Market Outlook

By Mark T Dodson, CFA

Market Risk Index

Rec Allocation 25% Underweight

86.9%

Category Percentiles

Category	Percentile
Psychology - P6	98.8%
Monetary - M4	58.8%
Valuation - Extremely Overvalued	100.0%
Trend	0.1%

Largest Psychology Influences

Levered Investments	Negative
Option Activity	Negative
Fund Flows	Negative
Insider Sentiment	Negative

Largest Monetary Influences

Inflation	Negative
Interest Rates	Negative
Velocity	Positive

Valuation

7-10 Year Rtn Forecast	-0.3%
10Yr Treas Yield (on 06/08)	1.5%

Market Trends

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

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.

Don’t fight the Fed - Front-run them.

Market Risk Index improved but remains range bound and too elevated to recommend an increase to equity allocations. Investor sentiment improvements have proven elusive, and the leading inflation headwind inside the monetary composite could take several months to resolve itself. A summer correction would improve both.

The Bank Sentiment category has shifted to positive readings for markets within the psychology composite, as banks have opened their balance sheets up for lending again. The only other two positive categories are Technical Indicators and Trading data, both of which have considerable overlap in the kind of data they are measuring - highlighting a market that is mostly free from any major technical flaws.

The rest of the eight categories are negative, and at least four of those are maximum negative. Those four categories reflect aggressive risk-taking on behalf of investors and the extreme investor euphoria that it implies. Option Activity has gone back to being one of the largest detractors for psychology. The buy signal from our de-trended equity put/call ratios turned out to be what we mentioned was a possibility, just a short pause followed by a fresh push by investor psychology back into uber-euphoric territory. Fueled mainly by the speculative move in AMC, the equity put/call ratio is taking a shot at challenging the 2021 lows. It is growing hard for anyone to argue that this environment looks different than the persistent euphoric behavior that we saw a little over 20 years ago in US markets at the pinnacle of the dot-com bubble.

We learned that core CPI is growing at the fastest pace in 30 years this week, but a rally in the bond market suggests that the bond market vigilantes aren’t too concerned about it. However, signals from the bond market vigilantes might have some noise in them, as the Federal Reserve has been mopping up 50-60 percent of Treasury issuance since the onset of the pandemic[i].

Inflation will continue to drive headlines all summer. Housing prices make up nearly 40% of CPI, and it’s an imputed value based upon rents. Rent prices have just started to accelerate, and with the ratio of home prices to rent at all-time highs, the price pressure on rents is higher, not lower.

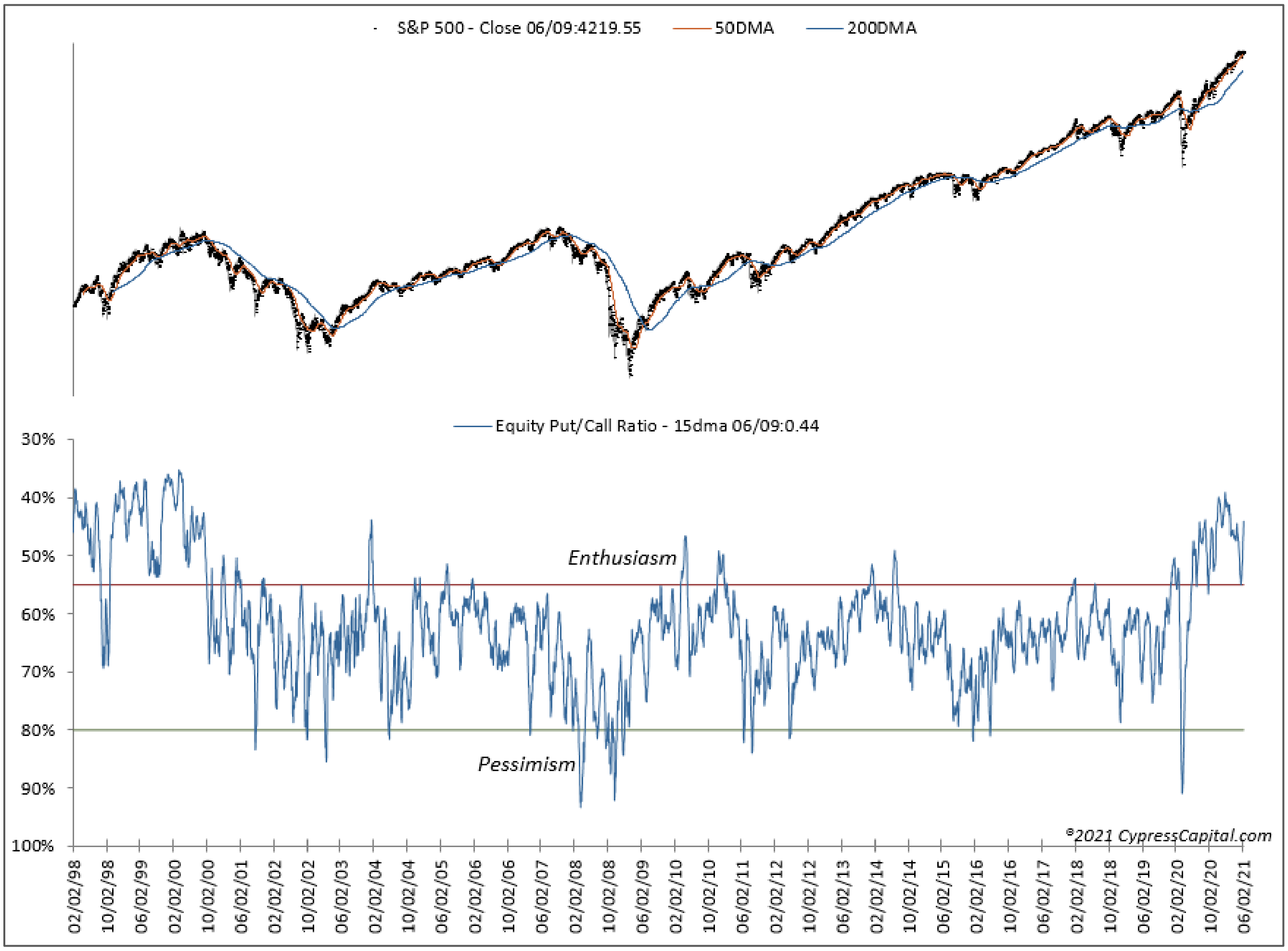
Milton Friedman described the Quantity Theory of Money like a game of hot potato. If money demand is stable, meaning we all prefer holding a specific amount of dollar bills, then dropping a bunch of money from a helicopter will lead to the public all trying to spend that money to get back to that preference. It’s a futile attempt to get rid of the money like it's a hot potato. Futile, because in the end, the only thing that goes up is prices, and the feeling of having received a windfall of wealth becomes illusory. This monster drop of liquidity and government spending has borne out that theory. Flush with cash, we've been in a mad dash trying to spend our World War levels of stimulus money. When a round of hot potato ends, what determines where inflation is transitory or not will depend on the timing and magnitude of continued Federal printing and spending.

