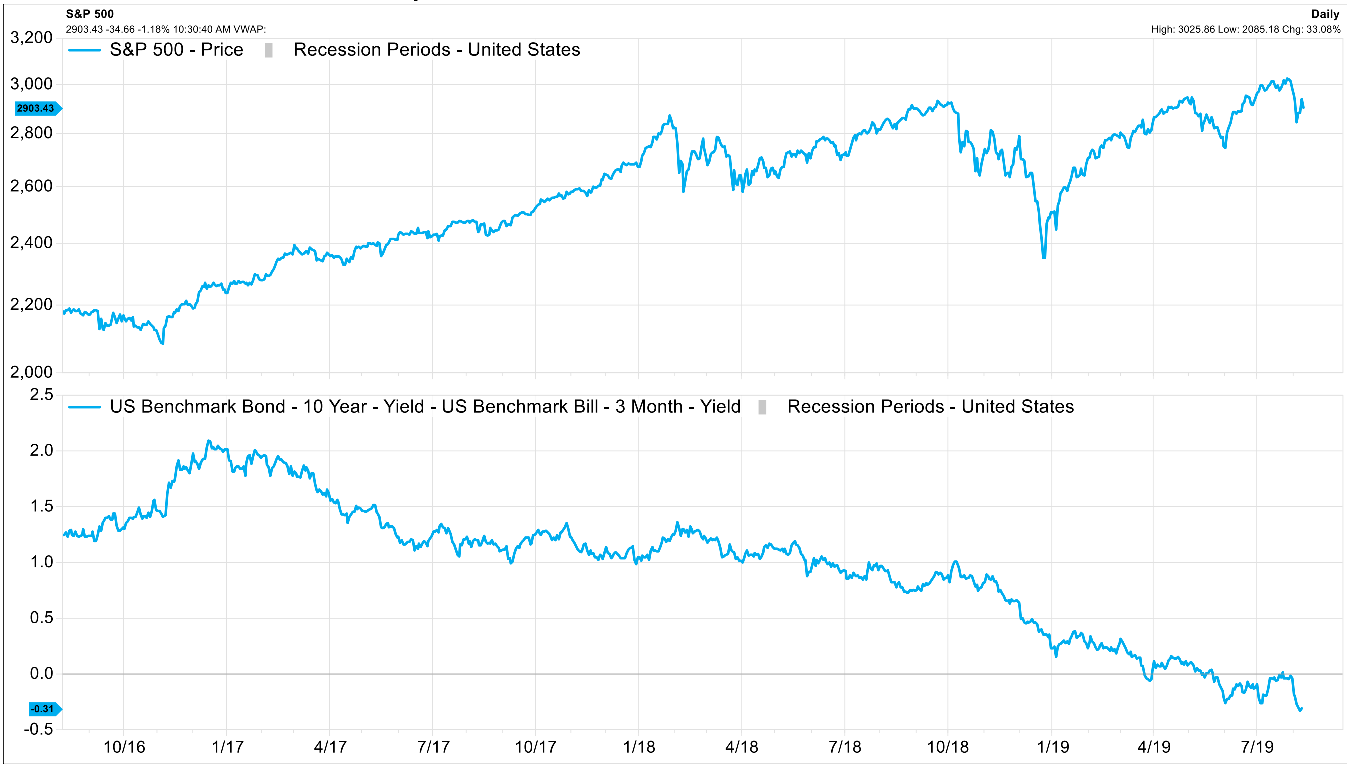
Charts – AAII Sentiment & Allocation Survey

A negative spread between bulls and bears on the AAII survey is rarely this wide, but so is the spread between AAII investor allocations between stocks and cash.



Source: Factset, AAII

Chart – Yield Curve inversion steepens



Source: Factset

Chart – Negative yielding debt surpasses $15 trillion globally

Source: Bloomberg

Chart – S&P 500 payout ratio exceeds 100% of free cash flow