Market Outlook

By Mark T Dodson, CFA

Highlights

Market Risk improved this week but remains elevated above the 90th percentile, and our cash recommendation is unchanged from January's recommendation of 40%. Psychology has started to improve, but outside of high volatility readings and being one of the most technically oversold markets in history, psychology hasn't improved to the levels that has marked correction lows over the last five years. The biggest tailwinds this week were volatility, oversold readings, and a shift in option activity back to neutral.

Our volatility category contains nine different measures of volatility. All are now in bullish territory, and all but one are at their maximum positive reading inside the composite. Volatility readings like this, normally unheard of outside of big bear markets, have become more commonplace this cycle. Welcome to a world dominated by quant-based strategies and passive investing.

Option activity, the category that registered all-time historic levels of euphoria last month has made a solid reversal back to neutral territory but has not turned constructive for markets.

We're disappointed by the lack of improvement in psychology given the severity of the sudden market decline, but this week began where last week ended, with a strong desire from investors to buy the dip. Simple evidence of this fact came again from the AAII survey results, which for another week revealed little concern for falling stock prices, as investors largely seem to view the market's action as a monster dip buying opportunity. Things began to change toward the end of the week, as some of our timelier investor psychology indicators registered some improvement. Rydex investors, for example, who levered up during last week's decline, finally began the process of pulling back on leverage in the second half of this week. Corporate Insiders, who were big sellers of stocks in February, started dipping their toes into the market on Thursday.

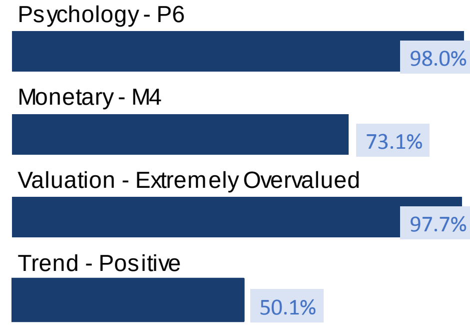
As a result of the historically sharp nature of the market's decline and our desire not to miss something occurring under the surface, we've begun focusing on the day to day point totals in psychology as much as the overall level of the smoothed composite. We've also gone as far as creating a new barometer to measure a handful of excellent shorter term sentiment indicators and removed some of the longer leading sentiment indicators, like the Consumer Confidence index. We've labeled it the "Buy the Dip Gauge" and included a plot in this week's report, and it gives a similar message – that being historically oversold doesn't necessarily mean there's blood in the streets.

Market Risk Index

Elevated

91.0%

Category Percentiles



Largest Psychology Influences

Volatility	Positive
Leveraged Investments	Negative
Consumer Confidence	Negative
Fund Flows	Negative

Largest Monetary Influences

Falling Bond Yields	Positive
Yield Curve	Negative
Velocity	Negative

Valuation

7-10 Year Rtn Forecast	2.1%
10Yr Treas Yield (on 01/31)	1.5%

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.

There's a number of historic extremes occurring with price and breadth based indicators, but as we argued last week, often times those can indicators signal more risk ahead instead of opportunity.

Pundits will say that Coronavirus as a correction catalyst was both unpredictable and unrepeatable. This may be true, but most corrections and bear markets begin this way – with a big surprise that no one saw coming. These shocks often serve as the first crack in investors' rose colored glasses. If this proves to break consumer confidence that is near all-time highs, Coronavirus will lead to more than just a correction. Last cycle's catalyst is never this cycle's catalyst either – which is why you should ignore your favorite strategist when he tells you that the housing market and banks are in much better shape than they were in 2007/2008. It's not helpful advice.

