Market Outlook

By Mark T Dodson, CFA

Highlights

A lot to unpack this week, and we'll try to do it using as few words as we can. Market Risk Index finally dropped under the 90th percentile, for the first time since crossing above the 90% threshold in mid-December, mostly on improvement from valuations. It was enough to get us to increase our exposure to equities modestly, and we're reducing our cash recommendation to 30% from 40% for US equities.

What may surprise you is that MRI improvement didn't come as much from a result of the psychology composite. In the face of one of the most rapidly unfolding bear markets since 1987, psychology's stubborn lack of improvement is due to a couple of factors. One is a result of how extreme the readings have become on some of our longer leading sentiment indicators that likely won't break until the credit cycle completely breaks. The other is a result of just how fast the market mood has shifted. We smooth out the daily readings from the composite to reduce the noise from day to day readings, and it was barely two weeks ago that we were seeing some of the worst investor psychology readings in the history of the composite.

Up until the last 7-8 trading sessions, we saw a stubborn persistence to buy the dip. It took one monster of a market decline to break those animal spirits. In spite of an unforgettable week, our daily psychology point totals still haven't surpassed where they were at the lows in 2018. Like each of the previous two weeks, the second half of the week saw our psychology composite continue to make improvements. Our Buy the Dip Gauge, made up solely of quicker moving sentiment indicators, put this week on par with the week that Bear Stearns failed in March 2008, when the previous bull market's desire to buy the dip hadn't fully given way to bear market capitulation, and the market bounced, for a time.

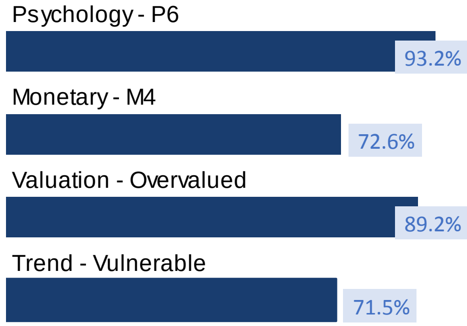
All that said, between improving valuations and enough improvement inside psychology, we saw enough there to begin increasing equity exposure inside portfolios. There is still a lot of excess from the cycle to work off here, and a quick upward resumption of a new bull market so soon with peak employment, record corporate debt and an inverted yield curve would be a first in stock market history. Adding more monetary stimulus this time around is unlikely enough to be able to buoy confidence, and recession seems unavoidable.

Market Risk Index

Elevated

87.9%

Category Percentiles



Largest Psychology Influences

Volatility	Positive
Option Activity	Positive
Technical Indicators	Positive
Consumer Confidence	Negative

Largest Monetary Influences

Falling Bond Yields	Positive
Yield Curve	Negative
Velocity	Negative

Valuation

7-10 Year Rtn Forecast	4.2%
10Yr Treas Yield (on 03/12)	0.8%

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.

We also cut our long maturity Treasury position between 50-75% this week. Our bond momentum gauge is the most overbought in history, and Treasury markets started acting toppy early this week. We have that piece primarily for its ability to hedge market declines, and the value of the hedge has diminished with Treasury yields edging closer to zero. We used the pop on the Fed intervention announcement to execute the last bits of our trade. On the monetary front, this week taught us that the strange ongoing activity in repo markets ended up being the canary in the coal mine. Just how rapidly the Fed was forced to give assurances that exceeded a trillion dollars should put in perspective how fragile the current cycle was. We haven’t initiated any positions in credits inside income strategies, as spreads haven’t widened enough to move us off our defensive positioning.

For questions that we receive this week about our Market Trend for US equities, it’s unlikely to break for some time. We designed it both as a slow moving fail-safe and to keep us from going all-in on bear markets too quickly. Regardless, this bear market has proven useless for trend followers, and for those pure trend following strategies that sold this week, a coming bear rally would prove very painful. The only way to sidestep any of this drawdown was using an old school, blue collar margin of safety approach. It wasn’t fun watching everyone get sloshed at the punch bowl, but we’ve been to the party enough times to know how much we hate the hangover.

