Cypress CAPITAL

Market Outlook

By Mark T Dodson, CFA

Highlights

Market Risk Index ticked down just slightly on modest improvement in the investor psychology and monetary scores this week. MRI is still above 90%, levels that have historically only denoted euphoric markets with substantial risk of a large drawdown. Our equity exposure is well below its maximum (last time at maximum was in early 2016), but it's well above zero as well, because a trending, overvalued market can remain irrational longer than most of us can stand it.

Indicators in Technical and Internals categories of our Psychology composite are indicating that the odds of a short-term peak have grown dramatically over the last couple of weeks, but they also still suggest that big caps have yet to see their highest prints for 2020.

Investor psychology reached a peak mid-week and has started to make its first inkling of a move toward improving in well over a month. While this week didn't see the psychology risk score increase, we did see additional extremes and records set in many of the same psychology indicators that have pushed the composite to the 98th percentile. Some indicators are hitting euphoric levels that will become high water marks for future bull markets. Activity occurring in options markets is arguably some of the most extreme in the history of exchange traded options. The president of the CBOE doesn't often make headlines, but this week, he stated that volatility hedging (more of a smart money phenomenon) around the election is "unprecedented."

The biggest chatter on the monetary front is the Fed's activity in repo markets and their resumption of balance sheet expansion, to the tune of about $400 billion in four months. It's difficult to argue for a mechanism that would immediately cause a move in markets as a result of this, other than a psychological one. If investors believe it, then it can increase animal spirits, but only for a shorter period of time. The repo intervention appears to have led to a rollover in M2 and MZM growth, signs that money demand is decreasing as economic fears subside. That's action that will cause the yield curve to stop steepening, and that's exactly what we've seen happen over the last couple of months. Meanwhile, our bond momentum gauge, maybe one of the five best indicators that we've created, still hasn't given the full risk off signal for Treasuries with long maturities.

Market Risk Index

Elevated

91.7%

Category Percentiles

Psychology - P6: 97.7%

Monetary - M4: 75.2%

Valuation - Extremely Overvalued: 97.5%

Trend - Positive: 1.0%

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.

The bottom line here is that the yield curve still remains in end of cycle territory, and it serves as a simple graphical representation of an economy with unemployment well below its natural rate and with GDP above potential. It's a key reason that our monetary composite has yet to make substantial improvements. The Fed can prolong the inevitable, but it cannot "eliminate the boom-bust cycle", no matter what the elite in District 1, uh, we mean Davos, think.

Chart – OEX Put/Call Avg is seeing record hedging

We derive a smart money measure for options markets using average the put/call volume and open interest in OEX options. Granted, volume in OEX options has dwindled over the years, but we hit an all time record in hedging activity this week, in this traditionally smart money gauge of investor sentiment.

