Market Outlook

By Mark T Dodson, CFA

MRI Climbs Above 81

Psychology continued to press further into enthusiasm territory and is edging closer to the worst 10% of readings, pushing Market Risk Index to 81.1%. MRI is still firmly in the high drawdown risk category, after crossing the 75% threshold on June 4th. The official asset allocation model cash recommendation is 30%. For portfolios where the market rally has taken the equity allocation well beyond that, we trimmed and liquidated some equity positions this week.

Speculative call option buying by traditional dumb money traders has been persistent and historic since June. However, within the last week, we have started to see smart option traders grow more defensive and begin putting on hedges. Consequently, the Options Activity category is now the largest headwind within the Psychology composite.

The surveys category is the only one still giving any major indication of a wall of worry. Older, possibly wiser, Baby Boomer investors, as measured by the AAII weekly sentiment poll are still extraordinarily anxious. That popular weekly poll, a great contrarian gauge inside of a low volatility bull market environment, instead becomes a good indication of recession when it stays mired in bearish readings for multiple weeks like it has been now. The poll became a member of the Conference Board’s Leading Economic Indicators after the 2008 recession for this reason.

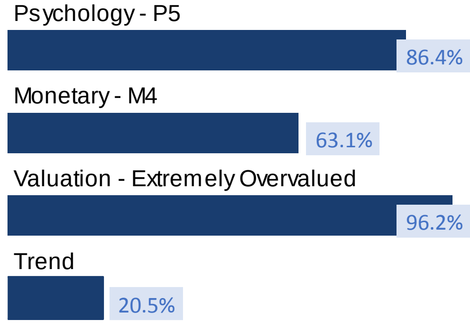
After getting significant breadth thrusts, and even a major NYSE High Low Logic Index buy signal a couple of weeks ago, breadth has disappeared. Outside of a brief push above 50% for a couple of days around the June 8th peak, the percentage of S&P 500 stocks trading above their 200 day moving averages has been anemic, and the ARMs index is also hovering near warning levels. As we caveated in previous weeks, the positive developments that we saw with internals and breadth came after a much larger move off the lows and at much higher valuations than we have ever seen, making them less trustworthy. Also, when healthier equity markets reach overbought levels, experience breadth thrusts, etc., they tend to keep pushing higher fairly soon. Instead we’ve seen more money pile into the FAAM stocks, as they continue to set records and are largely responsible for most of any recent higher moves in cap-weighted indices.

Market Risk Index

Elevated

81.1%

Category Percentiles



Largest Psychology Influences

Surveys	Positive
Fund Flows	Negative
Leveraged Investments	Negative
Option Activity	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 07/08)	0.7%

Market Trends

US Equities	Bullish
Intl Equities	Neutral
REITs	Neutral
Broad Commodities	Neutral

