Market Outlook

By Mark T Dodson, CFA

Highlights

Market Risk Index jumped more than a percent to 87% on deterioration in both the psychology and valuation composites, and we are maintaining a more defensive posture in portfolios. We had to pull a Santa Claus and check the psychology list twice, because we were surprised to see the composite worsen again. Measures of breadth and volatility levels in small and mid-cap stocks were the reasons behind the poor showing from psychology this week. Internally however, there are some psychology indicators beginning to move in the right direction, so we suspect this week to market the worst readings in the composite for now. The Rydex Ratio for example, while still elevated, saw a substantial drop in levered bullish bets relative to bearish ones. The move was enough to move the Leveraged Investments category out of the number one detractor position for investor psychology. The Consumer Confidence category now holds that title.

The other detractor for MRI was valuation. Our valuation-based forward-looking forecast for equity returns has fallen below 3%, which puts valuations in the 95th percentile. This is not the worst level for valuation this cycle, however. That level occurred in January 2018 when the forecast fell below 2% and marked a peak in prices that still holds for global equities. At that time, our forecast had fallen below the yield on 10 Year Treasuries. Today, the expected return is higher than Treasuries, but in absolute terms, loading up on an asset with a 3% expected return and a historical standard deviation of 18% is making a bet that has high probability of a negative outcome and pain along the way. We don't need equities to become undervalued to recommend increases to equity exposure, simply falling out of the worst decile of readings would be a welcome development in this low return environment. It's only in the worst of the worst periods for valuations that it makes sense to take more defensive measures.

Monetary conditions improved some as T-Bill yields have fallen far enough below their 10 month moving average to levels that are historically bullish for stock prices, that is indicating recession. Much of the economic data being released recently has been of the same variety (e.g. Industrial Production and Cass Freight Index declines reported this week), indicative of an economy at risk of recession but with modestly bullish repercussions if recession is avoided. These are headlines and indications of an economy at a crossroads and point to a binary outcome for stocks – either pretty

Market Risk Index

Elevated

87.0%

Category Percentiles

Psychology - P6

94.8%

Monetary - M4

67.6%

Valuation - Extremely Overvalued

95.0%

Trend - Positive

2.0%

Biggest Psychology Influences	
Investment Surveys	Positive
Consumer Confidence	Negative
Leveraged Investments	Negative
Technical Indicators	Negative

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

Valuation	
7-10 Year Rtn Forecast	3.0%
10Yr Treas Yield (on 09/30)	1.7%

Price Trends	
US Equities	Positive
Intl Equities	Cautious
REITs	Positive
Broad Commodities	Cautious

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.

good or very bad. It's encapsulated in the arguments that you hear arguing for mid-cycle adjustments vs recession.

The yield curve and velocity continue to outweigh the more bullish components of our monetary composite based upon shorter term rates of changes in interest rates, as the former categories happen to be better at highlighting the times in the cycle where you should worry more about downside risks than buying the dip. The resilience of big cap US stocks, only a small move away from new highs, emboldens those arguing for growth to re-accelerate, while the ongoing struggle in both international equities and small/mid-cap US stocks to move higher for over a year now is typical end of bull market behavior.

Charting Trends

Chart – Rydex Ratio drops

This is unusual given the backdrop of higher equity prices this week.

