Market Outlook

By Mark T Dodson, CFA

Neutral MRI, but still the best reading since 2016

The prospect of the Fed buying stocks shouldn't lead you to chase equities here.

Market Risk Index scores a 42 this week, another week of improvement all on the back of our psychology composite. It's a neutral reading, but it's also the best MRI reading that we've seen since 2016. We're not quite to the stage of enthusiasm for equities as we were in early 2016 with our equity allocation, because of the thresholds that we require after such a poor MRI reading earlier this year. Even though 2016 wasn't a bear market, MRI also managed to fall below 20% back then. On average, markets have had reasonable returns with readings in the 40s, but we've never had a bear market since 1970 end without a reading below 25%. Admittedly, we've also never had a Fed throw this much money and radically experiment with policy on the fly like this either, all timed perfectly to coincide with very bad news releases. Every bit of it is aimed at shoring up confidence.

Because the improvement is built almost entirely on improvement to short term investor psychology indicators, it's a fragile 42 for MRI. There are initial signs that the improvements to our psychology composite are slowing on the market's strength off the March 23rd lows. The flurry of the Fed's nuclear arsenal aimed at markets is affecting short term sentiment, so it's growing less likely that we'll be able to reach bear-killing levels on our investor psychology composite without the addition of long-leading indicators, like the Consumer Confidence Index, coming down to levels that coincide with bear market lows. It's also a fragile 42, because valuations have now moved back up to the 10th decile of readings (with the exception of small and mid-cap stocks which are still attractive at current levels but in a negative trend). Markets are good at coming up with scripts that humble us, so we cannot rule out the idea that if the Fed throws enough money at this thing that it manufactures a bull market, but it would be a short-lived FOMO fueled one, quickly pulled back to earth by economic gravity.

If Bernanke opened Pandora's box 12 years ago, Powell went ahead and ripped the cover off its hinges. As the Federal Reserve and Treasury begin to choose the winners and losers, this will all become highly politicized over coming months and years. The dollar amounts of money creation that they are talking about are staggering, and now that they have expanded the purchase into junk credit, they are buying into highly levered balance sheets at the peak of the economic cycle.

For our process, less of this is about timing or trying to figure out whether a retest is likely to occur. It's all driven by the prospective returns that equities offer and ensuring that they offer enough margin of safety. It's the biggest driver of the tactical shifts that we make across portfolios. Long-term, it's the most reliable but also the most difficult behaviorally to follow. Layering in psychology, monetary conditions, and trend are there to help behaviorally to keep from taking too stubborn of a stance based upon valuations alone.

Market Risk Index

Neutral

42.2%

Category Percentiles

Psychology - P3

25.7%

Monetary - M4

68.9%

Valuation - Extremely Overvalued

90.4%

Trend - Vulnerable

71.3%

Largest Psychology Influences

Volatility	Positive
Surveys	Positive
Option Activity	Positive
Corporate Insider Buying	Positive

Largest Monetary Influences

Below Trend GDP Growth	Positive
Velocity	Negative
Yield Curve	Negative

Valuation

7-10 Year Rtn Forecast	3.8%
10Yr Treas Yield (on 04/07)	0.8%

Price Trends

US Equities	Positive
Intl Equities	Negative
REITs	Negative
Broad Commodities	Negative

