Cypress CAPITAL

Market Outlook

By Mark T Dodson, CFA

A Week That We'll Never Forget

Even the smallest bit of good news should lead to a powerful bear market rally.

Market Risk Index made a large improvement but remains in elevated risk territory. We saw improvement across all of our counter-cyclical categories but not quite enough to make additional changes to our current defensive positioning after last week's shift. The model sits with a 30% cash recommendation.

Investor psychology has broken out of the worst quintile of readings for the first time since September 2019. Without our smoothing constant, readings would be closer to the 50th percentile, good but still not back the truck up end of bear market levels. Fund flows and consumer confidence are the largest detractors, while Corporate Insider Sentiment, Option Activity and Volatility readings are the biggest positives. Volatility is full green. While the surveys and leveraged investments categories are the areas with the most near-term potential to push the psychology composite in the right direction, both are neutral today. For the leveraged investments category, moving to neutral is a colossal improvement, because it was the biggest detractor just four weeks ago. The likely drop coming to Consumer Confidence toward the end of the month could also be a positive driver. We'll be patient for the release, because we're less interested in nailing a short-term bottom than we are in making sure a risky market period is in the rear view mirror.

Unfortunately, the tape on up days this week weren't great with only 60-70% advancers – strong market rallies start with more and then follow through. Price action in sectors late the week have looked like unwinding of pair trades with quality lagging, and the trash getting a bounce. Friday's sell-off though was the first where internals weren't as bad as the indices made them look – an unusual number of advances considering how the indices fell.

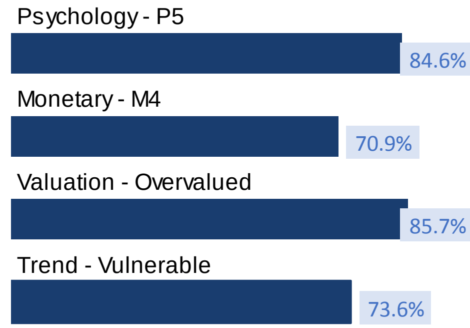
Shifting to the positives, our short-term psychology indicators are all at massive extremes, suggesting with even a modest bit of good news, the market could initiate a bear market rally for the ages. Even a bad news event could signify the end of a short term washout – clearing firm Ronin's Capital's forced liquidation today being one possible example. Having these short-term psychology indicators wound so tight has historically been good for powerful market bounces, but thus far the market has yet to respond, leading to the indicators to instead get wound tighter. Some, like NYSE Breadth Thrust, are hitting levels only reached a handful of times since the 1940s. We are

Market Risk Index

Elevated

82.4%

Category Percentiles



Largest Psychology Influences	
Volatility	Positive
Option Activity	Positive
Corporate Insider Sentiment	Positive
Consumer Confidence	Negative

Largest Monetary Influences	
Low Inflation	Positive
Yield Curve	Negative
Velocity	Negative

Valuation	
7-10 Year Rtn Forecast	4.6%
10Yr Treas Yield (on 03/18)	1.2%

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.

reaching levels that we are unlikely to see on some indicators for another decade. To say it's tightly wound is an understatement – based on stock market history – there's a better than good chance that we hit short-term capitulation next week.

Bear rallies aside, with such a large corporate debt overhang, expect announcements of major firm failures and bankruptcies, uncovered frauds, and probably a Millennial somewhere along the way who was making a massive bet on futures and hiding it from his Baby Boomer boss. It shouldn't come as a surprise. These are par for the course in a bear market – "Only when the tide goes out do you discover who's been swimming naked." Expect to see the final, big white knight deal (or deals) of Warren Buffett's career this year.

We purchased a couple of individual equities at attractive prices inside equity accounts and initiated a position in small cap value inside Global Allocation accounts. Prices on small value stocks have fallen so far from highs that when we update the data for Valueline Median Appreciation Potential early next week, it will likely cross or be close to the key 100% level. It can improve more, but this marks the level where the long term reward really begins to outweigh the short term uncertainty and volatility. It's led to good long-term buying opportunities in the past.

On the monetary front, improvement in the yield curve was partially offset by sharp increases in corporate bond yields, as money tightened rapidly during the week, and the Fed was forced to step in. QE Corona has yet to impact monetary readings. We liquidated the remaining portion of our Long Term Treasury position. Bond momentum is still positive but also the most overbought in history. The value offered by long bonds has dropped below their value as a hedge. Given a 2% inflation target and a conservative 1% GDP growth, a long-term Treasury should yield 3%, making a 1% yield too pricey for us here with momentum waning. It's also become apparent that the yield curve is in the middle of trying to normalize to a steeper positive slope as risk aversion increases, even though the Fed has stepped in to slow the pace down.

Some crowding out also seems likely to occur as deficits start expanding rapidly. Coronavirus is going to end up being a live test of Modern Monetary Theory. A mind-blowing increase is coming in deficit spending, sovereign debt, and central bank balance sheets. With countries around the world about to set on a course of the largest coordinated fiscal stimulus ever, this may mark the end of our low inflation era in the way that WWII spending bookended the end of the Great Depression era.

