Market Outlook

By Mark T Dodson, CFA

Valuations are back to August Extremes

Market Risk Index crossed back above 85% this week on a deterioration in monetary conditions and valuations. Monetary worsened on a softening in the Monetary Aggregates category, as recent rates of change in monetary base growth have flatlined after the large spike in March and April. The Fed has largely stepped aside, only putting more liquidity to work briefly when there are signs that the dollar is trying to rise. Instead, the perception of additional liquidity since the summer up to now is a result of the increase in animal spirits and speculative behavior. The belief in Fed liquidity has created liquidity – the most ephemeral and temperamental kind of liquidity.

The rally this week has pushed our valuation composite back to the levels that we saw at the August peak. Investors have more than discounted full economic recovery and a return to full employment in spite of the uncertainty around the possible paths forward, right as the economic risks from another wave of coronavirus cases is surging. The margin of safety, particularly for big cap US equities, is slim. There is room for a shift into underperforming asset classes as economic recovery takes hold, but markets almost never pass that baton to new leadership without a broad market drawdown.

Meanwhile, the psychology composite's second attempt at improving since those August extremes in greed was thwarted by a speculative burst into equities this week. The same quantitative machine that appeared to be spending the weeks leading up to the election trying to lower gross exposure all seemed to decide to increase exposure to stocks in unison again this week, pouring money back into the popular, big Tech Covid-trade that has dominated much of this year, at a time when big Tech is becoming more of a target of politicians from both sides of the aisle.

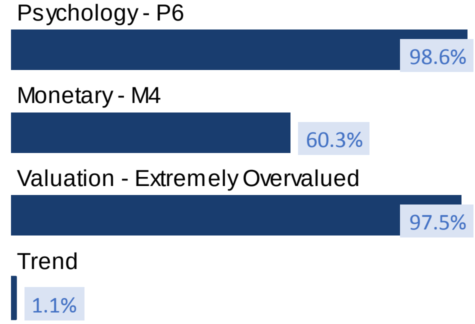
That's about all we have to say about the election from a market risk standpoint, because of all the hand-wringing and narratives about what elections mean for stocks, we've never seen one that mattered all that much for markets. Outside of any kind of temporary boost from fiscal spending or tax relief that

Market Risk Index

Elevated

85.5%

Category Percentiles



Largest Psychology Influences

Levered Investments	Negative
Option Activity	Negative
Fund Flows	Negative
Volatility	Negative

