



Market Outlook

By Mark T Dodson, CFA

Watching the Silent Generation for Clues

Market Risk Index increased to 82.7% this week on deterioration in all three of our counter cyclical categories – psychology, monetary, and valuation.

The psychology composite continues to creep closer to the worst 10% of readings, as indicators that were already extreme continued to become more so. The equity put/call ratio set nearly a 20 year record low reading this week, dropping to levels not seen since September 12, 2000. Professional investors bought into the rally this week too, with both the NAAIM Equity Exposure Index and the Investor's Intelligence Survey hitting the highest decile of their respective historical readings. A surge in leverage has pushed the Rydex Ratio to within a few percent from the all-time record readings we saw on Feb 26 of this year. Assets chasing both levered ETFs and funds hit a record high this week, and the total speculative assets in both levered and inverse funds imply that the recent downturn in volatility is a temporary phenomenon.

Meanwhile, the Silent Generation and some of the baby boomers, remain stubbornly bearish, according to the AAll survey. (The average age of members of this organization is high.) This isn't unprecedented – it's very similar to what we saw throughout 2008. Because this indicator gave consistently false assurances that the wall of worry was intact throughout 2008, we instead use this indicator, looking for a massive surge in bullishness to indicate that the recession has ended, as an all-clear.

Having suffered through three bear markets and a housing crash in the last 20 years, it seems likely that the Silent Generation has one eye on valuations and no tolerance for taking the risk of a large drawdown anymore. They've grown wiser. They control much of the wealth in the country, and their savings rates have surged to Great Depression era levels. This is the reason that we are seeing record growth in M2 and MZM – it's not because of the Fed (common misconception). That growth still hasn't shown signs of rolling over, but monetary base has. Monetary base is what the Fed controls, and the rate of change there has rolled over. The Fed has taken a step back in the last couple of months, likely as a result of how quickly and persistently the dollar has continued to weaken. This rollover in base growth, combined with the continued growth in M2 and MZM is a detractor for our reading of monetary conditions. However, yields are falling rapidly again, so this is providing an offsetting boost to the monetary composite.

Market Risk Index

Elevated

82.7%

Category Percentiles

Psychology - P5



Monetary - M4



Valuation - Extremely Overvalued



Trend



Largest Psychology Influences

Volatility	Positive
Fund Flow s	Negative
Option	Negative
Leveraged Investments	Negative

Largest Monetary Influences

Falling Yields	Positive
Monetary Aggregates & Velocity	Negative
Yield Curve	Negative

Valuation

7-10 Year Rtn Forecast	1.7%
10Yr Treas Yield (on 07/22)	0.6%

Market Trends

US Equities	Bullish
Intl Equities	Bullish
REITs	Neutral
Broad Commodities	Neutral

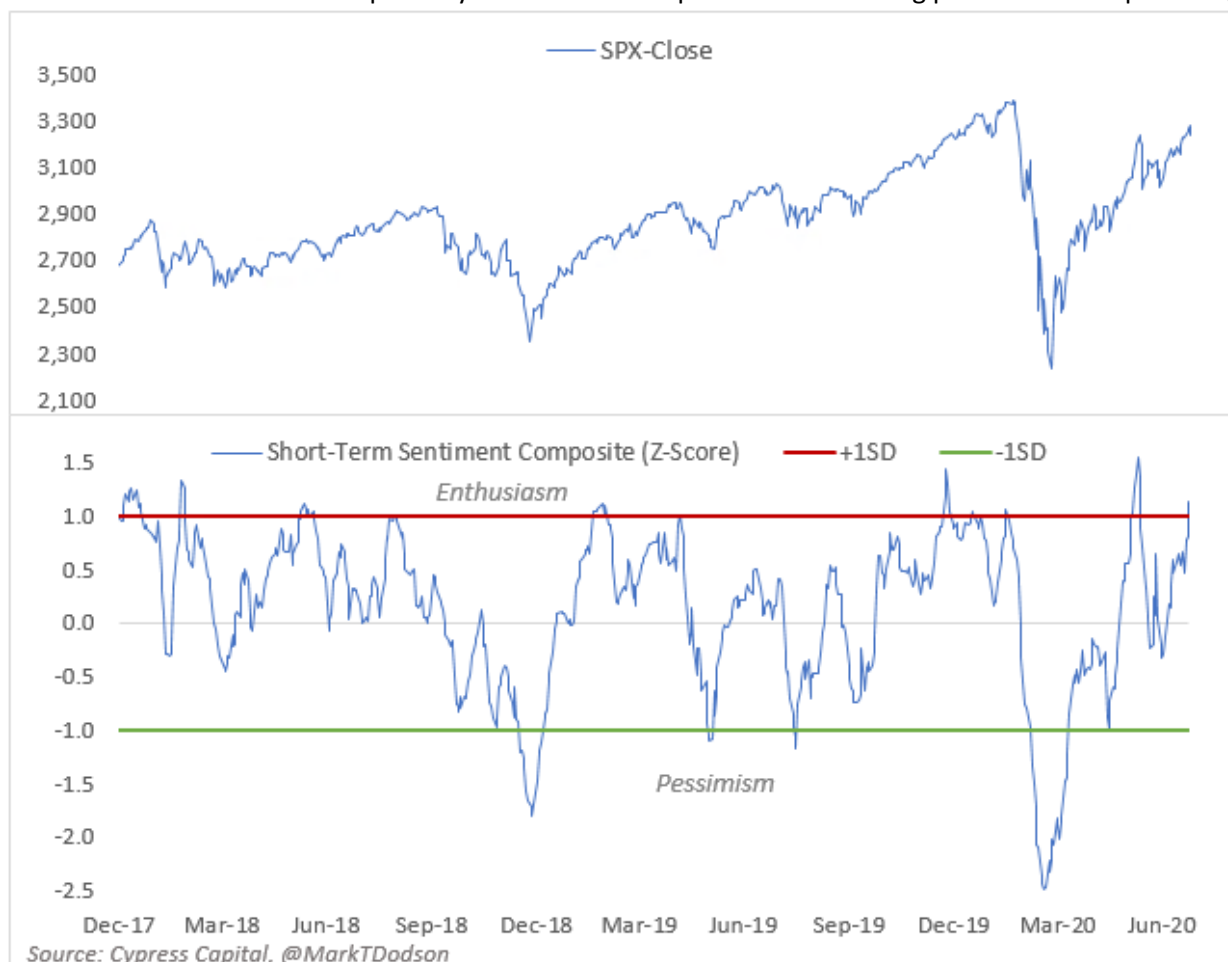
Market Risk Index scales from 0 to 100%. Higher readings correspond with higher risk markets. Scores below 25% are bullish. Scores between 25-75% are neutral, and scores above 75% are markets vulnerable to major drawdowns.