We care less about the policy and more about our wallets, and our inflation basket of indicators suggest it's a riskier time to press those stock market bets. There aren't many indicators in our arsenal that have timely warnings of stock market weakness, but this category is one of them. Better to wait for inflation pressures to recede. Historically, this only comes with policy changes, recessions, and/or severe market corrections. With lots of notable eggheads *not at the controls* taking up their pens to write editorials and warn of the danger of current Fed policy, we expect it will make eggheads who are *at the controls* blink.

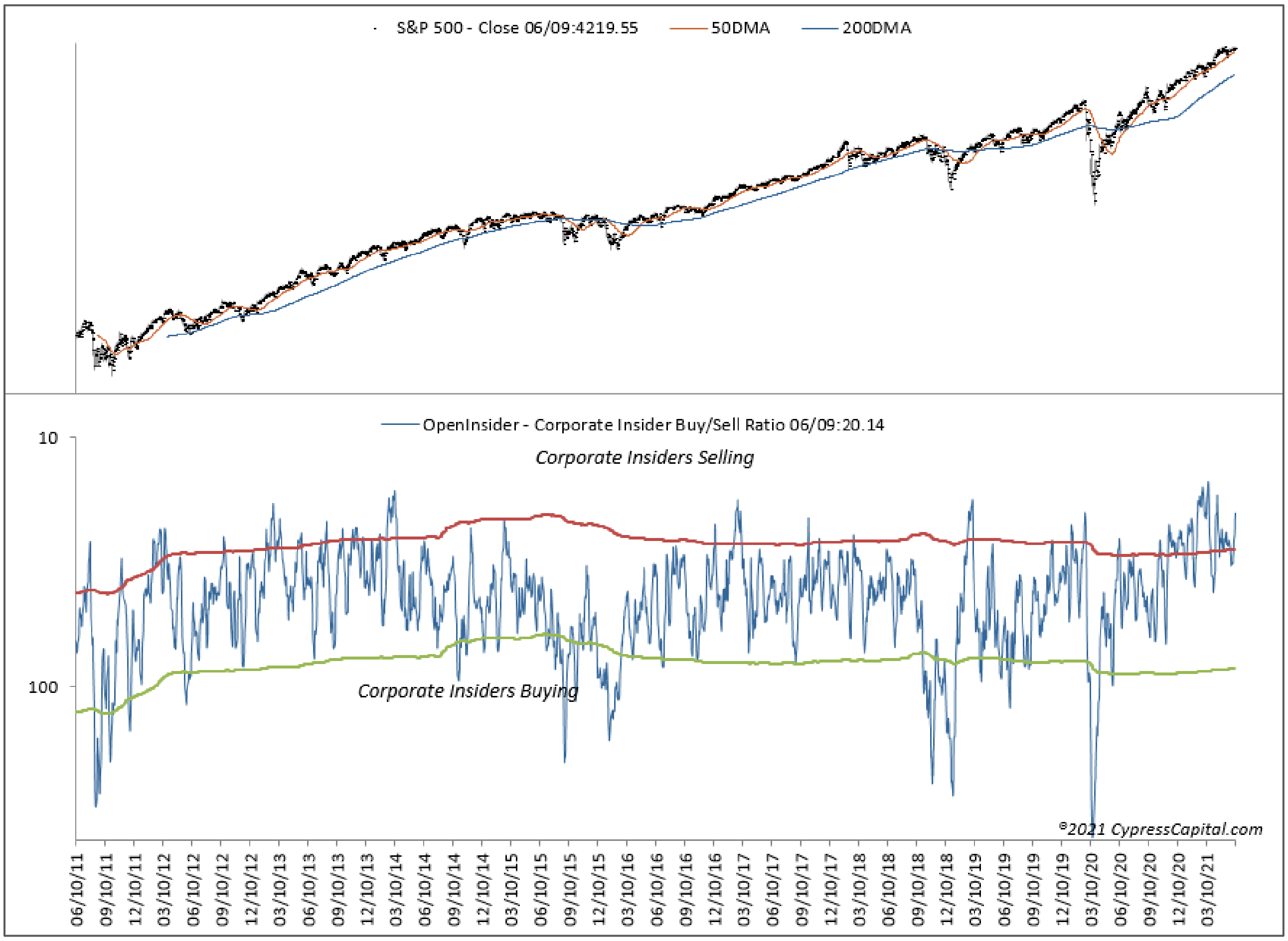
Can World War levels of spending and printing persist in an environment with dot-com era euphoria and valuations, while inflation pressures are building in a way unseen in a generation? Don't Fight the Fed is a well-known market axiom, for a good reason. However, it doesn't mean that you can't front-run the Fed as well with some of your assets.

Charts of the Week

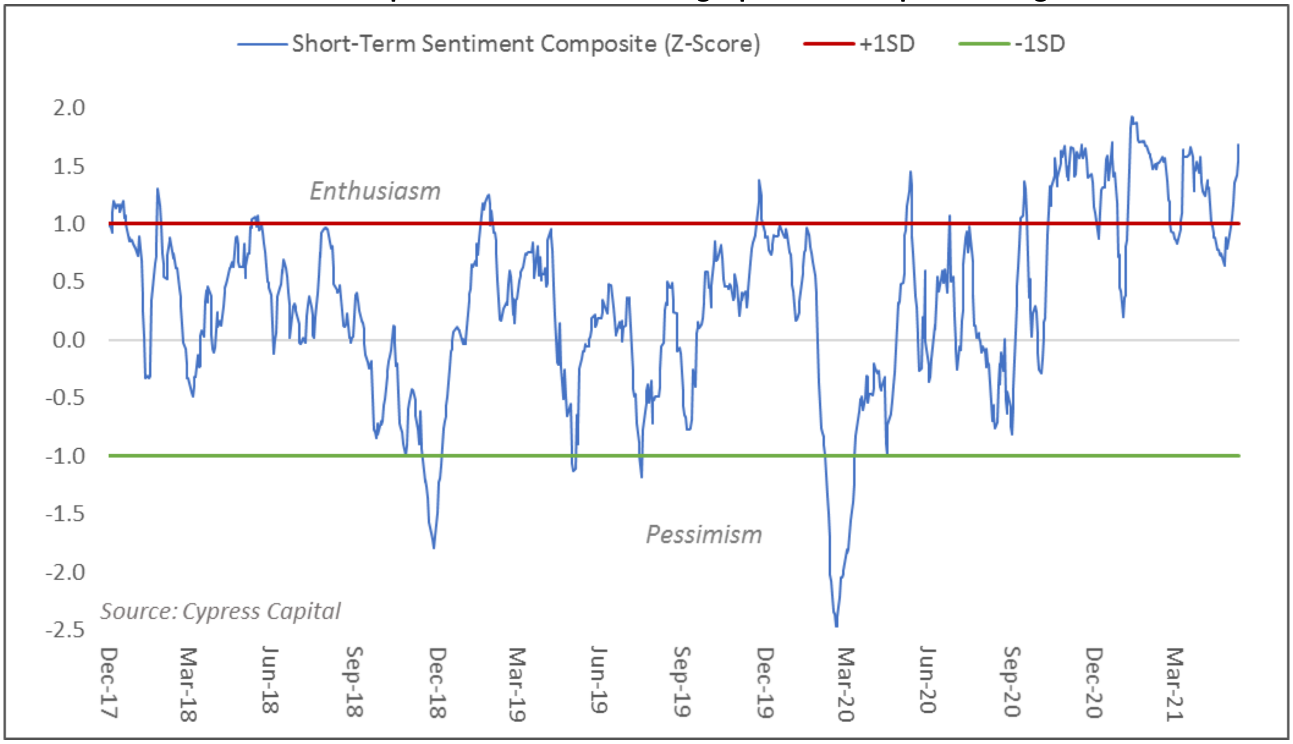
Another resurgence in equity call buying is pushing the equity put/call ratio toward the 2021 lows.



