Market Outlook

By Mark T Dodson, CFA

Highlights

Market Risk Index climbed to 91.4% on some unexpected deterioration in our psychology composite. We are decreasing our recommended equity allocation to 60% of maximum.

The January 2018 peak in investor enthusiasm, as measured by our psychology composite, is still holding, if only by a thread. We felt more comfortable just a week ago with the idea that the 2018 peak in enthusiasm would hold but have grown less certain this week. While psychology is still inching closer to new cycle peaks, the MRI has now surpassed the previous peak set in January 2018, with the main difference between now being a noticeable worsening in monetary conditions since the January 2018 MRI peak.

The action in the yield curve and monetary aggregates is still consistent with early recessionary behavior and also consistent with economic releases like the ISM Manufacturing survey this week, which revealed continued declines in manufacturing activity. It's also consistent with the behavior in the Conference Board's Leading Economic Indicators, which is declining if you remove the recent behavior of the stock market as an input. Booming stock prices, and the animal spirits that they are fueling are singlehandedly working to create their own set of improving economic fundamentals. Some have pointed to correlation in stock prices and the recent $500 billion surge in the Fed's balance sheet over the last three months, a development that we have noted had begun to impact our monetary readings. While the charts are enticing, there isn't a slam dunk argument for a direct cause and effect relationship over such a short time frame.

Shifts inside psychology this week included a shift in the total put/call ratio to negative, as it joined the already extreme readings occurring in ISSE and equity put/call ratios. The IPO market firmed up enough in December that the its readings inside the psychology composite moved from positive to neutral. Finally, all key indicators that we track inside surveys for both Investors Intelligence and the American Association of Individual Investors are now increasing the risk score coming from investor psychology.

The arguments for taking additional risk here are thin and largely revolve largely around breadth and chasing momentum. Media recently reported that famed hedge fund trader Stanley Druckenmiller was bullish, despite his belief that markets are in a bubble, because the bubble could last for years. That's a quintessential example of speculation using greater fool theory - it's not investing.

Market Risk Index

Elevated

91.4%

Category Percentiles

Psychology - P6: 97.1%

Monetary - M4: 74.7%

Valuation - Extremely Overvalued: 97.4%

Trend - Positive: 0.0%

Biggest Psychology Influences

Volatility	Positive
Leveraged Investments	Negative
Option Activity	Negative
Surveys	Negative

Biggest Monetary Influences

GDP Growth (Below Avg)	Positive
Velocity	Negative
Yield Curve	Negative

Valuation

7-10 Year Rtn Forecast	2.3%
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.

Chart – ARMS Index is hitting levels that have halted rallies over the last two years.

