Market Outlook

By Mark T Dodson, CFA

Highlights

Market Risk Index rose for the ninth straight week – on poorer psychology and valuations scores. Our investor psychology composite broke through January 2018 levels to reach a new cycle peak and the worst readings since October 2000.

For several psychology indicators, it was much of the same but new extremes. Option activity continues to set records in favor of call buying, corporate insider selling accelerated further, and one of our bank sentiment indicators flipped negative this week, as banks willingness to lend to smaller firms has begun to decrease. The technical indicators category has started to weaken slightly as some measures of market internals have begun to soften, even as daily records in cap-weighted indices continue.

Our valuation based equity return forecast has fallen to 2.2% based on where equity prices closed in December, a return that is 0.3% better than the yield on the 10Yr Treasury. Our forecast is a bottom up forecast that uses as much valuation data that we can find. Internally, we also track a purely regression based forecast, where US equity returns are regressed against stock market valuations since 1990. In the majority of cases, the regression model forecasts higher returns than the bottom up forecast, but for the first time since 2000, the regression based forecast expects lower returns than does our bottom up based model. It likely means our internal expectations for earnings growth over the next 10 years is too high. We aren't alone here, as the growth that analysts continue to forecast for S&P 500 earnings is extremely high for this point of the economic cycle with tight labor markets.

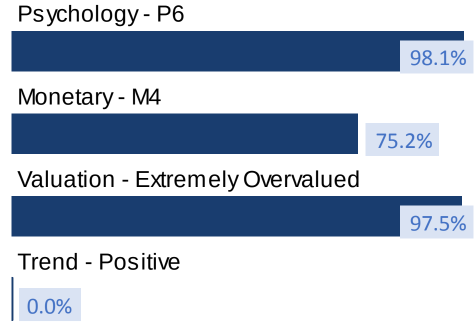
In an economy that continues to require historic amounts of monetary stimulus and balance sheet expansion from global monetary authorities around the world, this level of animal spirits – as measured by our psychology composite – is quite a feat. The impossible conundrum facing these global central bankers has become two-fold – how to stimulate the economy without creating asset bubbles and what to do if public confidence in the cure-all of quantitative easing starts to fade, or worse, if it becomes a major reason that investors begin to lose their nerve.

Market Risk Index

Elevated

91.9%

Category Percentiles



Biggest Psychology Influences

Volatility	Positive
Leveraged Investments	Negative
Option Activity	Negative
Fund Flows	Negative

Biggest Monetary Influences

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

Valuation

7-10 Year Rtn Forecast	2.2%
10Yr Treas Yield (on 12/31)	1.9%

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 – S&P 500 Drawdowns & Investor Psychology Composite

Animal Spirits reached a new cycle peak this week, and the highest euphoria reading since October 2000. Even when these euphoric readings were early, they led to better buying opportunities for investors.