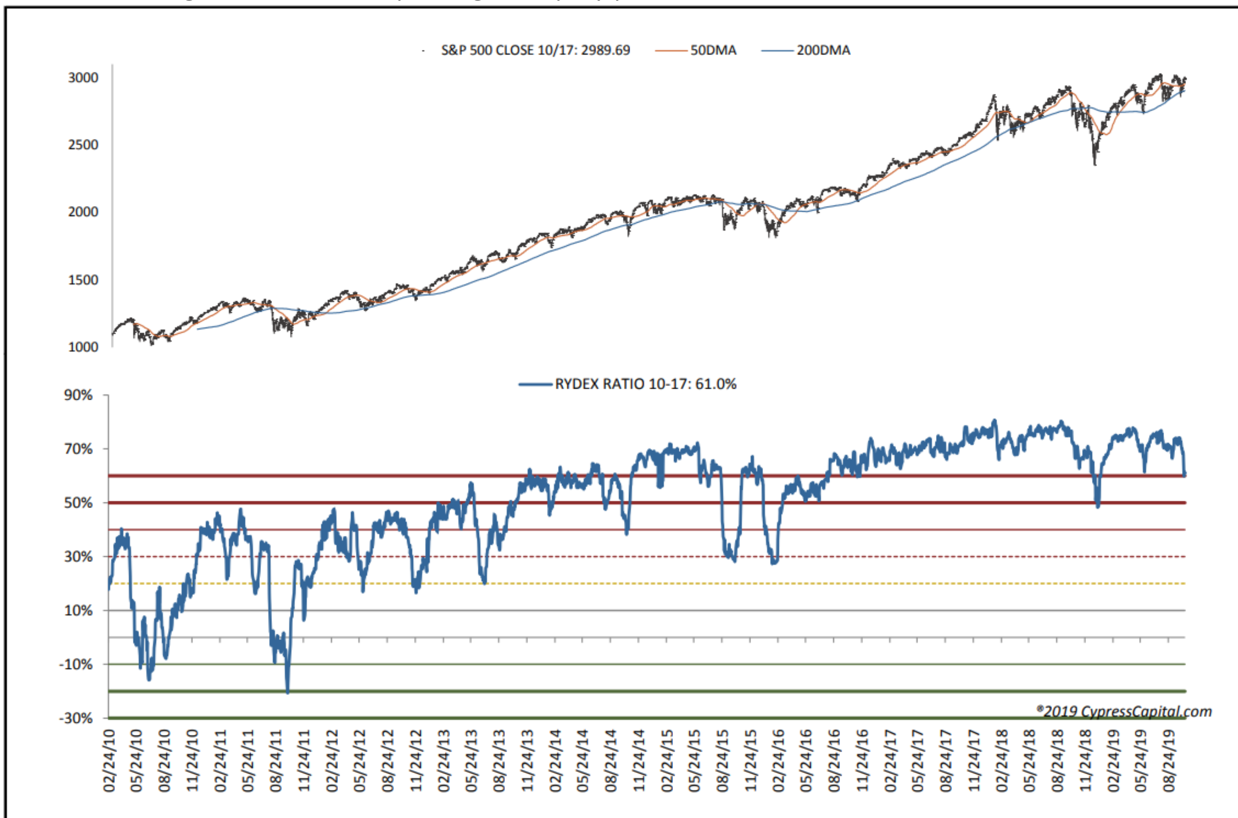
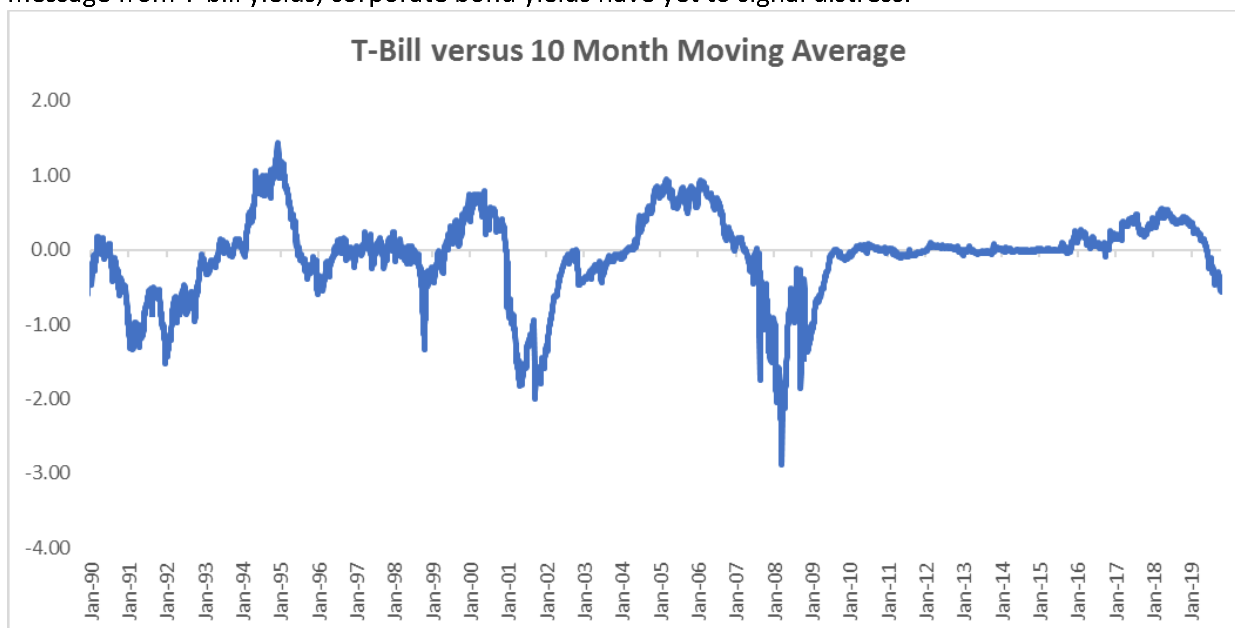


