# Market Outlook

By Mark T Dodson, CFA

## Market Risk Index moves to Neutral

***Small and Mid-Caps presenting a good investment opportunity***

Market Risk Index made another significant improvement and moved into Neutral territory for the first time since February 2019. Almost all of the improvement came from the psychology composite, which continues to recover at a rapid clip. Our smoothing constant that we apply to readings makes the composite slower to respond, which helps in the majority of market environments, but might be a little behind given how quickly markets have fallen. The daily readings on the psychology composite since our last report have all been in the best 20% of readings.

Given how shocking the market's decline has been, you might wonder why the psychology composite still isn't showing the most extreme readings possible, as we've had better readings at correction lows that weren't as severe as this one. The main reason is the condition of longer term measures of investor psychology that tend to move with the full market cycle like Bank Sentiment, Consumer Confidence and AAII's Allocation survey below as examples. Some of those indicators are or were still at peak cycle levels. They are included to help precisely the way that they are now – to prohibit becoming too aggressive early in a recessionary, bear market environment.

Short-term sentiment indicators work great for corrections, but they can push you into catching the falling knife too soon. Using psychology this way may not lead to the gratification of nailing every bottom print but loading up early on stocks after a 25% decline on their way to a 50% decline is not a 25% difference. It's another 33% drop from where you bought. Investors get hurt a few ways when buying during bear markets – two of which are buying too soon in a decline or buying near the ends of bear market rallies. Both are a result of emotional investing.

The monthly update to Consumer Confidence will come early next week, but if the Michigan survey is giving clues, it will suggest that the full realization of what has hit the economy has not fully sunken in with consumers or investors. There is still some denial that has yet to fully process in the minds of consumers as well as our own. It's quite a shock to the system and the economic narrative that you had in your mind to go from new highs to severe bear market over the span of a few short weeks. Yesterday's shocking initial claims data was the first shot across the economic bow that the virus has dealt. The virus impact will be worse, because we were at the most vulnerable point in the cycle to receive an economic shock like this. The bear market isn't solely about a dreadful pandemic, although the pandemic was maybe the worst kind of trigger.

### Market Risk Index

Neutral

**73.3%**

### Category Percentiles

Psychology - P4

66.7%

Monetary - M4

70.0%

Valuation - Overvalued

88.5%

Trend - Vulnerable

67.1%

| Largest Psychology Influences | |
|---|---|
| Volatility | Positive |
| Surveys | Positive |
| Option Activity | Positive |
| Corporate Insider Buying | Positive |

| Largest Monetary Influences | |
|---|---|
| Below Trend GDP Growth | Positive |
| Rising Corporate Bond Yields | Negative |
| Yield Curve | Negative |

| Valuation | |
|---|---|
| 7-10 Year Rtn Forecast | 4.3% |
| 10Yr Treas Yield (on 03/26) | 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.*

Last Friday and Sunday, we described our short-term psychology indicators as being wound incredibly tight for a powerful bear market rally. No doubt, you probably felt that in your stomach last weekend, questioning whether you should sell to wait things out. That pressure has been alleviated by a face-ripping rally,

and if you are honest with yourself, it has probably left you with some feelings of wondering whether the worst is over, and if you should have been more aggressive a week ago. Could this thing continue to rip higher and resume a new bull market?

Markets have humbled us enough times that we cannot rule it out, particularly in light of the Fed's hedge fund protection bazooka operations this week, but let's ignore for a minute the coming large increase to the unemployment rate and substantial hit to GDP and any possible second order effects from the virus fallout. In a historic feat for the ages, should March 2020 have marked both the sharpest beginning of a bear market ever and also the start of the ensuing bull market a matter of days later, it is not a generational opportunity like it was in 2009, and the new bull market would likely be a short-lived one with frail economic growth.

