Market Outlook

By Mark T Dodson, CFA

MRI moves firmly into neutral territory

Psychology is improving rapidly but not yet signaling capitulation seen in previous bear markets

Market Risk Index moved close to the 50th percentile this week, the lowest level since January 2019, all on improvements to the investor psychology composite. The psychology composite continues to make rapid improvement, but we still aren't yet seeing pervasive readings across the composite consistent with the ends of bear markets. Consumer Confidence was an important release this week, and it didn't improve enough to provide a boost to the psychology composite. Our matrix for asset allocation recommendations requires a bigger improvement than this to recommend additional increases to equity at this point.

The Market Trend for REITs and International equities turned more defensive this week, joining small cap US stocks, and it's growing more likely that the trend for big-cap US equities will turn defensive as well. Market Trend is our failsafe, so as this factor turns negative, MRI will begin to move higher again as it offsets the improvements that are coming to the counter-cyclical factors in our model. With our propensity to be early over our long history of investing, we include pure price measures in how we measure drawdown risk to markets as a way to help keep us from catching the falling knife too soon in a bear market. Just as bull markets can move further into euphoria than can be predicted, bear markets can be just as unpredictable in how they ebb toward fear. If we've learned from our mistakes in previous bear markets, it's to avoid trying to go in big too soon. Perfectly timing a bottom may lead to a surge of adrenaline or fame, but when it's money on the line, we're more focused on avoiding long-term or permanent impairment of capital.

Big cap US equity valuations changed little, but small-cap valuations as well as international valuations continue to improve. Valueline Median Appreciation Potential shot higher again to the 145% level, still shy of the 185% reading from the market bottom in 2008, but it's an impressive reading signaling a long-term opportunity building there. Emerging market equities are now priced very close to where they were in 2008 on a cyclically-adjusted PE and price to book basis. The growing disparity between small and large cap US equity valuations illustrates a desire to hang on to the previous bull market's winners. Case in point – this week NASDAQ reported that March saw the biggest inflow into the Nasdaq 100 ETF (QQQ) in 20 years. By the time small-caps were this attractive in 2008, big cap stock valuations looked very attractive as well. Valuations are setting up in a way that

Market Risk Index

Neutral

56.3%

Category Percentiles

Psychology - P3

42.0%

Monetary - M4

69.2%

Valuation - Overvalued

89.2%

Trend - Vulnerable

74.6%

Largest Psychology Influences

Volatility	Positive
Surveys	Positive
Option Activity	Positive
Corporate Insider Buying	Positive

Largest Monetary Influences

Below Trend GDP Growth	Positive
Monetary Aggregates	Negative
Yield Curve	Negative

Valuation

7-10 Year Rtn Forecast	4.1%
10Yr Treas Yield (on 04/02)	0.6%

Price Trends

US Equities	Positive
Intl Equities	Negative
REITs	Negative
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.

the first year of the next bull market should be led by a powerful move in mid and small-cap US equities and international equities, but with our Market Trend being negative for both asset classes, it's OK to be patient.

On the monetary front, growth in monetary aggregates has skyrocketed but not as a result of QE-Covid. Instead, it's consistent with the flight to safety that occurs during recessions – this is what it looks like when velocity drops like a rock. We highlighted this action that as it began last Fall. The thing that we aren't seeing is a coincident re-steepening of the yield curve, which actually shallowed out some this week. This is where the Fed's actions have come into play, and while they might have provided cover for levered players to rapidly unwind risky bets during March, we will be unable to have a powerful economic growth cycle if they prevent the yield curve from normalizing, regardless of our coming defeat of the war against the viral pandemic. It would be a mistake to think of this as just a deep recession caused by a virus, because signs of cycle excess were already there.

