Cypress CAPITAL

Market Outlook

By Mark T Dodson, CFA

Psychology Edges Closer to Worst 10% of Readings

Market Risk Index was unchanged at 81.1%. Both psychology and valuations deteriorated this week, while monetary conditions made another modest week to week improvement.

The psychology composite is edging closer to the worst 10% of readings, but high anxiety coming from the AAII survey and the high volatility of small cap stocks have kept it from crossing the threshold. The option activity category managed to deteriorate again as smart money option traders continue to increase hedging activity. The daily point total for our psychology composite has hovered around the negative 100 point level for the last couple of weeks, a level that usually stops bear market rallies or weaker markets in their tracks. Thus far, stocks have held up relatively well, although if you look under the surface this week, it looked like a rotation out of high momentum stocks might be underway.

Valuations worsened slightly but will not be able to do much damage to Market Risk Index from week to week, because it is already so extreme. While not part of our model, our regression based forecast for equity returns crossed into negative territory this week. It's a model that looks at the average valuation levels of six popular valuation metrics for US equities and regresses those levels against 10 year forward returns. The coefficients for regression are based only on the period after 1990, when some argue that valuations trended to a higher level, giving us a best fit line for this era. For a model with such a tight fit, if it is wrong on drawdown risk present in equities here, it means that we have entered a new, new-era.

Monetary conditions improved again but for now appears unlikely to be able to give us a similar backdrop like we had coming out of the last three recessions, where the model was suggesting higher expectations for a more robust credit cycle. We need to see the rates of change in monetary aggregates & leverage settle down, and we need a steeper yield curve.

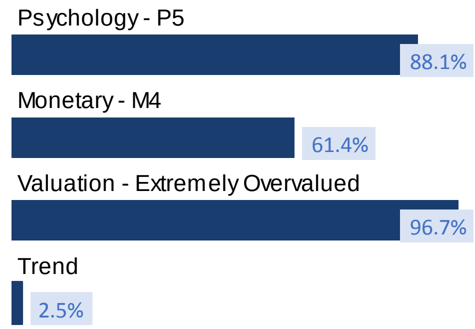
In the very near term, with the dollar now very oversold, we saw the first uptick in the Fed's balance sheet this week since early June. With Coronavirus case counts rising, how the dollar behaves over coming weeks will yield important clues. It has implications for the strength in FAAM stocks, and whether the improving trend for commodities and emerging markets can be sustained. The dollar's trend becomes even more important over the

Market Risk Index

Elevated

81.1%

Category Percentiles



Largest Psychology Influences

Volatility	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	1.9%
10Yr Treas Yield (on 07/15)	0.6%

Market Trends

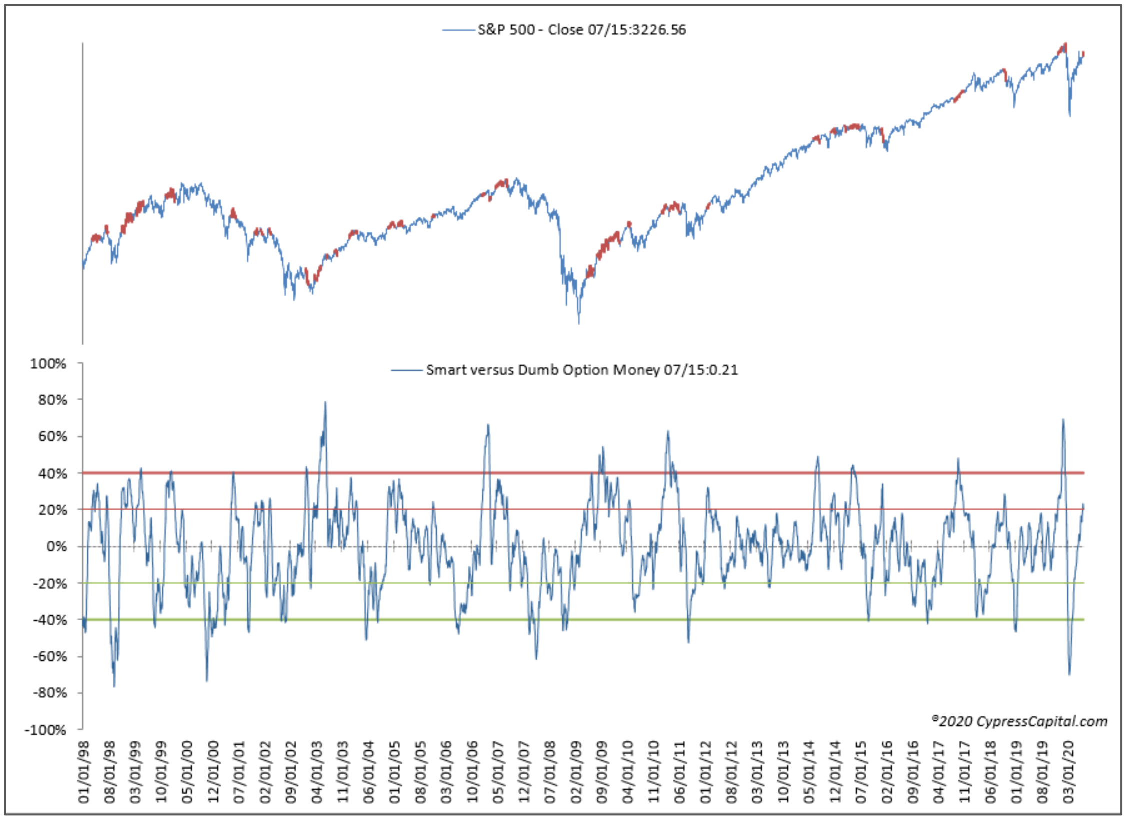
US Equities	Bullish
Intl Equities	Bullish
REITs	Neutral
Broad Commodities	Neutral

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.