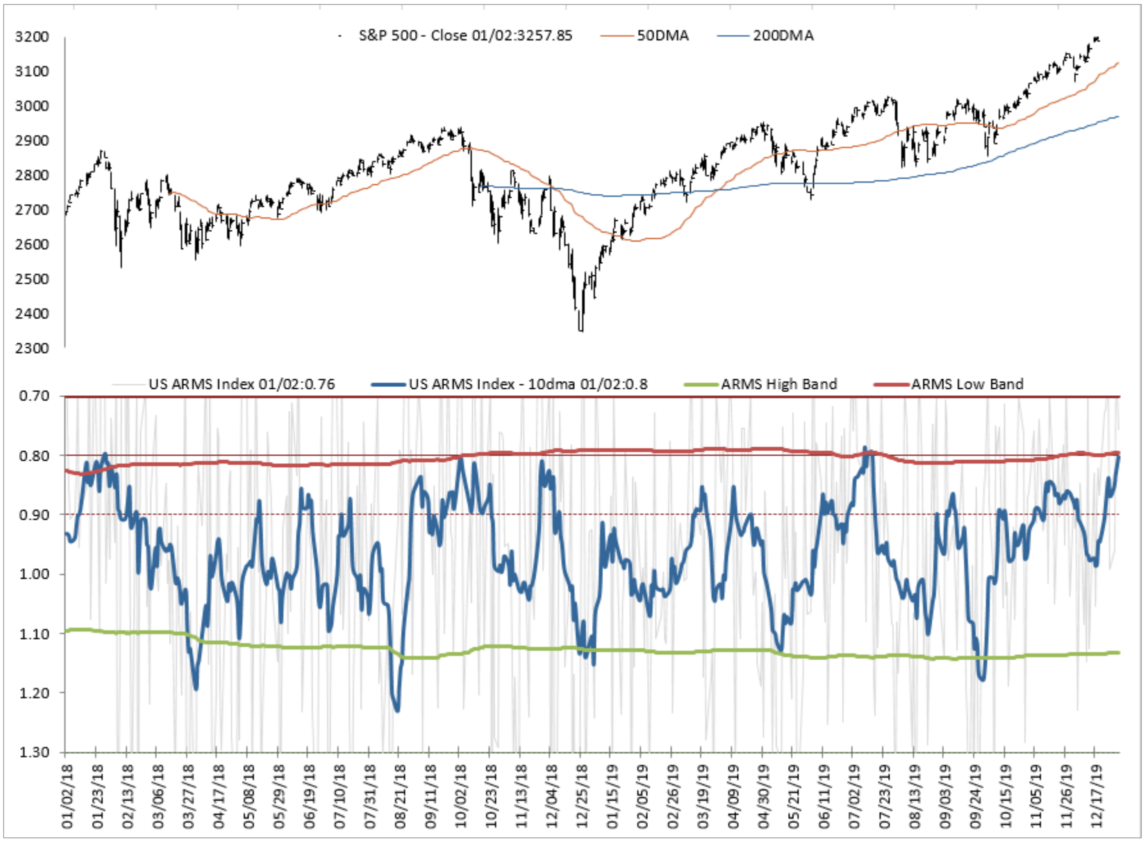
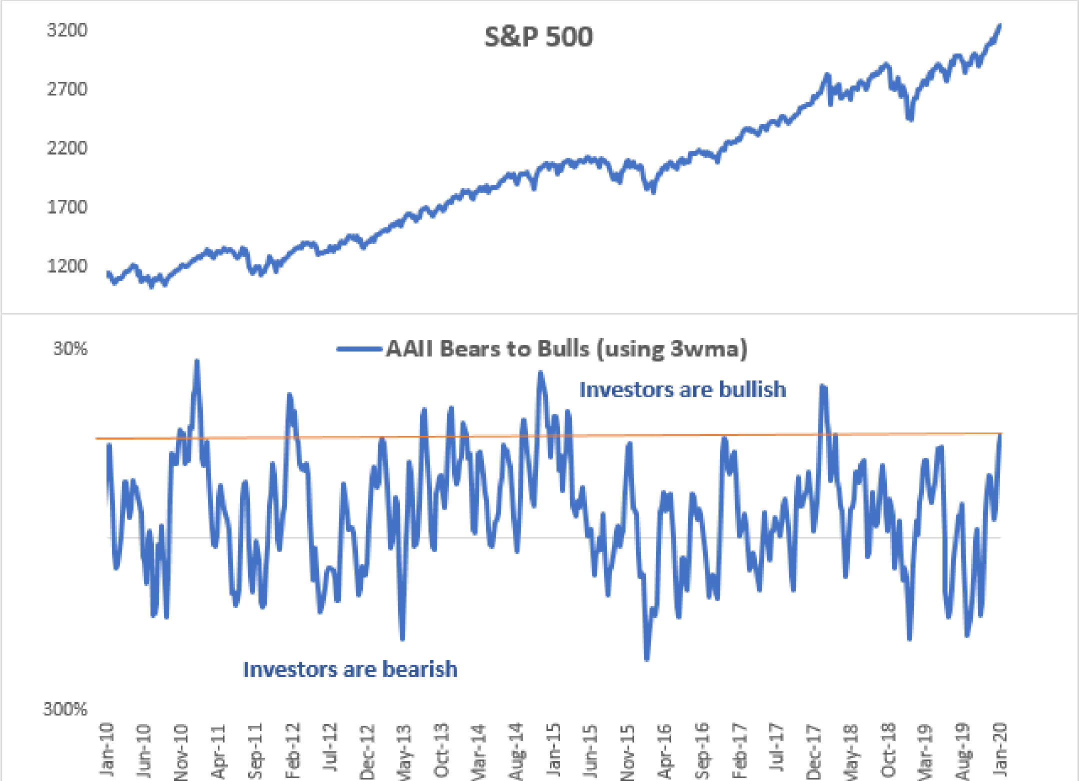


Chart – AAII Investment Survey

Bullishness among individual investors has climbed to the highest levels since January 2018.



