Market Outlook

By Mark T Dodson, CFA

Psychology Breaks into the Worst 20% of Readings

Market Risk Index climbed above 80% this week for the first time since March. Monetary conditions made another improvement, but this week it wasn't enough offset a substantial worsening of the Psychology composite. Our psychology composite has crossed into the worst quintile of readings, also for the first time since March. Crossing above 80% has traditionally been our hurdle to denote stock market periods with excessive enthusiasm.

We are still seeing more crosscurrents that are difficult to reconcile within both the monetary and psychology composites than ever. Within psychology, gurus have grown more bullish, while the veteran individual investors, measured by the AAII investment survey, haven't bought in at all to the rally – which is similar to how that group of investors behaved during the 2008 bear market. We continue to see super-high volatility readings, a positive for psychology, but throughout June it was paired with some of the lowest equity put/call readings on record (lots of speculative call buying). That kind of mix of call buying with a high vol backdrop is out of character with normal market behavior – it's only happened during very brief periods in Jan-Feb 1999 and Mar-April 2000.

On the monetary front, we're seeing our measures of liquidity increasing like its early in a credit cycle, but we're also seeing late cycle acceleration in the Lending & Leverage category and a yield curve that is much too shallow given the conditions of other indicators historically. Even the normally easy to decipher reports on jobs and employment have become difficult to separate the signal from the noise. All of it suggests that market volatility is unlikely to recede soon.

Our valuation composite is close to exerting its maximum negative influence on MRI, so there's little more damage that it can do to our quantitative assessment of drawdown risk present in the market. The pure regression based valuation model that we have flirted with over the past several months, based purely on a best fit regression of forward returns with our valuation composite since 1990, has broken into single digit return expectations and is close to breaking into negative return territory for the first time since 1999-2000.

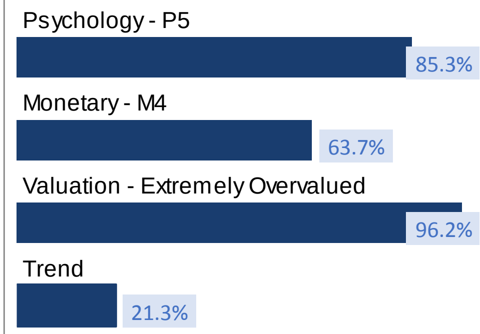
Can we find evidence to suggest a pure momentum & liquidity-driven FOMO rally that might continue to push markets further into obscene territory? Sure, but we remain grounded

Market Risk Index

Elevated

80.7%

Category Percentiles



Largest Psychology Influences

Volatility	Positive
Fund Flows	Negative
Option Activity	Negative
Leveraged Investments	Negative

Largest Monetary Influences

Rate Spreads	Negative
Velocity	Negative
Lending and Leverage	Negative

Valuation

7-10 Year Rtn Forecast	2.0%
10Yr Treas Yield (on 07/01)	0.7%

Market Trends

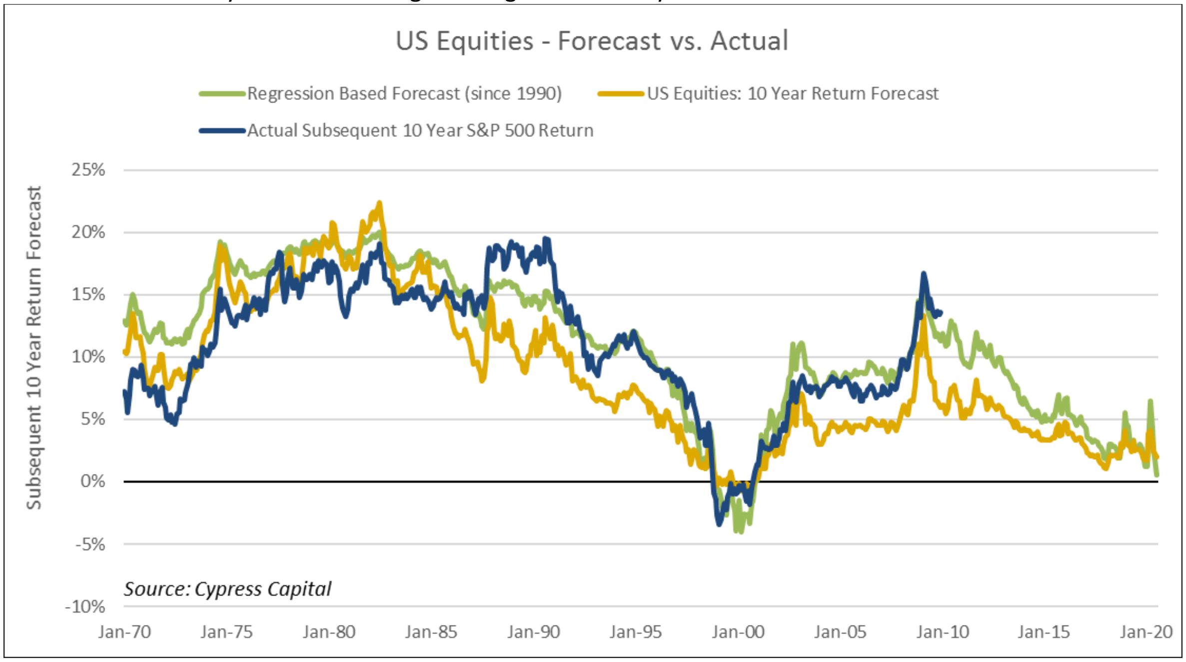
US Equities	Bullish
Intl Equities	Neutral
REITs	Neutral
Broad Commodities	Neutral