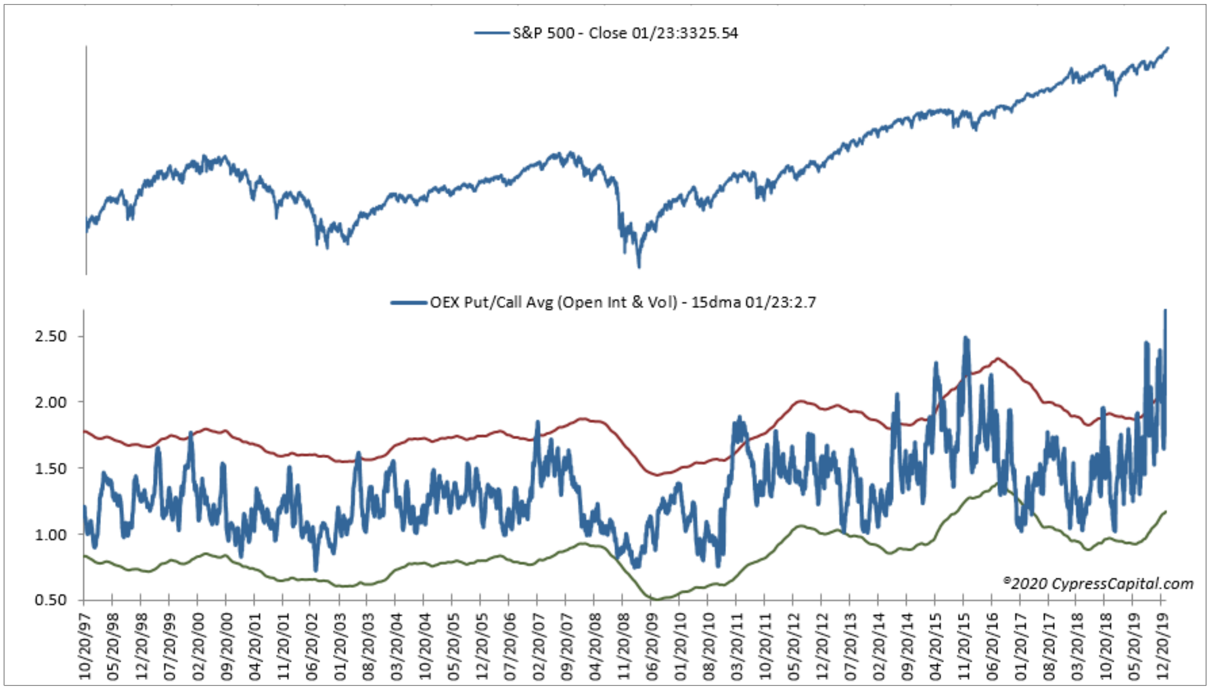
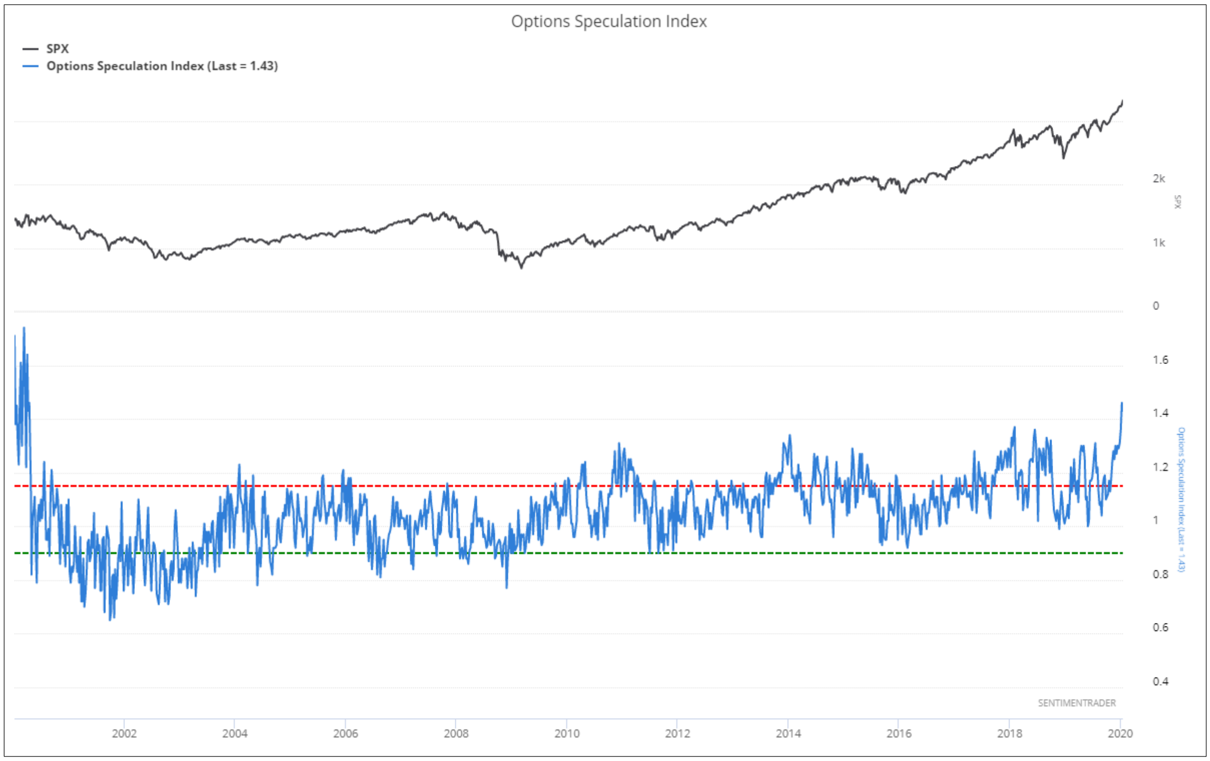