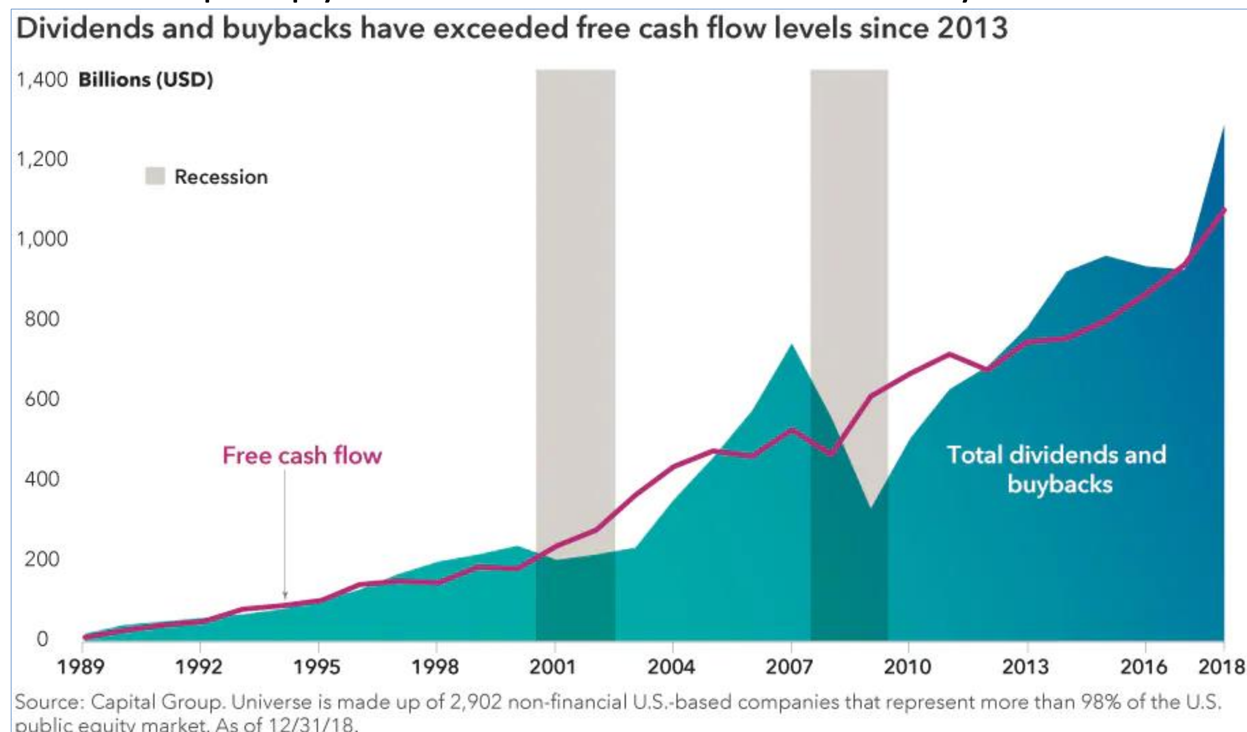
Chart - Treasury bills versus 10 month moving average

Treasury bills have dropped to levels that are bullish, but only if the economy avoids recession. In defense of the message from T-bill yields, corporate bond yields have yet to signal distress.