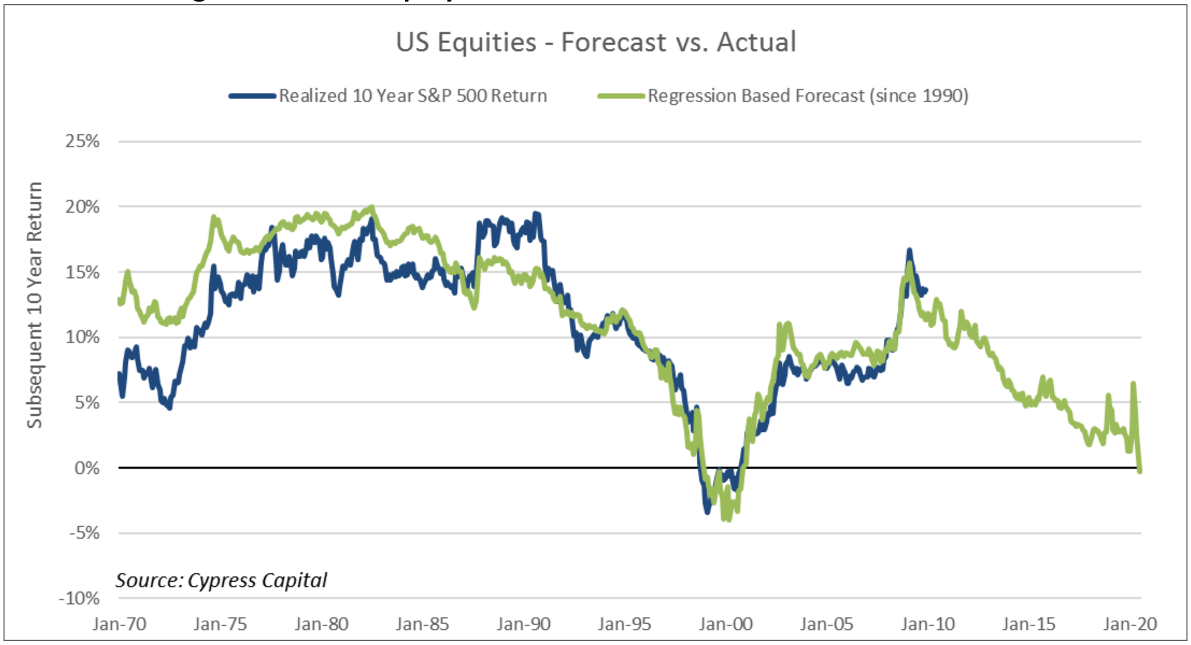
next couple of years, as higher inflation is the last thing on anyone's radar and presents the greatest risk to this current fiscal and monetary experiment.

Smart versus Dumb Option Money

The persistence of low equity put/call ratios since June has been historic, as has the level of retail traders buying call options. Within the last couple of weeks, smart option traders are beginning to hedge. The chart below shows the instances where the spread between the smart and dumb option money exceeds the 20% level. It's marked major market peaks, but also highlighted the initial thrust of enthusiasm from early in a bull market run, like in 2003 and 2009. We had better valuations and monetary conditions for both the 2003 and 2009 periods, however.



Valuations – Regression Based Equity Return Forecast falls below Zero

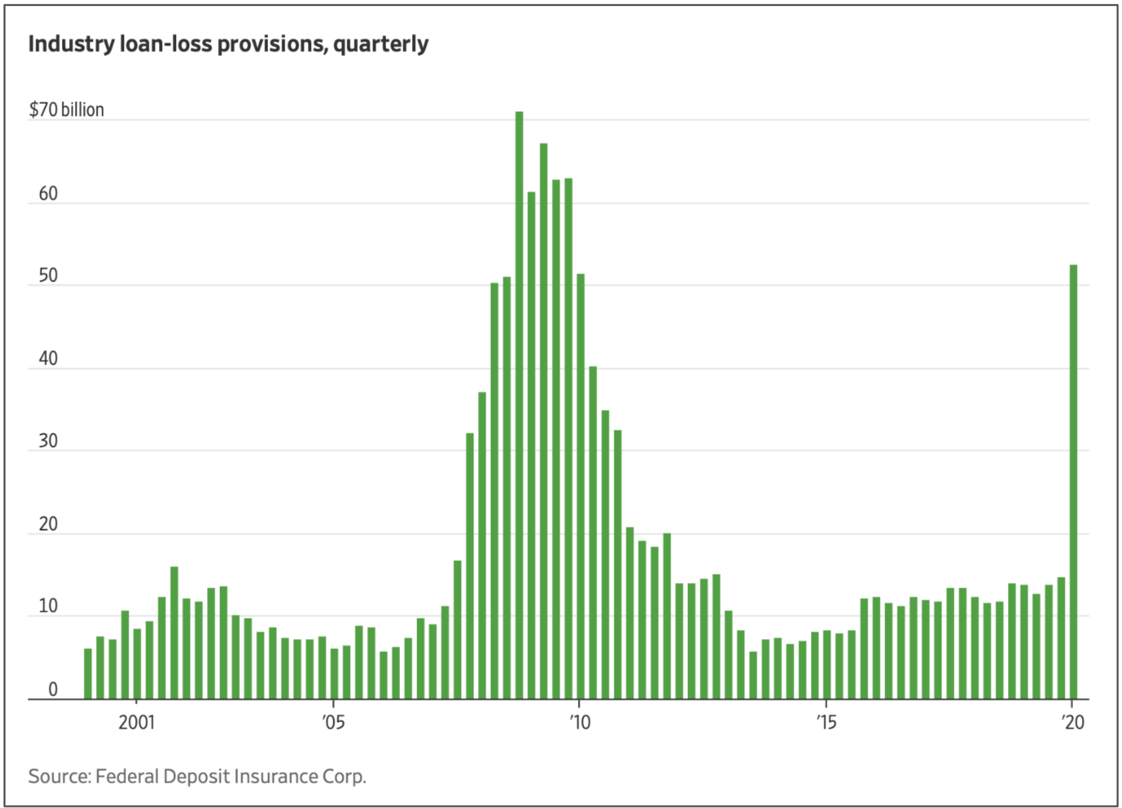


Daily Psychology Point Total

Daily point totals for our psychology composite has been hovering in the -100 level for the last couple of weeks. The market has been resilient in the face of enthusiastic sentiment thus far.