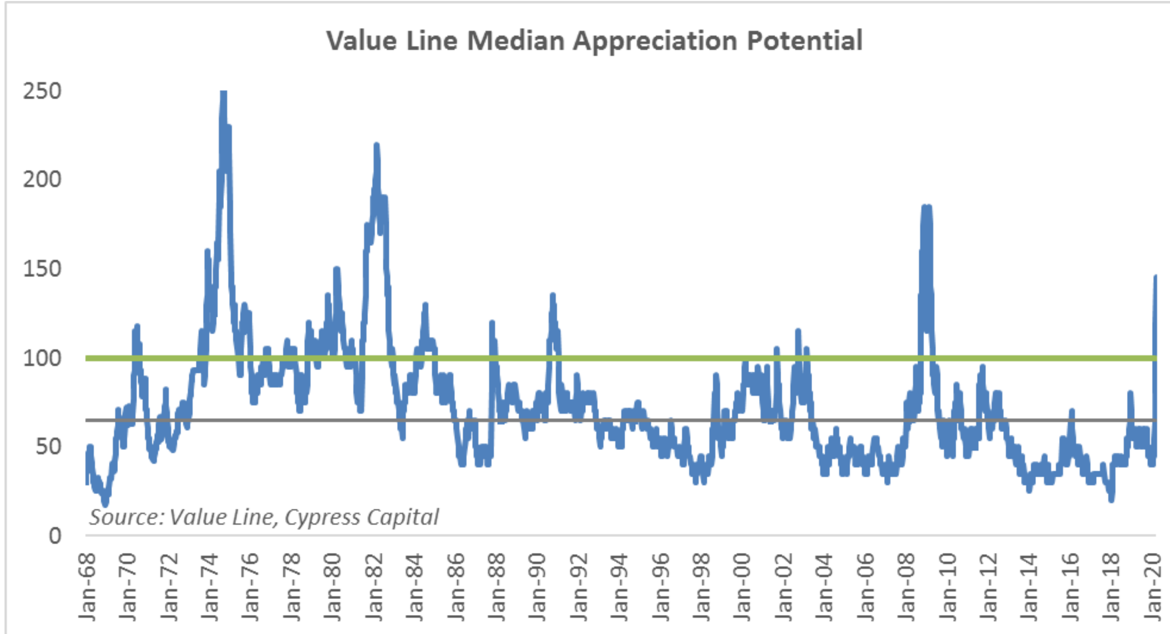
If the Fed ends up expanding its intervention into buying even riskier asset classes, which they will be very tempted to do should the bear market make fresh lows, it may provide a temporary backstop, but it won't lead to better investment returns like we saw coming off the 2008 lows. The Fed put will eventually "put" us into an economy that looks more like Japan's. Just as other countries like Italy and Spain have provided a good example for what to expect from the virus weeks in advance, Japan has continued to provide a good lead on what to expect if we continue to follow the same path monetarily several years in advance. Don't get us wrong – we encourage the Fed meeting the sudden demand for US dollars that occurs during financial crises, but we don't like the Fed bailing out risky bets in corporate credit. Encouraging investors to reach for yield and then bailing them out when those bets don't pan out – it's not sustainable.

Bear rallies can be as painful as the selloffs in bear markets. It's imperative to avoid panic as well as the fear of missing out. With stocks settling into a trading range over the last week, maybe the latter is beginning to build. Extreme sentiment on some of our psychology indicators combined with good news on the virus front has the potential to lead to powerful bear rallies; however, until there is a vaccine, public behavior is unlikely to return to normal when it comes to frequenting service businesses. This is the first recession where our reliance on being a service economy hurts more than helps.

To hope that US equities will quickly rally back to Feb levels that marked the second most expensive US equity market in US history or to hope that the economy will quickly in a matter of months be able to repair the damage sustained this year is unwise. It takes years to lower the unemployment rate from recessions. Ultimately, the iron law of valuation guides us in measuring risk versus reward. We'll take it a day at a time and continue to follow the process. Our framework is our compass in the storm, and we look forward to the day when we can pound the table and wholeheartedly recommend buying stocks again.