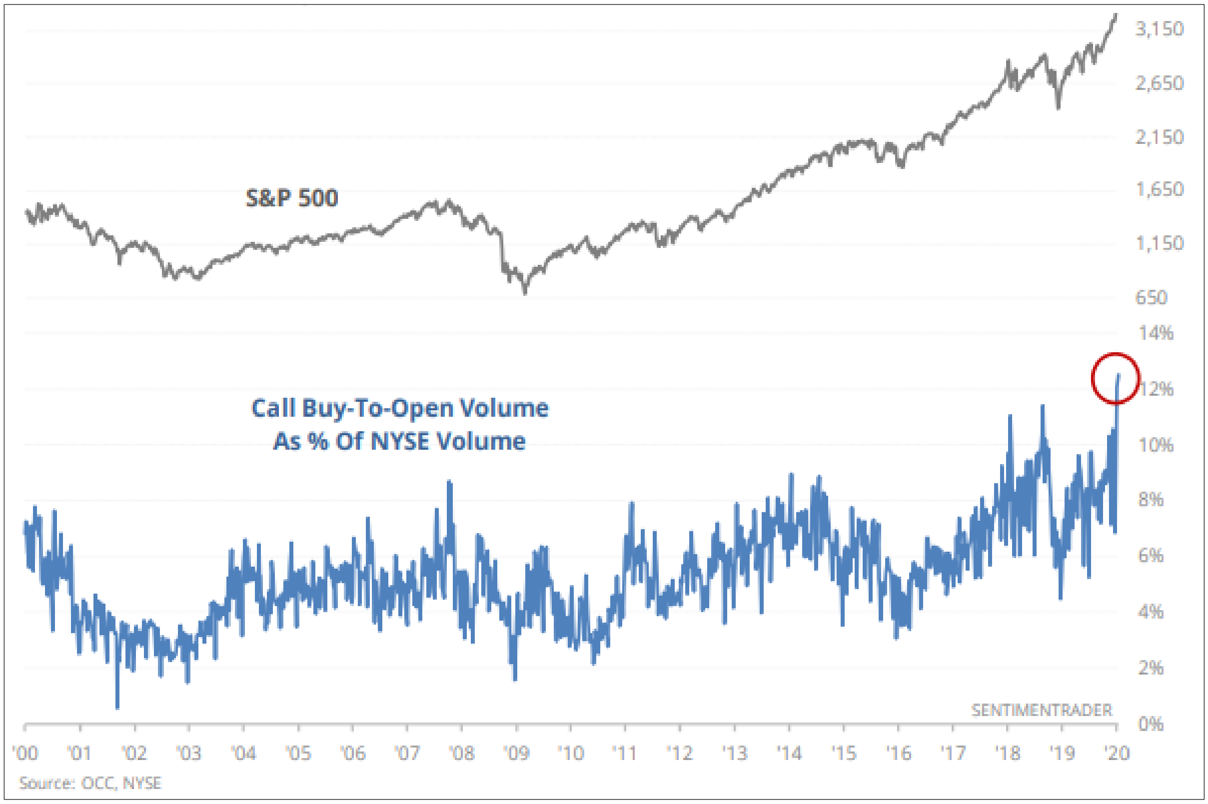