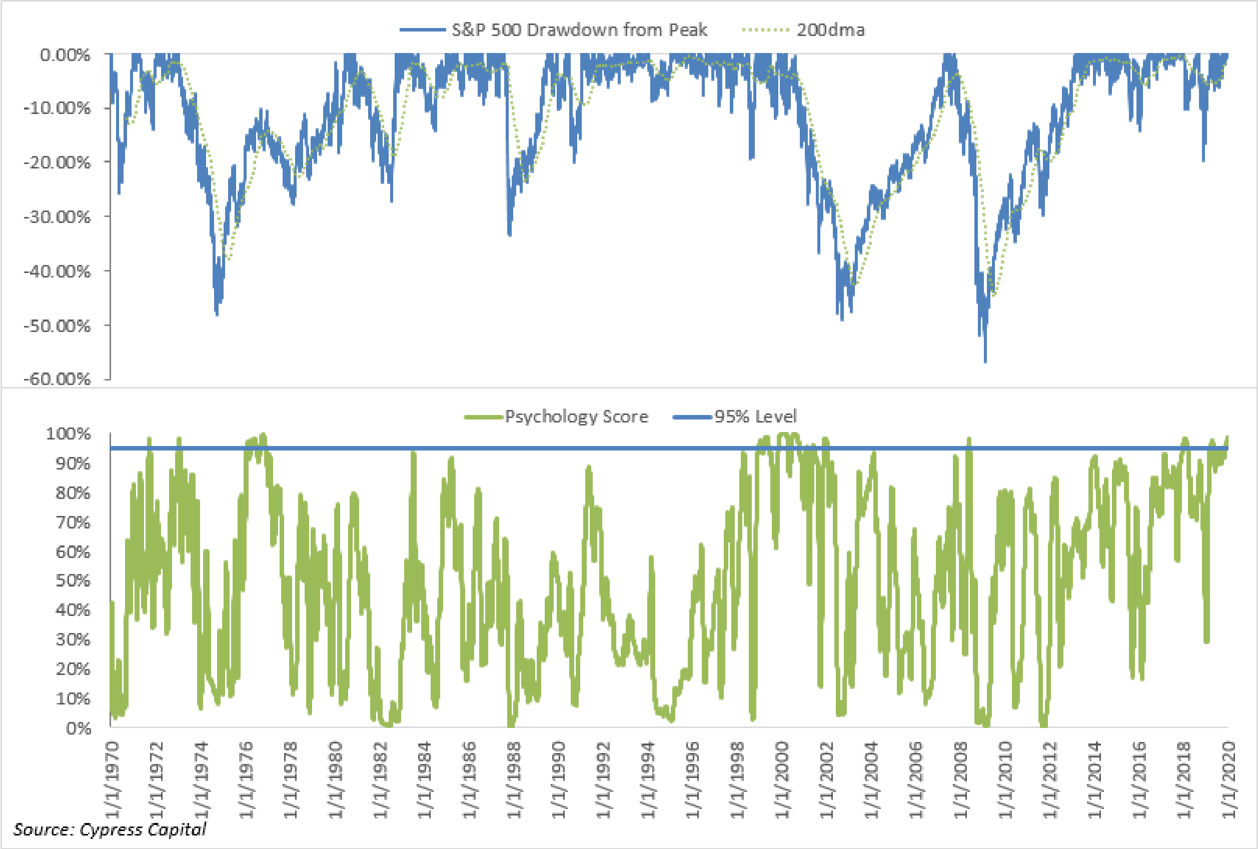


Chart – Ratio of Forward Earnings to S&P 500 Peak Trailing Earnings

This is a proxy for analyst enthusiasm. Analysts are generally too optimistic, and we tend to see forward earnings estimates for the S&P 500 about 20% higher than the S&P 500's peak trailing twelve month earnings. When estimates climb about 30% above peak earnings, analyst enthusiasm is running too hot. We're hitting that level again.