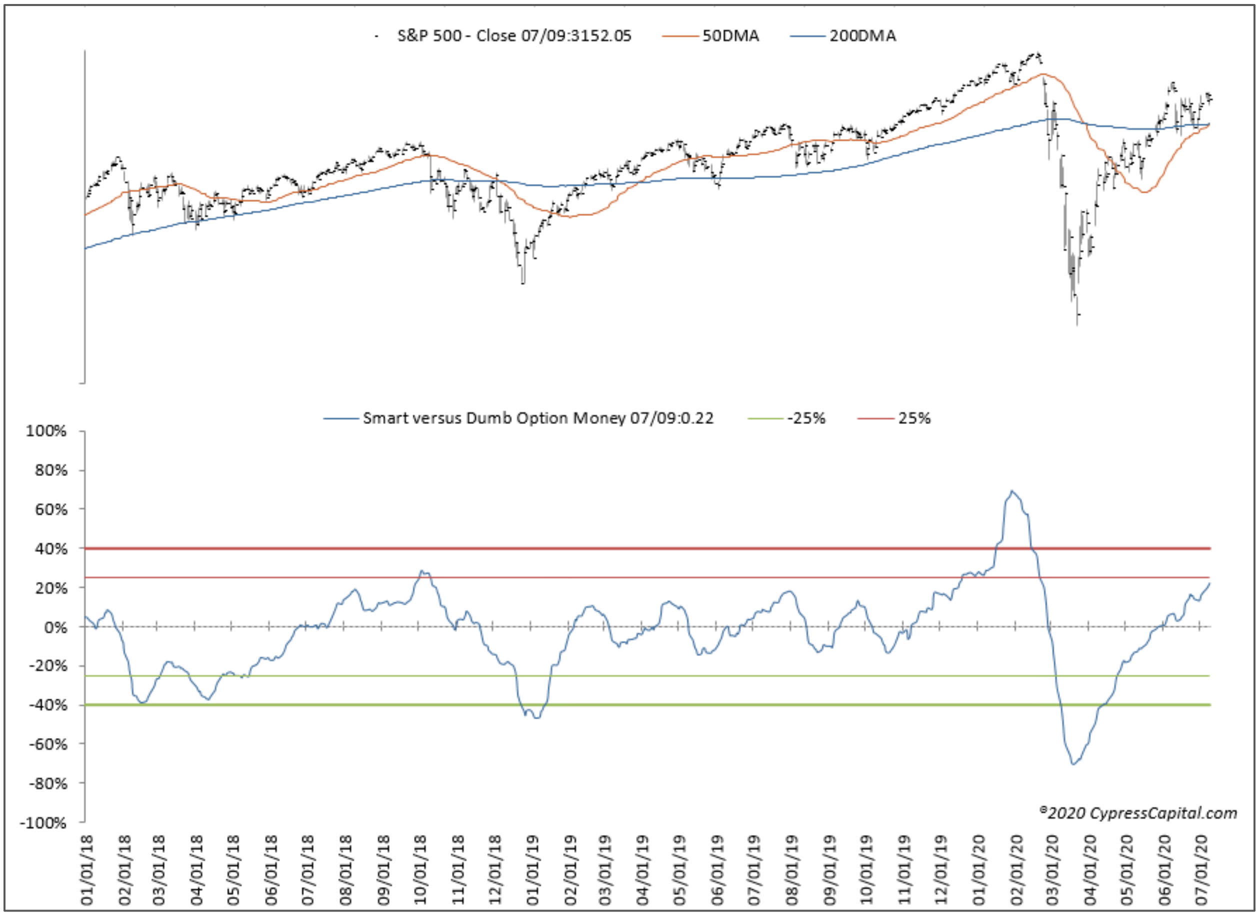
Market Risk Index scales from 0 to 100%. Higher readings correspond with higher risk markets. Scores below 25% are bullish. Scores between 25-75% are neutral, and scores above 75% are markets vulnerable to major drawdowns.

Monetary conditions improved this week, but the improvements have not been as substantive as they were when the Fed embarked on the experiment in quantitative easing during the GFC. Some major complicating factors are the slope of the yield curve, which has steepened very little, because the Fed put a stop to it. Also, unlike typical recessions, instead of seeing a decrease in leverage, which sets the economy up for the next credit cycle, we are seeing a speculative credit surge within our lending and leverage category. Our lending and leverage category has become the largest detractor from the monetary composite. The message from our monetary composite is one of liquidity being pushed into a credit cycle that looks old and full of excess by traditional measures.

On the price trend front, commodities are close to shifting from neutral to bullish market trend. We're seeing broad strength across a range of commodities, outside of precious metals. Copper is showing persistent strength. Meanwhile, our bond momentum gauge still gives no indication that the trend has turned bearish for US Treasury prices. This would be a stagflationary combination. Combine that with a weakening dollar, and it looks like a setup that might become more favorable for portfolios that allocate to more than just passive, cap-weighted US equities.