Chart – Options Speculation Index at highest level since March 2000.



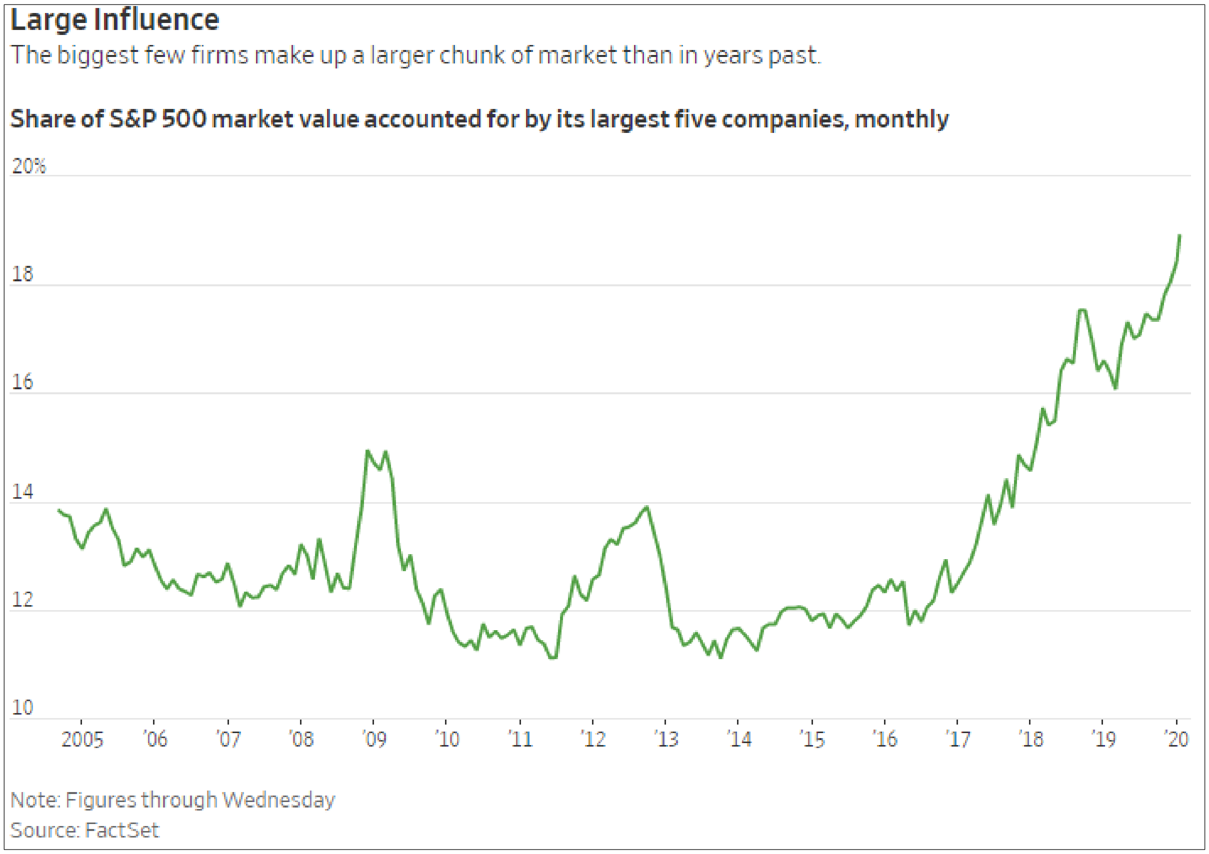
Source: SentimenTrader

Chart – New Call option positions as a percent of NYSE Volume hit an all-time high



