



Market Outlook

By Mark T Dodson, CFA

The Benjamin Button Bull Market

A New Bull Market that Looks Really Old

Market Risk Index pushed up to 68% this week, drawing closer to the 75th percentile, which marks market environments most vulnerable to substantial drawdowns. Psychology’s rollover that we highlighted last week quickly reversed, as higher equity prices this week were able to goose animal spirits again and push our psychology composite to 56%. Call option activity this week was extreme, and our favorite measures of option activity are not close to where they were in February, but they hit levels consistent with markets near the end of a short-term upward move. The options category, Levered Investments, and Bank Sentiment categories were responsible for most of the deterioration this week within Investor Psychology.

Monetary conditions are still stable but still not showing signs of improvement – again primarily because the Fed’s drastic interventions in March prevented the yield curve from normalizing, and monetary aggregates are growing at such a record pace that it limits confidence that we have exited the risky deflationary period that coincides with falling velocity. The relative weakness in financial stocks highlights the problems with trying to stop the credit cycle from its completion and using too much liquidity to mask the solvency issues that are now brewing under the surface.

That brings us to valuations, which also worsened modestly this week. We recognized that short-term sentiment was wound up so tight that it led us to put out a special note on a Sunday, March 22nd, to highlight how likely the odds had grown that a bear market rally was about to ensue. We felt the fear in our bellies as much as we saw it in the data, but the biggest hurdle to keep MRI from ringing the gong for a new bull market was valuations.

If you have seen the movie Benjamin Button, you know that Benjamin was born an old man and lived his life in reverse. If March 23rd marked the bear market lows, it did so at valuations that were more than 20% higher than every other bear market in our country’s history of having financial markets. The rally off the March lows has now pushed the Price to Peak Earnings ratio on the S&P 500 within 10% of the levels from the 2020 bull market peak. For a bull market that is less than a month old, this one already looks as old as the two longest bull markets in US history. It’s the Benjamin Button Bull market.

Market Risk Index

Neutral

68.3%

Category Percentiles

Psychology - P4



Monetary - M4



Valuation - Extremely Overvalued



Trend - Vulnerable



Largest Psychology Influences

Volatility	Positive
Surveys	Positive
Leveraged Investments	Negative
Option Activity	Negative

