



Market Outlook

By Mark T Dodson, CFA

Highlights

Market Risk Index improved by less than one percent this week. The investor psychology category continues to improve modestly and managed to break out of the bottom decile of readings for the first time since the end of July. Much of the improvement to MRI from psychology was offset by deterioration in both the monetary and valuation categories, as our valuation-based forecast for equity returns has fallen to 3.3% over the next 7-10 years. With little chance of short-term improvement to monetary conditions or valuations, investor psychology needs to make a bigger push to move MRI back into neutral territory.

The improvement in psychology came from additional progress by short-leading sentiment indicators. Put/call ratios have all moved to key levels that mark good short-term market opportunities. Smart money corporate insiders have picked up buying behavior enough to help the psychology scores, and the Surveys category has gone from a strong negative four weeks ago to neutral today. Although the AAll survey softened some this week, bearishness has been elevated among AAll members for the last three weeks. The over-zealousness of stock market gurus, as measured by Investor's Intelligence, has backed off enough to bring the category back to neutral for markets overall.

Uber-high readings in the NYSE Arms index are also helping the psychology composite. One concern internally that mutes the ARMS reading is the High Low Logic index – an index that is based upon weekly stock highs and lows and has done a better job of highlighting non-uniform market internals than traditional advance/decline based statistics. The NYSE High Low Logic index hit an all-time high last week – a troublesome indication for uniformity in a nascent stock market rally.

Both assets chasing leveraged investments and the volatility in small cap stocks are holding the psychology composite back from substantial improvement. Even one of the shorter-term indicators in leveraged investments category, where we track volume flowing into and out of levered and inverse ETFs, has yet to signal much in the way of concern about stock prices.

One thing we are keeping a close eye on is the confidence of CEOs, a pillar of this stock market. The market buoying trend of CEOs (with a case of private equity envy) who lever up balance sheets to buy back stock has been driving US equity prices more so than

Market Risk Index

Elevated

83.5%

Category Percentiles

Psychology - P5

10.6%

Monetary - M4

33.6%

Valuation - Extremely Overvalued

5.2%

Trend - Positive

84.1%

Biggest Psychology Influences

| | |
|-----------------------|----------|
| Option Activity | Positive |
| Leveraged Investments | Negative |
| Consumer Confidence | Negative |
| Volatility | Negative |

Biggest Monetary Influences

| | |
|-------------------------------|----------|
| Falling Corporate Bond Yields | Positive |
| Yield Curve | Negative |
| Velocity | Negative |

Valuation

| | |
|----------------------------|------|
| 7-10 Year Rtn Forecast | 3.3% |
| 10Yr Treas Yield (on 7/31) | 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.

traditional stock investors. Buybacks are arguably the most important element in the continued dominance of big cap US stocks – dominance in a sea of asset classes that saw their peaks anywhere from 11-17 months ago. The drop in the confidence of CEOs this year as a result of uncertainty around US-China trade not only has appeared to have led to a slowdown in capital investment plans, but the post corporate tax-cut surge in buybacks has decelerated to its slowest pace in 18 months.