We're also seeing TIPs yields fall faster than nominal bond yields, causing inflation expectations to rise, and alongside it the prices of gold, silver, as well as lumber and industrial metals. After the lack of inflation (other than financial assets) produced by quantitative easing after 2008, we have entered an era where policymakers don't fear the bouts of inflation that we experienced in our nation's past. Inflation is the one asymmetric risk to this \$6 trillion government experiment. We weren't concerned about inflation after 2008, but we're growing more concerned about it now. Countries around the world are simultaneously adopting tactics that encourage investors to flee their assets as a result of low yields. These aren't normal times – it's an experiment being created on the fly, and central banks are leaning on the wealth effect from inflated asset prices more than ever before.

Valuations are still super-stretched. With both yields and stock market valuations hitting historical extremes at the same time, it's encouraging investors to lever up to produce higher returns in the mother of all reach for yield environments, and with record faith in the Fed put. For those pushing the risk too far, we'd caution that volatility has been making regime shifts quicker than we have ever seen over the last couple of years. When the music stops on this Fed trade, the pain will be swift and severe, and you won't know what hit you. Our Market Risk Index suggests that our best course of action is to continue to balance out the longer term risk of drawdown with the shorter-term pain of regret as an emotional hedge to avoid the fear of missing out. Investors don't go broke from buying risk assets when they are cheap. They grow broke when they are over-confident that they can outsmart the other guy.

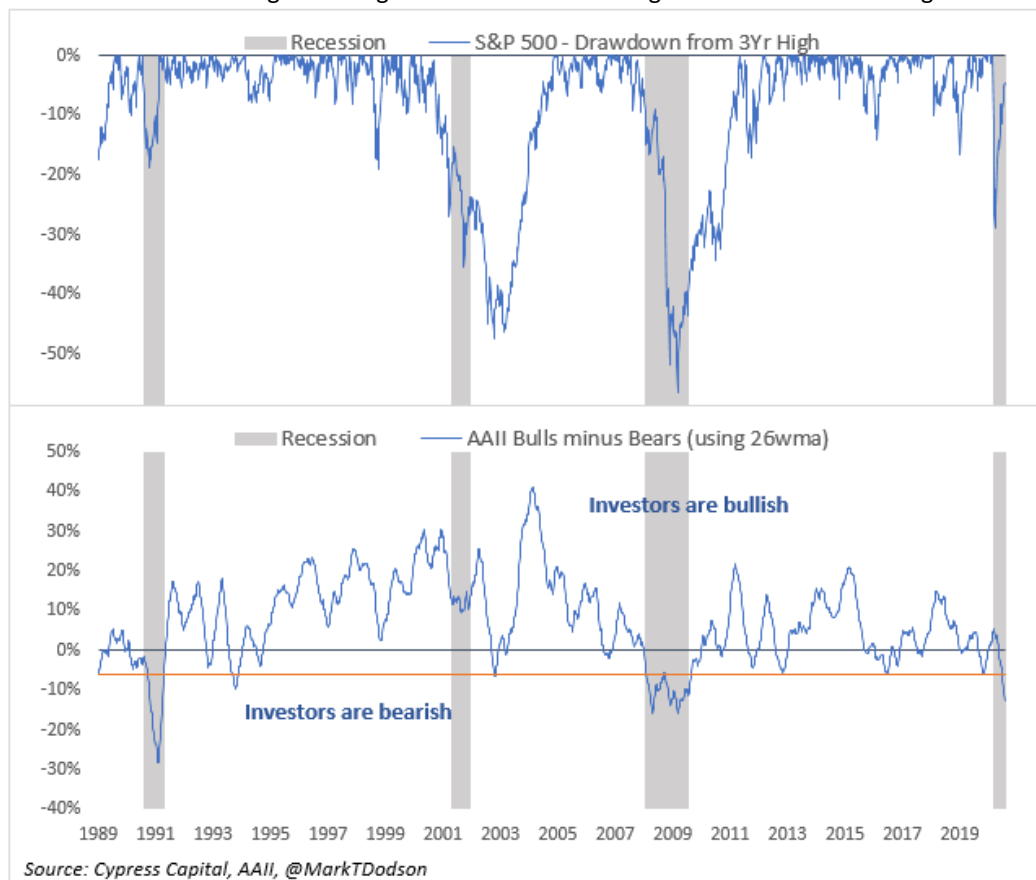
Short-Term Sentiment Composite

Our short-term sentiment composite breached the 1 standard deviation level of enthusiasm this week, the first time since the June 8th market peak. Rydex Ratio and corporate insider selling pushed the composite higher.

