Market Outlook

By Mark T Dodson, CFA

The most top heavy market performance since March 2000

Uncertainty doesn't drive returns - the price that you pay does.

Market Risk Index surpassed the 90% mark this week, the highest level since early March, just before the pandemic fears began to accelerate. It took the previous bull market nearly a decade to breach that level, whereas this one just turned five months old.

The daily point total in our psychology composite has started to reverse, but the psychology composite itself is a rounding error away from the worst 1% of readings since 1970. Our valuation composite has moved into the worst 1.5% of readings since 1900 and worst 10% of readings since 1990. Even the risk score on our monetary composite has continued to creep up to the point of crossing into worst third of possible readings, which is what some of our OG followers may affectionately remember as being an "M5" condition. If it moves much higher, we will recommend an additional decrease to equity allocations.

Meanwhile, our cap-weighted Trend component is at 0%. Contrasted with the other components of our four-factor framework at the other extreme, it means that this is a full bore FOMO momentum market. We use the Trend factor as a counterbalance to keep us from growing too defensive in a strong trending market, like today, and also from becoming aggressive too soon in markets with bearish trends where out counter-cyclical components can improve rapidly. This helps us manage regret.

We borrowed this week's title from one of our late February reports – where out of frustration with traditional measures of market internals (which in recent years continue to give poor signals), we looked at the percentage of stocks outperforming the S&P 500 over different time frames. It was exceptional timing in highlighting the risk in late February. Today, looking at the percentage of S&P 500 stocks outperforming the index over the last 13 weeks, it has grown even more extreme. There are fewer stocks beating the S&P 500 over the last 13 weeks than any other time since March 2000. Seeing such a small number of stocks outperform the S&P 500 while the market is at new highs over the last 20 years is rare too – only occurring in early 2000 and late 2007.

Market Risk Index

Elevated

90.3%

Category Percentiles

Psychology - P6: 98.9%

Monetary - M4: 69.1%

Valuation - Extremely Overvalued: 97.5%

Trend: 0.0%

Largest Psychology Influences

Surveys	Negative
Fund Flows	Negative
Option Activity	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 08/24)	0.6%

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.

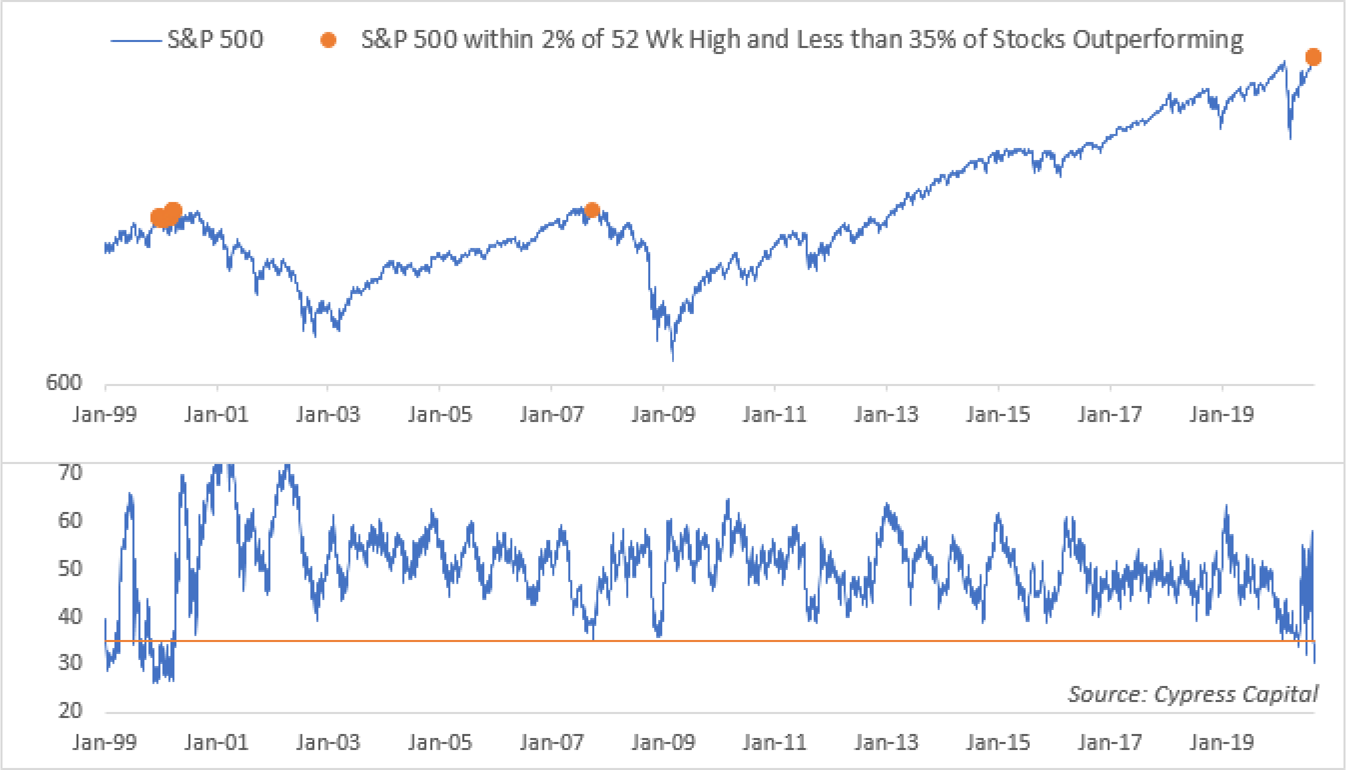
An argument can be made that some of the mega-cap stocks that are outperforming are Covid-immune, but this is also part of a larger trend that began in the second half of the 2010s, where investors embraced large cap tech stocks and neglected everything else – value stocks, small stocks, international stocks, whole asset classes. We can debate causation as much as we want, but all of it has coincided with experimental, aggressive monetary policy that policymakers created on the fly, where every decision has been driven by falling asset prices and financial market volatility. It's policy that provides pacifiers to speculators who play with moral hazard and uses fancy phrases like inflation targeting and yield curve control as cover.