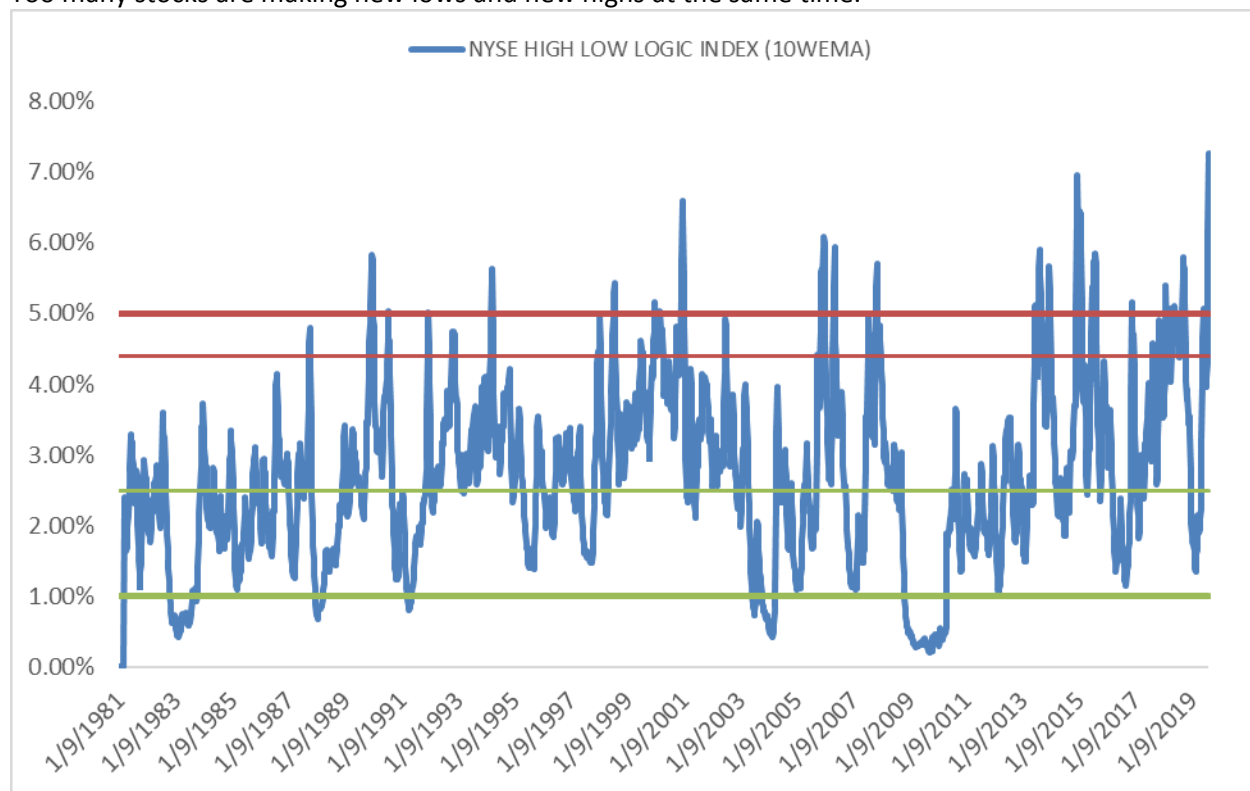
Monetary conditions worsened on a drop in the velocity category, which like the yield curve, is exerting its maximum negative pressure on the composite. The cause of the drop in velocity is a result of the continued acceleration in the short-term growth rate of monetary aggregates like M2 and MZM, which are early warning signs for the economy. This is not from the Fed or a surge in lending. Instead, it's a sign of money beginning to move to the sidelines in an economy that is most vulnerable to a break in confidence.

Price trends are unchanged for the week. US equities are positive overall, but both small cap US equities and international equities are in the cautious phase of a negative trend. Broad commodities are in a defensive phase of a negative trend, while gold is in an uptrend.

Our portfolios will maintain their above average allocations to cash and fixed income so long as the Market Risk Index suggests such a small margin of safety offered by equities.

Chart – NYSE High Low Logic Index reaches all-time high reading

Too many stocks are making new lows and new highs at the same time.



Source: Cypress Capital

Chart – Strength in S&P 500 has been masking underlying deterioration in markets

Economically sensitive commodities, the performance of the average US equity, and international equities all peaked 11-17 month ago.