This market reminds us a little of 1987, for the sharp and swift nature of the decline, and a little of 9-11 just for the sheer shock of its surprise – how quickly it opened the eyes of the Western world to risks to that were never even on the radar. There is Coronavirus headline shock risk that will continue for the public as traditions we hold dear, like March Madness get canceled, or when another celebrity contracts the virus. Even in panics though, the human mind fatigues of living in that state of fear, and we can’t live that way for long. That fatigue should coincide with a bear market rally, and unless Chairman Powell is hiding a Flux Capacitor in a Fed vault somewhere, there is still likely to be another leg down. It seems a mistake to dismiss this as just a Coronavirus bear market that will go away as the virus panic eases. It was a catalyst, but it comes at the most vulnerable time in the both the bull market and credit cycle.

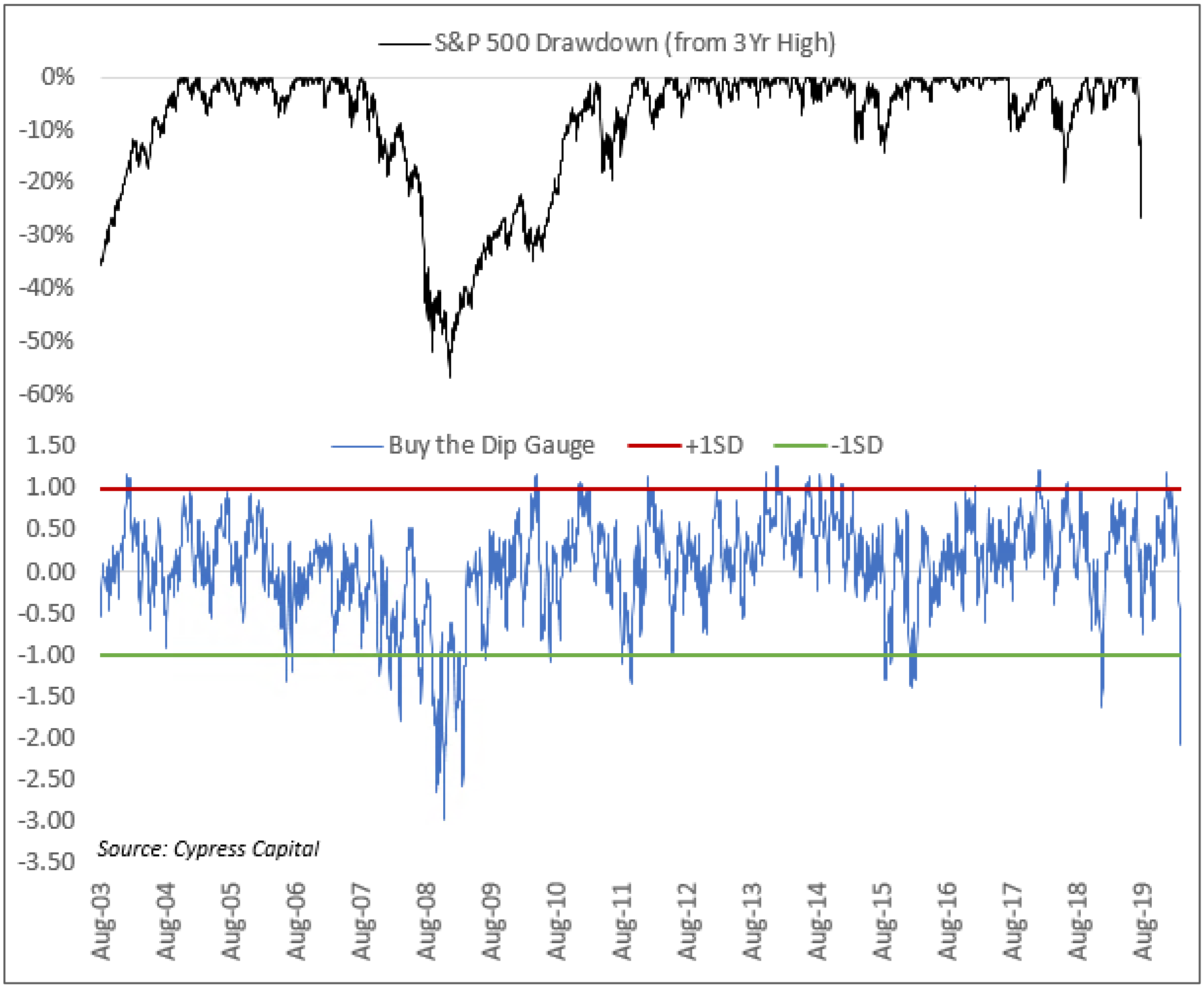
For speculators, selling pressure has set all-time records and short term sentiment has hit enough of an extreme that some upside volatility has grown likely, and if previous bear markets can serve as lessons, it will take us right up to the point that we think the clouds are beginning to clear. Our psychology composite still hints at an enduring desire to buy the dip, as the idea of recession and how it constricts consumer wallets has yet to sink in.