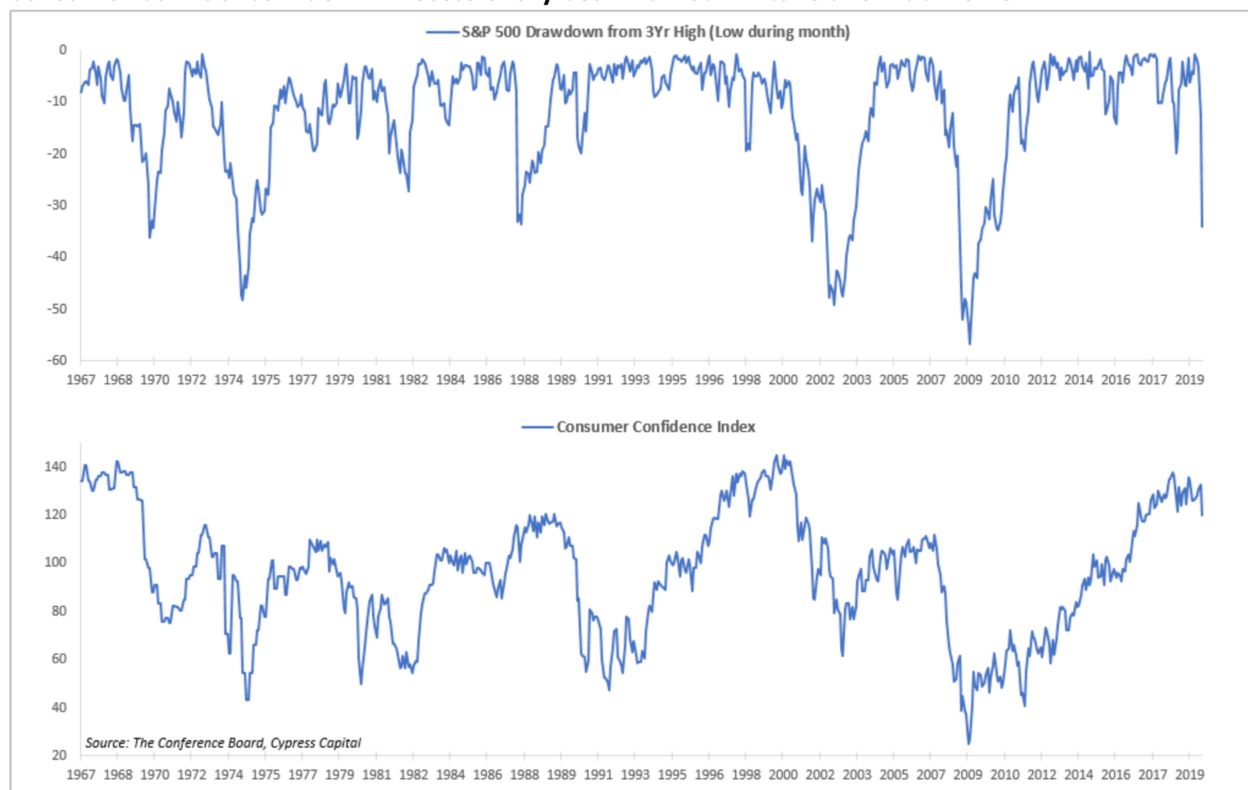
Market Risk Index scales from 0 to 100%. Higher readings correspond with higher risk markets. Scores below 25% are bullish. Scores between 25-75% are neutral, and scores above 75% are markets vulnerable to major drawdowns.

Our valuation composite is made up of seven factors. From them, we build a 7-10 year nominal return forecast, which continues to show a tight fit with ensuing stock market returns over the next 10 years. We also break those valuations out by deciles and have found that deciles have been systematically tied to the level of drawdown risk present in equity markets over history, regardless of where interest rates were and regardless or Fed policy. Valuation is economic gravity for financial assets and markets.

