Market Outlook

By Mark T Dodson, CFA

Highlights

Market Risk Index surpassed the 90th percentile this week on increased risk scores from every counter-cyclical component of our model. We are just shy of the levels reached in January 2018 on the MRI, investor psychology and valuations. Both psychology and valuation score in the worst 5% of readings.

Individual psychology indicators are beginning to make attempts at challenging the peaks in euphoria made in January 2018 - some are likely to breach that level before the end of the year. Rydex Ratio is a rounding error away from a new high. Bullishness from the AAII survey broke out and the spread between bulls and bears is also the highest since early in 2018.

The run up in prices and valuations has pushed our equity return forecast down to 2.4%, and at month's end the forecast is likely go below 2% for the first time since January 2018 and come close to pushing the premium an investor can earn over Treasuries into negative territory. If you think valuations in 2000 should be the benchmark for this bull market, Tobin's Q has taken out the 2000 peak valuation, and The Buffett Ratio (Market cap to GDP) is only a 10-15% move away from surpassing the 2000 levels. Shiller CAPE and Price to Peak earnings have quite a way to go, but the gap between NIPA profits and S&P 500 earnings suggests that the E in PE ratios is still vulnerable.

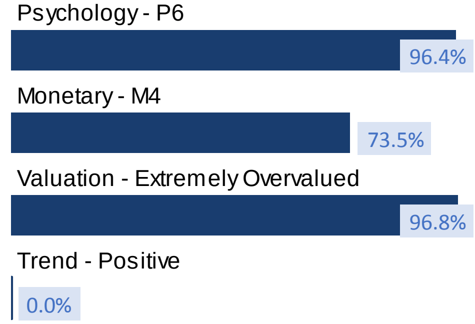
Our monetary score deteriorated as a couple of indicators based upon the rate of change in corporate bond yields went from positive to neutral. It would have had a larger impact than it did, but the velocity category of our monetary model made its first, significant improvement since before the Fed began attempting (and failing) to normalize its balance sheet. The improvement to velocity is a direct result of the $400+ billion dollar infusion of cash from the Fed shore up a shaky repo market. It's not enough to turn velocity positive, because the short term growth in broader monetary aggregates (and the behavior of the yield curve) like M2 and MZM is accelerating with behavior that normally coincides with the early onset of a bear market. However, equity markets are shaking off the implications of any late cycle indicators, and momentum is winning.

Market Risk Index

Elevated

90.9%

Category Percentiles



Biggest Psychology Influences

Flow of Funds	Positive
Leveraged Investments	Negative
Option Activity	Negative
Surveys	Negative