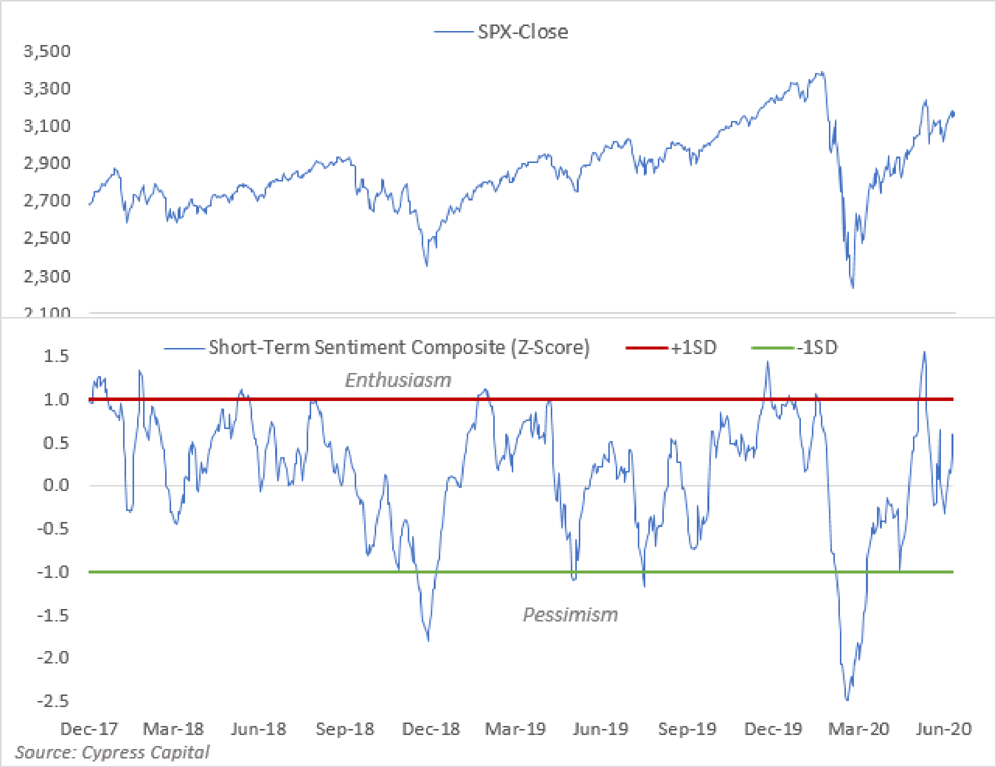
Smart versus Dumb Option Money

The enthusiasm for buying call options that we saw during June by retail traders persists. Meanwhile, smart money option traders have started to hedge again. The spread between the two is close to hitting the first level that marks a red flag. This level preceded the Q4 2018 correction and the March 2020 bear market were triggered