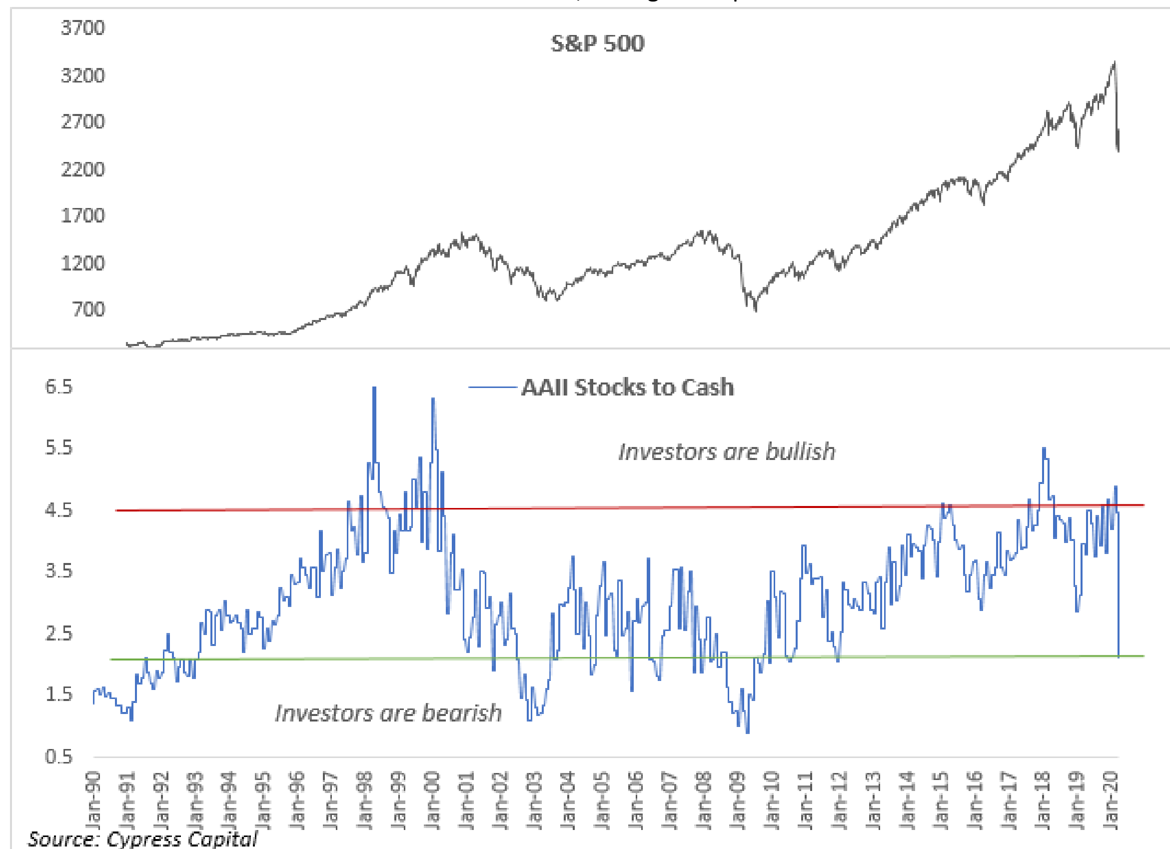
Value Line Median Appreciation Potential

Another big improvement in valuations for small and mid-cap stocks this week.