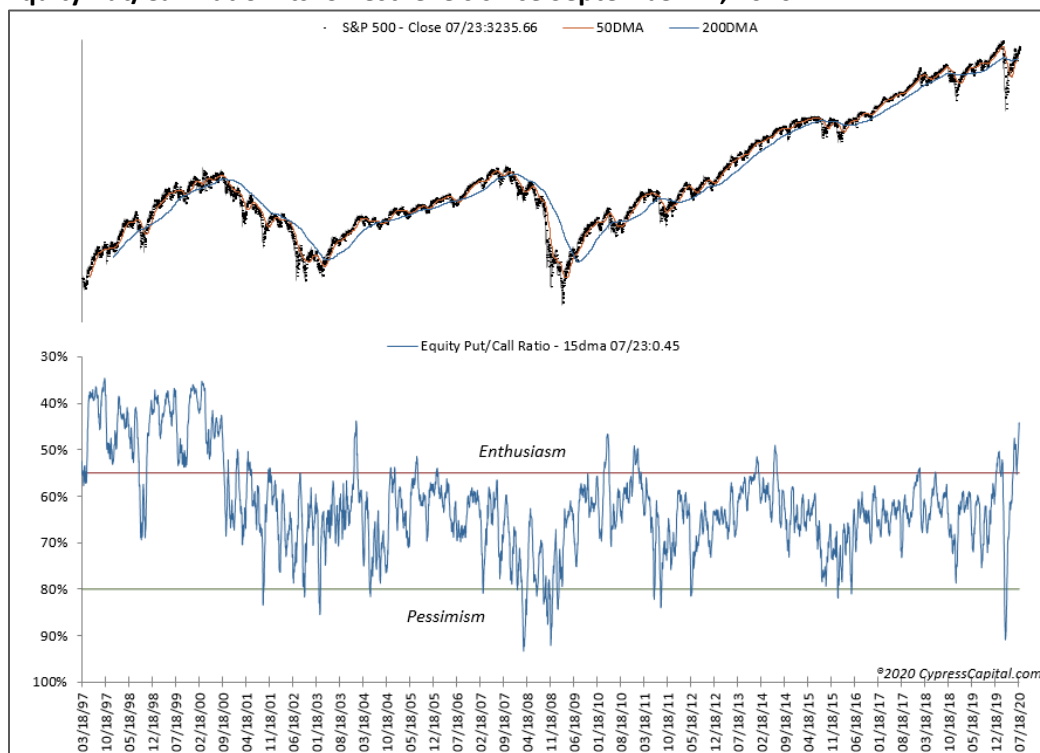


The Silent Generation is still bearish

The AAIL survey continues to stay mired in apprehension about embracing equities, similar to 2008, or even the 1990 recession. We are looking for a surge in the six month average of AAIL sentiment to signal that the recession has ended.

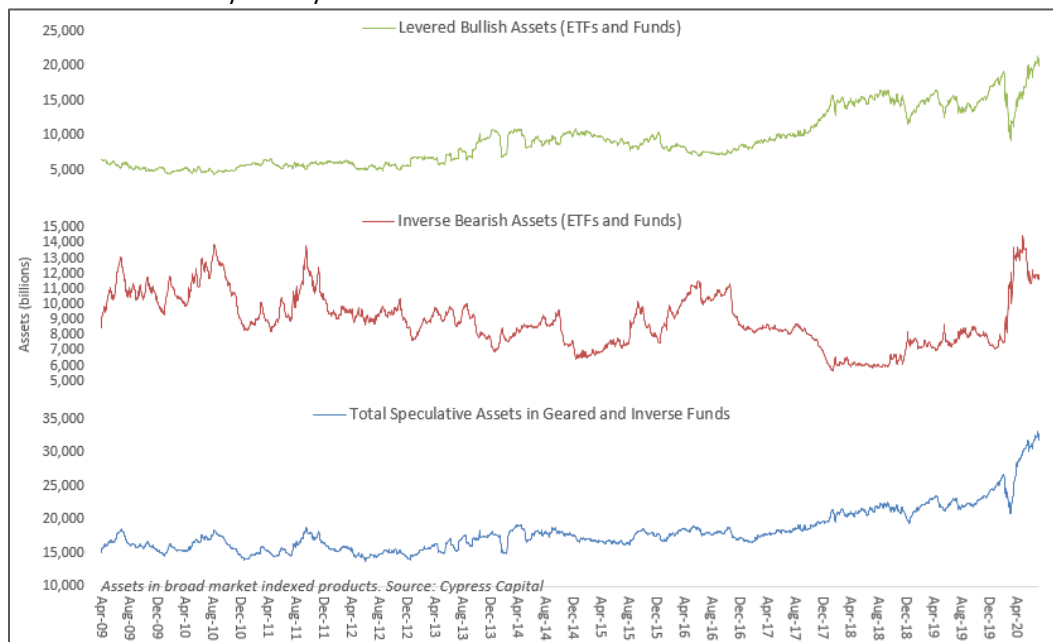


Equity Put/Call Ratio hits lowest levels since September 12, 2020



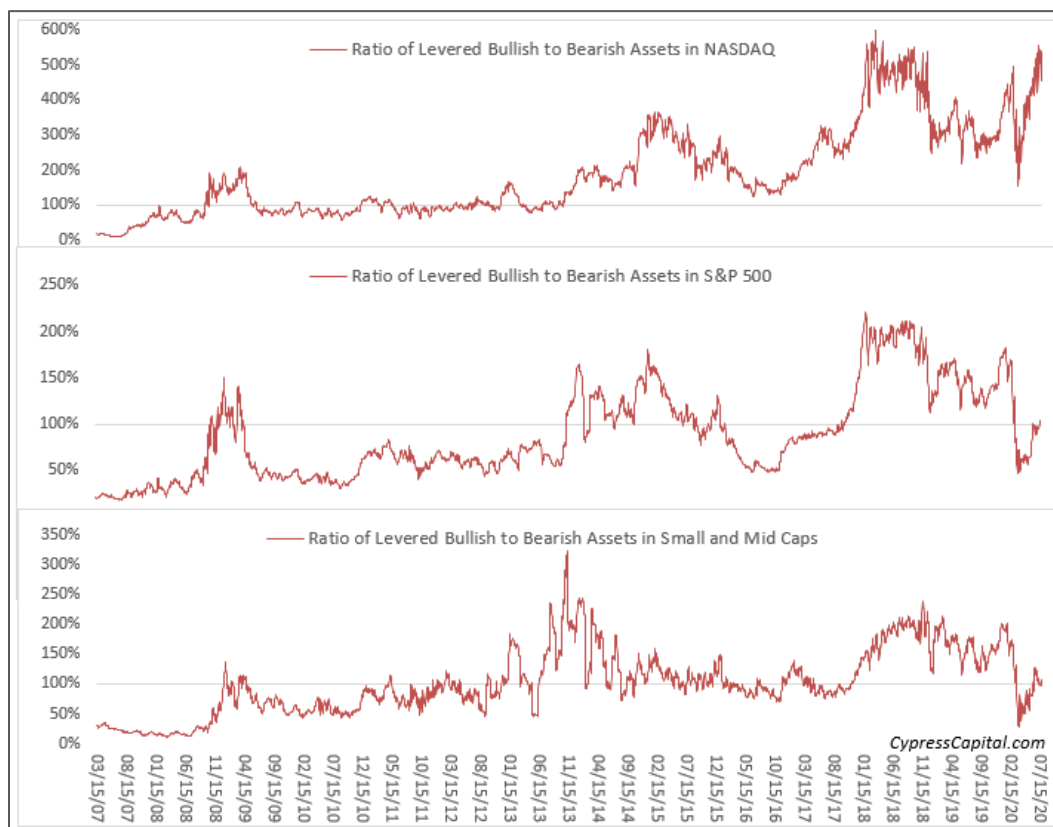
Speculative Assets hit Record Highs

Assets chasing levered ETFs and funds surged to record highs this week, pushing the total speculative assets to record highs as well. There is a high correlation between the speculative assets total and volatility, which implies that the recent downturn in volatility is likely to be short-lived.

