Market Outlook

By Mark T Dodson, CFA

Market Risk Index

Rec Allocation 25% Underweight

88.9%

Category Percentiles

Category	Percentile
Psychology - P6	98.2%
Monetary - M4	63.8%
Valuation - Extremely Overvalued	100.0%
Trend	0.4%

Largest Psychology Influences

Levered Investments	Negative
Surveys	Negative
Option Activity	Negative
Fund Flows	Negative

Largest Monetary Influences

Inflation	Negative
Velocity	Positive
Interest Rates (rate of change)	Negative

Valuation

7-10 Year Rtn Forecast	-0.6%
10Yr Treas Yield (on 07/15)	1.3%

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.

Inflation has the full attention of consumers.

Market Risk Index fell back below 90% to 88.9%, aided by the Monetary composite. Although spreads are tight, yields on medium-grade corporate and junk bonds are still falling fast enough that the interest rates category saw a modest boost this week.

The inflation category of our monetary composite is at its maximum negative score, and there was little to signal that this will change in the near term. The Producer Price Index release showed commodity inflation above 19%, the most significant year-over-year change since 1974. PPI inflation leads CPI inflation and is one of the biggest components of the inflation category of our monetary composite.

Stock returns are poor when PPI exceeds 5%, and returns are living in a van down by the river when PPI inflation climbs above 10%. Producer price inflation has rarely run hotter than what we are witnessing in 2021. One can argue why inflation is transitory until they are blue in the face, but this level of inflation introduces notions of price instability, which creates uncertainty – uncertainty for businesses and consumers.

The University of Michigan Survey of Consumers illustrated the point. Consumers randomly mentioned high prices on houses and autos more than any other time in the survey history, beating out the previous record set in – you guessed it – 1974. That's a stagflationary kind of reading on a survey question – levels of concern about prices that can cause consumers to pull back. Long after the rate of change on cars and airplane flights peaks, rents will continue to increase, putting pressure on the housing component of CPI well into 2022. If you are working from the post-Lehman QE playbook to build your narrative and analogs, it's the wrong one. The combined stimulus, both monetary and fiscal, that we unleashed dwarfed that response.

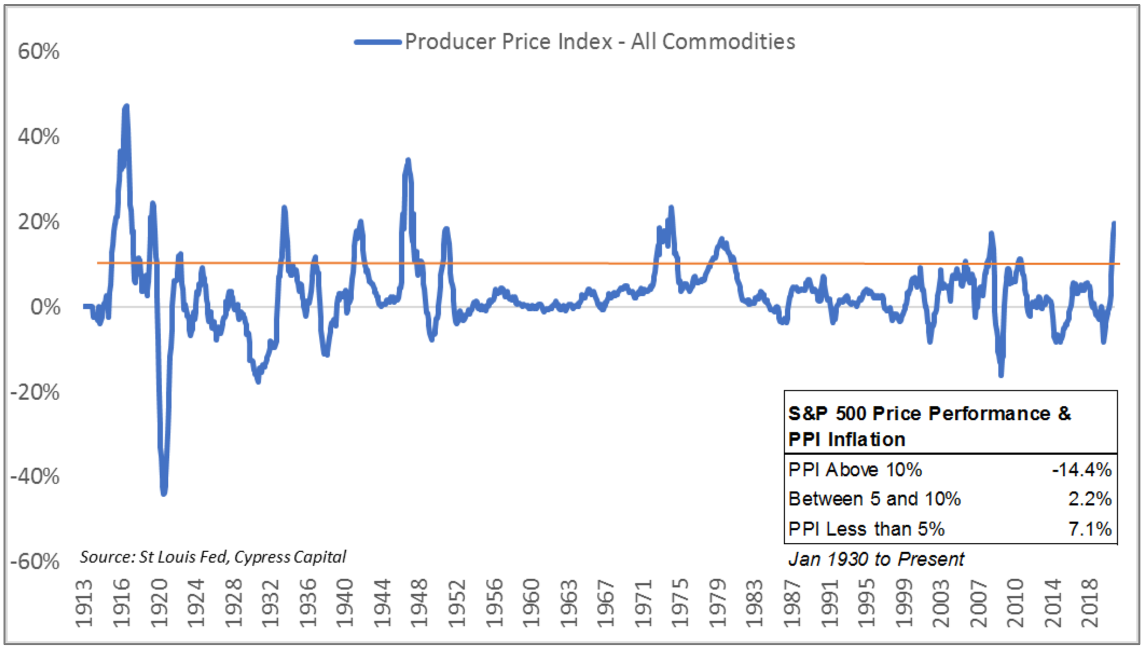
Our valuation composite has not budged from the 100th percentile, and our equity return forecast has been negative five months in a row, beating the previous four-month record set in the summer of 2000. Pundits have been come up with clever rationales for why Treasury yields have started to drop despite higher inflation. A simple one is that financial assets have been bid up so much in the euphoric Robinhood retail free-for-all that the yield on Treasuries doesn't look so terrible anymore. As a result, our measure of the equity risk premium has fallen low enough to put the 2000 lows within reach, and that was an environment when Treasuries were yielding more than 6%.

Investor psychology peaked earlier this year but remains elevated, and breadth started to peak in the spring. Still, widely followed cap-weighted indices continue to run off an impressive string of new highs. That's typically a classic setup for a correction, but thus far, speculators are stubbornly holding onto animal spirits with the same zeal that drives them to cling AMC and Gamestop stock.

