Cypress CAPITAL

Market Outlook

By Mark T Dodson, CFA

The frogs are getting warmer.

Model recommends a 10% equity allocation reduction.

Earlier this week, Seth Klarman, well regarded value hedge fund manager, likened market conditions "*to frogs in water that is slowly being heated to a boil, investors are being conditioned not to recognize the danger.*" Our Market Risk Index suggests the water temperature climbed again, to 92.9%, or 92.9 degrees Celsius for those who prefer the frog analogy.

Almost all of the deterioration was from the Monetary composite, as our inflation and interest rate categories stopped being supportive of the Monetary composite readings. They had been acting as a counter-balance to the poor readings from the Velocity and Lending & Leverage categories.

Combining the record euphoria readings from our psychology composite and near record valuations, the deterioration in our monetary composite was enough to push our model into recommending a decrease in equity exposure by 10%, to 25% underweight. This is the most defensive the model will become with a market that possesses as much strength in both momentum and breadth as this one. We suspect this increase to cash will be short-lived and will reverse on even a modest correction.

Meanwhile, there has been no letup in euphoric sentiment toward markets, with anecdotes from both traditional media and TikTok videos showing classic signs of a bubbly FOMO market. The valuation metrics that still compare favorably to the dot-com era are all within 10-20% of making this a new, definitive high watermark for irrational exuberance in US markets.

Note – after receiving several requests for it, you'll notice that we have added the allocation recommendation to the table on the right. In all but the most extreme market environments, the weightings will shift between -25% and +25%. Over the course of a market cycle, the weighting should average 0%, representing a neutral, strategic weight in equities. For a 50/50 investor, it would imply making tactical shifts between 25/75 to 75/25 as the market cycles from overvalued and over-bullish to undervalued and over-bearish.

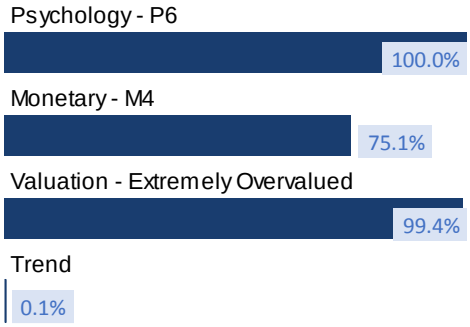
The shifts are identical to the way that we have previously reported them – the only adjustment is in its presentation, so that it better aligns with how our managed portfolios vary in their risk tolerance and base allocation to equities.

Market Risk Index

Rec Allocation 25% Underweight

92.9%

Category Percentiles



Largest Psychology Influences

Levered Investments	Negative
Surveys	Negative
Option Activity	Negative
Fund Flows	Negative

Largest Monetary Influences

Velocity	Negative
Monetary Aggregates	Negative
Lending and Leverage	Negative

Valuation

7-10 Year Rtn Forecast	0.5%
10Yr Treas Yield (on 01/20)	1.1%

Market Trends

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

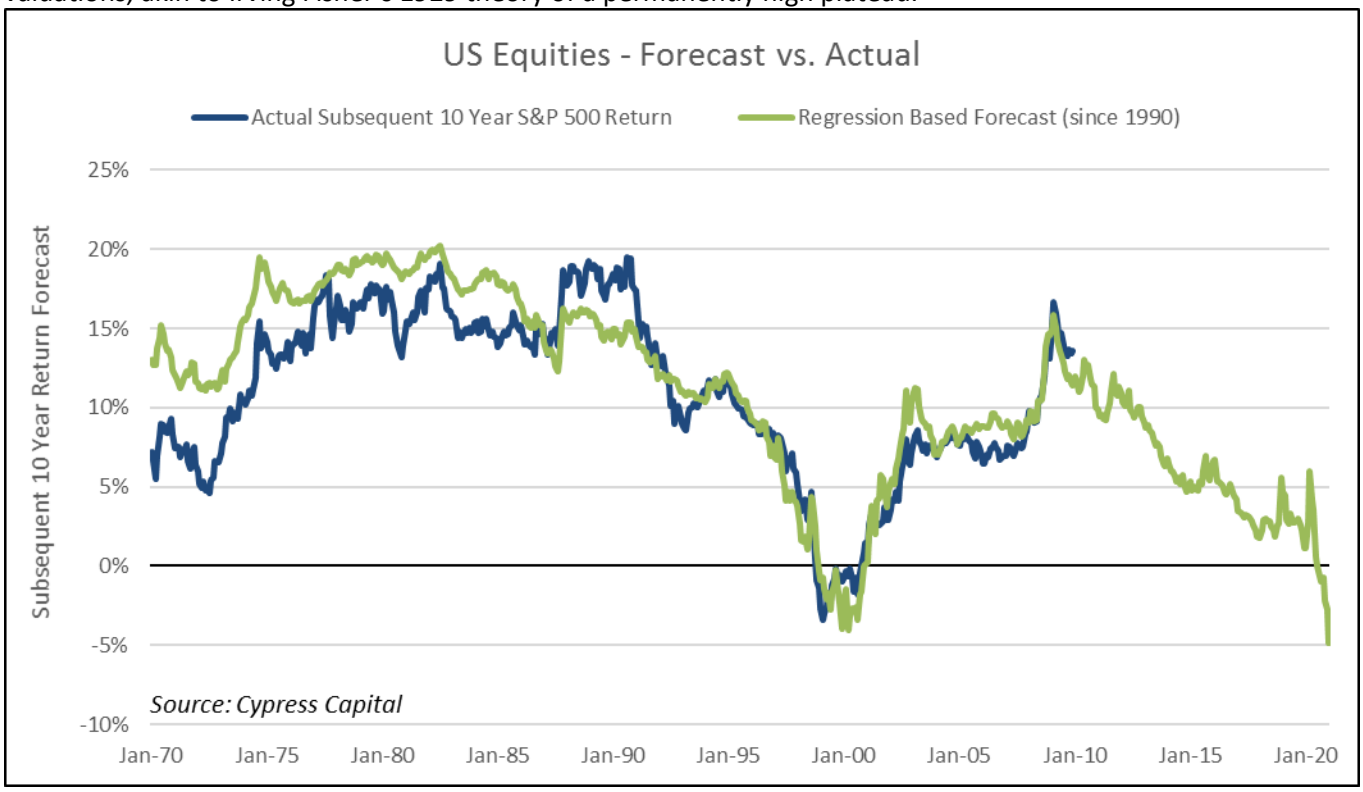
Market Risk Index scales from 0 to 100%. Higher readings correspond with higher risk markets. Scores below 25% are bullish. Scores between 25-75% are neutral, and scores above 75% are markets vulnerable to major drawdowns.