If you are looking for a mental road map for the bear market, based on a simplified version of our framework for knowing when reward outweighs uncertainty – at bear market lows, unemployment will be high, consumer confidence will be back toward the low end of its historical range, the yield curve will be fully normalized & upward sloping, and large cap US valuations will be better than their median levels since 1990. Simple metrics with a whole lot of emotional volatility in between.

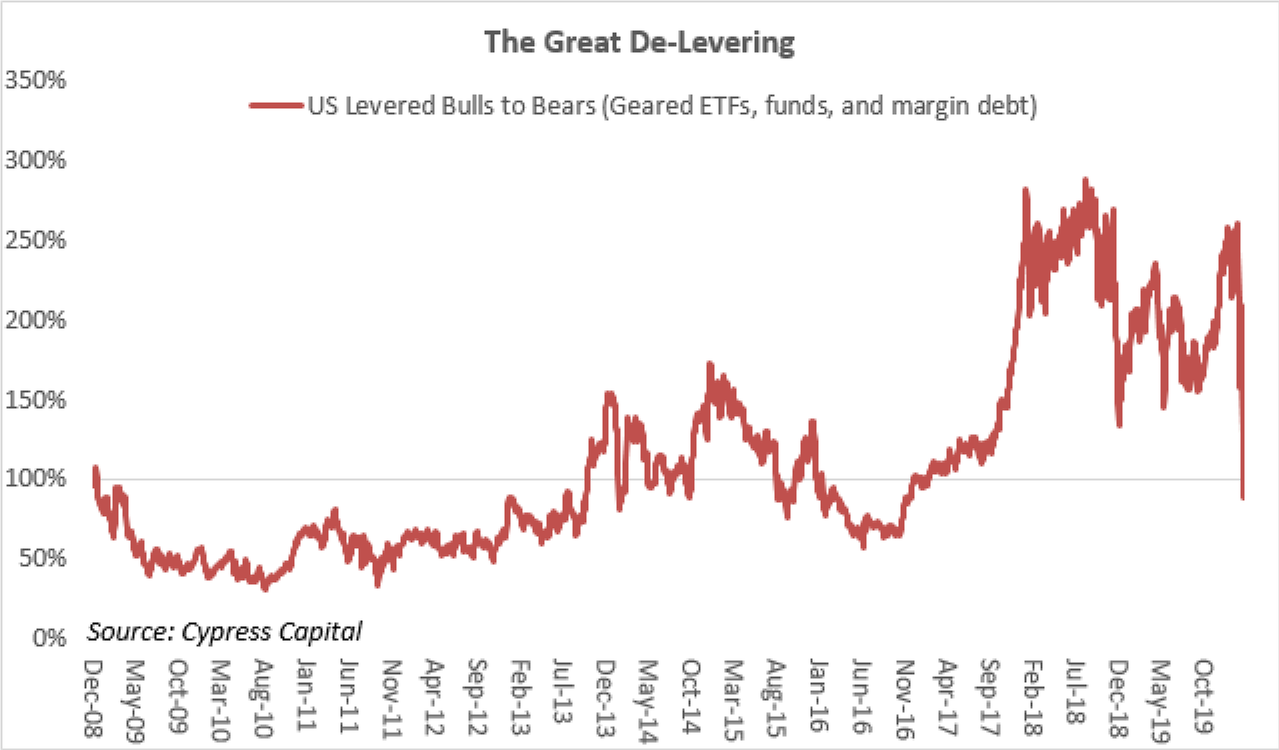
These aren't all lined up today, though we are growing closer at a faster rate than we have ever seen for a bear market. Those serve as straightforward examples of what is holding us back from adopting a fully bullish posture. This isn't the time to panic though, because if you get out of sync with a bear market – selling at lows, buying at bear rally peaks, you will compound the damage. Avoid the mindset, maybe I should just sell here and wait until the clouds part – that's often a recipe for falling into the bear's trap. We have a set of rules and a playbook to follow, and we'll continue to focus on executing it.

Be safe and avoid entertaining thoughts of the system imploding. There will be a vaccine, and there will also be stories of heroism and courage in 2020, as well as brilliant new ideas formed that will drive us forward. Banks are in better shape than they were in 2008, and there's a lot of amazing ingenuity, creativity and intangible value underlying the US economy. The value of Lady Liberty's assets got very overpriced, and her corporations levered up their balance sheets too much, and she needs to fire all of her central bankers for letting it all go unchecked. She had to catch a virus to expose it.

Green Shoots:
Morgan Freeman does not have Coronavirus.
Corporate insiders are buying at the fastest pace since October 2008.
Breadth is hitting some of the most oversold levels ever.
Volatility indices have hit the highest levels ever.
Put/Call activity has swung hard in the other direction and is short-term bullish for markets.
Small-cap valuations are becoming very attractive for the first time in a decade.
The record leverage in geared ETFs, mutual funds, and margin debt has been completely erased.