It is culminating in what we believe is the nuttiest market environment that we have ever witnessed – more so than the late 90s. It's a full market cycle playing out in fast forward. In a matter of weeks, we went from looking for historical comparisons to previous bear market rallies to making comparisons with some of the most euphoric market environments in market history. As confident as your favorite CNBC personality may sound, there are no analogs for this one.

There is a pandemic, double digit unemployment, social unrest, World War II levels of Federal debt issuance and a public announcement by the Federal Reserve to let inflation run hot, while turning a blind eye to the level of asset prices. These should be the times that we can buy equities at a bargain, but instead they are priced like Louis Armstrong is thinking to himself that it's a wonderful world.

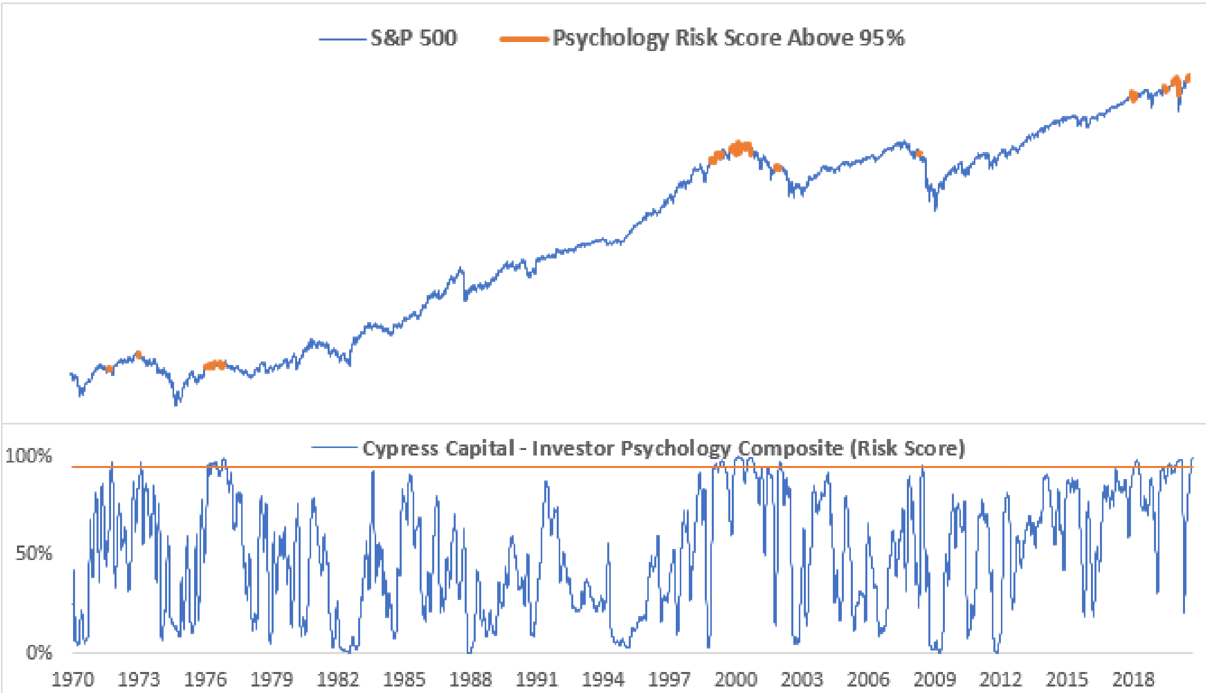
It's the price that you pay for an asset that drives investment returns, not the level of uncertainty in a market environment. The principle of margin of safety is to give you a standard, so that you can buoy your confidence in times of uncertainty. Margin of safety can be measured objectively, but it requires patience and discipline in practice. Uncertainty may be high, but markets are pricing financial assets like an environment where certainty runneth over. As investors, not speculators, we can navigate this peculiar period in time, but it will require adherence to the principle of margin of safety and a patience that means not giving into the euphoria of the moment.

