Market Outlook

By Mark T Dodson, CFA

Recommended Cash Allocation Increases to 40 Percent

Psychology daily point totals are approaching record euphoria

Market Risk Index climbed 88.2 percent, as the risk scores from all three of our counter-cyclical categories jumped this week. The model now recommends increasing cash allocations to 40%, or put another way, setting equity exposure to 60% of its maximum.

Psychology is pushing some uber-rare extremes, extremes that we have seen on very few occasions going back to the start of composite in 1970. Our psychology composite is based upon a smoothed reading of our daily point totals. Each of the indicators in the composite is assigned a range of possible points, negative to positive, and scored based upon their current readings. The day to day readings are volatile, but sometimes they can be instructive. This is one of those times.

This week, the daily point total fell below -180, which has only happened during three other time periods – October 1976, the first three months of 2000, and February 2020. All were examples of euphoric markets vulnerable to drawdown and close to major peaks. We've included a chart below

Monetary conditions worsened, even though falling yields are providing a nice tailwind for monetary conditions, with junk bond yields setting a new record low. Ball Corp priced the lowest yielding long duration junk bond ever this week, according to Bloomberg data. $1.3 billion in 10yr notes at a yield of 2.875%. Record low yields won't be enough, and the composite will not improve substantially until the credit cycle has more solid footing. Fed policy works by driving credit cycles, and it's most powerful when there's room for credit to expand. The liquidity infusion has instead taken an already frothy and full cycle and stretched into more extreme, extra innings. A good analog is eating a big dinner, and then you loosen the belt to make room for dessert. When you are done, you aren't ready to run a marathon – you are ready for a nap.

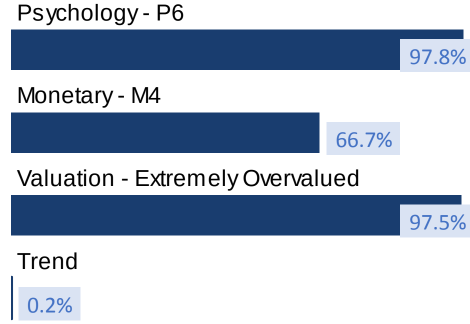
Valuations managed to deteriorate again and are in worse shape than they were at the market peak in February. We again find ourselves only being able to compare the current environment to one other in history, the 2000 dot-com era. The 12 month forward operating PE ratio, usually one of our most optimistic valuation tools, is now less than 10% away from surpassing

Market Risk Index

Elevated

88.2%

Category Percentiles



Largest Psychology Influences

Bank Sentiment	Negative
Fund Flows	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	1.5%
10Yr Treas Yield (on 08/12)	0.7%

Market Trends

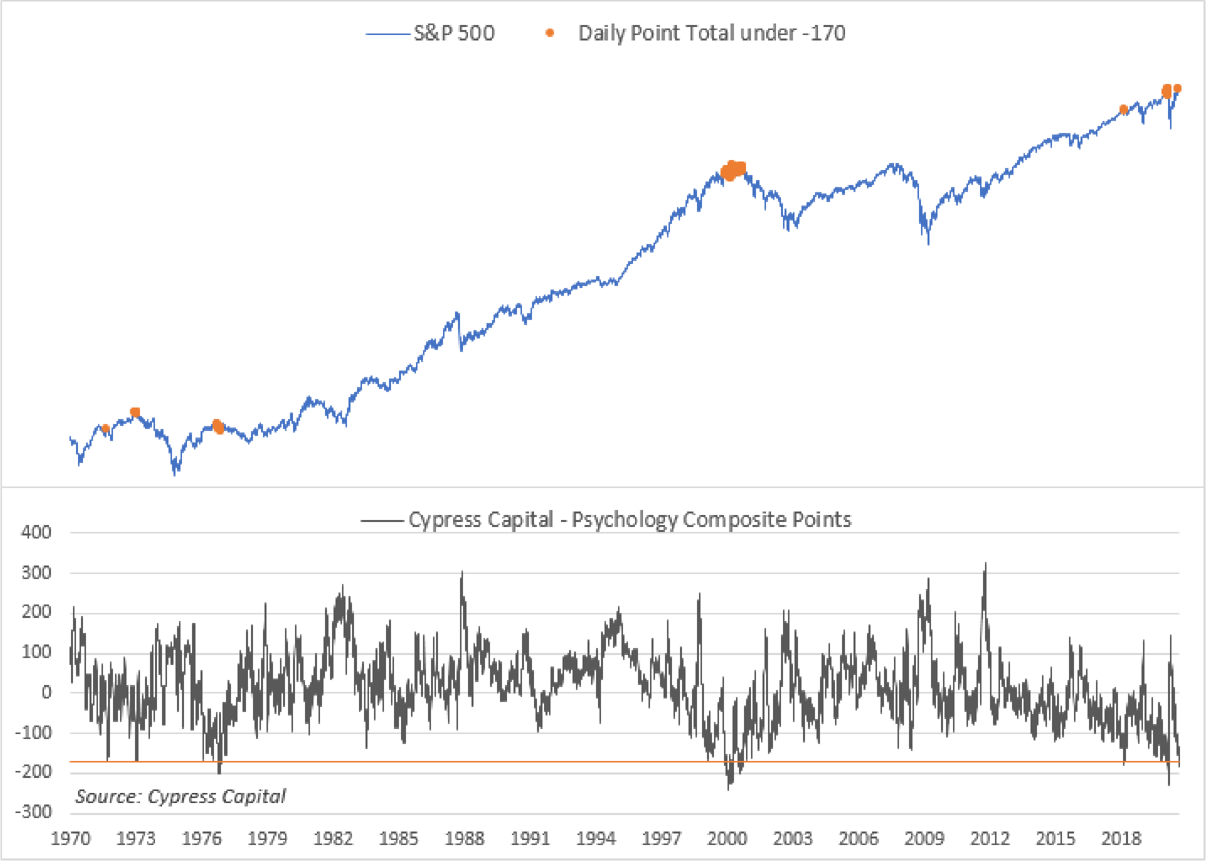
US Equities	Bullish Investment
Intl Equities	Bullish Trade
REITs	Neutral Trade
Broad Commodities	Bullish Trade

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.