Largest Monetary Influences

Interest Rates	Positive
Monetary Aggregates	Negative
Velocity	Negative

Valuation

7-10 Year Rtn Forecast	1.5%
10Yr Treas Yield (on 11/05)	0.8%

Market Trends

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

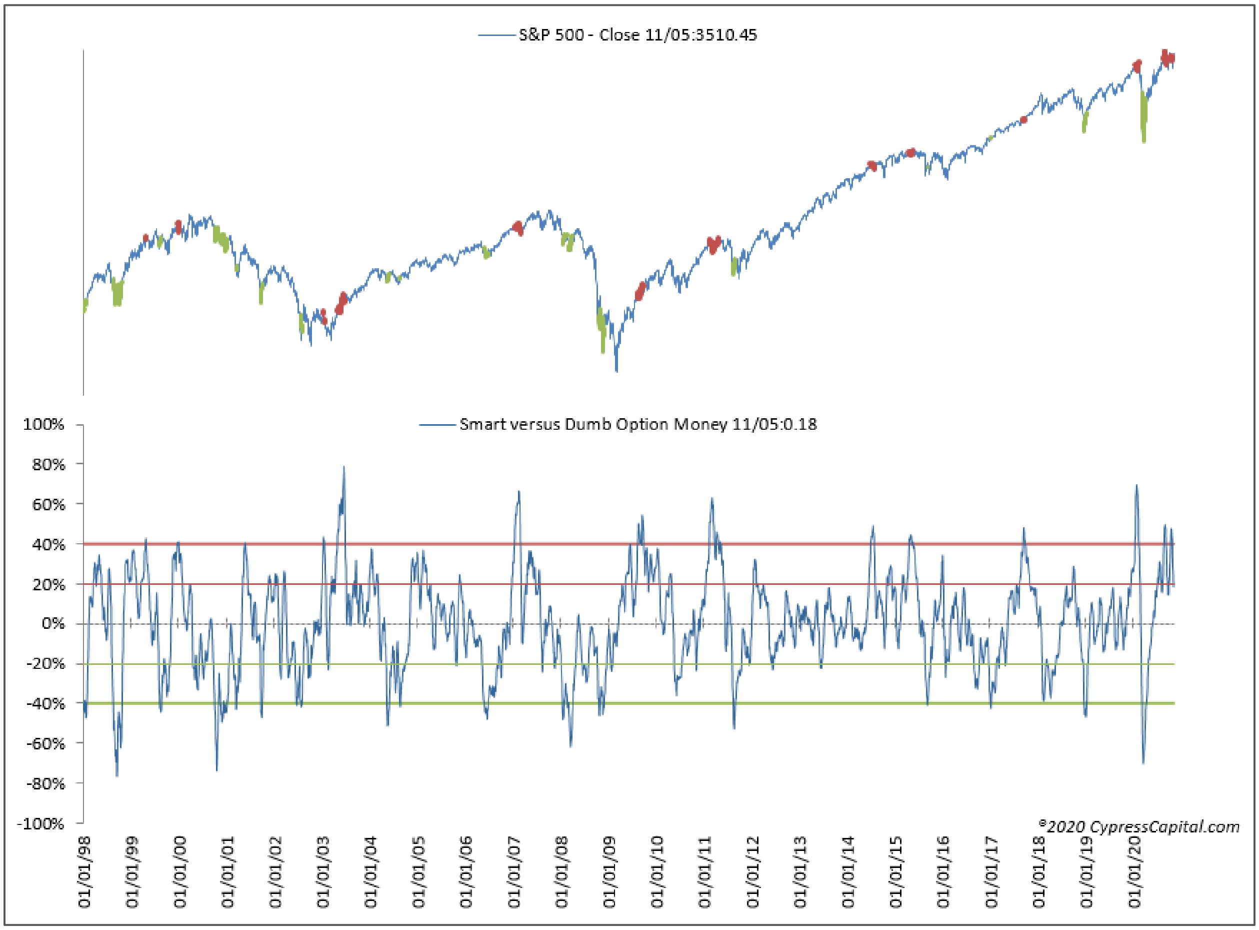
Market Risk Index scales from 0 to 100%. Higher readings correspond with higher risk markets. Scores below 25% are bullish. Scores between 25-75% are neutral, and scores above 75% are markets vulnerable to major drawdowns.

politicians might pass, it's the credit and emotional cycles and the prices paid for risk assets that drive investor returns and outcomes. That, and having the patience to dismiss the noise of the most popular narratives.

We pared back a couple of individual stock positions in the second half of the week within our Select Dividend portfolio. Outside of that, we made no significant shifts to equity allocations across our portfolios. To reverse our most recent decrease in equity allocation made in August, and possibly more, we need more evidence that the speculative fever has broken.