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.

by Ben Graham's dictum to invest heavily in equities only when there is a margin of safety. Without it, we won't throw caution to the wind, regardless of any pain from missing out in the short-term. Run your race turtles – ignore the rabbit.

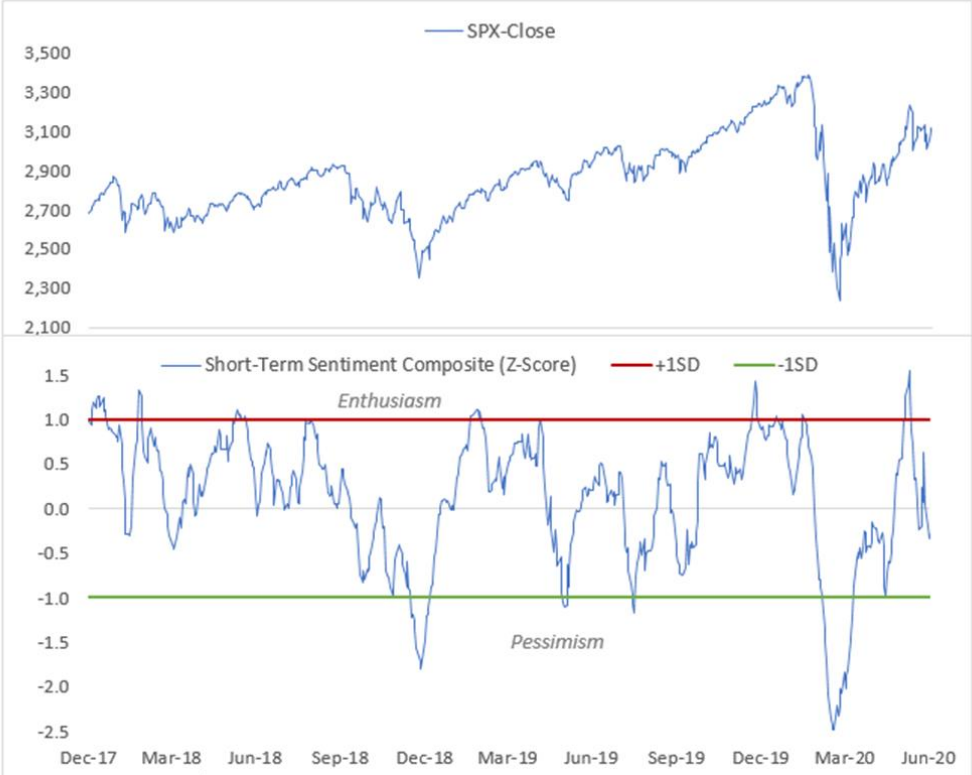
Valuation Based – Equity Return Forecasts

The post-1990 regression based return forecast model (the green line) that we built below was a concession to the idea that only the valuations after 1990 matter for markets. That model is now signaling lower returns than our traditional bottoms up return forecast and has fallen into single digit return expectations. It's the best fit line between valuations, after 1990, and subsequent stock market returns over the next 10 years. It's ironic, because we started flirting with the model as a way to push our return expectations higher. The work was part of our continuing desire to improve, but it was mostly as a result of our impatience (FOMO) as investors. In spite of our emotionally driven intentions, the "optimistic" regression based forecast is very close to crossing into negative territory for the first time since 2000.