Largest Monetary Influences

Velocity	Negative
Monetary Aggregates	Negative
Yield Curve	Negative

Valuation

7-10 Year Rtn Forecast	2.4%
10Yr Treas Yield (on 05/21)	0.7%

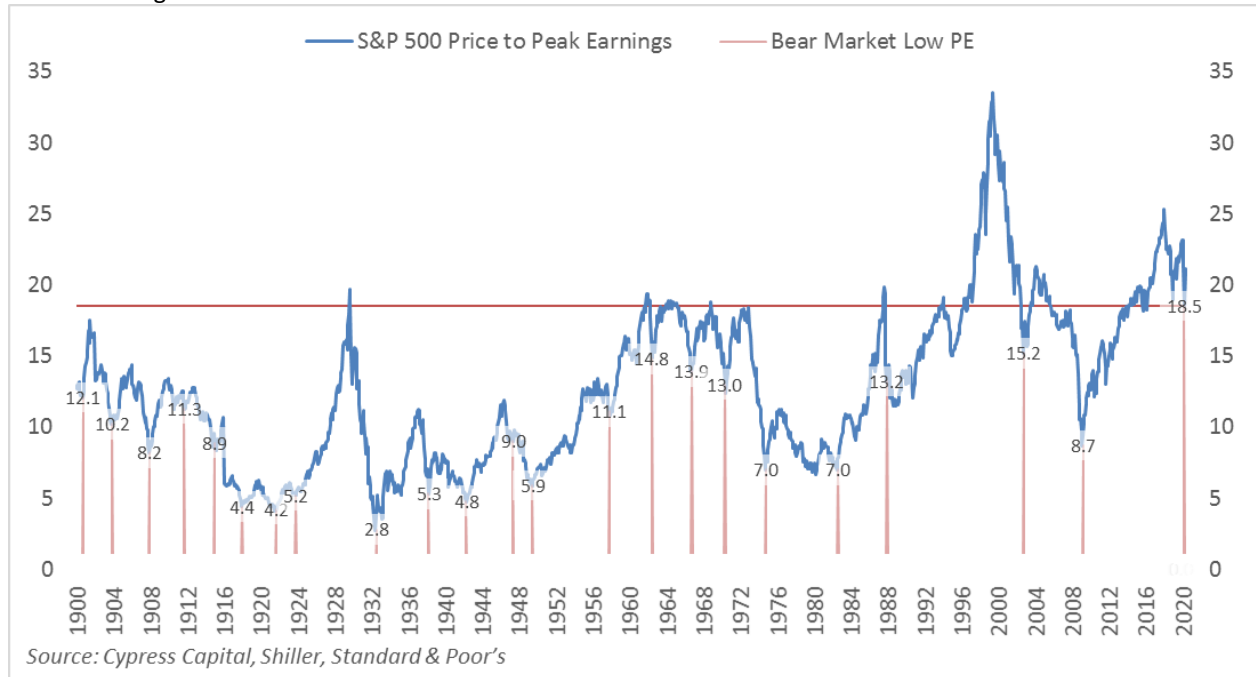
Price Trends

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.

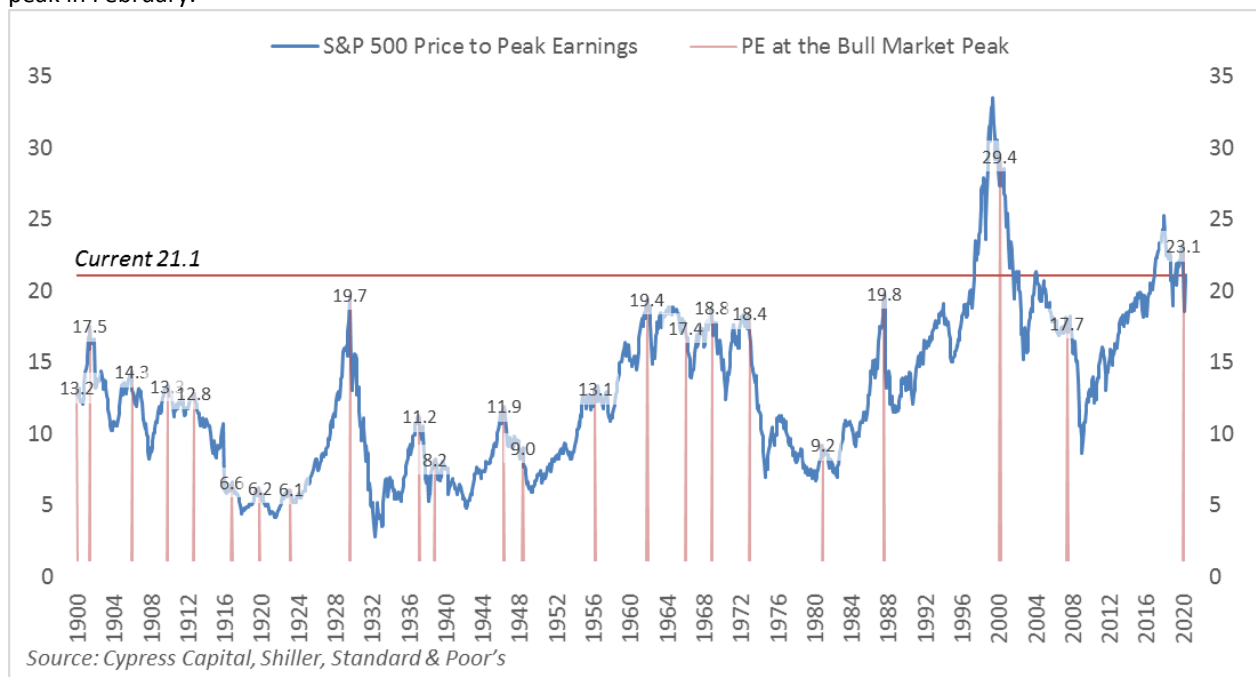
History of Price to Peak Earnings at Bear Market Lows

We specifically used this metric, because it is not sensitive to the earnings cycle or recessions, and it also is not sensitive to accounting arguments that investors use to criticize Shiller’s Cyclically Adjusted PE Ratio. It uses the peak trailing 12 month earnings achieved to date for the S&P 500. If earnings fall by 50%, you are still using the earnings as they were at the peak of the cycle. Because it is anchored to earnings from the peak, it gives you an optimistic outlook for earnings even while earnings are falling dramatically, as they are today. Presuming March 23rd was the end of the bear market, it bottomed with the highest Price Earnings ratio in US history. The 2000-2002 bear market bottomed with a Price to peak earnings around 15. The average bear market since 1960 took the ratio down to 12.4x.