Top Heavy Market – Few stocks are outperforming while the market is at new highs.



Psychology Composite

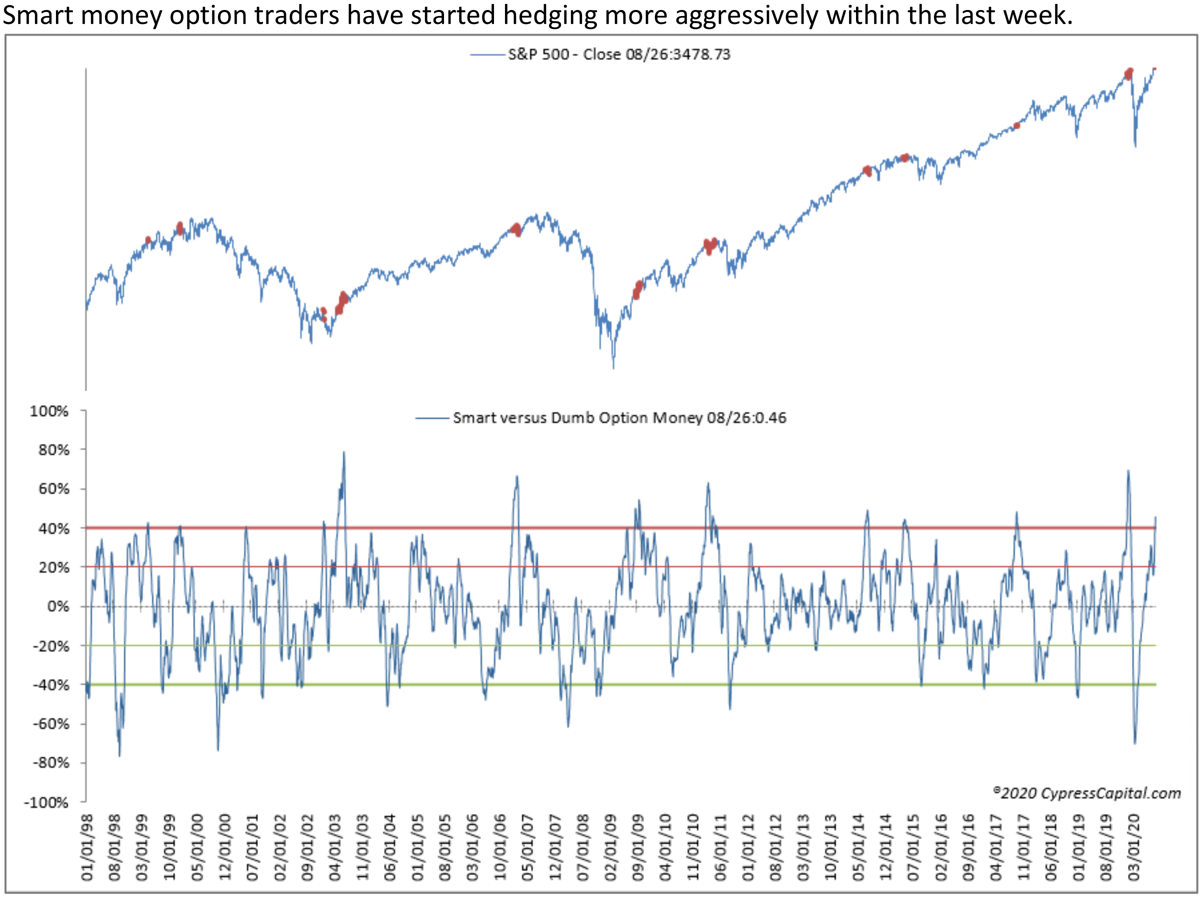
The daily point total for our psychology composite reversed over the course of the last week, but readings within the composite itself are unlikely to peak for at least the next couple of weeks.