Biggest Monetary Influences

Falling Bond Yields	Positive
Velocity	Negative
Yield Curve	Negative

Valuation

7-10 Year Rtn Forecast	2.4%
10Yr Treas Yield (on 11/30)	1.8%

Price Trends

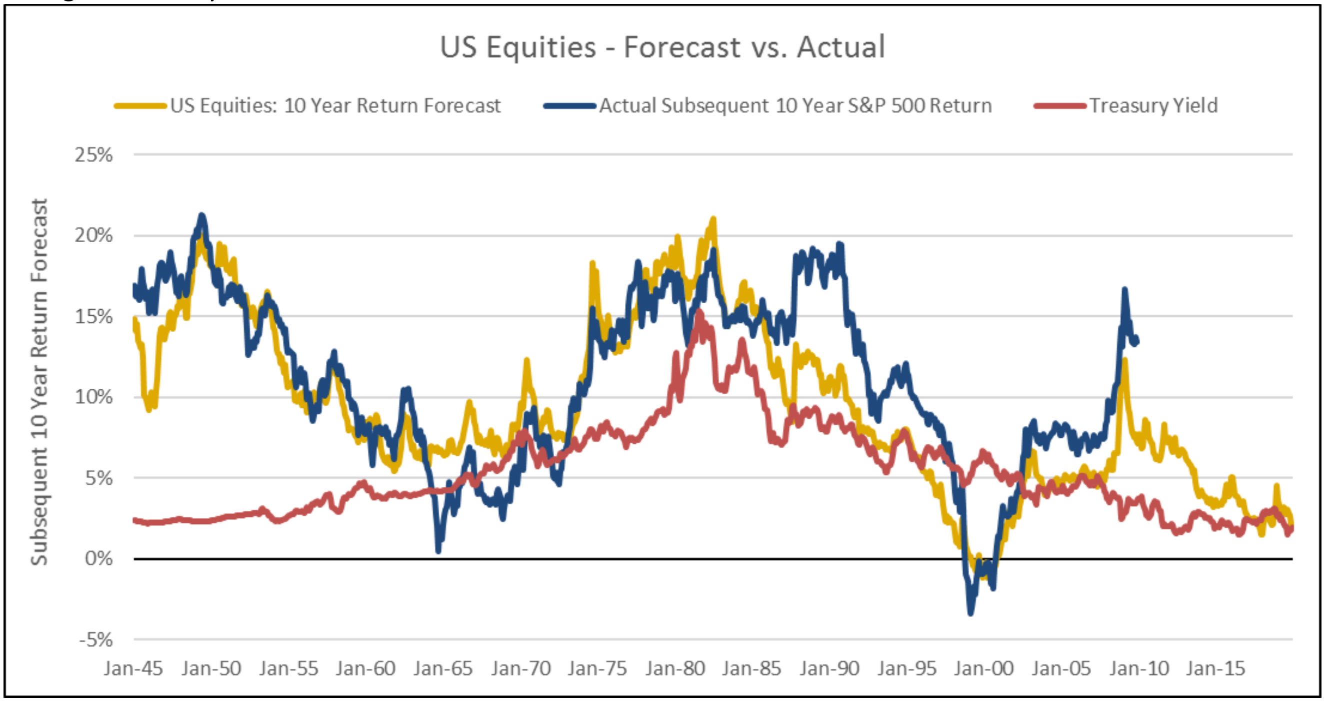
US Equities	Positive
Intl Equities	Positive
REITs	Positive
Broad Commodities	Positive

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.

If investor confidence is peaking again, it's peak confidence in the ability of central banks to lift asset prices. Somewhere in the last 10 years, Milton Friedman's maxim that inflation is always and everywhere a monetary phenomenon came to only apply to asset price inflation. The housing boom, and ultimately its demise, was fueled by the simple rule of thumb that home prices have never gone down. The sway of that narrative was difficult to ignore and proved systemically dangerous. Now, we've replaced it with a story about a simple cause and effect belief in the ability of the growth of central bank balance sheets to result in higher stock prices. Printing money doesn't create real wealth, only the illusion of wealth. Valuations should serve as the ultimate arbiter in how much of a bet to place in a story, whether it's an individual holding or an asset class – behaving otherwise is speculation not investing. Valuation answers the question – how much will I lose if my story is wrong? At the close of 2019, the story about central banks isn't a cheap one – it's a crowded trade.