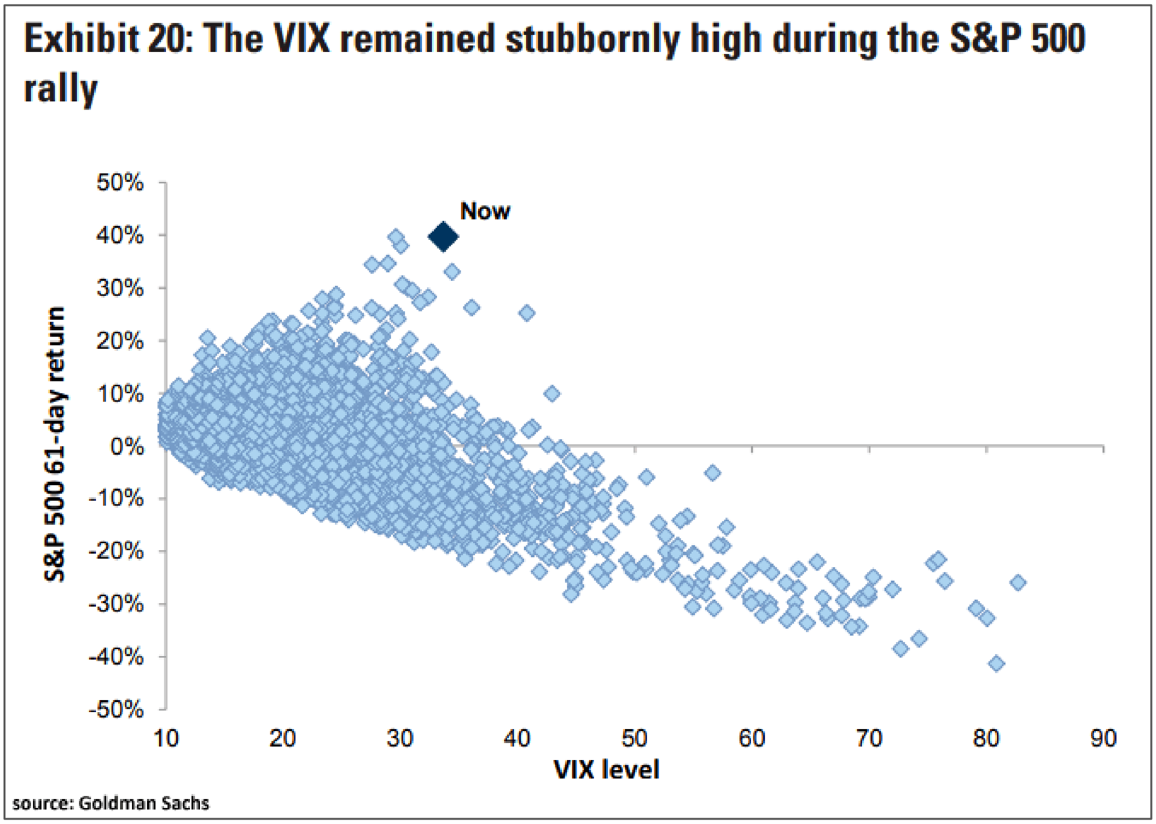
Short-Term Sentiment Composite

Our psychology composite might be in the worst 20% of readings, but some of our faster moving, shorter-term psychology indicators are moving back toward pessimism after peaking on June 9th.