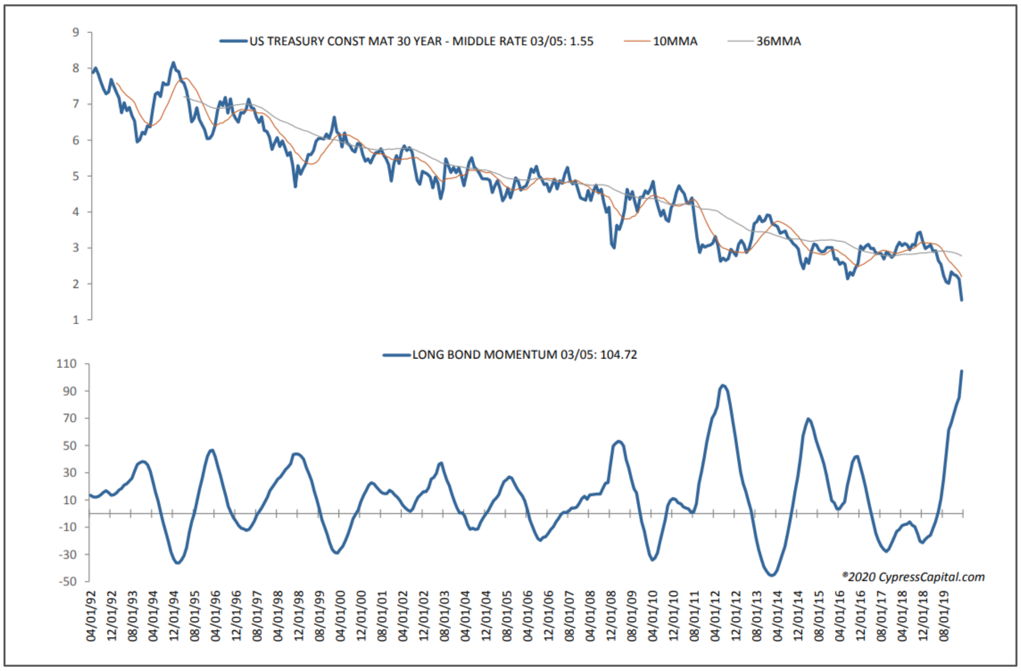
Correction or bear market catalysts may not be predictable or repeatable, but animal spirits are. Over-valued markets marked by investor complacency and a dismissal of a cycle's red flags in favor of a simple, collective narrative aren't that difficult to spot. And, these episodes of animal spirits only need the flap of a butterfly's wings as a catalyst to unwind. Cycles may be easy to spot and dismiss, but it takes courage and discipline to avoid getting caught up in the crowd.

The February 2020 highs have enough hallmarks of a bull market peak to lead one to believe that the Feb 19th peak will prove to be the bull market's final high, but again the desire to avoid losses and seize opportunities that Mr. Market presents us outweighs the desire to make the perfect call. We believe that you should treat this correction like the beginning of a bear market, which means there's still much work left repair the wall of worry and erase the excess from this cycle.

In the meantime, bear markets just don't continue at this pace. They lose about 2% a month on average, fall too far under that level for a month or two and a bear rally ensues. The worst losses come at the end, and valuations are the best guide for when the reward begins to outweigh the risk. While the last two weeks have quickly erased six months of gains, valuations still suggest risk is higher than reward, but our hunch is that investor psychology will begin to suggest the odds of a bear rally to begin this month will soon grow quite high.

Long Bond Momentum

Our Long Bond Momentum gauge reached record overbought levels this week. The gauge turned positive in December 2018. When overbought and moving higher, the indicator suggests a barbell strategy is most appropriate, but yields are approaching levels that the value of Treasuries as a hedge is becoming limited.