Speculators shouldn’t count on buybacks as a backstop this time around. The folks who have provided a floor for stocks in both of the previous bull markets have been notorious for pulling back when conditions sour, precisely when their stocks start becoming most attractive. They won’t provide the cover for dip buyers that they have over the last few years. With spreads widening, borrowing money to buyback a falling stock suddenly won’t be a priority anymore.

As investors, in the Ben Graham sense of the word, we don’t mind going all-in on equities during times of high uncertainty, but stocks need to be priced to offer a large margin of safety. Despite the fact that we have entered a bear market and have dropped quite a bit from market highs, we still don’t have enough margin.

Buy the Dip Gauge

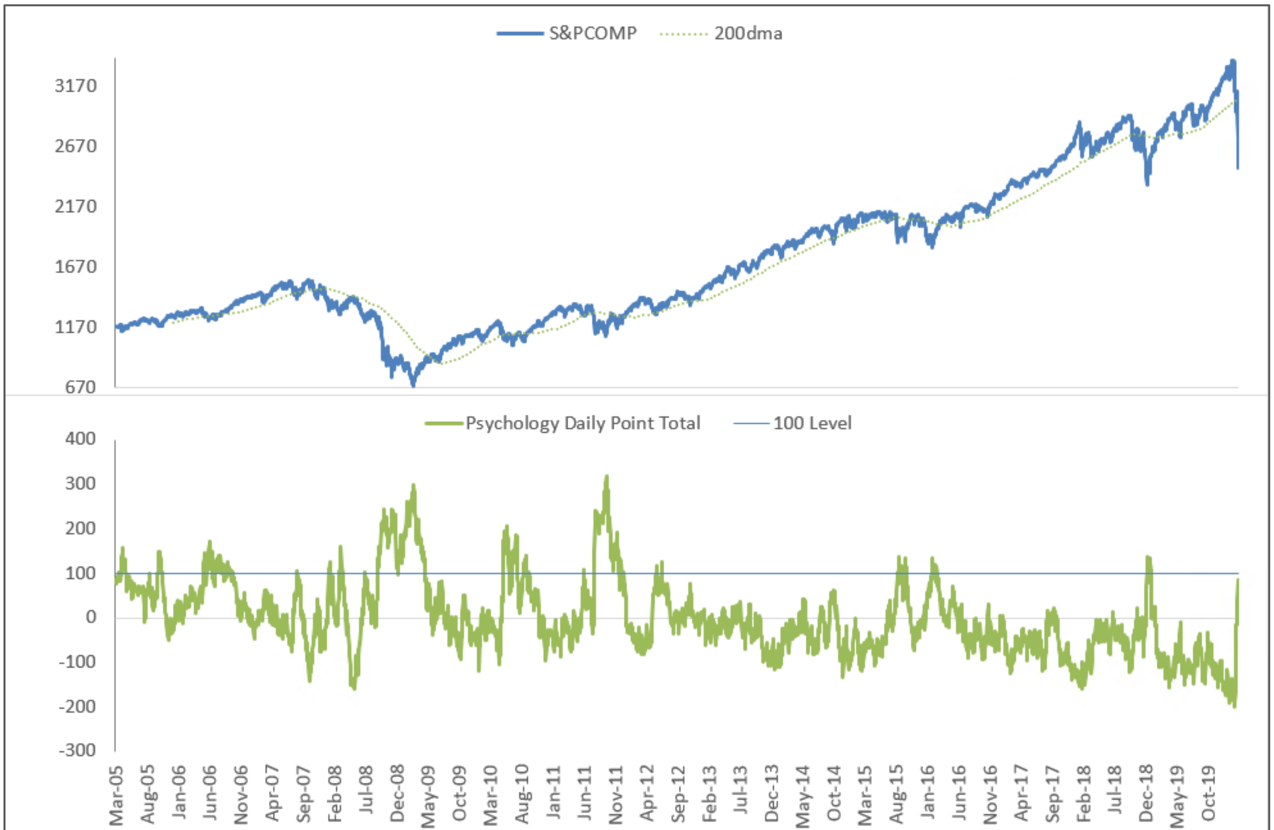
We shared this chart last week, and it wasn't registering much of a shift. One week later, and it's a 2-standard deviation short-term investor sentiment event, most comparable with the week Bear Stearns failed in March 2008. Its message is to expect a short-term market rally.