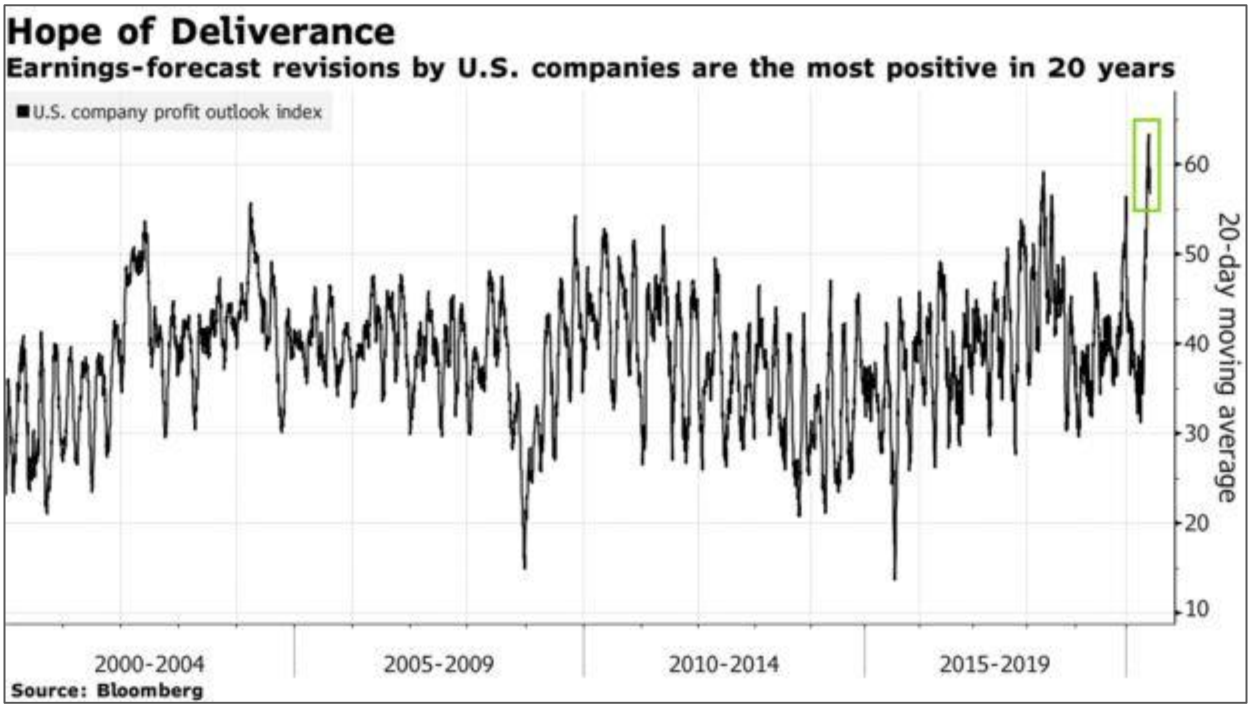
Source: Cypress Capital

Volatilty is Abnormally High Given the Stock Market's Powerful Rally



Source: Isabelnet

Earnings Revisions – Most Positive in 20 Years

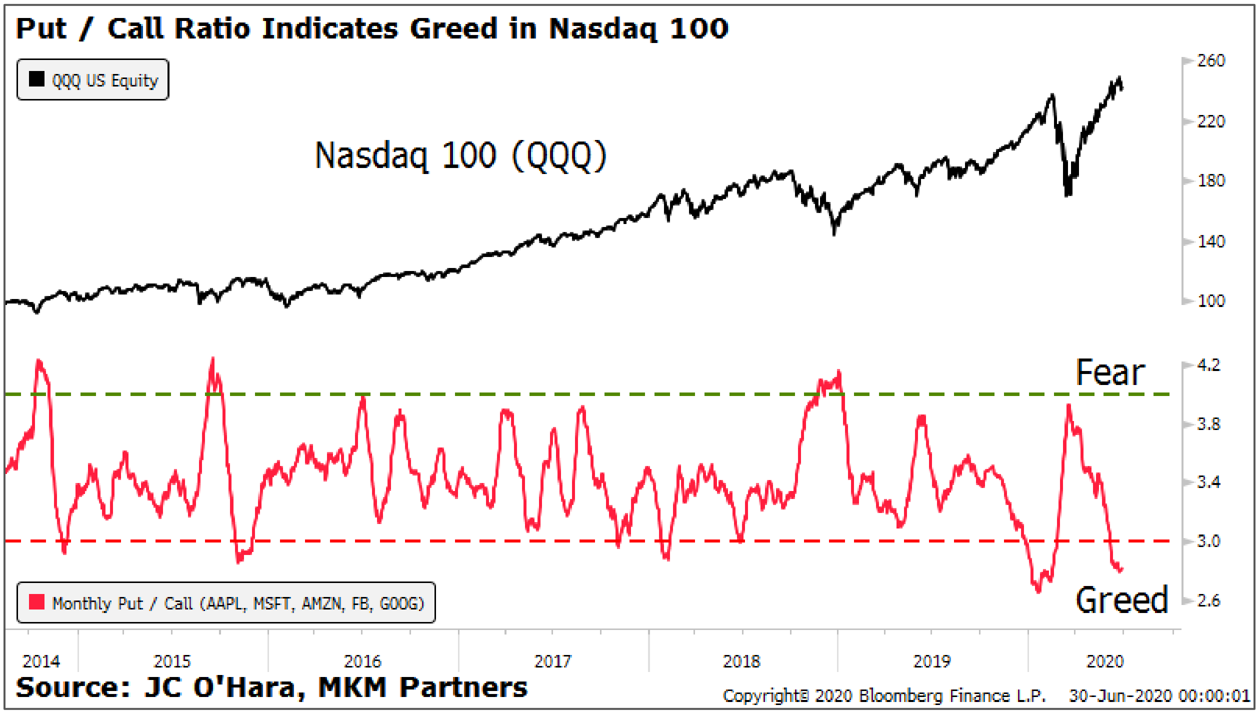


Tesla Surpasses Toyota

Tesla's stock has surpassed even Elon Musk's expectations. The stock has climbed more than 50% from the point that he said it was too high on May 1st.