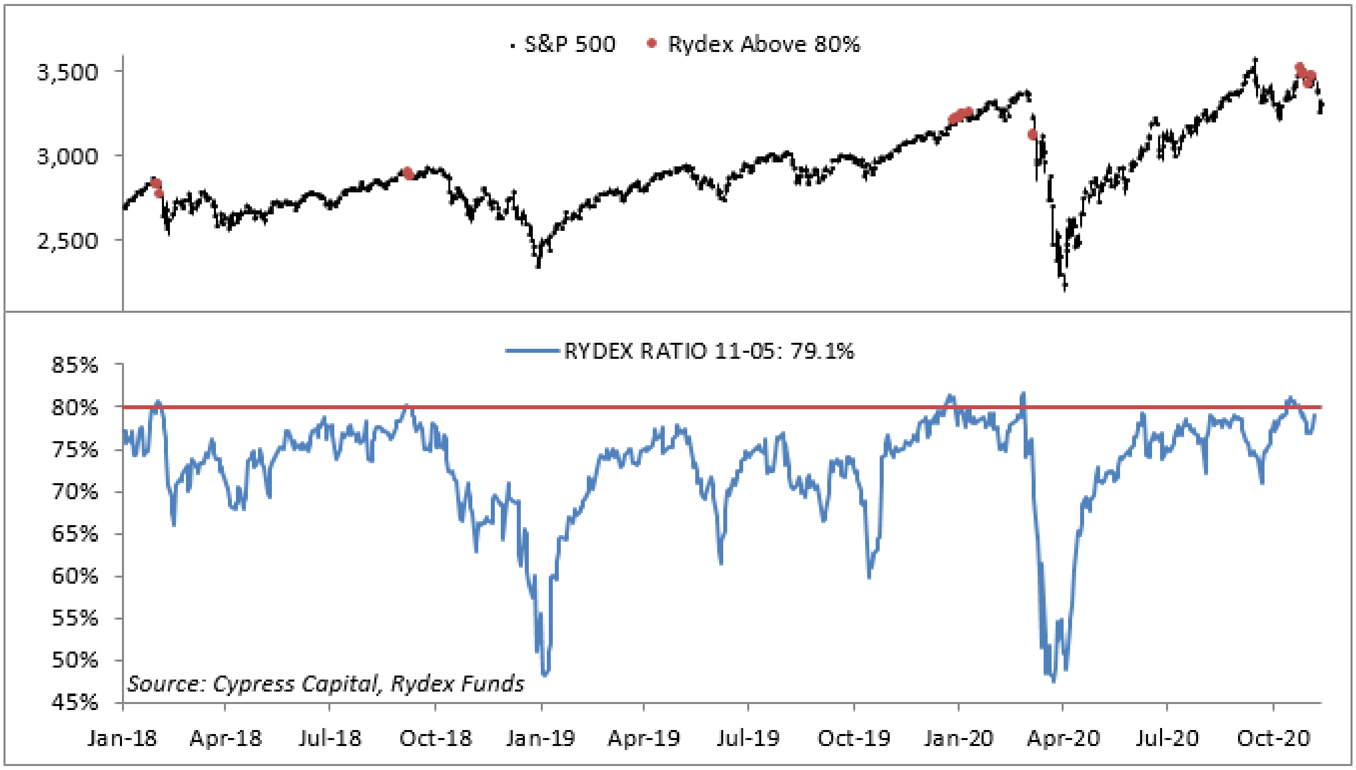
Smart versus Dumb Option Money

Smart money hedgers did back off some of their defensive positioning this week but not enough to move the needle here. We've had two clusters of warnings from options markets but no signs of the speculation breaking yet.