Source: Cypress Capital

Chart – Action in Yield Curve inputs looks recessionary

But, the rollover in interest rates hasn't yet led to a curve steepening on par with more recent bear markets and recessions.

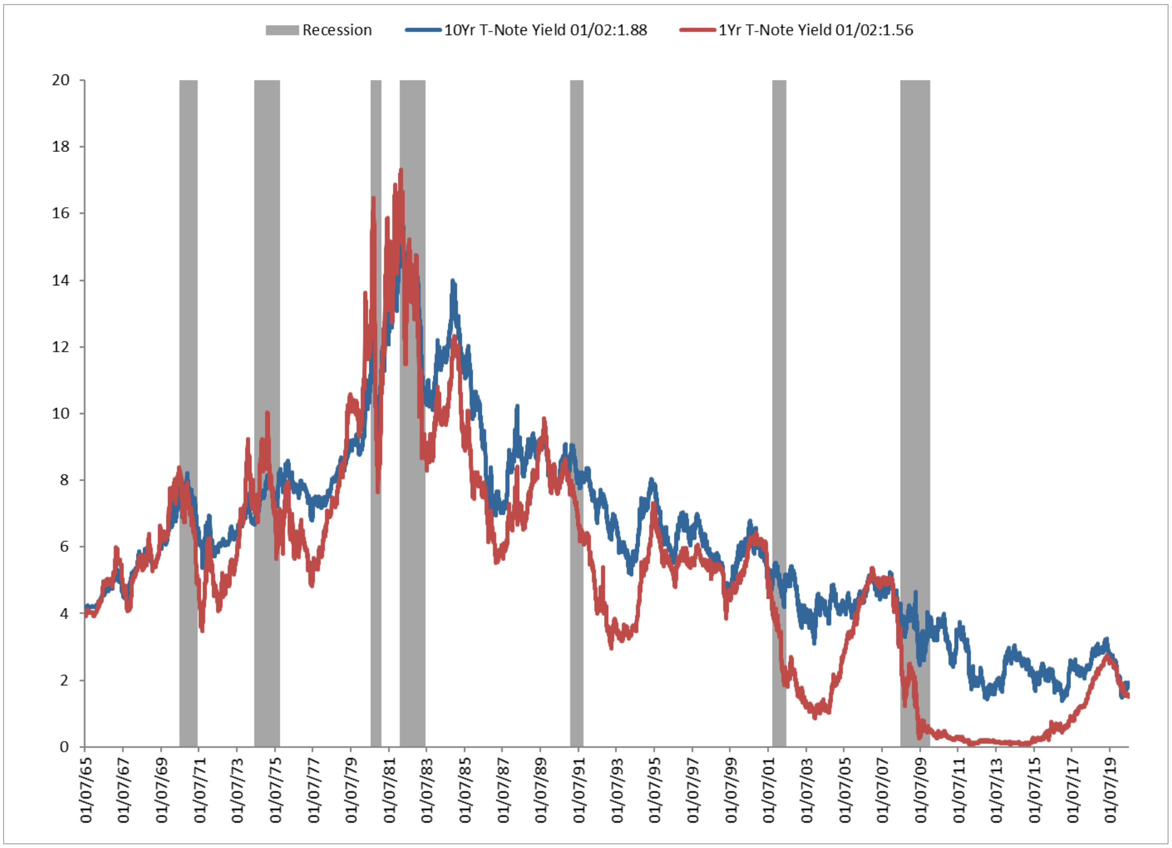


Chart – Corporate Buybacks are still largely debt fueled

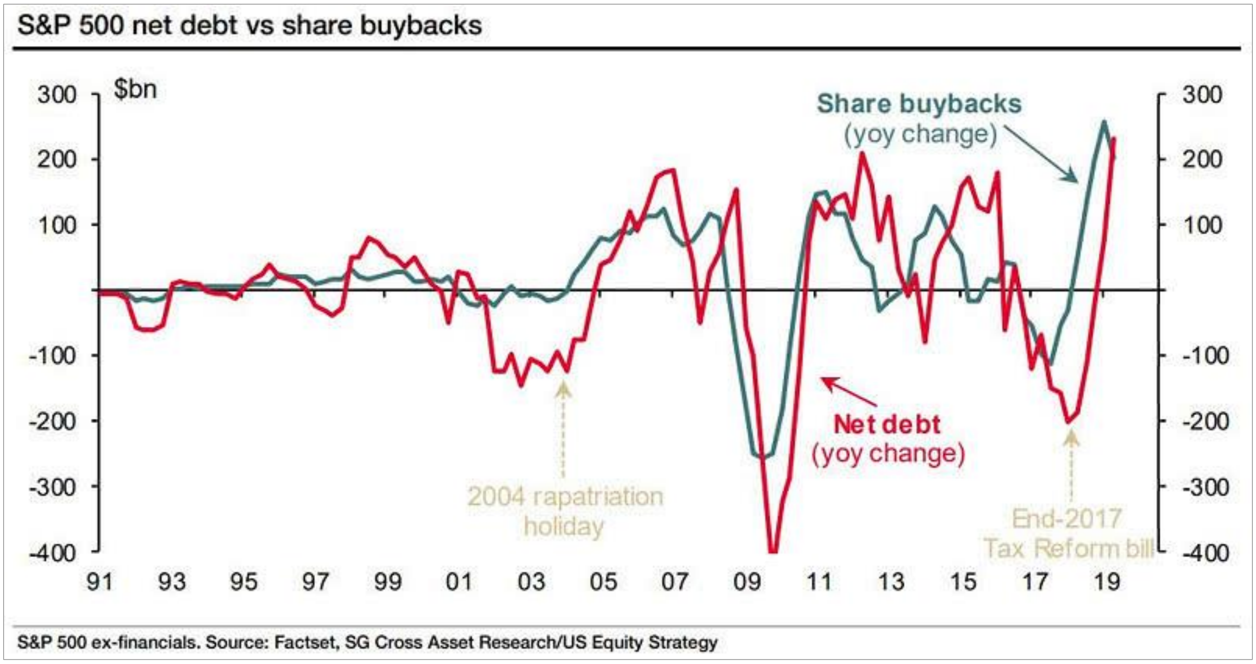