Chart – Valuations

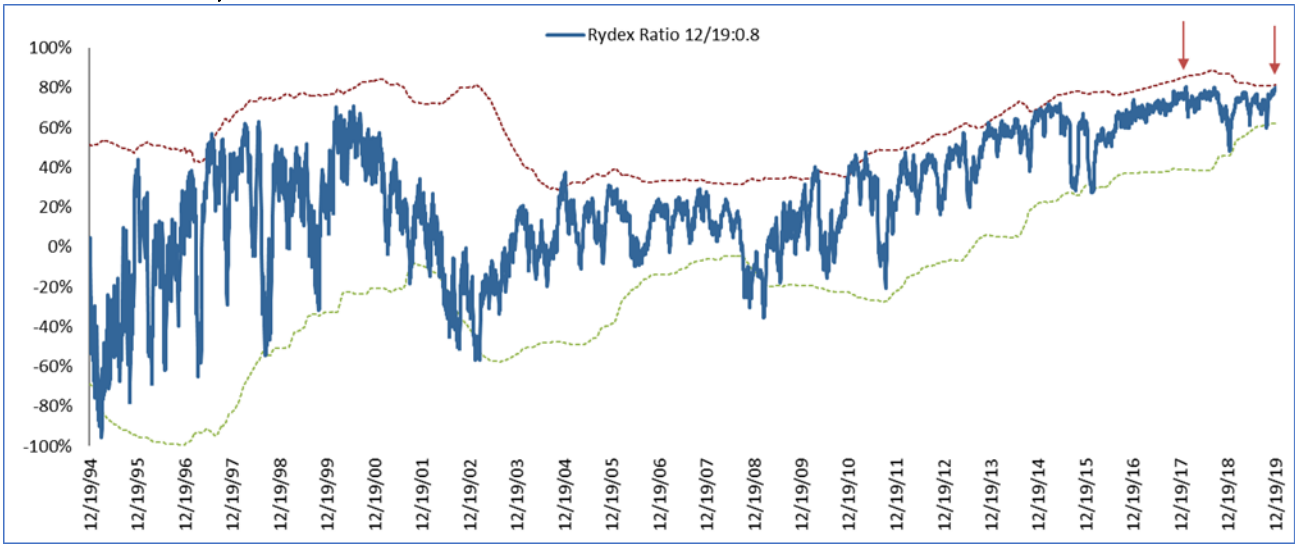
Our forecast for equity returns has grown nearly as thin as it was in January 2018 and is also growing close to falling under the yield on 10 Year US Treasuries.



Source: Cypress Capital

Chart – Rydex Ratio

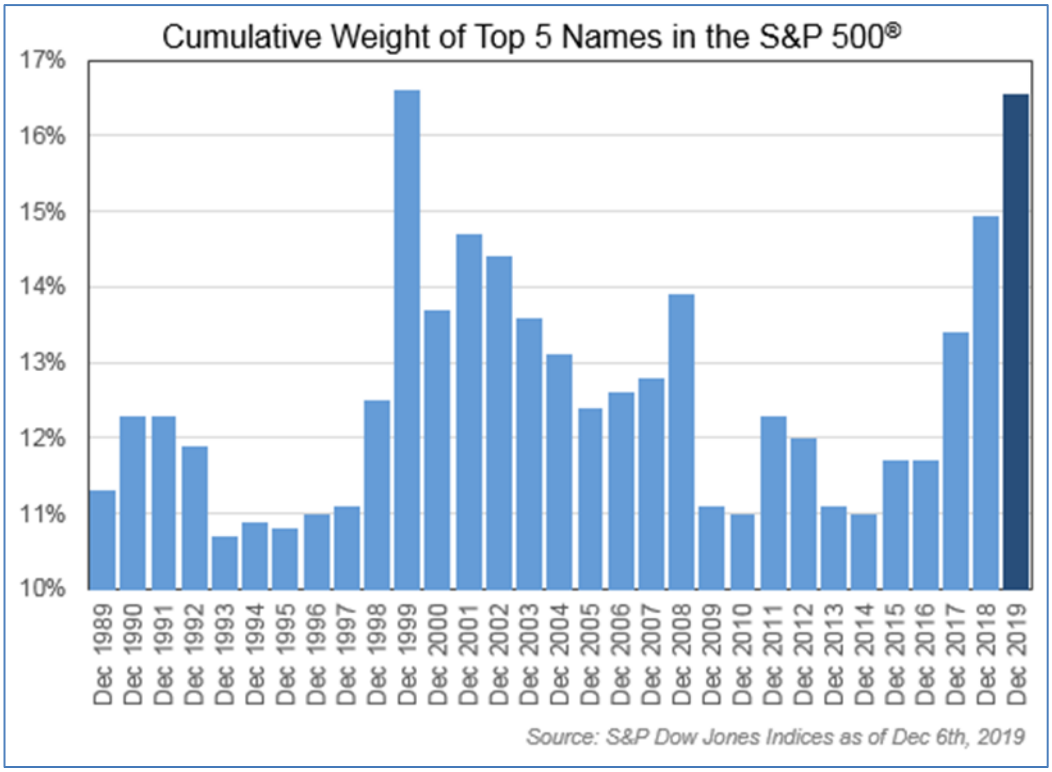
Rydex investors are going all-in on leverage, with the Rydex Ratio coming within a half a percent of the peak reached in January 2018.