There has also been another resurgence in Corporate Insider selling.

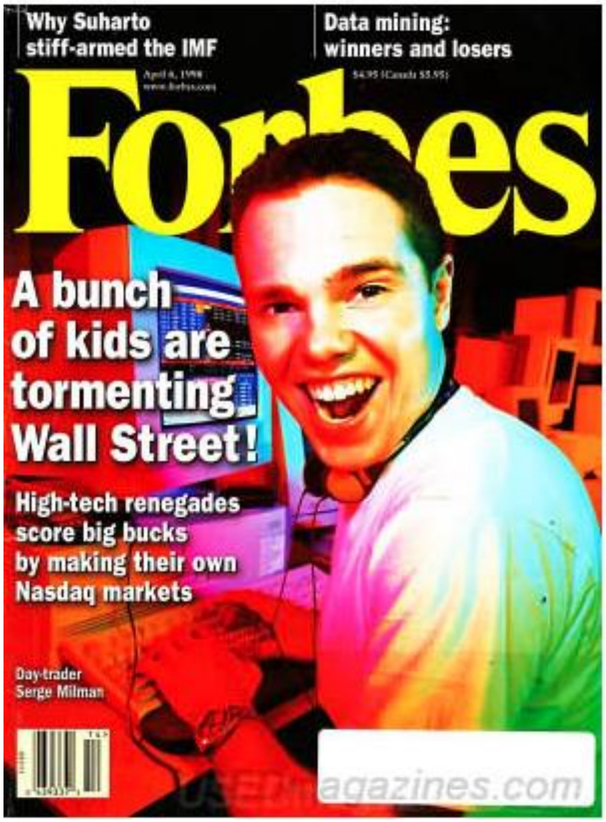


Our Short-Term Sentiment Composite also started making a push toward previous highs.



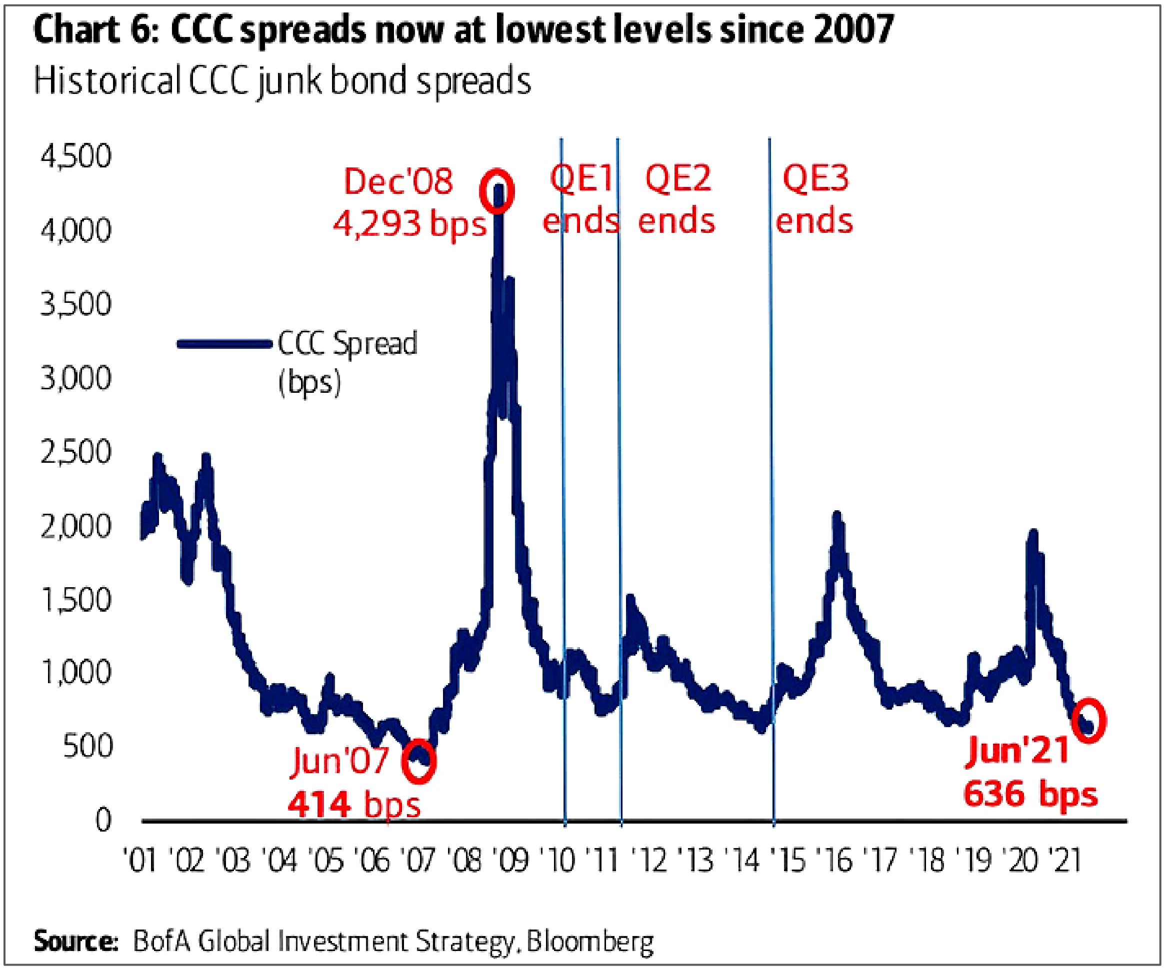
MS Market Timing Indicator is in line with its all-time high from 2007.

A Forbes magazine cover and headline from 1998 that could have easily been recycled in 2021.