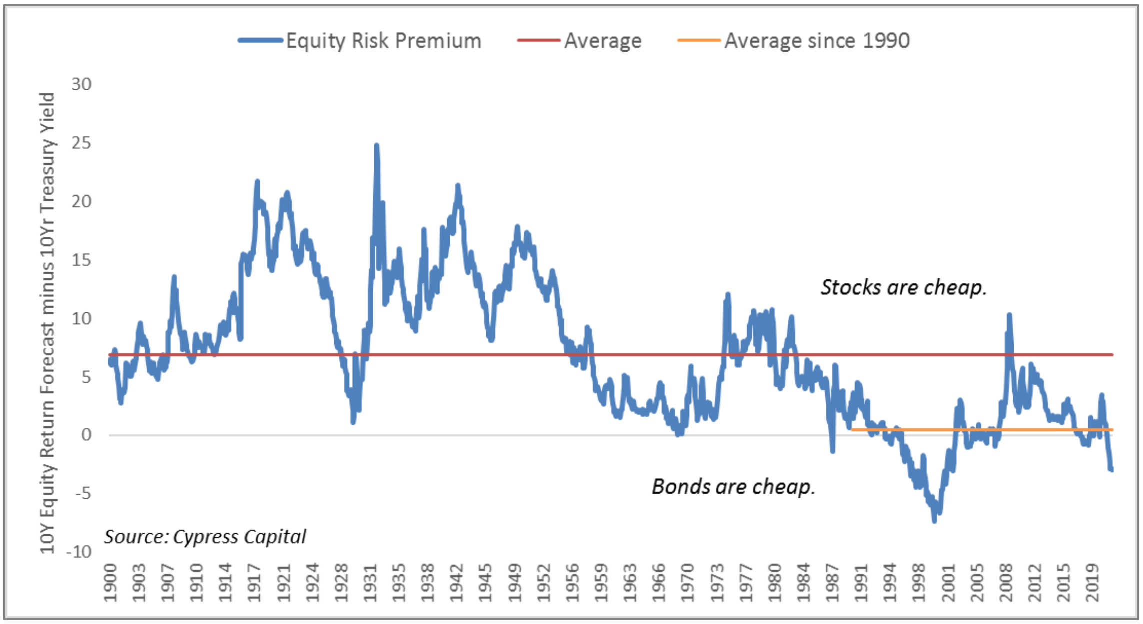
With such a thin margin of safety for equities, we don't expect valuations or the wall of worry to be repaired overnight. For the time being, we'd settle for an end to 2021's steady streak of historical comparisons to 1970s inflation and late 1990s investor psychology.

Charts of the Week

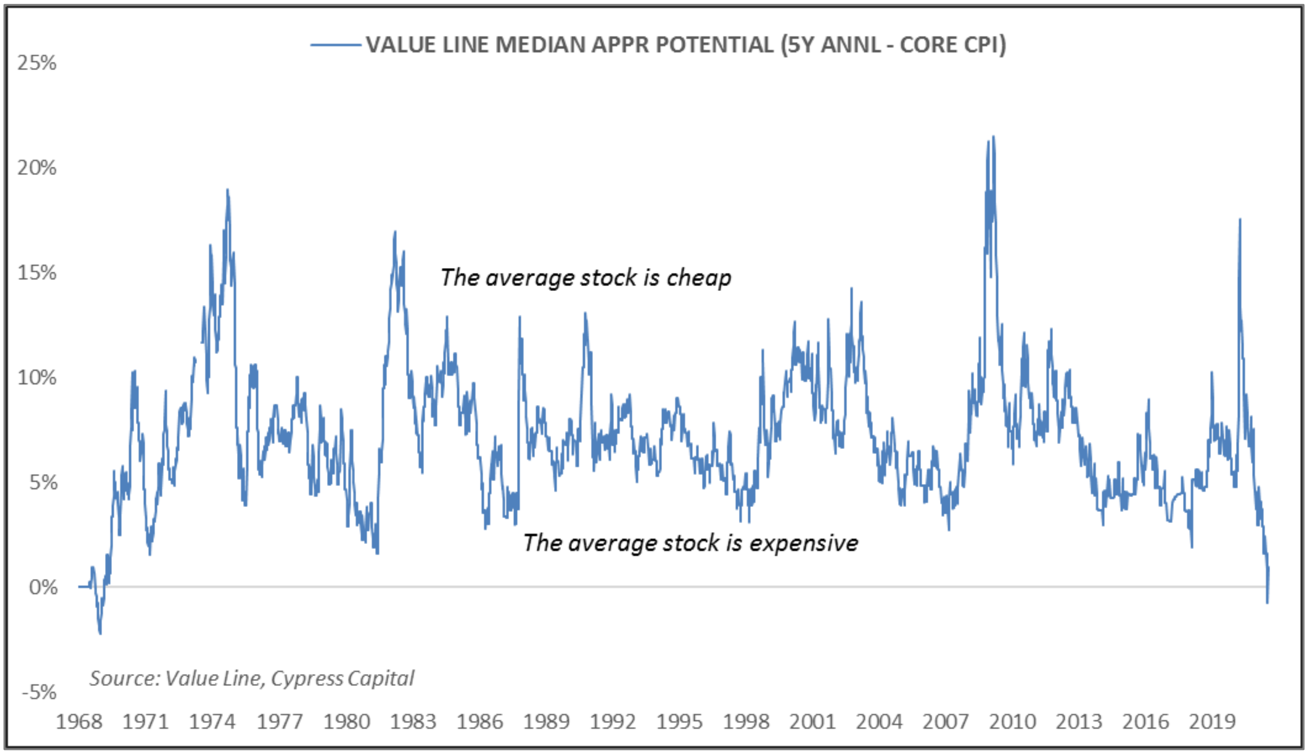
Producer Price Inflation in June was the highest in 45 years.



