Market Outlook

By Mark T Dodson, CFA

Highlights

Market Risk Index rose on increased risk readings from the monetary composite. Psychology was unchanged on the week but managed to set another market cycle record mid-week. October 2000 was the last time the psychology composite score was this high. There have only been three other brief periods since 1970 where our psychology composite score was worse - in 1971, 1973, March 2000 and October 2000. When we update the valuation composite for MRI next week, our return forecast is likely to fall under 2% for equities. The work that went into Market Risk Index was objective, done without an agenda or bias. If it's measuring the drawdown risk incorrectly, then the only conclusion is that we've entered a new era, and this time is different.

One of the bigger detractors from psychology this week was from the Market Internals category. The highs in February are distinct from December and January in this way. Other than the Advance/Decline line, our other favorite measures of market internals have not gone on to make new highs with the cap-weighted S&P and NASDAQ this month. It is enough to put a momentum market on watch.

Inside the monetary composite, the yield curve continues to flirt with inversion and hurt the score, but some of that deterioration was offset by the interest rate category. The drop in corporate bond yields has hit a level that is historically short-term bullish for markets. It's a two edged sword here though. Yields are falling, but yield chasing behavior, and the risks investors are taking to chase them, is egregious. This week, an uber-popular strategist said that investors need to abandon 60/40 investing and go all-in on dividend paying stocks to ensure they keep getting income. We are big fans of high quality, dividend-paying stocks, but we've also saved the quotes from this interview for posterity as examples of 2020 yield-chasing behavior.

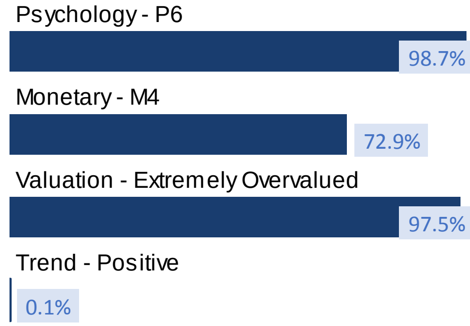
Meanwhile, the Jerome Powell from 2013 who seemed to worry about asset bubbles has disappeared and been replaced by black-tie wearing Fed Chair Powell who has been setting records for his number of meetings and dinners with politicians. Instead of worrying about asset bubbles, he's letting the balance sheet rip to see what it takes to knock inflation expectations loose and move them higher. The hazard in this experiment is that monetary policy hasn't worked way in over 30 years.

Market Risk Index

Elevated

91.4%

Category Percentiles



Largest Psychology Influences

Flow of Funds (Buyback activity)	Positive
Leveraged Investments	Negative
Option Activity	Negative
Consumer Confidence	Negative

Largest Monetary Influences

Interest Rates (Falling)	Positive
Yield Curve	Negative
Velocity	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	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.