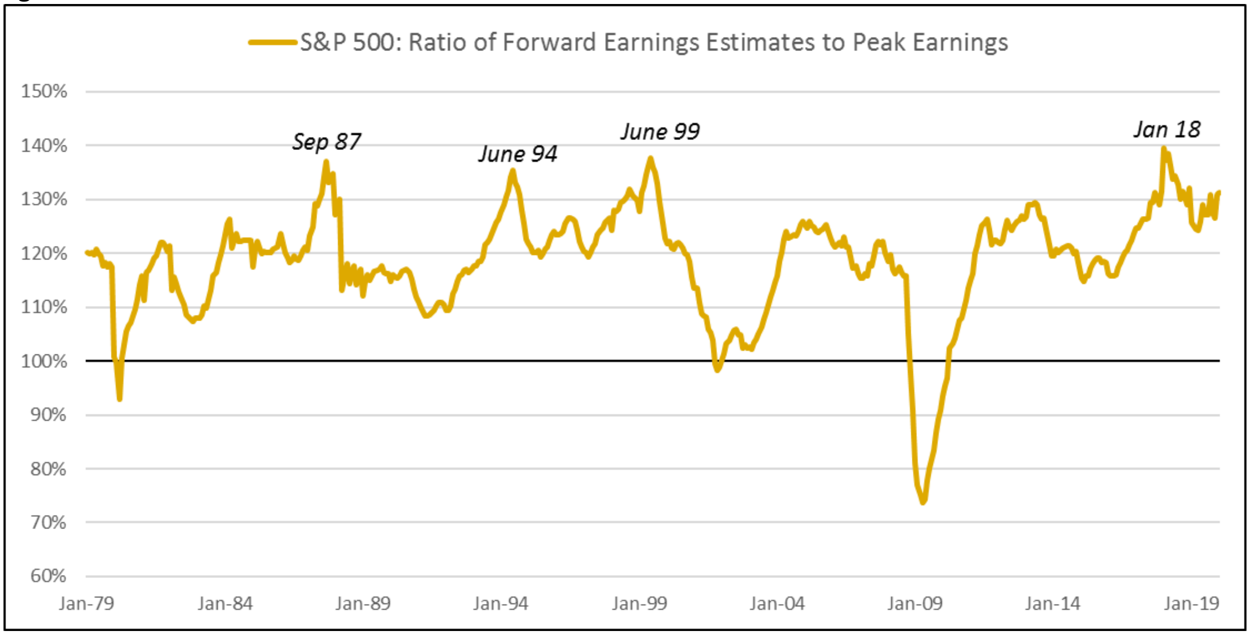


Chart – Valuations & Equity Return Forecasts

We build our return forecasts from the bottom up using as much historical data that we can find. We also calculate a purely regression based forecast for equity returns, which uses only the range of higher equity valuations after 1990. Although it doesn't use the full history of US equity valuations, it has had a tighter fit with more recent stock market returns. The regression forecast is almost always more optimistic, but for the first time since 2000, it's forecasting lower returns than our bottom up forecast.

