Market Outlook

By Mark T Dodson, CFA

Is it time to Buy Bonds?

Market Risk Index crept up another notch higher to 83.8%, but Investor Psychology was in the driver seat this week, with several indicators moving back into super-enthusiasm zones. As the magnitude of each minor dip proves fleeting, the ensuing rallies grow easier to predict, and with that Fed put still firmly in investors' back pockets – there is no alternative other than for the Fear of Missing Out to grow.

The Rydex Ratio set another record, and the equity put/call ratio came close to taking out the speculative peak in February when we reached peak re-opening optimism. The volume-based put/call ratio may not have set a record, but the nominal dollar volume in options trades did. The amount of money chasing options trades is so out of the scope of what anyone would have imagined just a couple of years ago. It has grown to feel normal, but it isn't. Moreover, the level of levered speculation increases the likelihood that the correction that finally breaks those animal spirits will be sharper and more severe than usual.

The Monetary composite barely budged this week, bucking its recent trend, but there is still a significant development on that front. <u>Our Bond Momentum gauge is nearly a lock to confirm a buy signal for Treasuries over coming days and weeks.</u> The record of momentum upturns in that indicator at calling turning points in the bond market is enviable. With a significant history of relying on the indicator, we know that its record at forecasting where yields will be over the next 12-18 months is better than our current "feelings" on the state of the market.

As unusual as this buy signal will be, given the shocking CPI release this week, it's also coming at a time that sentiment for bonds is as bearish as it has ever been. Meaning, the pain trade is for yields to move lower. Admittedly, this is complete economic and investing heresy, given what we know about the current state of inflation. So, while we will add exposure to longer duration Treasuries in those managed accounts where it is appropriate, we will likely do so in a more measured way than we have done in the past. We always make a special effort to delineate our thinking on investments into the categories of investment versus speculation – in the spirit of Ben Graham's definition of speculators and investors.

Real yields are hitting all-time lows, in negative territory, making the application of this bond momentum signal more speculative than it has been in the past. Bonds aren't yielding more than inflation right now, but as we survey the investment landscape, nothing without an exceptional level of risk is priced to return more than the 6% inflation reported this week. Nevertheless, our bond momentum gauge is suggesting that bonds are becoming a better option as an inflation hedge, at least over the next 12-24 months.

Market Risk Index

Rec Allocation 25% Underweight

83.8%

Category Percentiles

Category	Percentile
Psychology - P6	96.7%
Monetary - M4	57.9%
Valuation - Extremely Overvalued	100.0%
Trend	0.6%

Largest Psychology Influences

Levered Investments	Negative
Option Activity	Negative
Flow of Funds	Negative
Consumer Confidence	Negative

Largest Monetary Influences

Inflation	Negative
Velocity	Positive
Exchange Rates	Positive

Valuation

7-10 Year Rtn Forecast	-0.4%
10Yr Treas Yield (on 11/11)	1.6%

Market Trends

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

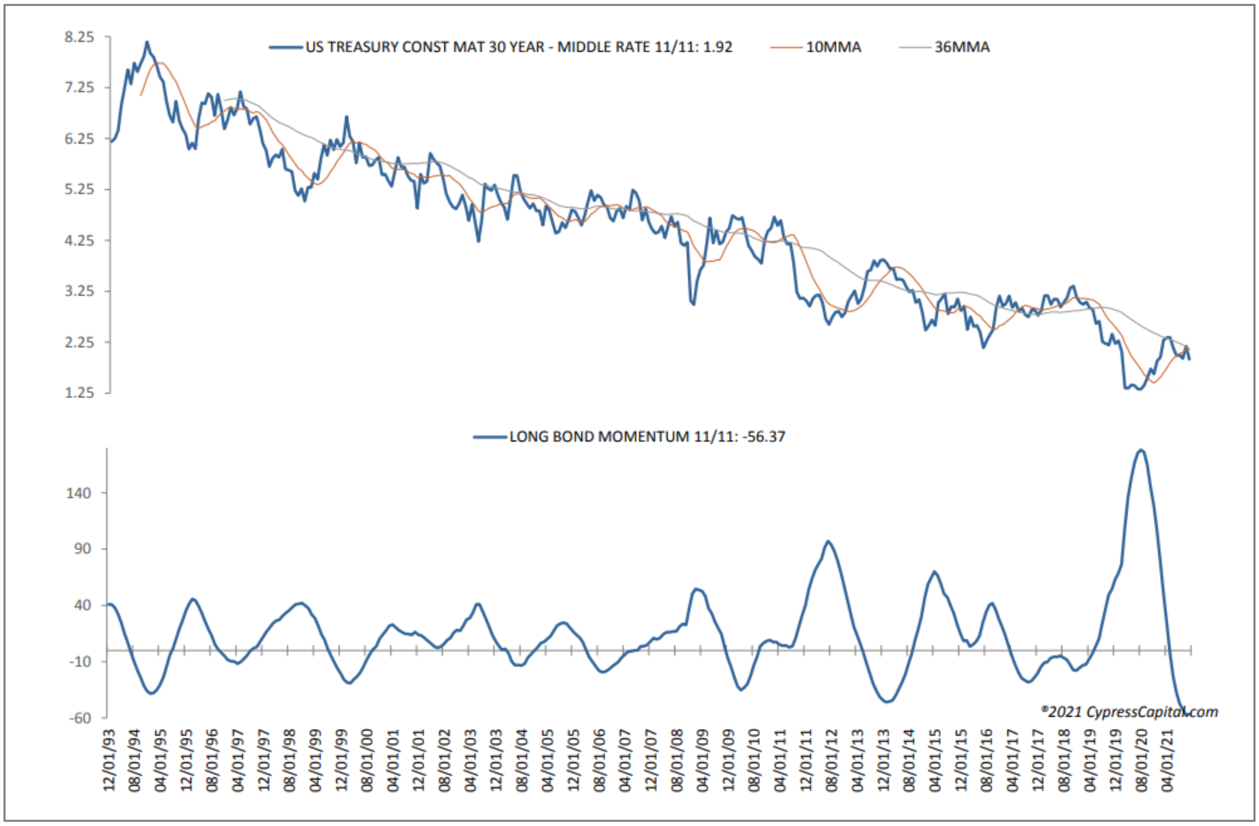
Market Risk Index scales from 0 to 100%. Higher readings correspond with higher risk markets. Scores below 25% are bullish. Scores between 25-75% are neutral, and scores above 75% are markets vulnerable to major drawdowns.