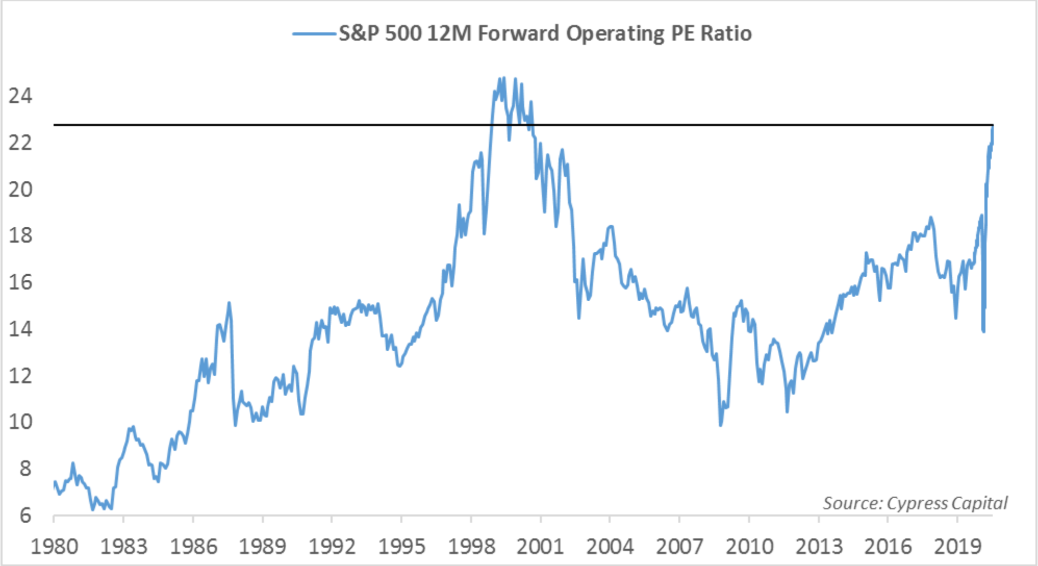
the 2000 peak, as stock prices are putting together a historical rally in the face of declining earnings estimates. Regardless, the current combination of sentiment and valuations are so elevated that they are making our noses bleed.

Cypress Psychology Composite – Daily Point Total

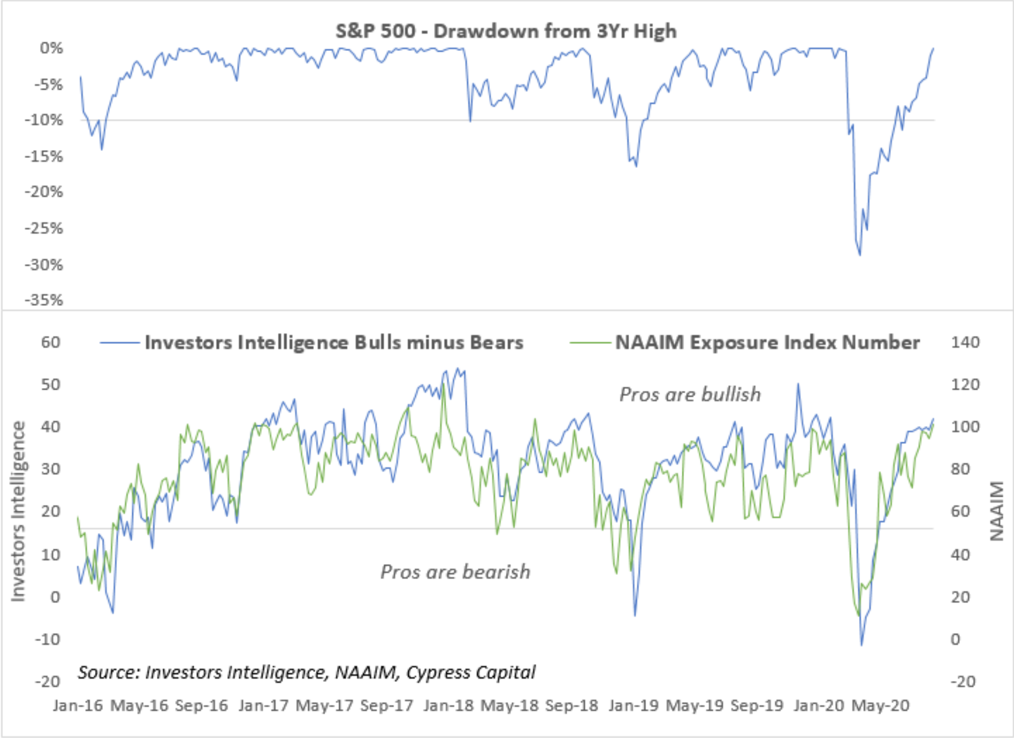
The point total for our psychology composite fell under -180 points, but we've relaxed that constraint to -170 points in the chart below for more observations. After crossing the threshold, the market declined 12.2% over the next 52 weeks and was only positive 1.3% of the time. 1976, 2000, and 2020 were the only instances where the daily point total went below -180.



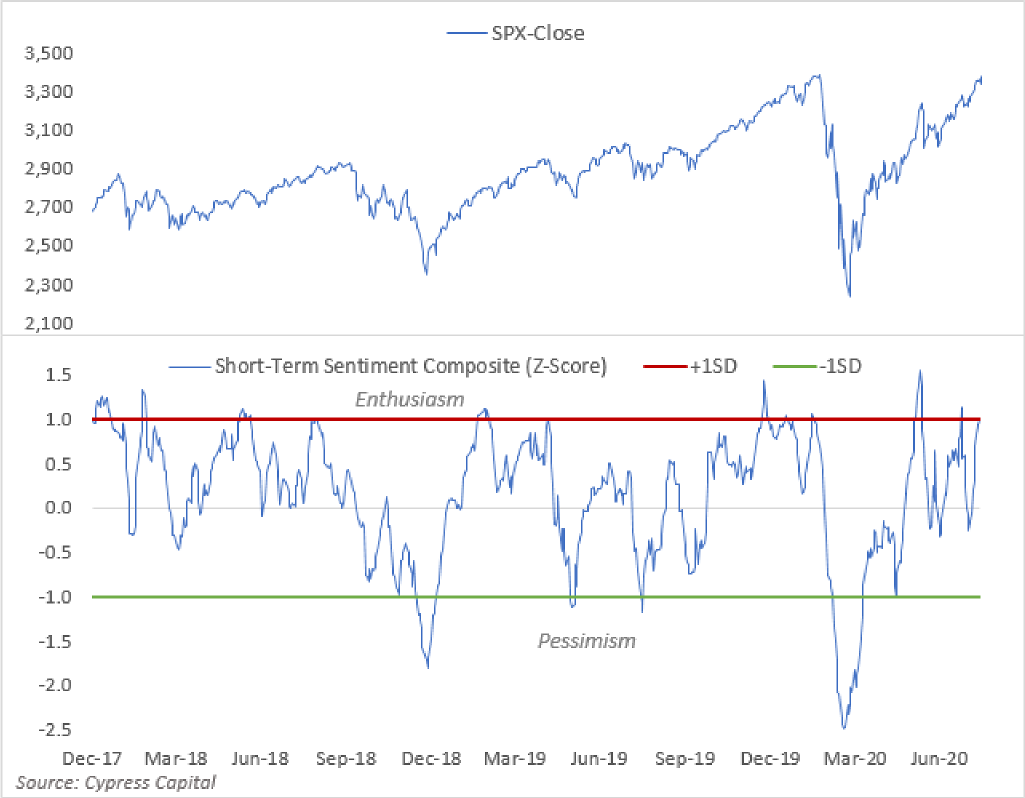
S&P 500 Forward PE is less than 10% away from surpassing the 2000 peak.