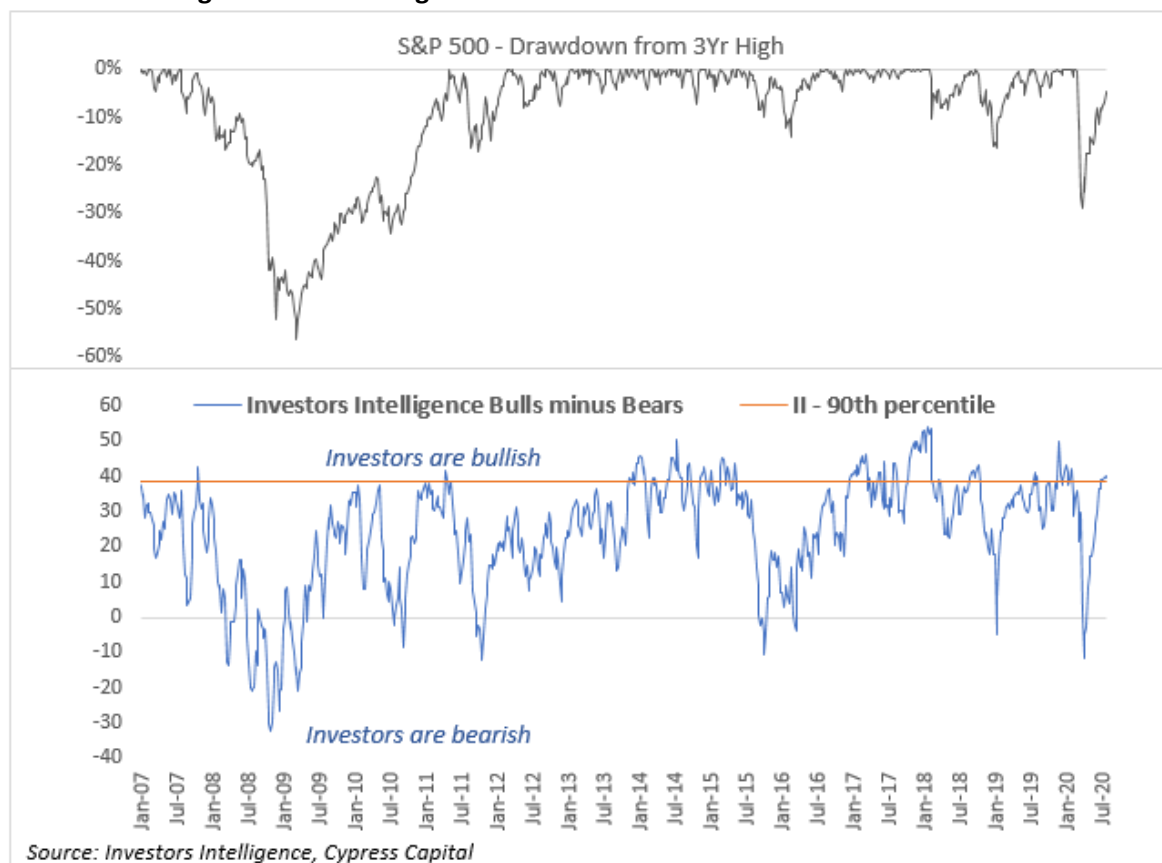


NASDAQ leverage surpasses February highs

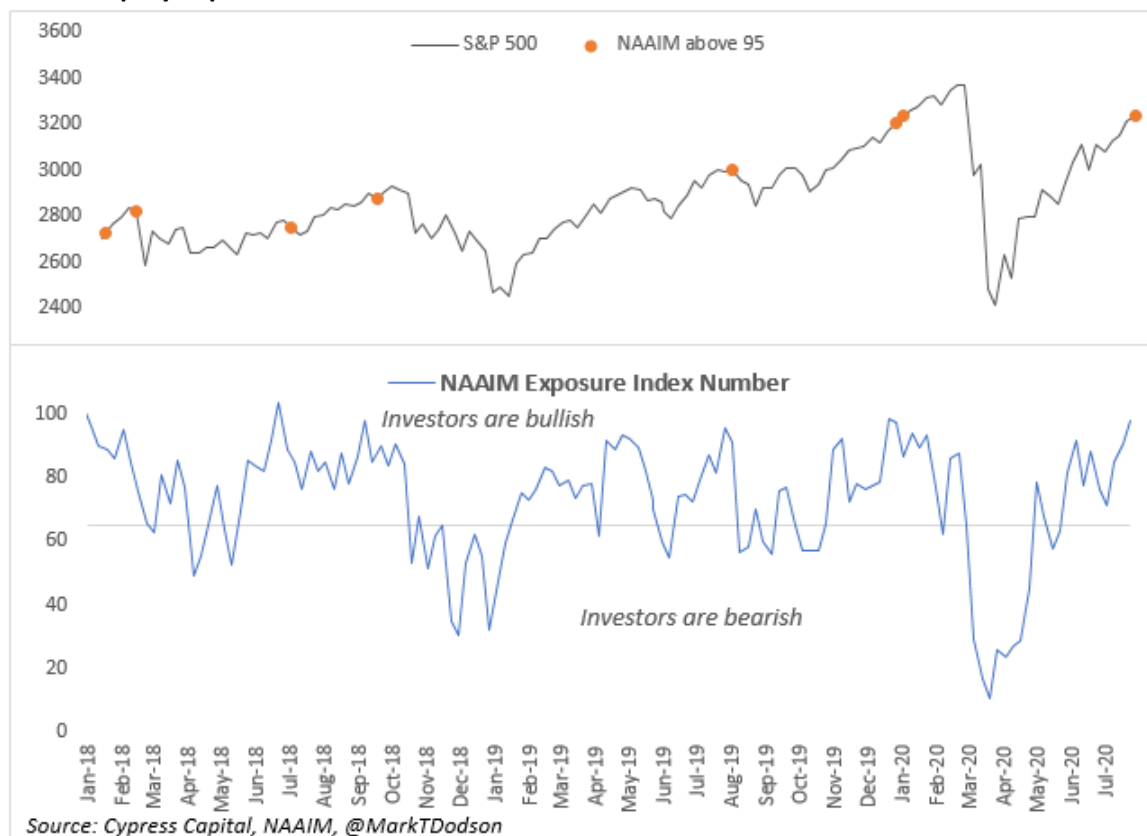
Unlike the broad-based surge in enthusiasm for equities and leverage that came in early 2018, this one has almost totally been focused on the NASDAQ and the FAAM trade. Levered to inverse assets in NASDAQ 100 ETFs and funds is 6 to 1, while ratio for the S&P 500 or small and mid-cap stocks is roughly one to one. This market environment is a highly concentrated bet on one trade.