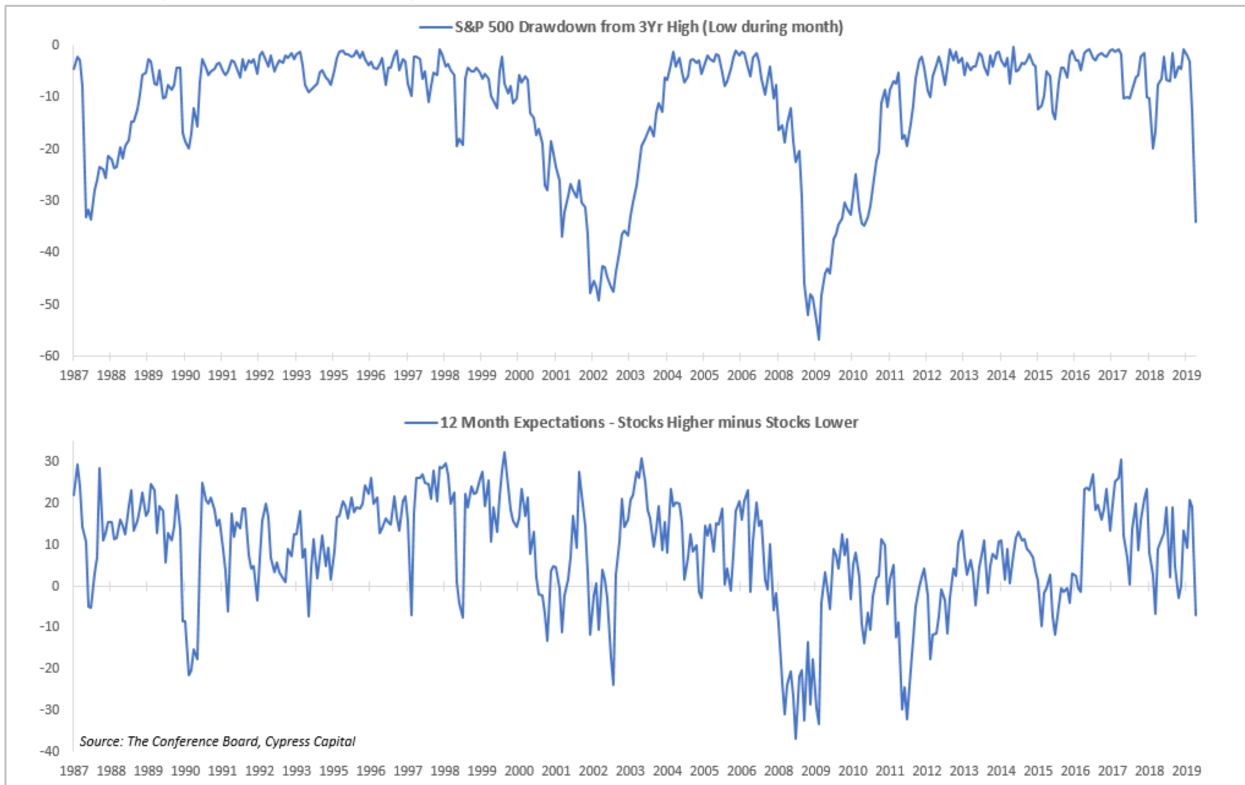
Should the Fed cross the final line in the sand and decide to buy equities and provide a floor for stocks, what are the implications? When the Fed allows us to exercise this put on bonds or stocks, it may provide a floor, but it also creates a ceiling on returns. If in an extreme example, the Fed decided to buy all corporate credit in the country yielding more than 4%, then guess what? Investors aren't going to earn more than 4% on their capital, regardless of default risk of the issuer. The same holds true for stocks. At current levels, we'd be locking in low returns for a long time. Your hope for above average returns would rest on valuation multiples climbing higher than they ever have, something that would likely hinge on corporations levering up their balance sheets even further from here. Like every economic and policy door we seem to open several years later, Japan has already experimented with this, and it hasn't prevented bear markets or managed to overcome the effects of economic gravity. Creating wealth is a result hard work and ingenuity, not financial engineering and monetary sleight of hand.

Ignoring any deflationary or inflationary consequences to Fed policy, there would be longer term implications for asset allocators. It will deal a blow to passive, buy and hold investing, particularly for fixed income investing, where avoiding default risk becomes more paramount with a ceiling having been placed upon your returns. It will become imperative for investors to change their mindsets about what you will be willing to invest in to earn good returns with a margin of safety, and it's likely to be in assets that aren't being backstopped by the Fed.

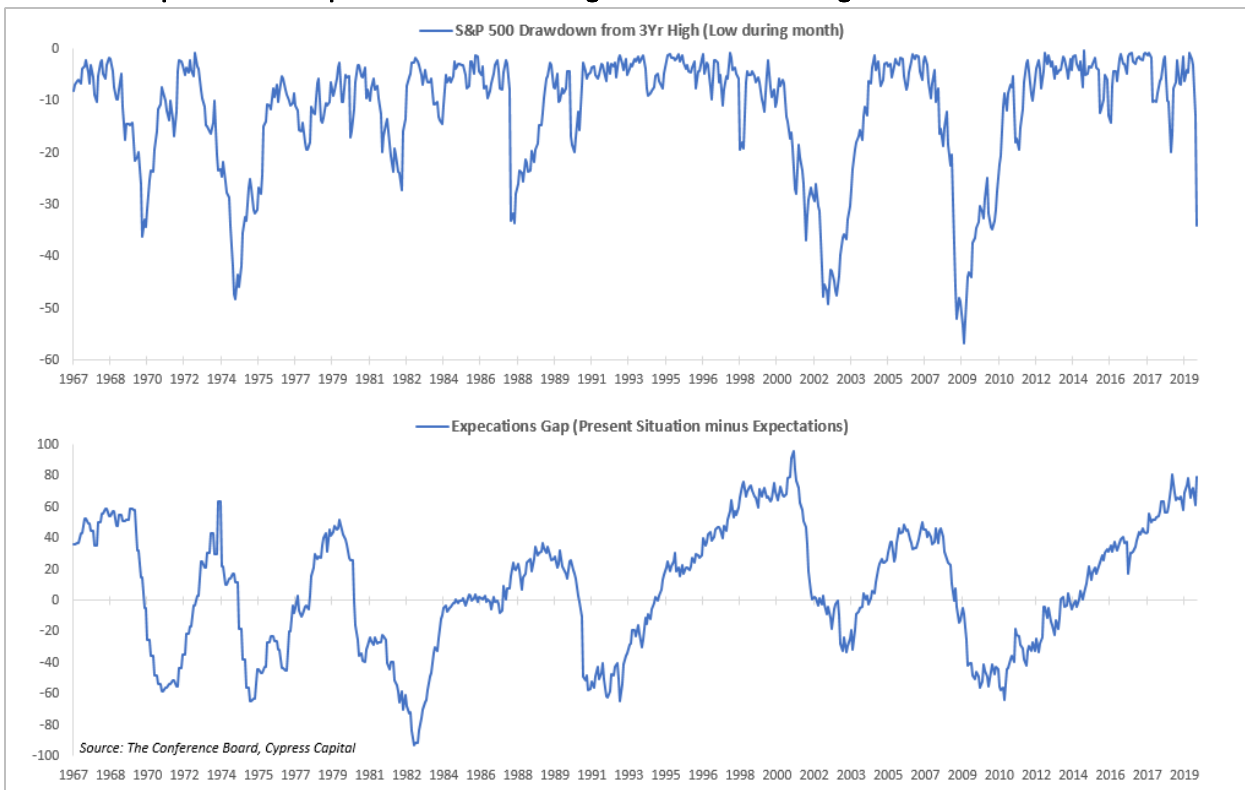
Consumer Confidence Index – A recessionary bear market will take this much lower