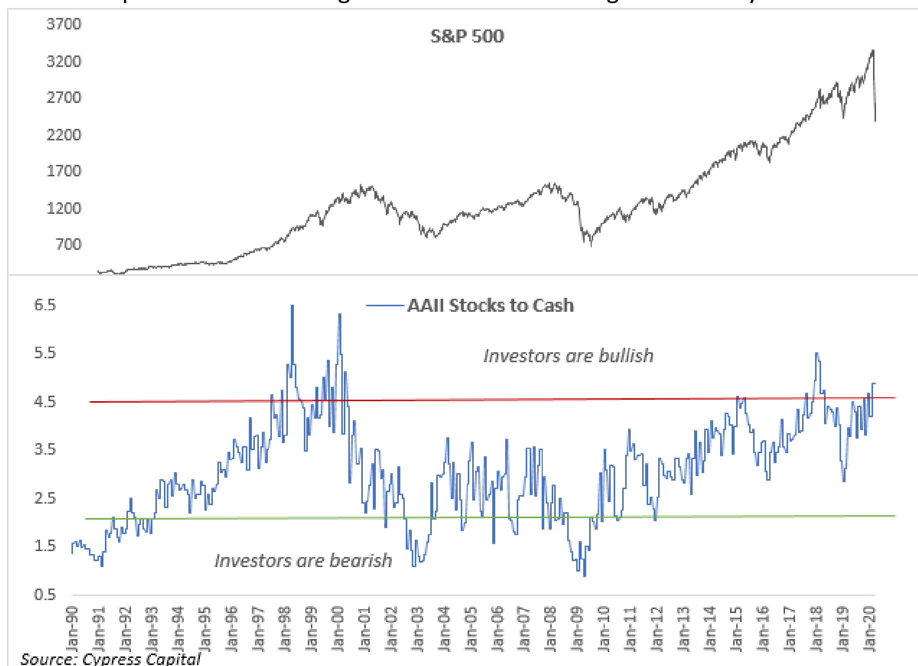
The key reason why – we have not fully repaired the excess from the cycle that just completed. Money has yet to flow from weak hands to strong hands and wring out yesterday's bad decisions in the allocation of capital. In part, the Fed has complicated things. They stepped in, in an unparalleled way, to aid hedge funds and quants in unwinding their levered long bets to get flat. They not only stepped in, Powell looked at what Bernanke did in 2008, and said, "Here, hold my beer." While we were pro-stimulus both monetary and fiscal in this case, we're not entirely comfortable with the Fed teaming up with Treasury to become an investor in corporate credit, bonds that carry above average risk of default here, especially when the yields barely hit 4%.

It opens up a lot of new questions. In our own income accounts, we've been holding Treasuries, waiting for an opportunity to buy corporate credit at attractive prices, but the Fed swooped in well before any rational investor should realistically call them attractive. Flows poured into investment grade credit this week as a result, not because it was a good buy, but because the Fed is a backstop. As a result of the uncertainty that this brings, we increased our gold position this week.

Now for the good news. While large cap valuations have not grown attractive enough to help push MRI down to low risk readings, small and mid-cap valuations are attractive here. Our favorite measure, Value Line Median Appreciation Potential, which measures the 3-5 Yr. forward looking total return potential for the average stock in Value Line's 1700 stock universe, broke above 100% at the close of last week and hit the highest level since 2009. Ignoring the cautious stance recommended by Market Trend for small cap stocks, if our Market Risk Index was built solely around small cap valuations, we'd recommend a fully invested posture today. We will continue to look for opportunities to add exposure.

### AAII Allocation Survey – Ratio of Stock Allocations to Cash Allocations

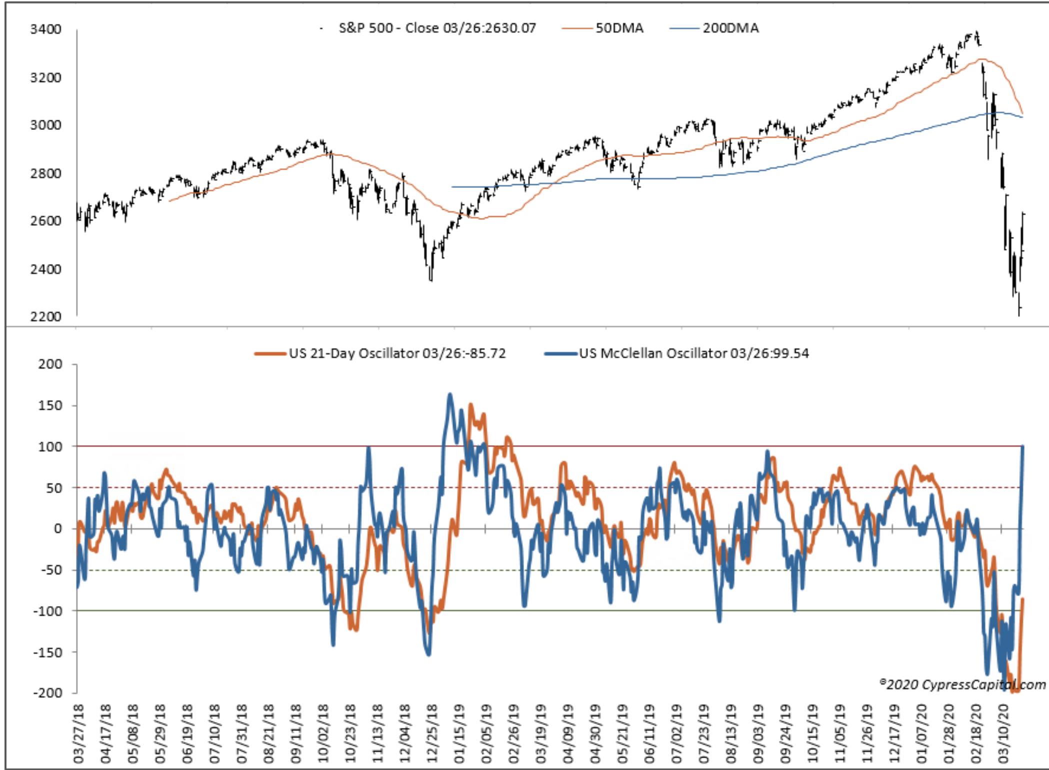
The weekly sentiment survey from AAII is hitting correction level bearish extremes, but the allocation survey was pushing toward the extreme optimism at the end of last month. Every bear market since the survey has been around has coincided with a sharp fall in stock holdings relative to cash holdings. That rarely comes until the end of a bear market.