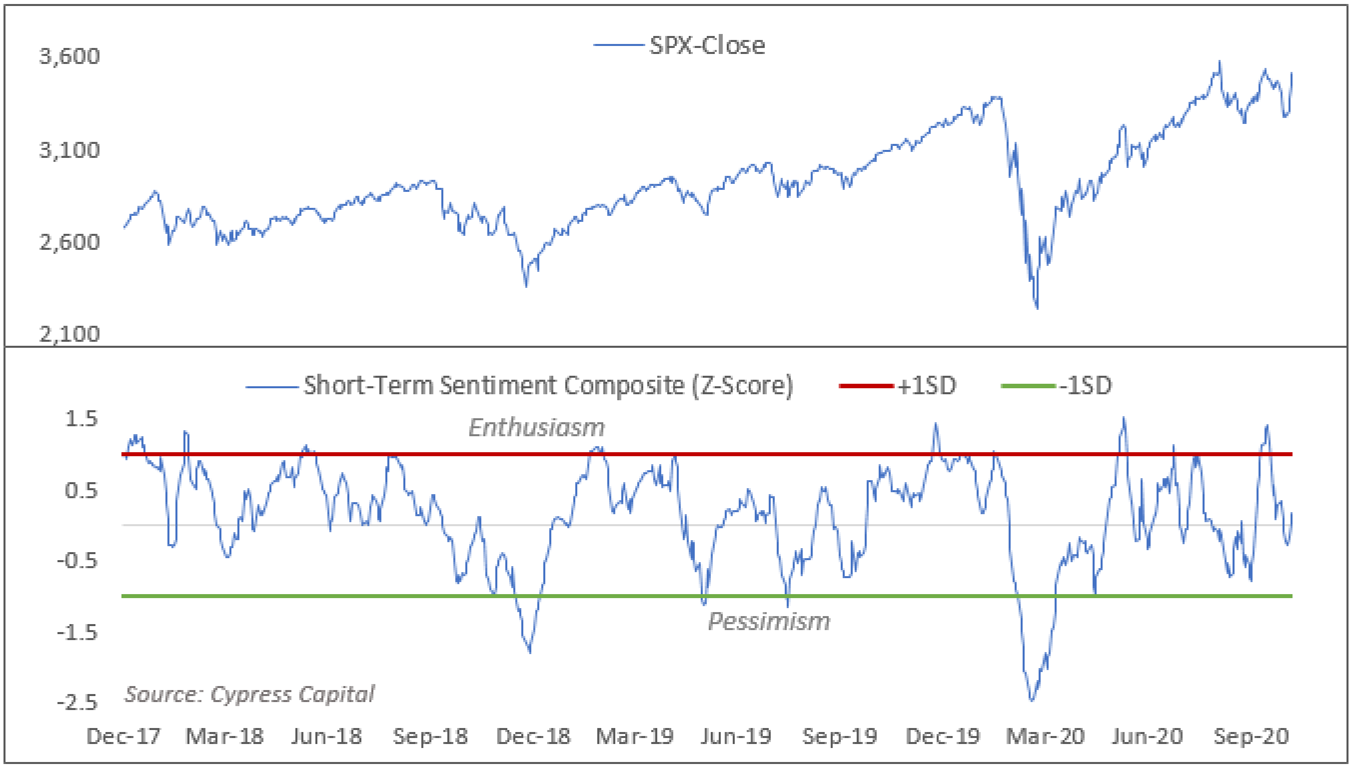
Rydex Ratio

Levered Rydex investors are holding steady, right near the 80% speculative line in the sand.



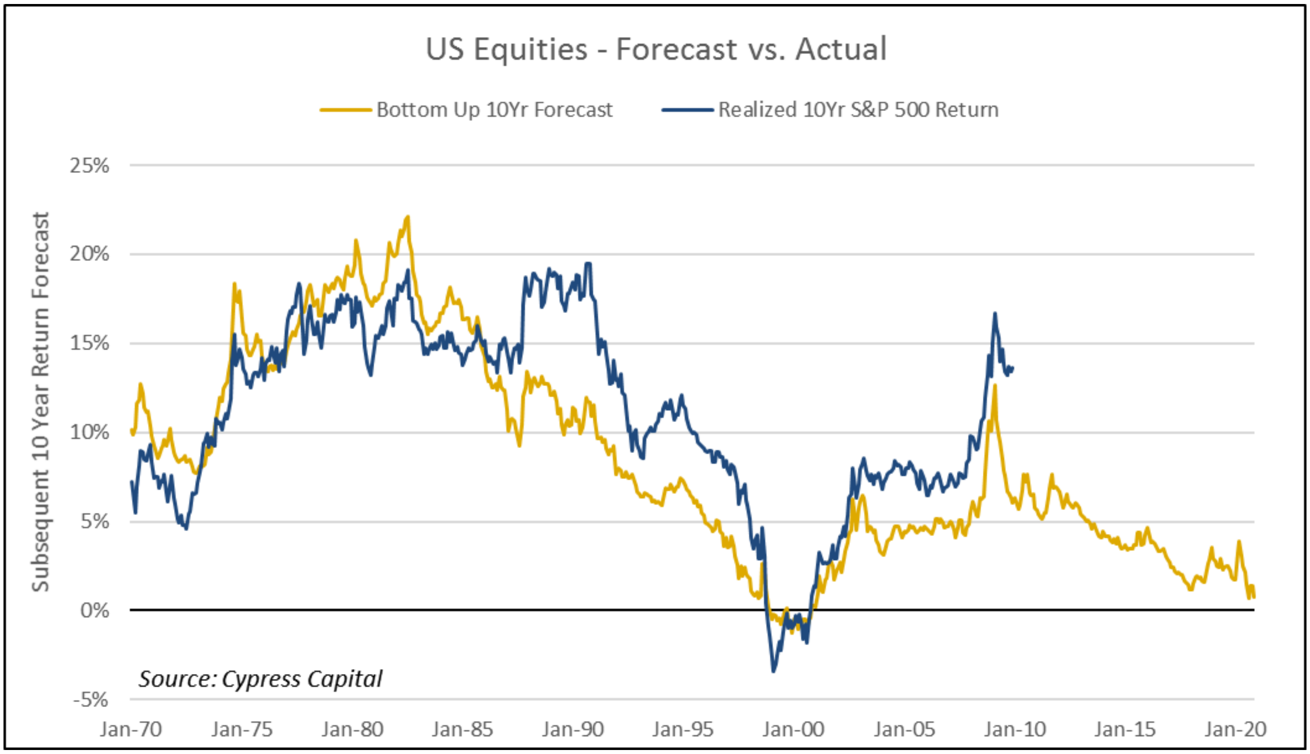
Short-Term Sentiment Composite

It did manage to briefly fall below zero, but there have been no signs of a major break in speculation from our short-term sentiment composite yet either.



Valuations – Equity Return Forecast

Valuations have driven our equity return forecast back down to match the lows seen in August, under one percent. Investors have grown numb to the elevated level of valuations in US equities that have persisted the last couple of years and have grown more speculative in spite of it. The sheer magnitude of rally off the March lows has reinforced investor confidence that only the Fed matters, not valuations.



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.