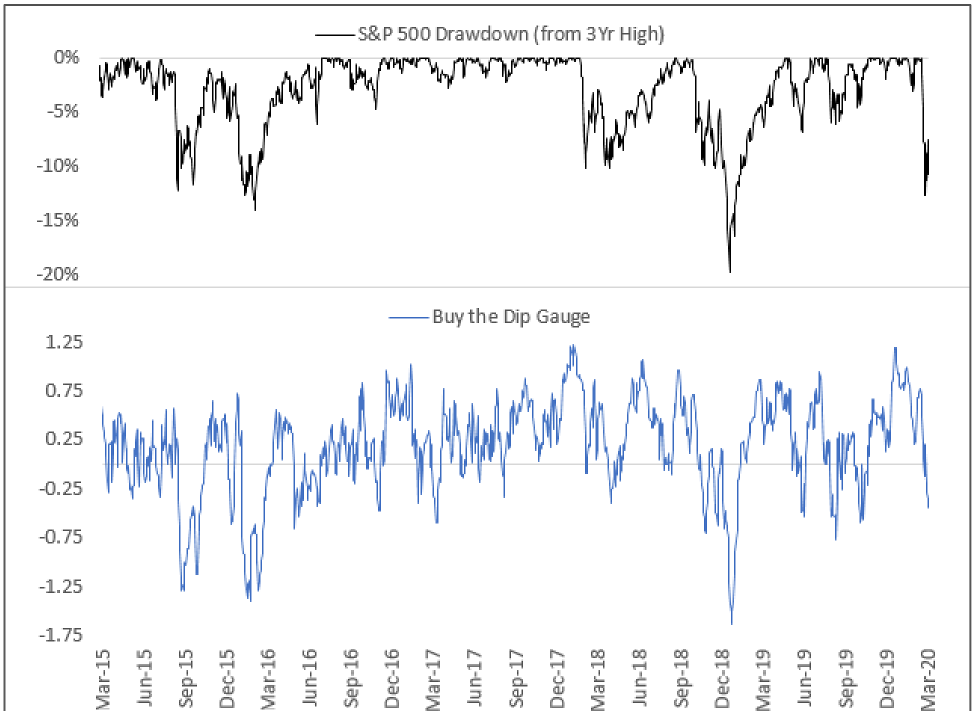
Psychology Composite Daily Point Total – 10Yr Chart

The daily point total on our psychology composite has now hit levels consistent with the ends of minor pullbacks but not levels that marked the end of the most significant corrections in the last five years. At the current pace, the market is likely to put in short-term low this month. Notice that the same daily point total that coincides with correction bottoms also marks the beginning of bear market rallies.

Source: Cypress Capital

Buy the Dip Gauge

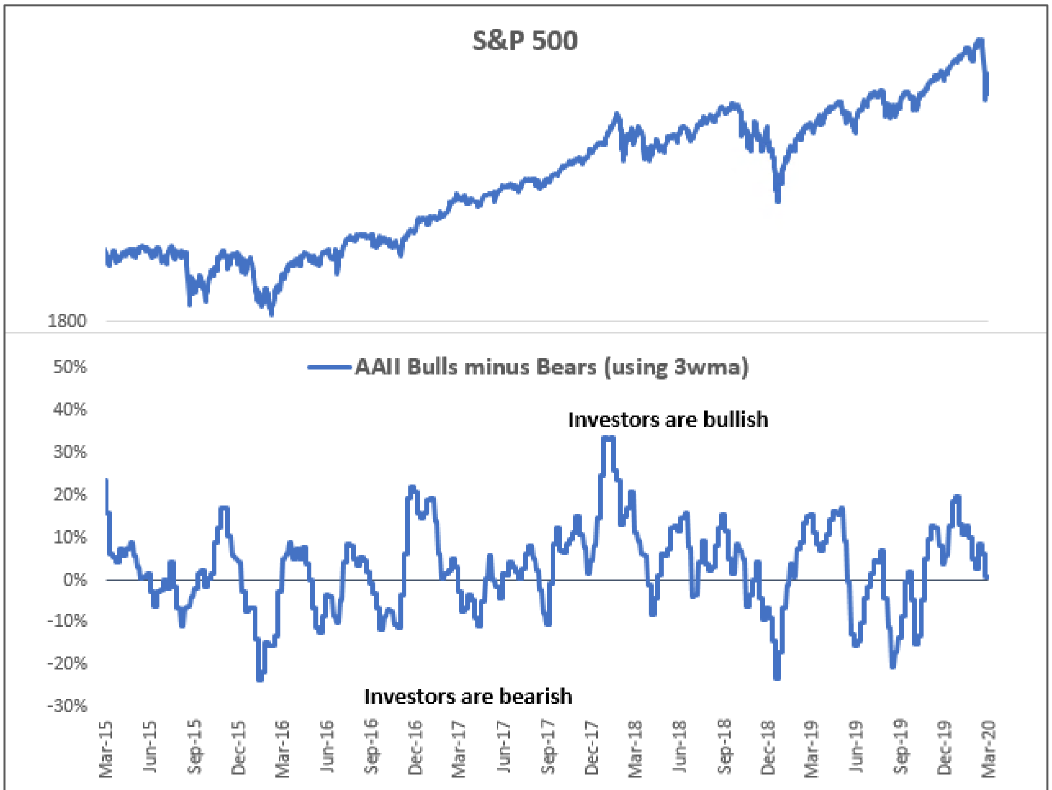
This composite of six indicators of shorter term, more timely sentiment indicators, particularly over the course of the bull market cycle that began in 2009, still suggests that fear isn't as rampant as it was at the lows in 2015 or 2018. Two of the six, Breadth Thrust and Volatility, are hitting extremes.