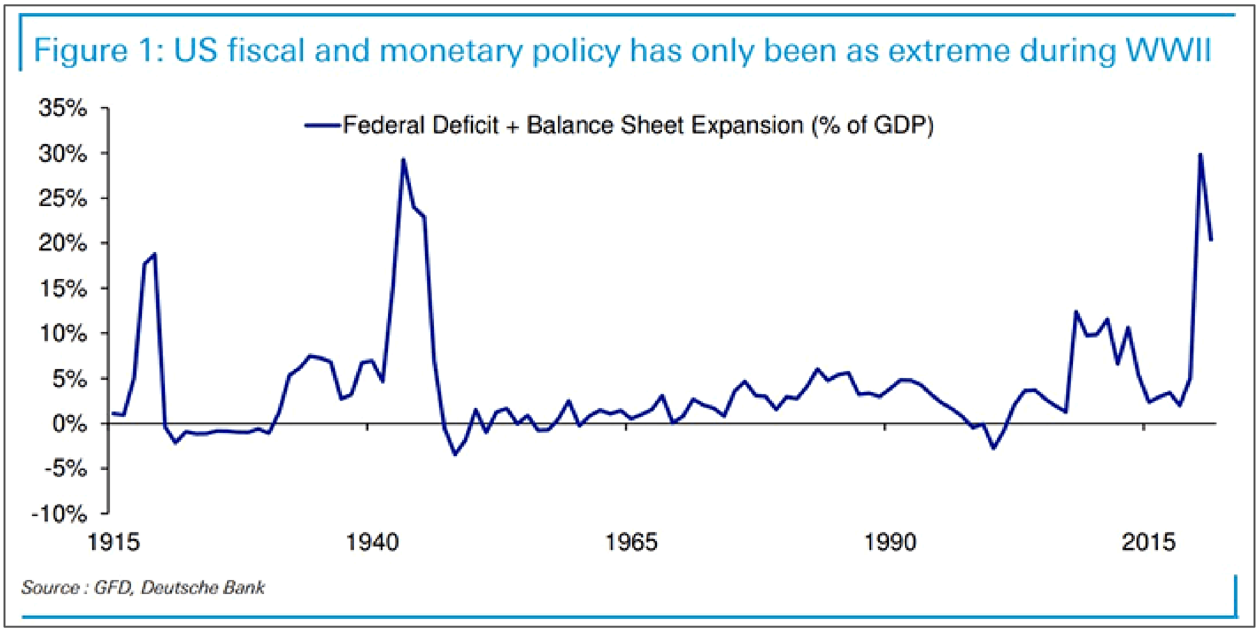
Source: Brian Sullivan, @SullyCNBC

Junk spreads hit the lowest levels since 2007.

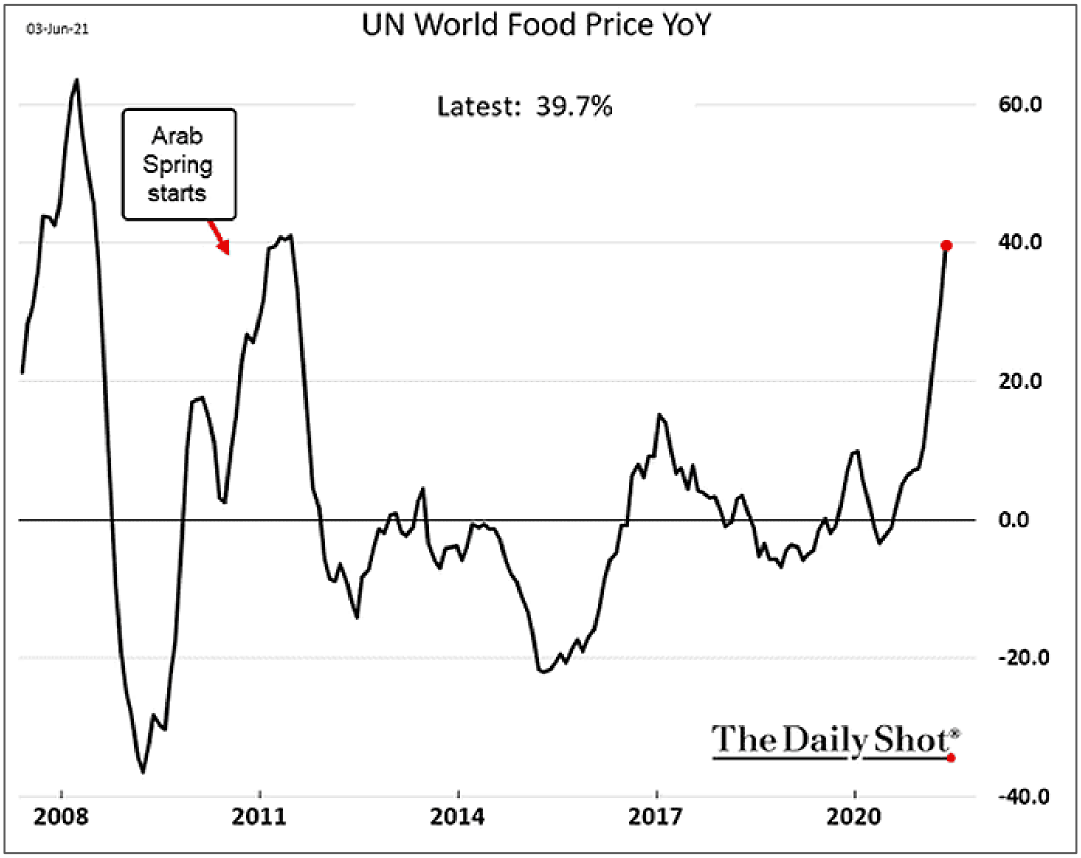


Loosest Financial Conditions in four decades.