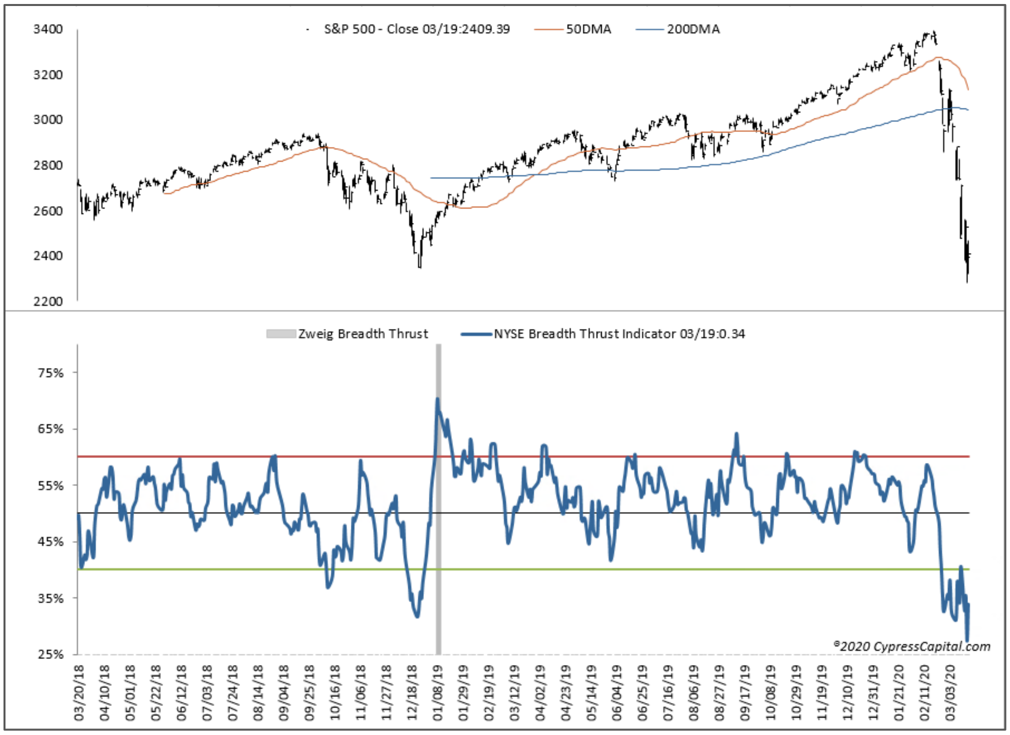
What we need to see:
Tom Hanks and Idris Elba full recoveries.
More yield curve normalization
Better large cap valuations
A significant correction in Consumer Confidence
Capitulation from key surveys like AAII and Investor's Intelligence

The Great De-Levering
It was called the Trump trade when it started - leverage in geared ETFs, mutual funds shot to all-time highs soon after Trump was elected and was nearly constant for the last four years. Most ignored it was there, and the higher markets went, the easier it was to dismiss. It completely unwound in a few short, painful weeks. Euphoria died in March 2020. The good news is that fear gives way to new bull markets.