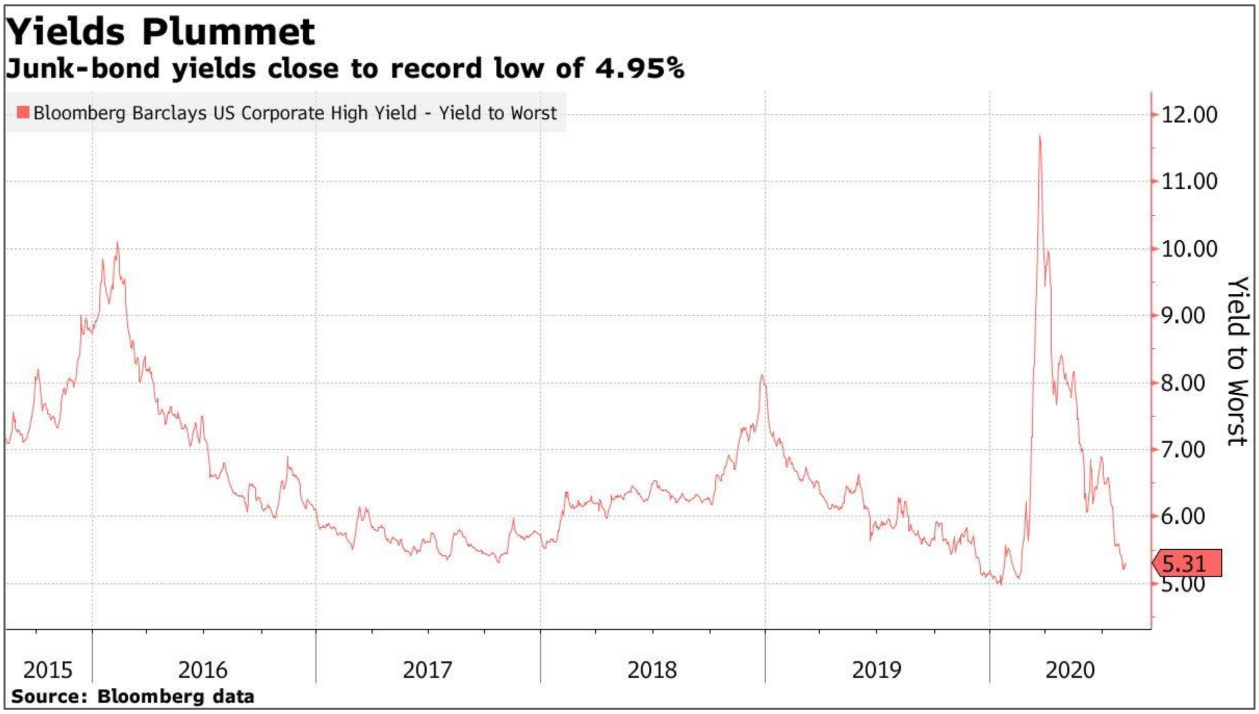
Investment Professionals grow more bullish.
Both the Investors Intelligence Survey and NAAIMs Exposure Index are in the 90th percentile of euphoria readings, with the NAAIM exposure index crossing into the highest 2% of readings.



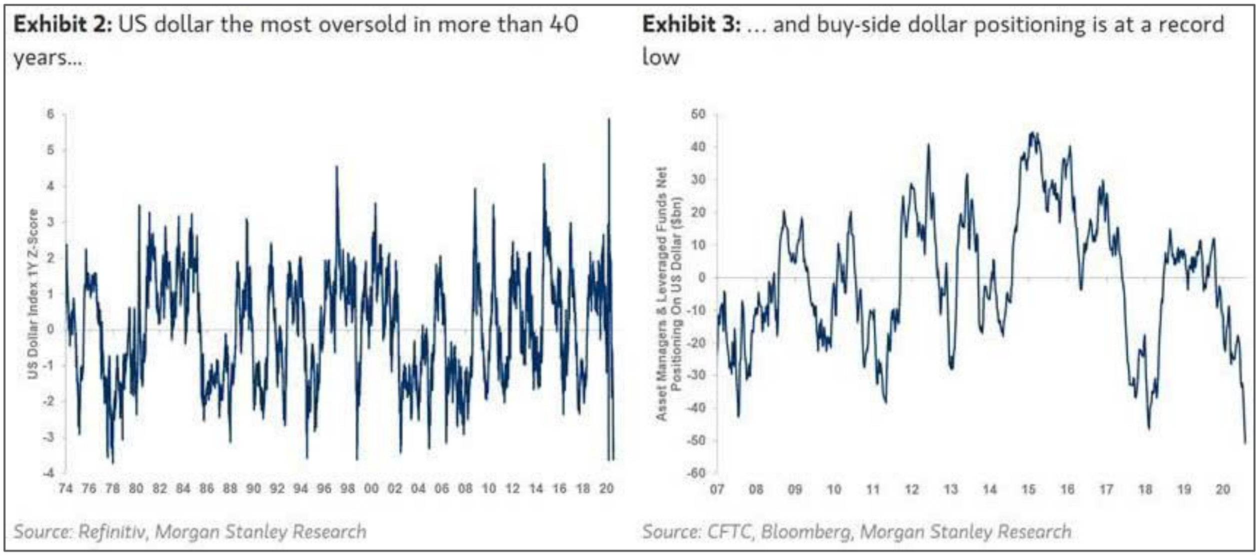
Short-Term Sentiment Composite
Our short-term sentiment composite crossed one standard deviation into euphoria territory for the third time since early June, similar to last winter.