Chart – Stock prices are keeping Leading Economic Indicators from declining

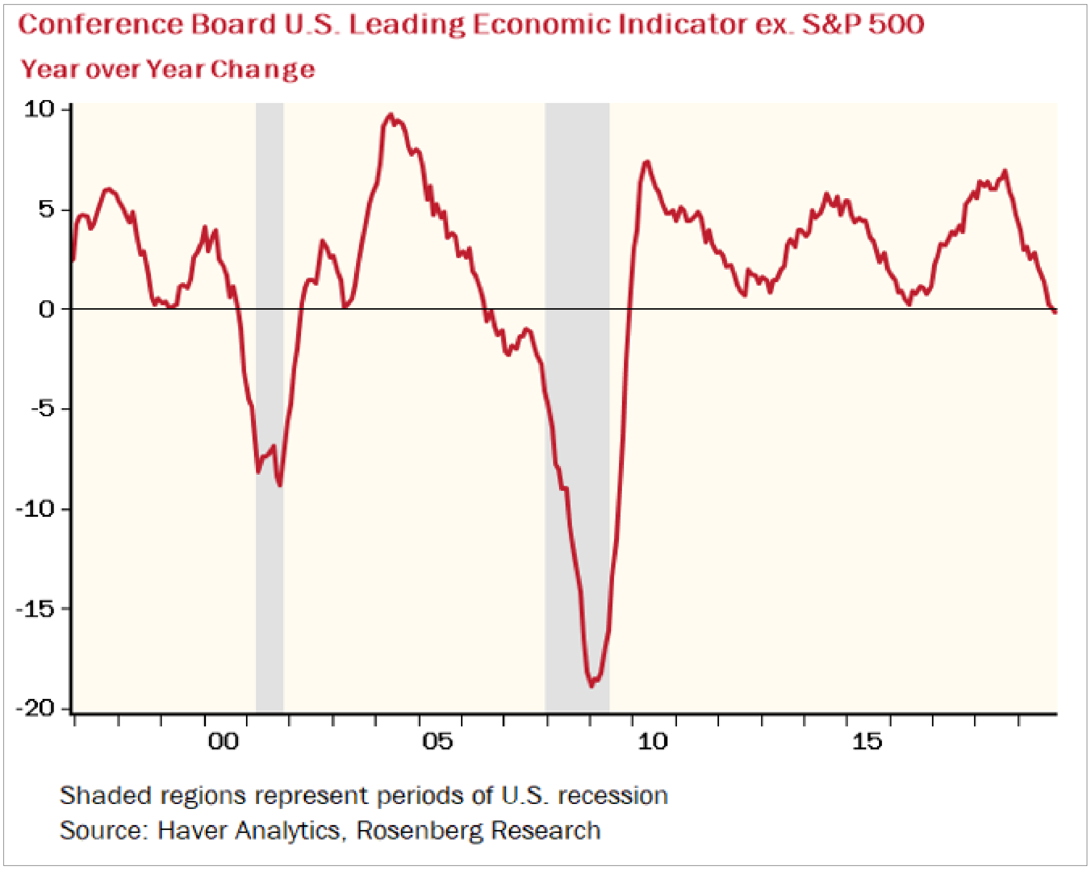


Chart – Large Disconnect between Stock Prices and US Manufacturing