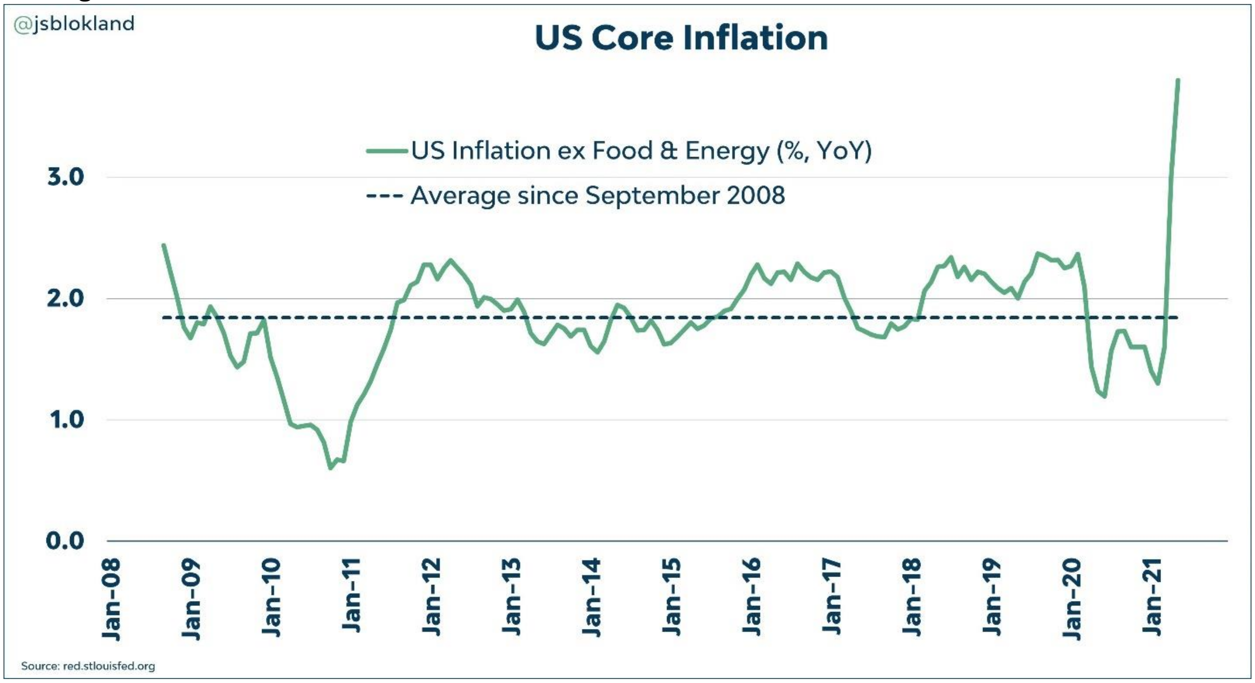
Fiscal and Monetary Stimulus combined have matched WWII.



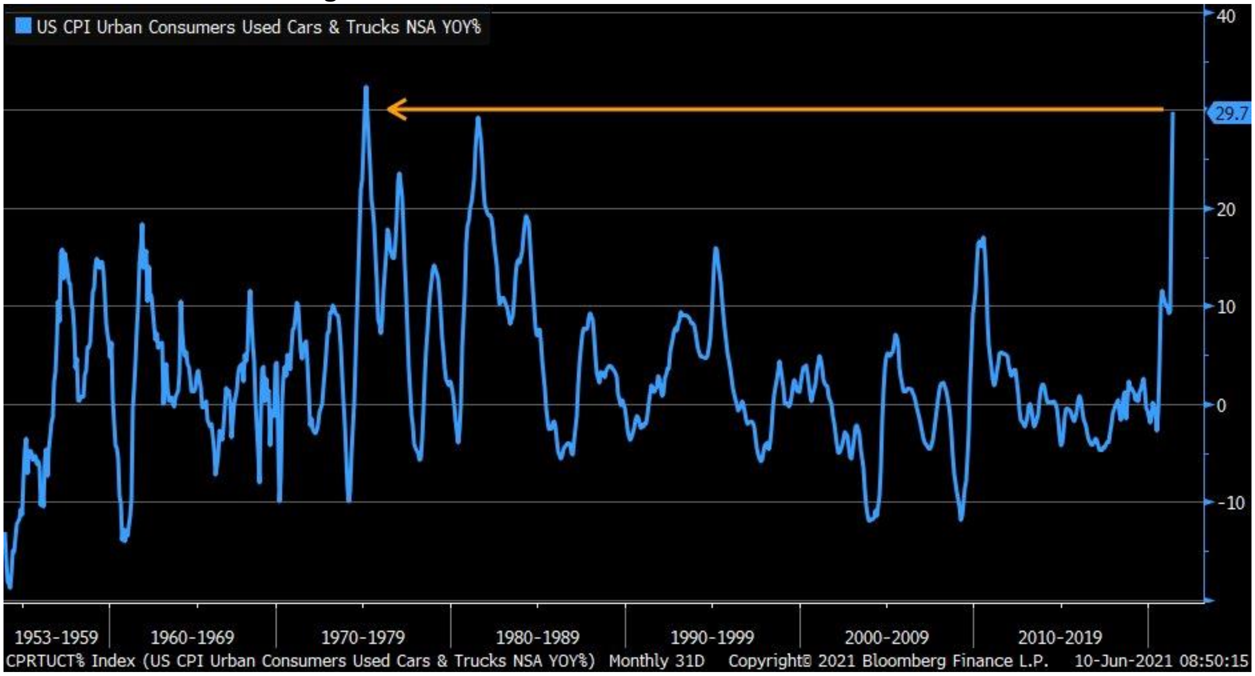
Food price inflation continues to accelerate...to levels that make politicians and dictators nervous.



The highest rate of Core Inflation since 1991.



Used Car inflation is the highest since the mid-1970s.

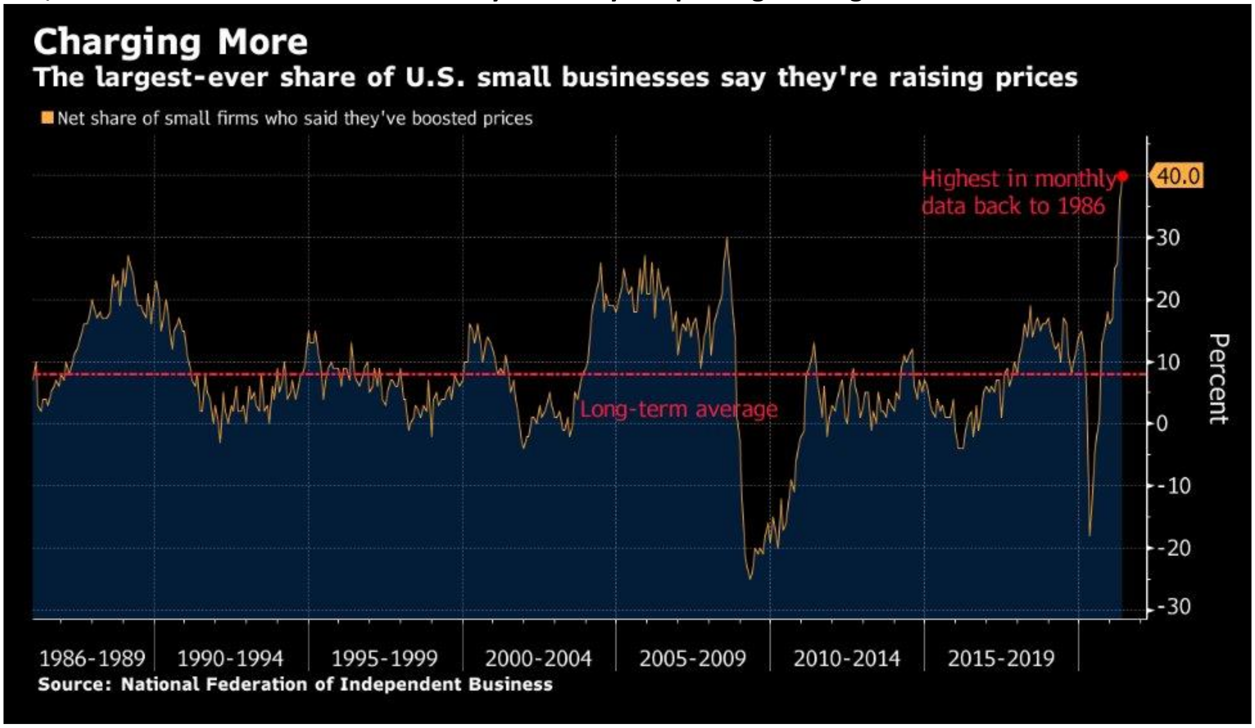


Source: Liz Anne Sonders

Small business concern about higher prices is the greatest since 1981.