Quote of the Week

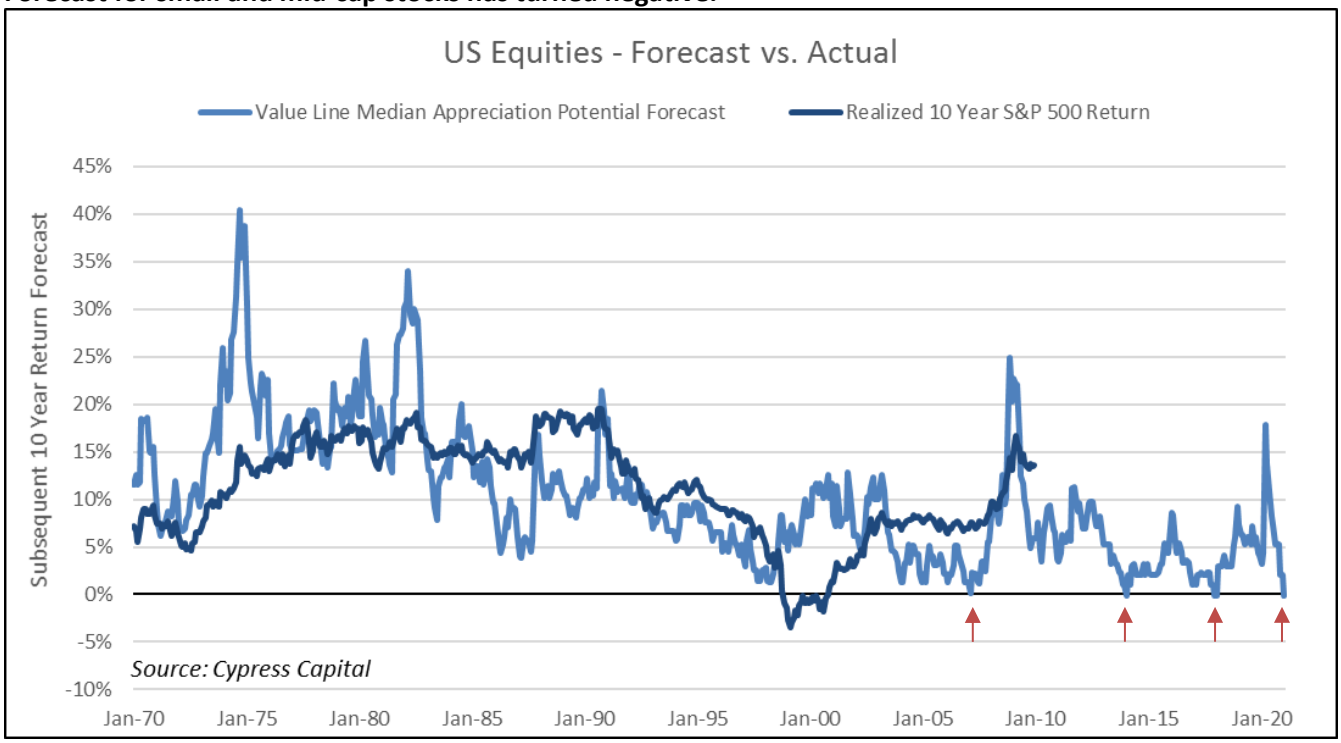
"All of a sudden I'm hearing people saying, 'I'm a millionaire now!' and I'm like, 'Oh my God, I literally could have been you...I didn't do too much research. I was just thinking, 'Let me just get in there any way I can...I just wanted to be a part of it...The world is changing...America could literally flip to crypto tomorrow, and I don't want to not have any crypto to my name." - Amber Wells, 23, of Atlanta, on her recent initial purchase of Bitcoin
Source: Bloomberg

Charts of the Week

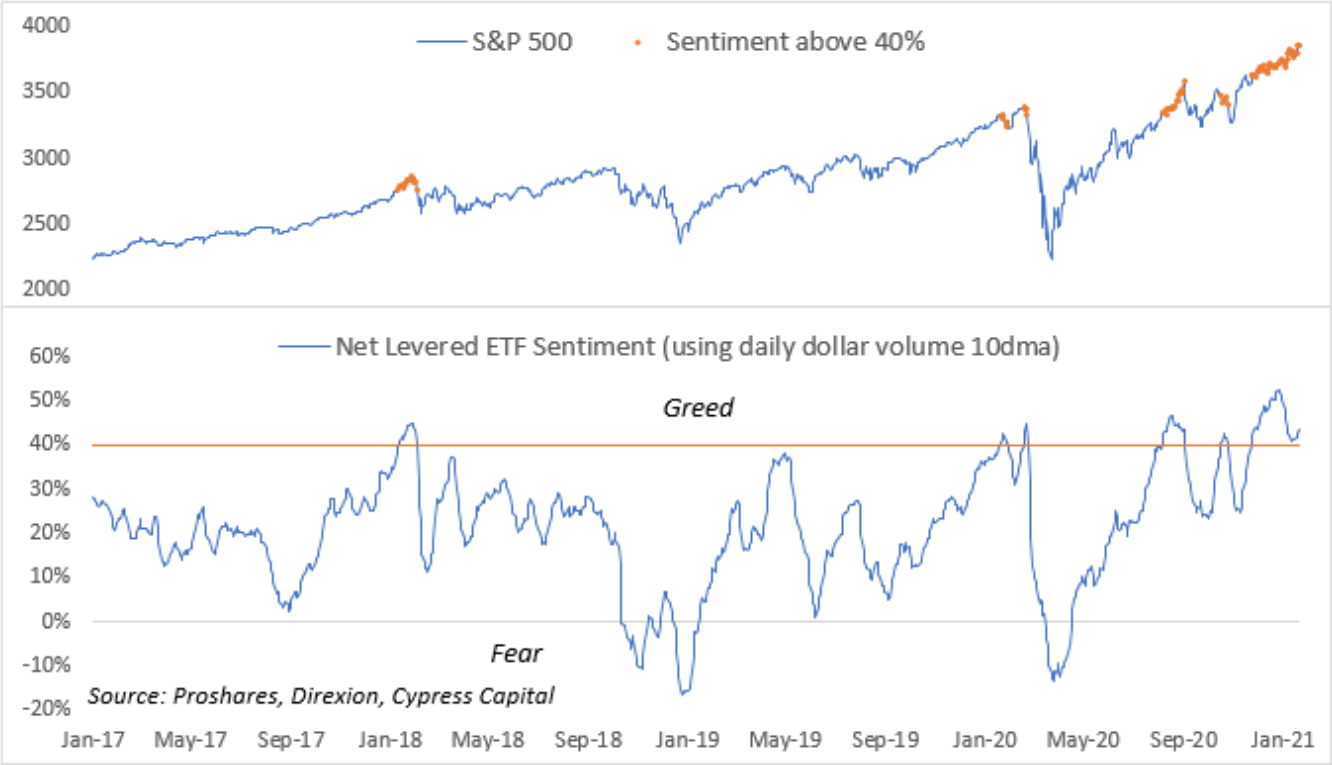
Regression based return forecast for big stocks falls below the dot-com era.
The green line represents a best fit line with returns and a composite of seven valuation metrics since 1990, the era when valuations began to trend higher. (Notice how tight the fit is with returns from the period from 1990 forward.) In order for the relationship to break down, equities will have to enter a new, new era of ultra-high valuations, akin to Irving Fisher's 1929 theory of a permanently high plateau.