Source: Cypress Capital

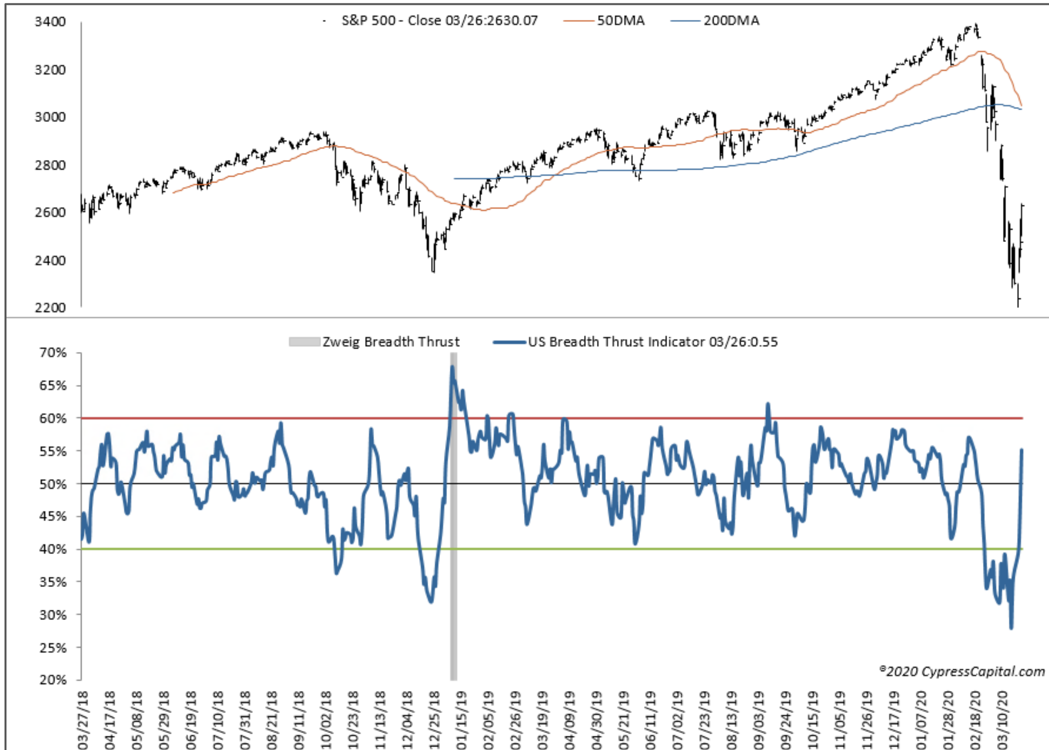
**McClellan Oscillator hit overbought levels on the close Thursday**

This usually marks the first bit of short-term resistance for an upward move.