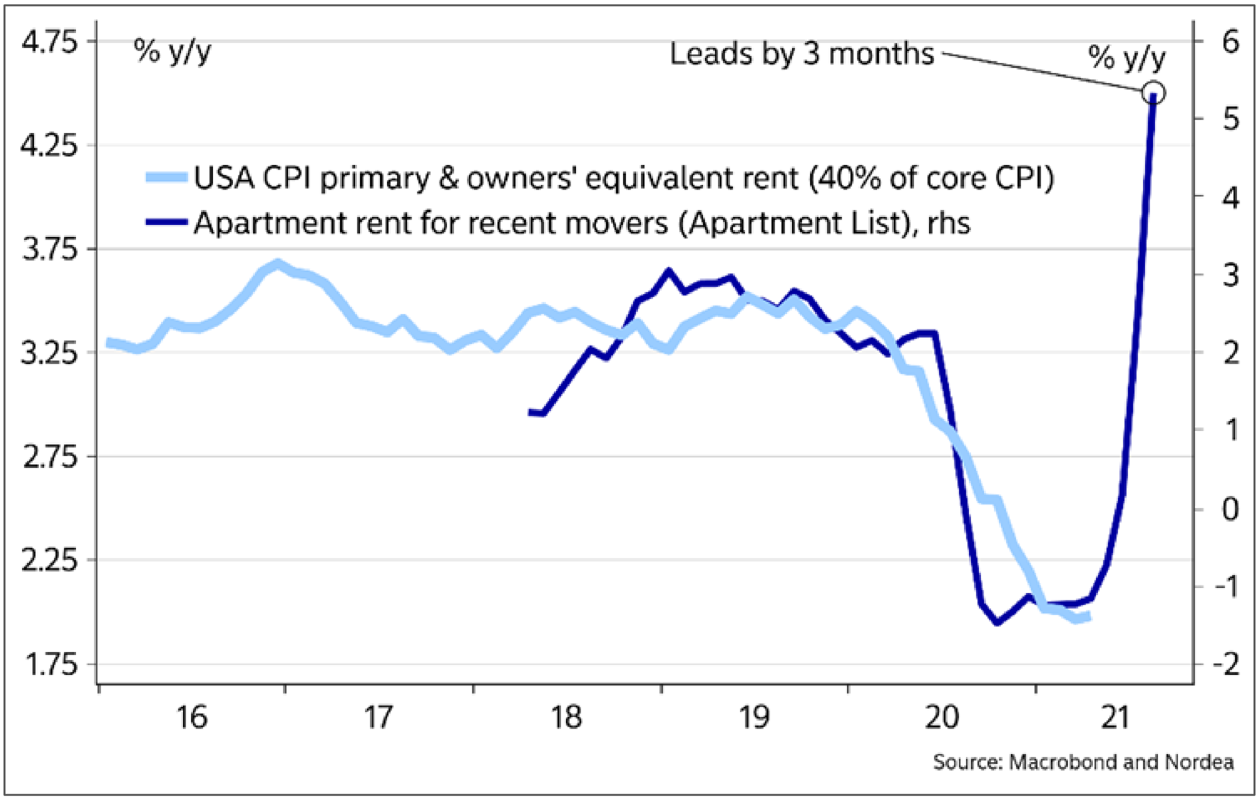
Source: John Authers

But, more small businesses than ever say that they are passing it along to the consumer.