Source: Cypress Capital

Note: Buy the Dip is an average Z-Score of the following indicators – US Breadth Thrust, Rydex Ratio, OpenInsider Buy to Sell Ratio, the 15 day moving average of the CBOE equity put/call ratio, the 3wma of AAII Bulls minus Bears, and the Volatility Index (VXO). For indicators that don't have a stationary trend, a 3Yr Z-Score is used.

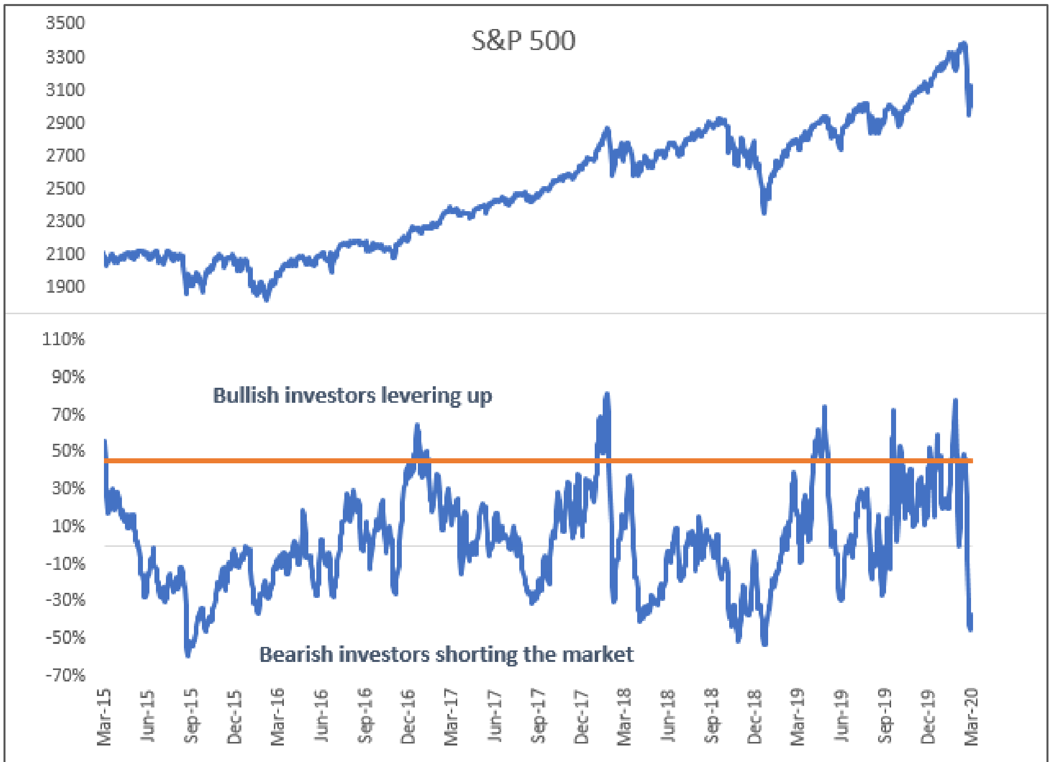
AAII Investor Sentiment not registering investor anxiety