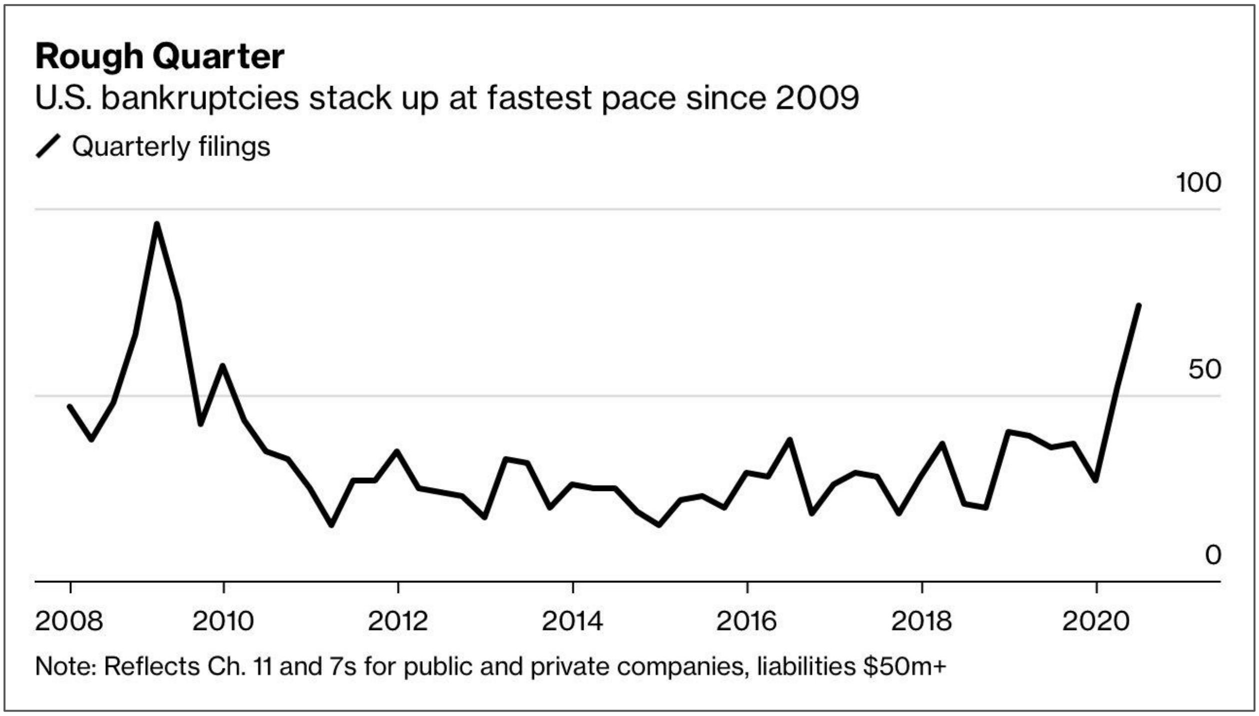
FAAAM Stock Greed

The equity put/call ratio has rolled over in the last week, but looking solely at the handful of stocks that are driving market returns, the animal spirits are still strong.



