Market Outlook

By Mark T Dodson, CFA

Highlights

Commodities experienced a sharp reversal, causing the trend to turn positive again. Recent strength in copper prices (Dr. Copper) is beginning to suggest economic recovery, and with it a growing likelihood of higher Treasury yields, although the direction of our bond momentum gauge is still positive for longer term Treasuries.

Market Risk Index edged higher again this week, moving up to 89.7%, this time from a move higher in the risk score of our monetary composite. MRI has now been above 75% since late February. This length of time is not unprecedented, and it's associated with run-ups in markets where more severe drawdowns eventually ensued - 1973, 2000, and 2007.

While it hurt the MRI this week, movements in the monetary composite are still marginal from week to week. The most notable developments are occurring on the Fed's balance sheet. The Fed's balance sheet is expanding rapidly (nearly $400 billion in the last three months) as part of their effort to shore up the repo market, and it looks an awful lot like quantitative easing, although that phrase seems to have been retired from the Fed's vocabulary. At first it wasn't impacting the monetary base, as the US Treasury had been simultaneously been increasing its holdings at the Fed. US Treasury deposits at the Fed have started to fall, and now the 6-month growth rate in monetary base has turned positive for the first time since January 2018. We say all that to note that growth in monetary base is an input in our monetary composite, and its upturn will reduce a major headwind for our monetary score should it persist.

The psychology composite saw its daily readings peak internally this week but not before another indicator could hit an extreme. The volume flowing into leveraged ETFs relative to inverse ETFs hit a reading that was in the 90th percentile of readings. The psychology composite has now surpassed 1999 for length of time spent without a dip below the 80th percentile.

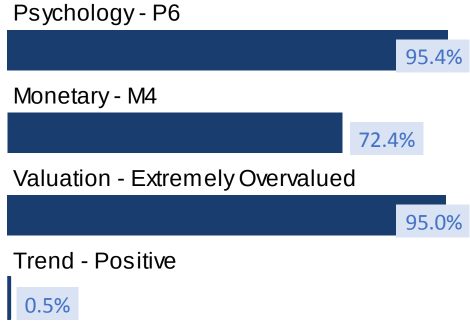
There have been enough momentum and breadth signals to suggest price increases could continue, signals that typically act like a reset on when investors should expect a market peak. However, the current backdrop of psychology and valuation still imply that this is historically one of the riskiest momentum markets to chase. Momentum works, but it's inherently a higher risk strategy. We both prefer and built our process to take full advantage of momentum when markets are undervalued and unloved – momentum markets with better risk-reward setups. This one doesn't fit that bill by a long shot.

Market Risk Index

Elevated

89.7%

Category Percentiles



Biggest Psychology Influences

Flow of Funds	Positive
Leveraged Investments	Negative
Consumer Confidence	Negative
Surveys	Negative