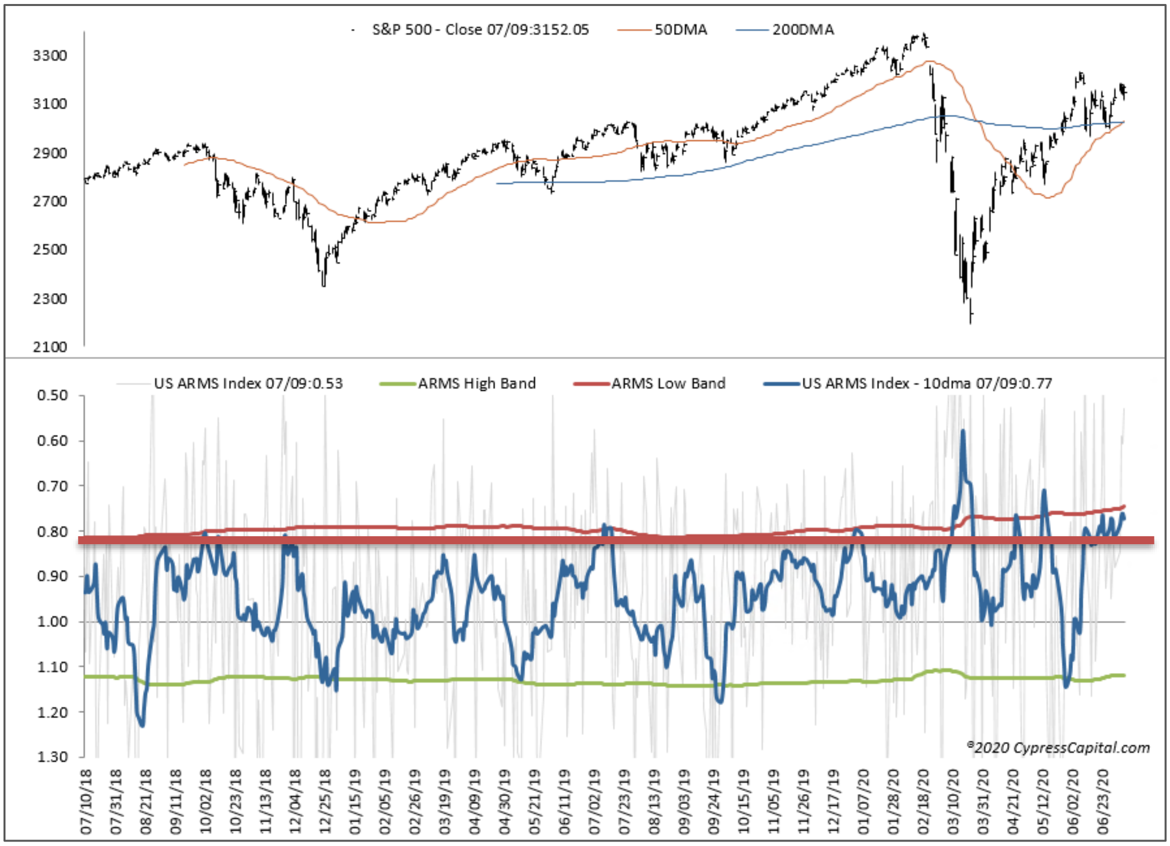
Short-Term Sentiment Composite

Short-term sentiment rebounded. Rydex investors added leverage, and corporate insiders started selling shares again.



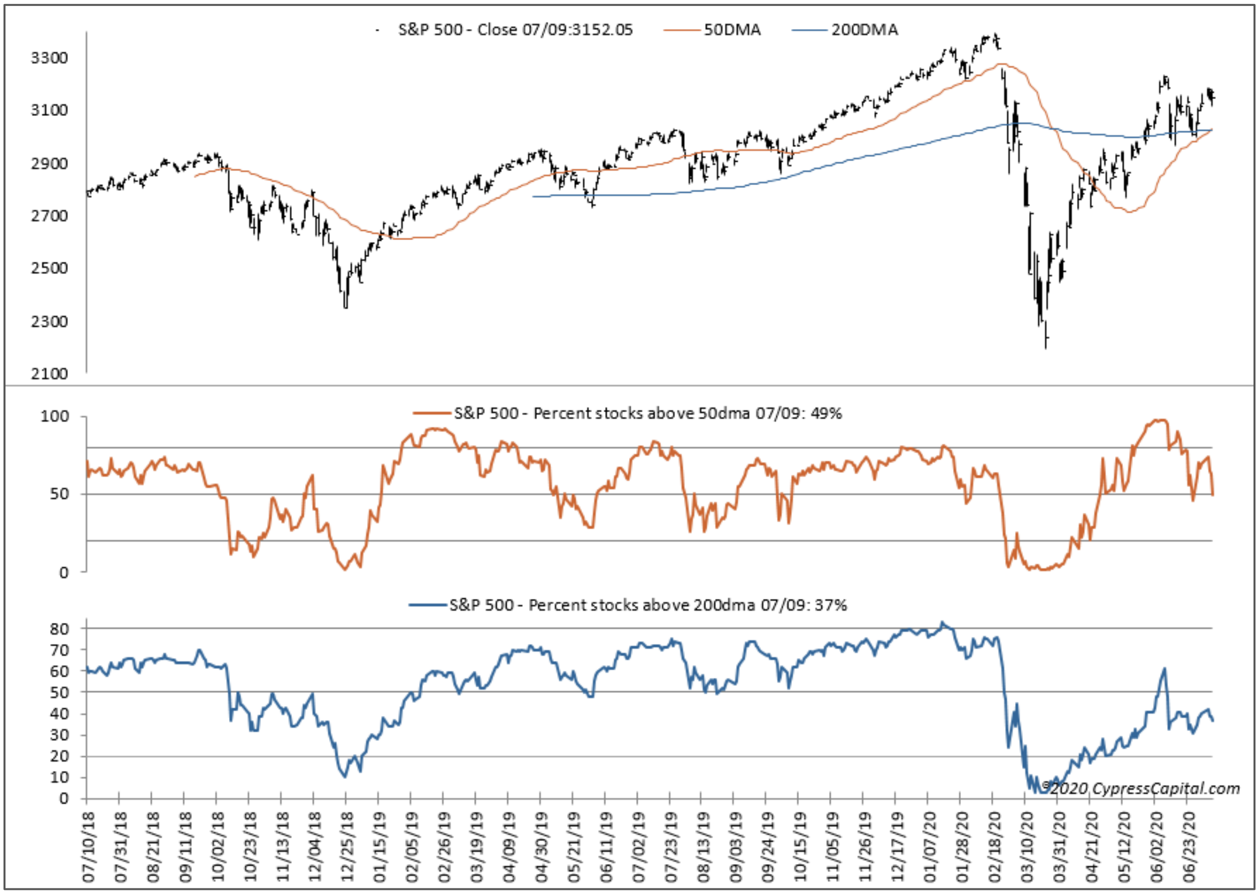
ARMS Index

ARMS Index has had some unusual out of sync behavior with markets this year. That said, it's hovered near overbought levels since the early June market peak.