**US Breadth Thrust and Zweig Breadth Thrust**

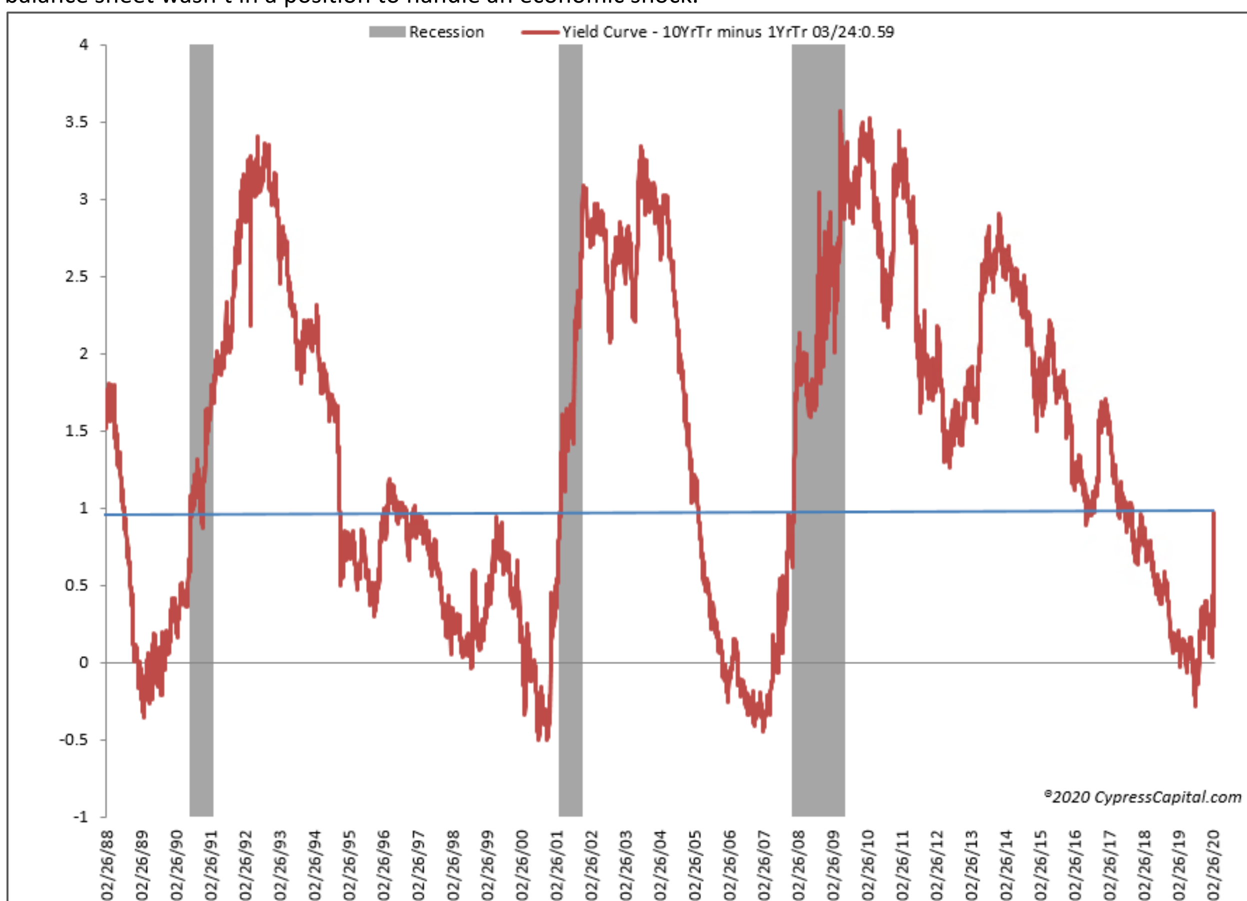
Solid precedents were set on this week's powerful upward move in terms of breadth. Not all marked the ends of a bear market, but some did. One we're watching closely is the Zweig Breadth Thrust, which was hit after the 2018 decline and ended up signaling that a retest was not in the cards for 2019. The rally that began this week hasn't met this threshold yet.