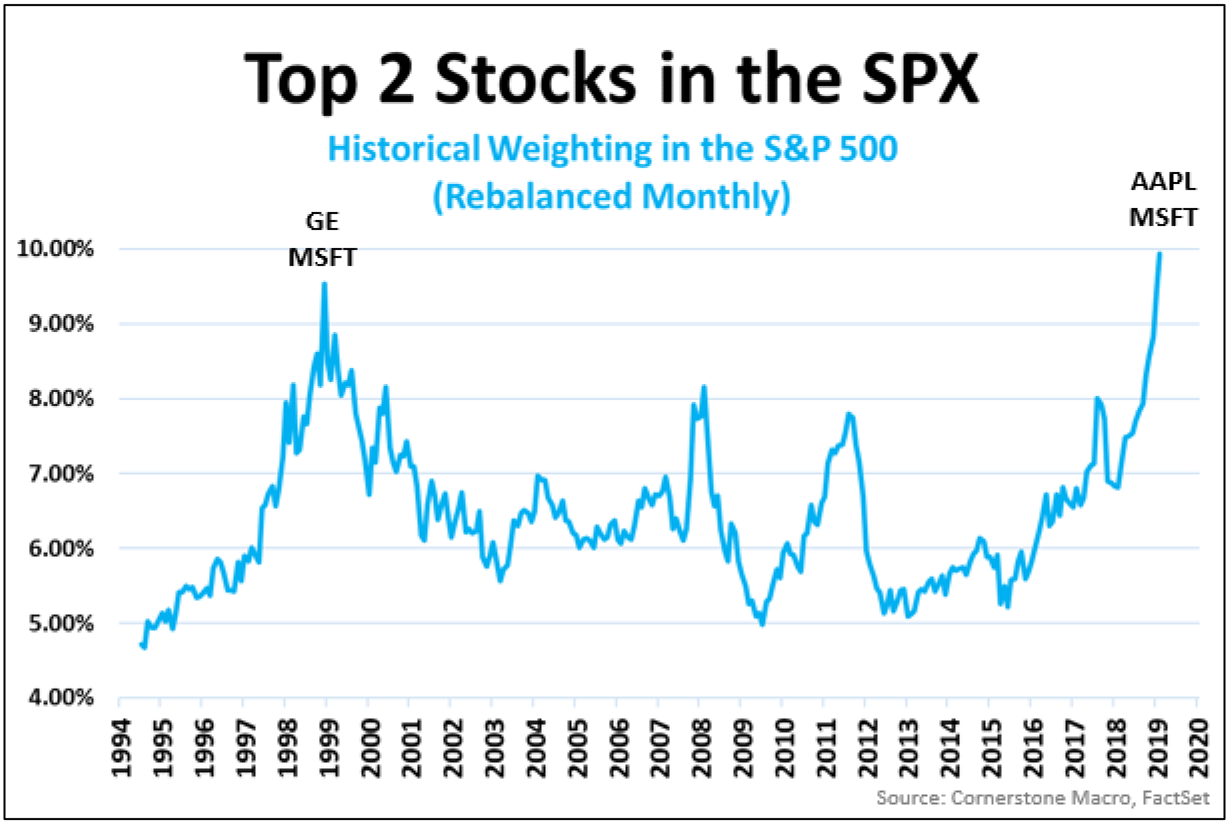
Between 1950 and 2000, the correlation between the changes in the velocity of money and stock prices was negative 43% and a positive 38% correlation with inflation. Since 2000, the correlation between changes in velocity and stock prices has not only switched signs, but it's done so in dramatic fashion – it's a positive 55% to asset prices, while the correlation to inflation has stayed roughly the same at 37 to 38%. The correlation has totally reversed for stock prices and become larger than the correlation with inflation.

In simple terms, back in the olden times, when the risk-free rate was assumed to be 5% (not -1%) and excess money-printing caused the economy to run too hot, it led to inflation in the prices of goods and services, and then stock prices got hammered. That's the textbook that central bankers read. Today, too much money printing has a larger impact on stock prices than it does inflation of goods and services. People don't buy as much stuff, and corporations don't over-invest in factories and fixed capital.

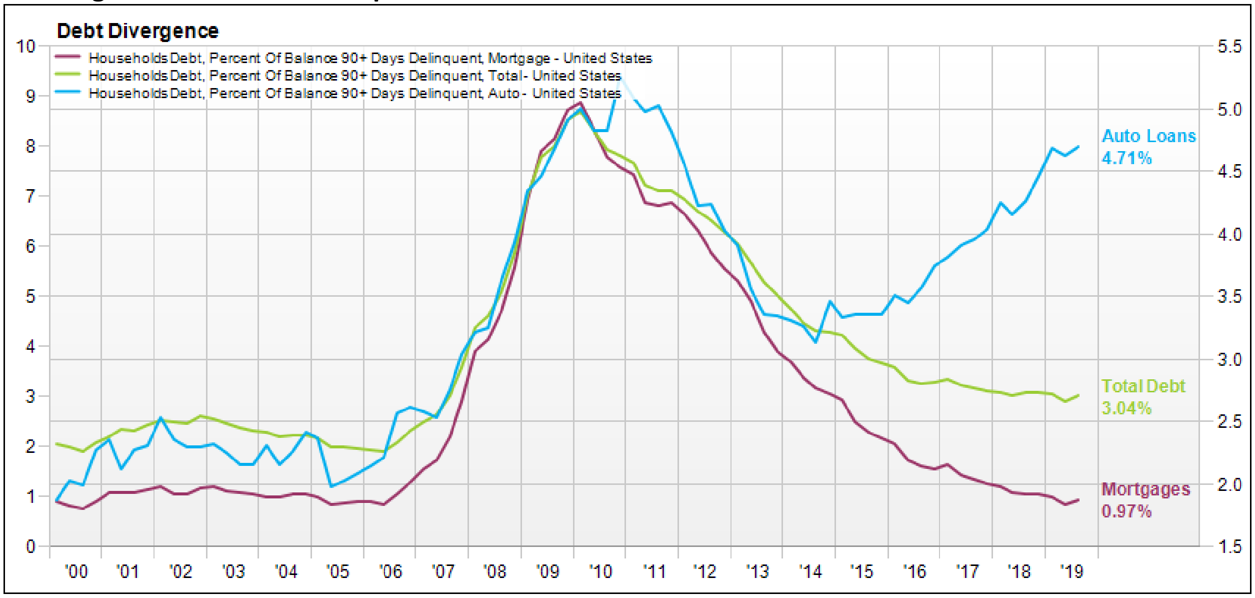
Instead, when there is too much money, the public buys more Tesla, junk bonds, and anything with a higher yield that Moody's or S&P says is investment grade, while corporations issue more bonds to buy back stock. These asset price inflations inevitably lead to deflationary bust, without any signs of old-school 70s inflation, and in a feedback loop, central bankers push monetary stimulus further to an experimental edge. To the point that...negative rates have actually become a thing. And the further they push, the more unpredictable and extreme the politics seems to become. This fall don't be surprised if it's Trump versus Sanders – twin New Yorker brothers from another mother. If they played together as kids, we all know which one would like to blow the bubbles and which couldn't wait to pop them. Can you seriously believe that the initials of the four trillion dollar companies (leading to the most concentrated S&P 500 ever) are M-A-G-A? Microsoft-Apple-Google-Amazon. You can't make this stuff up. Interesting times.