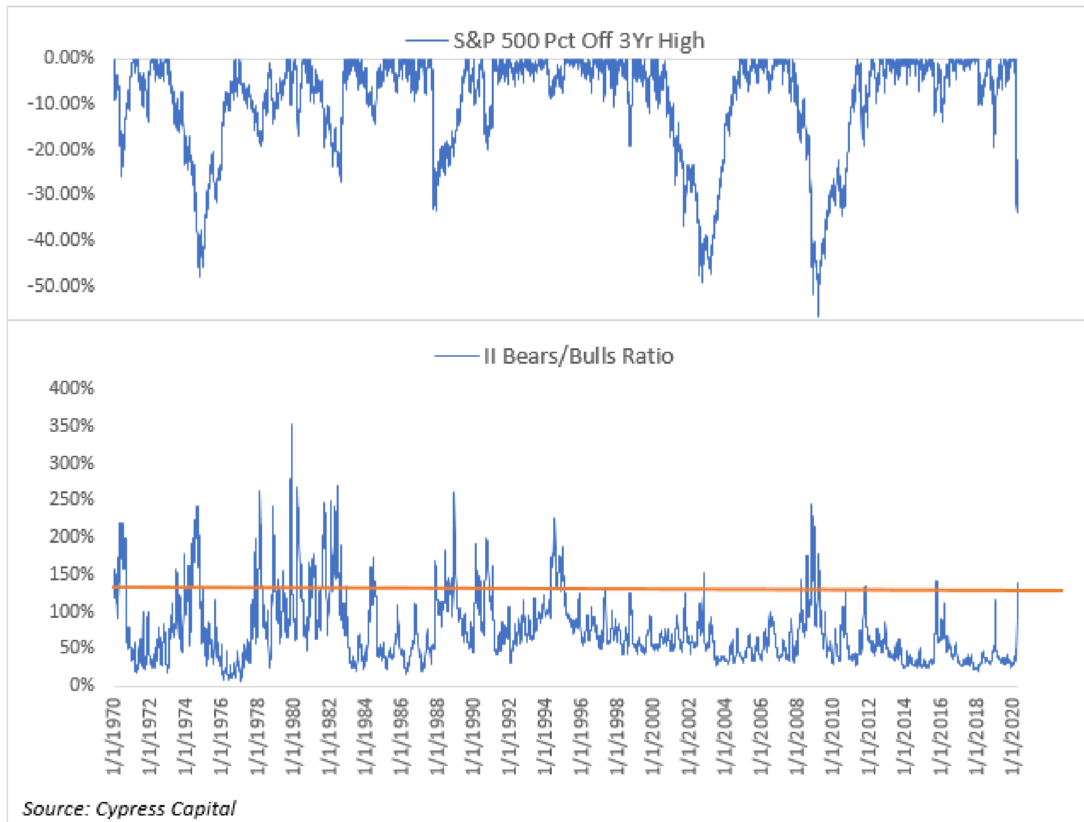


AAII Allocation Survey

We included this chart last week right before the month-end update. Members of AAII increased their cash allocations dramatically over the course of the month, and the ratio of stocks to cash has fallen to the lowest levels since 2011. This is a huge improvement over the course of a month! Corrections have bottomed here, but each of the last three bear markets didn't end until the stocks to cash ratio fell under 1.5, during those periods where the bear market overshoots.



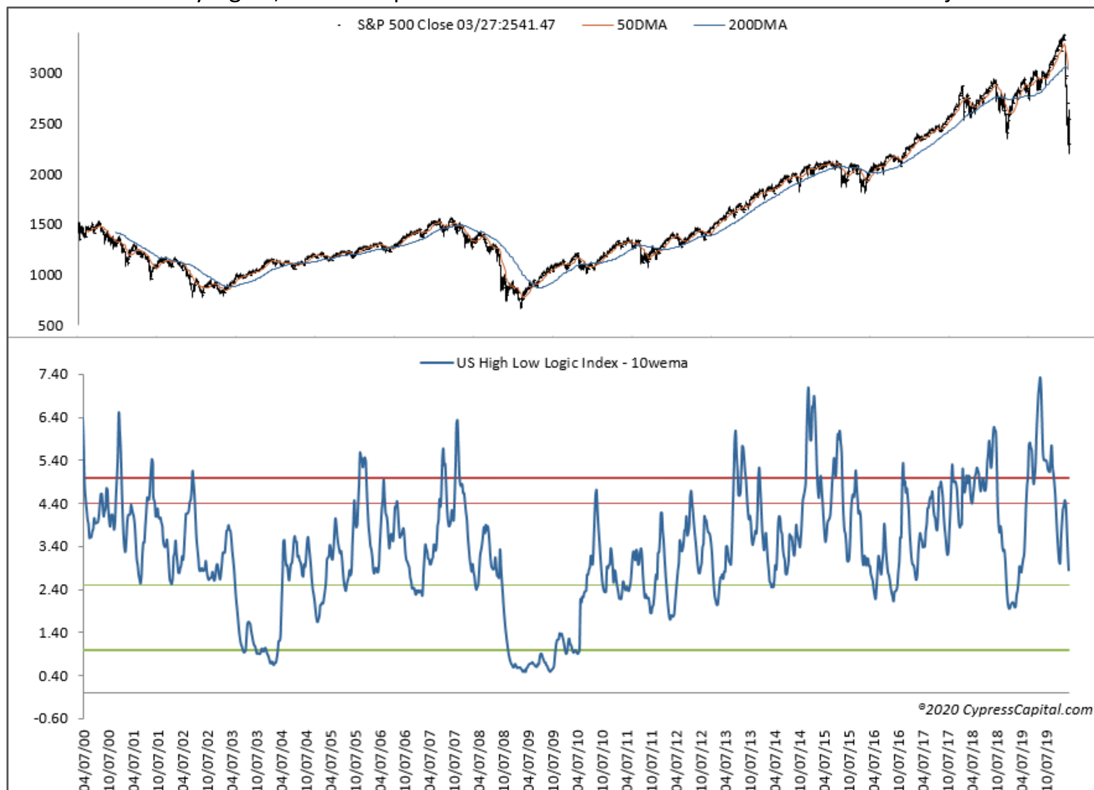
Investors Intelligence Survey – Largest spike in bearishness since 2016