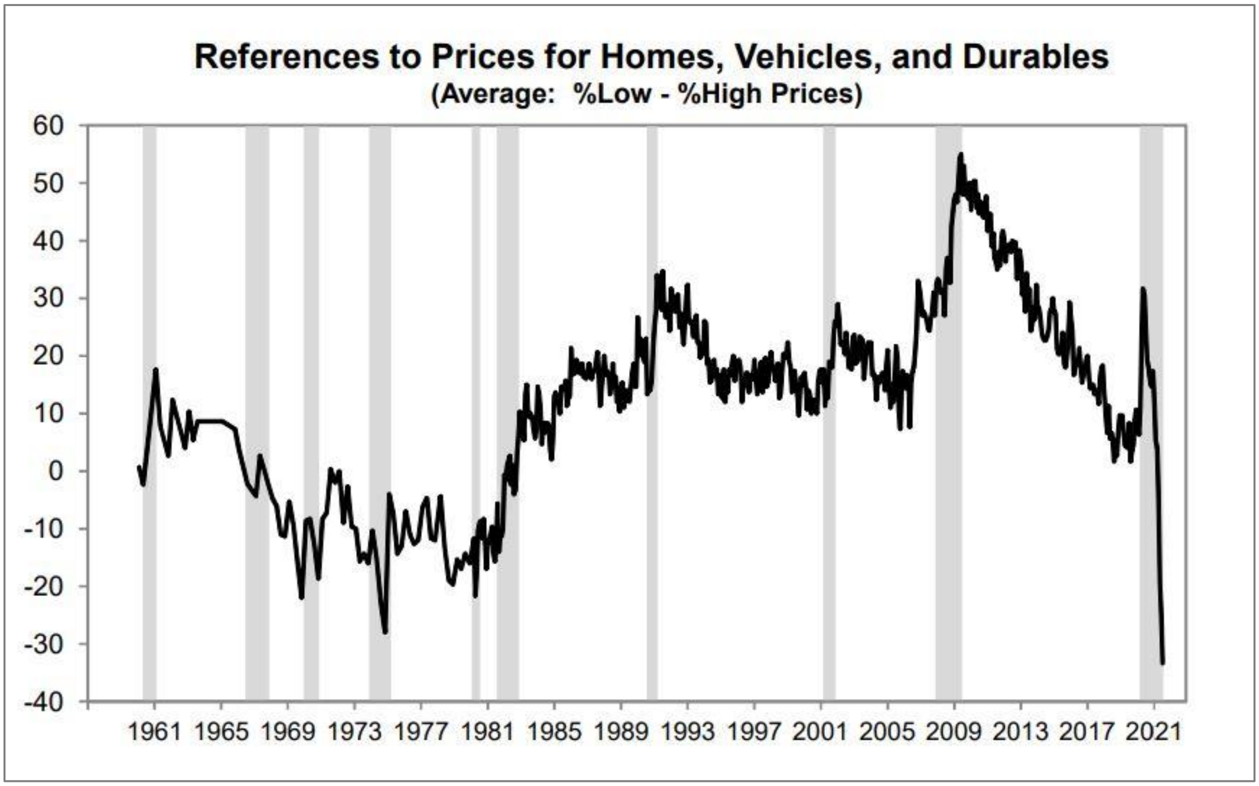
The equity risk premium has fallen to the lowest level since 2000.



Real Appreciation Potential for the average stock is at the lowest level since 1969.
This uses Valueline's Median Appreciation Potential indicator (a measure of small and mid-cap valuations) minus core CPI inflation.

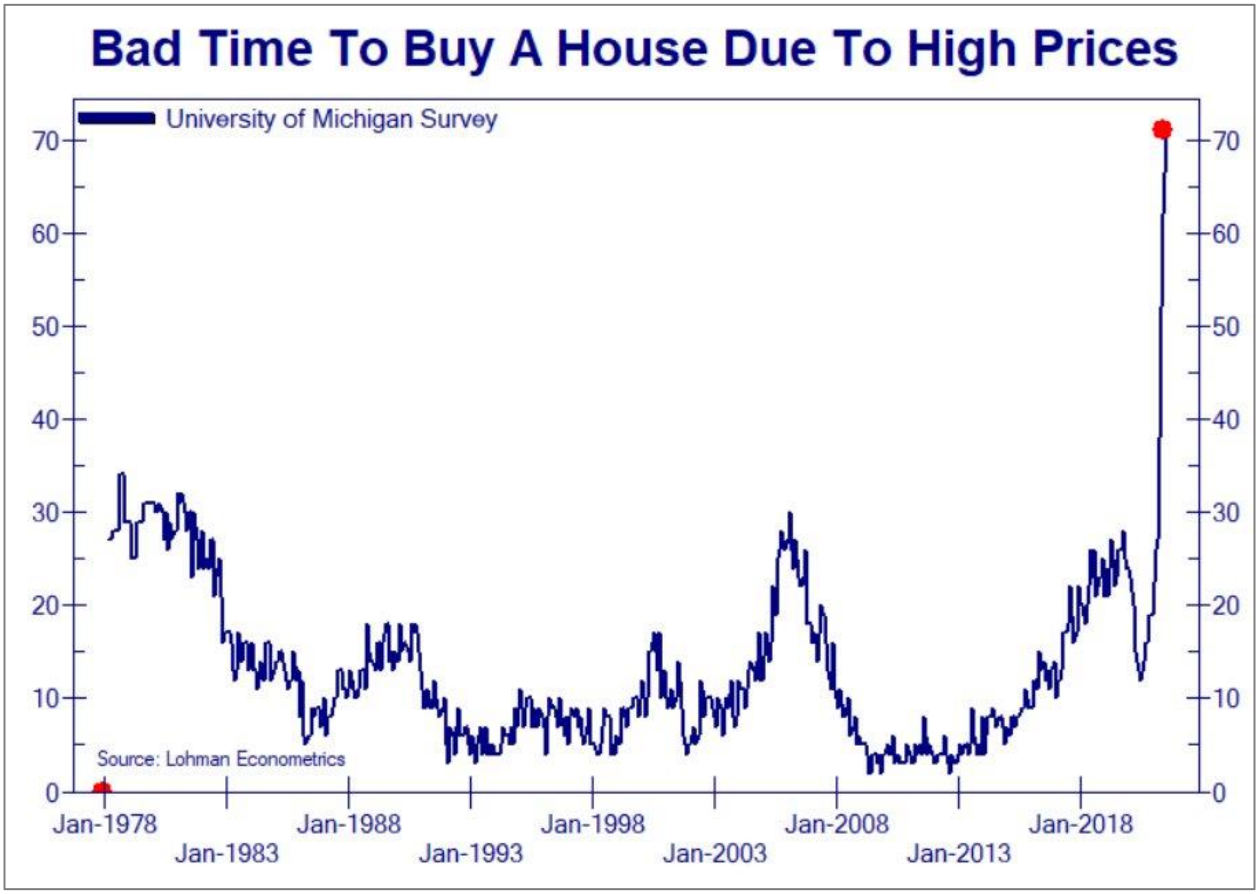


Consumer concern about the high prices for Homes and Autos set a new record, beating 1974.