Investor's Intelligence breaches highest decile of Bullishness

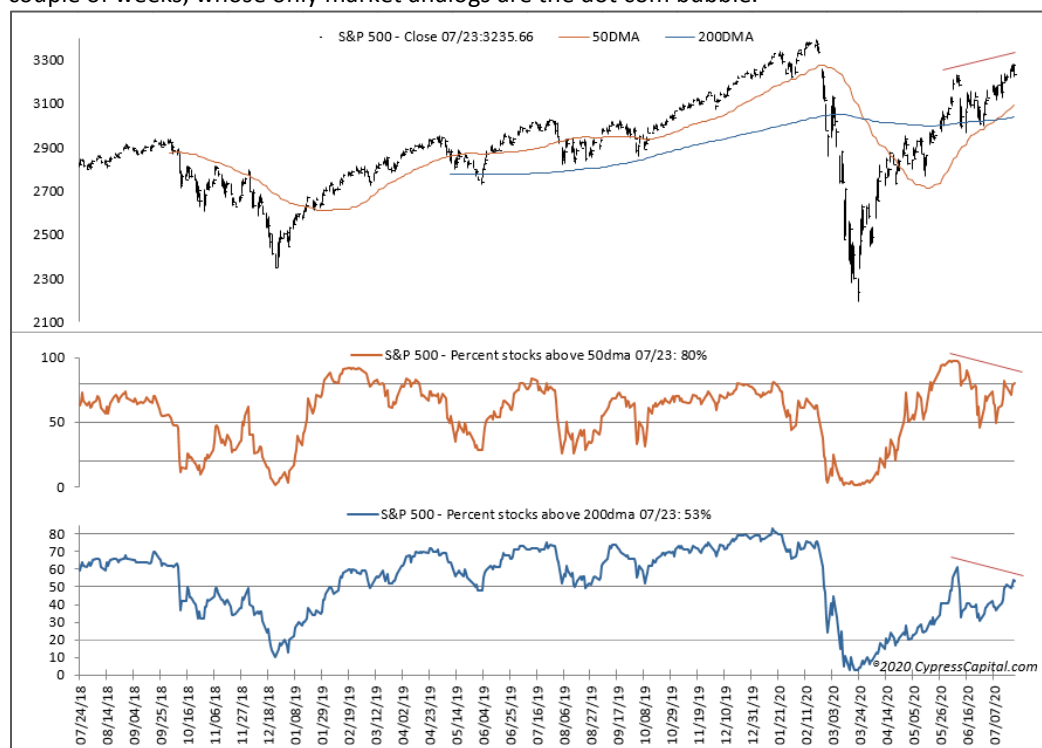


NAAIM Equity Exposure did the same as well.



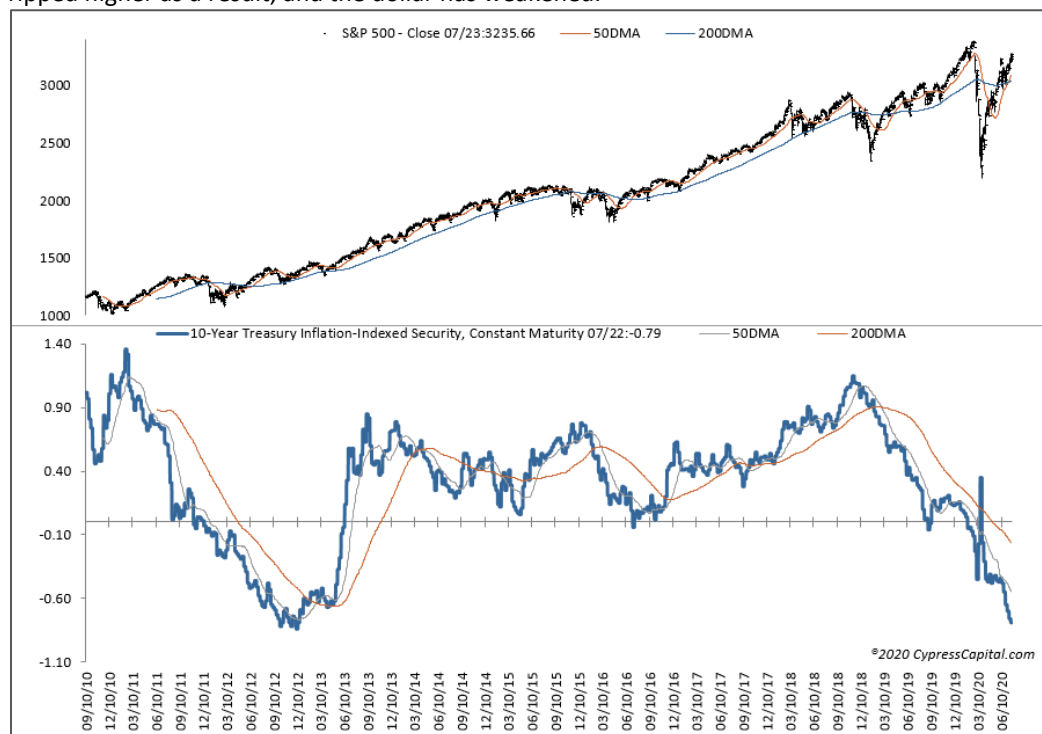
Percent of S&P 500 stocks above 50 and 200 day moving averages