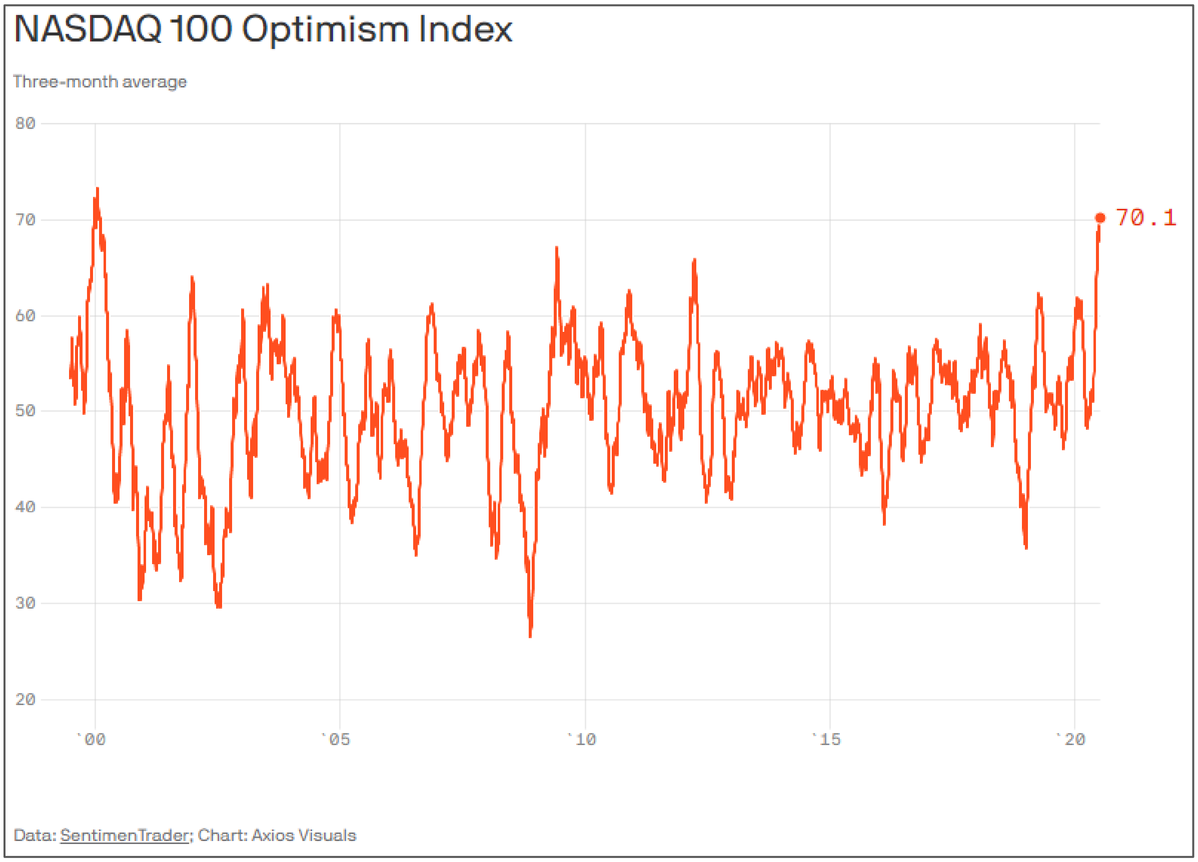
Source: Cypress Capital

Banks are beginning to set aside capital to cover Bad Debt

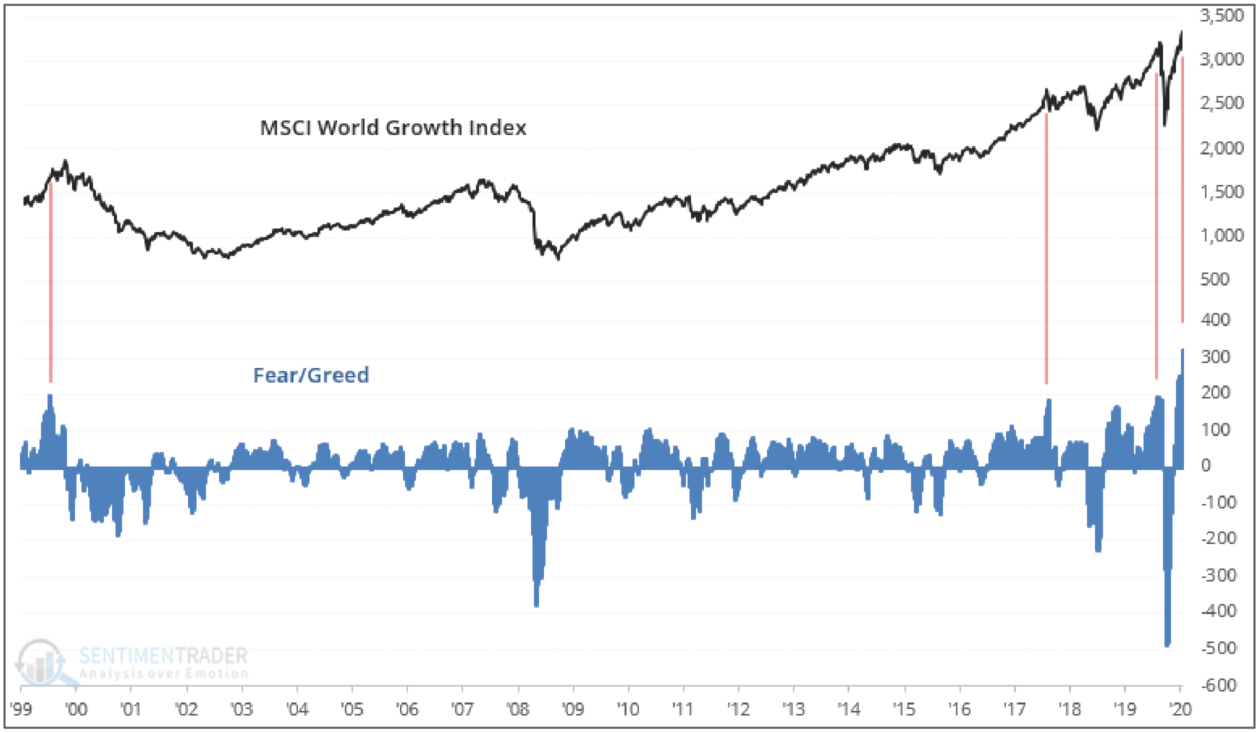


Source: WSJ

NASDAQ 100 Optimism Index reaches Dotcom Era Levels

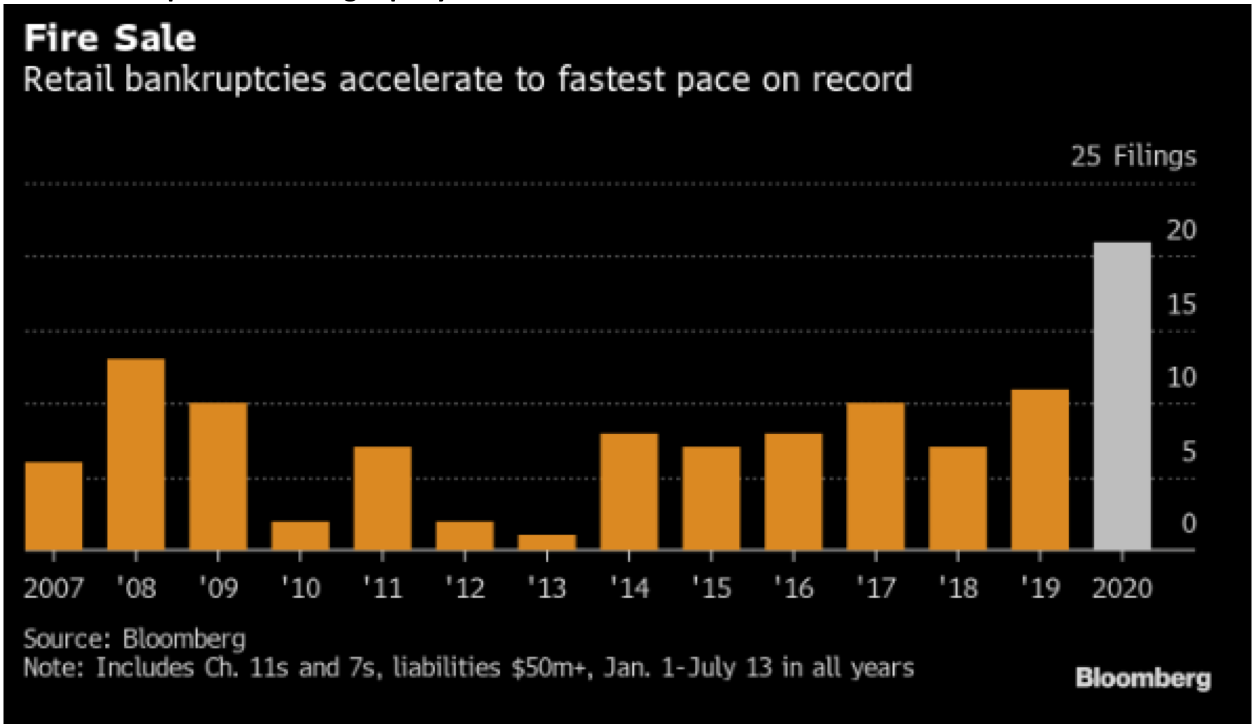