Junk Bond Yields close below 5% for the first time ever.

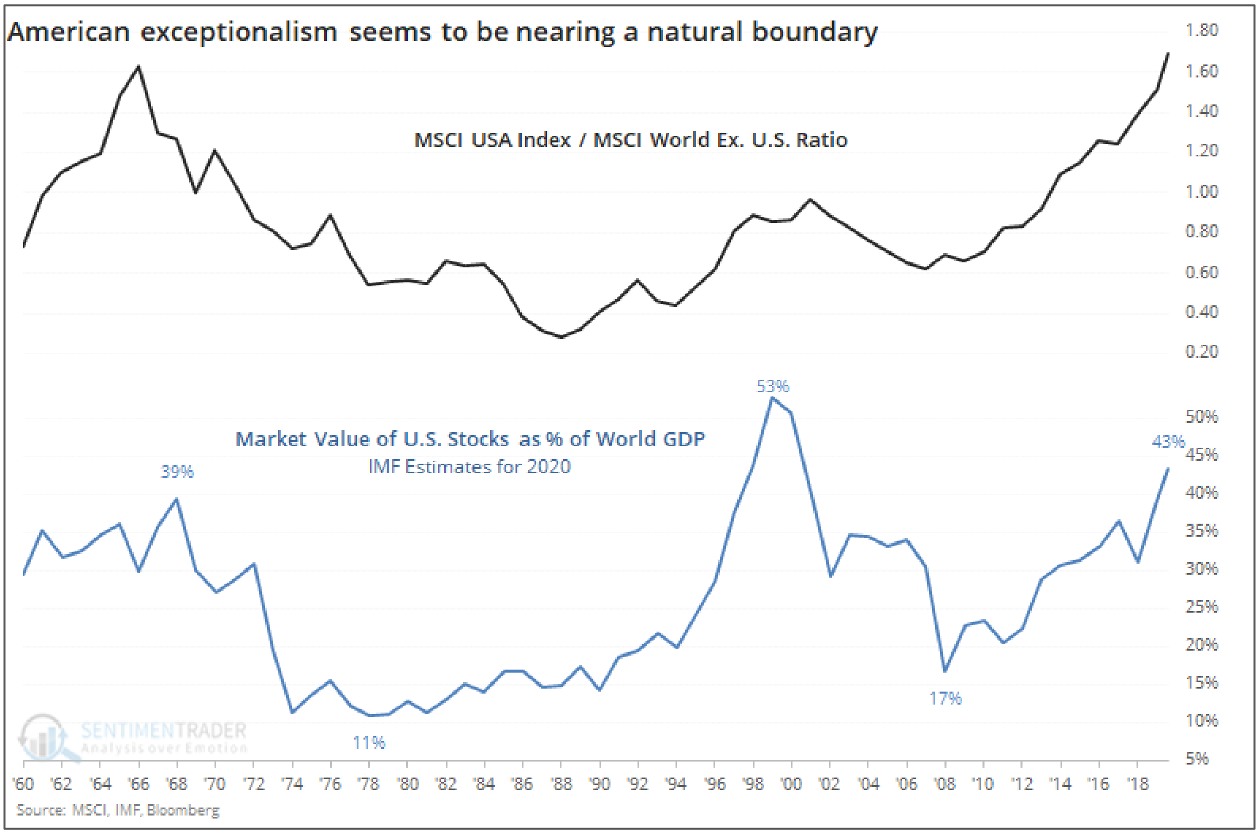


US Dollar – most oversold in 40yrs, and Asset Managers are the shortest on record.



Source: Morgan Stanley, Isabelnet

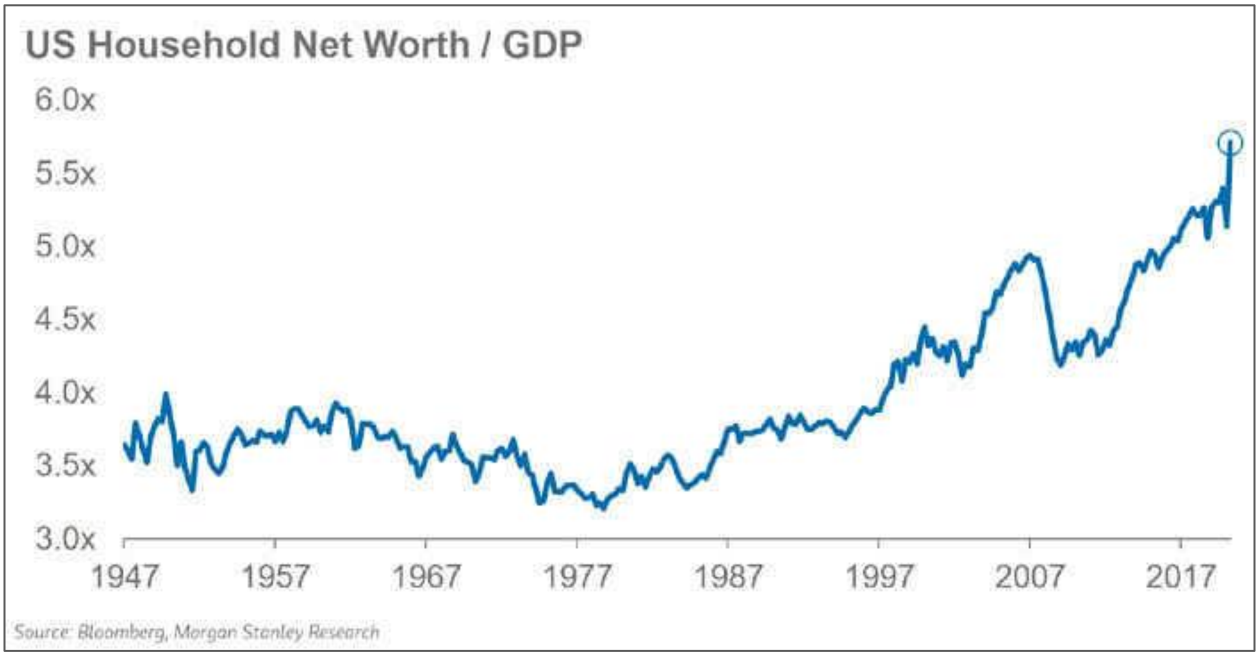
Market Value of U.S. Equities as a Percent of World GDP climbs above 40%.