Central bank policies have relied so heavily on extreme policy measures that they nearly force the hand of investors to become more speculative in their thinking to avoid succumbing to inflation. Granted, US Treasuries are considered one of the safest investments in the world, but they are currently priced to put too much money into the hands and coffers of politicians over the next 10-30 years.

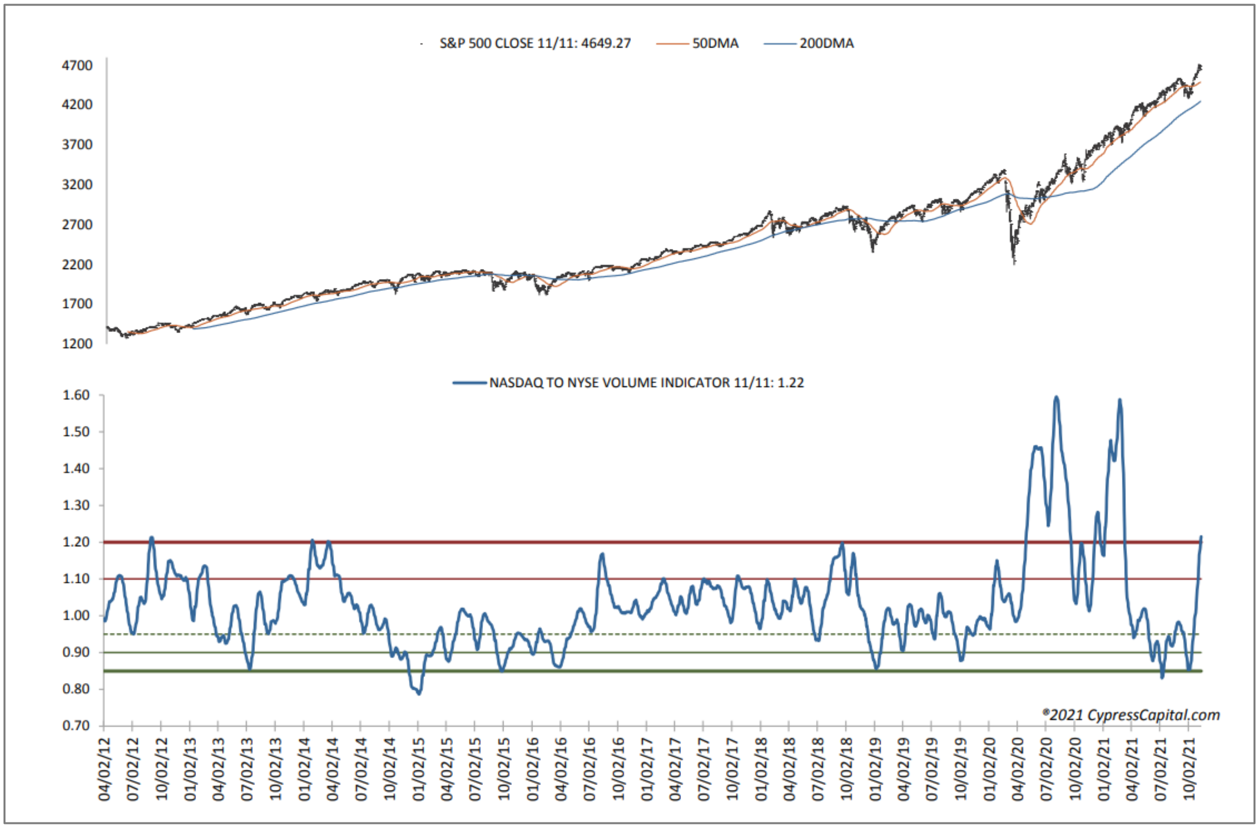
Absent extreme government intervention with cash payments to businesses and individuals and central bank money to buy bonds from institutions at sub 4% yields, we would never have an inflation problem to this degree this early in an economic recovery. “Supply-chain issues” is the phrase that Team Transitory produced as an excuse for a cause that the rest of us can see clearly – it’s reminiscent of Fed excuses from the 1970s.

Any “non-transitory” inflation problem is one created by politicians and bureaucrats, and it is an easy, but painful, problem to solve. Team transitory can still win, but it will take a strong backbone, less government intervention, and restraint by the Federal Reserve. There is a limit to moral hazard, and of all the cans politicians and bureaucrats like to kick, this one is growing into the riskiest one to keep putting foot to can.