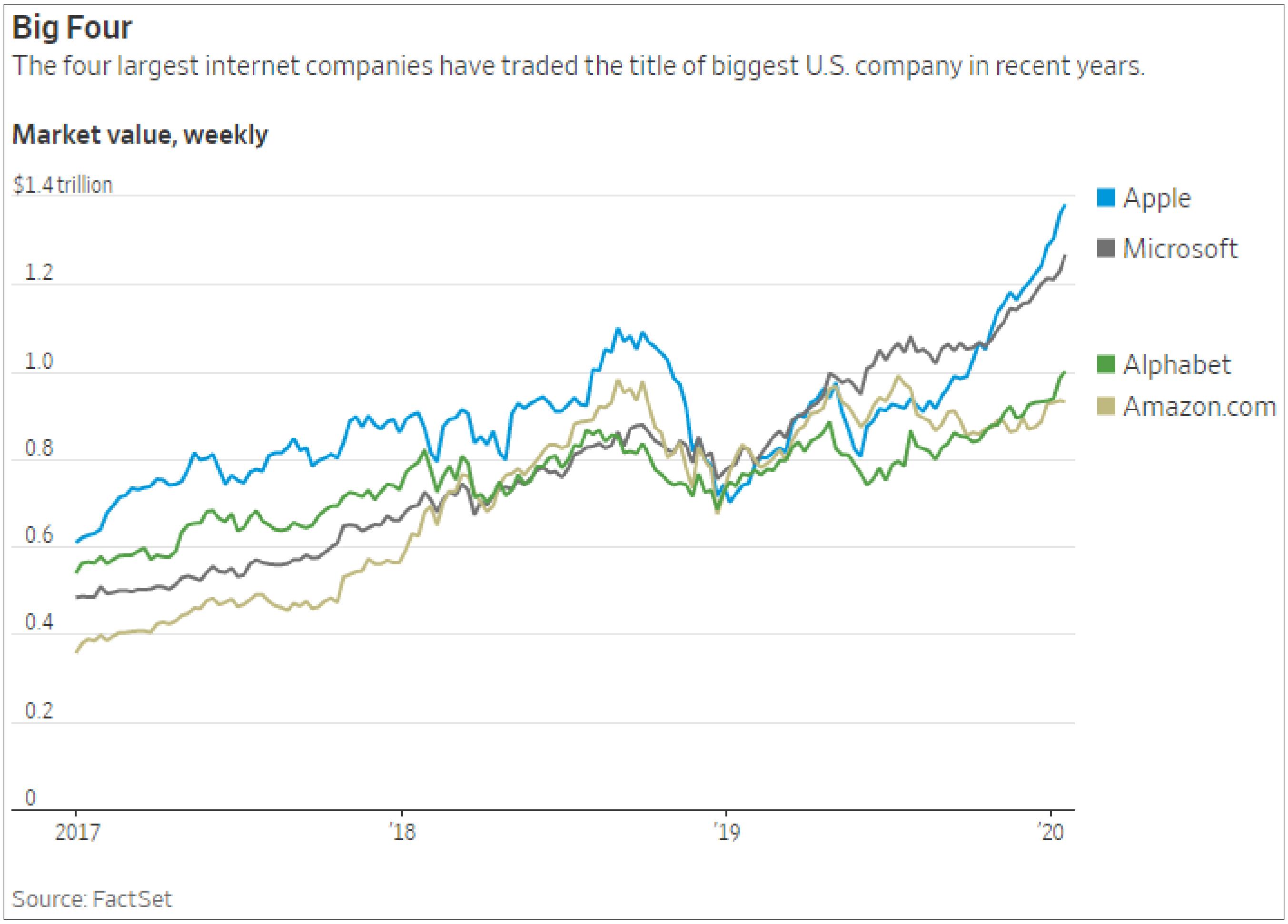
Source: SentimenTrader

Chart – Market Cap Share of largest 5 Companies in the S&P 500 is through the roof



Source: WSJ

Chart – Google has joined Apple and Microsoft in the Trillion Dollar Club



Source: WSJ

Chart – Large Cap to Small Cap Relative Strength

Large Caps are dominating, but relative outperformance has struggled to break some resistance since last September.