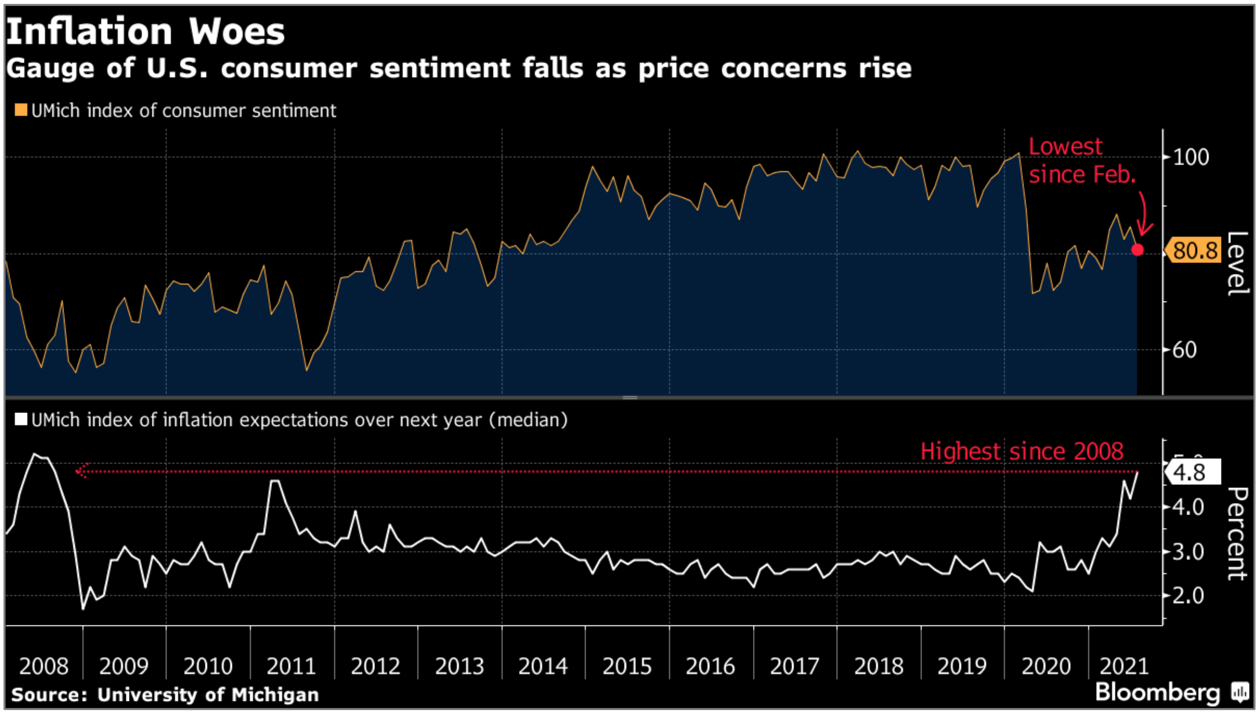


Source: University of Michigan

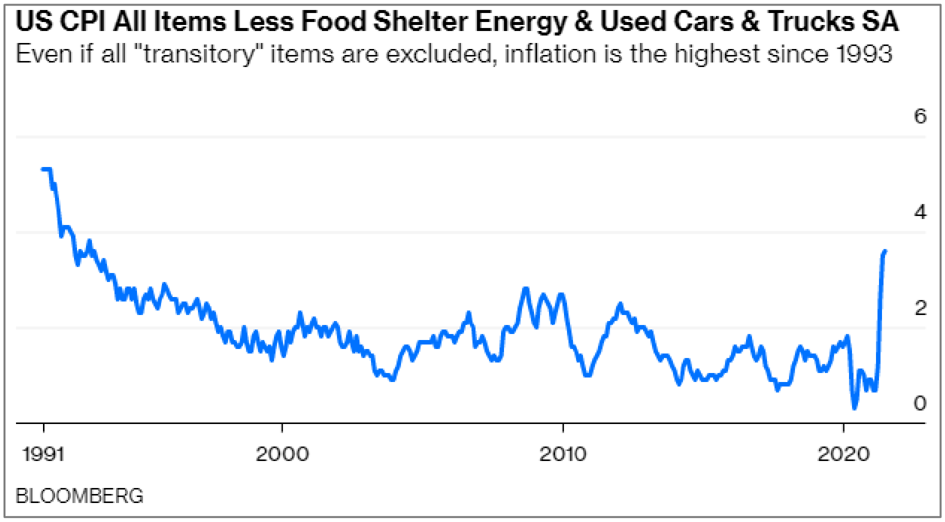
Consumers are souring on buying a home because of rising prices.



Consumer inflation expectations have climbed to the highest level since 2008.

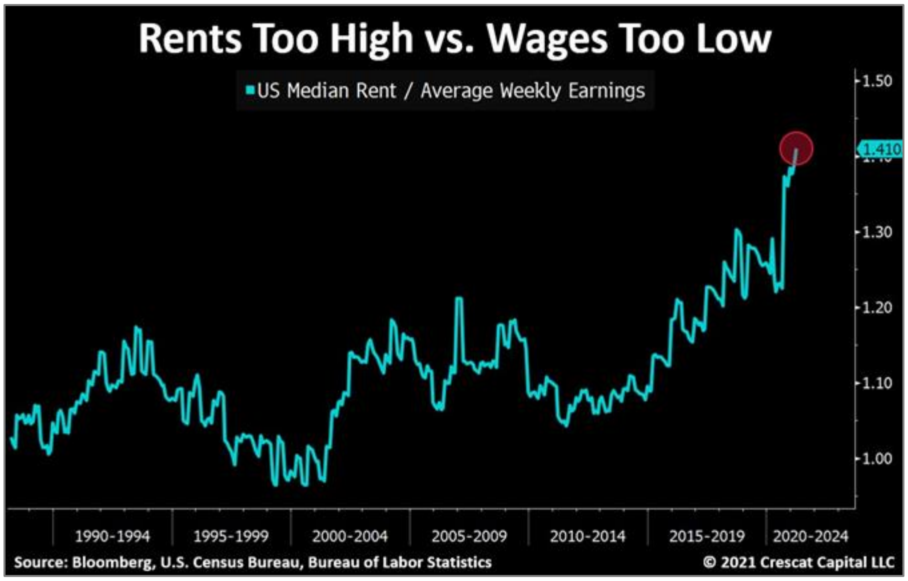


Inflation ex-Transitory items is the highest since 1993.