The Week in Charts

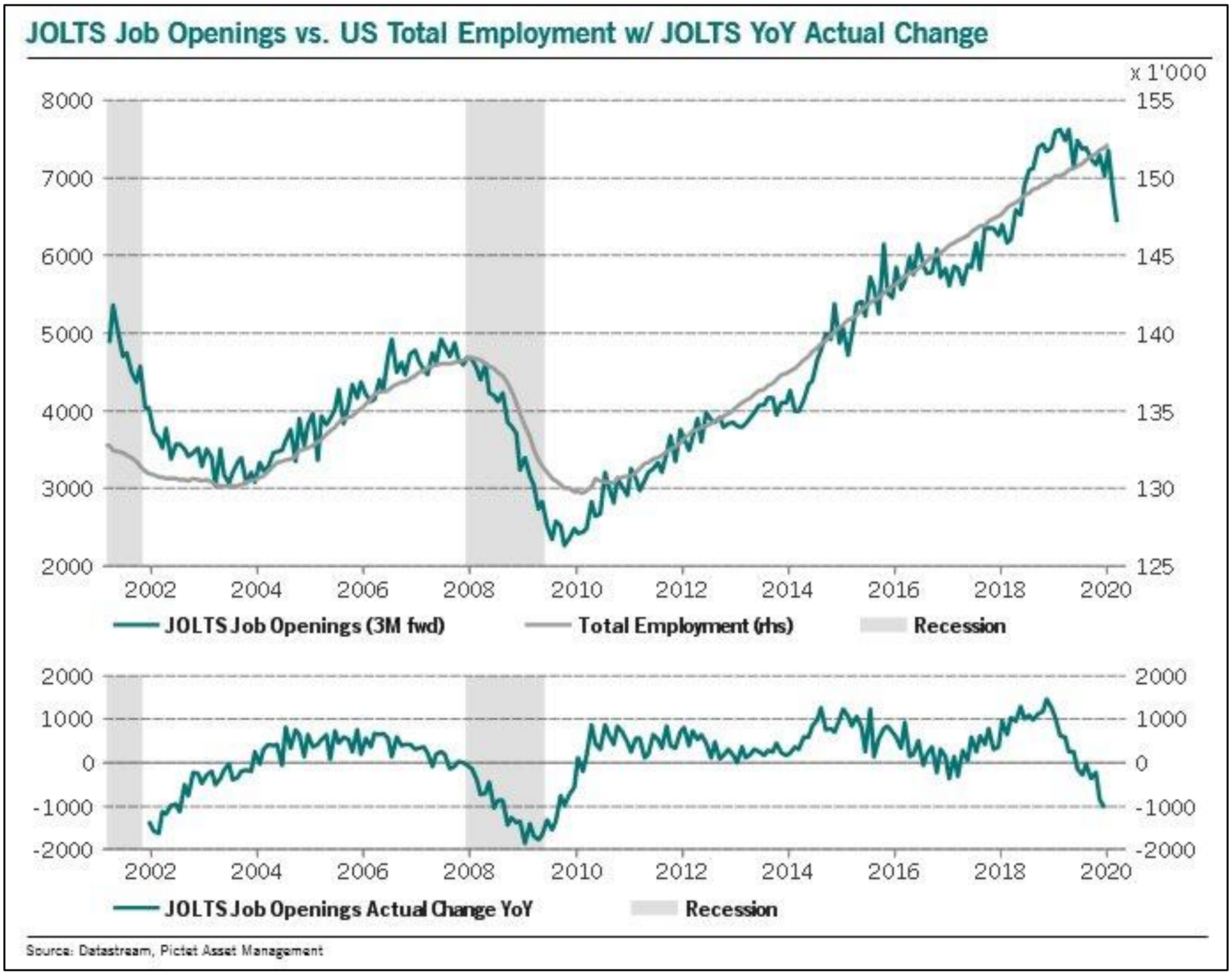
Two Stock Concentration in S&P 500 is at all-time highs
Impressive that 20 yrs. later, Microsoft is one of the top two.