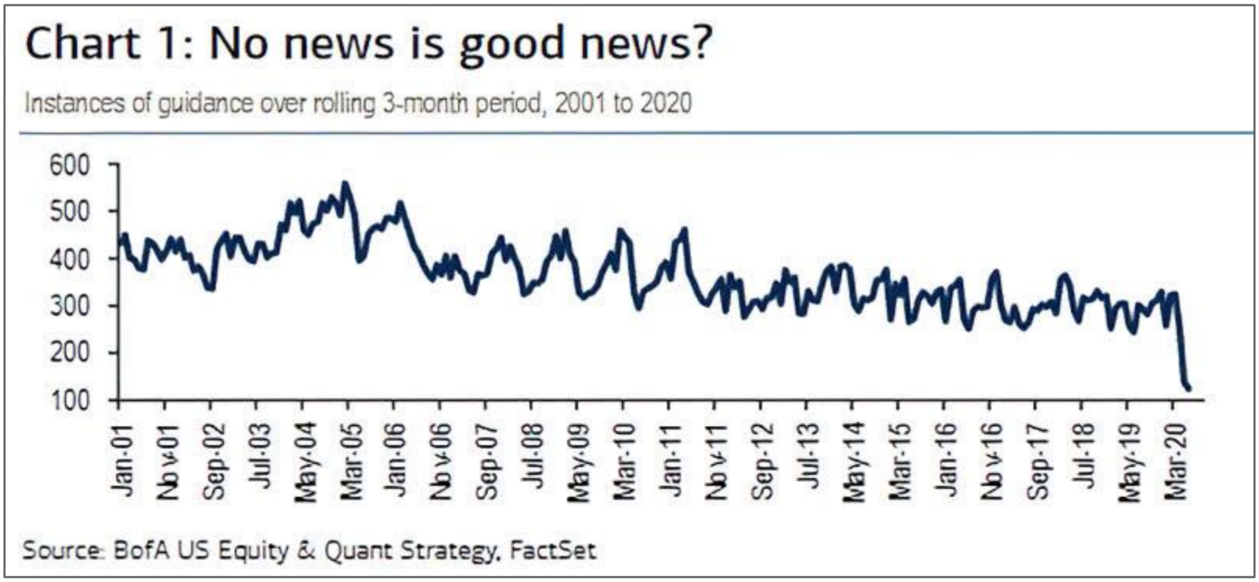
Percent of S&P 500 Stocks Trading Above 50 and 200 DMAs

Outside of a brief move above 50% when the S&P 500 made its island peak on June 8th, most stocks have struggled to maintain that strength. Contrast this behavior with markets after the sharp correction in Q4 2018.



Record Absence of Corporate Guidance

As Q2 Earnings seasons begins to ramp up next week, we've never entered an earnings season with so little guidance.