MSCI World Growth Index Enthusiasm surpasses Dotcom Era Levels

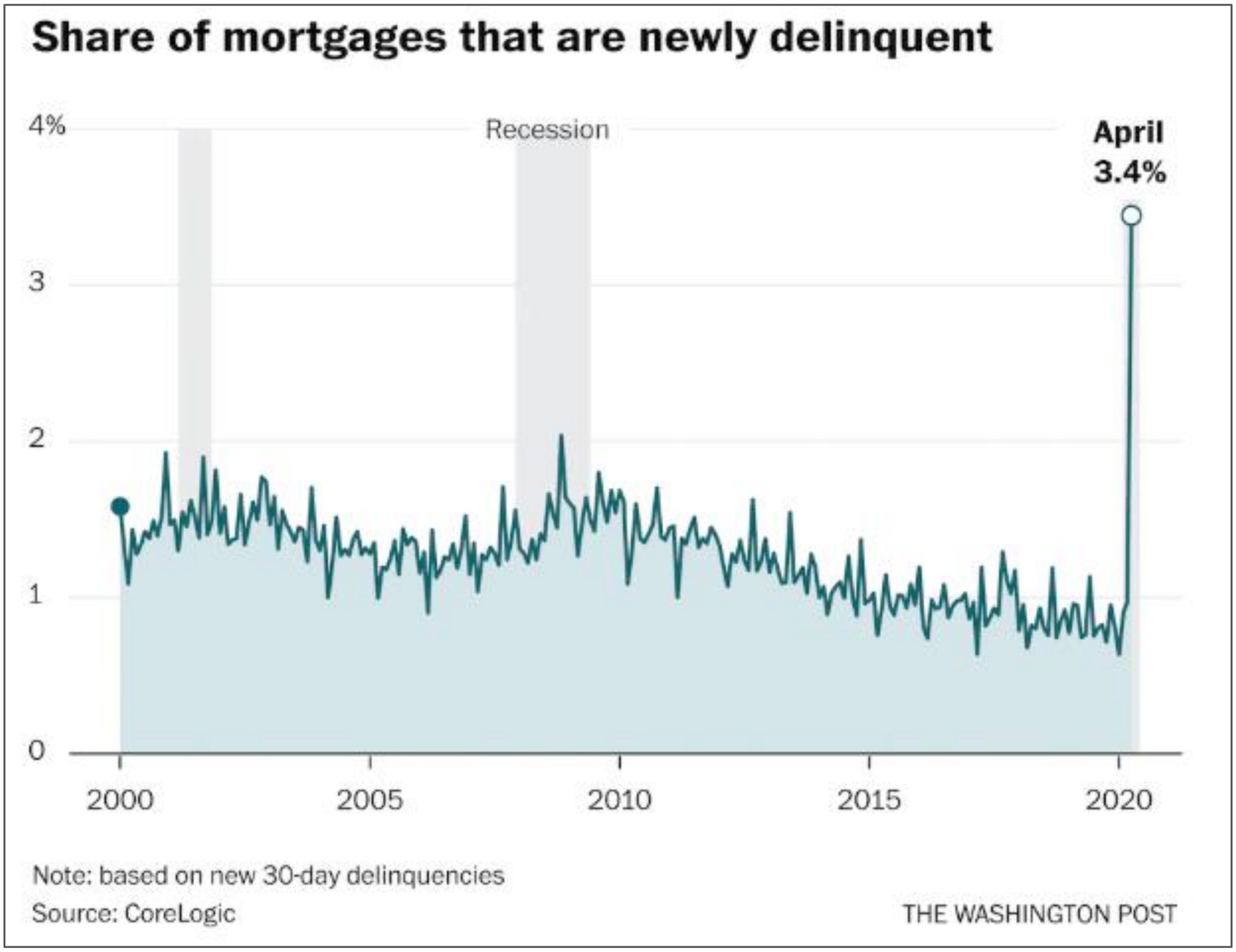


Source: SentimenTrader

Retail bankruptcies are rising rapidly



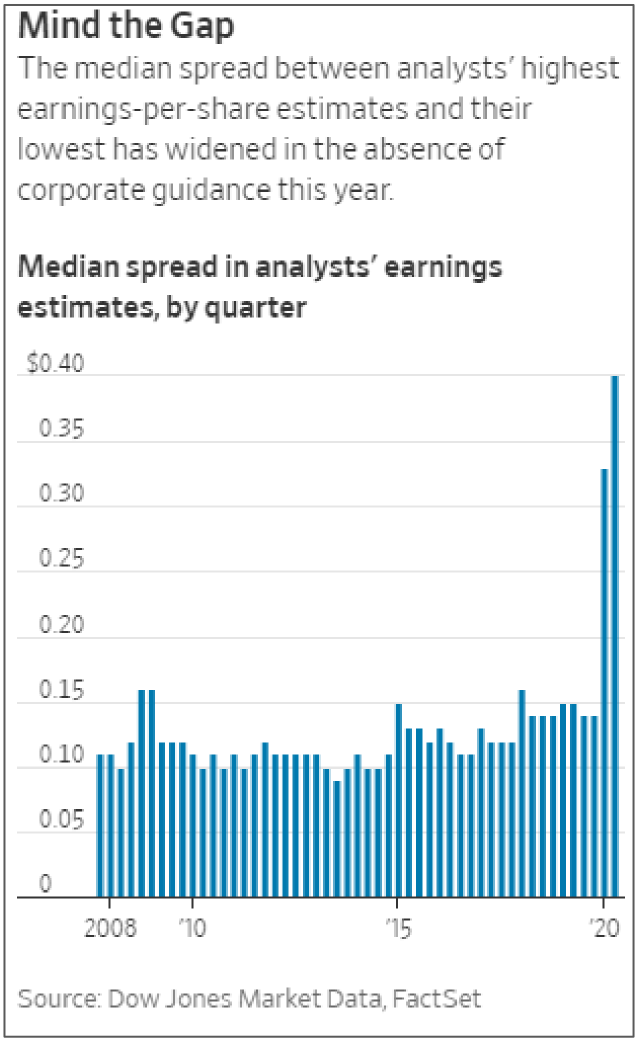
Share of delinquent mortgages are on the rise



Source: Jesse Felder