New Highs in Auto Loan Delinquencies

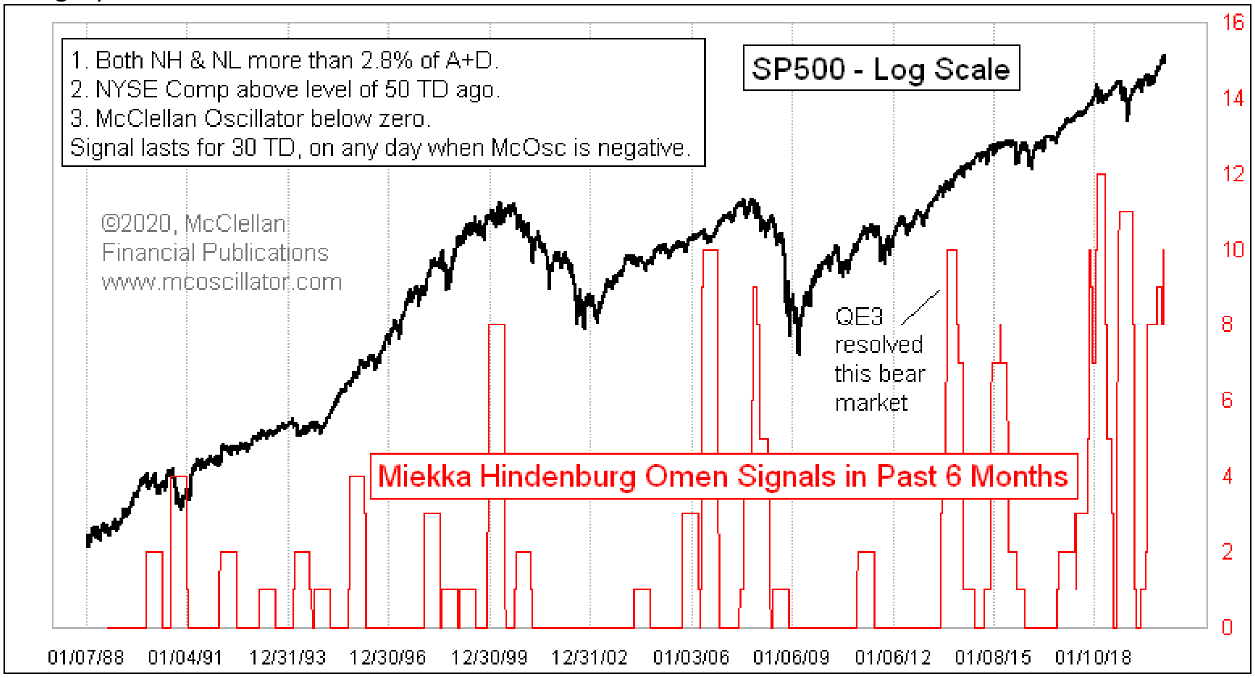


Employment numbers have been very good, Job Openings continue to roll over



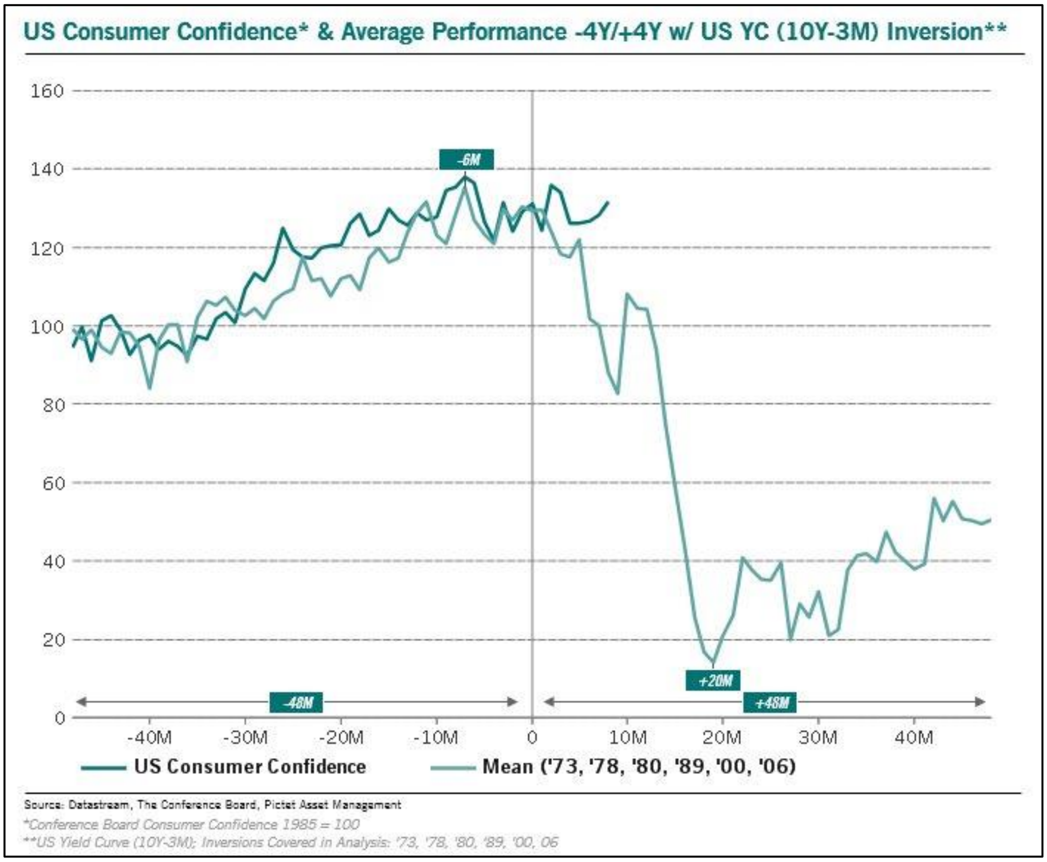
Hindenburg Omens on the Rise

In the modern era, Hindenburg Omens come in