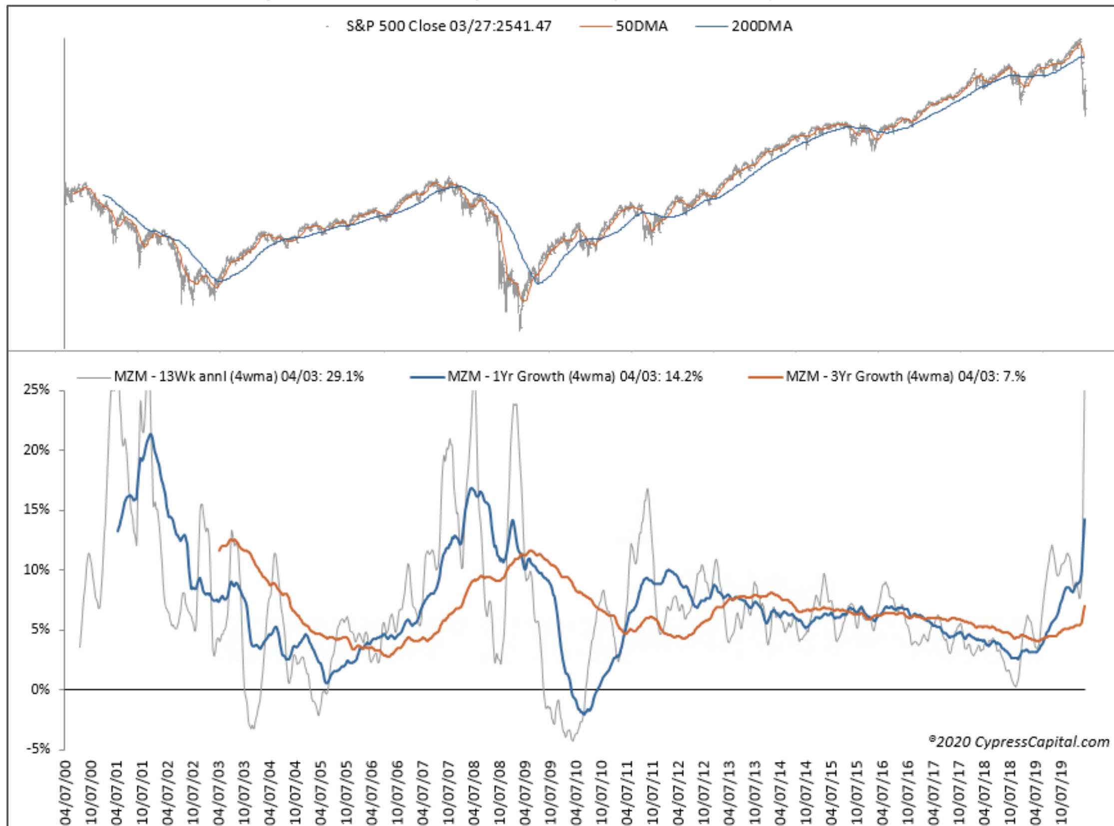
Source: Cypress Capital

High Low Logic Index

High Low Logic Index is making quick improvements but is still on its sell signal that occurred in 2019. The first green line marks a minor buy signal, while the previous two bear markets hit levels that led to major bull market buy signals.