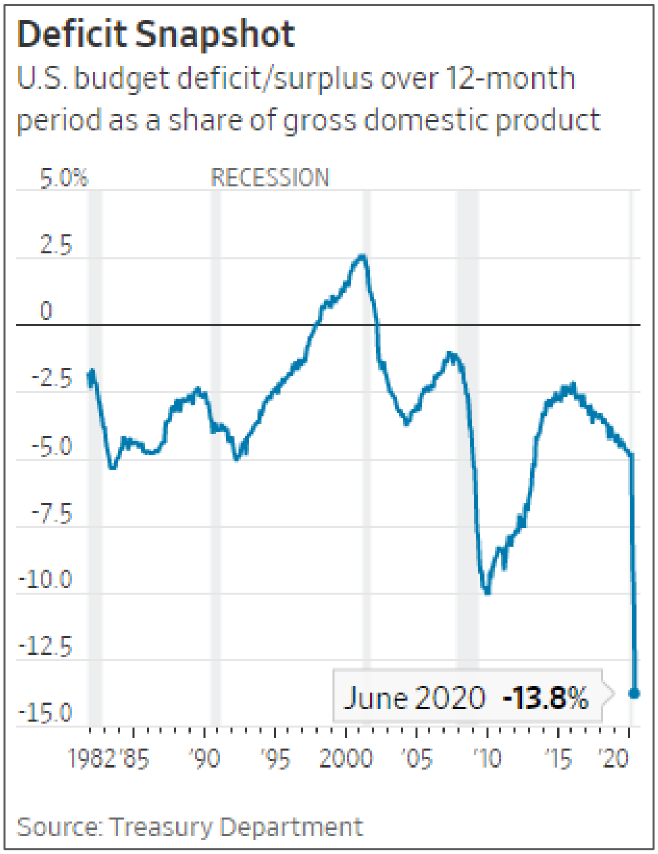
Wide spread in analyst earnings estimates

With little corporate guidance, the range of analyst earnings estimates is widening, which should lead to more volatile price reactions, both positive and negative, this earnings season.