**Yield Curve (10Yr minus 1Yr)**

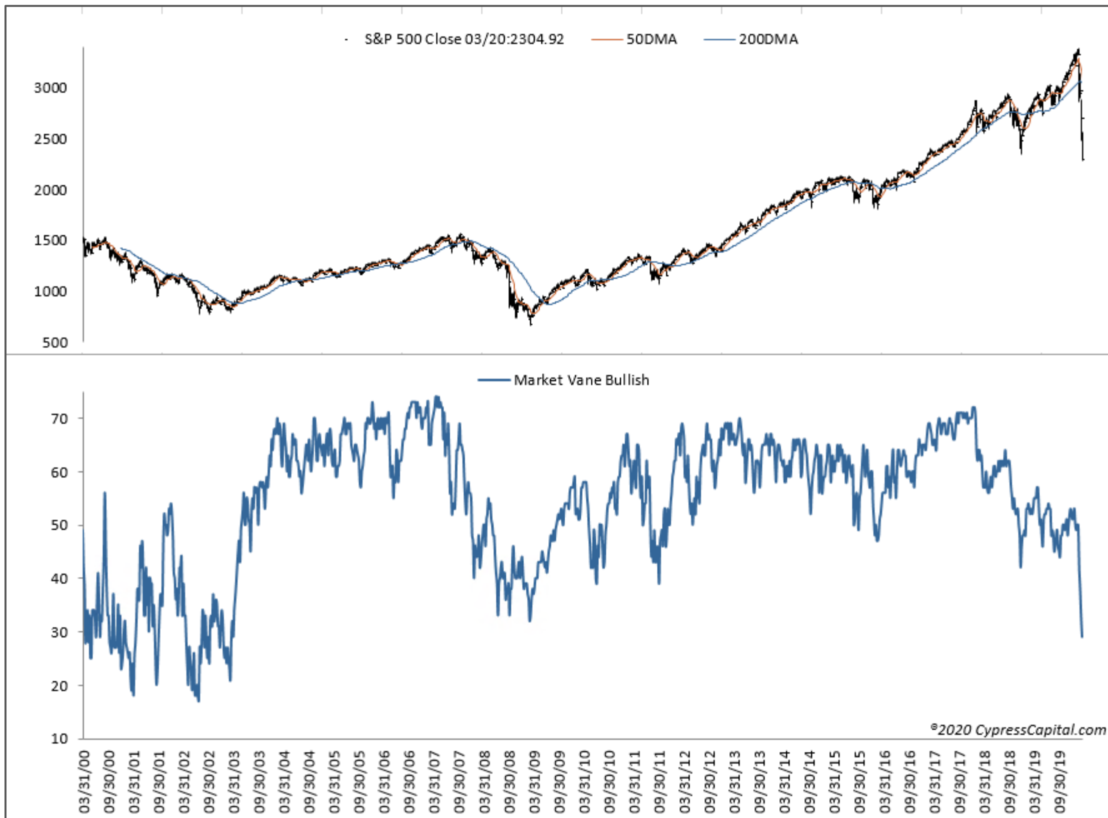
The yield curve normalized to around a 1% spread this month, which coming from a state of inversion, has corresponded almost to the month, the beginning of the last three recessions – make that four recessions. If the bear market is going to give way to a powerful new bull market cycle, this needs to normalize. While sympathetic to the Fed's predicament, they went further, faster, bigger, sooner than they ever have in the history of financial markets in the United States. In doing so, they aren't allowing markets to clear.

If they prevent the cycle from purging its excess while backstopping bad bets, our next economic growth cycle will be even more of a dud, built on even worse financial engineering, and we will have to come up with a new name for the resulting secular stagnation. Take a look at a long history of Japan's yield curve for evidence. If you find market participants buying risky securities only because the Fed is backstopping it, that's not security analysis. We're the furthest thing from gold bugs, but come recovery, it's time to put an end to the Fed put. Don't just keep the printing presses rolling because there is no inflation in the prices of goods and services. Incorporate asset price inflation or something. It was apparent, even to them, that low yields were leading to a massive levering up of corporate balance sheets as corporations bought back stock and pushed valuations higher. Some of those companies are going to the government now with their hand out, because their balance sheet wasn't in a position to handle an economic shock.



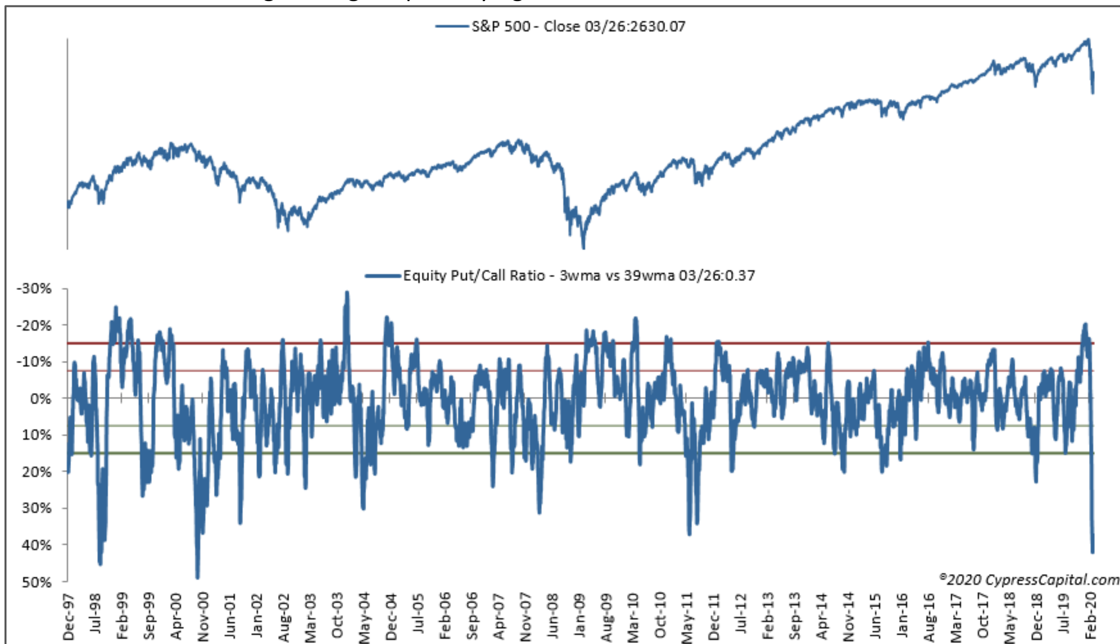
### Market Vane Bullish Sentiment

Market Vane's measure of bullish sentiment is the lowest since the 2000-02 bear market. It hit levels below 20 on several occasions before that bear market was over.