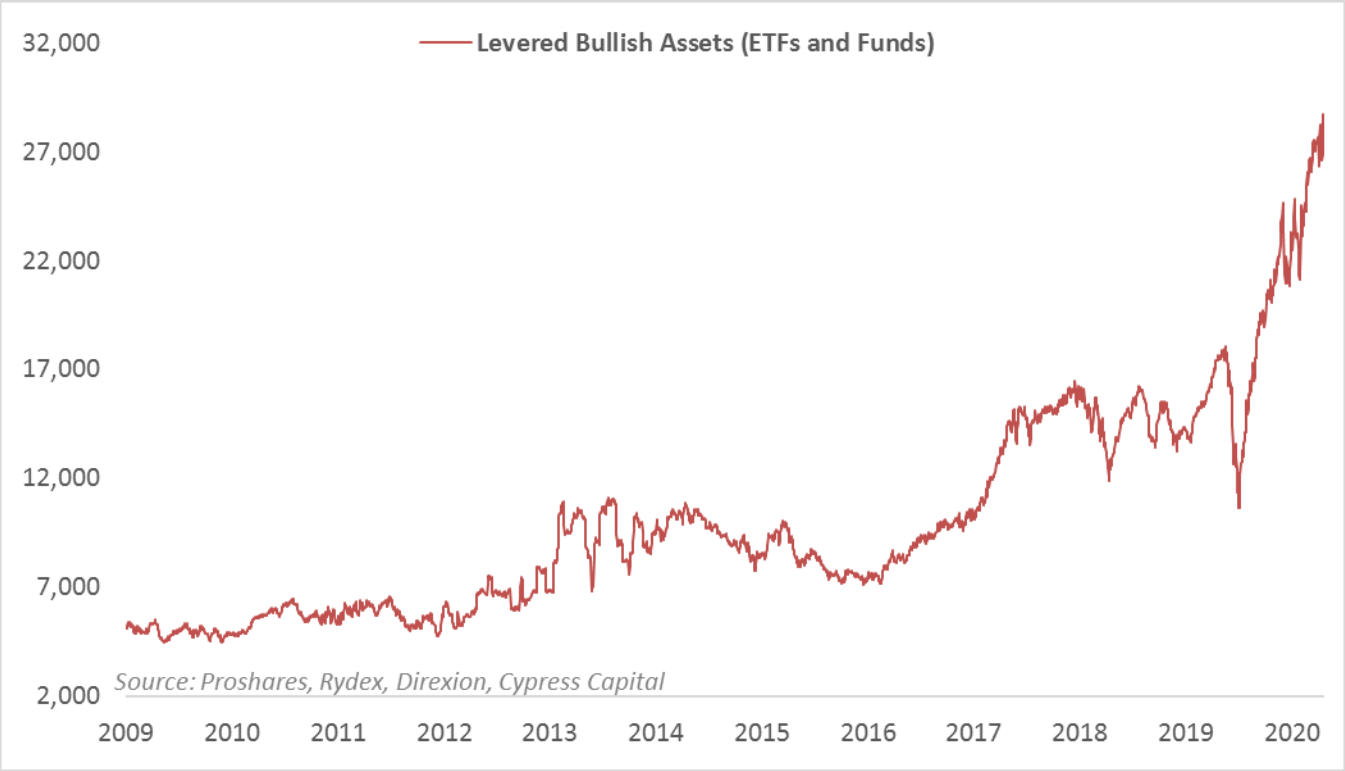
Forecast for small and mid-cap stocks has turned negative.



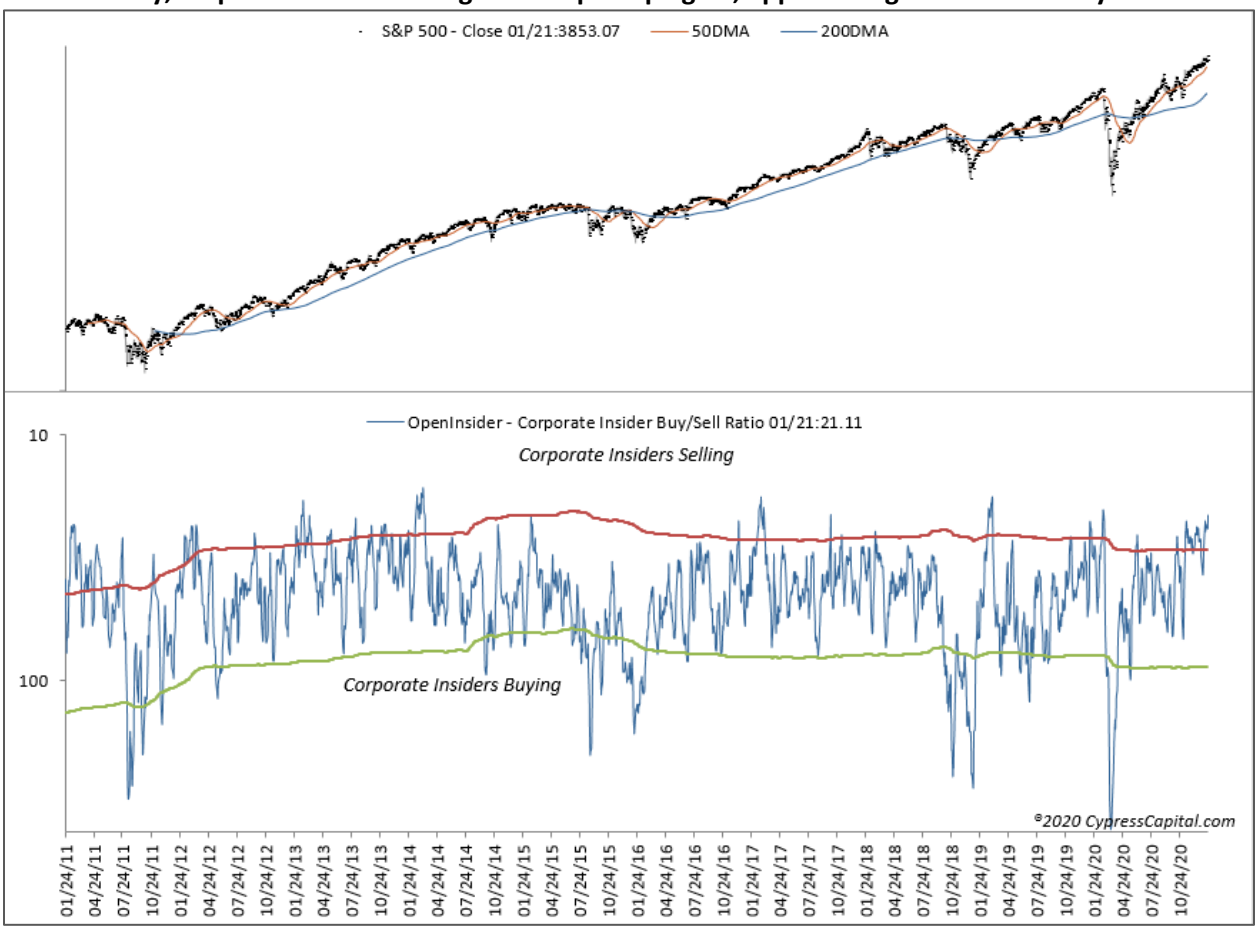
Volume flowing into levered assets has been camped in the red zone longer than we have ever seen.