Source: Cypress Capital, YCharts

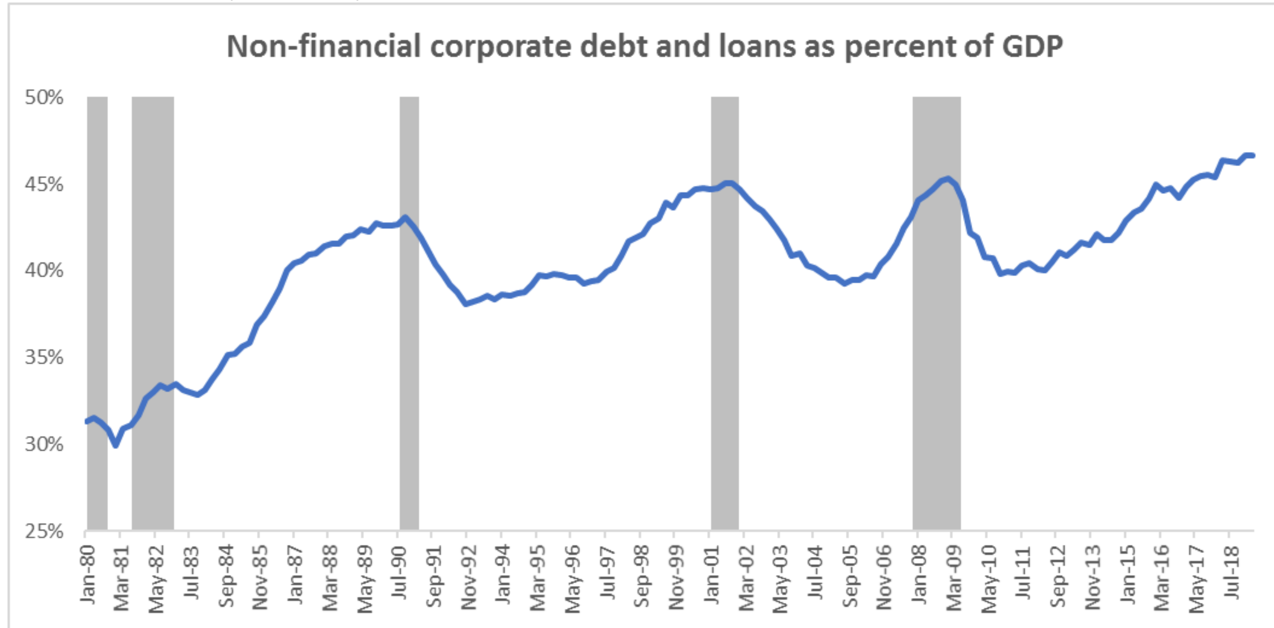
Chart - Total corporate payouts have exceed free cash flow for more than five years



Source: Capital Group. Universe is made up of 2,902 non-financial U.S.-based companies that represent more than 98% of the U.S. public equity market. As of 12/31/18.

Chart – Corporate borrowing is at record highs

Corporate payouts can only exceed cash flows when supported by borrowing, and the boom has pushed corporate borrowing to levels beginning to approach half of US GDP. Corporate borrowing tends to peak when a recession is already underway.



Source: Cypress Capital, St Louis Fed

Chart – Similar to last cycle, corporate payouts have dwarfed capital expenditures