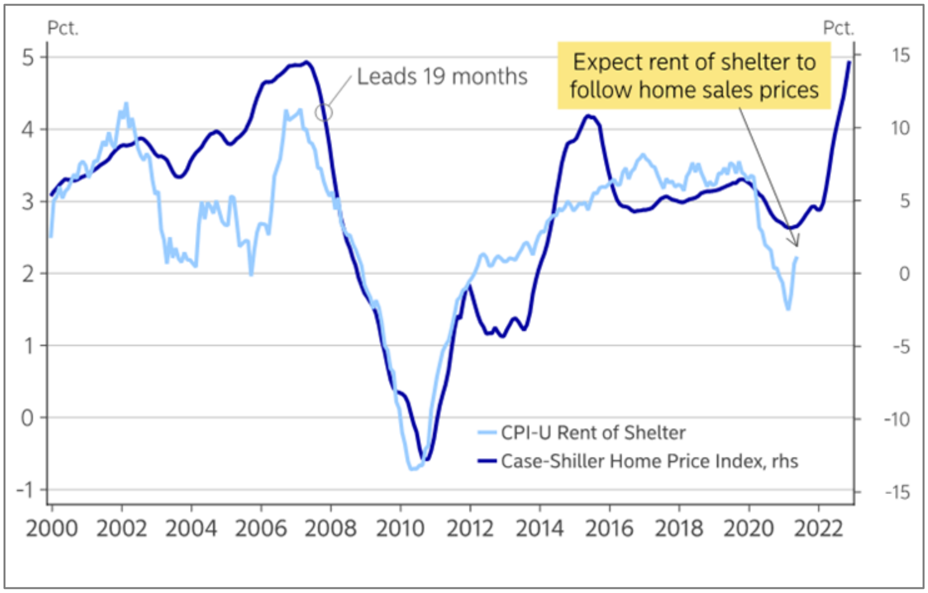


Apartment Rent Growth hit another record high in June.

The ratio of rent to wages climbed to a new all-time high.

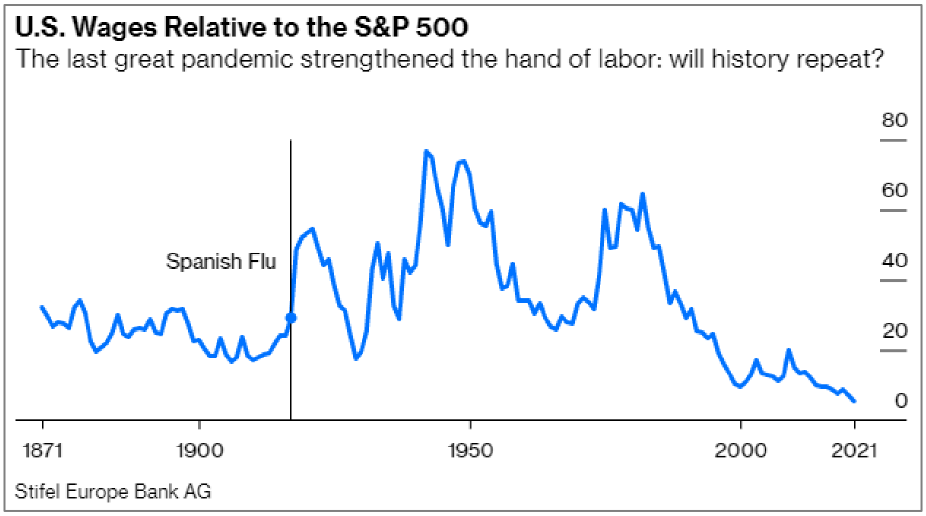


It takes more than a year and a half for CPI to register high home prices.



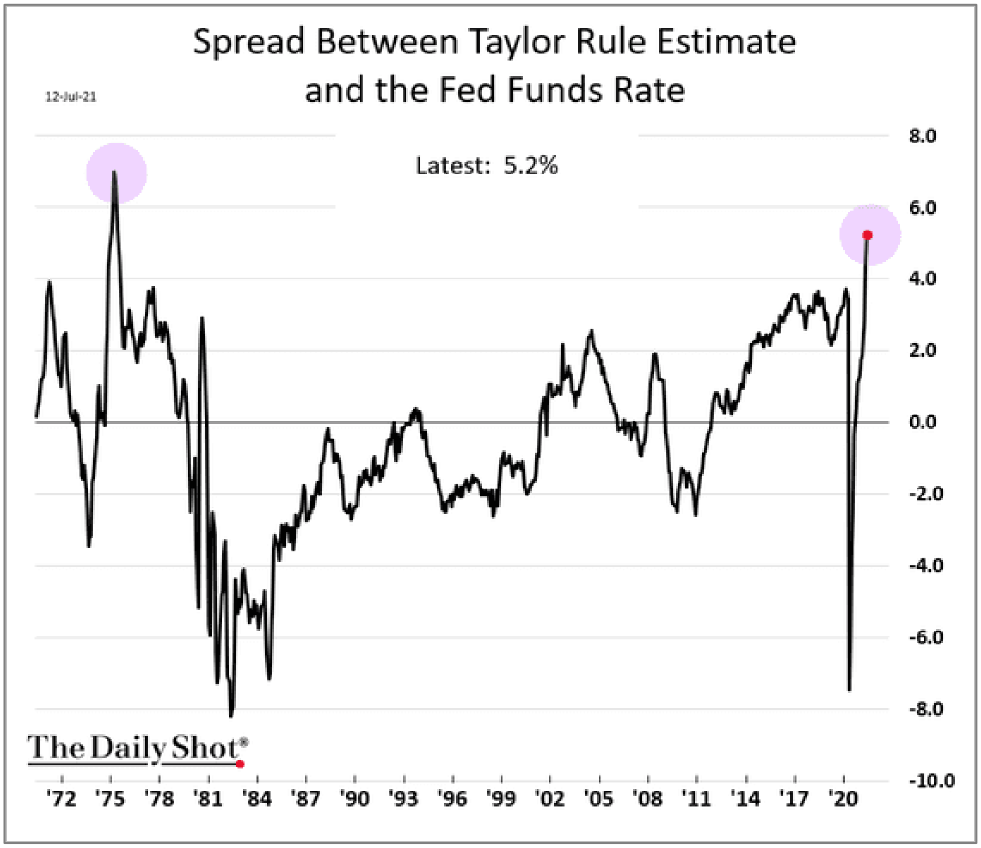
The labor market appears much tighter than the unemployment rate suggests.