Source: Cypress Capital

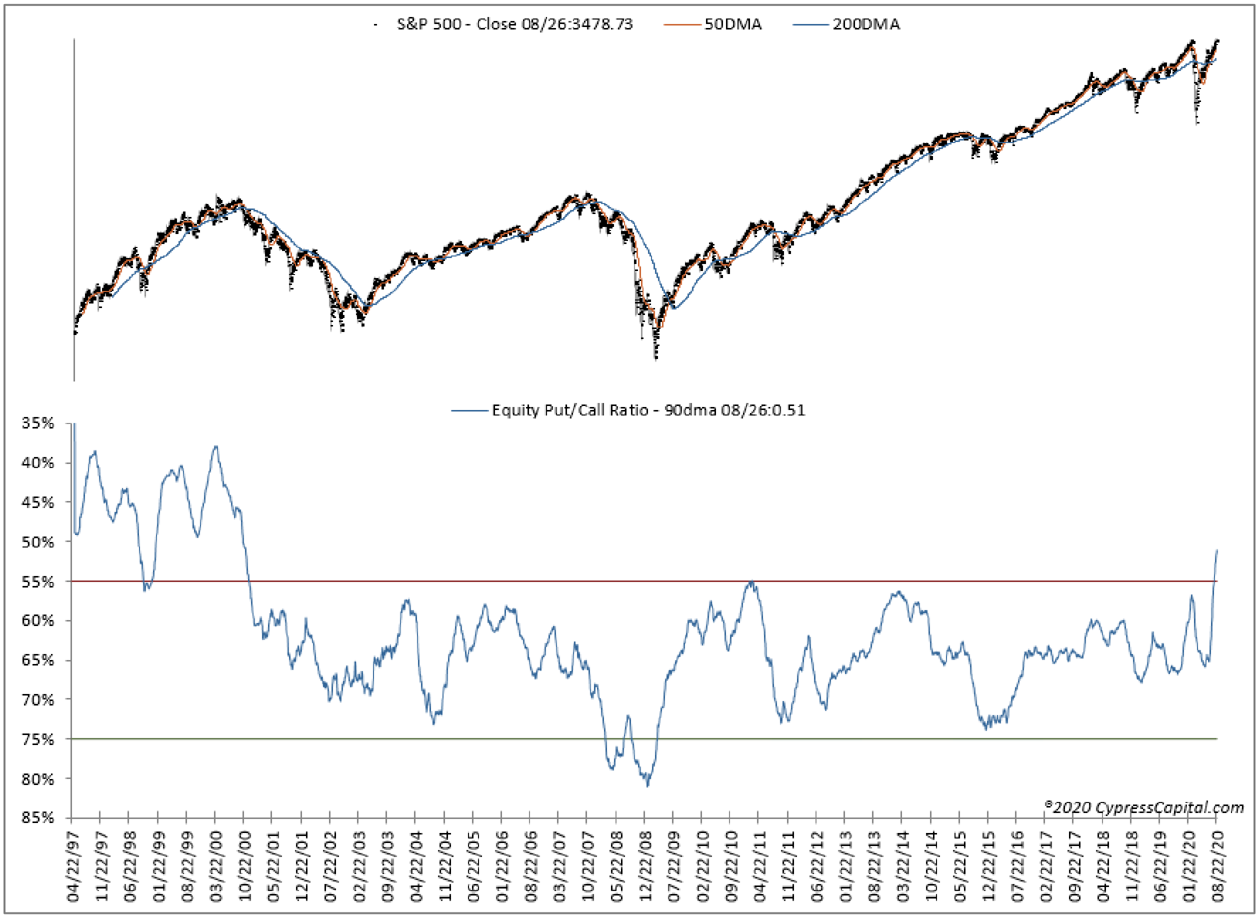
Smart versus Dumb Option Money Indicators crosses into our highest category.

Smart money option traders have started hedging more aggressively within the last week.