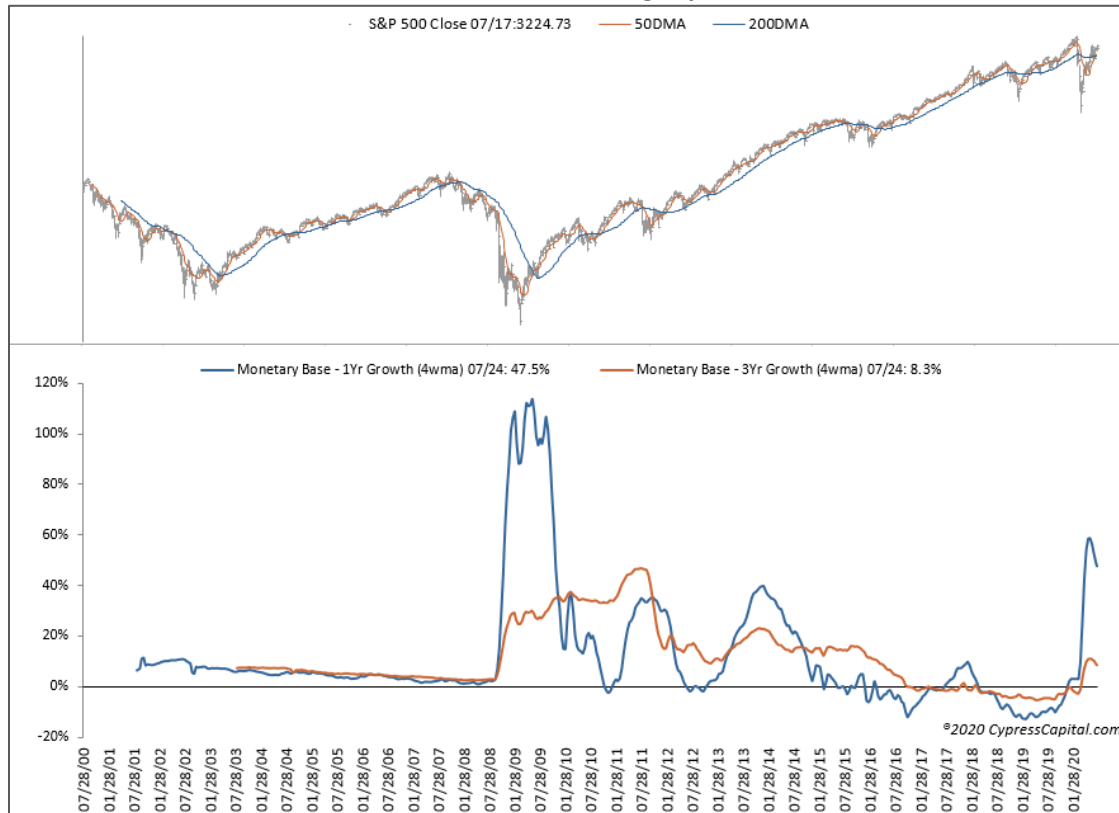
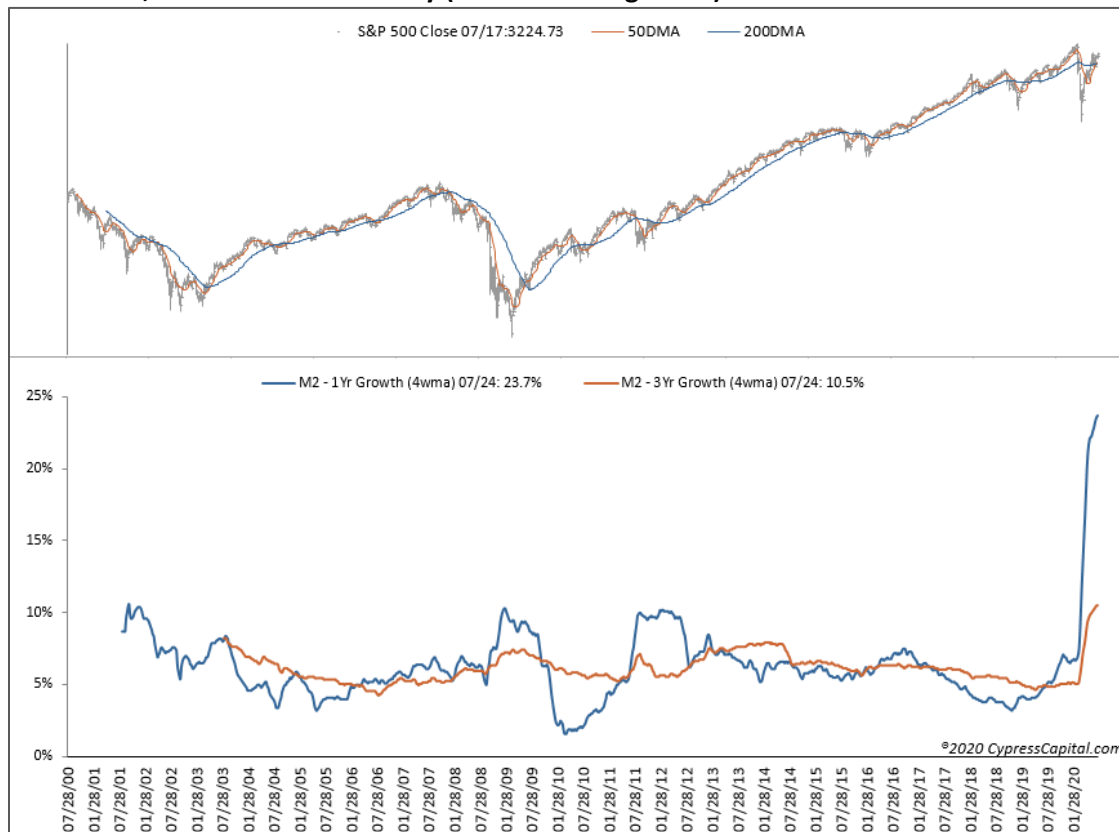
We saw some decent breadth when looking at the advance decline line and our breadth thrust indicator this week. Because it occurred as volatility started to rise, it was indicating at least a temporary unwind in the FAAM momentum trade. However, the higher high in the S&P 500 did not see a corresponding increase in the percentage of stocks trading above their 50 and 200 day moving averages. There have been a number of anomalies related to a lack of participation over the couple of weeks, whose only market analogs are the dot com bubble.