Biggest Monetary Influences

Falling Bond Yields	Positive
Velocity	Negative
Yield Curve	Negative

Valuation

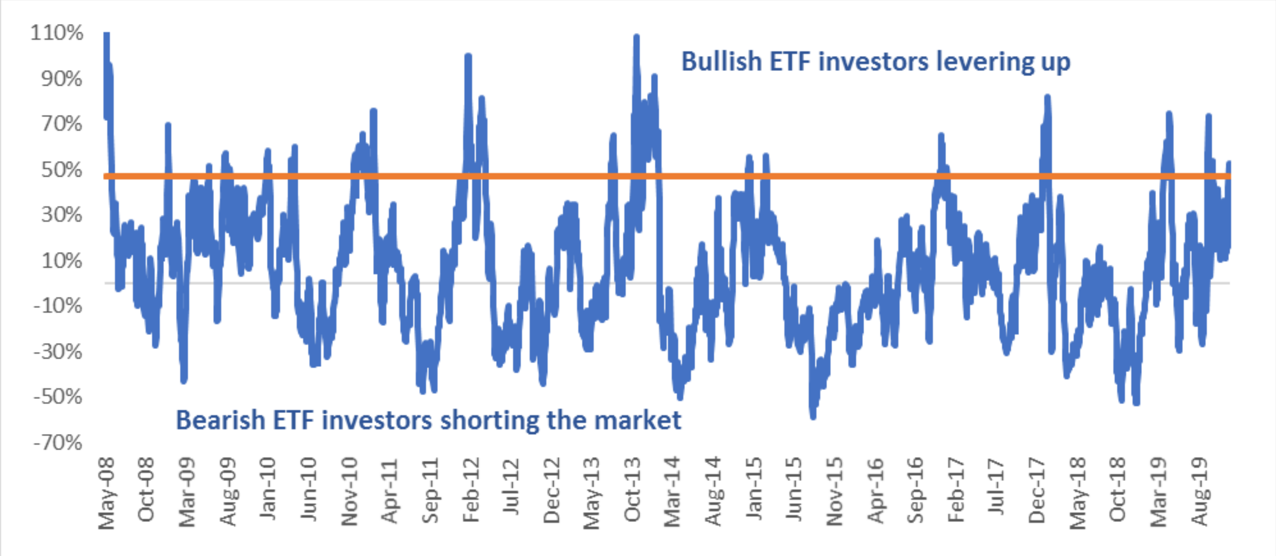
7-10 Year Rtn Forecast	3.0%
10Yr Treas Yield (on 10/31)	1.7%

Price Trends

US Equities	Positive
Intl Equities	Positive
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.

Chart – Geared ETF Investors are Levering Up



Source: Cypress Capital

Chart – Percentage of IPOs with Negative Earnings

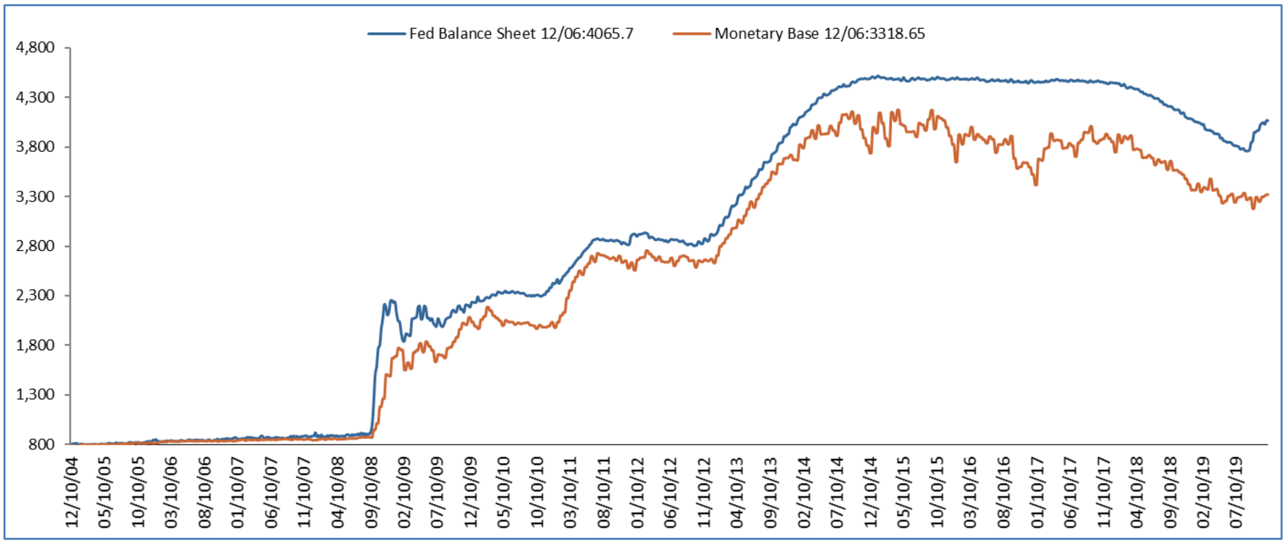
2019 is closing in on a repeat of 2018 for percentage of IPOs with negative earnings. For seven calendar years in a row, 60% or more of IPOs have gone public with negative earnings. The search for growth and returns in our low yield environment has had an unprecedented impact on the quality of companies going public.

Source: Professor Jay R. Ritter, University of Florida, Bloomberg, S&P Dow Jones Indices.
Note: 2019 results are pro-forma as of October 14 and include reported earnings of companies after offer date.