Consumer Expectations for stock prices are at correction levels but bear market low levels

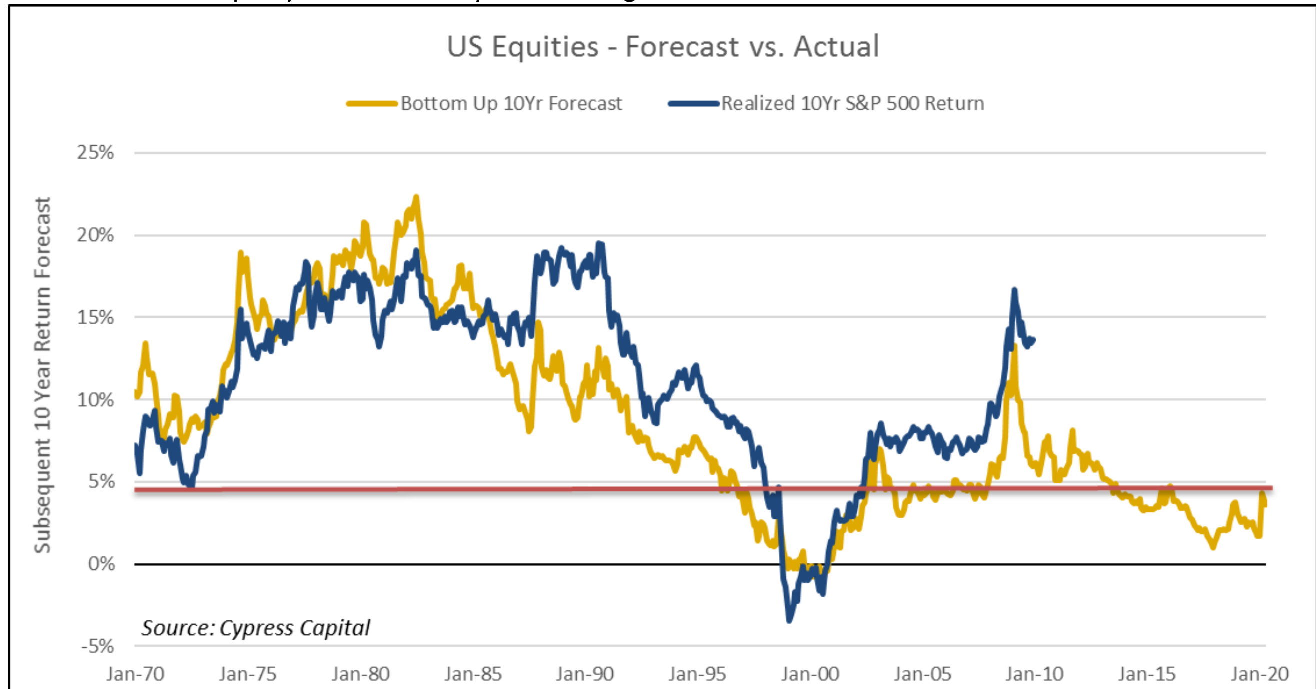


Consumer Expectations Gap widened – this will go much lower during the recession.



Valuation based return forecast for equities

If the Fed put gets applied to equities here, it would lock in lower returns for quite some time. Earnings growth can eventually create a better environment, but that would take a long time. Outside of that, you're hoping for valuations to run up beyond where they were during the tech bubble.



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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