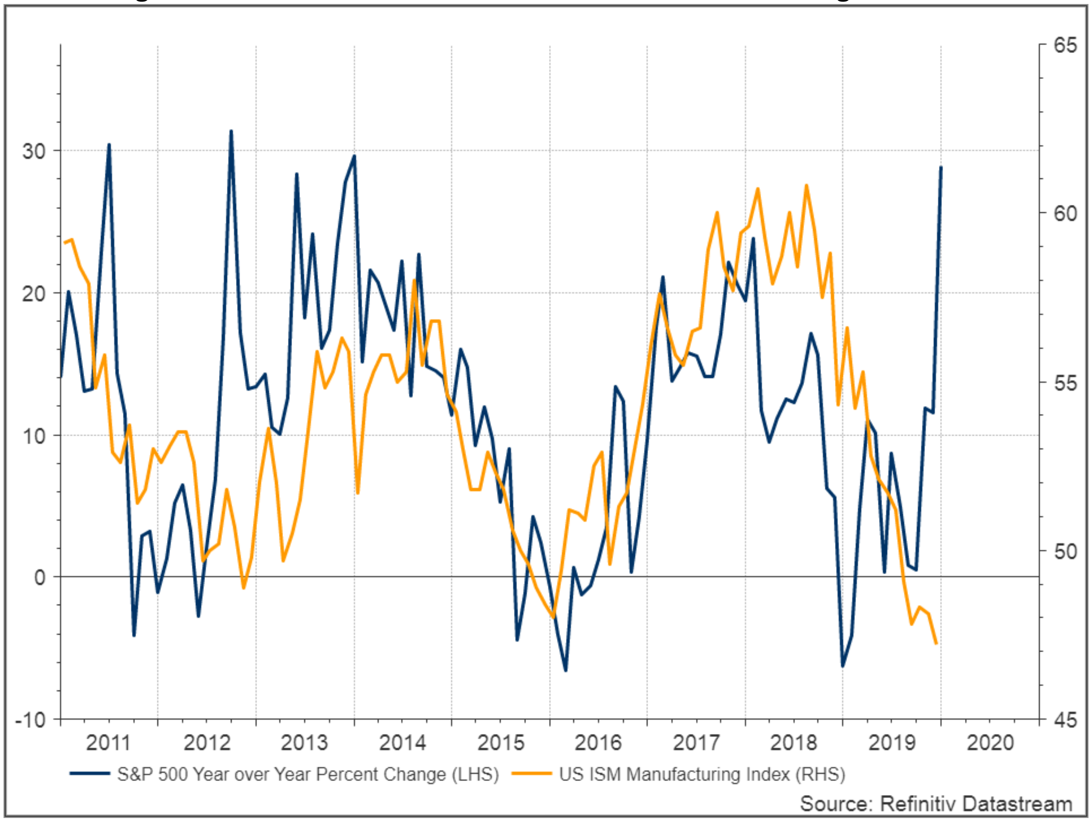


Chart – Apple's Market Cap has surpassed the entire US Energy sector

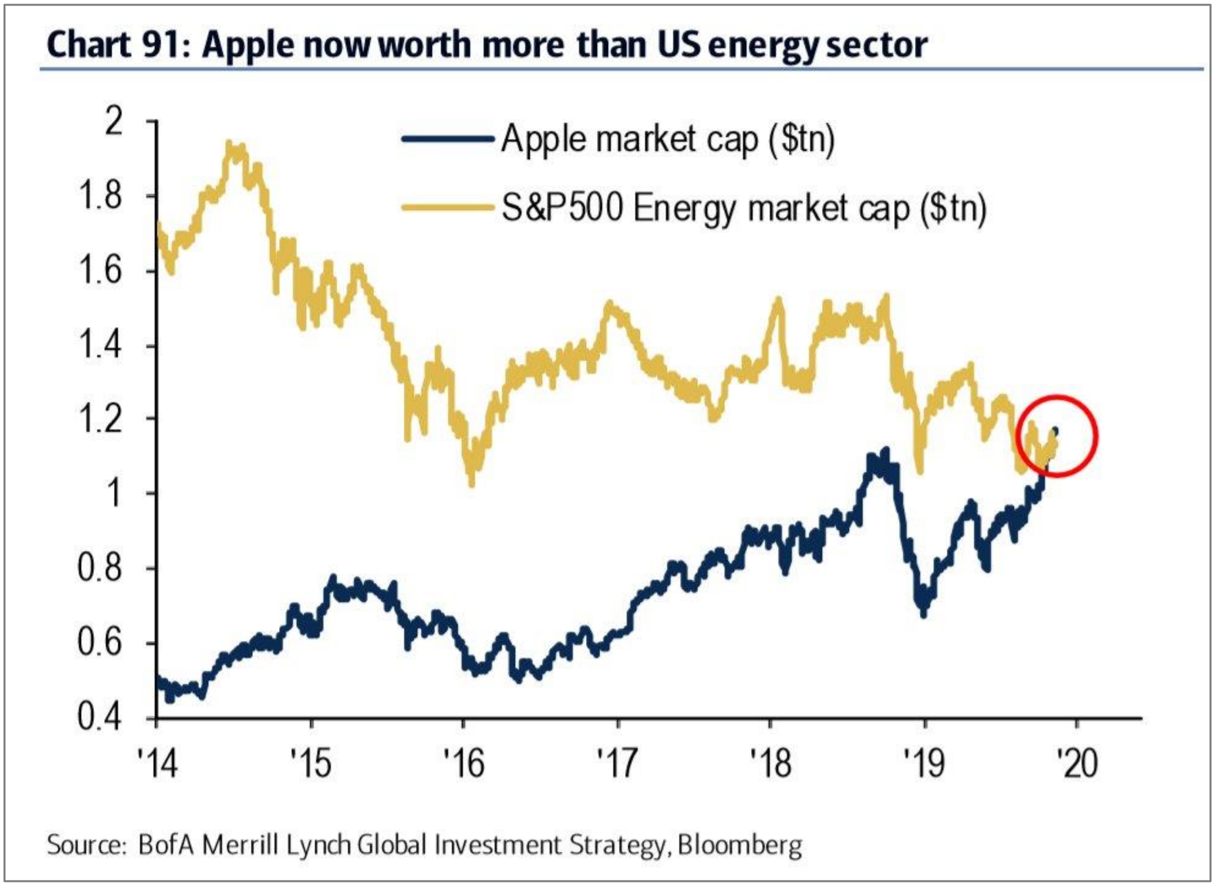
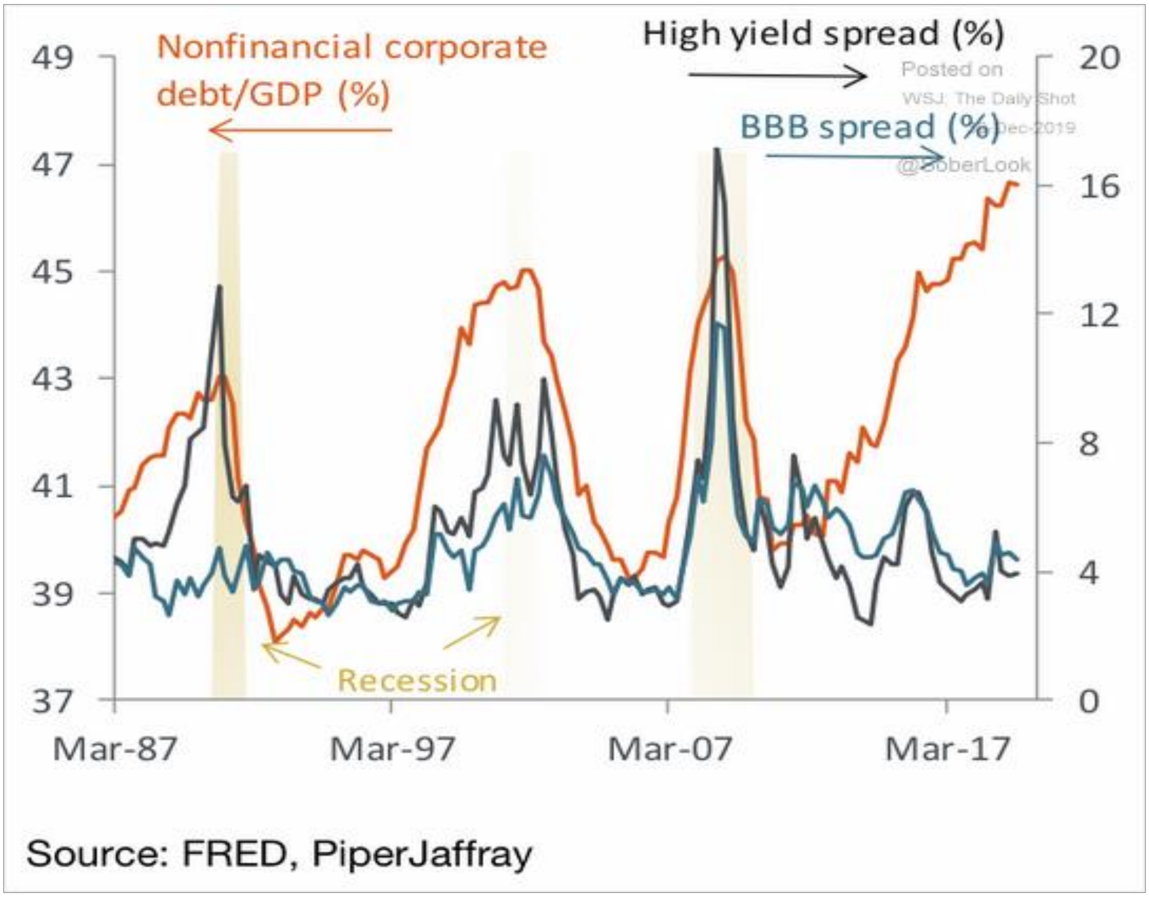