clusters, and the number of omens is approaching the rally stopping levels from 2018. Some of the inputs to Hindenburg Omens are included in our Market Internals category.



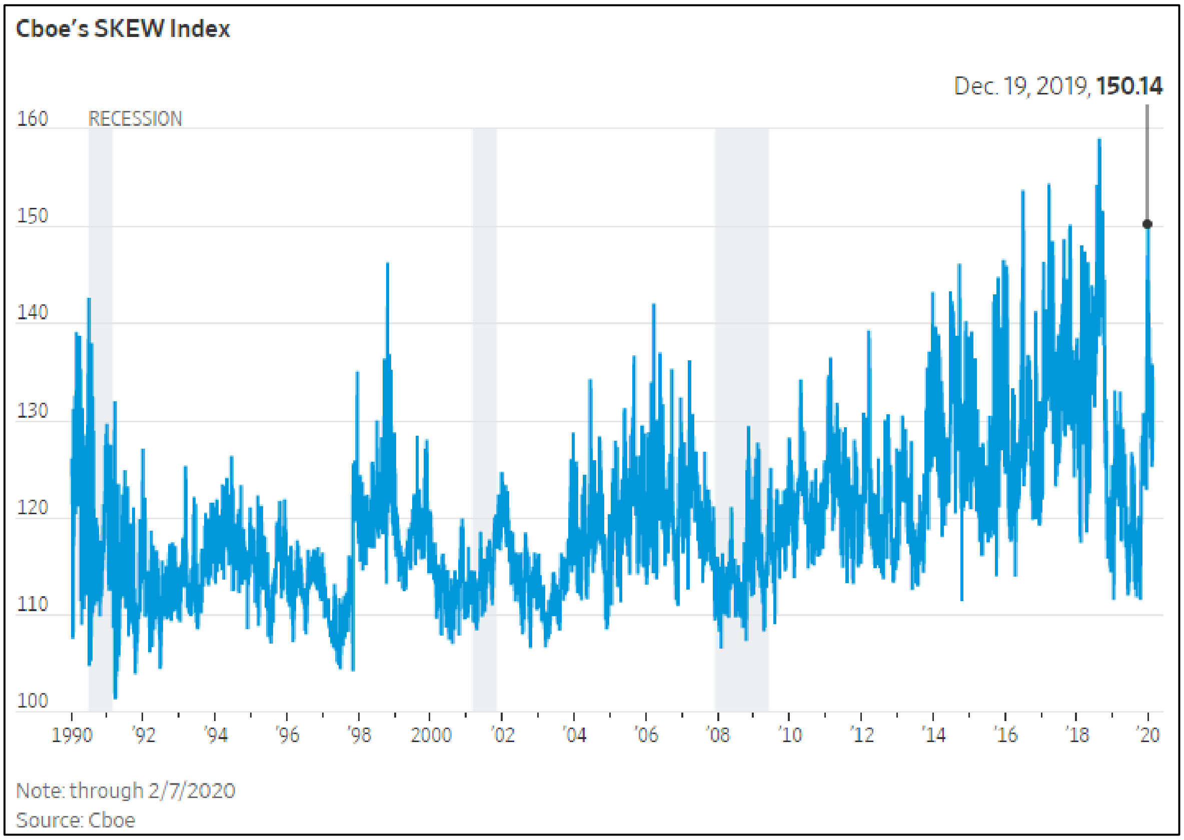
Shallow Yield Curves lead to drops in Consumer Confidence