Source: SentimenTrader

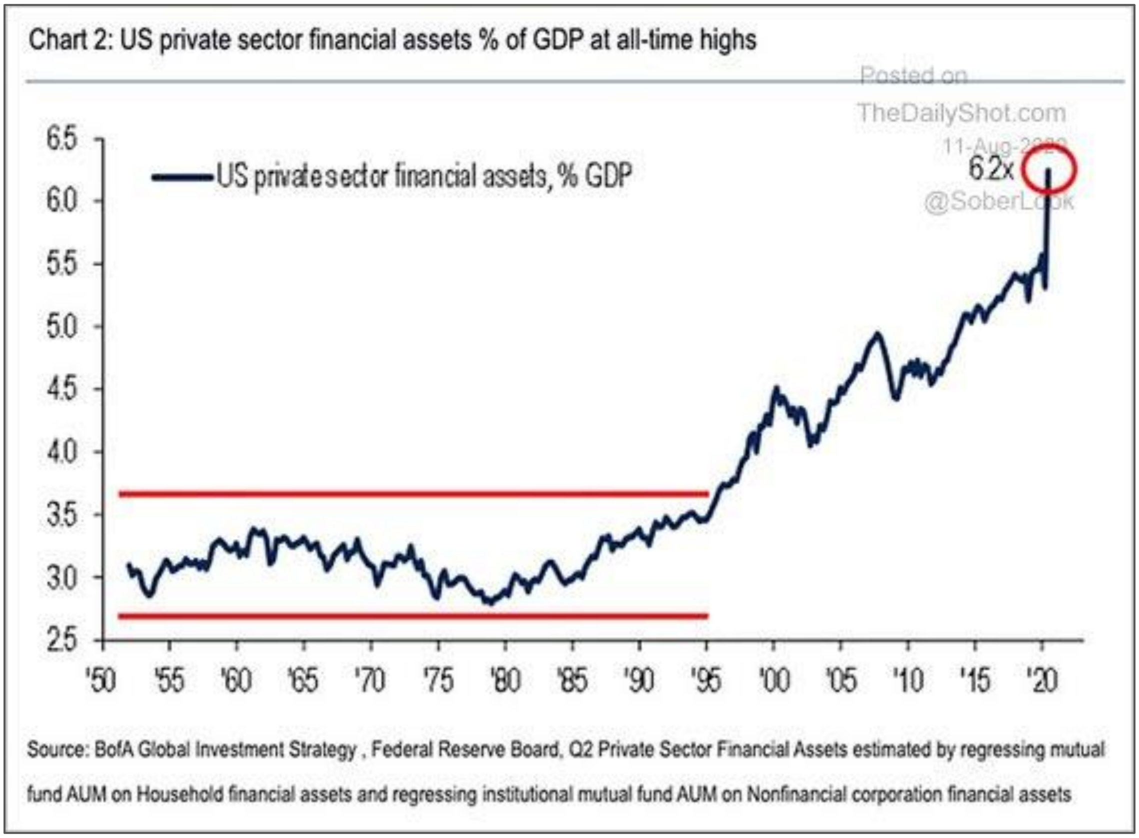
Global Equity Values have surpassed Global GDP.

Household Net Worth as a percent of GDP goes parabolic.



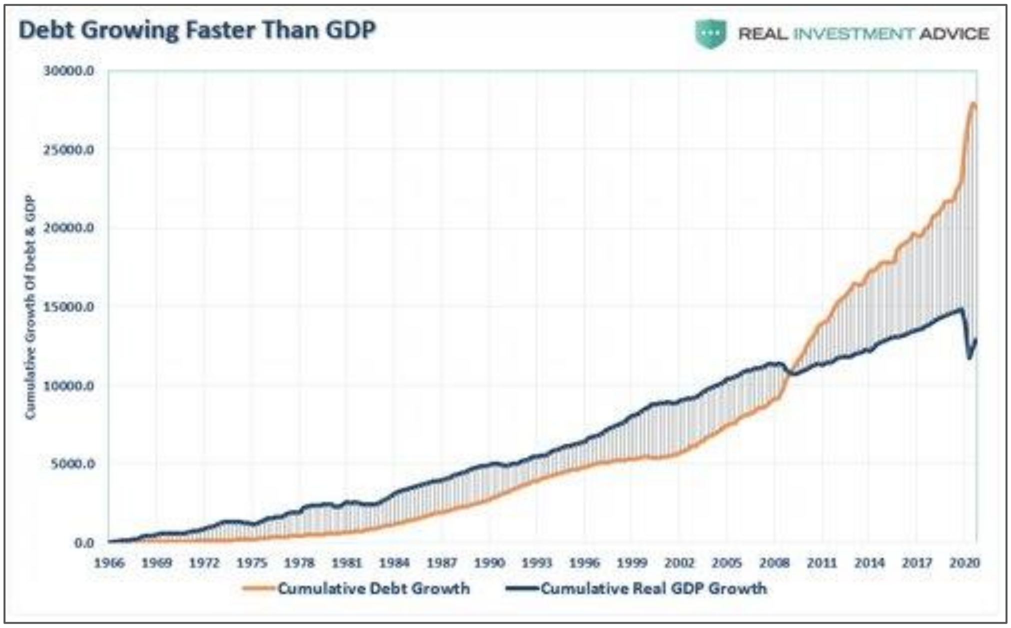
Source: Liz Ann Sonders

Financial Asset values as a percentage of GDP have also gone parabolic.