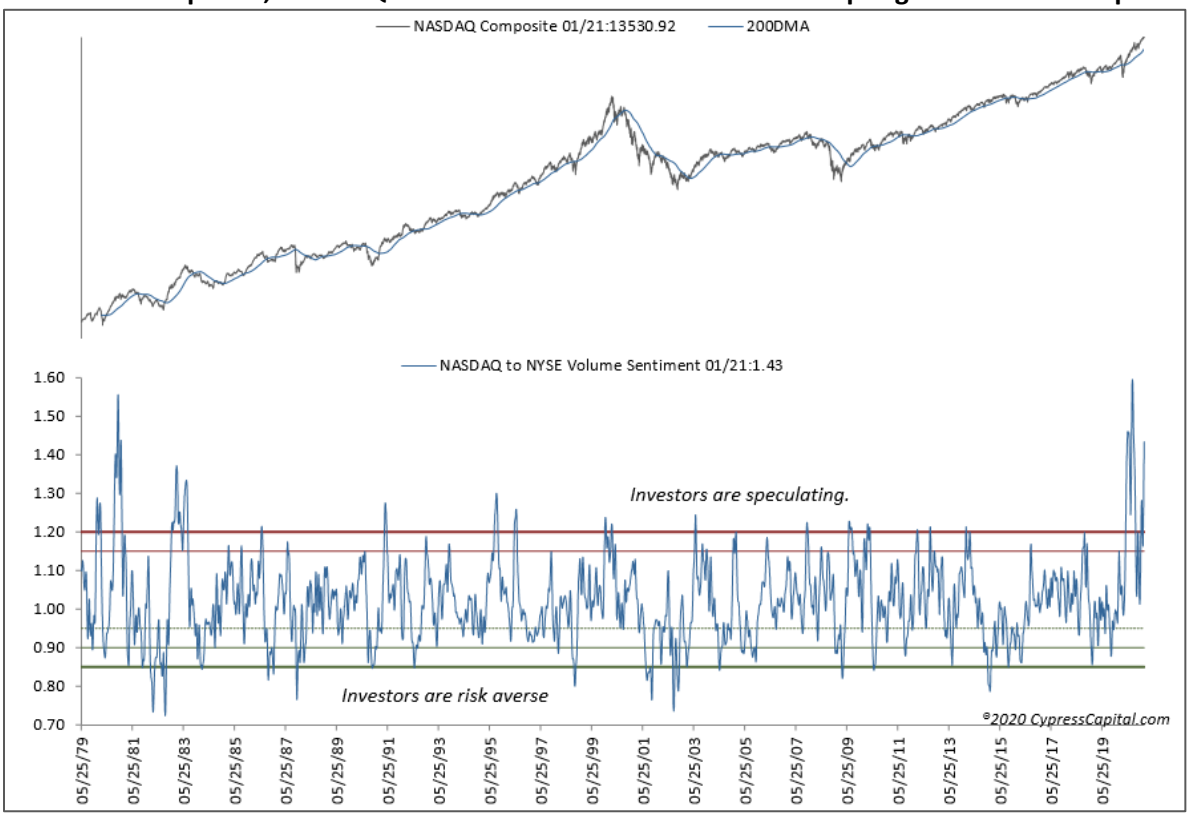
The volume is causing Levered Bullish assets to climb a slope that's also unlike anything we have ever seen.



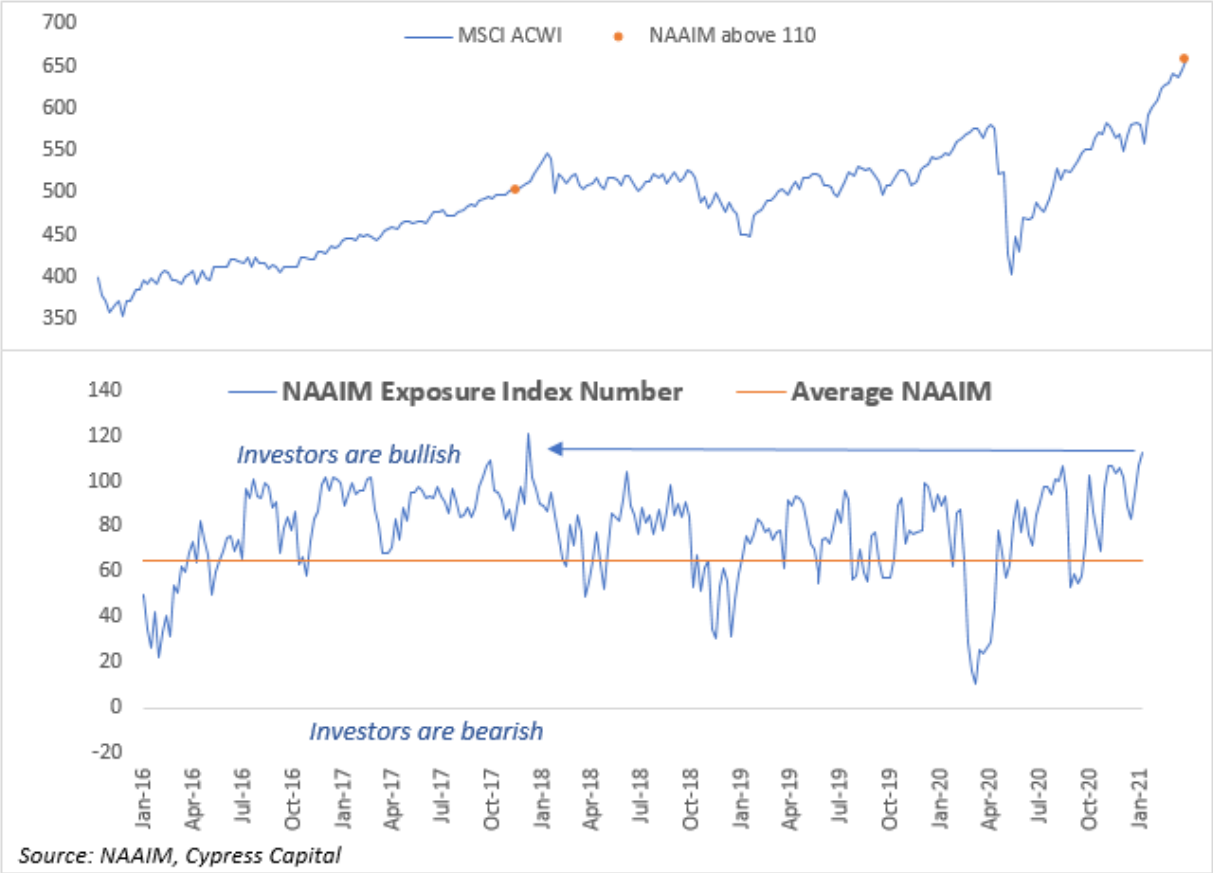
Smart money, corporate insider selling has ramped up again, approaching levels from early 2020.