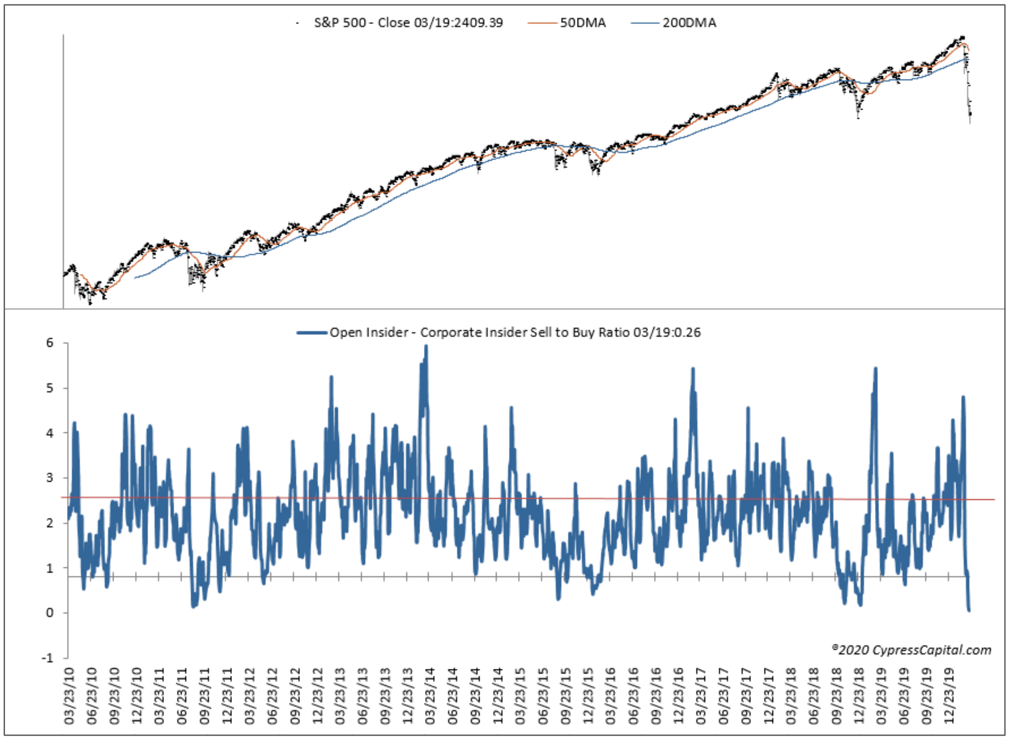
NYSE Breadth Thrust

The level of how oversold the market is – nearly unprecedented. Breadth Thrust hit the lowest level since October 2008, a level reached post Lehman's failure when Congress failed to pass TARP. Outside of this, breath thrust hasn't been this oversold since October 1987, October 1978, August 1966, and May 1940. Not all marked bear market lows, but all were at or near notable short-term lows. The market is wound extraordinarily tight for a bear market rally.



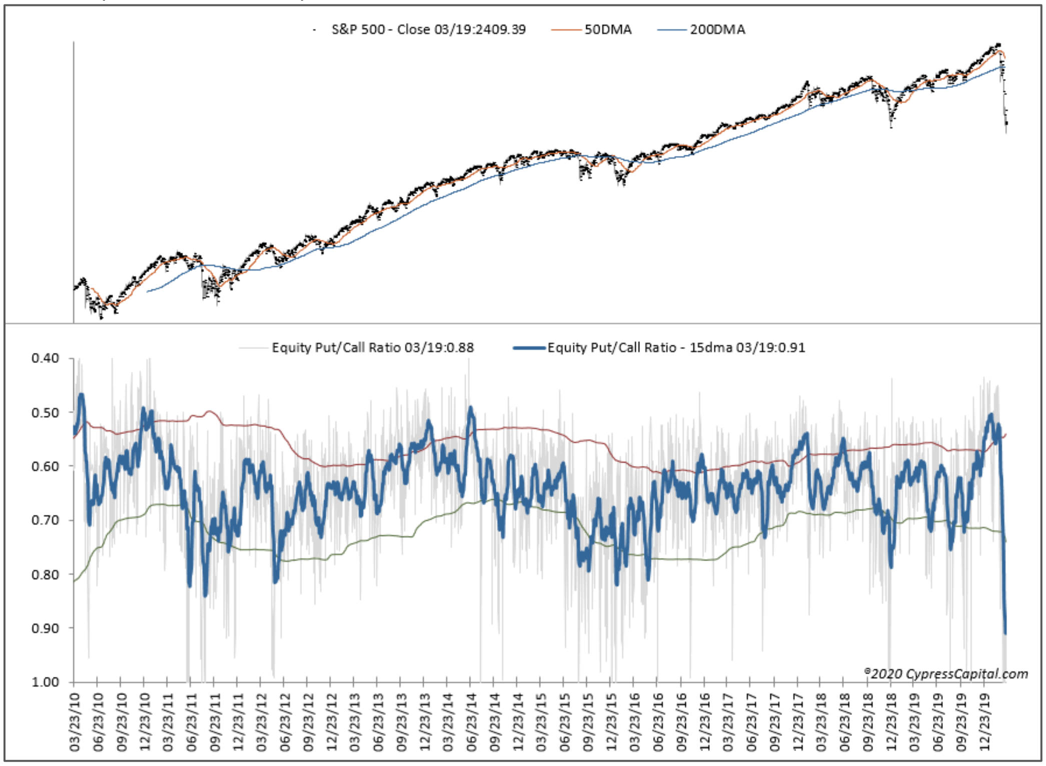
OpenInsider – Corporate Insider Sell to Buy Ratio

We saw more insider buying of stocks this week, other than two days in October 2008. Those didn't mark the bear market lows in 2008, but they occurred within days of the start of a very large bear market rally. Buying has outnumbered selling by 4 to 1. It was a mirror image four weeks ago. (Frustrating side note – it's common, but right when corporate insiders like the stock enough to start buying in their own accounts, they suddenly stop buybacks for shareholders.)