Source: Cypress Capital

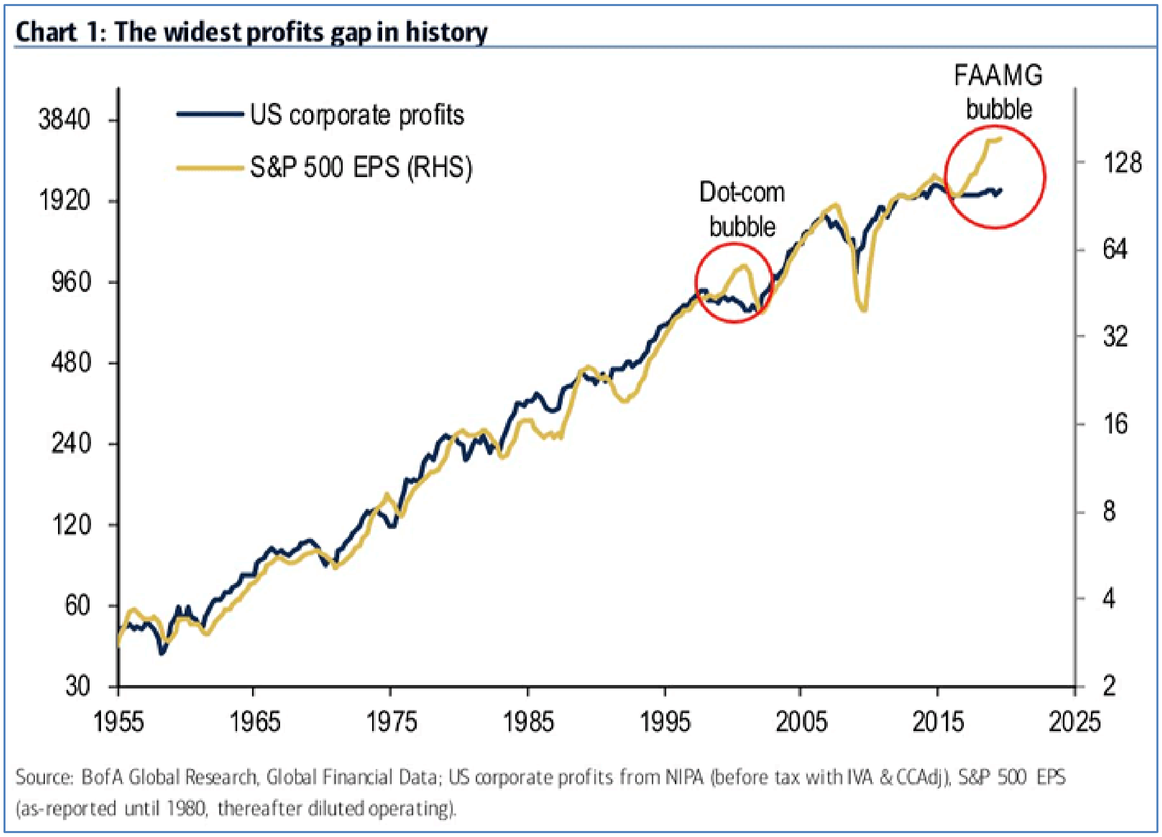
Chart – Cap-Weighting...too much of a good thing?

Cap-weighted indices are making the largest, most concentrated bet on the biggest five stocks since 1999.



Source: @drtimedwards

Chart – Growing gap between US Corporate Profits and S&P 500 Earnings



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.