After a short reprieve, NASDAQ to NYSE Vol Sentiment index is attempting to make a new speculative high.



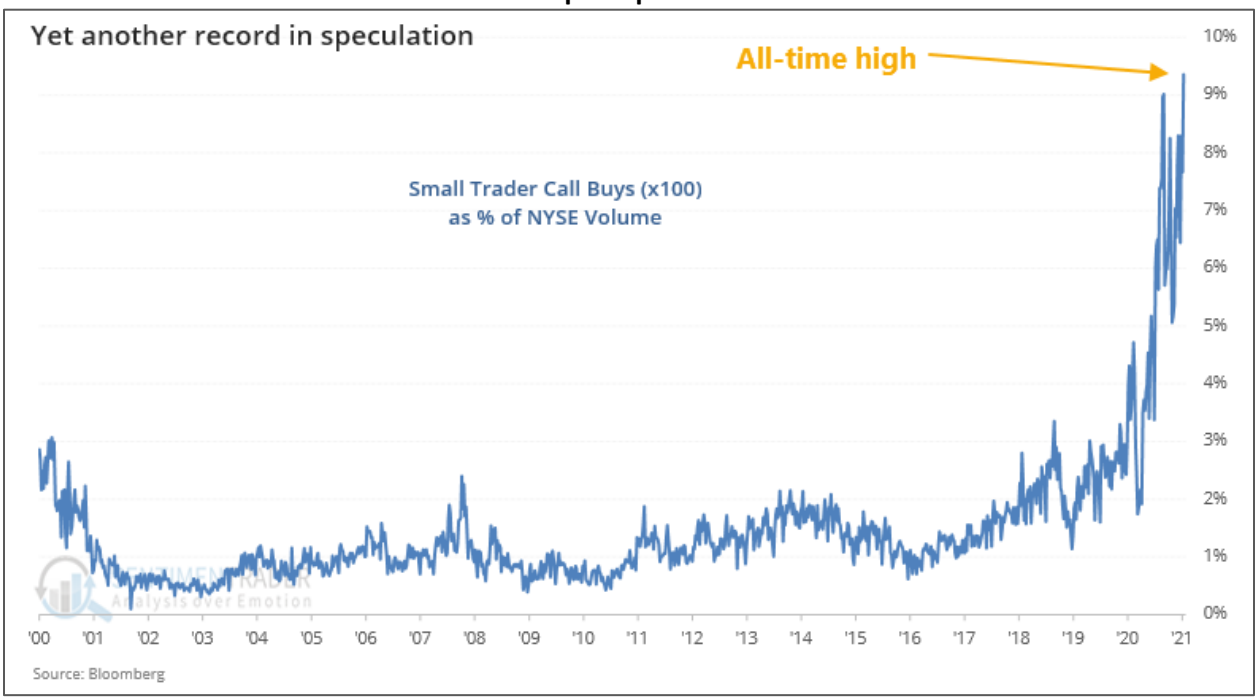
Active Investment Managers are levered up and close to record investment exposure.



Fund Managers are maximum risk-on.