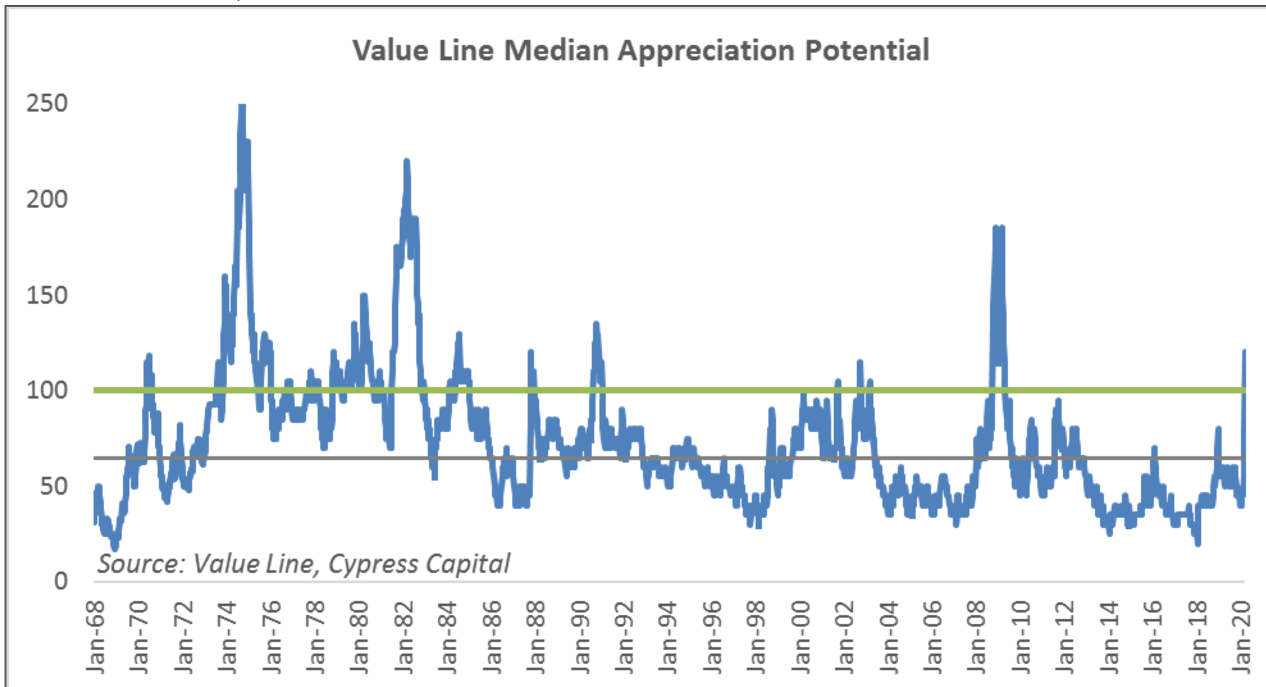

### Equity Put/Call Ratio – 3wma minus 39wma

As a short term gauge of investor psychology, this is the first time in history that a surge in call buying has signaled the end of a bull market with this much accuracy. Readings have now given way to lots of put-buying, and in the last two bear markets the first and largest surge in put-buying marked the starts of bear market rallies but not the ultimate lows.