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.

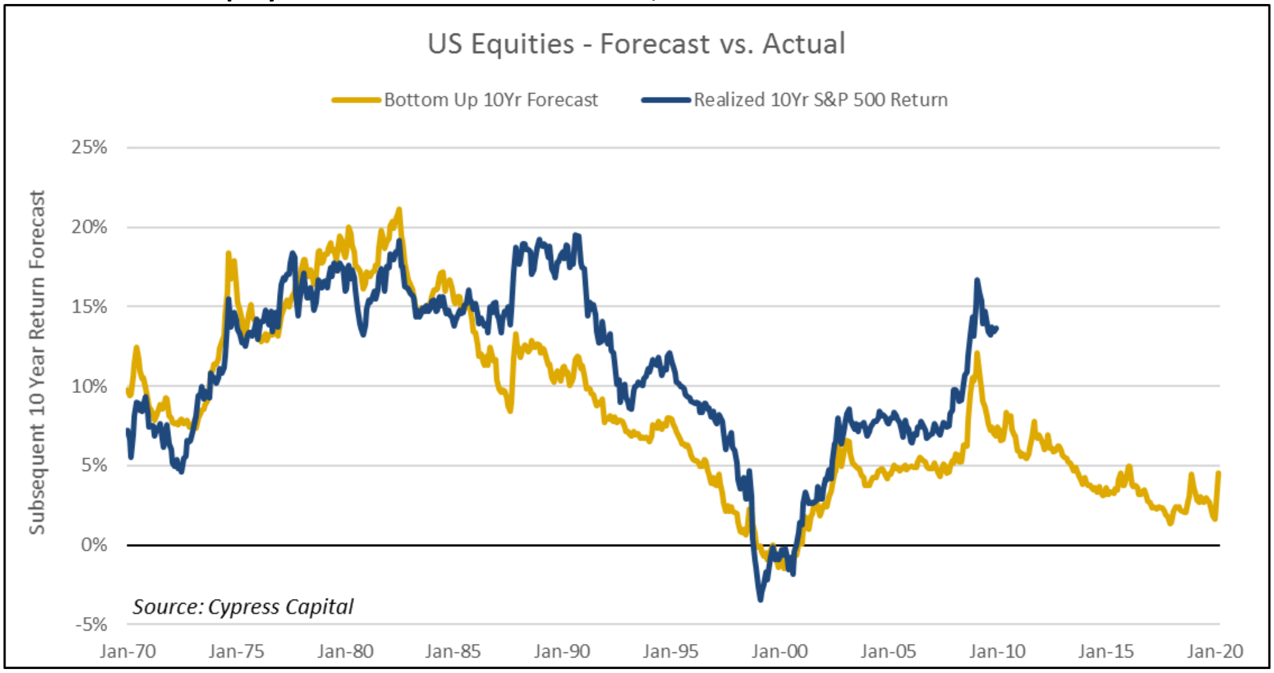
Psychology Daily Point Total

As unprecedented as this decline has been, the daily total for our psychology composite has not quite crossed the 100 point threshold, a level reached in every major correction over the last 15 years. We caveat that we expect that our update of the composite over the weekend with weekly frequency indicators to reveal the 100 point threshold has been breached. Note that this threshold typically marks the ends of corrections or the beginning of bear market rallies. Based solely on our psychology composite, it would a be first if a new bull market began from this level once in a bear market. Every bear market since 1970 saw persistent daily totals above 150 points. The 2000-02, 2008, and even the 1987 bear markets saw daily readings climb above 200 points before the worst was over.