MZM Growth has surged in a classic flight to safety that accompanies recessions

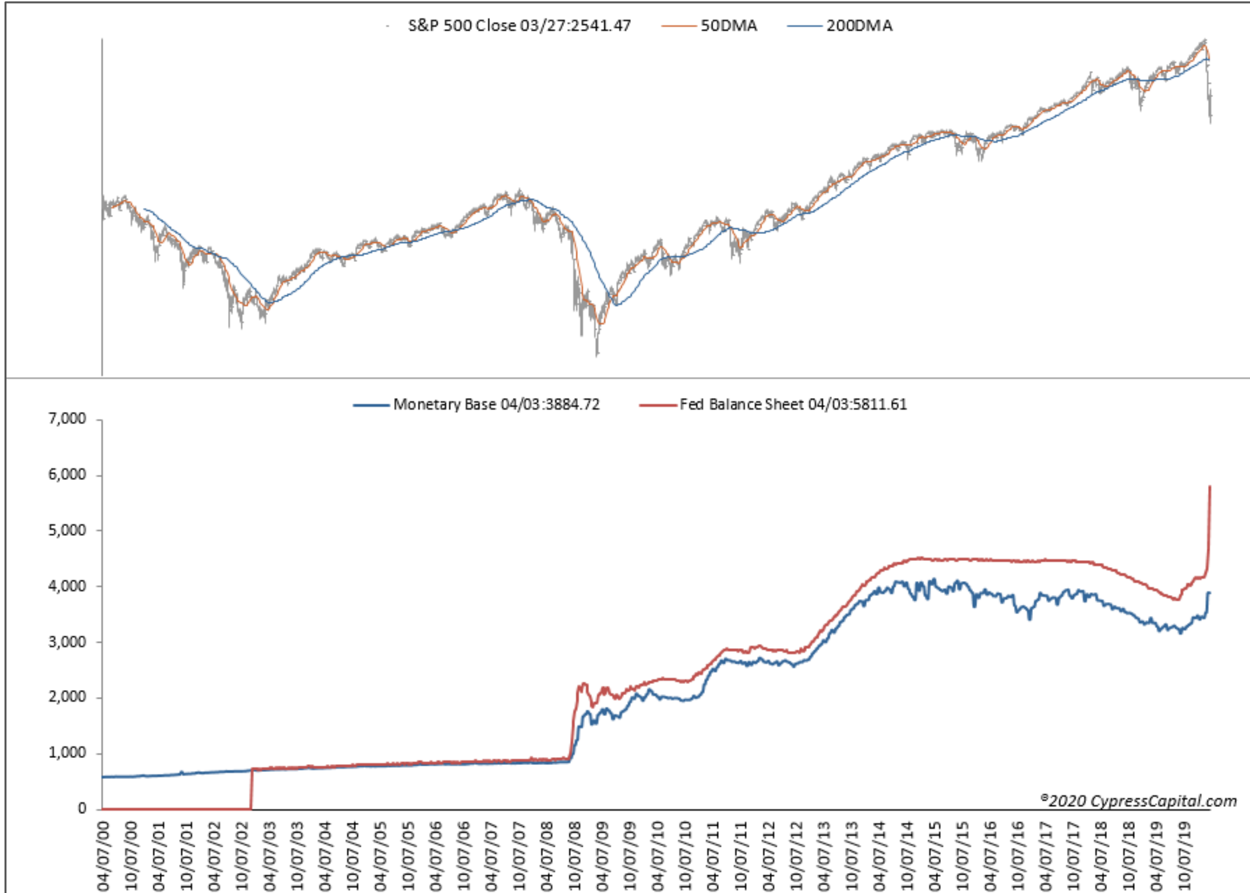


Dr. Copper

Copper sank to new lows this week. Copper also peaked alongside global equities early in 2018.

Powell to Bernanke – hold my beer.

Fed Balance Sheet has jumped by over a trillion in a matter of weeks.



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.

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