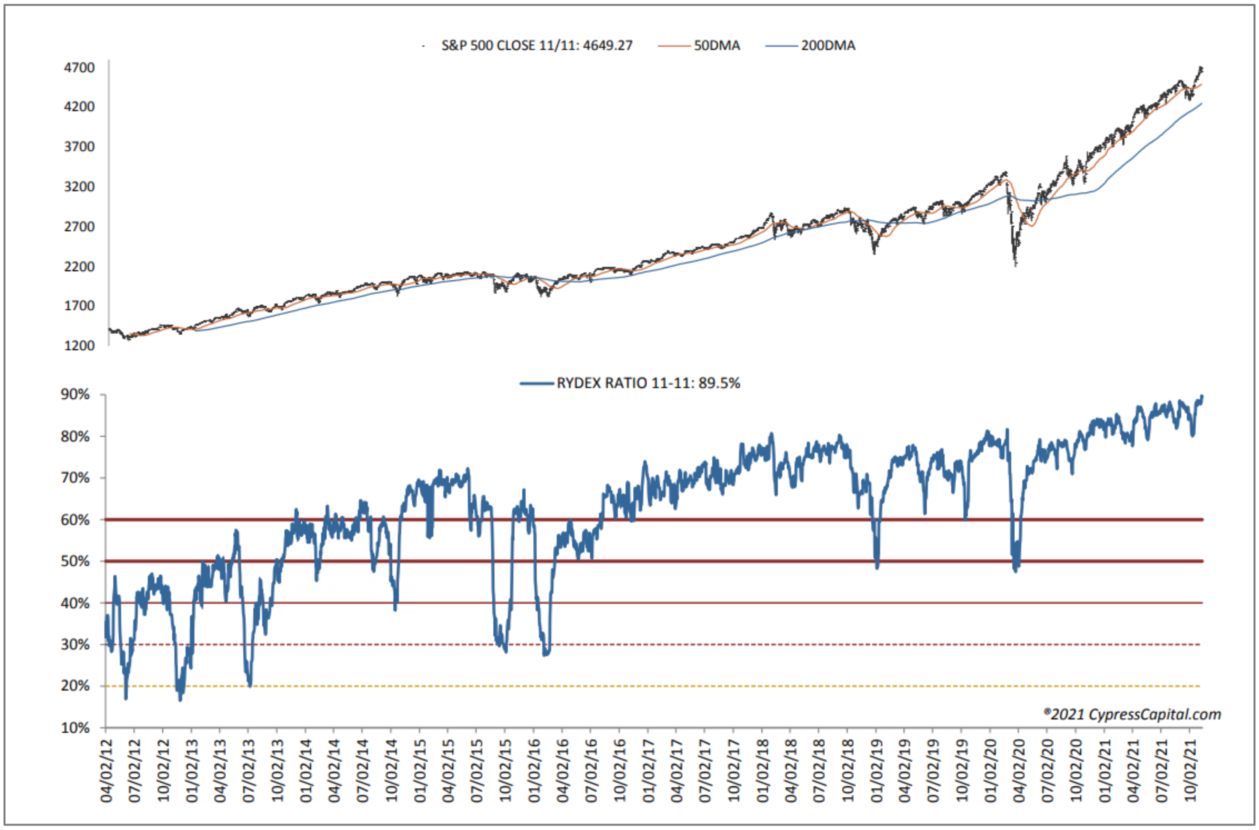
Always the contrarian, Long Bond Momentum is days away from giving a buy signal on US Treasuries.



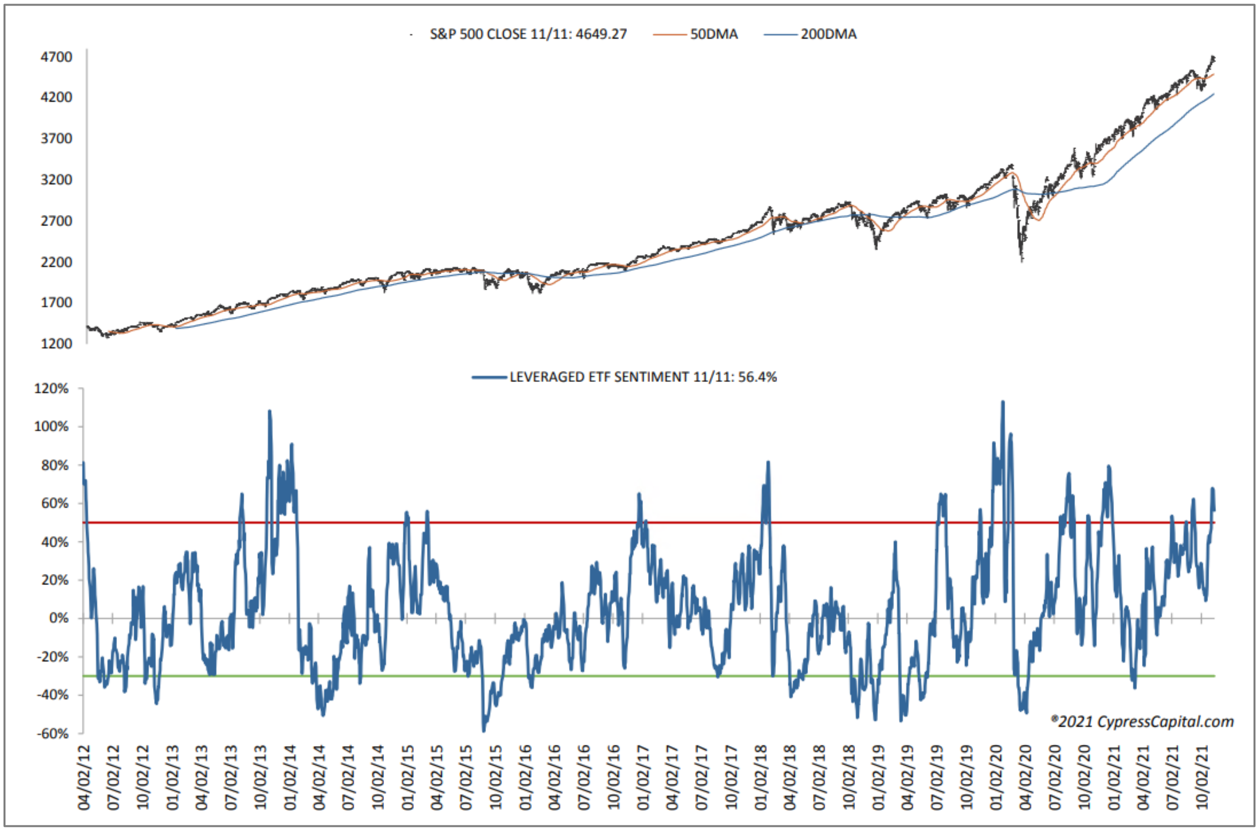
NASDAQ to NYSE Volume Indicator hits speculative extreme territory again.