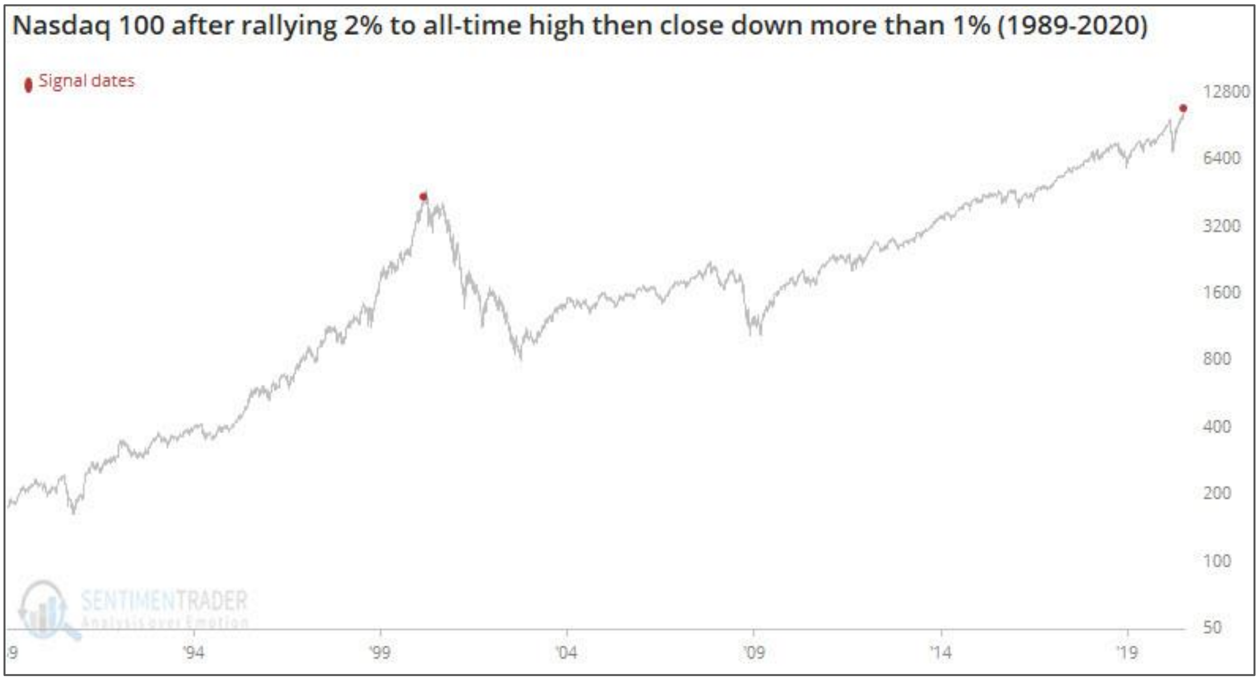
U.S. Budget Deficit

The budget deficit is "on pace to be the largest since World War II."



Source: WSJ

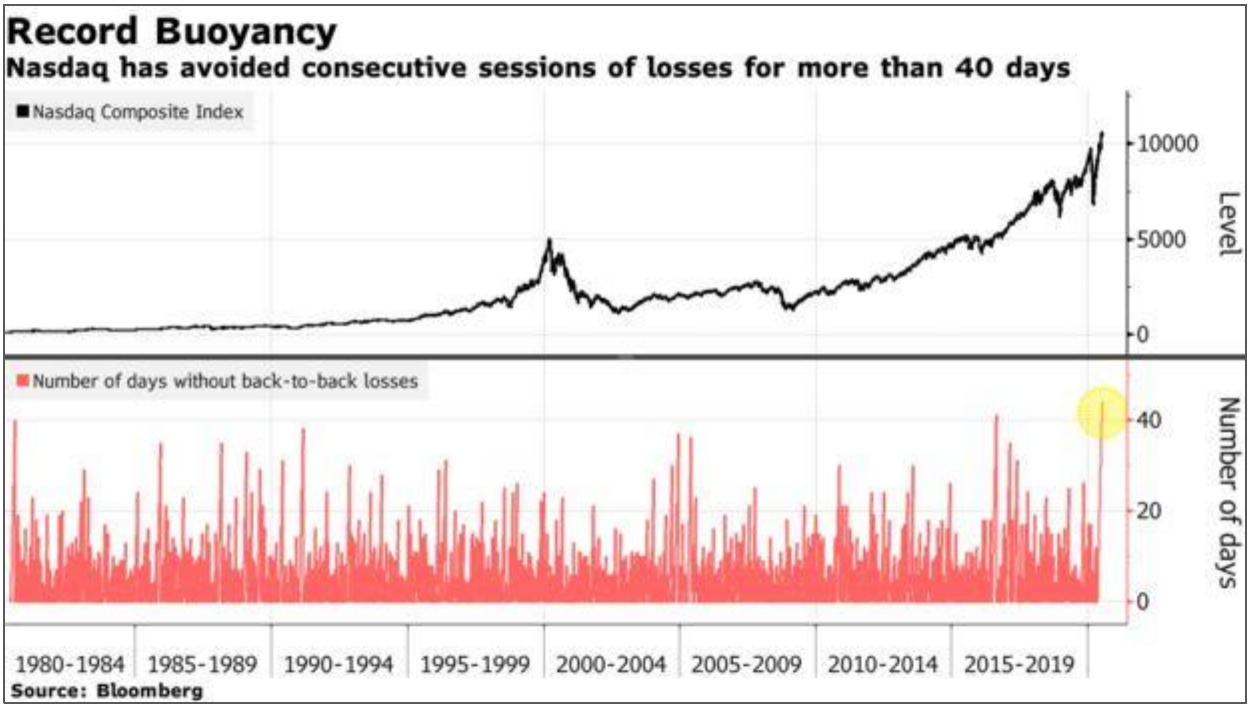
A Nasdaq 100 reversal like this week only happened one other time – March 7, 2000.