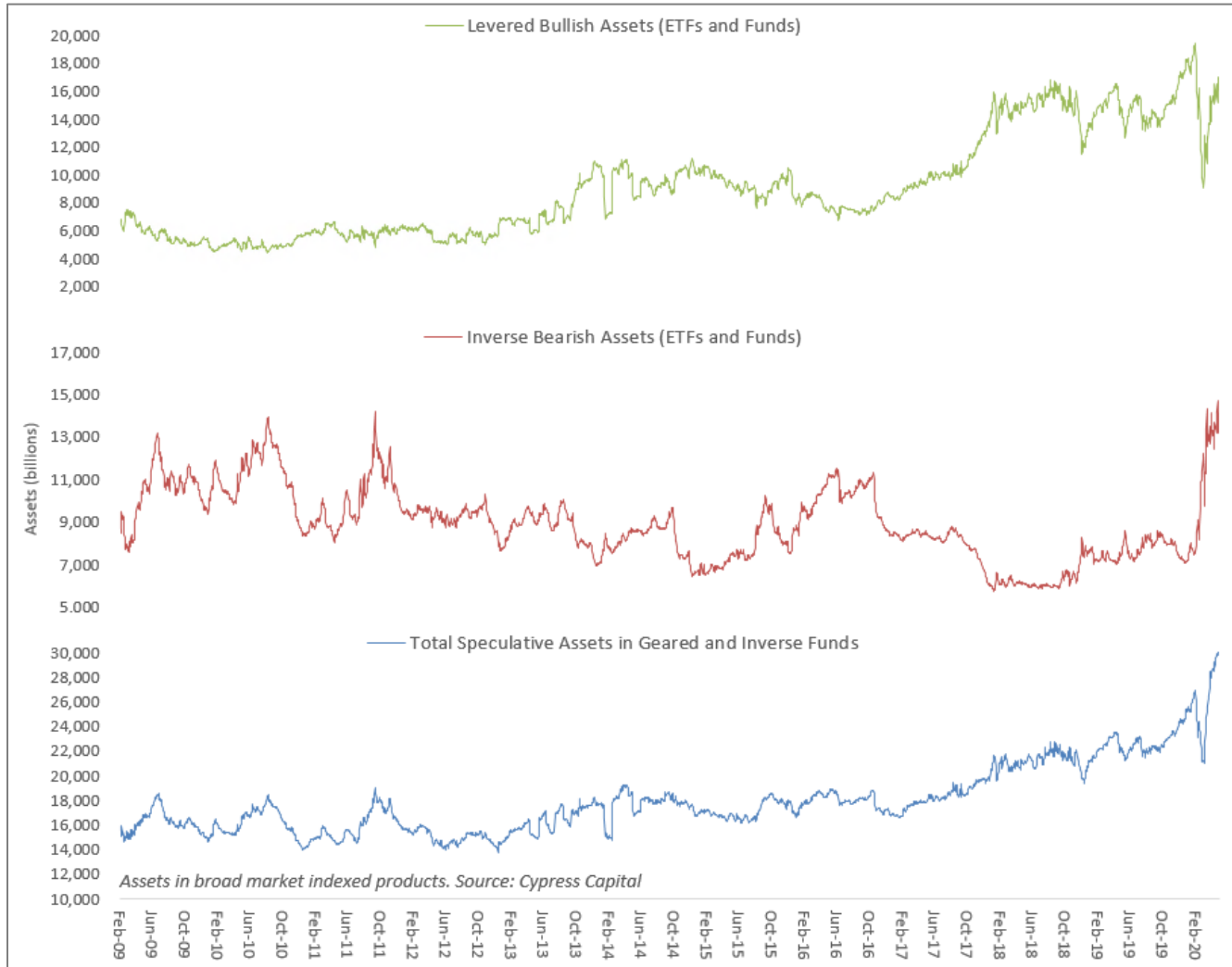
History of Price to Peak Earnings at Bull Market Peaks

Operating under the assumption that a new bull market began on March 23rd, the current price to peak earnings ratio of 21x has already reached levels higher than every other bull market in history except the one that ended in February, and the 2000 tech bubble. This bull market is less than 10% away from breaching the Price/Earnings ratio from the bull market peak in February.