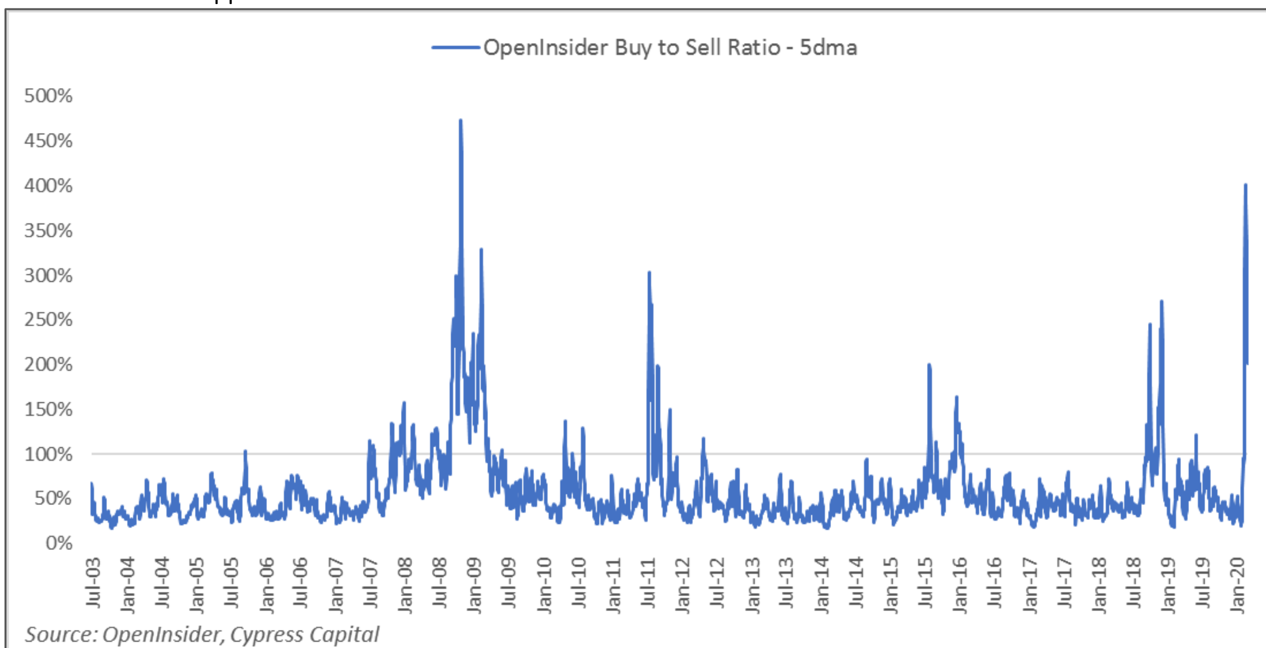
**Value Line Median Appreciation Potential**

As we prefaced in our note last Sunday, bear markets have taken this reading higher before, but looking a couple of years out, small and mid-cap stocks are attractive here.



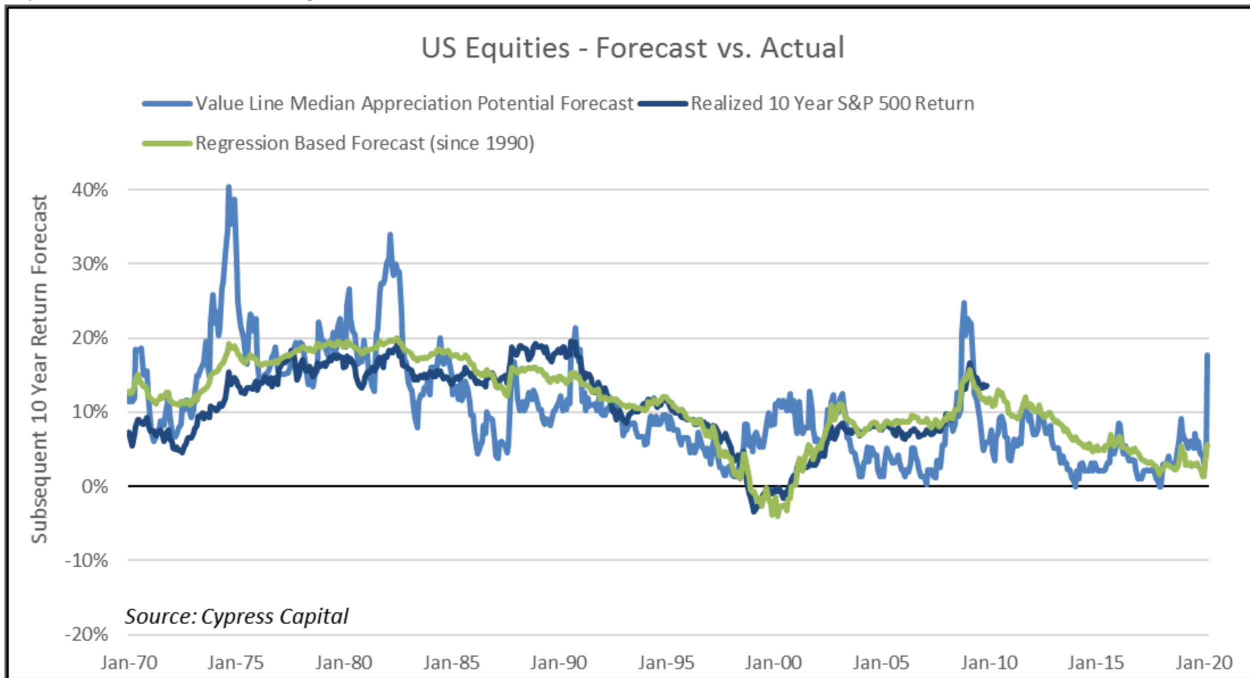

**OpenInsider – Corporate Insider Buy to Sell Ratio**

Near record levels of corporate insider buying have occurred this month, surpassed only in November 2008. Because this is based upon the quantity of insider transactions and not dollar-weighted, it's confirmation of the valuation readings from Valueline Median Appreciation Potential.