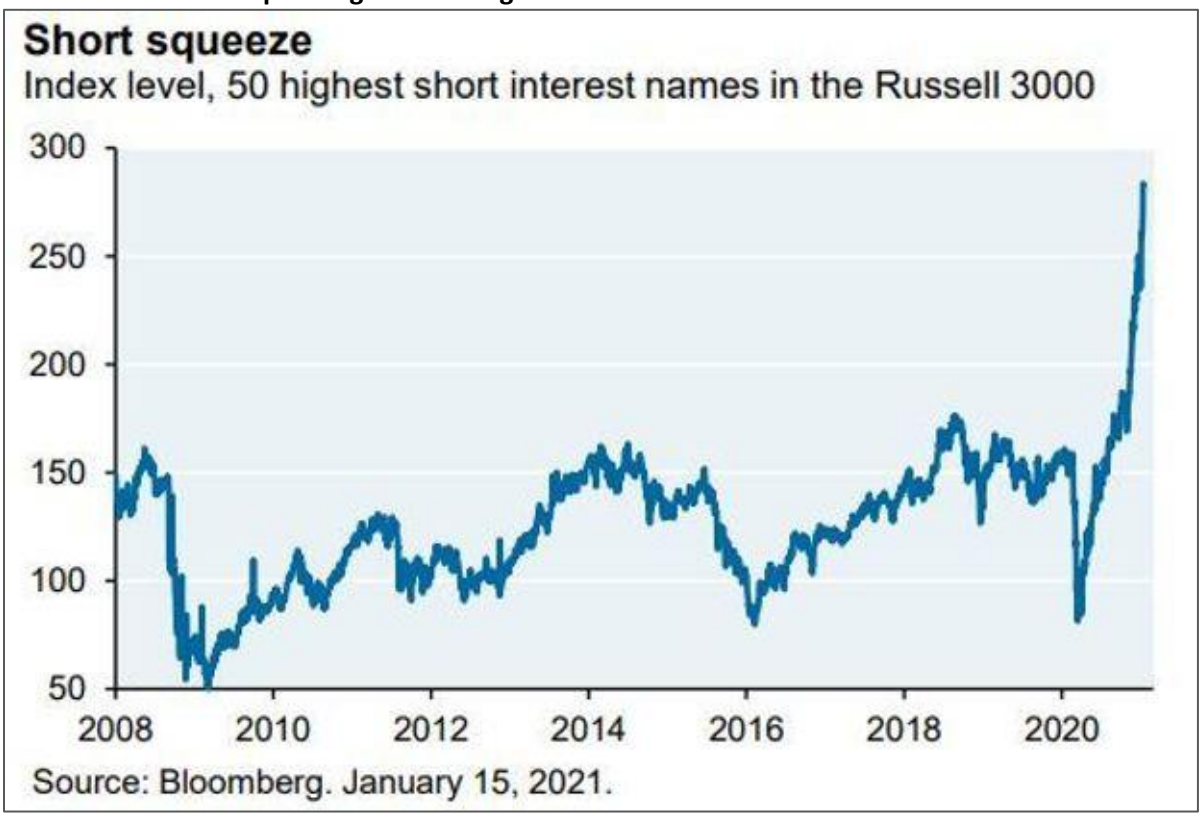
Source: BofA

Retail Traders set another new record in call-option purchases.



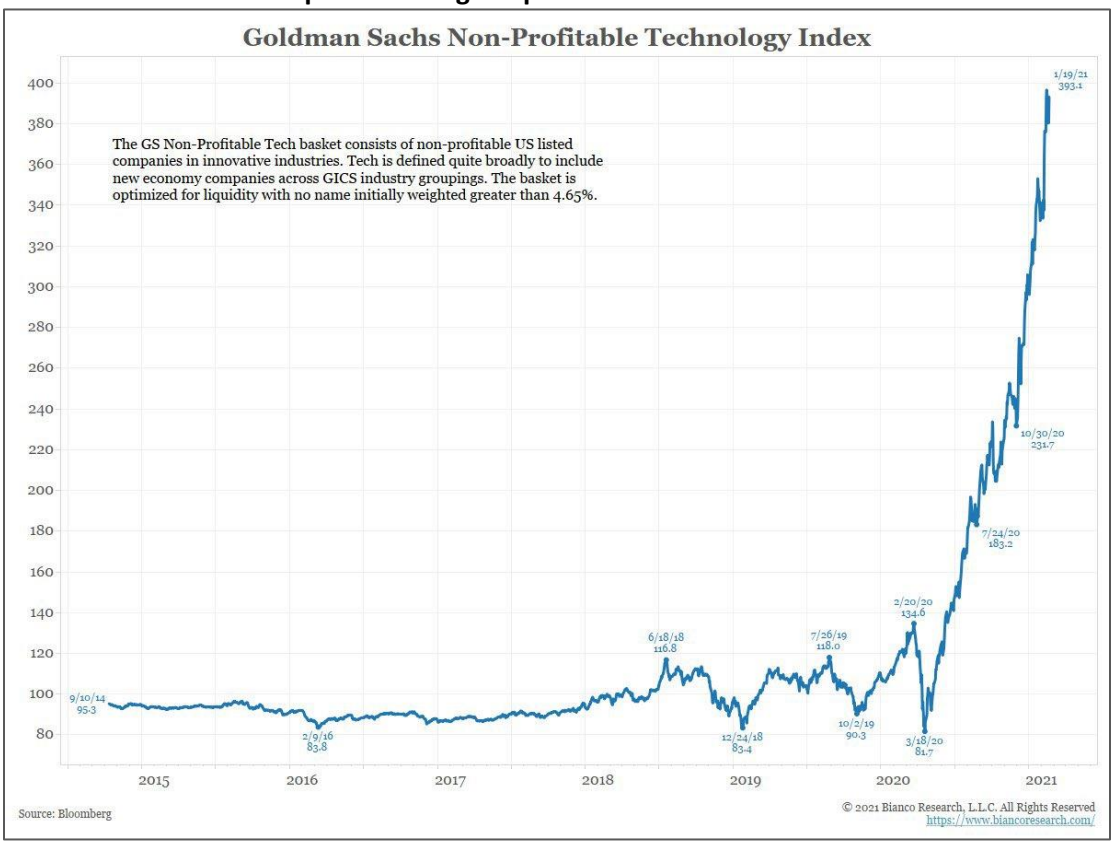
Source: SentimenTrader

Retail investors are squeezing all the hedge funds' favorite shorts.



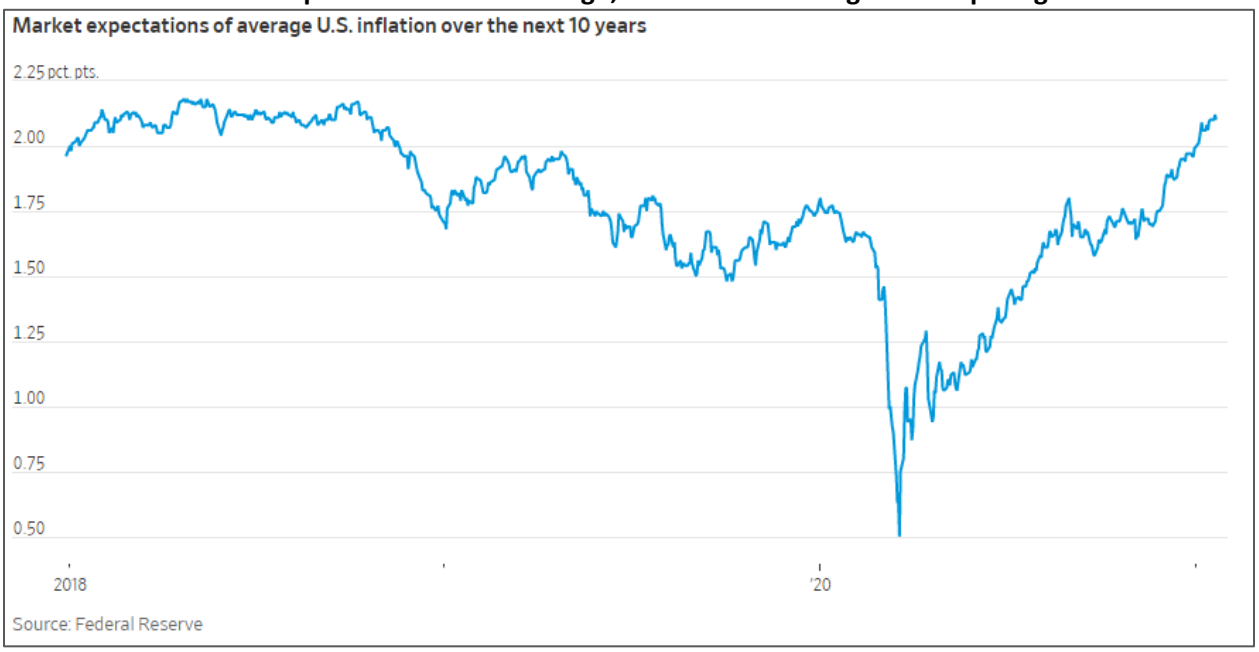
Source: MarketWatch, Jesse Felder

Non-Profitable Tech companies have gone parabolic off the March 2020 lows.