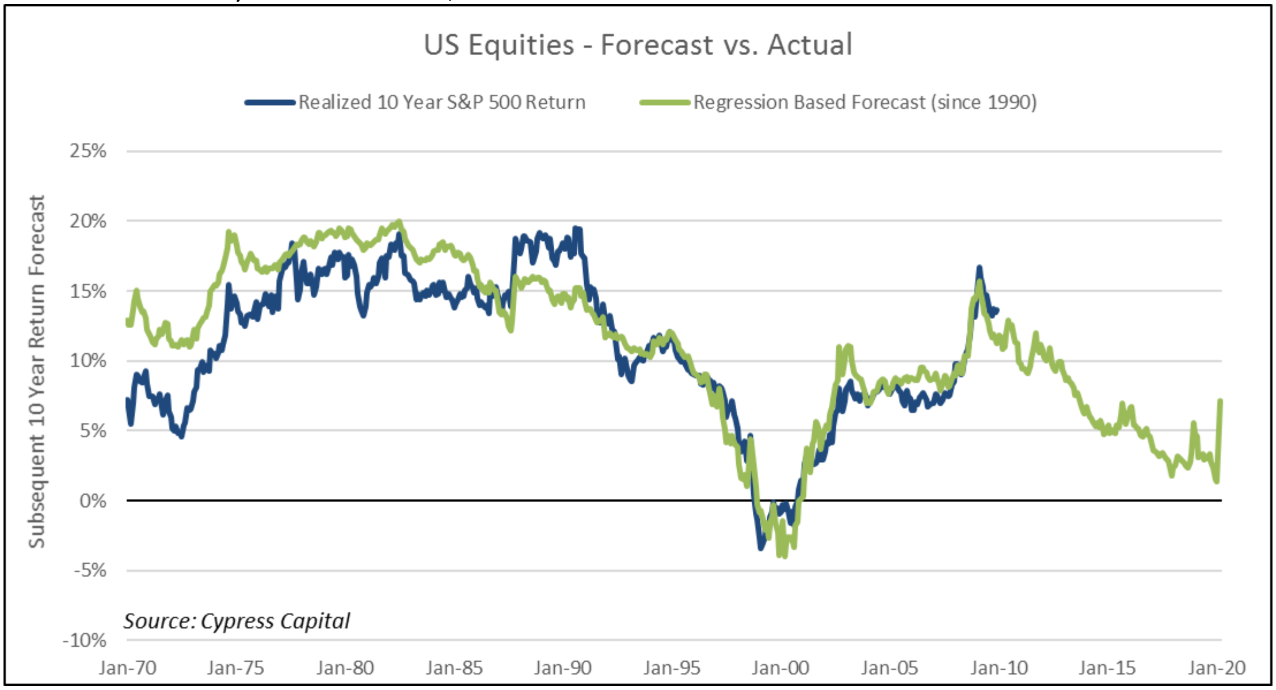
Source: Cypress Capital

Valuation – Our equity return forecast climbs to 4.5%, close to where it was at the end of 2018



Regression Based Equity Return Forecast climbs to 7.1%

This valuation model is growing on us. It's our concession to the idea that higher valuations since 1990 have become the norm, and it's based on a regression of the levels of our seven factor valuation model with S&P 500 total returns (notice how tight the fit becomes with realized returns from 1990 forward). The market's decline through the 3/12 close has caused return expectations to jump to 7.1%. The 2000-2003 bear market saw return expectations climb above 10%, while the 2008 bear market saw return expectations jump above 15%. Notice how low stock return expectations fell early in 2020 - if the bear market from the second most overvalued stock market in US history ended this week, we'd be shocked.



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.