### Valuation

Our return forecast has moved up during the bear market (it moved down some in the last week), but it isn't presenting an opportunity with a solid margin of safety, outside of some kind of Fed backstop to equities. The same is not true or small and mid cap stocks, as you can see from this return forecast that we built from Value Line's valuation indicator. Return expectations there have surged.

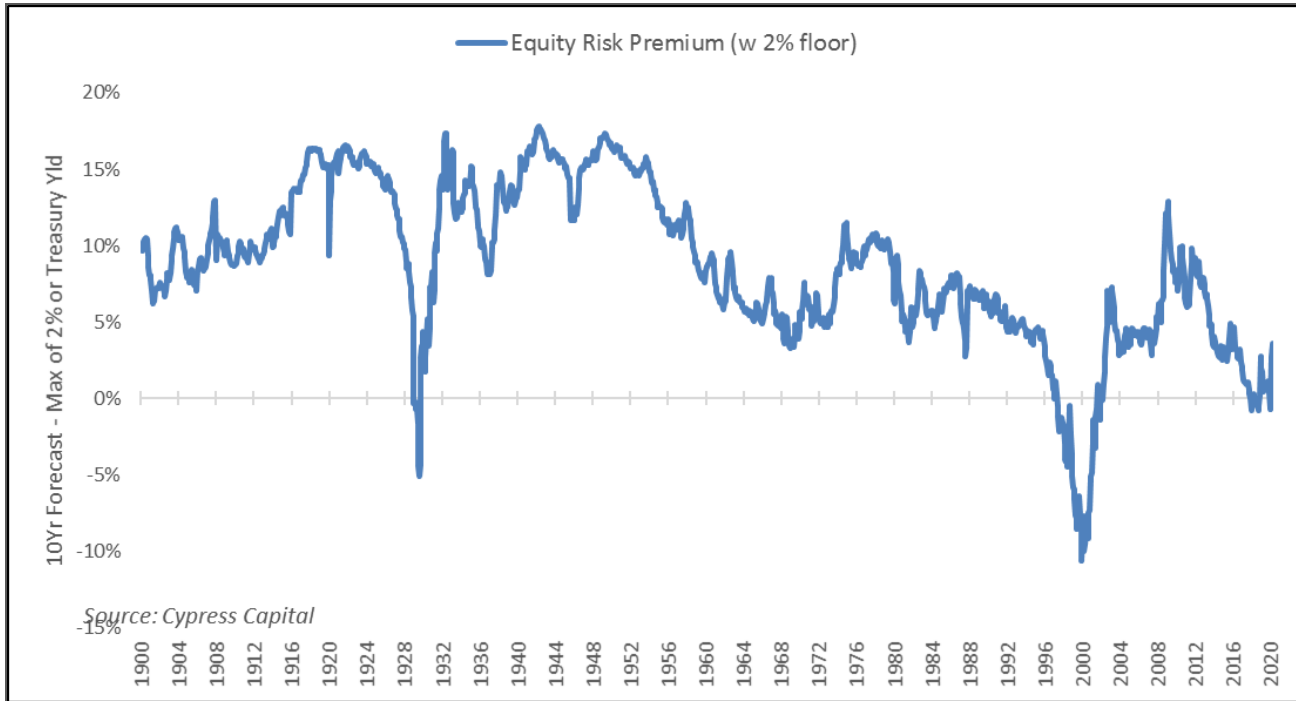



### Valuation – Spread between Small Cap and Large Cap Return Expectations

This is the widest spread since 2009. Notice how wide the spread was between the forecasts in January 2000 right as the tech bubble was beginning to burst. This was a unique time where small-cap stocks were priced with enough margin of safety that prices moved higher for the first two years of the 2000-2002 bear market.

**Valuation – Equity Risk Premium**

This is based upon the spread between our return forecast for equity markets and the higher of the 10Yr Treasury yield or 2%. The premium has risen but not high enough to provide a base for a long lasting bull market, in part, because the premium was negative just a month ago. Jeremy Siegel's seminal work that led to mainstream adoption of buy and hold investing, Stocks for the Long Run, was released in 1994 and was quickly followed by the sharpest drop in the equity risk premium ever seen.



## 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.