H/T: @LizAnnSonders

Chart – Fed Balance Sheet Expansion

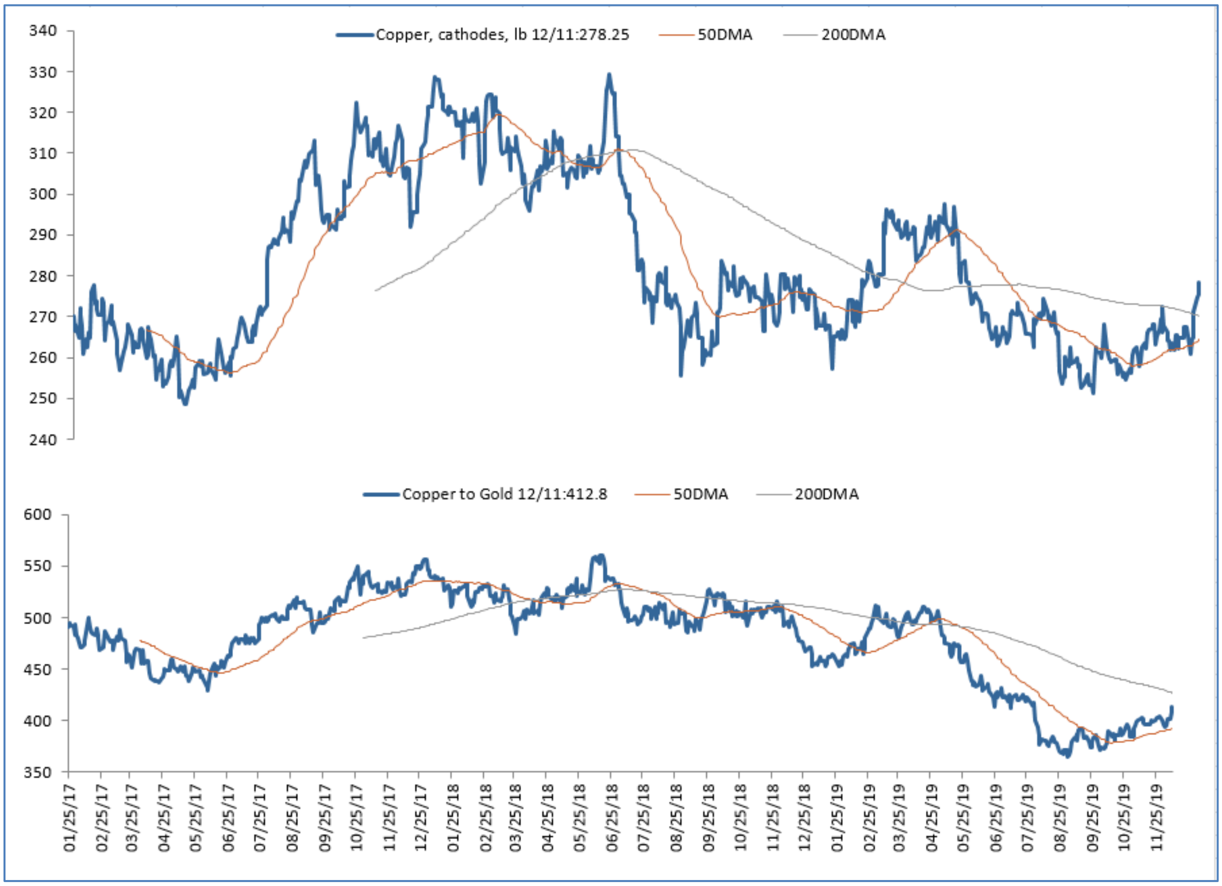
The Fed's intervention in repo markets over the last three months would be described as unparalleled in any other era except this one. Money from that intervention is just now beginning to find its way into monetary base statistics, the aggregate that has the most impact on funds available for banks to lend.



Source: Cypress Capital

Chart – Copper Breakout

While the copper breakout from earlier in 2019 failed, this is the first new sign of economic recovery from Dr. Copper. The boost is coming on the news of easing US-China trade tensions.



Source: Cypress Capital

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.