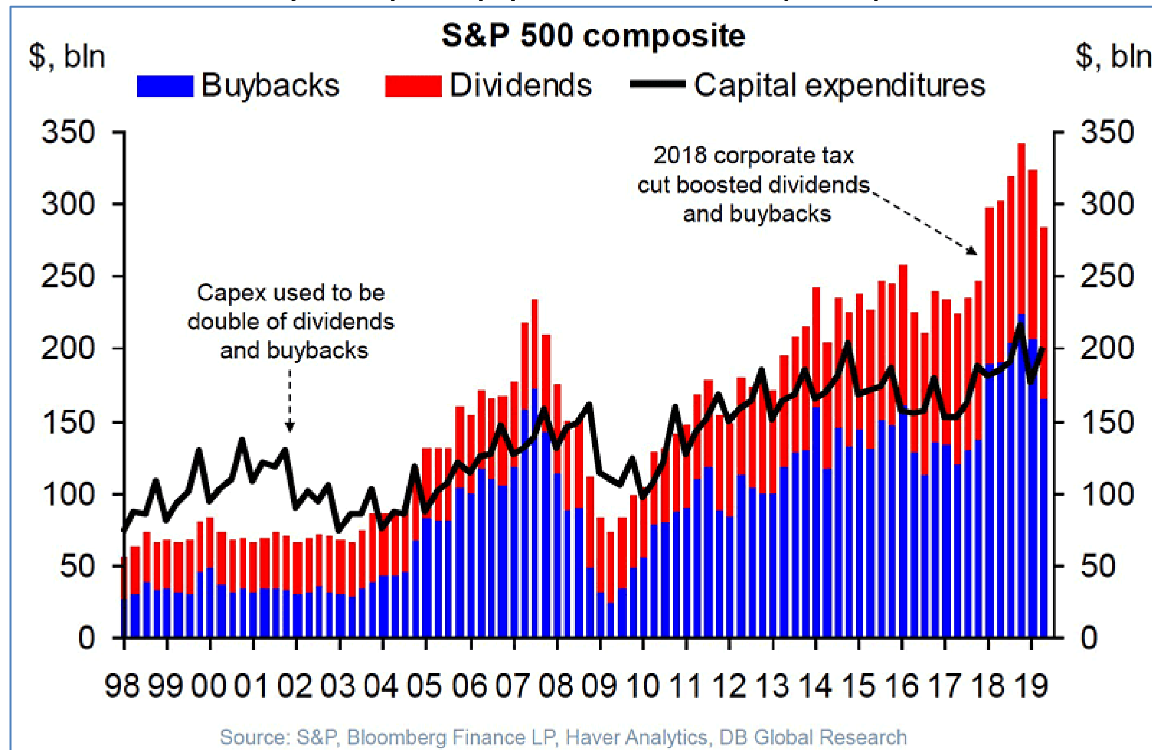
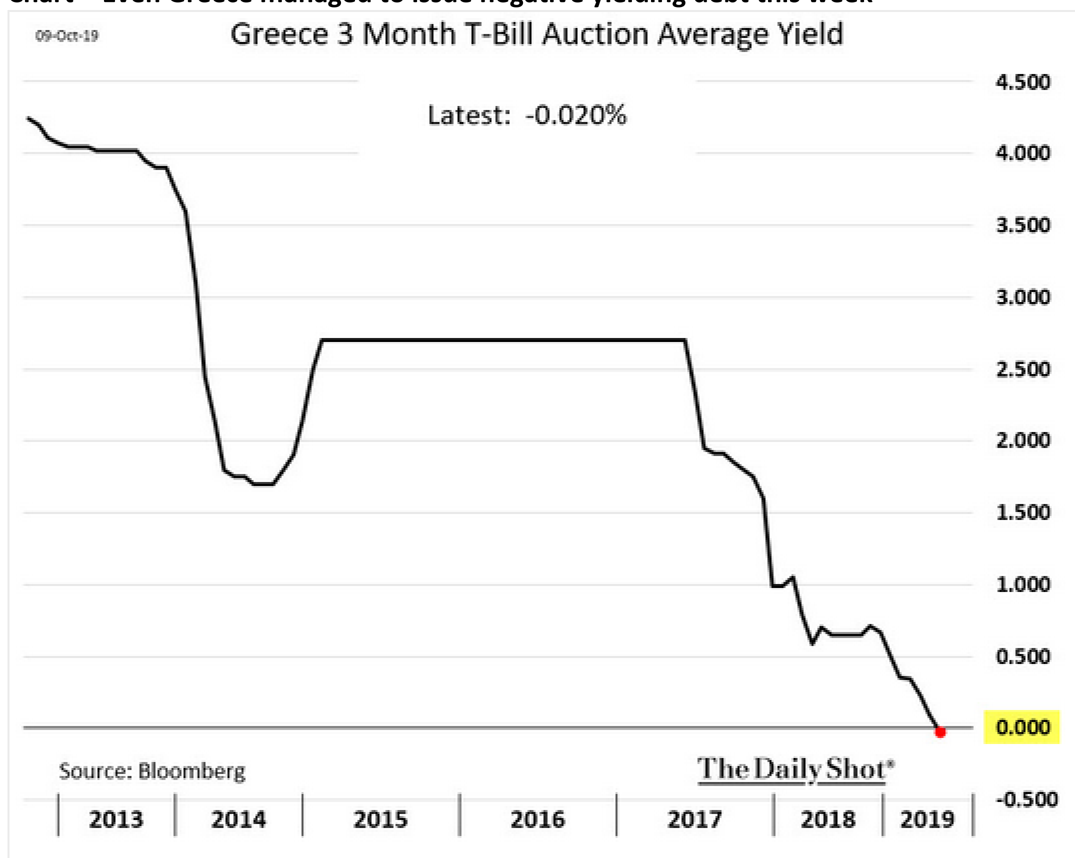