Wages to wealth spiked after the Spanish Flu.

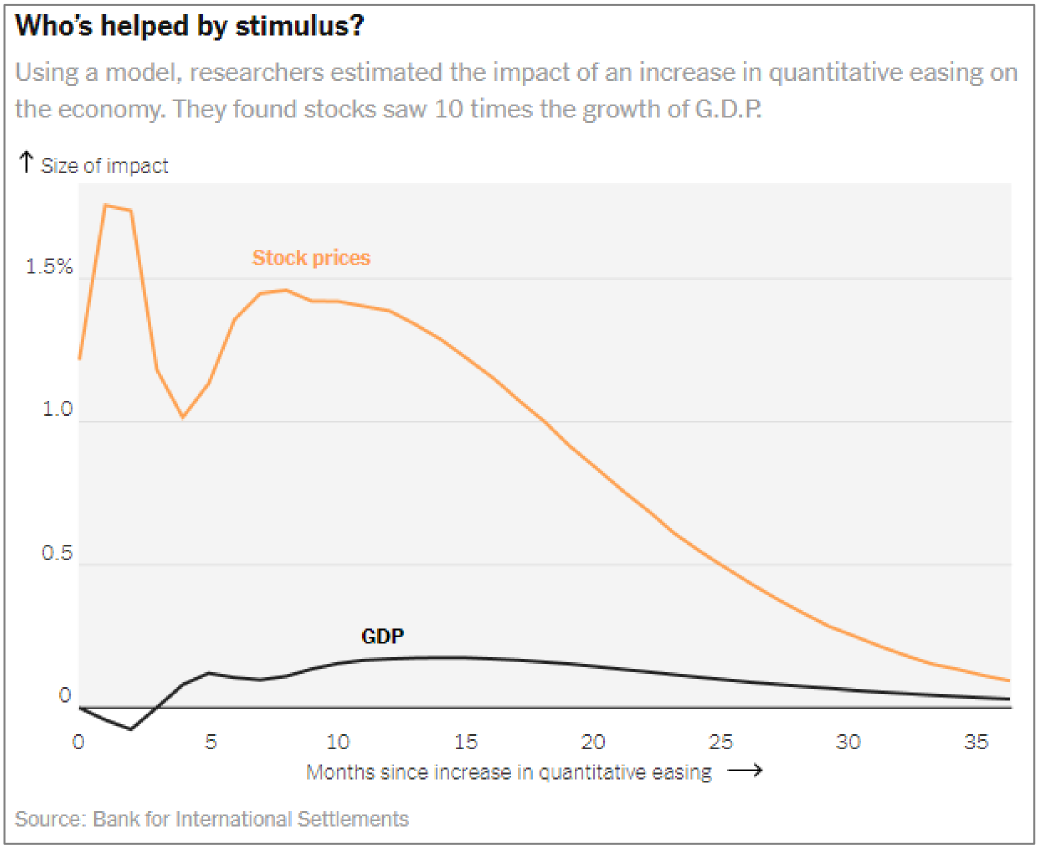


Source: Bloomberg

The Taylor Rule suggests the Fed hasn't been this easy since the late 1970s.



Quantitative Easing has helped stocks 10X more than it has GDP.