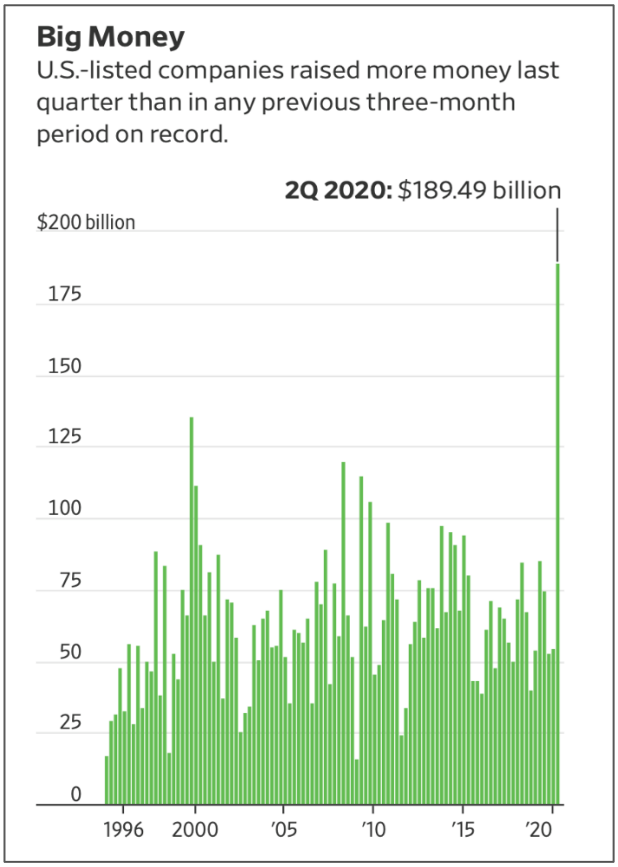


Source: Isabelnet

Corporate Leverage has Surged to Record Highs

Source: Financial Times

Record Fund-Raising by US Corporations in Q2