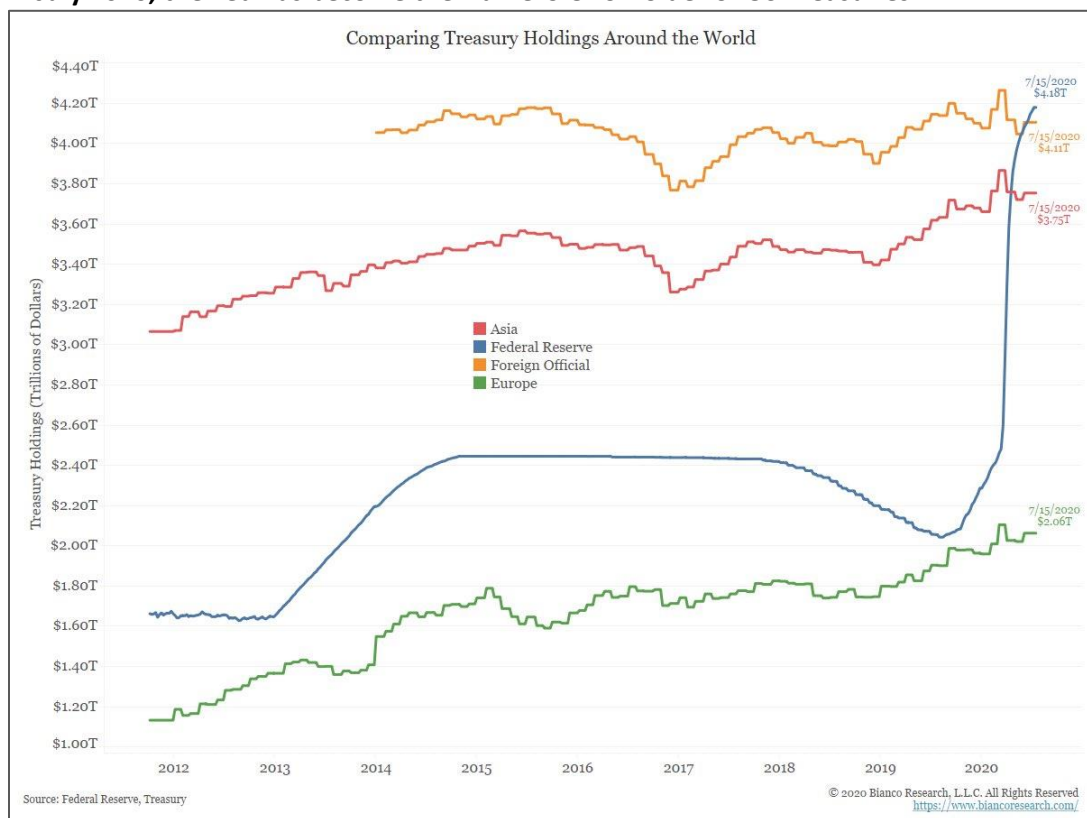
10 Yr. TIPS yields hit record lows

TIPs yields fell faster than nominal Treasury yields this week, pushing inflation expectations higher. Gold & Silver have ripped higher as a result, and the dollar has weakened.



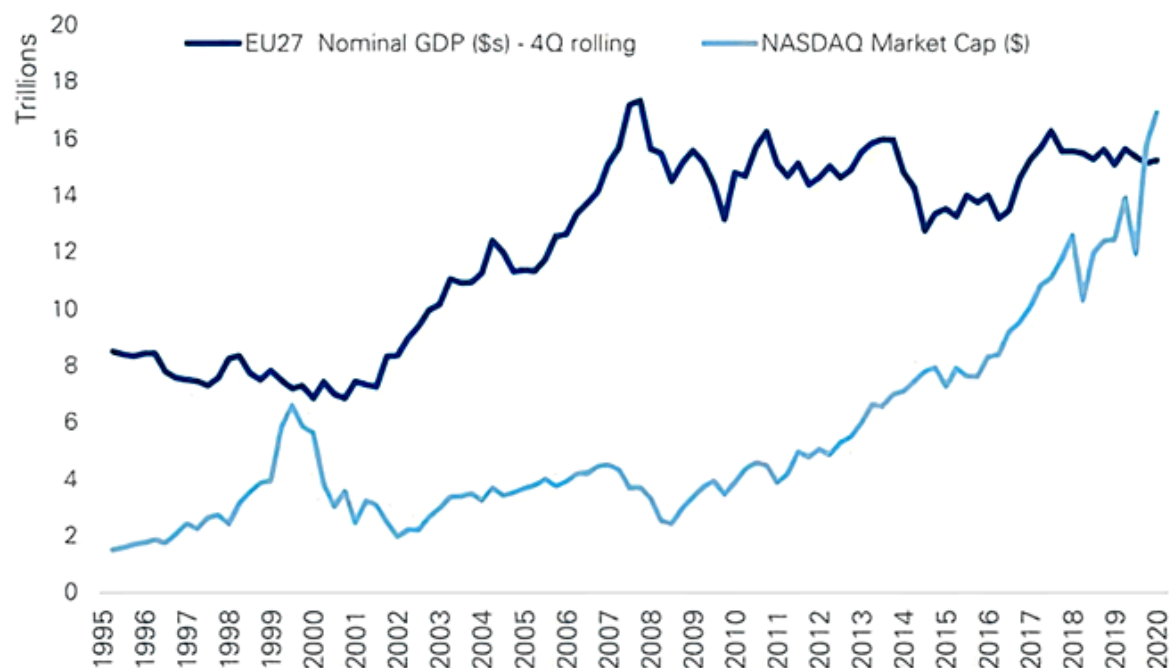
Rollover in Base Growth – the Fed has eased off the gas pedal as the dollar has weakened.**Meanwhile, the demand for money (M2 and MZM growth) continues to increase.**

In July 2020, the Fed has become the Numero Uno Holder of US Treasuries



And, the NASDAQ Composite's Market Cap has surpassed the GDP of Europe.

Figure 1: The Nasdaq's market cap has passed the GDP of the EU27 very recently....

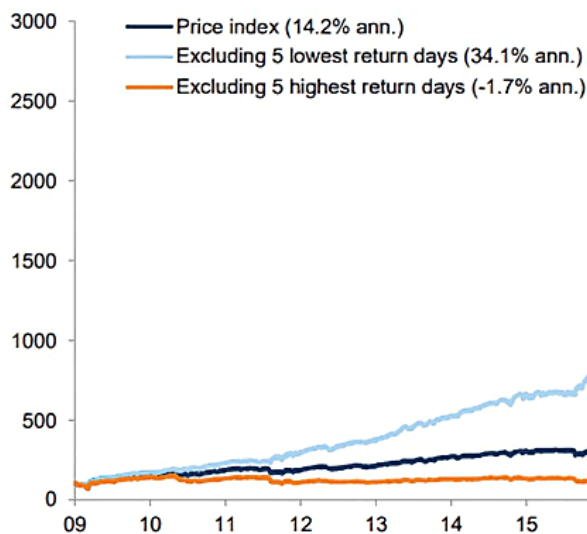


Source : Eurostat, Bloomberg Finance LP, Deutsche Bank. Includes DB forecasts for Q2 and Q3 EU-27 GDP

Missing the Best and Worst of Times

Incredible chart. Notice that the Exhibit frames it in terms of missing the five best days. That's a wirehouse for you, but avoiding the worst returns crushes everything. It's also a strong argument to avoid all or none thinking – markets don't force you to be all in or all out. The risk of drawdown is measurable. It requires patience to take advantage of it, but it doesn't require you to be a bull or a bear and make a call.