Source: Cypress Capital, AAII

Leveraged ETF Sentiment

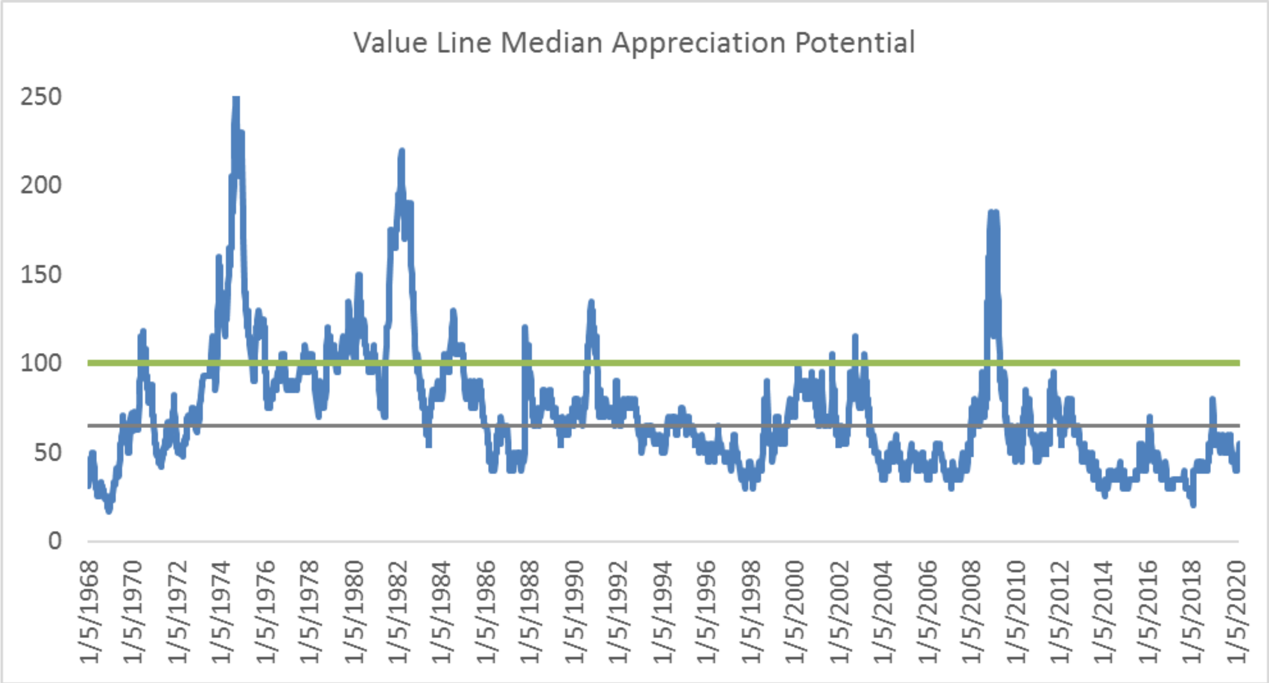
Volume in inverse ETFs relative to levered ETFs started to hit extremes this week. This indicator is a standout among the levered investments category of our Psychology composite.



Source: Cypress Capital

Valuations – Valueline Median Appreciation Potential

Our seven-factor valuation composite is still in the 10th decile and has only pushed return expectations up to the levels from where they were back in October. In other words, it's only erased the overshoot that occurred over the course of the last four months. If you didn't feel like loading up on stocks last October, you really shouldn't now. Mid and small cap valuations are better, but on an absolute basis, they are still below median levels. When our favorite metric in this space, Valueline Median Appreciation Potential, hits 100%, the reward to risk has become lopsided in favor of equities – that's the dip to go all-in.



Source: Value Line, Cypress Capital

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.