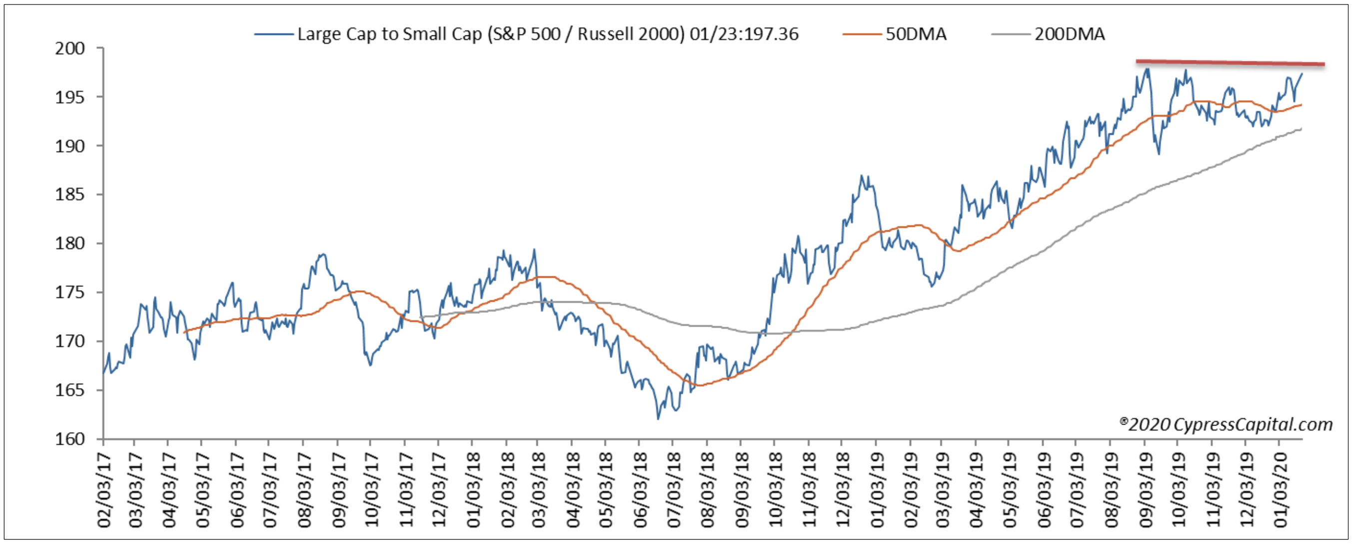
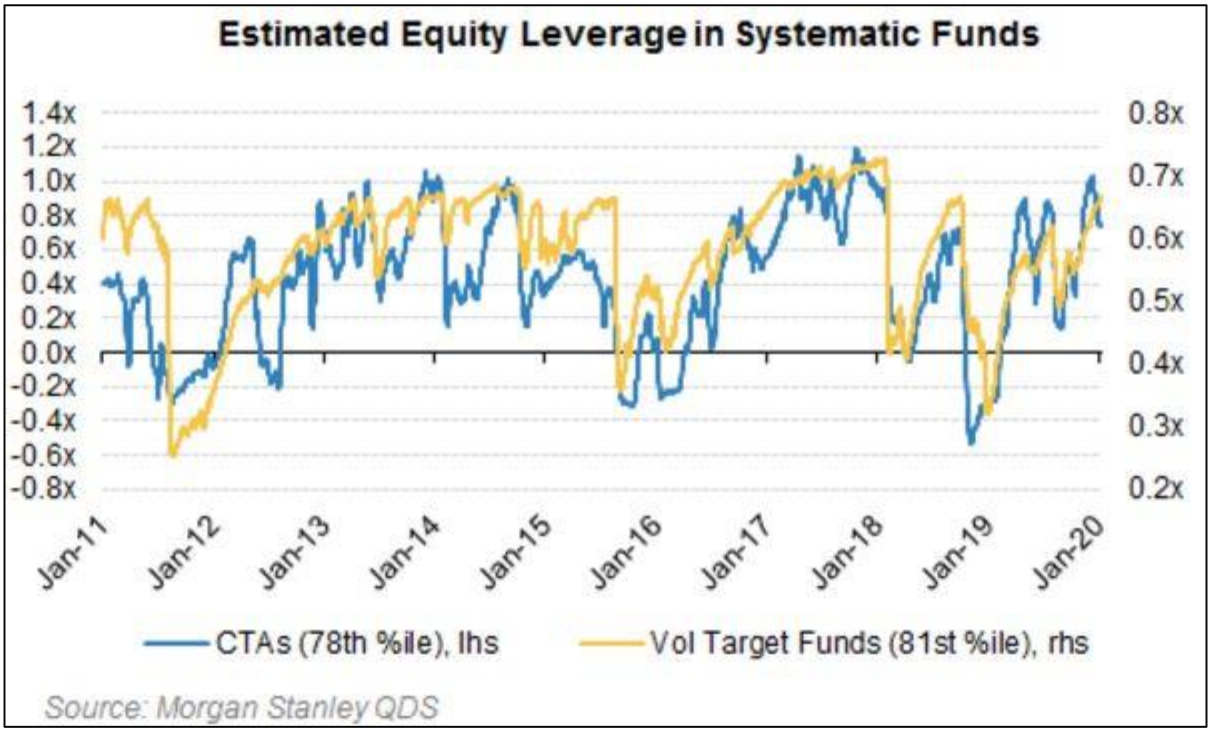