Source: SentimenTrader

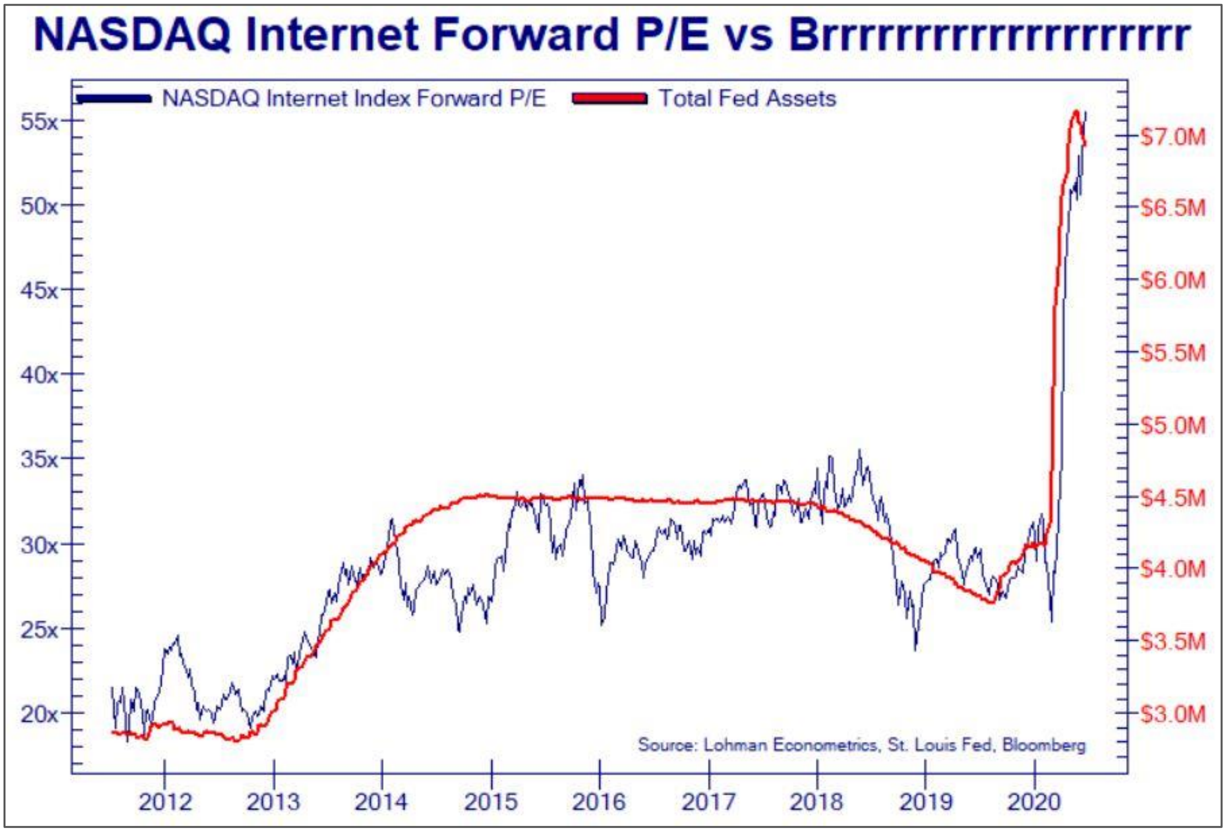
Nasdaq goes record number of days without back to back losses

The record stayed intact through Friday's close, in spite of the reversal above.