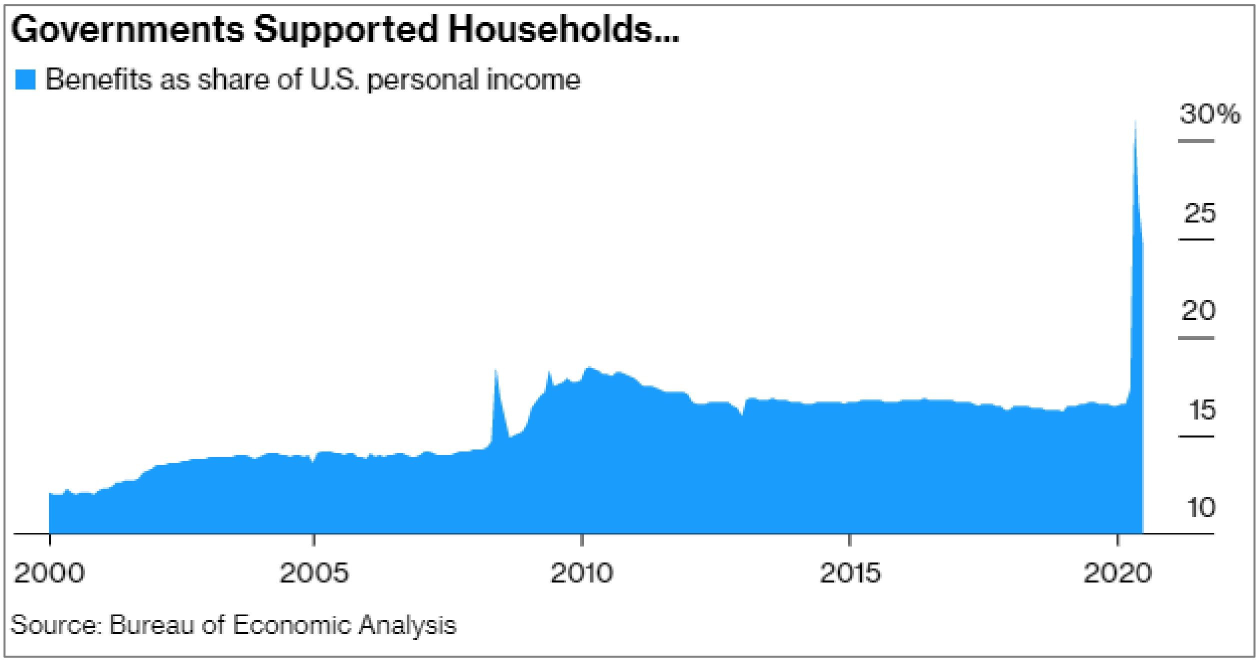
Equity Put/Call Ratio – 90dma

Speculation in equity calls has remained elevated for a long time. It's been over 20 years since we've seen this amount of persistent speculative activity, and it's occurring during the most unlikely of economic backdrops.



Keynesianism on Steroids

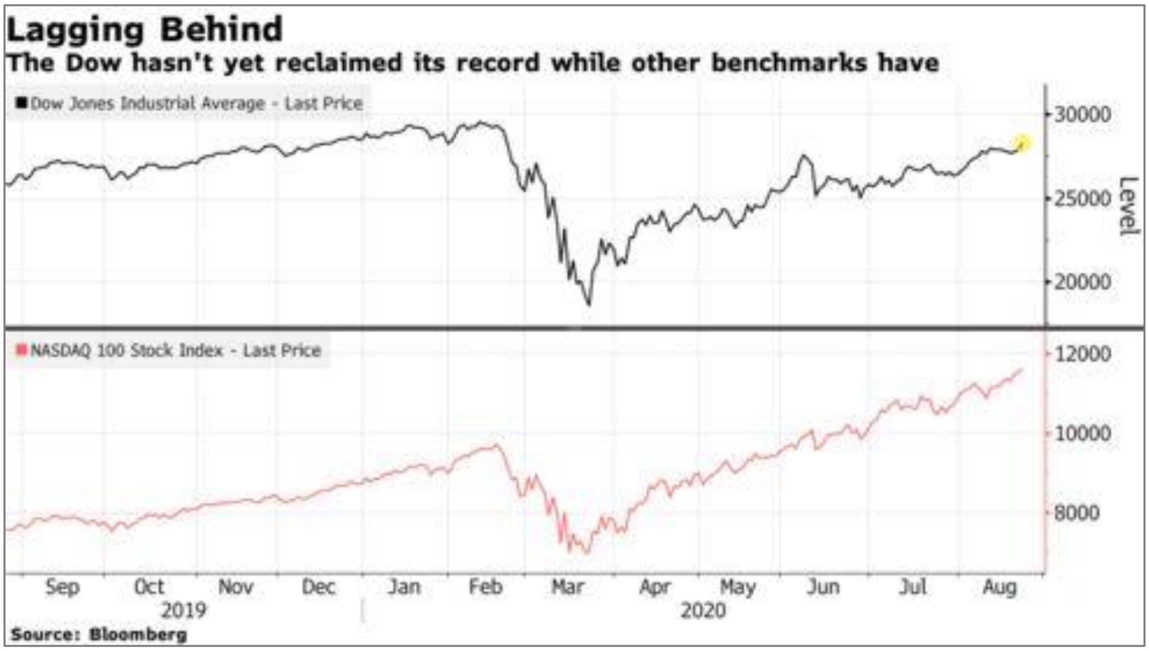
Government benefits as a percentage of personal income spiked sharply as result of Federal stimulus.