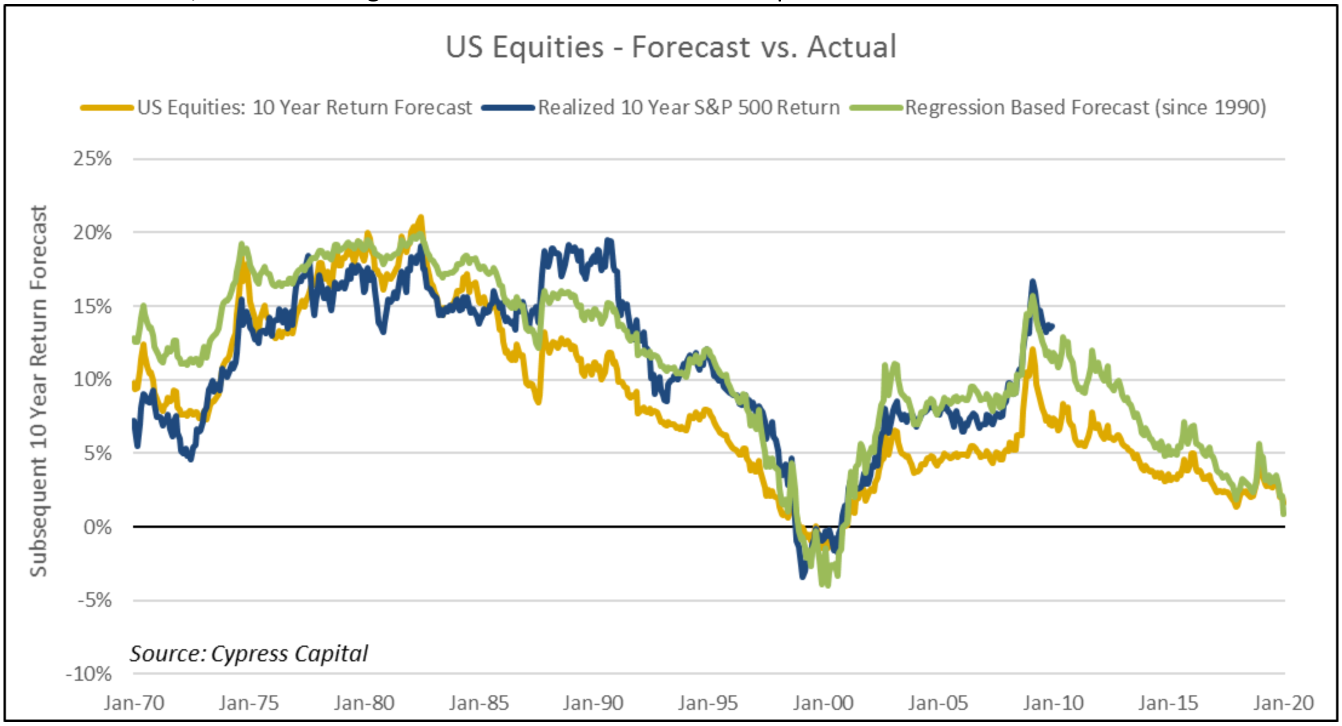


Chart – US Equity Valuations

Three of the seven valuation metrics we follow are shown here, with data going back to 1900. On average, those seven metrics are now 2.1 times above their long term norms. Only Price to Book and Forward PE are below the 200% level, but still trading at 1.5 and 1.74 times their long term averages respectively.