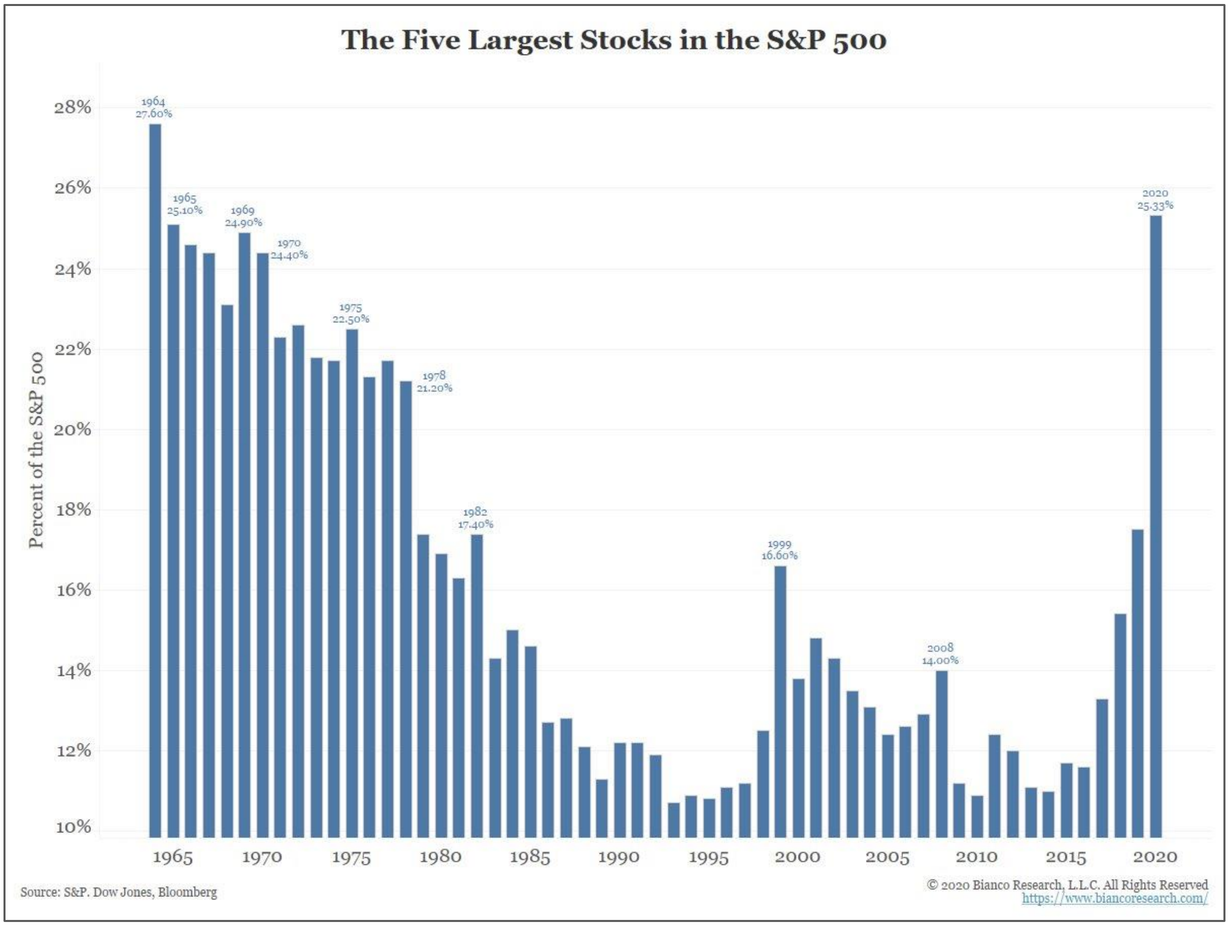
Source: WSJ

Herfindahl Index Hits Record High

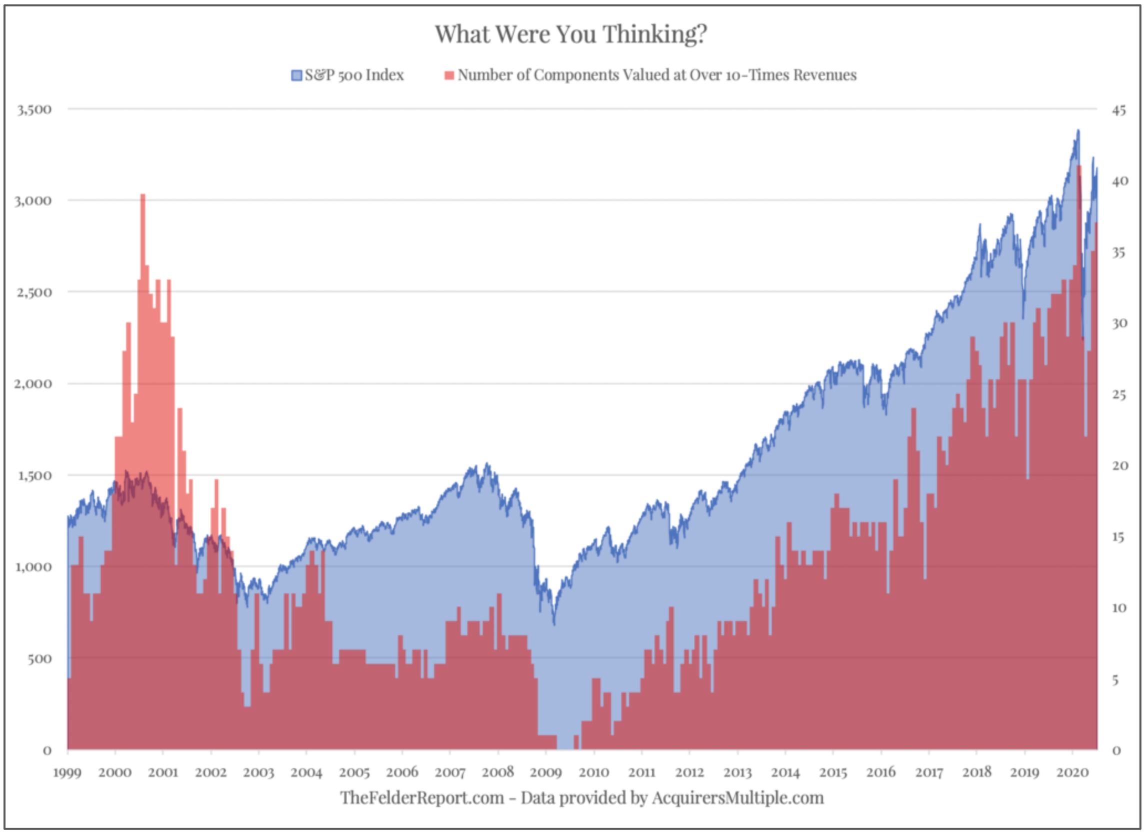
The index measures market concentration and monopoly power.