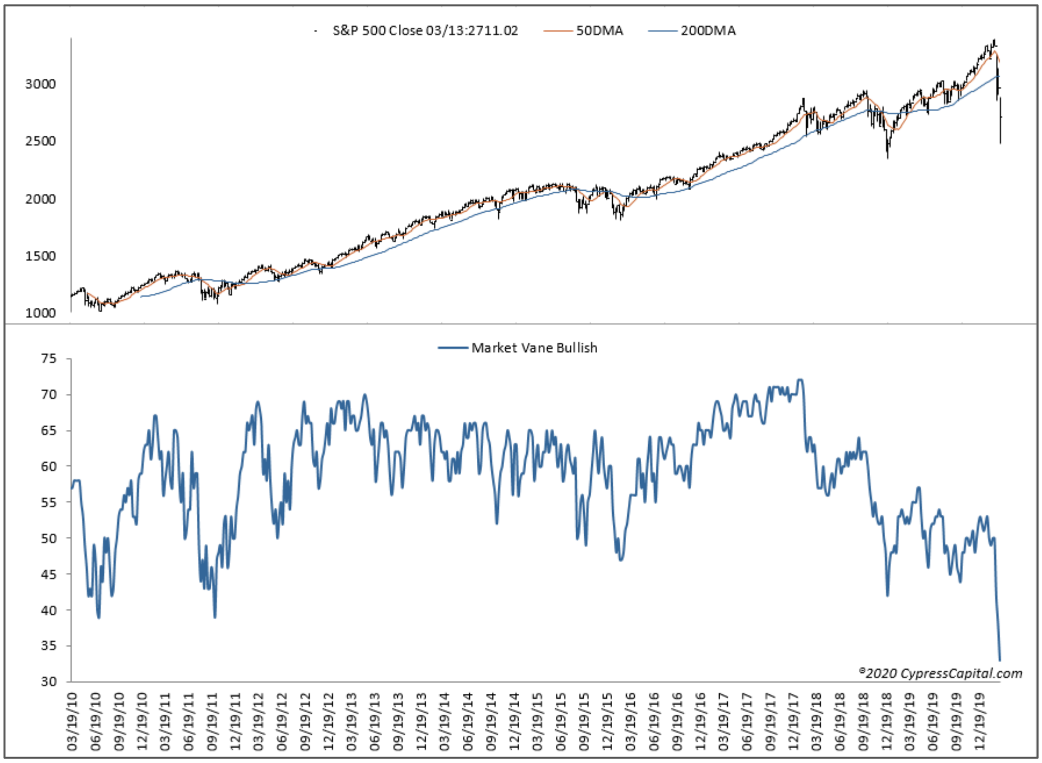
Equity Put/Call Ratio

The 15 day moving average of the equity put/call ratio hit levels only seen during the GFC in 2008, in March the week that Bear Stearns failed and in November 2008. Both marked short-term capitulations before large bear market rallies. This is the quickest shift from extreme optimism to extreme pessimism on this indicator that we've ever seen.



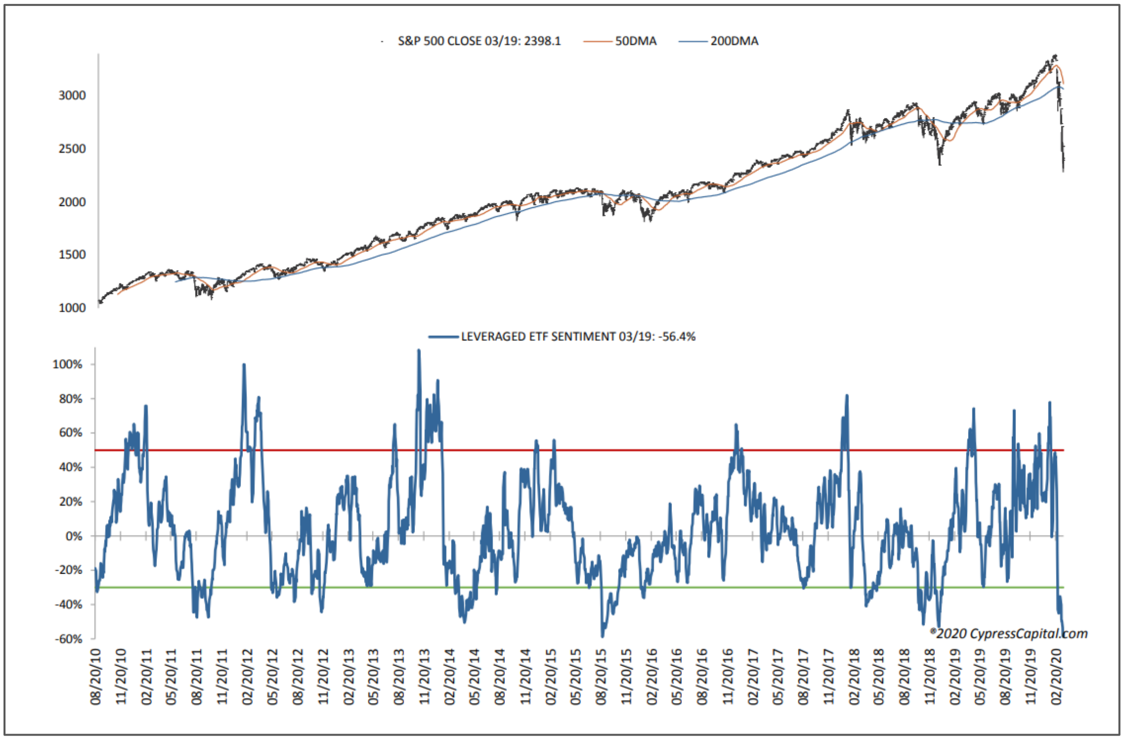
Market Vane Bullish Sentiment

Market Vane's bullish sentiment hit lows not seen since March 2009.