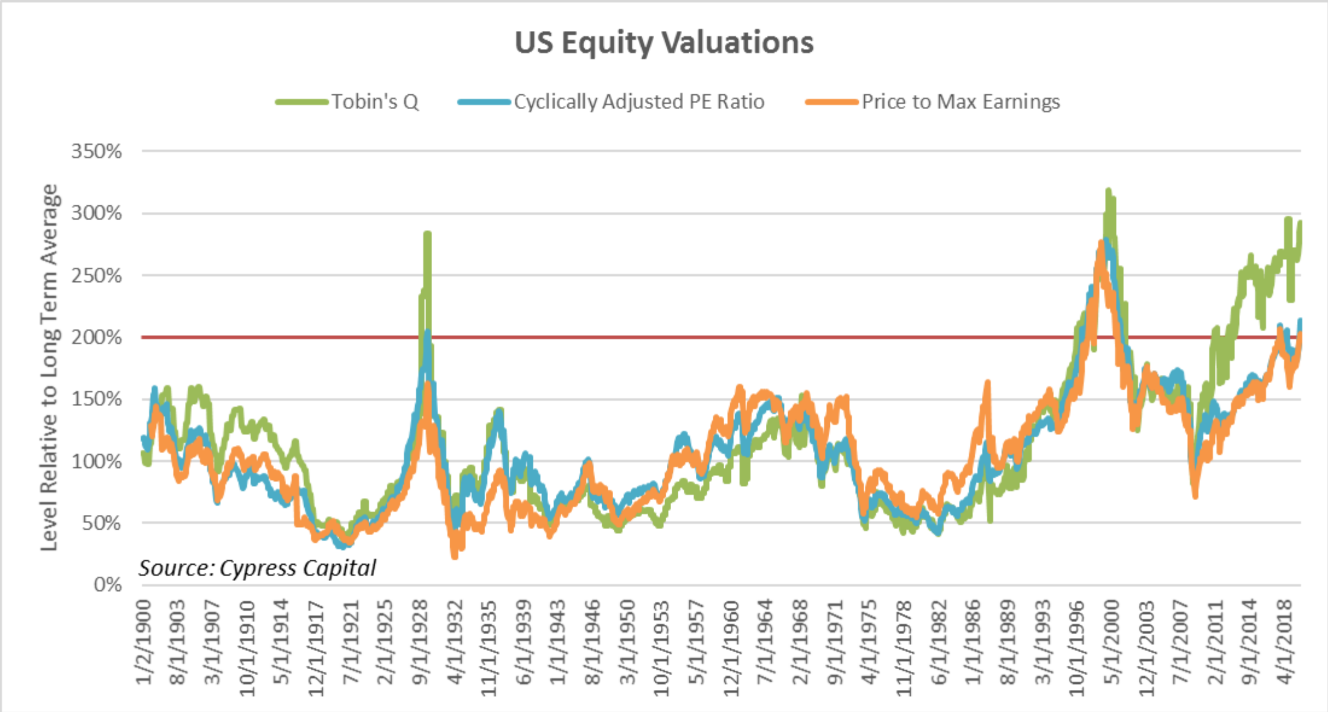
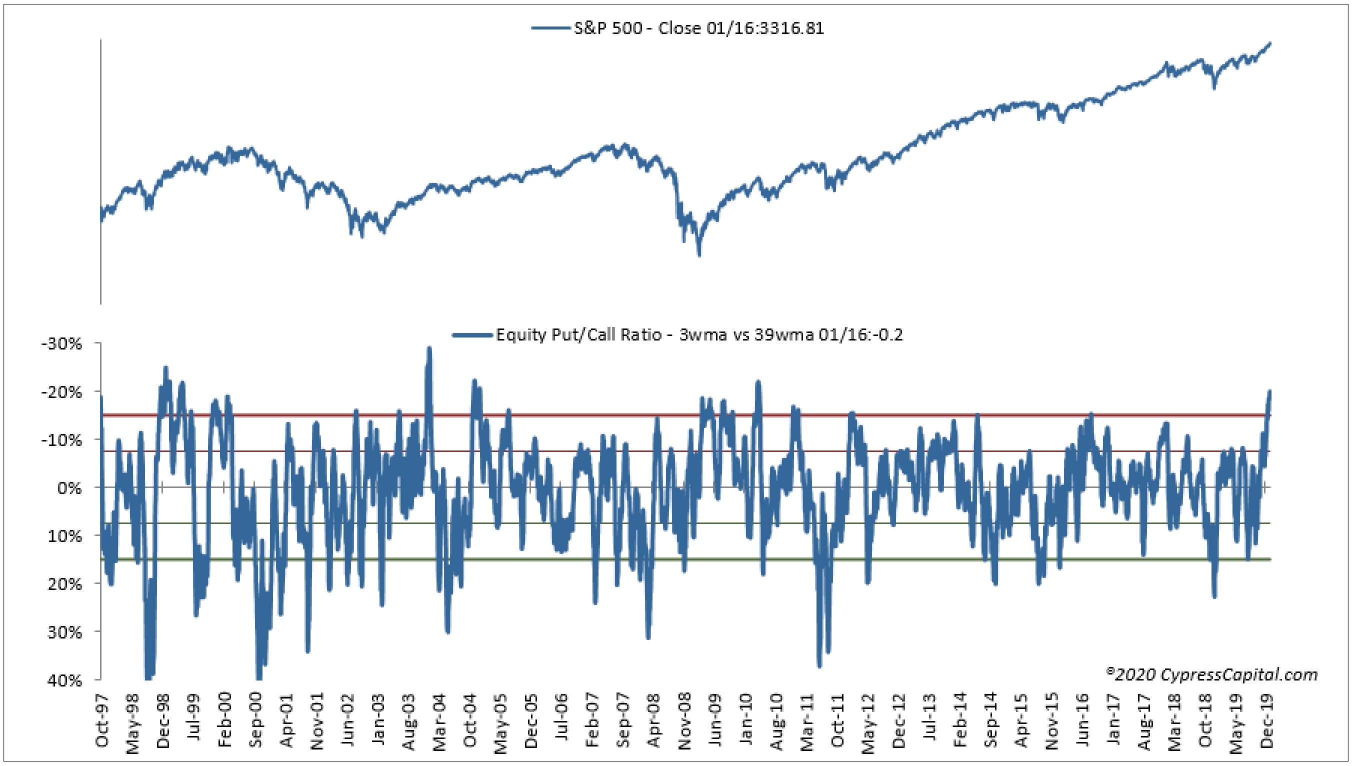


Chart – Equity Put/Call Ratio: 3Wk vs 39Wk Moving Average

Equity put/call ratios have only been this extreme in favor of call buying on a few occasions, in 2004 after stock prices broke out from their 3yr bear market. The other instances were all confined to the late 90s.



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.