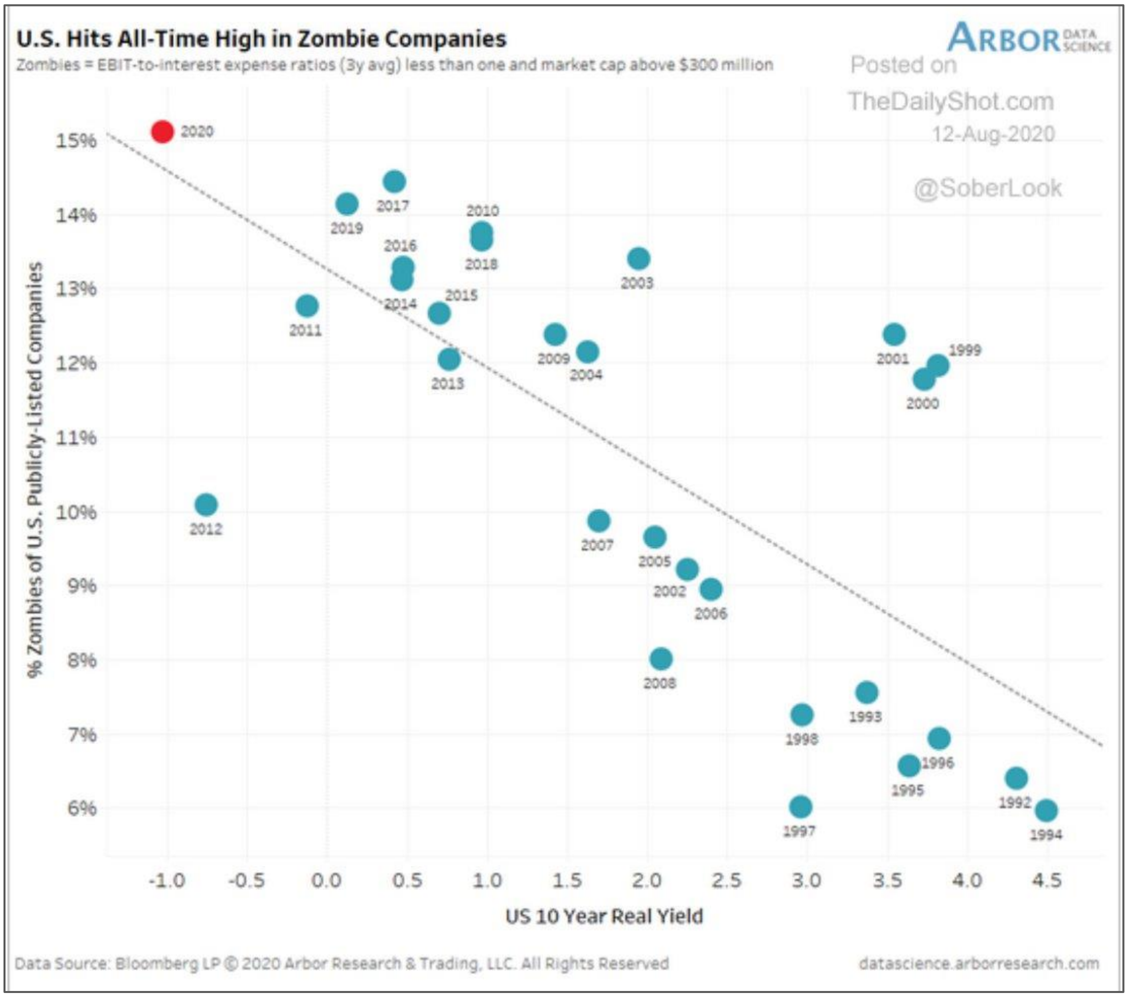


And, Debt as a percent of GDP goes parabolic.

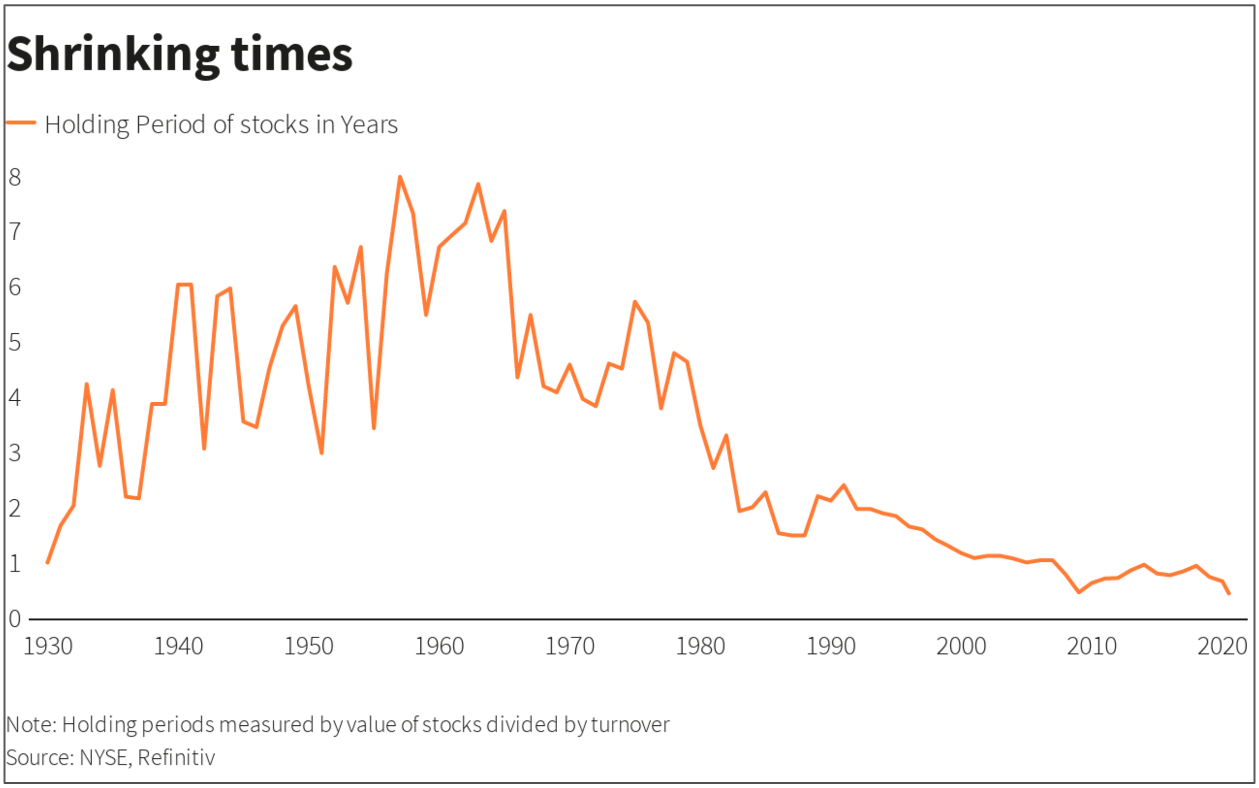
There's major overlap between the data in these three charts. Still, the message is that in the middle of a recession the value of financial paper is running super-hot in relation to the value of the stuff that we make.