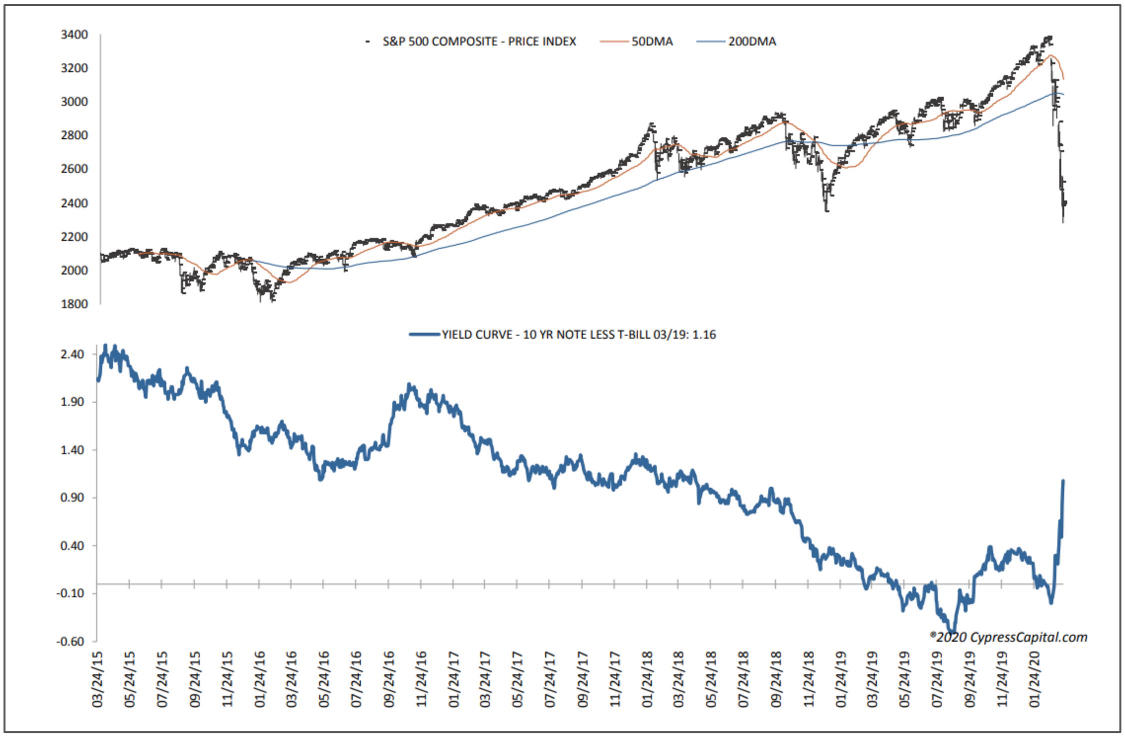


Leveraged ETF Sentiment

Leveraged ETF Volume Sentiment went from a minor buy signal last week to the most extreme readings in over 10 years.