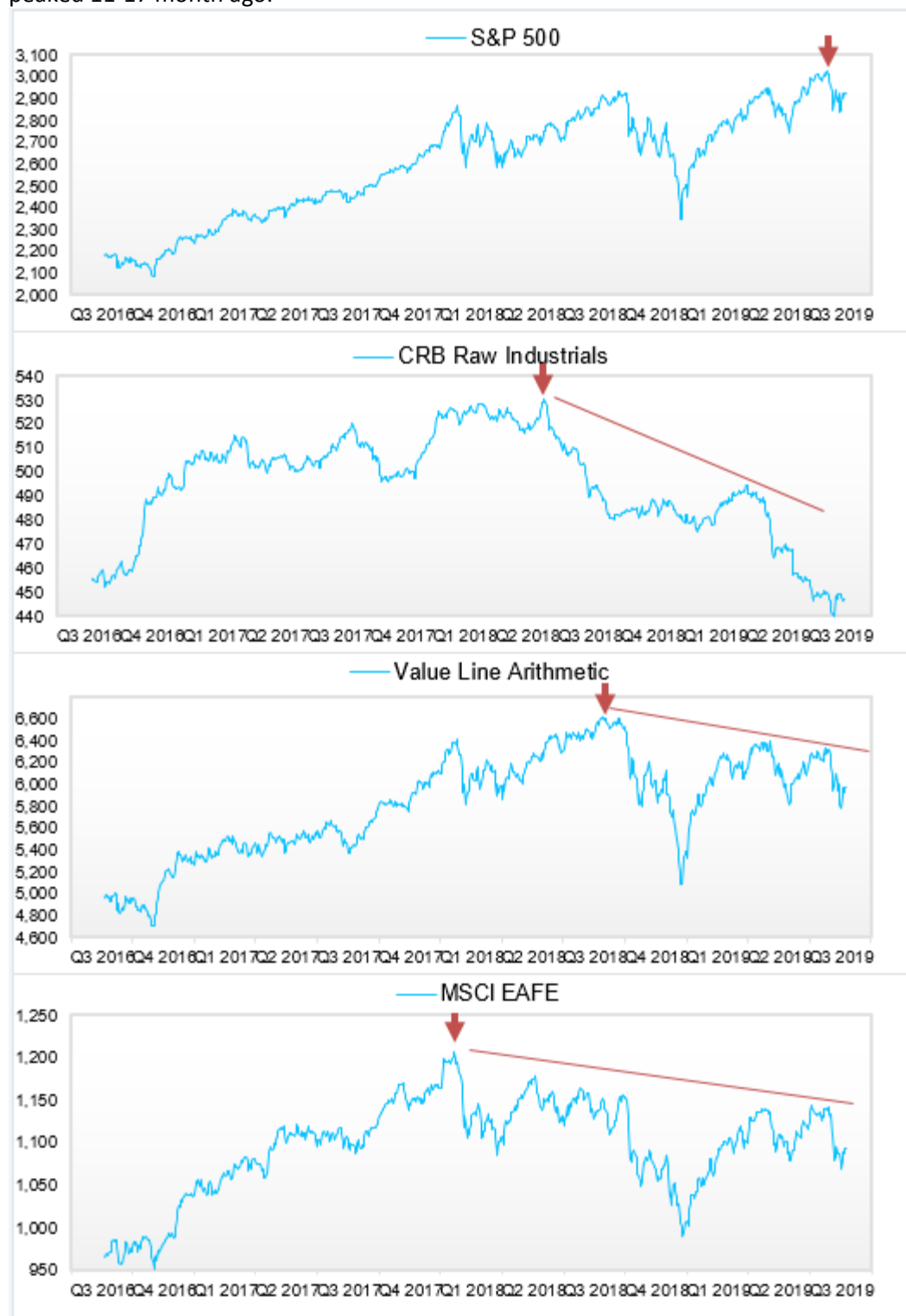