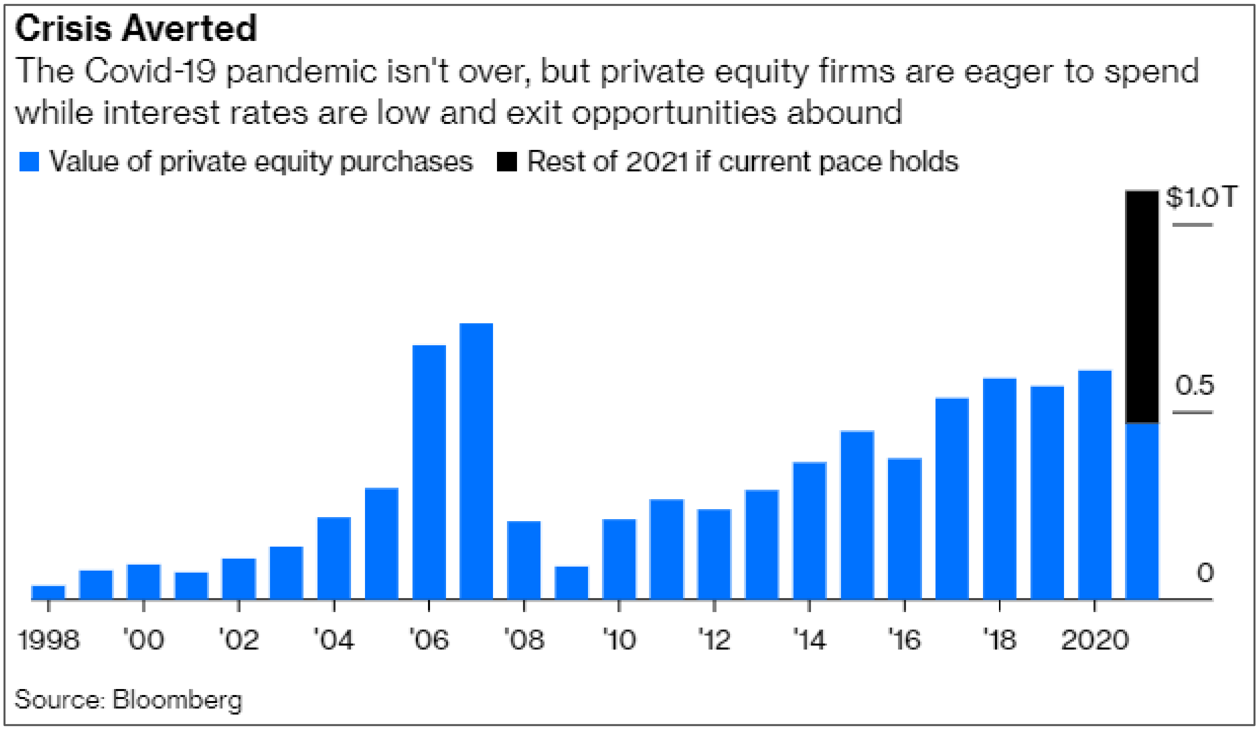


Source: Christophe Barraud

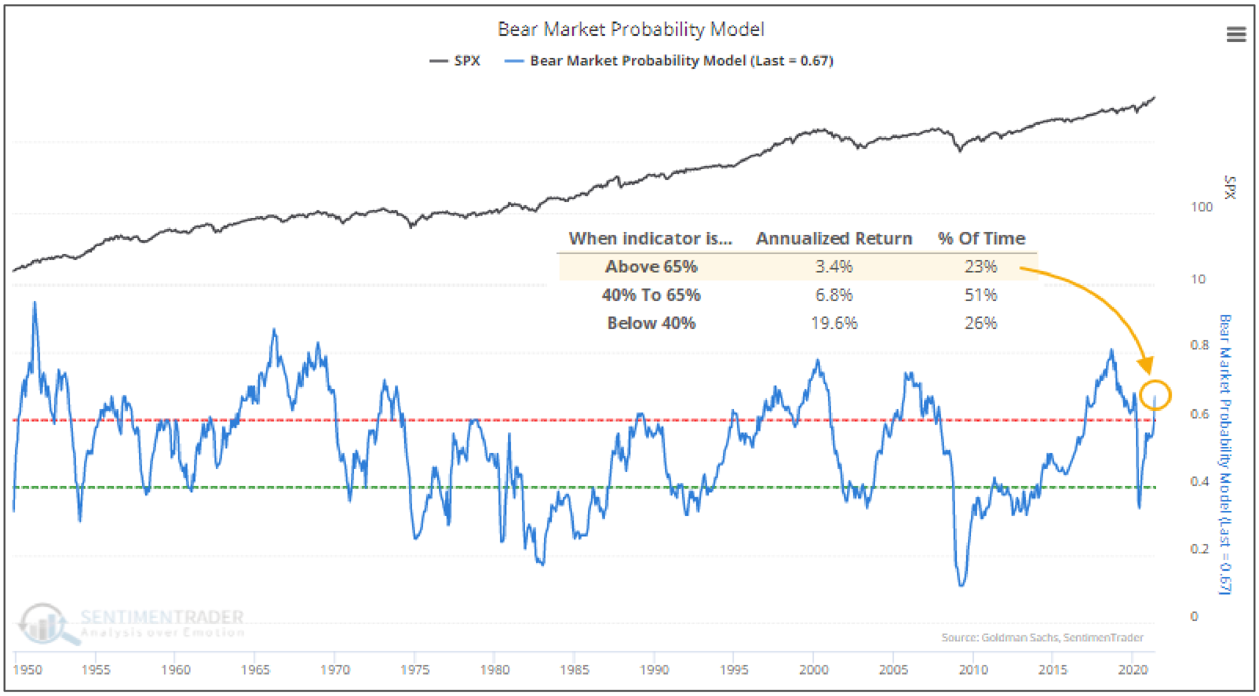
Higher rents should keep upward pressure on CPI for the rest of the summer.



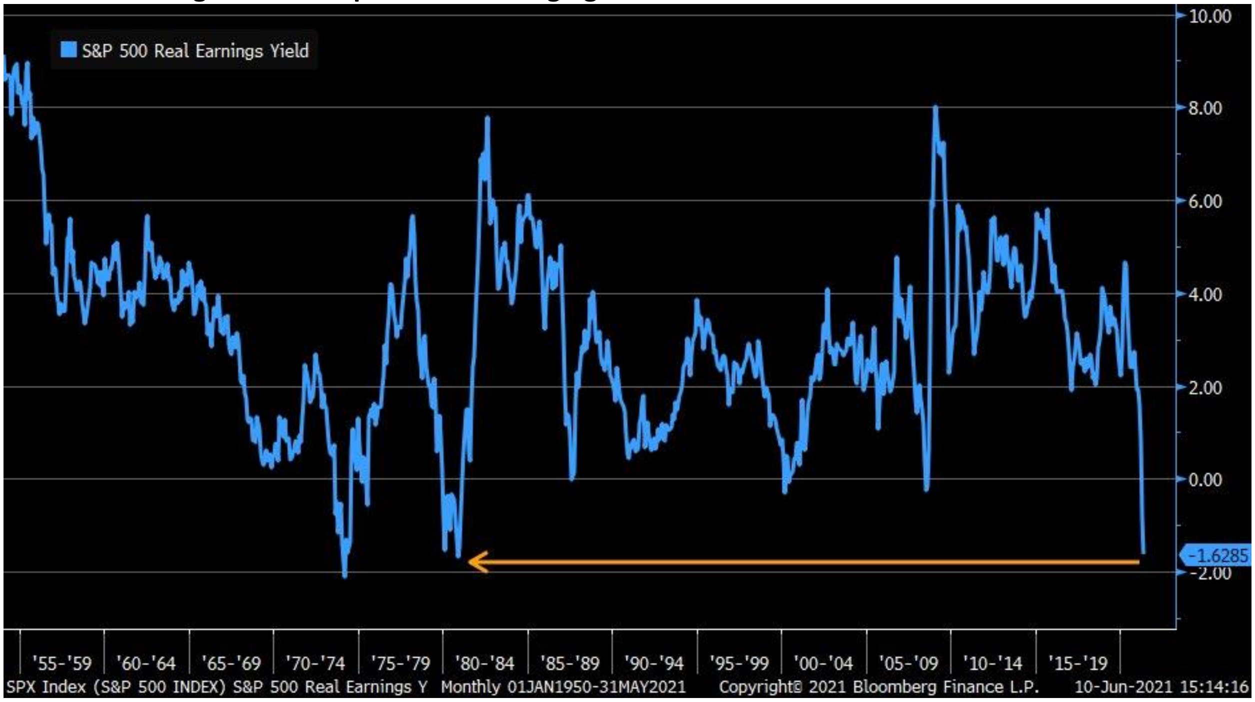
Private Equity is in a mad dash to buy companies – set to break the previous 2007 record.