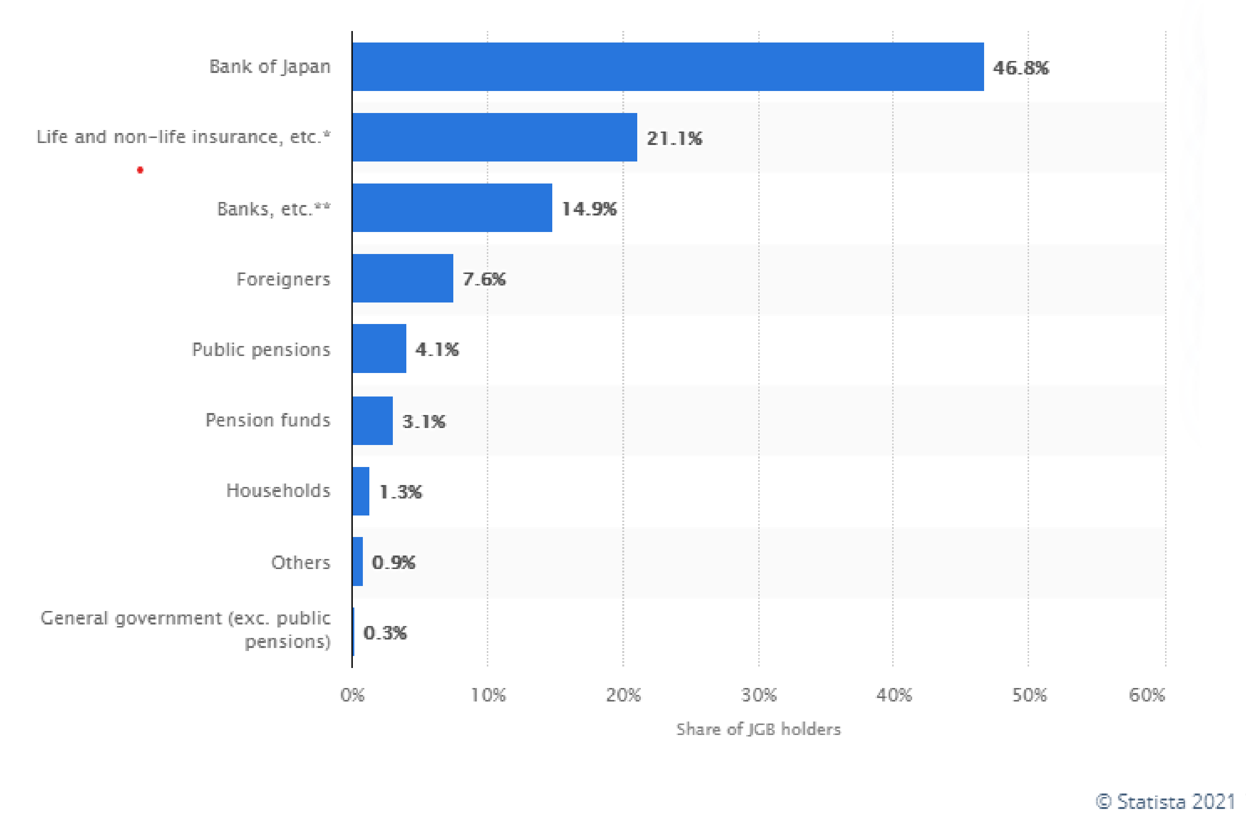


Fed owns nearly a quarter of the Treasury Market.

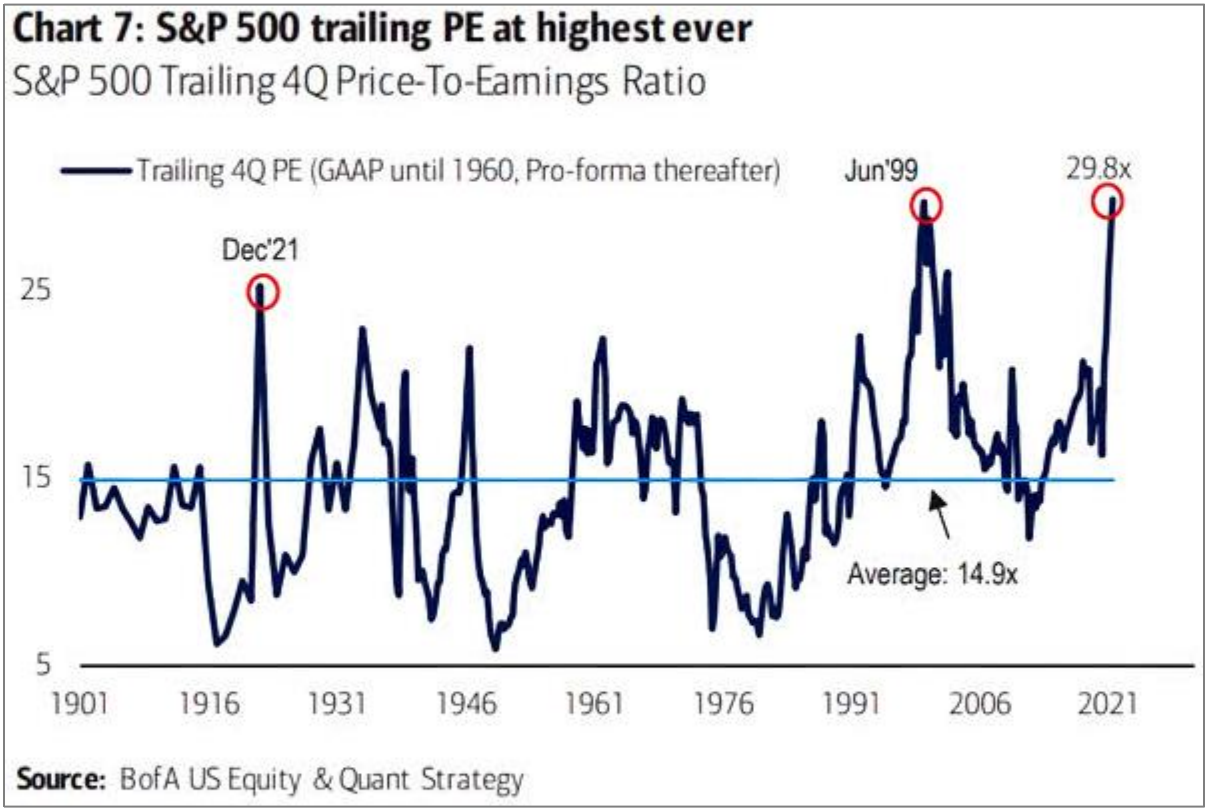
*Federal Reserve balance Treasury securities held/US total marketable debt outstanding
Source: Bloomberg as of June 30, 2021