Source: Bloomberg

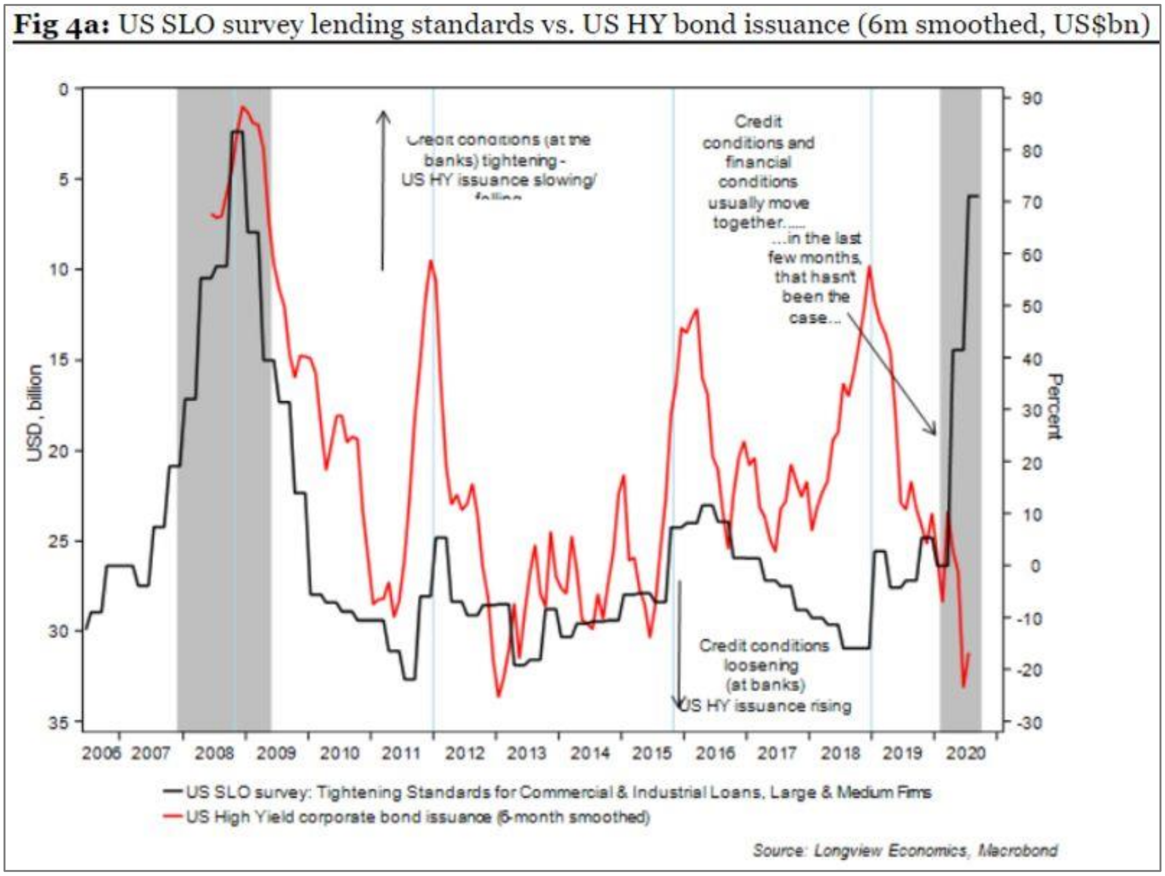
Dow Jones caught a case of FOMO this week.

The Dow Jones Industrial Average felt the pressure of underperformance this week, kicking out Exxon (and a couple of other stocks) in favor of Salesforce.com. Exxon had been in the Dow for 92 years, over 70% of the Dow's history.



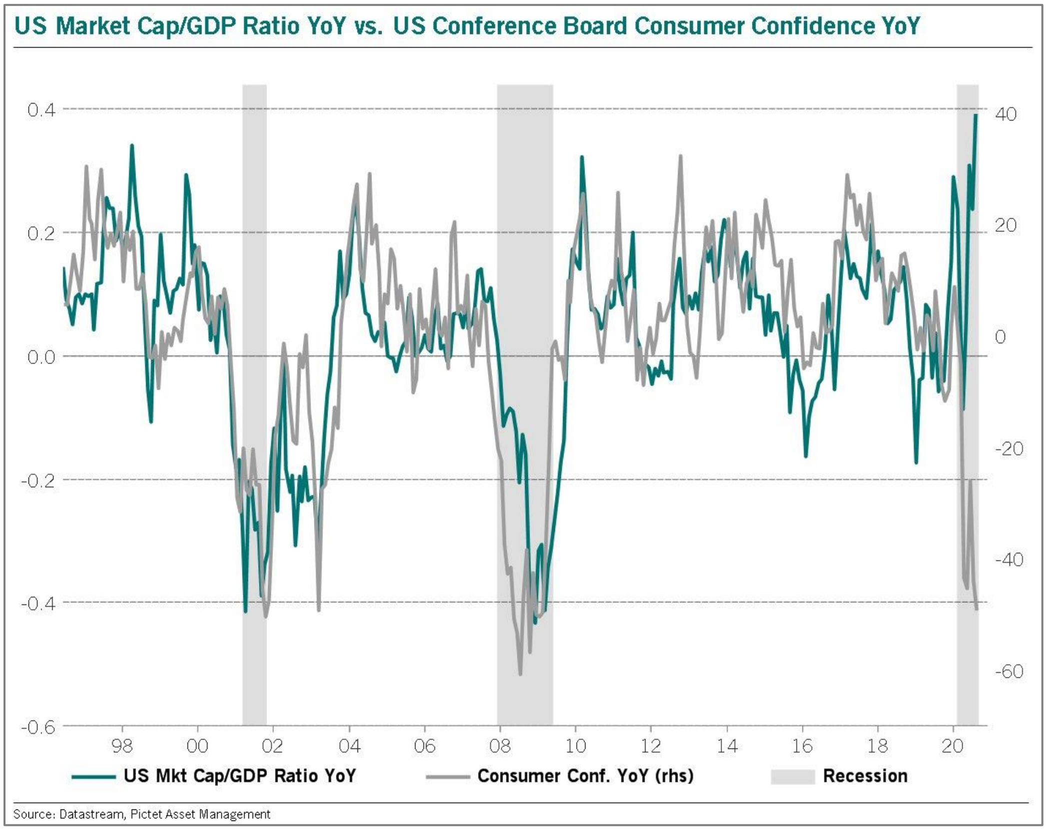
Correlations run amok between high yield issuance and lending standards

When credit conditions tighten, high yield issuance usually declines. Not this time. There's a boom where there should be a bust.