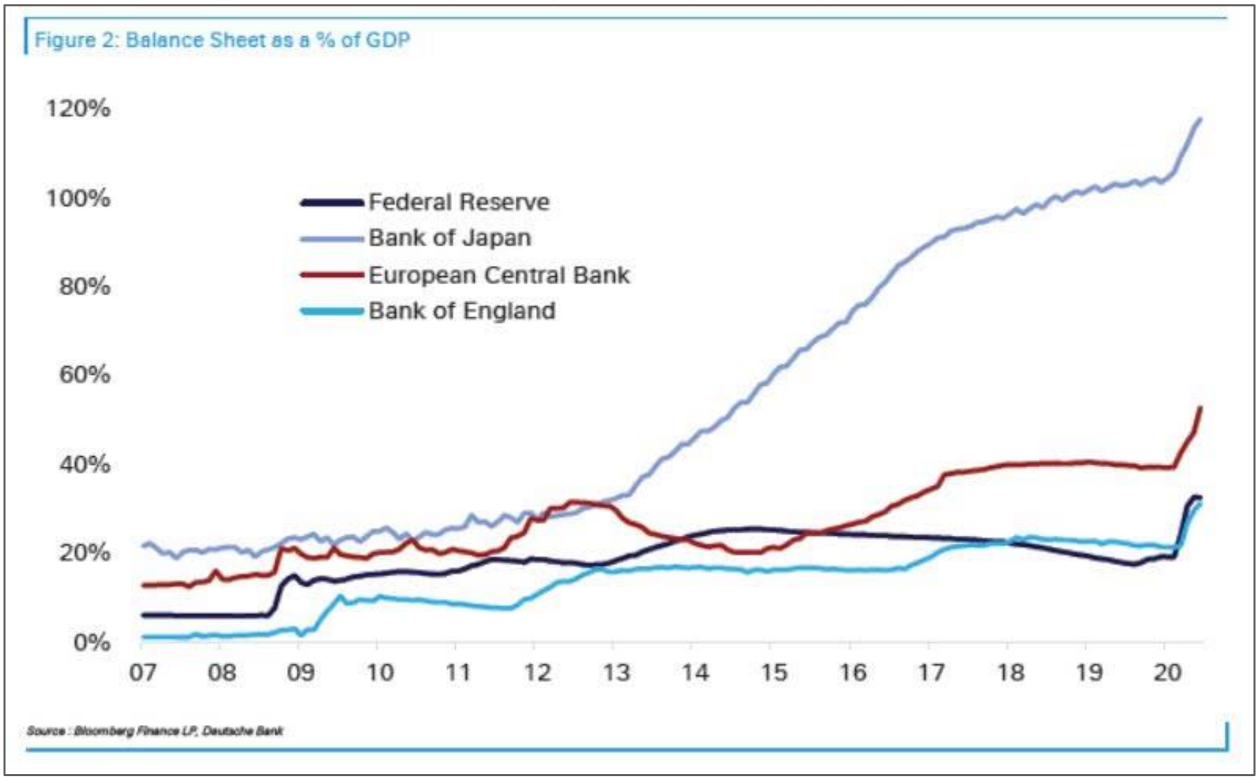
NASDAQ Internet PE versus Fed Printing

This one is definitely a chart crime, but it's a good one.



No one prints money like Japan

They have had a long head start, but as a percentage of GDP, Japan's money printing dwarfs the rest of the world.



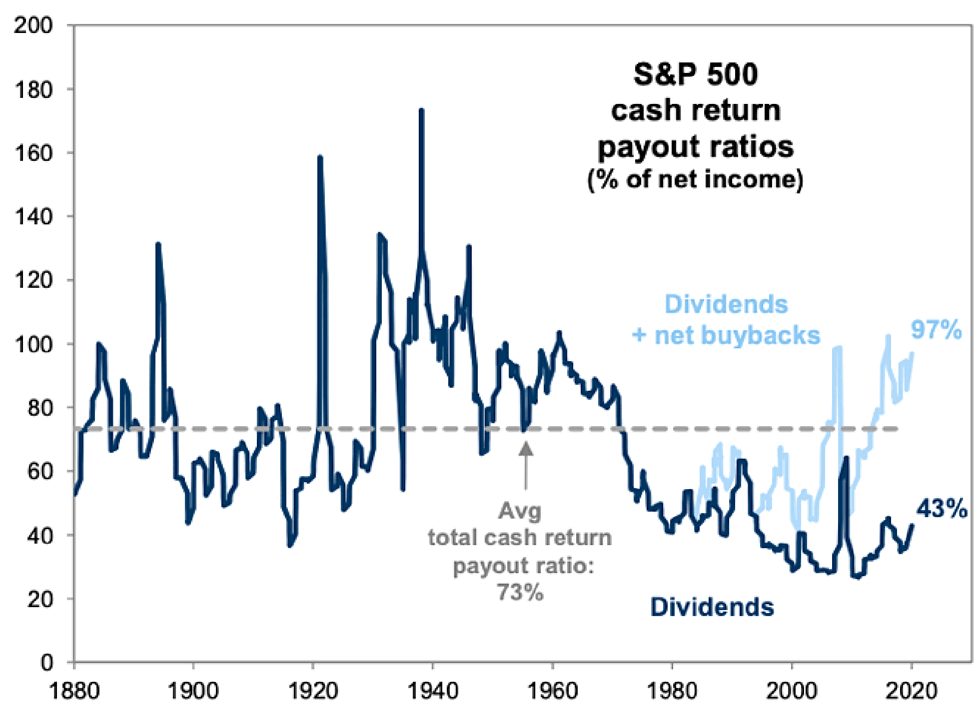
Source: Isabelnet

S&P 500 shareholder payouts still excessive

We highlighted this chart in the past when the payout exceeded 100%. There's still a lot of room for decline before reaching sustainable levels, and much of that will come from buyback reductions.

Exhibit 25: S&P 500 payout ratio in secular decline

as of 1Q 2020

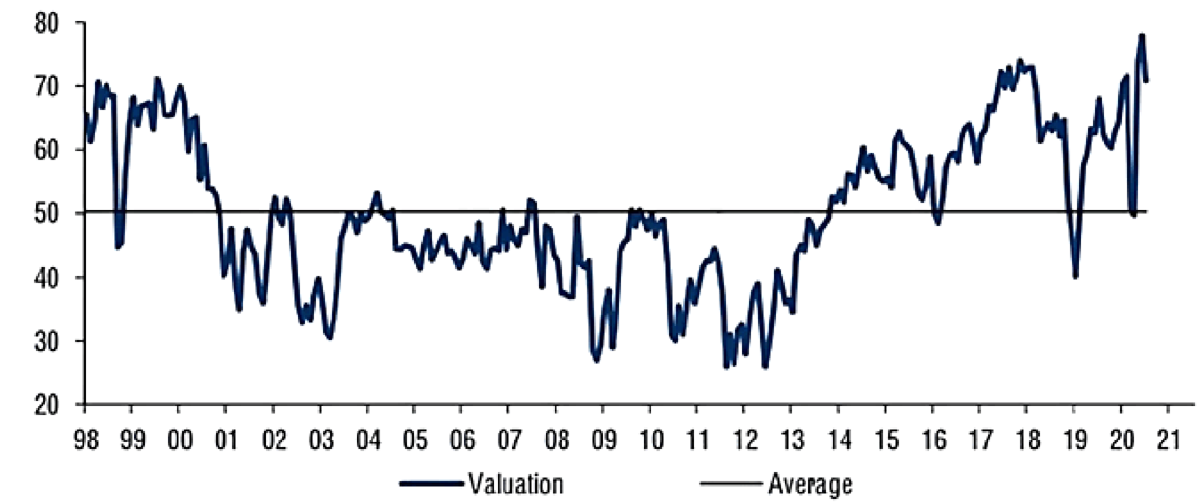


Source: Robert Shiller, Goldman Sachs Global Investment Research

Source: Isabelnet

More investment professionals agree that the market is overvalued than in the dotcom era

Exhibit 6: Large number of FMS investors still think stock market is "overvalued"



Source: BofA Global Fund Manager Survey

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.