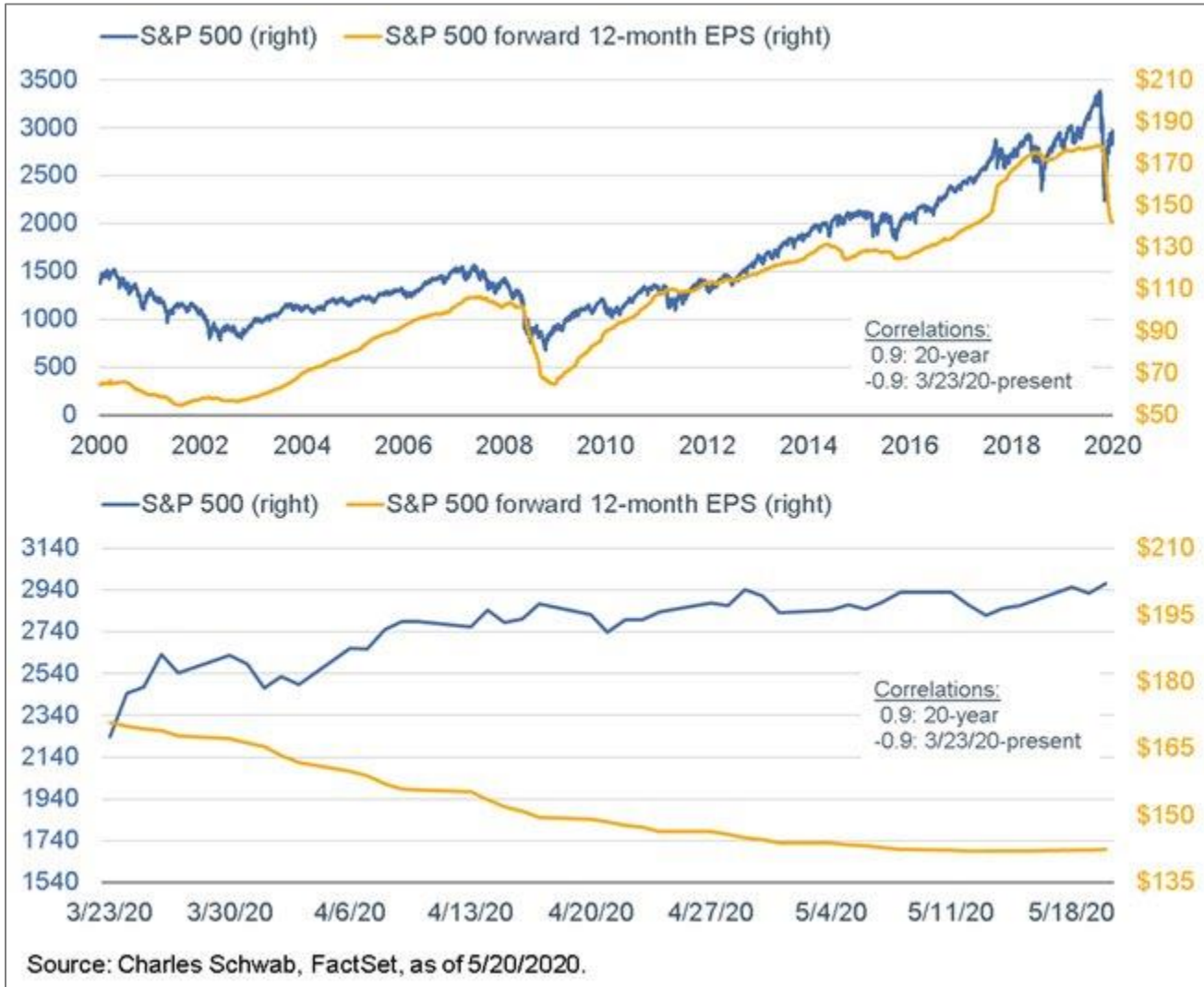
Speculative Assets Surge to New Highs

There has been a surge in assets chasing inverse funds (to record highs), which you would expect in a severe market decline, but the assets chasing leveraged ETFs and funds has also shot up to the highest levels since the market peak, which were also record highs. Call it the Robinhood effect, or Millennials versus Boomers, but the combination suggests the ongoing battle between bulls and bears will keep volatility elevated. There is a high correlation between the rates of change in these speculative assets and volatility indices.