Chart – VC funding of software funding surpassed the dot com bubble

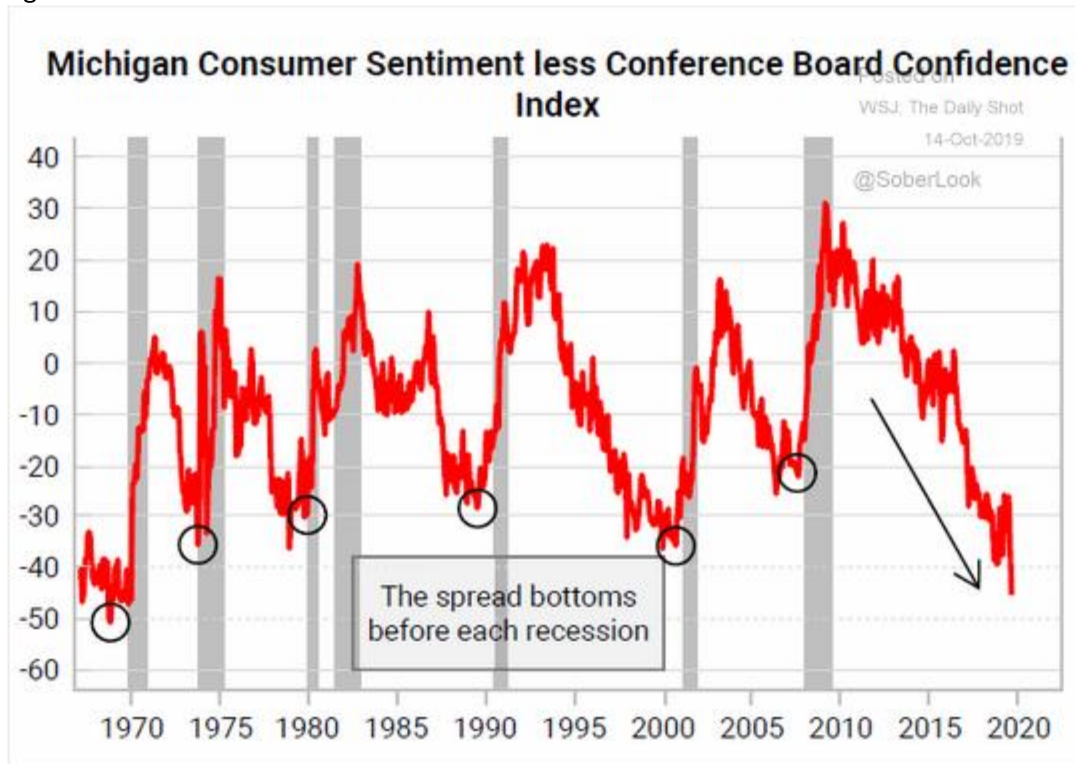
Chart – Even Greece managed to issue negative yielding debt this week



Source: WSJ

Chart – Consumer Confidence spread

The spread between two of the most popular consumer confidence indexes appears to predict recessions. Go figure.



Source: WSJ

Asset Management – Portfolio Lineup

The essence of investment management is the management of risks, not the management of returns.
– Benjamin Graham

Select Dividend – Bottom up risk managed dividend portfolio of up to 40 stocks that can hold cash and fixed income when markets aren't presenting attractive individual equity opportunities. Portfolio built upon Cypress Capital's own metrics that measure dividend quality and safety. The portfolio is divided 75/25 into payers and growers. Payers are stocks with above average yields and a long-term history of paying dividends, where the dividend is perceived to be safe. Growers are companies with high total shareholder yields and perceived to be high quality, franchise companies. The portfolio is generally made up with familiar, household names.

Global Allocation – Multi-asset class portfolio that invests in low cost exchange traded funds across eight asset classes based upon the margin of safety offered by each asset class in an effort to avoid significant drawdowns.

Strategic Income – Disciplined, value biased income portfolio that practices patience in awaiting excellent risk reward opportunities in fixed income. Disciplined in its refusal to reach for yield and put capital at risk of permanent impairment.

Asset Neutral – Absolute return focused multi-asset class portfolio that allocates assets based upon the margin of safety offered in each asset class. Portfolio can go defensive and hold up to 100% cash in some environments.

US Opportunity – Concentrated value portfolio of up to 50 stocks that increases allocations to cash and fixed income when the margin of safety offered by equities is too narrow. Portfolio quantitatively buys the cheapest, highest quality stocks that it can find. Quantitative sell discipline sells individual holdings based on value and momentum factors.

Contact us for more information.