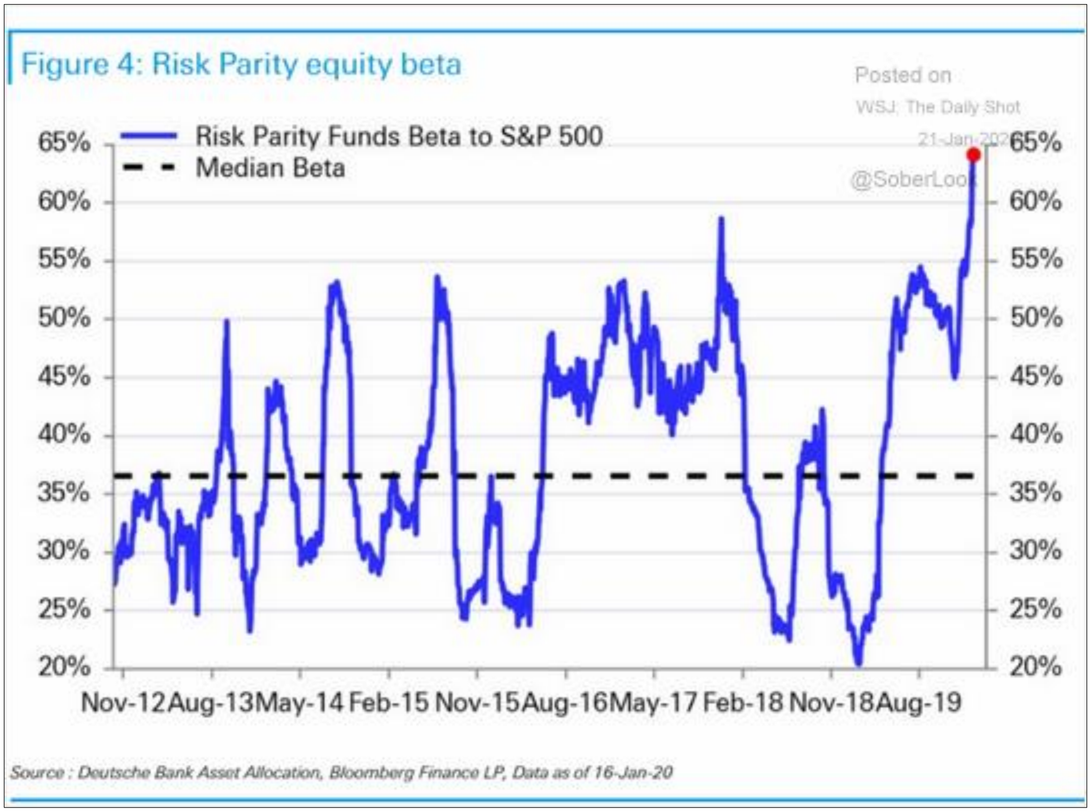