Source: @MacroCharts

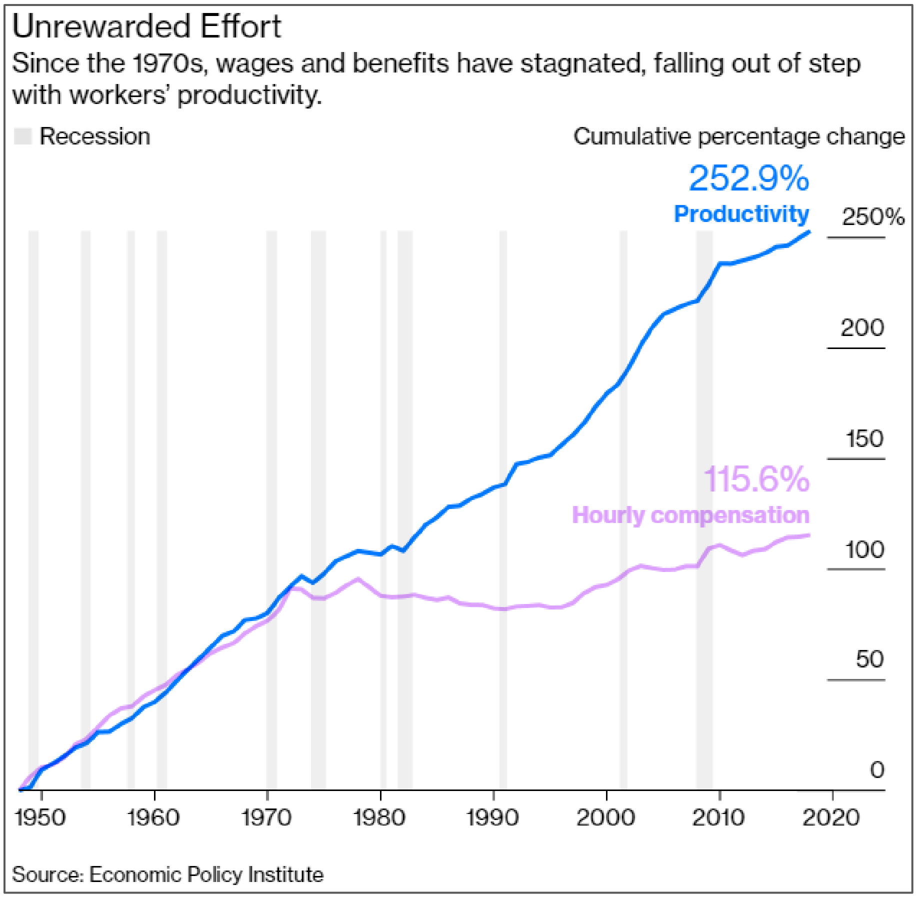
U.S. Bankruptcies continue to Climb



Source: Bloomberg

Wages versus Productivity

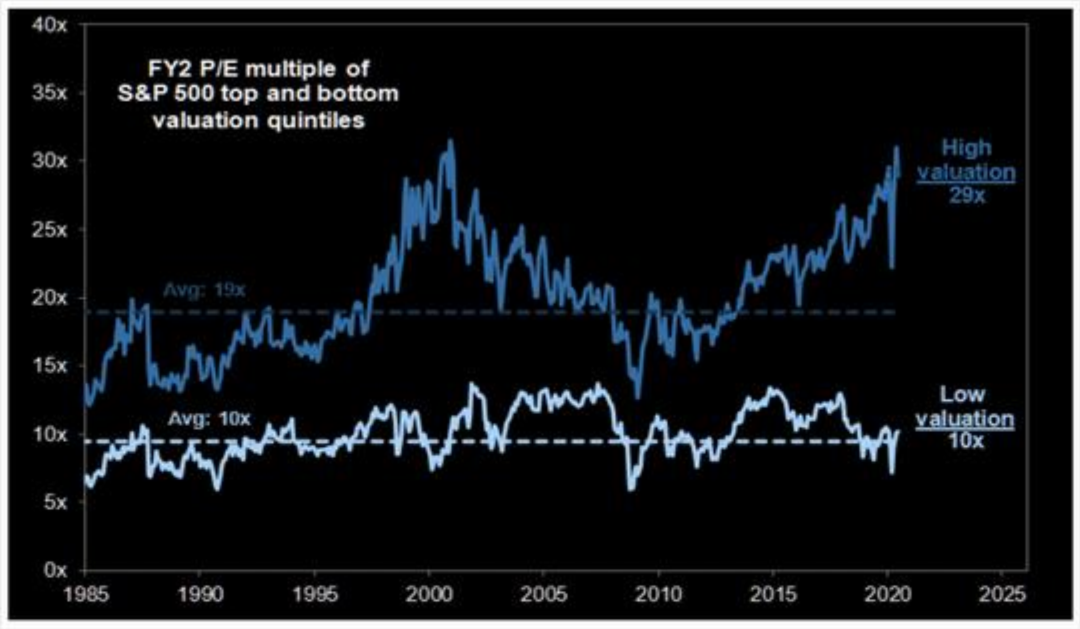
You've likely seen this chart before – how worker compensation has not kept pace with economic output over several decades, partly influencing the growing partisan and social divisions that we have seen in the country. What has always struck us about this chart, maybe coincidence, is that the break in trend came the year that the United States ended Bretton Woods and finally broke remaining ties with any semblance of the Gold Standard.



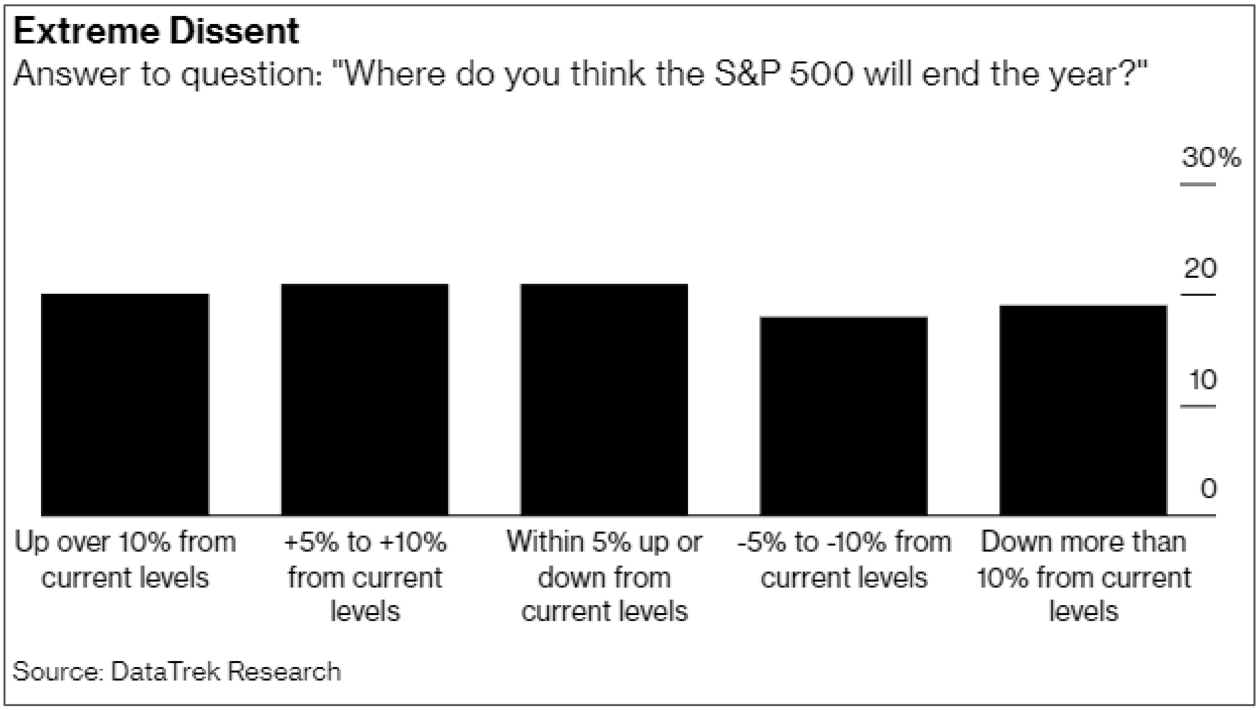
Source: Bloomberg

Wealth Inequality – the Corporate Version

Inequality among US corporations, measured by valuations, is at the highest level since 2000.