Chart – Passive flows are making the S&P 500 Top-Heavy

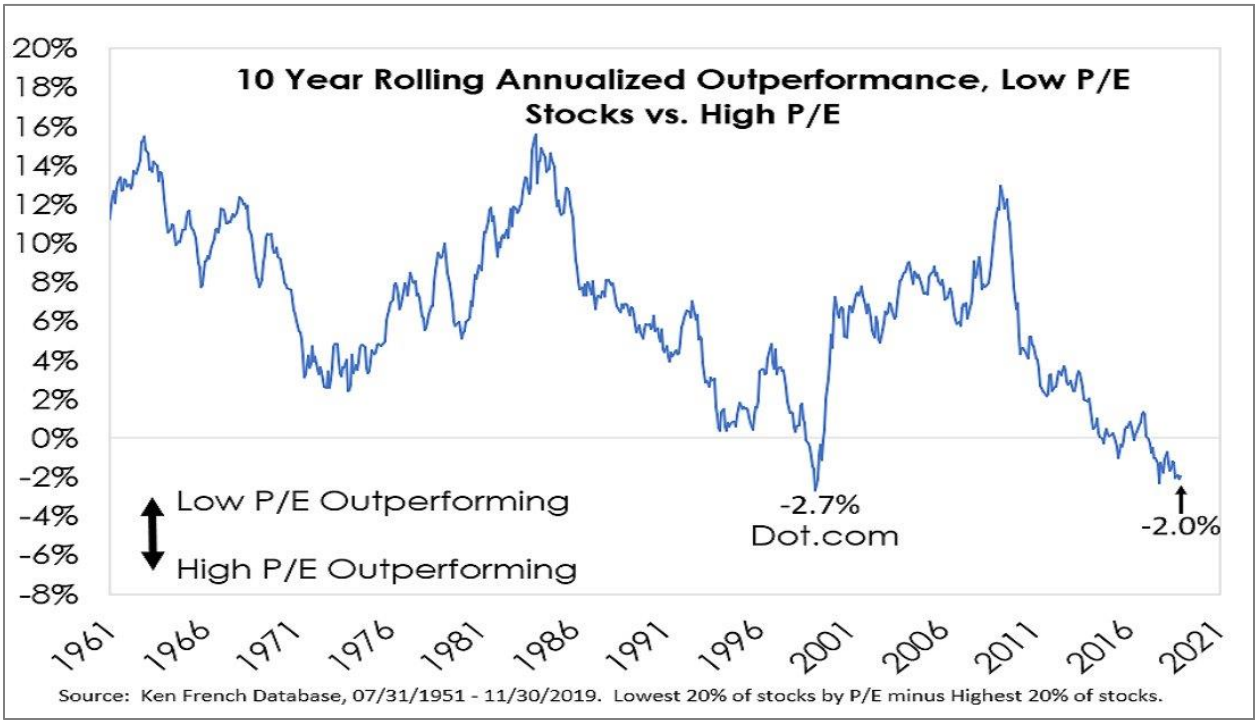
Source: WSJ

Chart – Corporate leverage at all-time highs, but corporate bond buyers don't seem to mind



Source: WSJ

Chart – Low P/E stock underperformance close to surpassing the Dot.com period

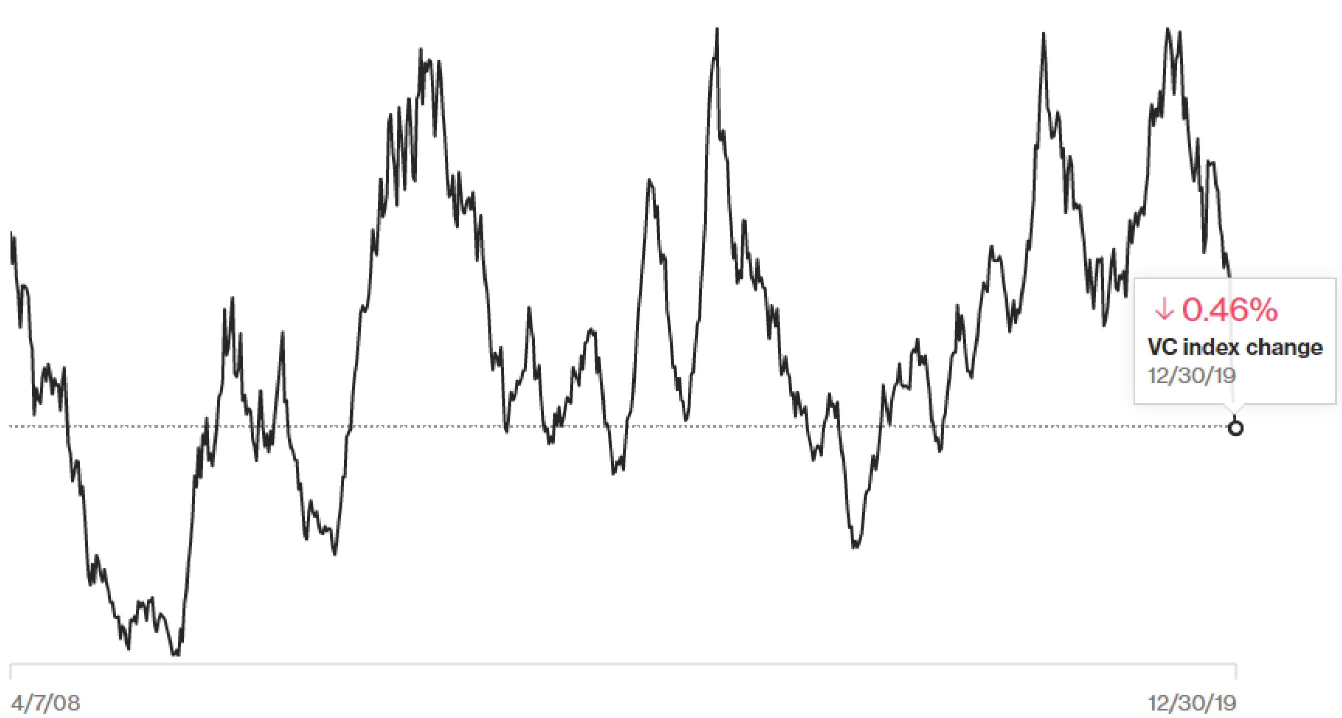


Source: Jeff Weniger

Chart – CEO Turnover likely to reach a new record when data is updated through December

Source: Challenger, Gray & Christmas; Refinitiv
© FT

Chart – Bloomberg US Startups Barometer is Rolling Over



Source: Bloomberg

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.