Source: NY Times

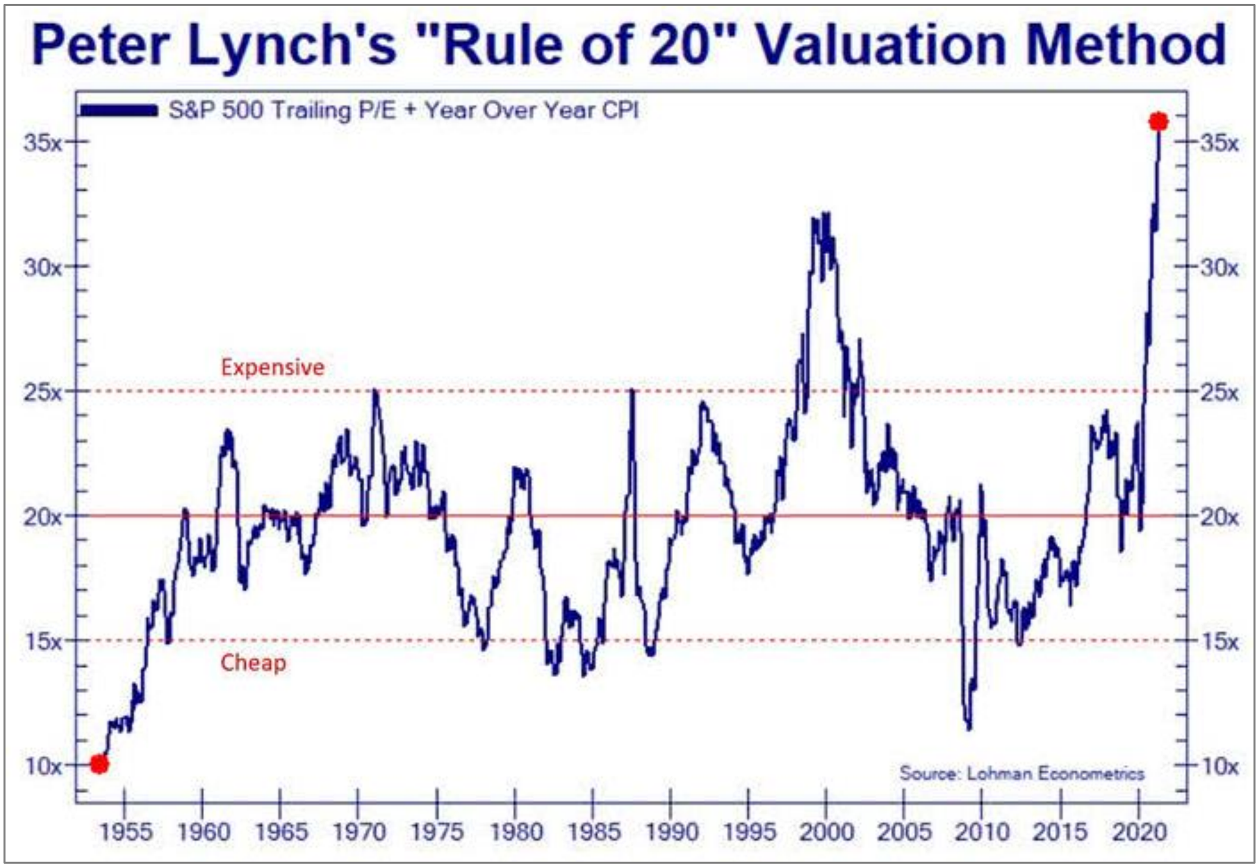
Meanwhile, the Bank of Japan owns nearly half of theirs.



S&P 500 Trailing PE Ratio set a new all-time record.

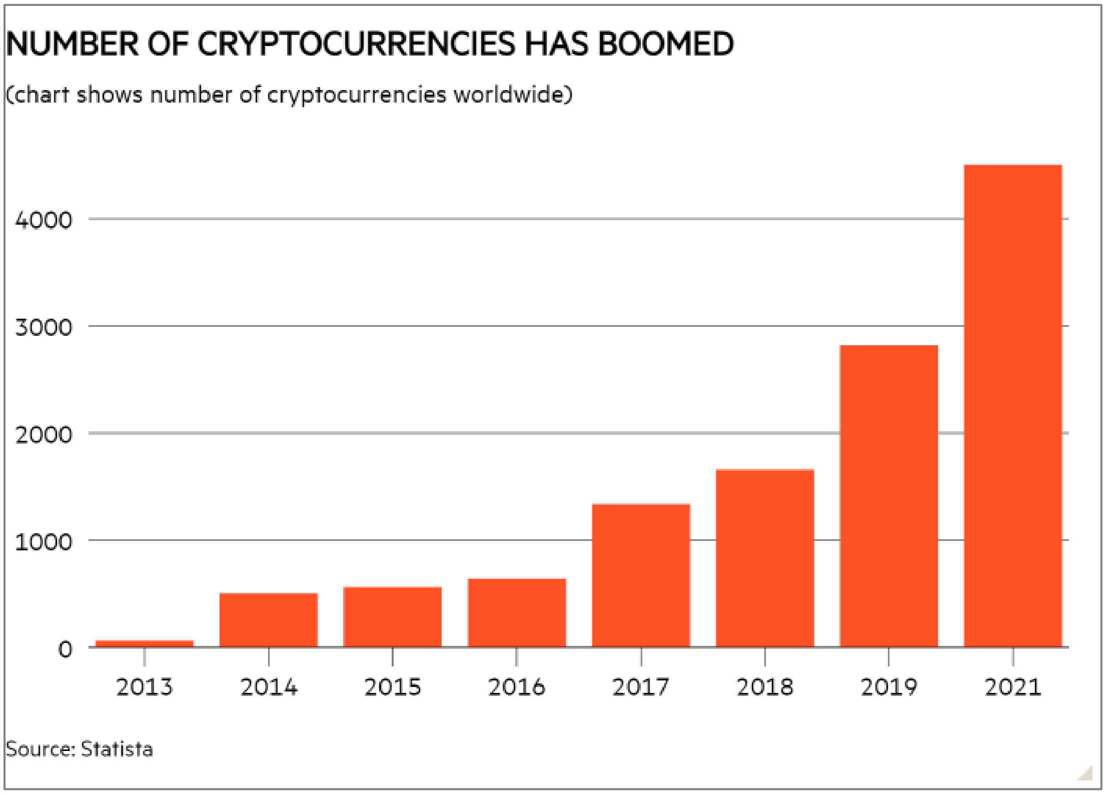


The inflation surge has driven the Peter Lynch version of the Rule of 20 well above the 2000 era.



International equities are patiently waiting for their time in the sun.

Fixed supply of Bitcoin – infinite supply of Cryptocurrencies...



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.