Growth in corporate debt has led to more Zombie Companies in the U.S. than ever before.

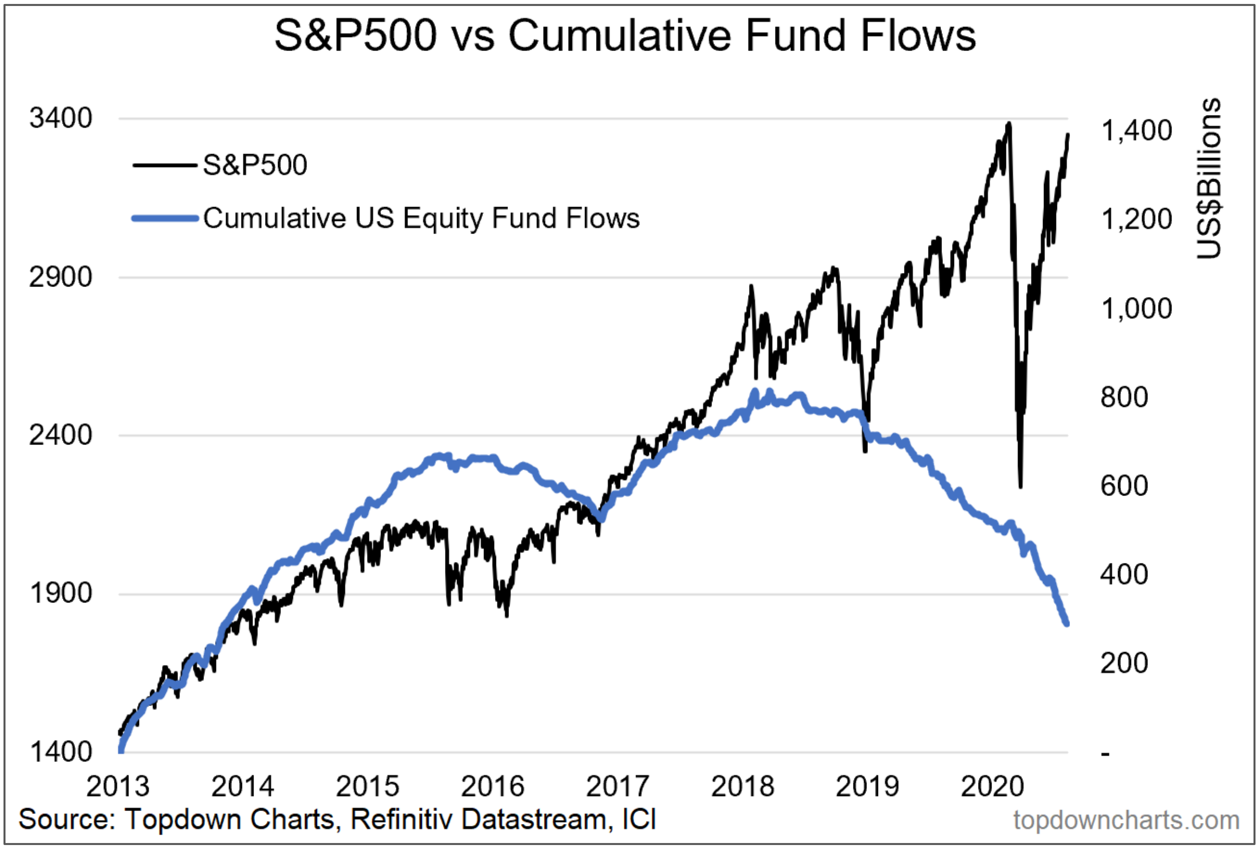


Investor holding periods of stocks in 2020 is pushing all-time lows. Zero commissions are likely one reason.



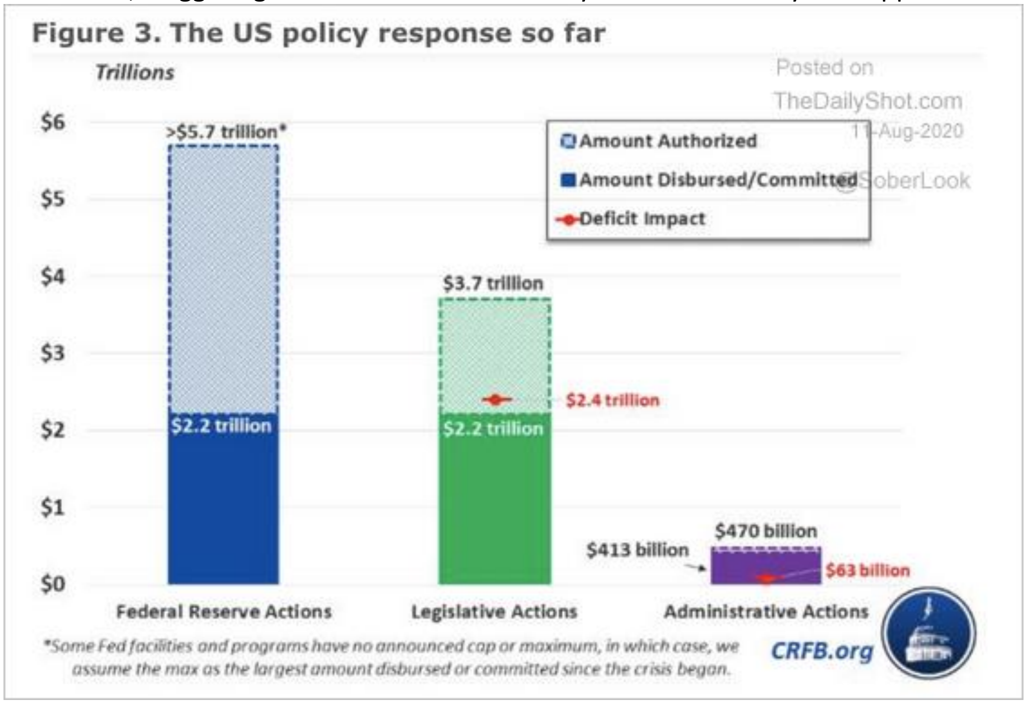
Source: Reuters

For the last couple of years, investors are persistently selling stocks whether they go up or down.