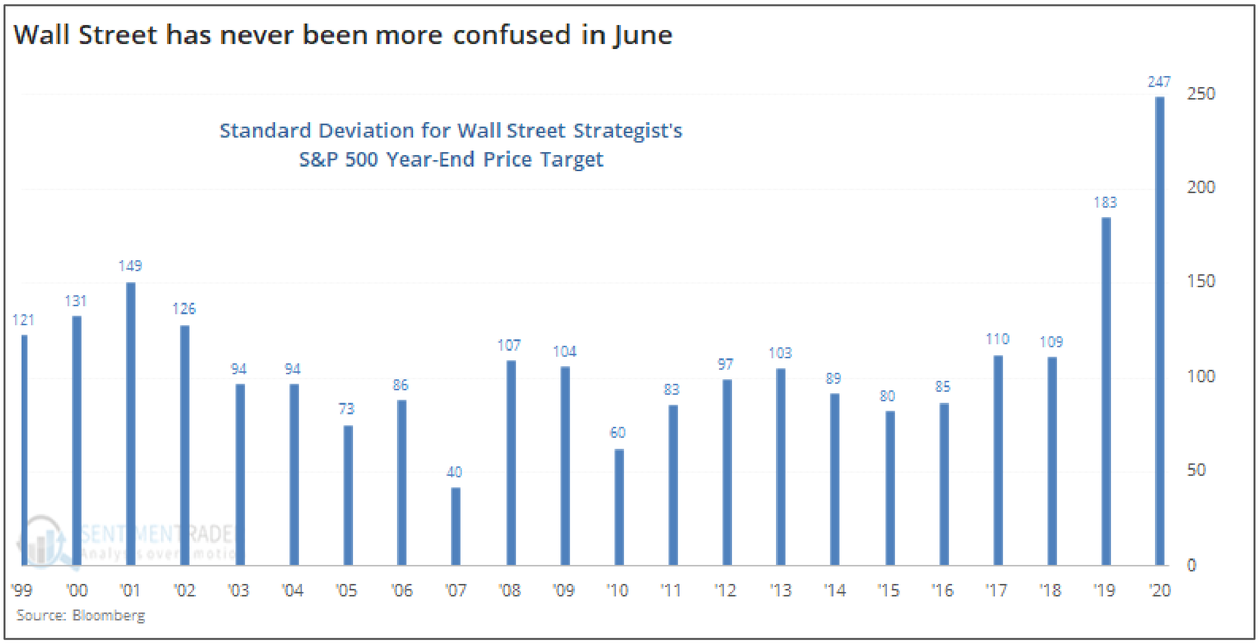


Wall Street Gurus Aren't Sure Where the Market is Headed



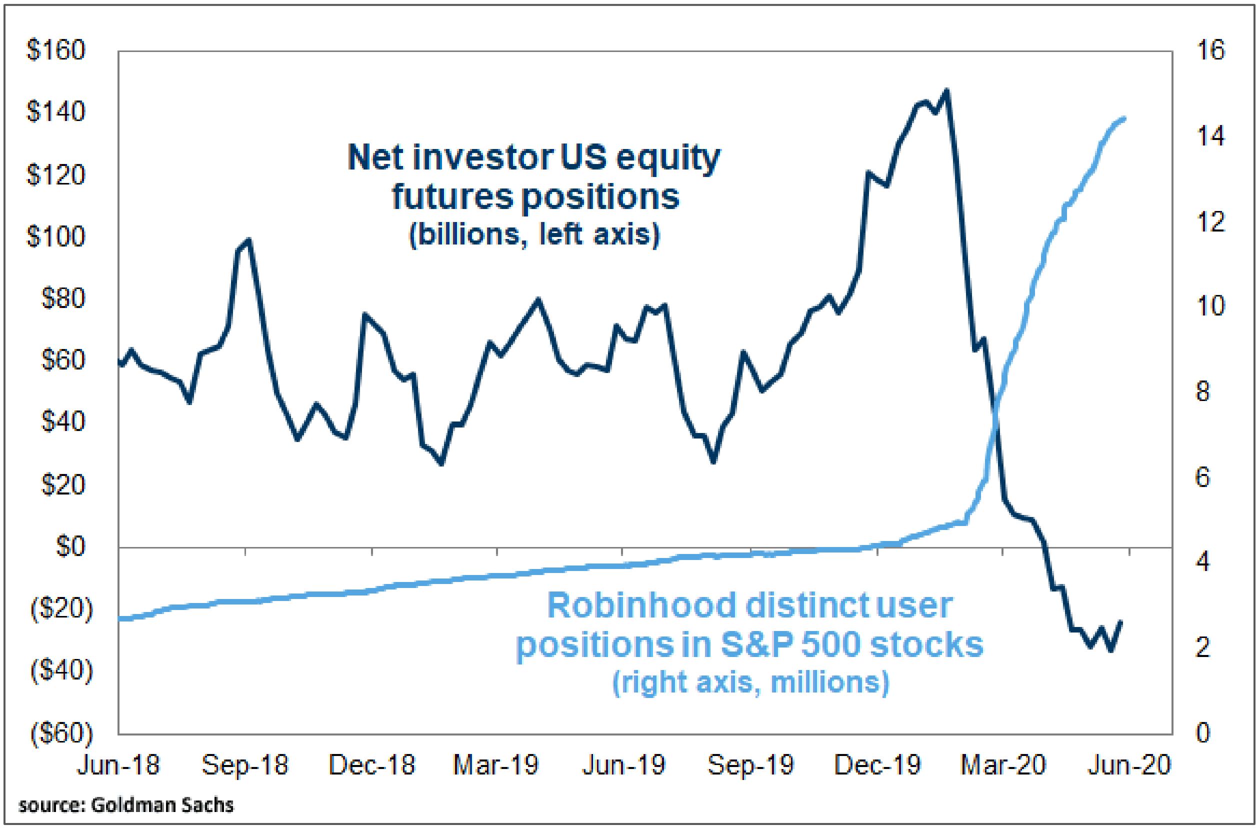
Standard Deviation of S&P 500 Price Targets