Notice the break this time around – so far, confidence has split from historical precedent.



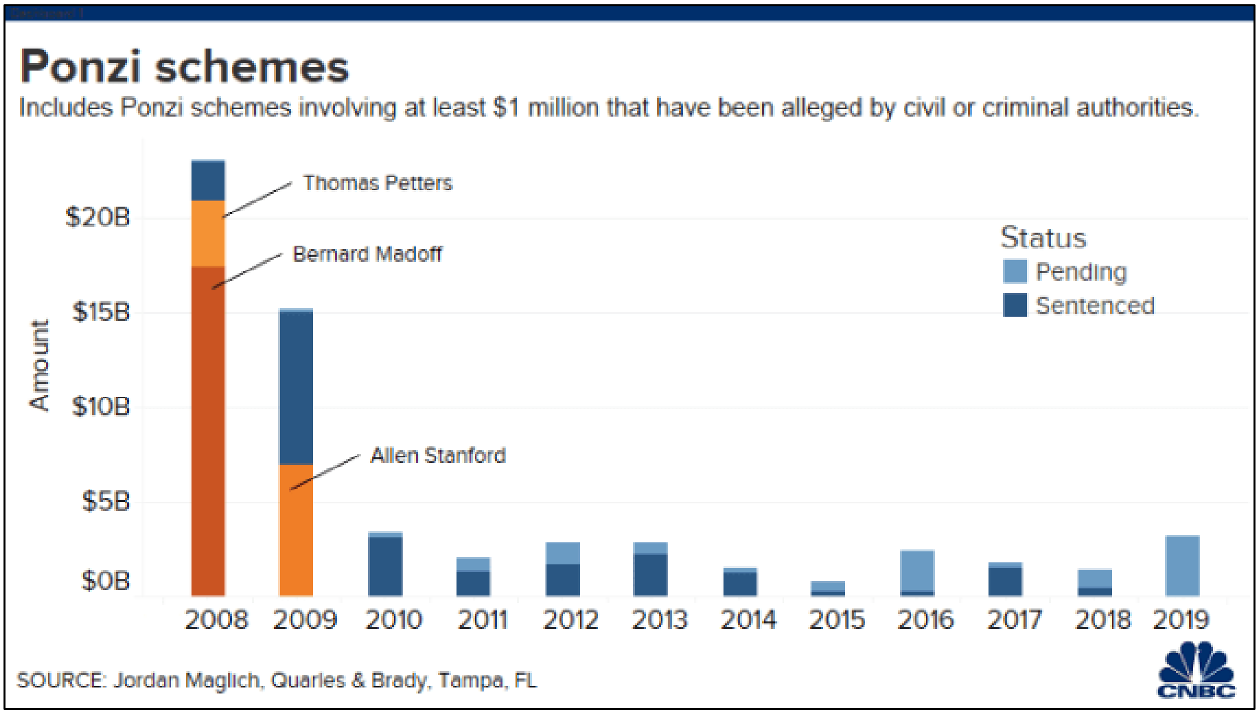
Skewing your view on the SKEW Index

Great piece in the WSJ this week on the Skew Index. The paraphrased short version – it's not so much that options investors are growing more bearish, it's that all the other option traders have gotten more optimistic relative to the bears. The bears haven't gotten more bearish – the option bulls have gotten more bullish.