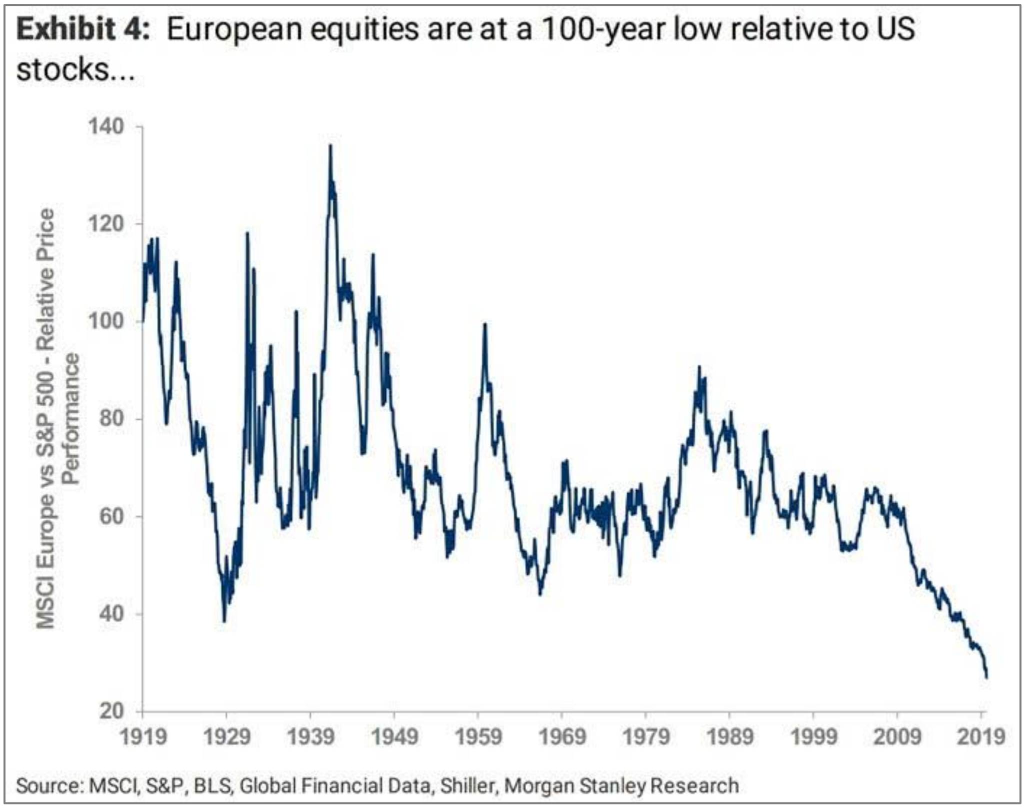


Correlations also run amok between Valuations and Confidence.

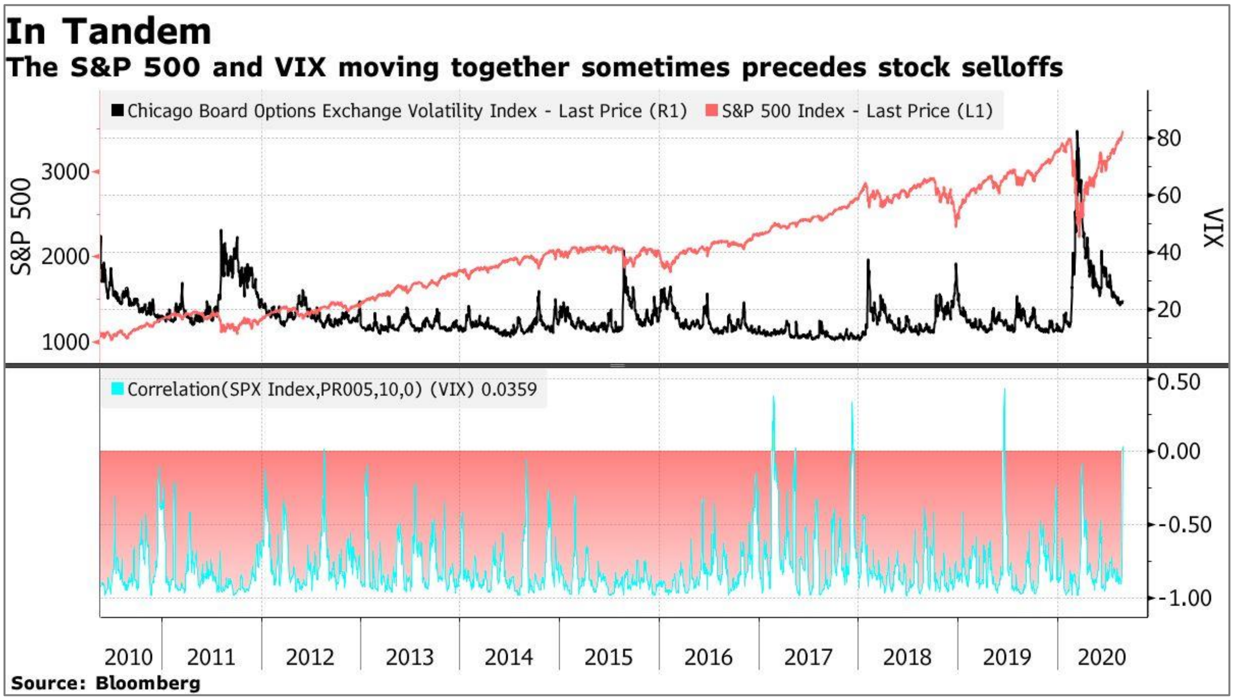
Stock market valuations usually rebound with Consumer Confidence, but valuations are already anticipating an all-time record rebound in confidence.