Wall Street gurus' S&P price targets, mostly useless anyway, are all over the map.



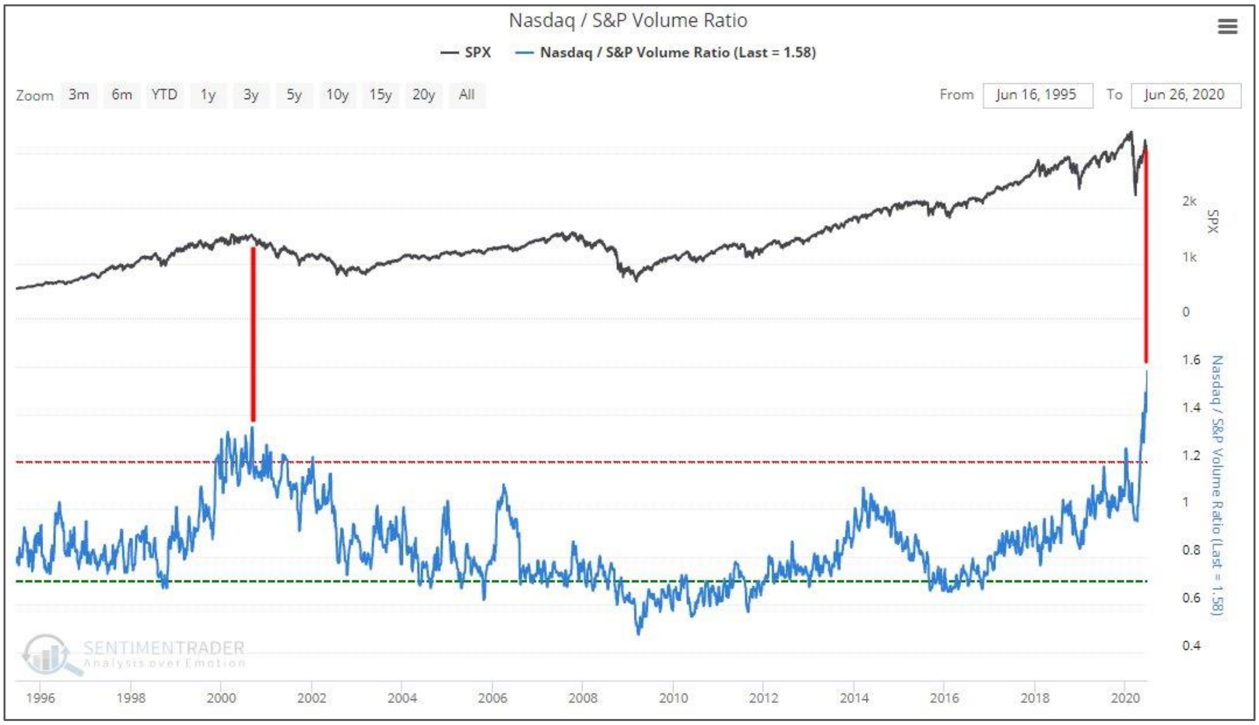
Robinhood versus Professionals

Robinhood investors are all-in, while professionals (as measured by futures positioning) aren't sure what to make of this unusual market.



Source: IsabelNet

NADAQ to S&P Volume Ratio Surpasses Dotcom Era



Source: SentimentTrader

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.