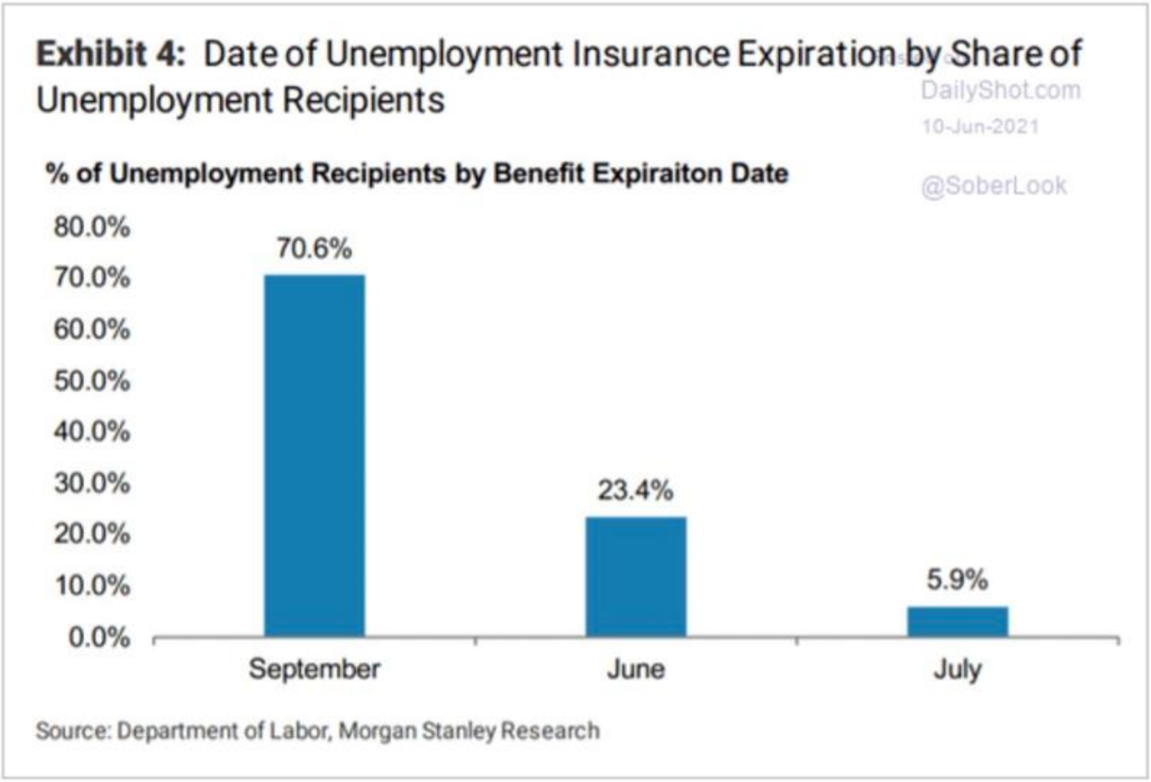
Bear Market Probabilities are rising.



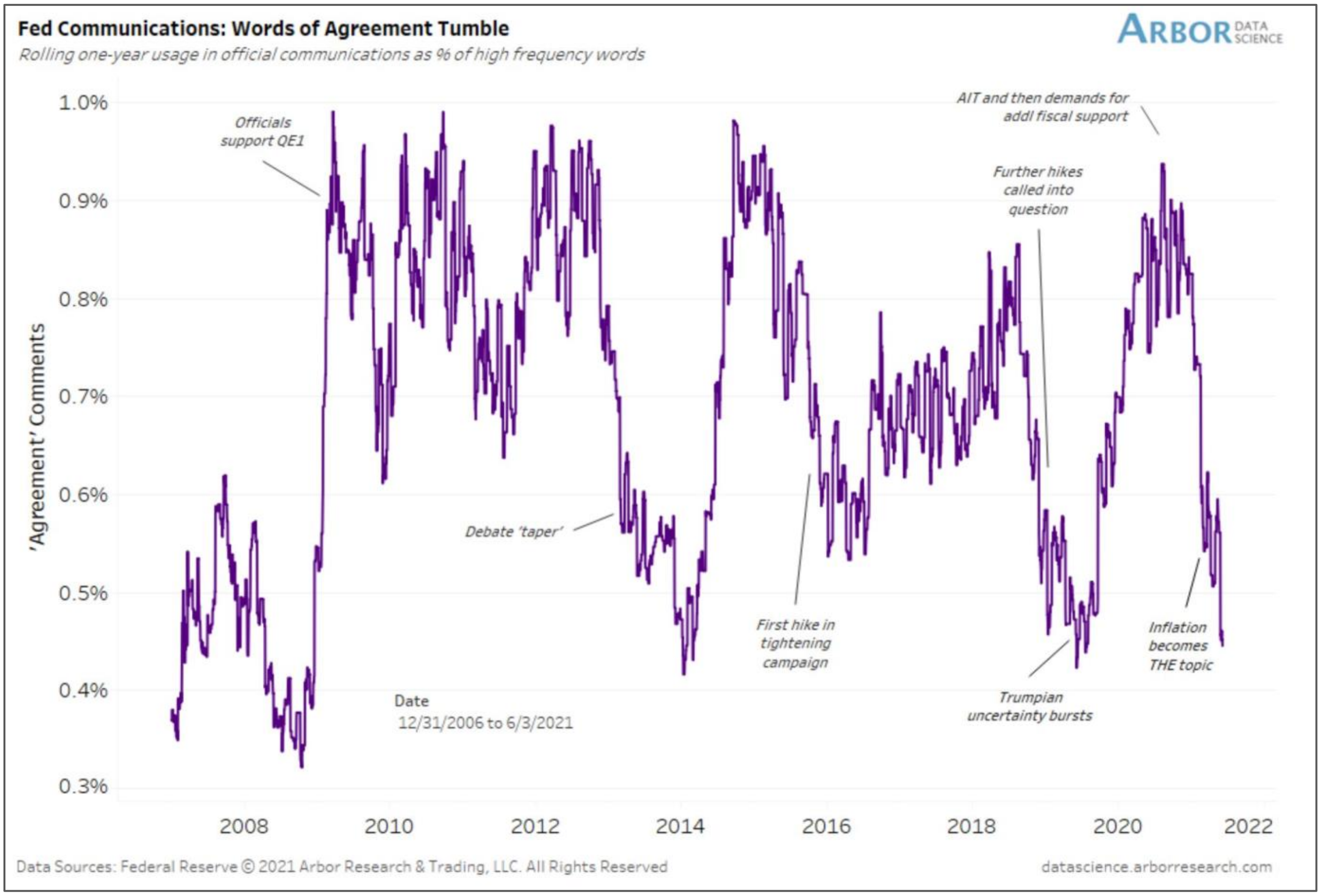
The Real Earnings Yield on equities is challenging all-time-lows.



Over 70% of unemployment recipients won't see benefits expire until September.



Fed word Sentiment suggests policy agreement is declining.



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. A portfolio built upon Cypress Capital's metrics that measure dividend quality and safety. The portfolio is divided 75/25 into payers and growers. Payers are stocks having above-average yields with 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 of 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 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. The 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.

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[i] *"Since the onset of the pandemic last February, the Fed has bought 56% of total Treasury issuance of $4.5 trillion. The Fed's asset purchases represent 76% of the cumulative federal fiscal deficit."* – Warsh, K. (2021, June 11). The Fed's Risky Fill-the-Punch-Bowl Strategy. Wall Street Journal. https://www.wsj.com/articles/the-feds-risky-fill-the-punch-bowl-strategy-11623085554.