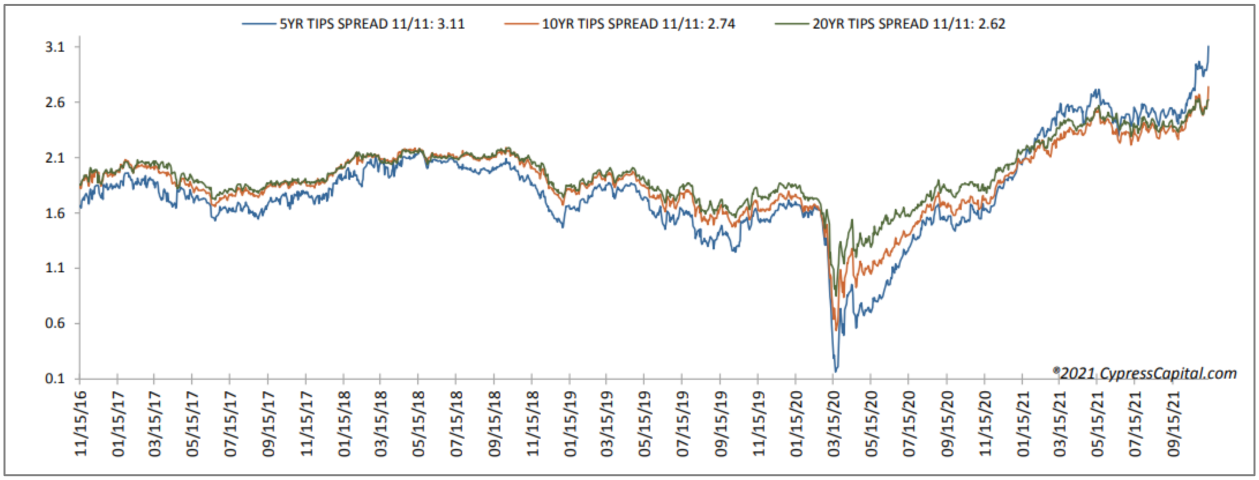
Rydex Ratio sets another speculative record.



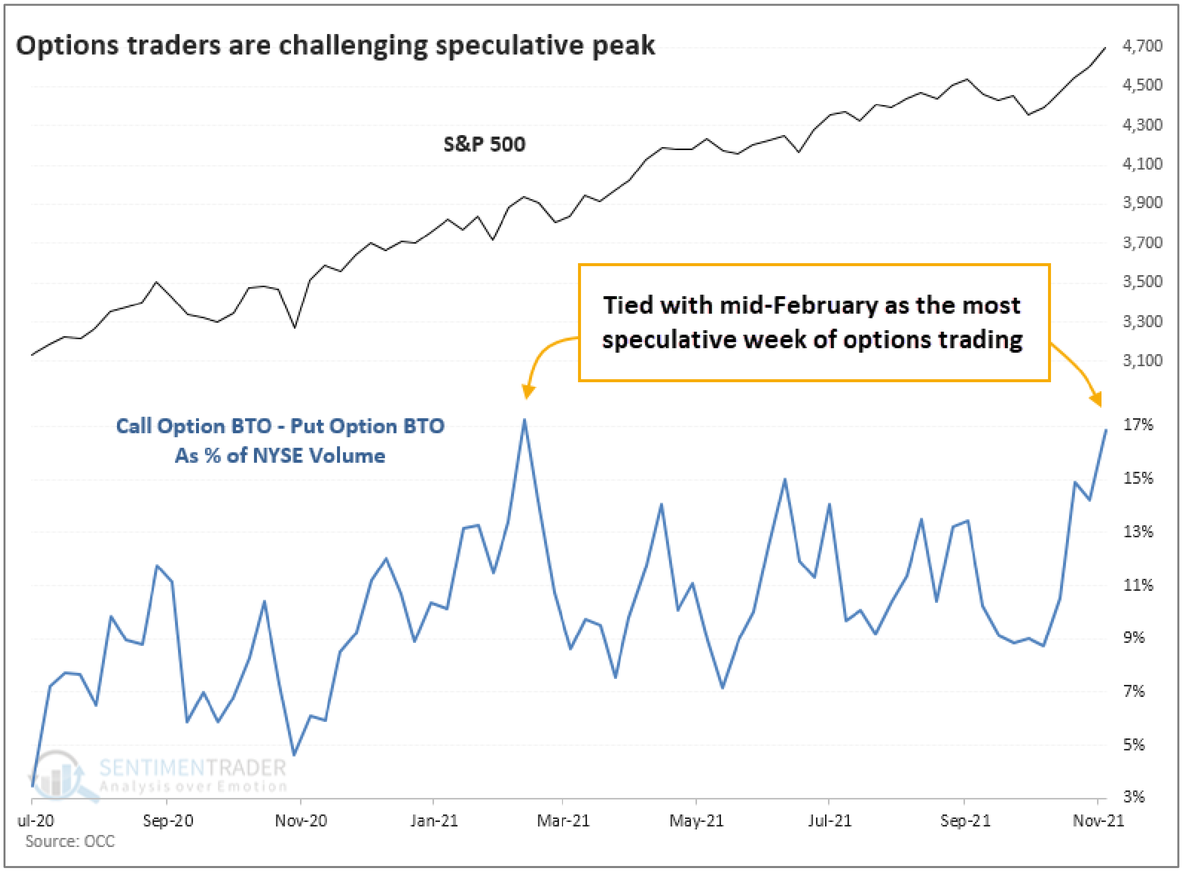
Leveraged ETF Volume Sentiment is back to enthusiasm.