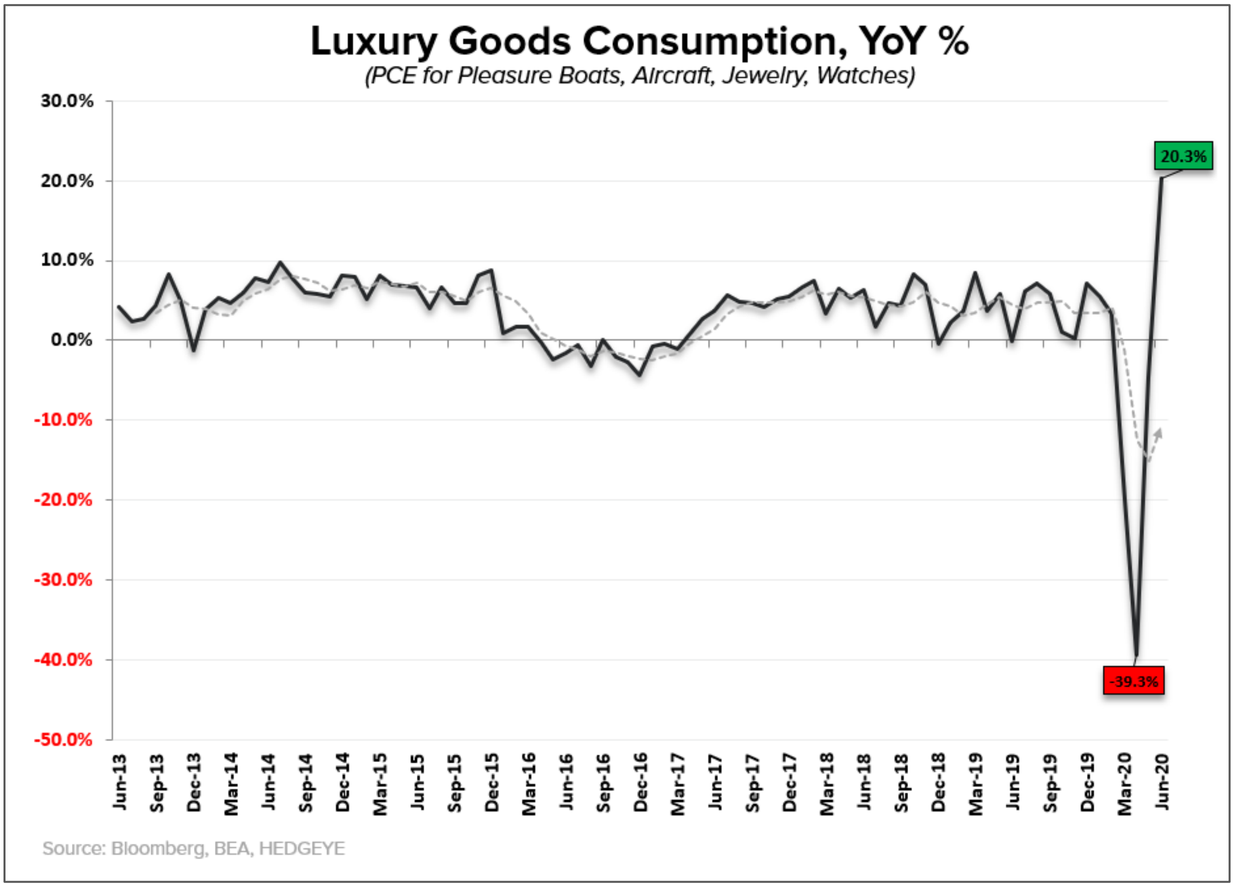


Mnuchin and Powell are making it rain.

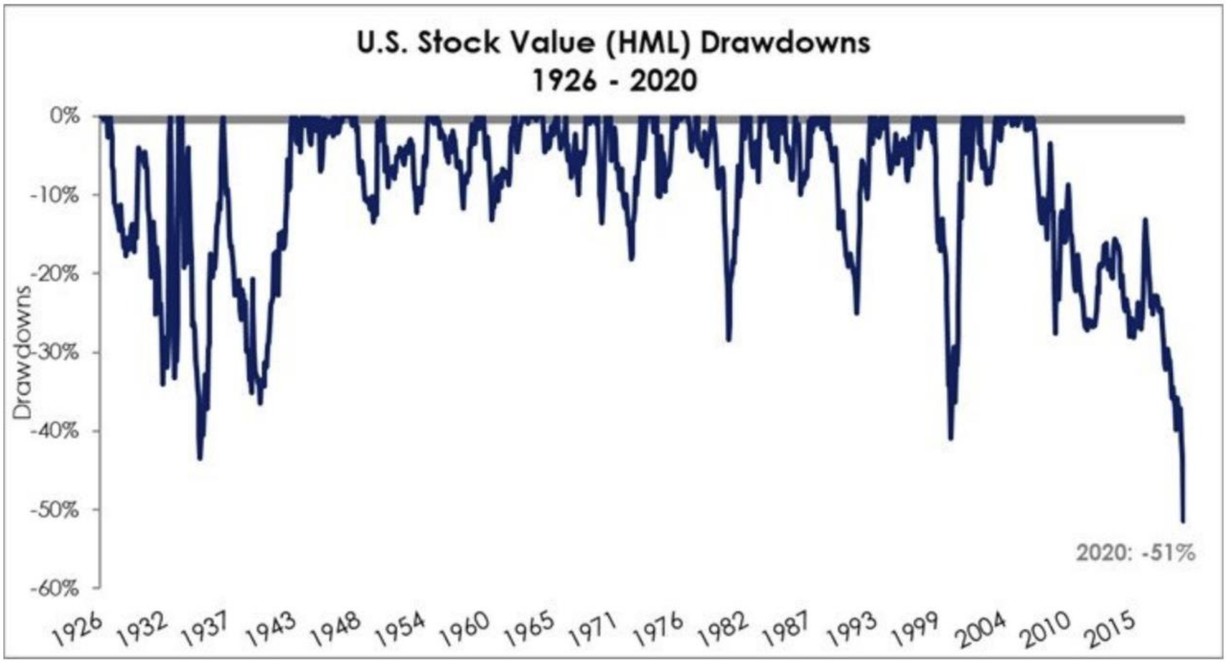
There are 128 million households in the United States. While most folks were waiting on $1200 checks, we've thrown over $37,000 per household at the economy this year and authorized to spend more than $77,000 per household, staggering sums. Some of that money has made its way into Apple stock and bonds, and some of it....



...is being used to buy Boats and Rolexes. Luxury Goods Consumption has surged on a year over year basis.



The Value Factor has never been more out of favor.



Source: Professor French

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.