Chart – Leverage in Systematic Funds Highest since January 2018



Source: Bloomberg

Chart – Risk Parity funds stock market exposure surges to new highs, surpassing Jan 2018 levels



Source: WSJ

Chart – Trump Stock Market Tweets surpass 2018 Peak

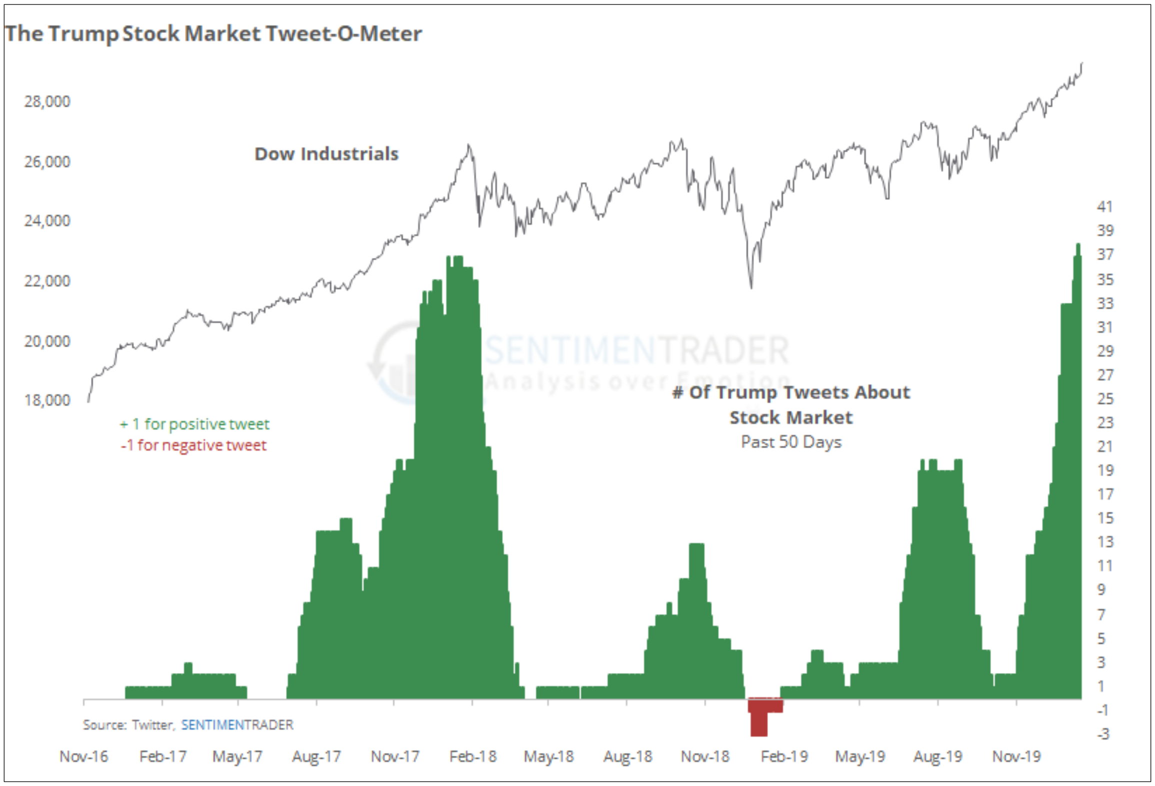
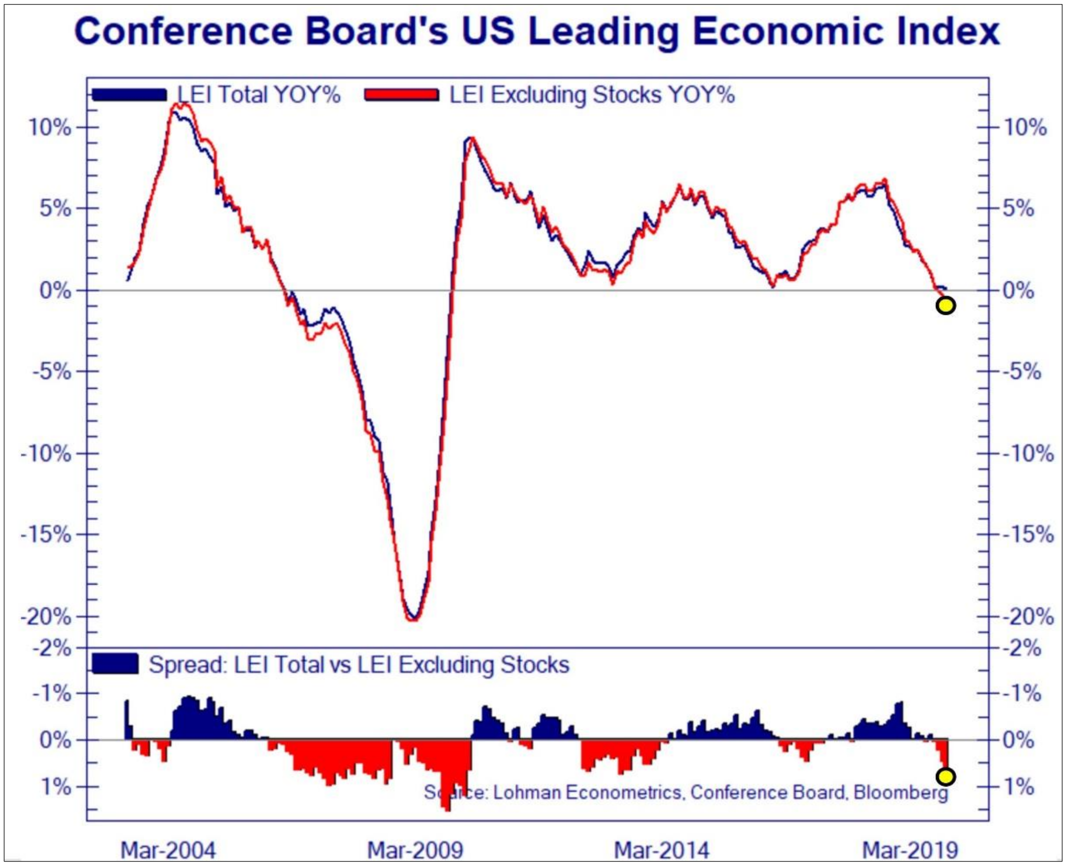


Chart – Leading Economic Indicators

LEI release this week revealed that stock prices are keeping LEI growth above water.



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.