Exhibit 36: Missing the best 5 days every year since the GFC resulted in no return
S&P 500 excluding 5 highest and lowest return days (indexed to 100)

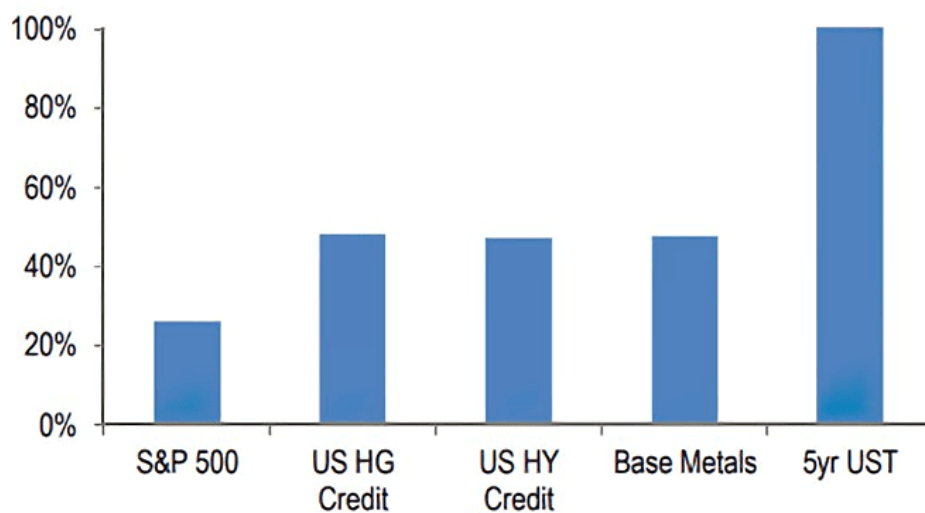


Source: Datastream, Goldman Sachs Global Investment Research

Bonds are priced for recession, but stocks aren't.

Chart A60: Probability of US recession as currently priced across asset classes

In %, as of Jul 13, 2020.

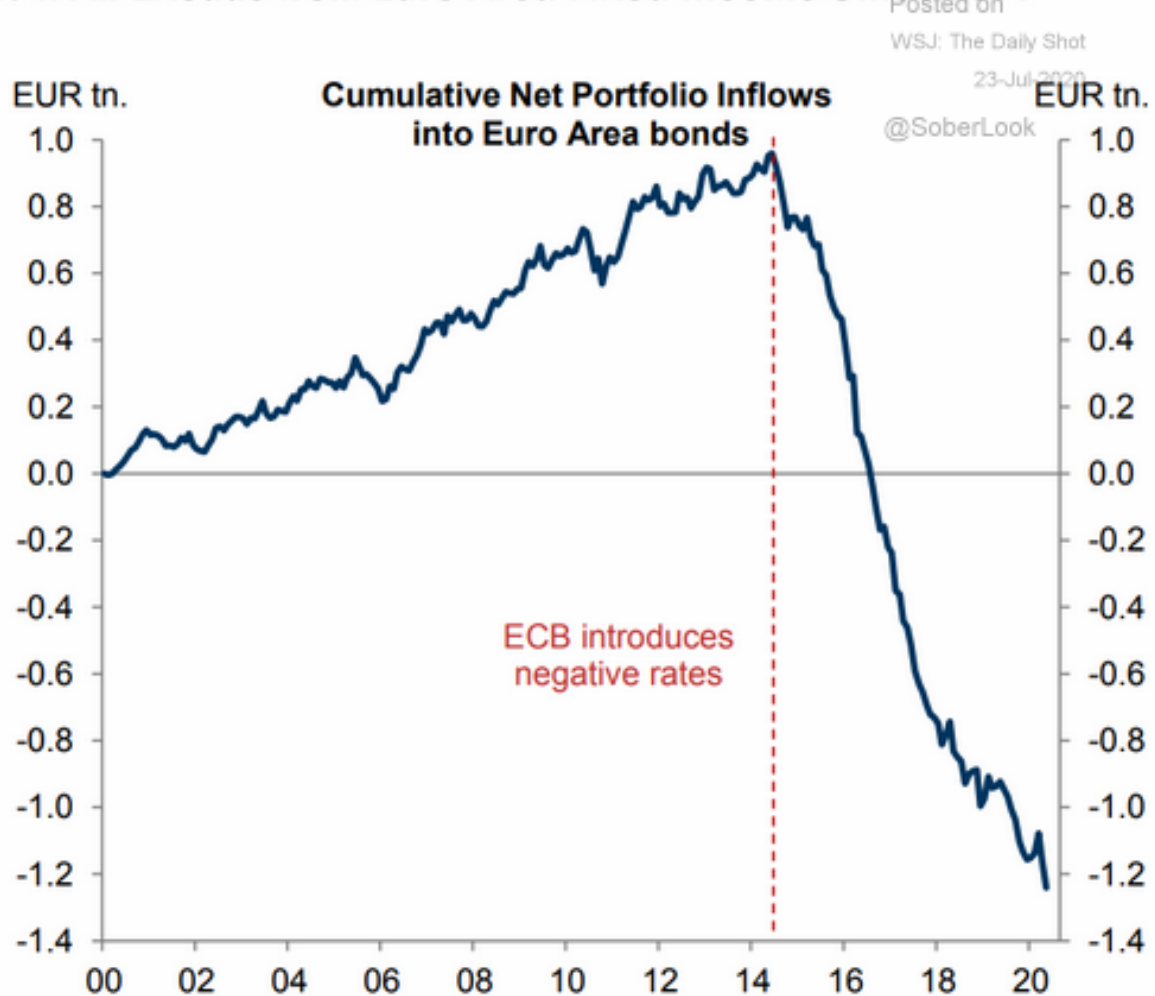


Source: J.P. Morgan

Europe's Extreme Central Bank Policy

It's the same lesson of Japan. When central banks get extreme with central bank policy, money flees. What happens when all central banks try the policy at the same time?

Exhibit 4: An Exodus from Euro Area Fixed Income Since 2014



Source: Haver Analytics, Goldman Sachs Global Investment Research

Source: WSJ

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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