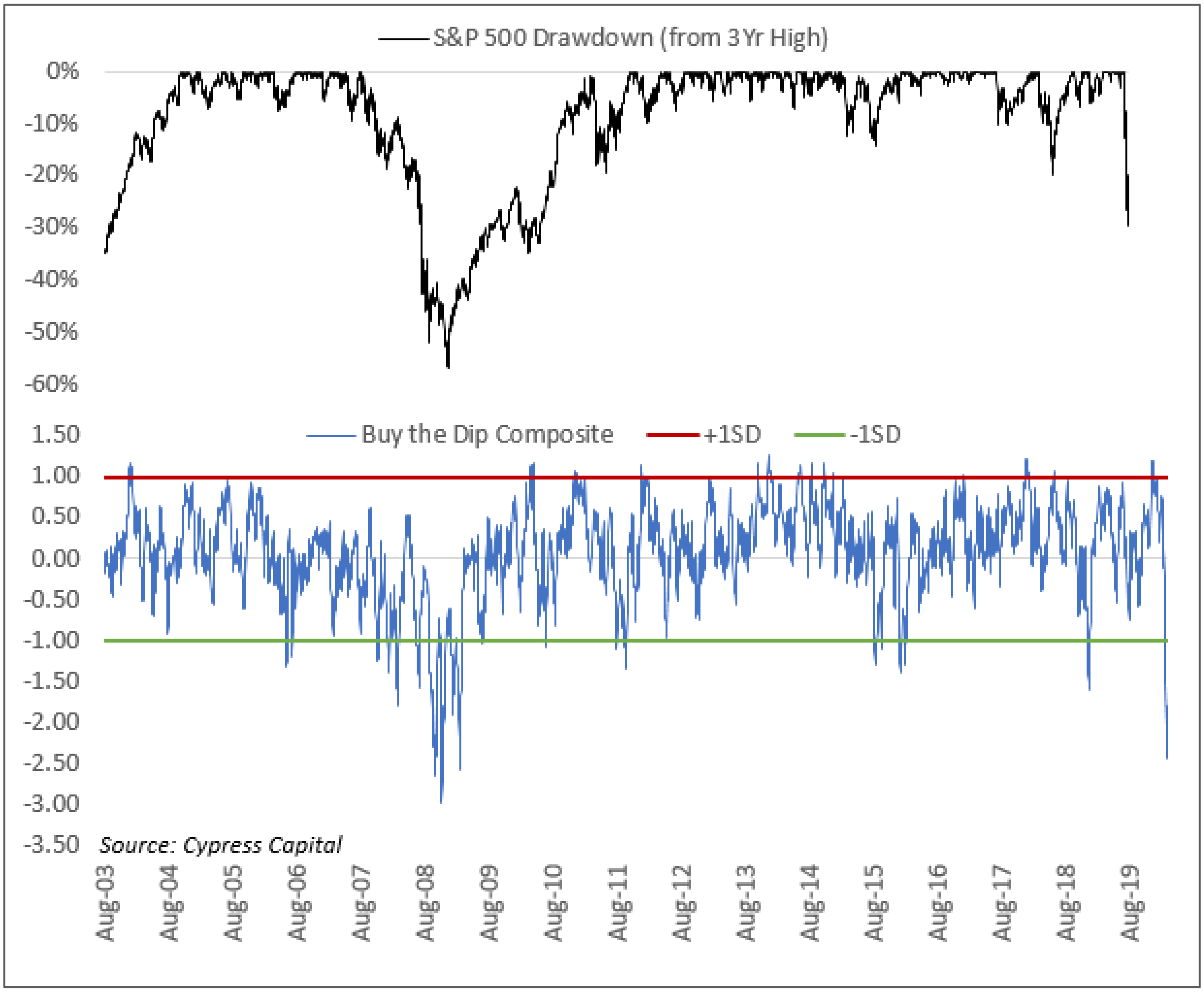


The Yield Curve is normalizing rapidly

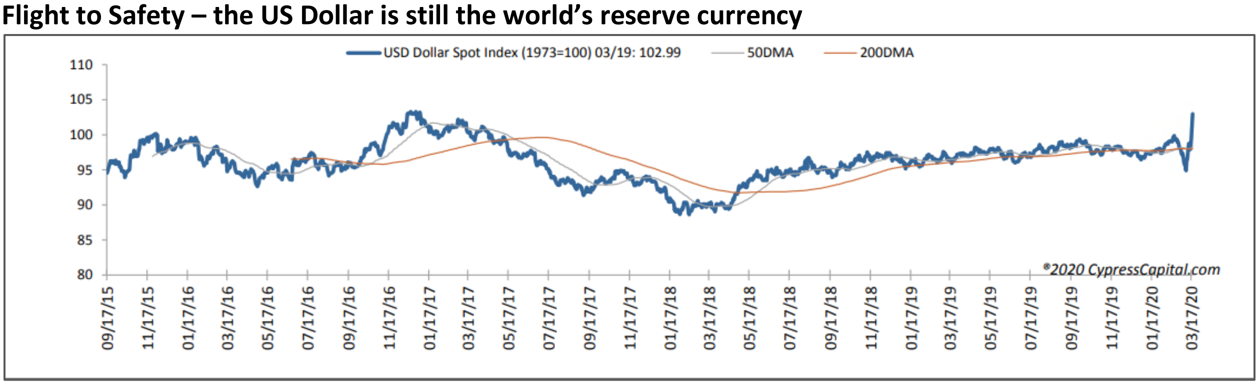


Buy The Dip Composite

Our composite of the best short-term psychology indicators skipped Bear Stearns and went right to post-Lehman. 2.44 standard deviations is right on par with the levels from October 2008.