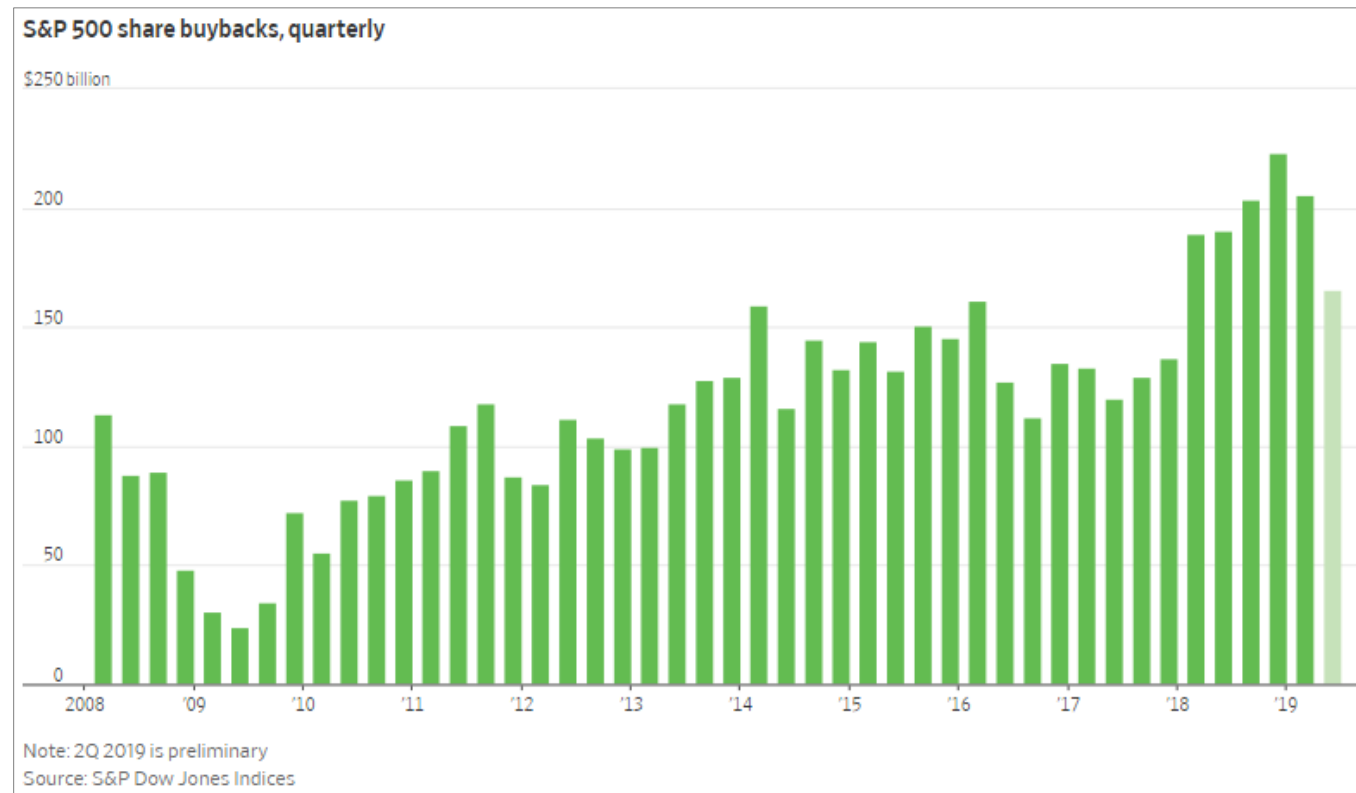