Source: Bianco Research

The last time inflation expectations were this high, the Fed was talking about tapering.

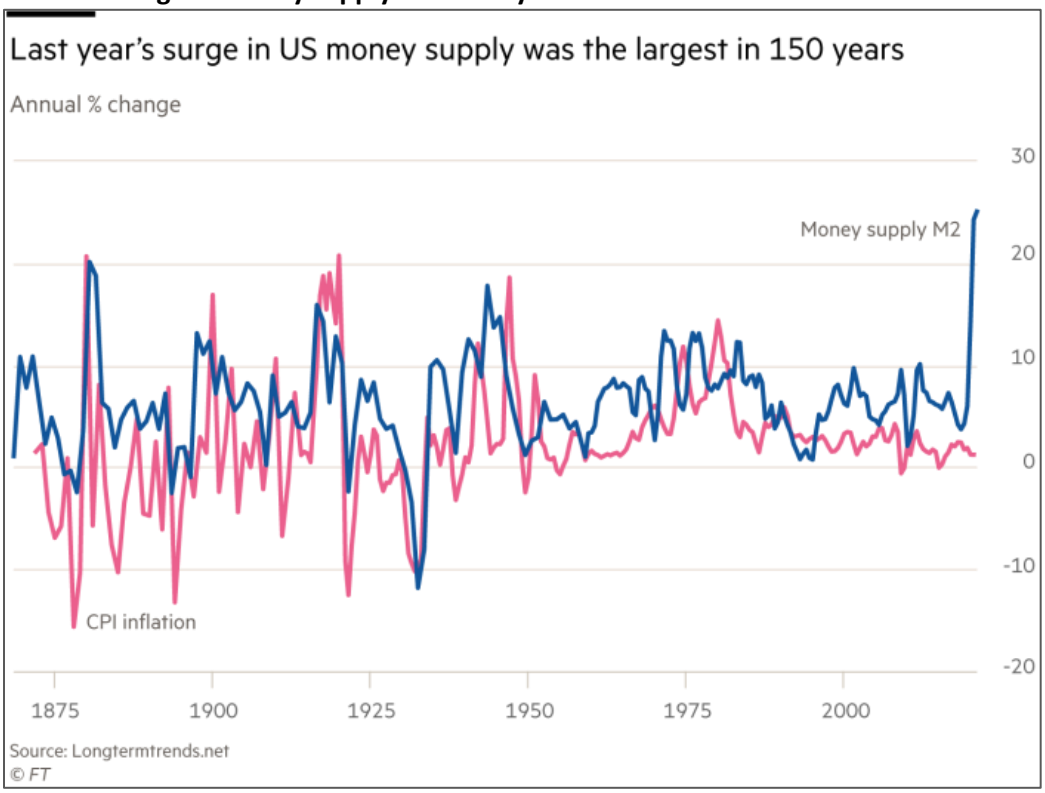


Source: WSJ

Home Price Inflation continues to accelerate.

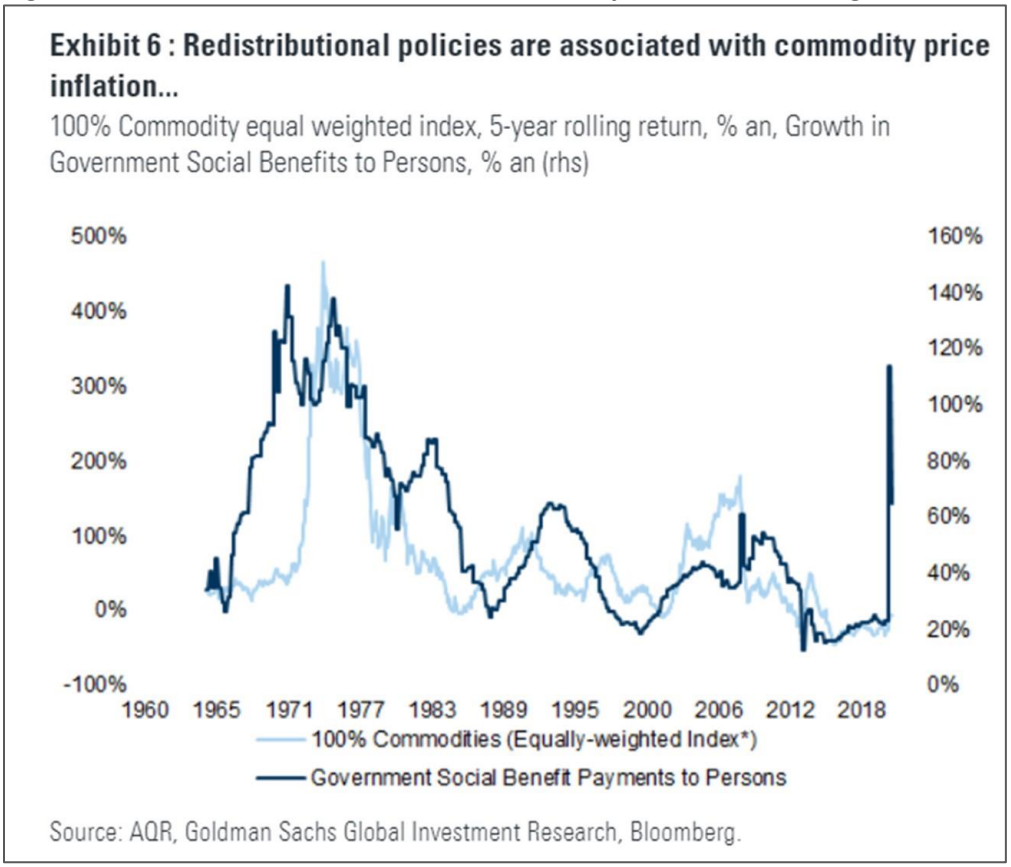
Source: Arbor Research

The 2020 surge in money supply set a 150 year record.