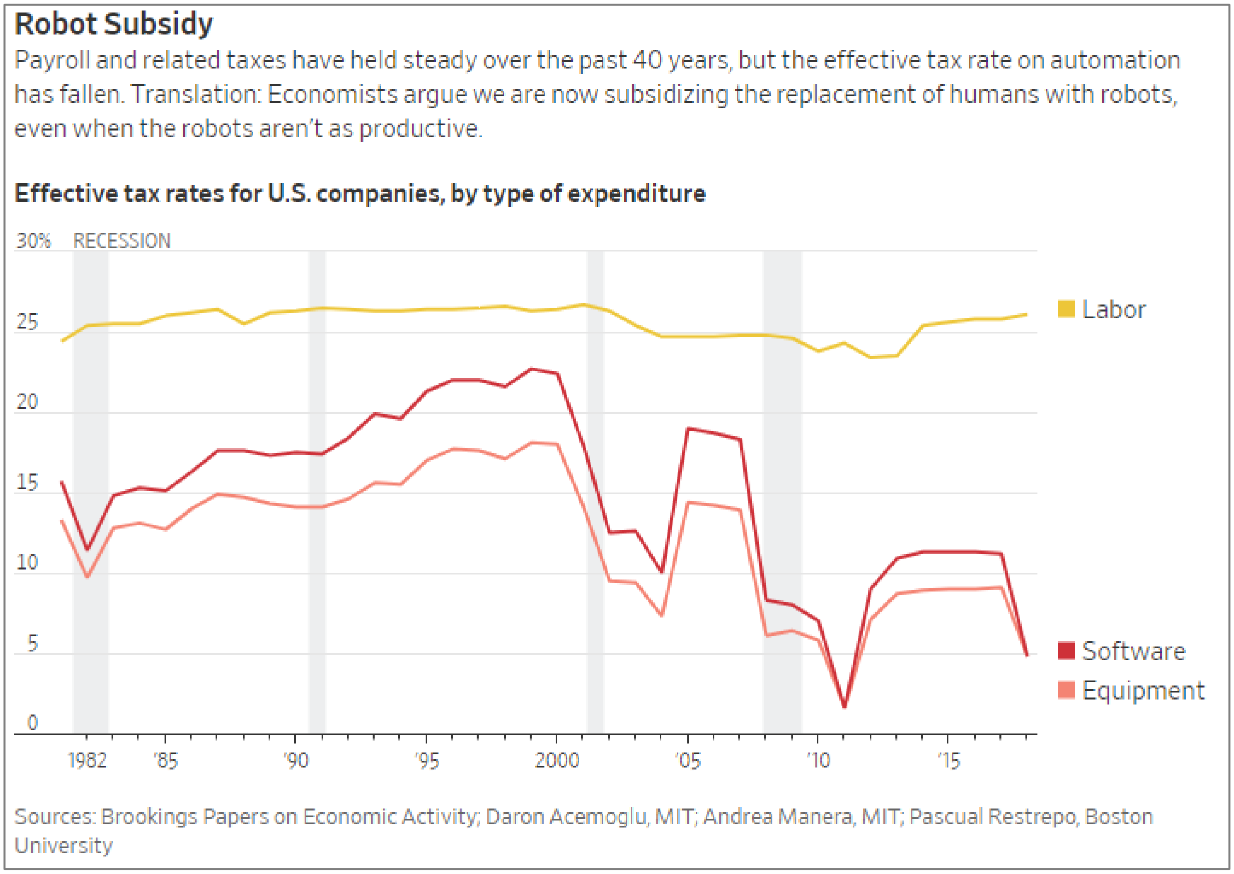
European Equities – 100 Year Low versus US stocks



Correlations between volatility and Equities have flipped positive.
If volatility is a proxy for fear, then fear rising alongside stock prices must equate to the fear of missing out.



Subsidizing Machines instead of People
This was the most thought provoking chart that we saw (and article that we read) this week, which argues that our tax code is subsidizing automation over labor.



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.

Contact us for more information.