Disconnect Between Prices and Fundamentals

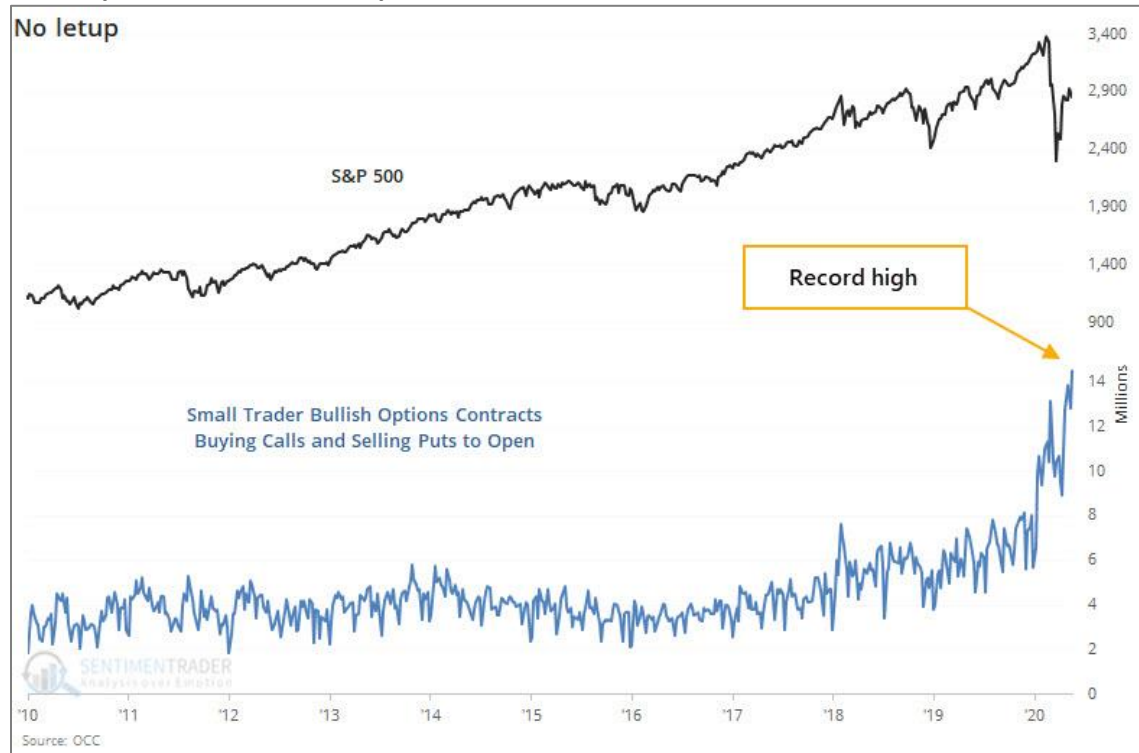
Maybe the stat and quote of the week from Liz Ann Sonders, “Intuitively, we can sense that stocks have disconnected from earnings estimates; but check out below, which shows that correlation between S&P 500 & forward earnings estimates has been +.90 over past 20 years, but a mirror image -.90 since 3/23/20.”



Source: Charles Schwab, FactSet, as of 5/20/2020.