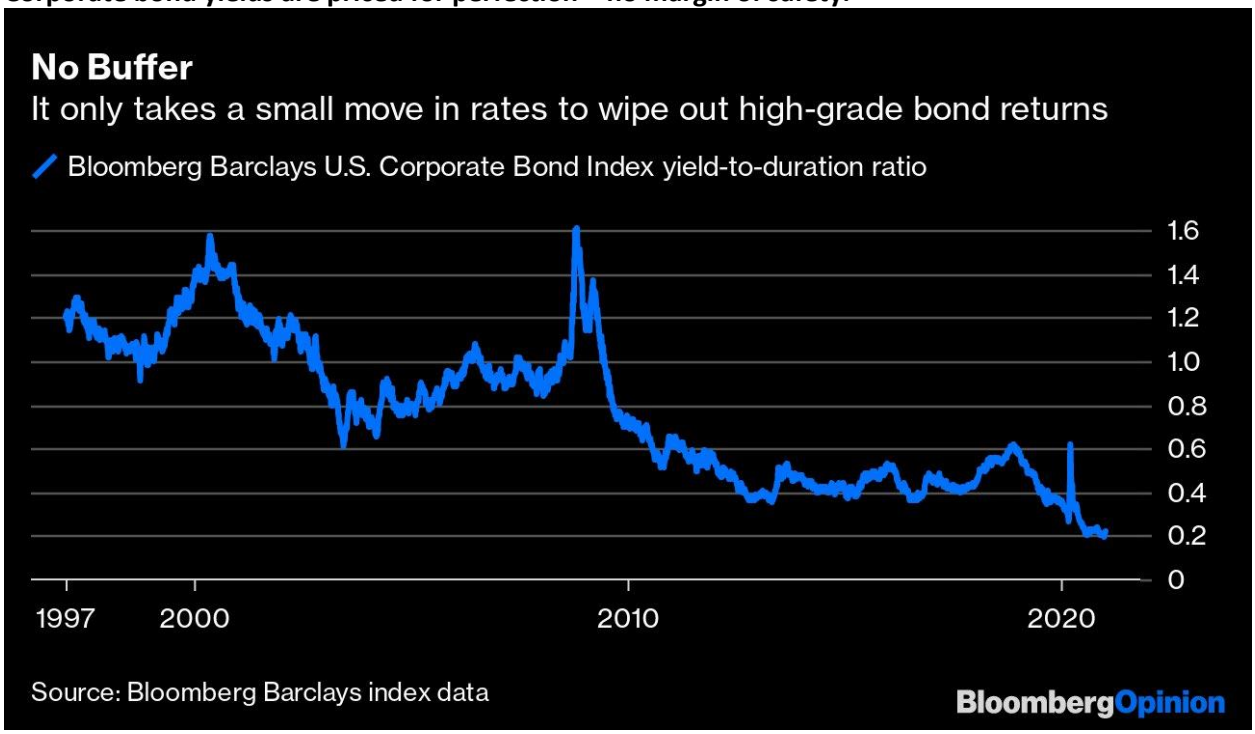
Source: Financial Times, Jeremy Siegel

Big Increases in Government checks are historically associated with big increases in commodity prices.



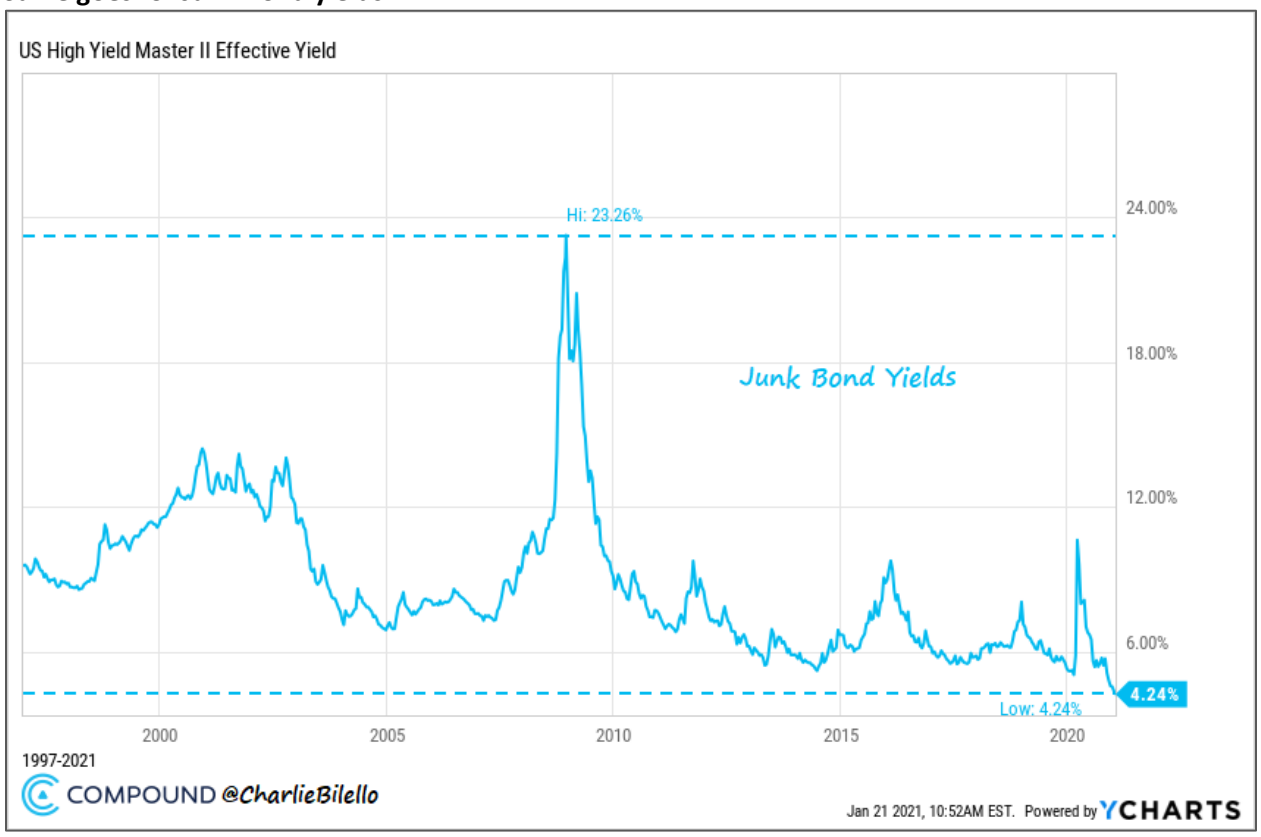
Source: Jeroen Blokland

Corporate bond yields are priced for perfection – no margin of safety.



Source: Bloomberg, Jerome Blokland

Same goes for Junk Bond yields...



Source: Charlie Bilello

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.