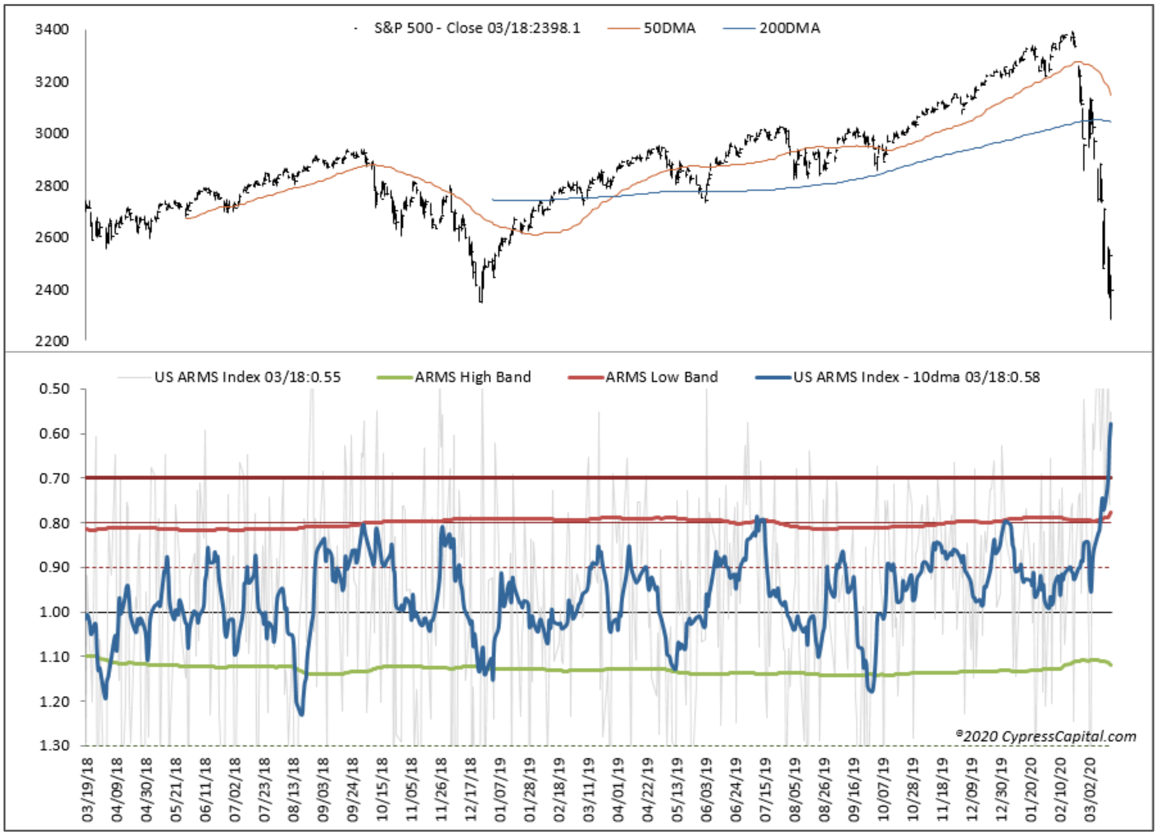


Flight to Safety – the US Dollar is still the world's reserve currency



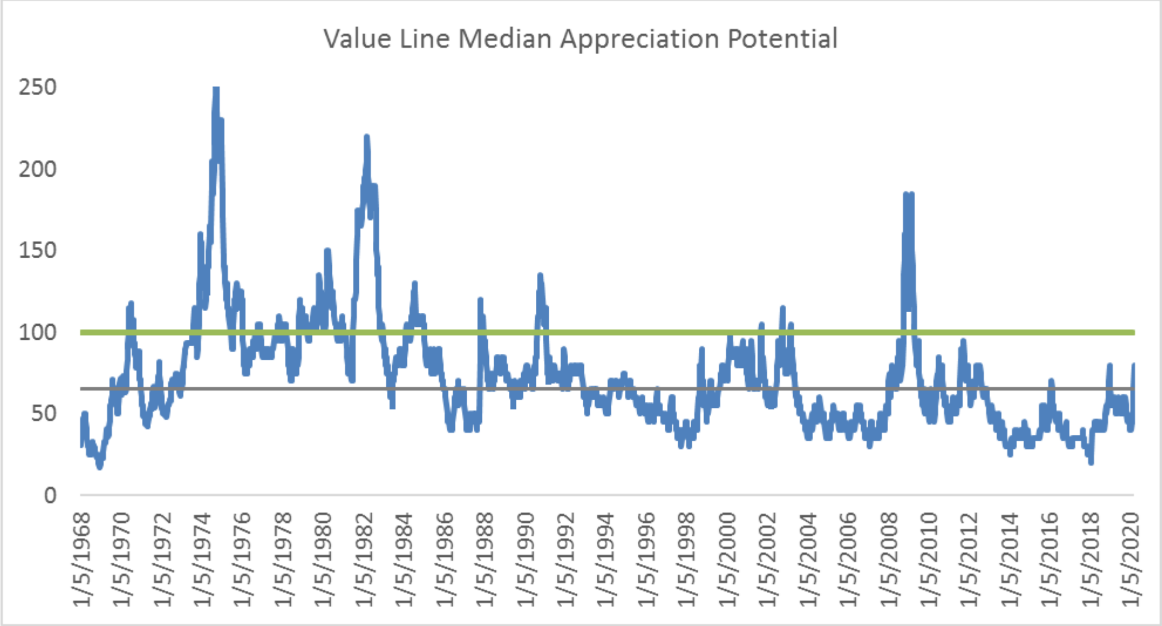
ARMS Index

The action in the ARMS index is a conundrum and totally out of character – another example of unusual breadth events in the last few years. ARMs readings are consistent with a market that is peaking, not one falling off of cliff. It's hurting the psychology composite. If you have insight or theories on why the ARMS index is behaving this way, please reach out.



Value Line Median Appreciation Potential

With the market weakness this week, it's likely that this measure of small and mid-cap valuations will hit or come close to the 100% level. It's a level where small and mid-cap valuations begin to become very attractive.



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.