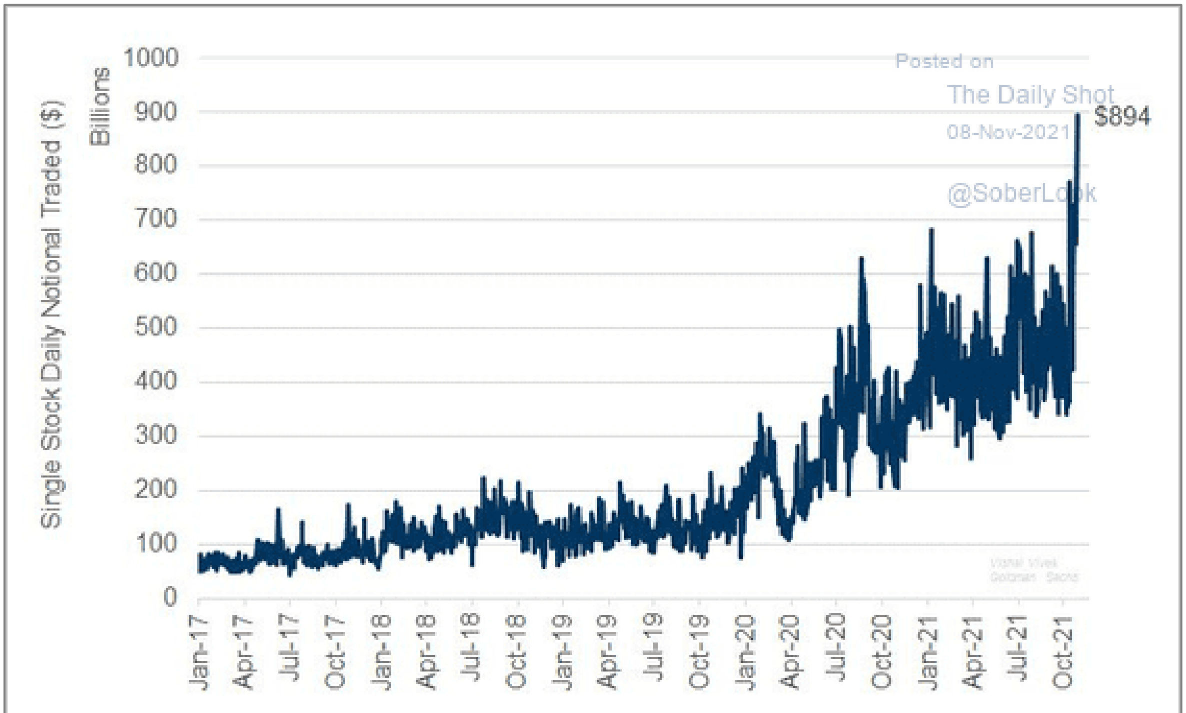
Bond Market inflation expectations surge to new highs.



Net purchases of call options to open pull even with February's speculative peak.

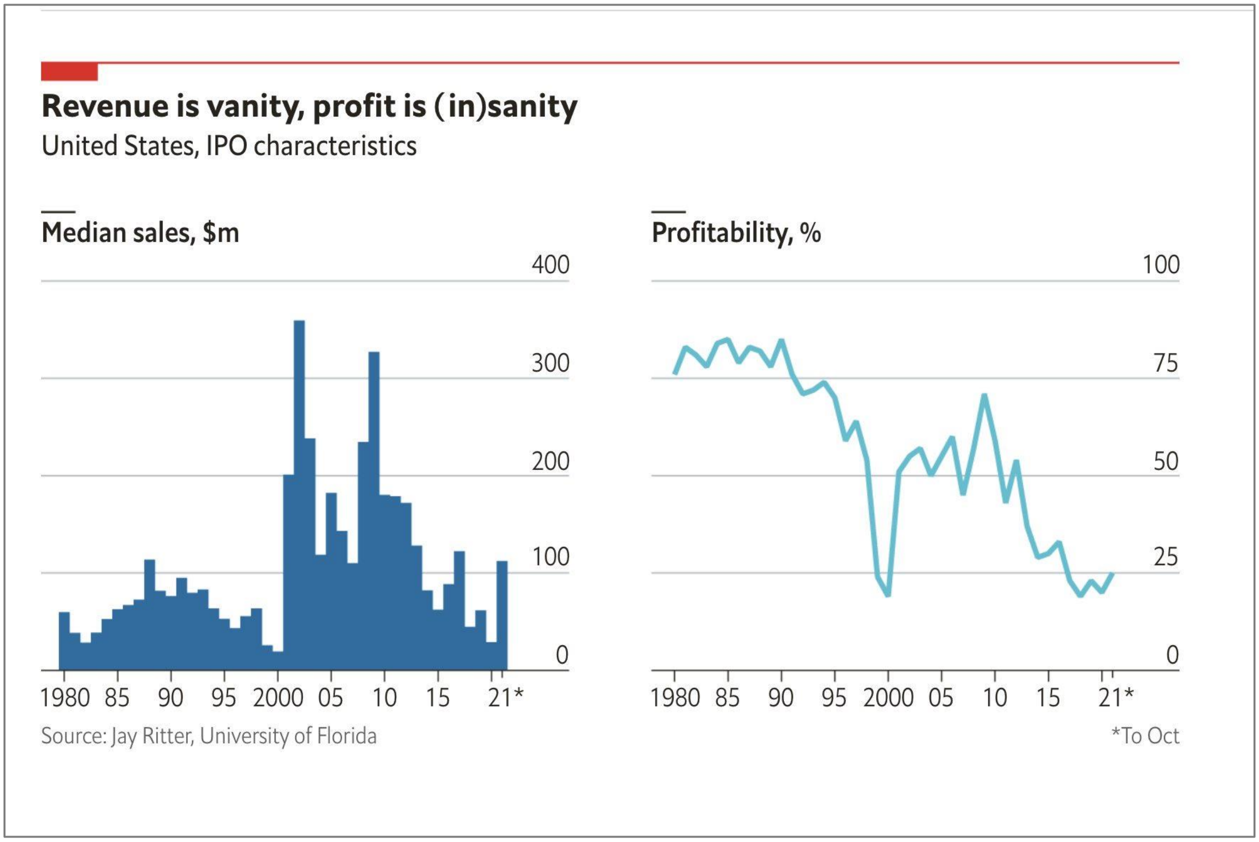


Notional Value of single stock options hit a record high.