Source: Schwab

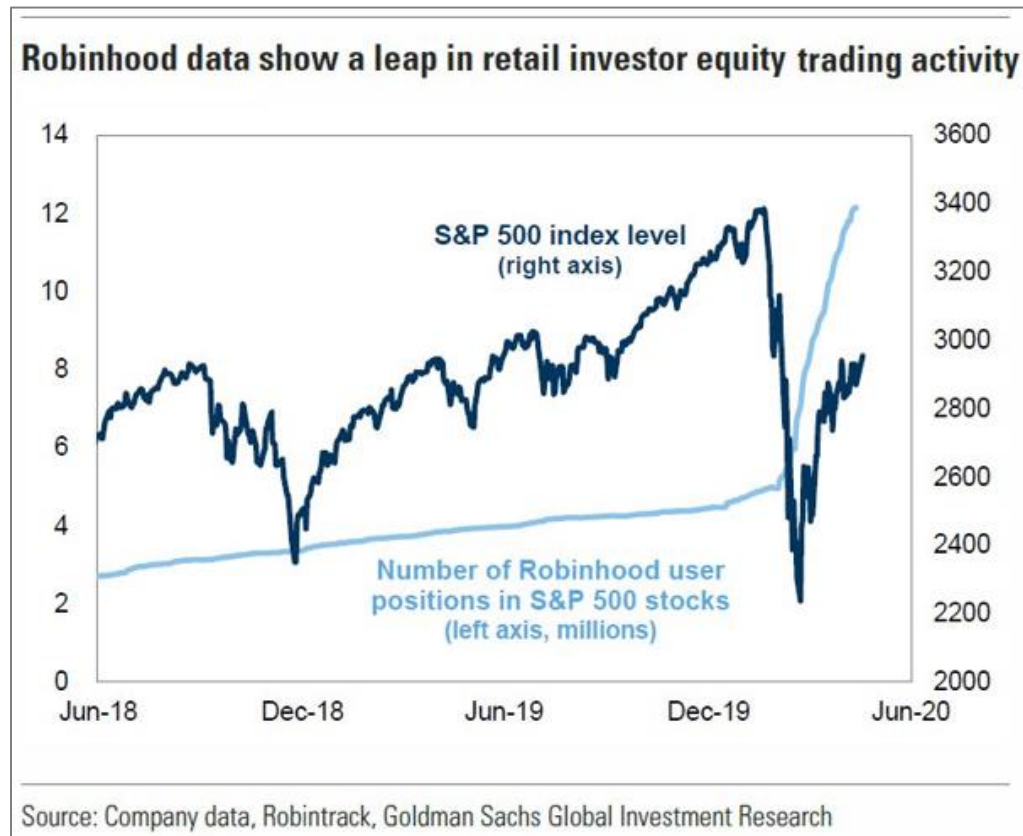
Small Options Trader Animal Spirits Reach New Record



Source: SentimenTrader

The Robinhood Rush

The activity of Robinhood retail investors, mirrors the small options trader sentiment above, and it doesn't look anything like bear market risk aversion.