Source: Peter Garnry @petergarnry

S&P 500's Five Largest Stock Concentration Breaks 55 Year Highs



S&P 500 – More Stocks Trading Above 10X Sales than Dot Com Era

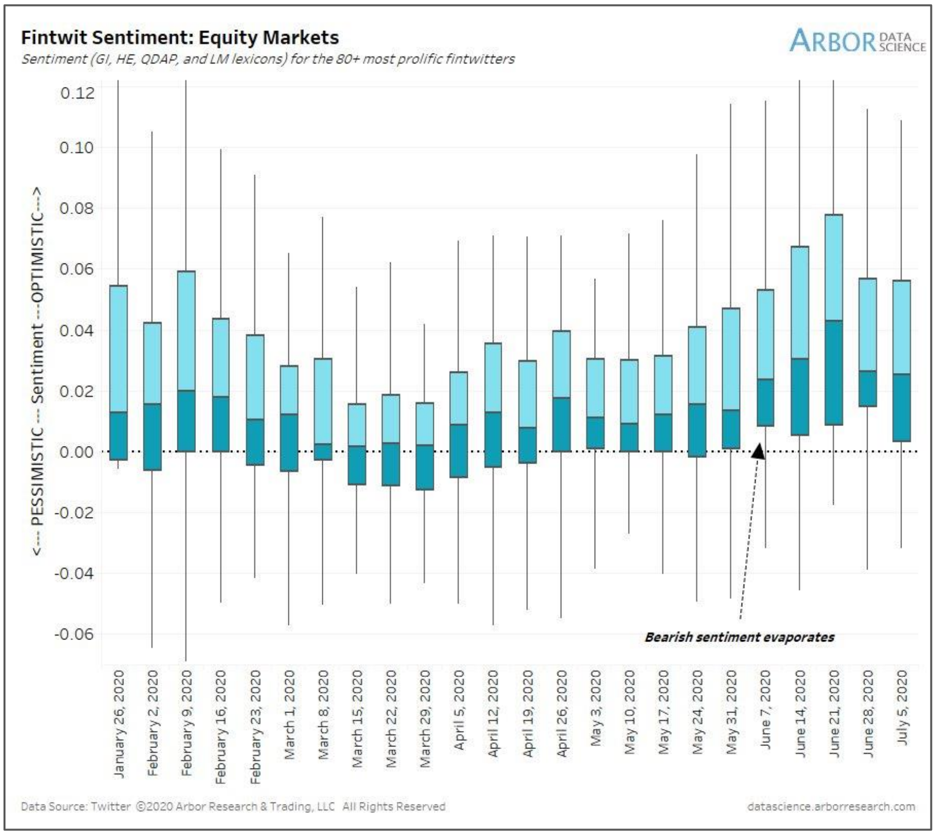


Source: Felder Report

FOMO in China

Trading on margin is heating up in China. South Korea, too, is seeing a US style spike in retail trading.

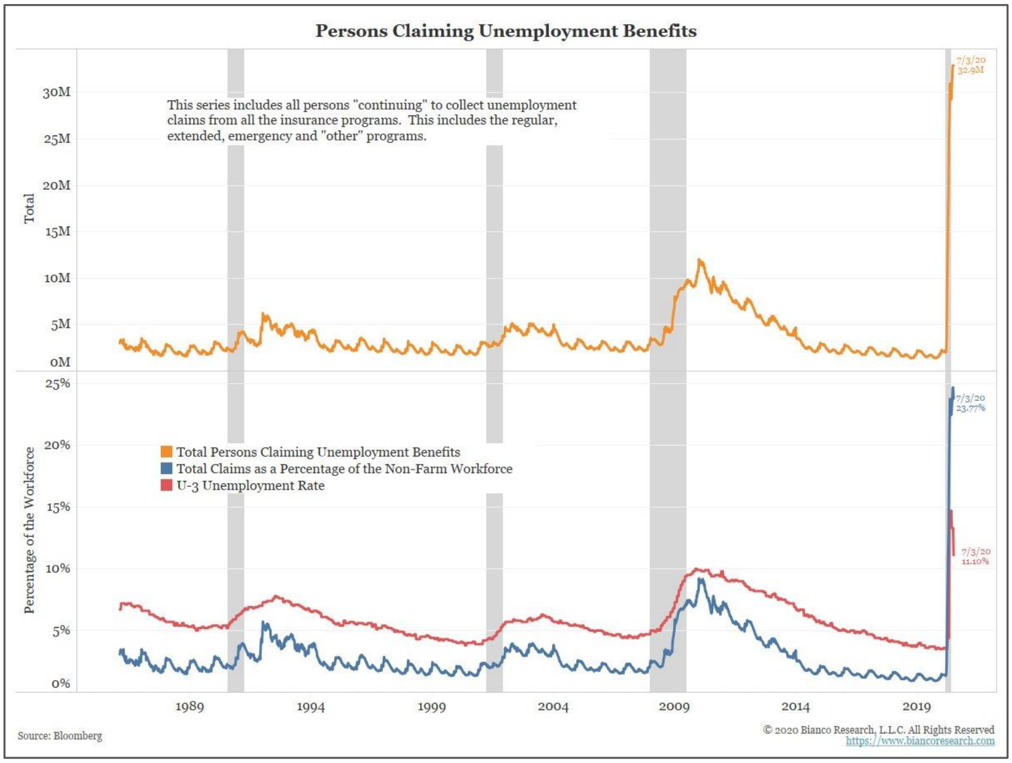
Twitter Stock Market Gurus flipped net bullish on the week ending June 7th



Source: Arbor Research

Unemployment Disconnect

There's a large discrepancy between the percentage of the workforce claiming unemployment benefits and the official unemployment rate.



Source: Bianco Research

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.