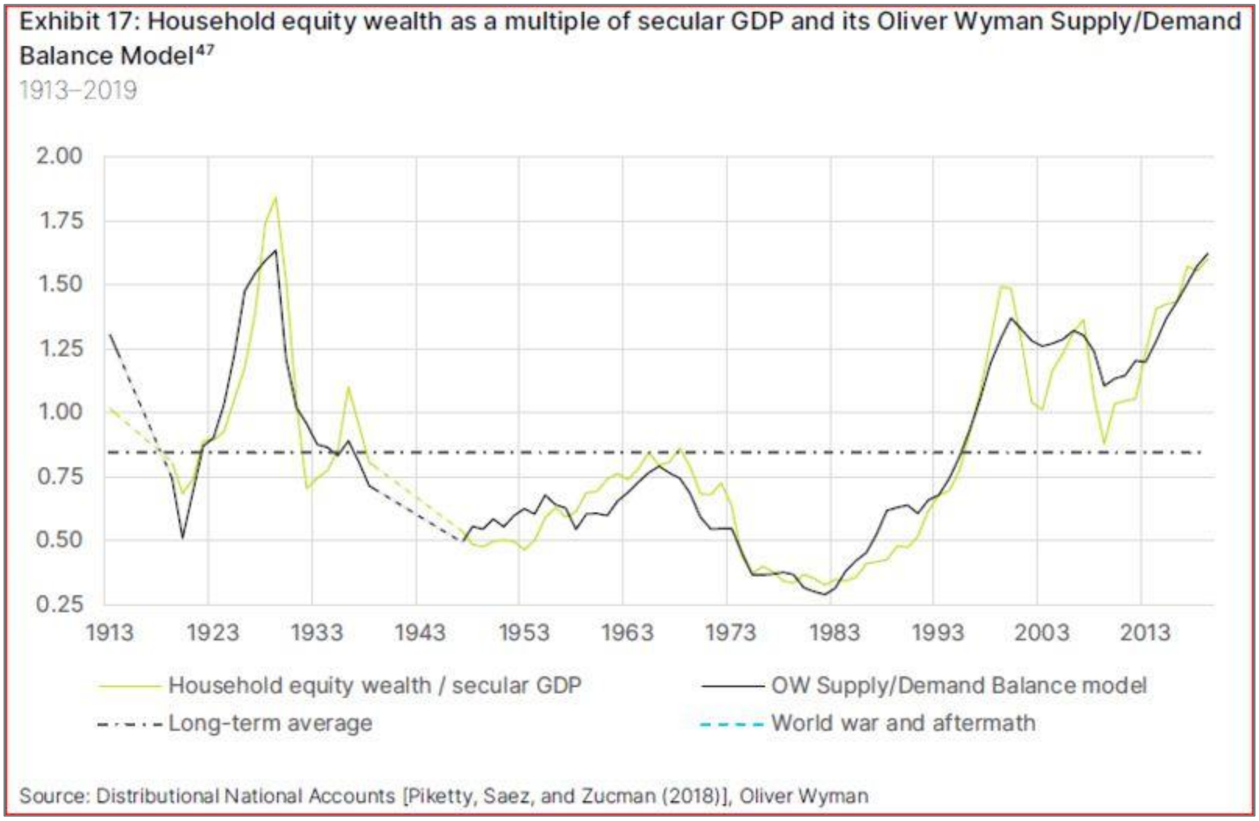


Source: Goldman Sachs Global Investment Research, Vishal Vivek, OptionMetrics, Bloomberg, All data as of 29-Oct close.

The percentage of Unprofitable IPOs period has persisted longer than the 2000 era.



Household Wealth/GDP is close to surpassing the 1929 record.