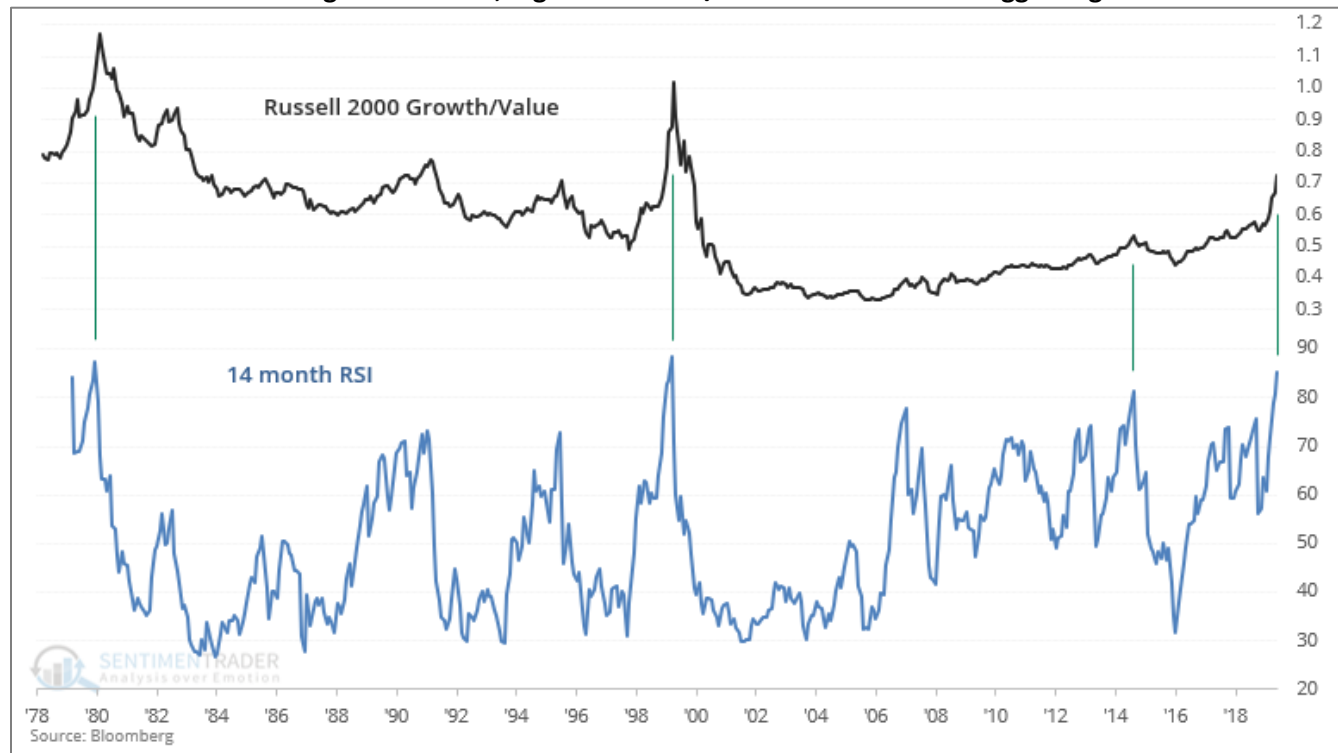
Source: MacroCharts

Professionals are throwing in the Towel on Value



Source: Bloomberg

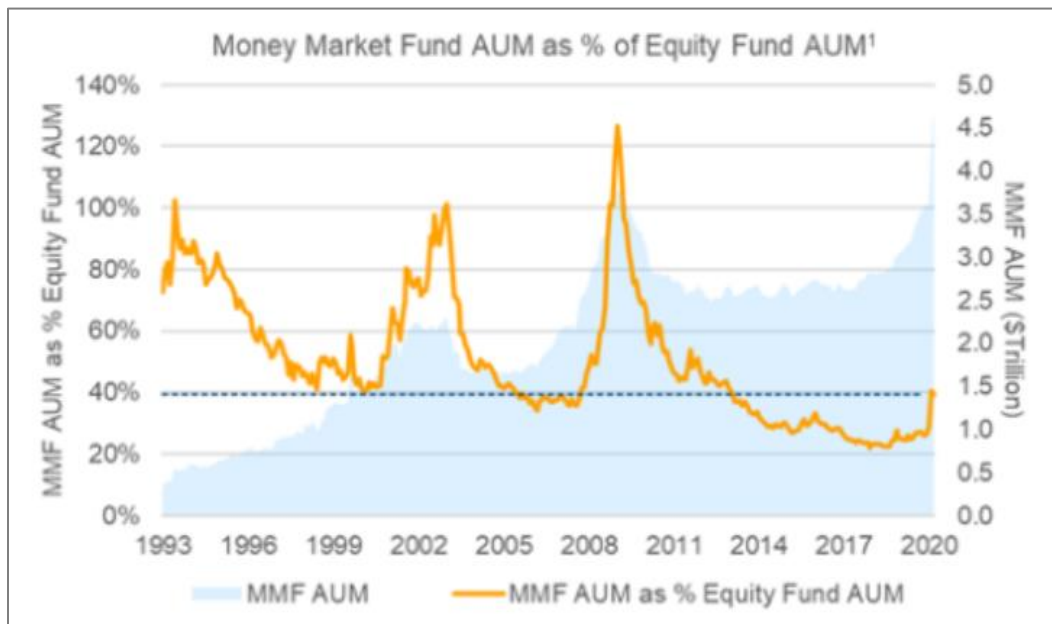
Professionals are Throwing in the Towel, Right as Growth/Value Momentum is Suggesting A Substantial Peak



Source: SentimenTrader

Money on the Sidelines

Monetary Aggregate growth is surging, but money market fund assets as a percentage of equity fund assets have only hit the low levels from 2007. The 2009-2020 bull market may have started as the most hated bull market, but this chart shows it was a record TINA bull market – rationalizing taking risk because There Is No Alternative to equities. There is more excess from this cycle than most realize, and it’s in large part, because most investors are anchored to the 2000 bull market peak as what bull market excess looks like.



Source: Bloomberg

Crazy, Ridiculous, Record Outperformance of Everything by the FAAAM stocks

The FAAAM stocks may seem invincible, but unless capitalism is broken, it’s hard to see them leading the next cycle. Value, International, Small Caps, all priced for good returns. But...no one really wants to own them.



Source: WSJ

Thanks for reading. Enjoy your long weekend!

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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