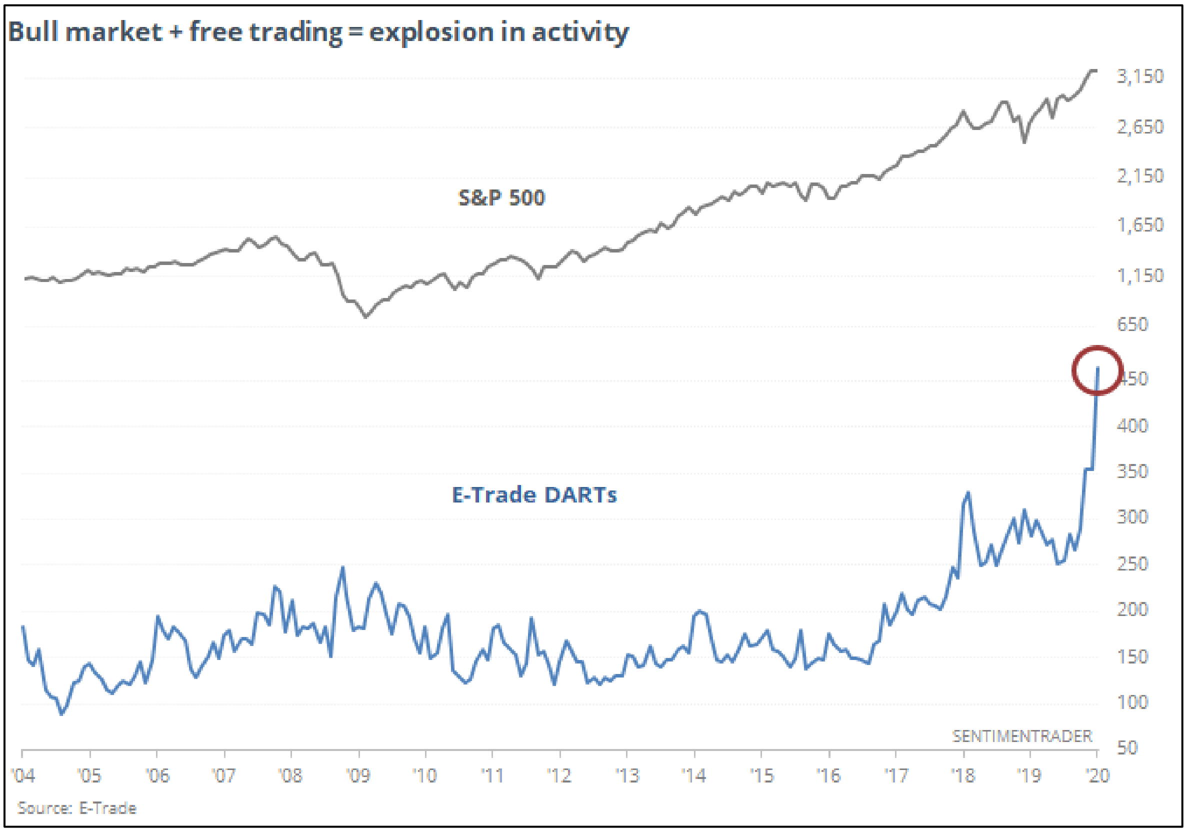


Source: WSJ

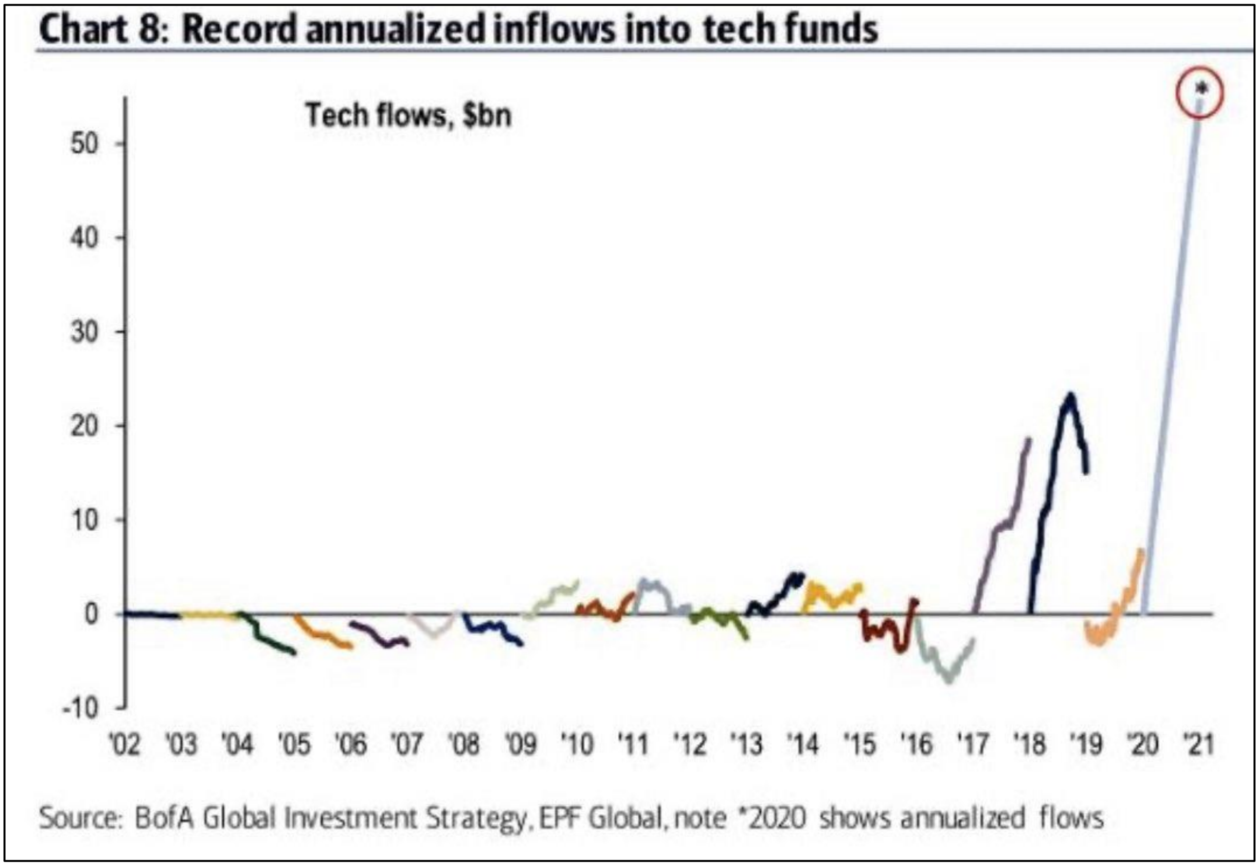
The tide hasn't gone out yet, but Ponzi scheme convictions are on the rise



Let's light this candle! Free stock trades have fired up small stock traders...



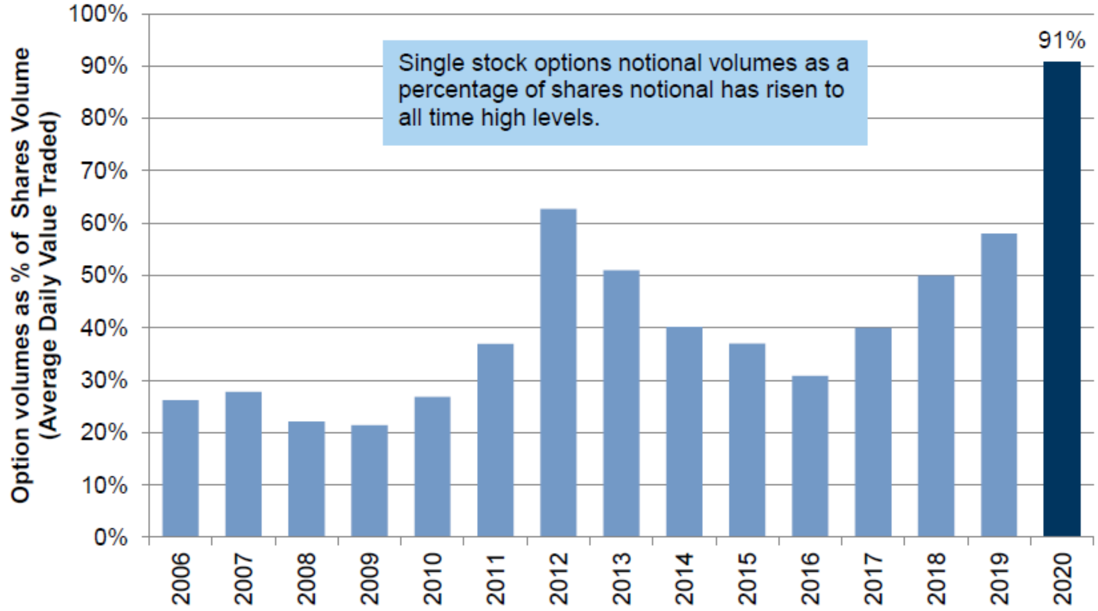
Pace of Inflows into Tech Funds setting records



Volume in options, relative to underlying share volumes, is setting records.

Exhibit 1: Single stock options notional volumes as a percentage of shares notional have risen to 91%, well above previous highs

Average daily notional traded for options vs the underlying stocks



Source: Goldman Sachs Global Investment Research, OptionMetrics, Data as of 10-Feb

Ratio of Tech to Energy Stocks is close to breaching 2000 levels

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.