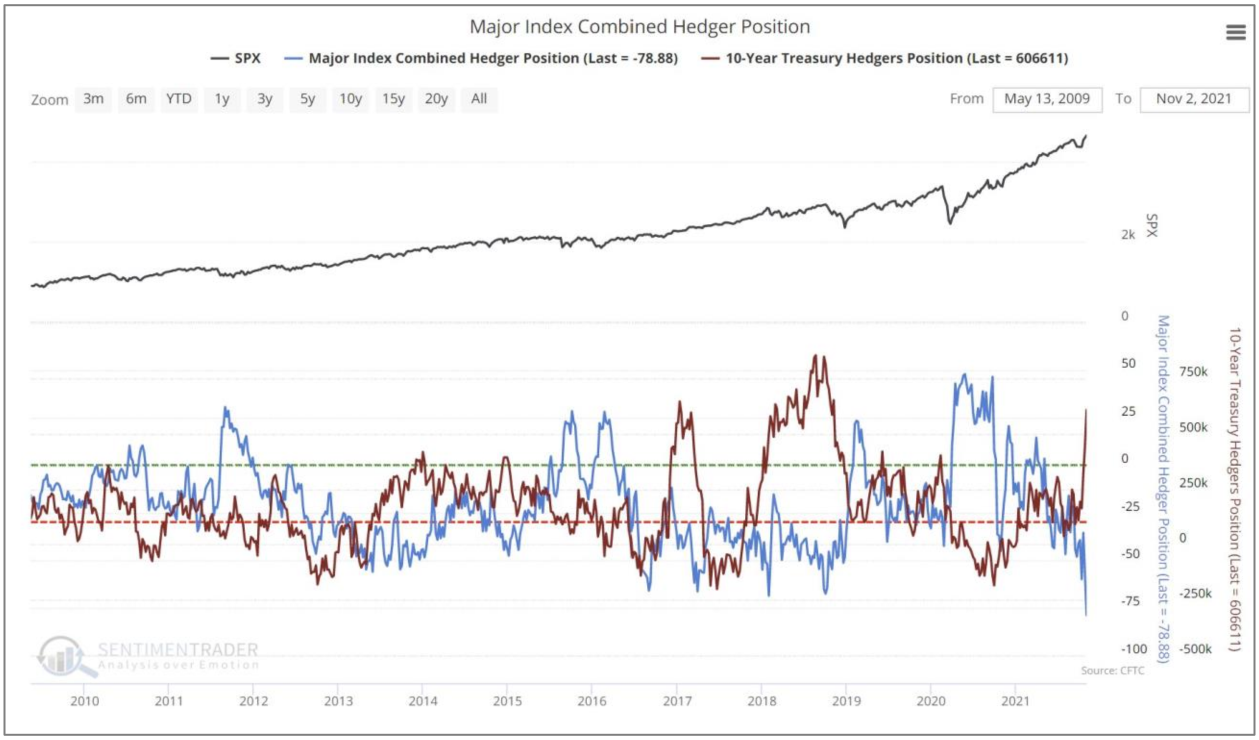


Source: John Authers

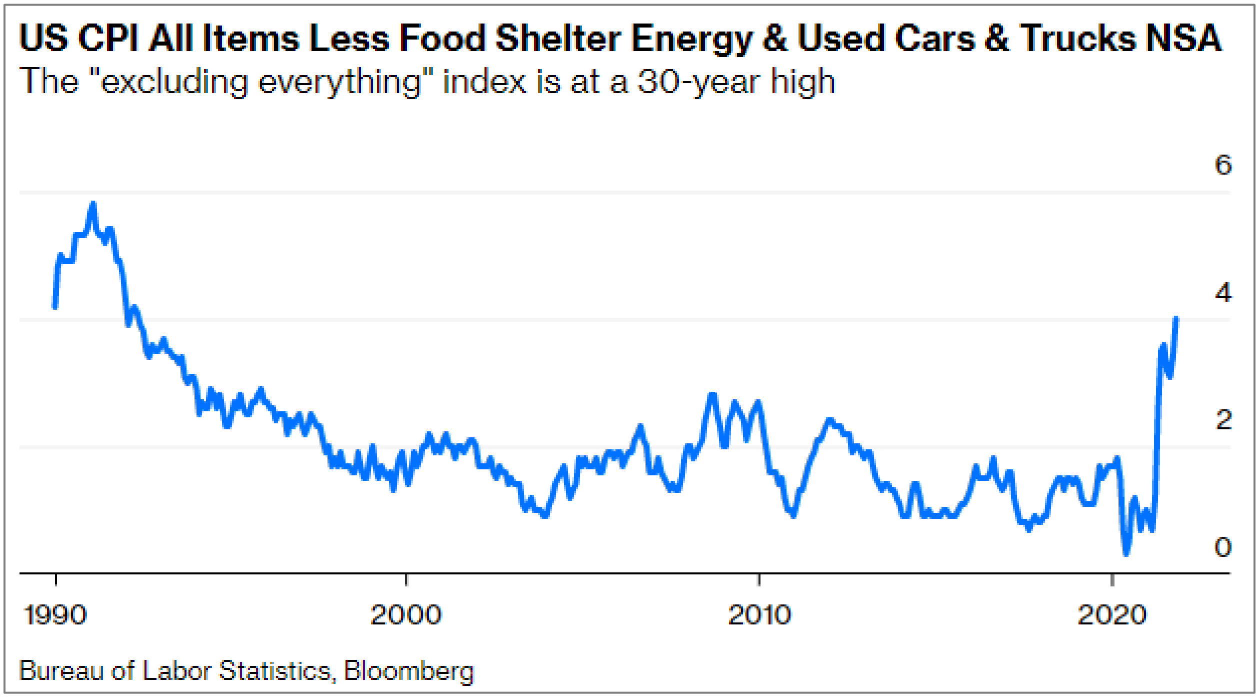
Tighter liquidity in China today implies lower US Treasury Yields tomorrow.

Source: Michael Arouet

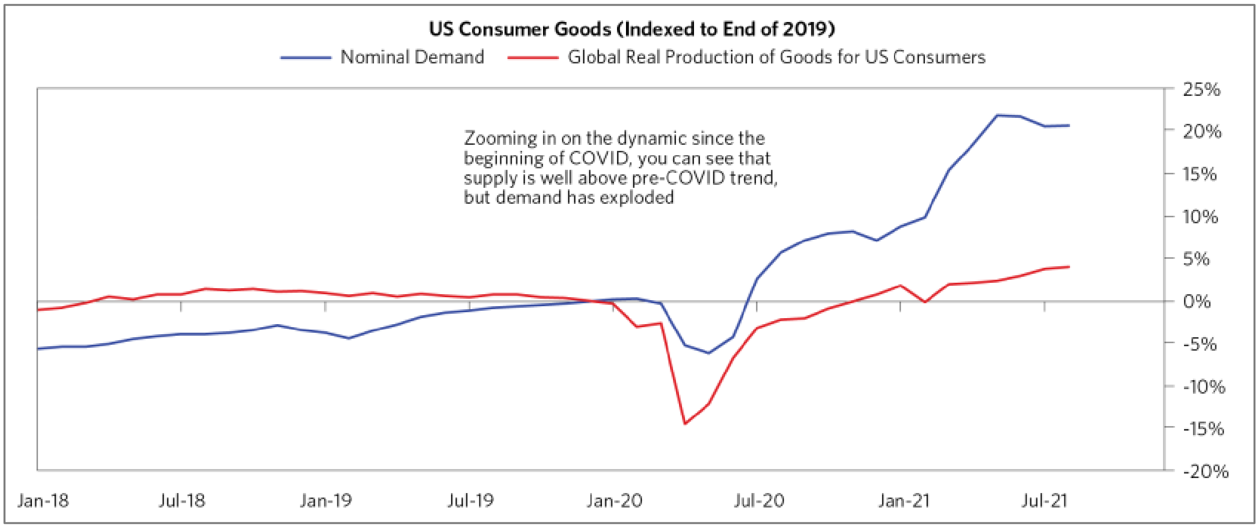
Smart-money surge in equity hedging and going long Treasuries.