Chart – Corporate tax cut induced buyback surge is beginning to fade

Source: WSJ

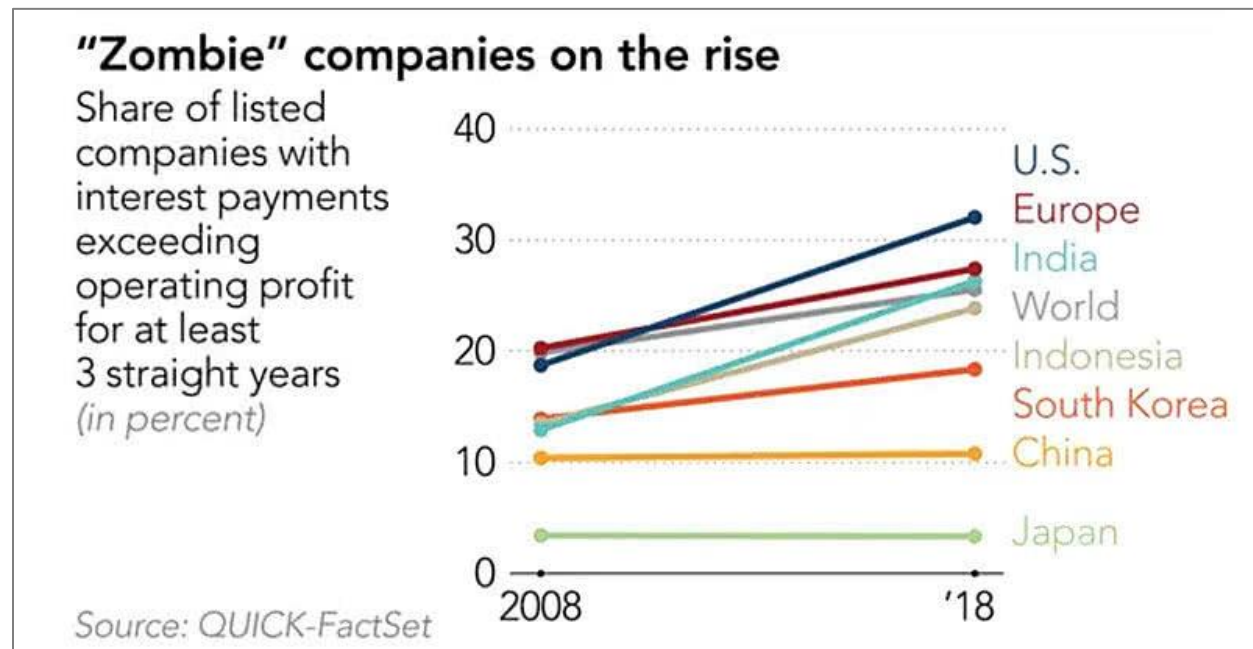
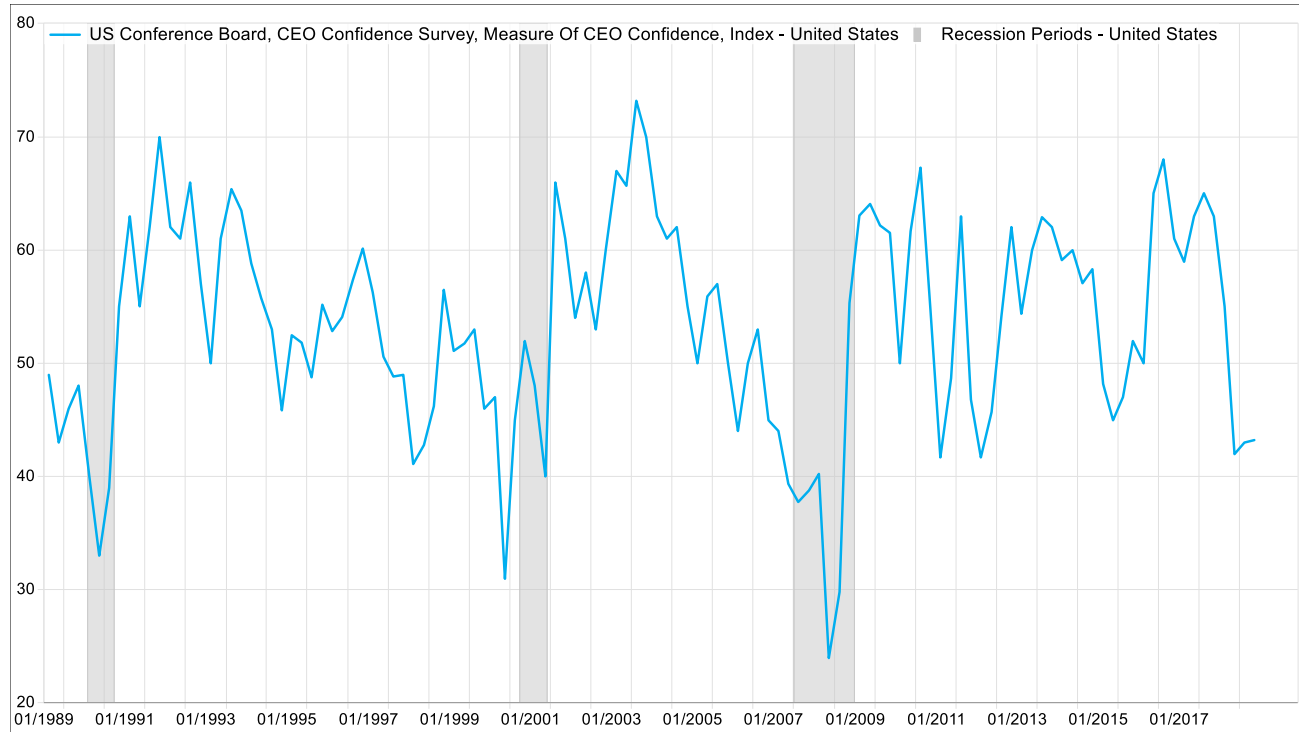
Chart – Buyback binge corresponds to sharp rise in US Zombie companies

Chart - CEO Confidence is waning

Source: Factset

Chart - So is the confidence of CFOs