CPI less every item that might be "transitory" or imply "supply chain issues" hits 30 Yr. High.

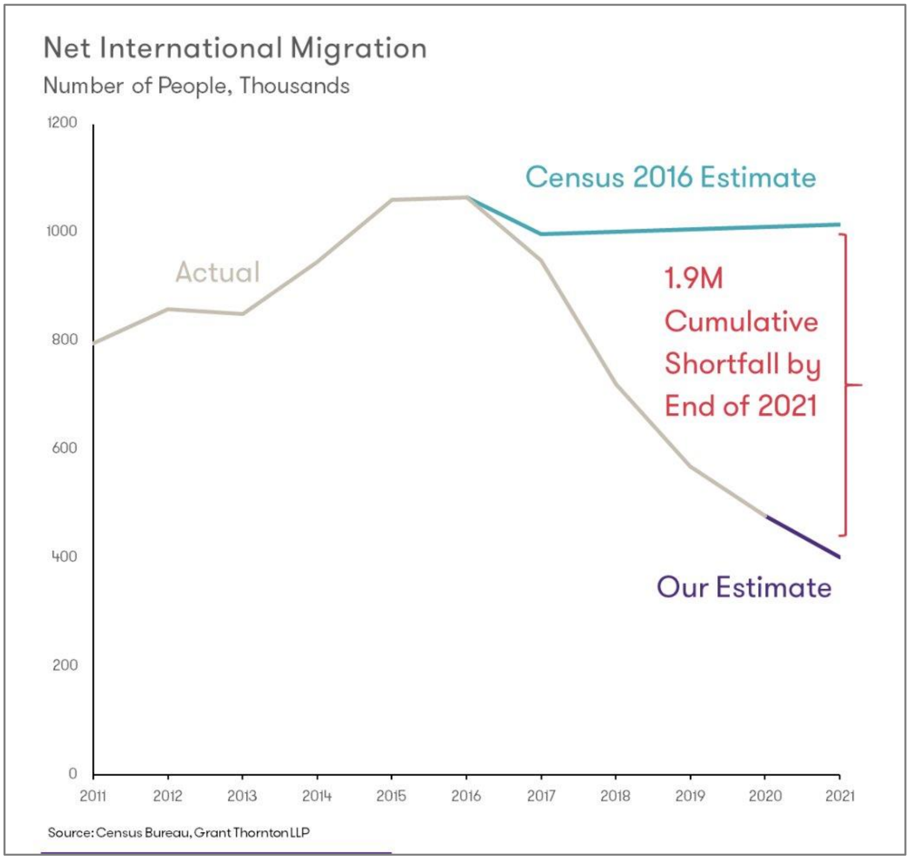


Supply is already above the pre-Covid Trend, but Demand has "exploded."



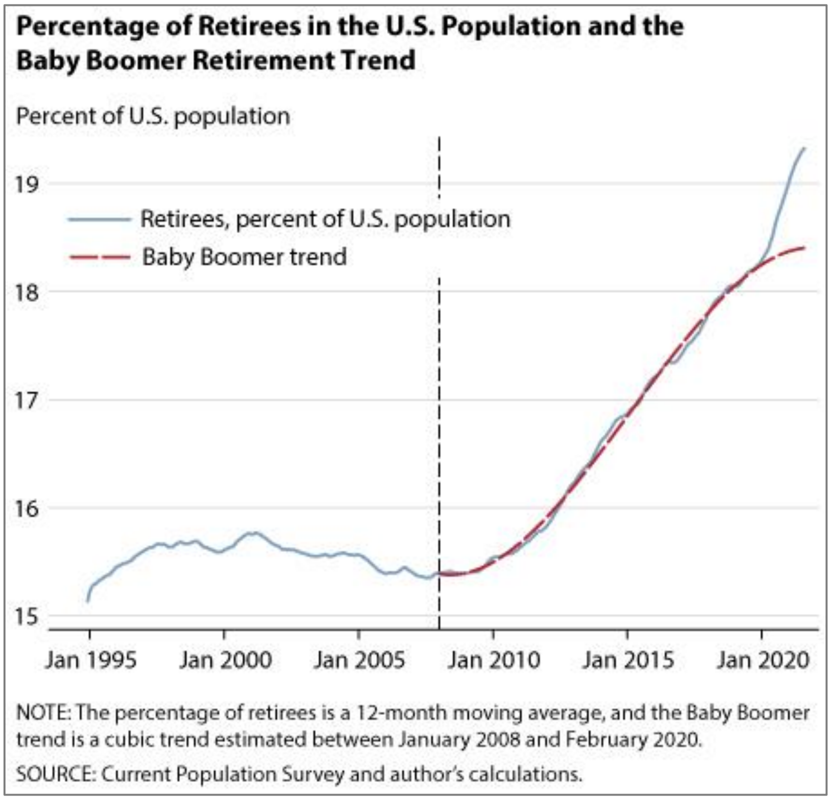
Source: Bridgewater

Legal Immigration has fallen 1.9 million short of estimates, leading to a shortage of Labor.



Source: Diane Swonk

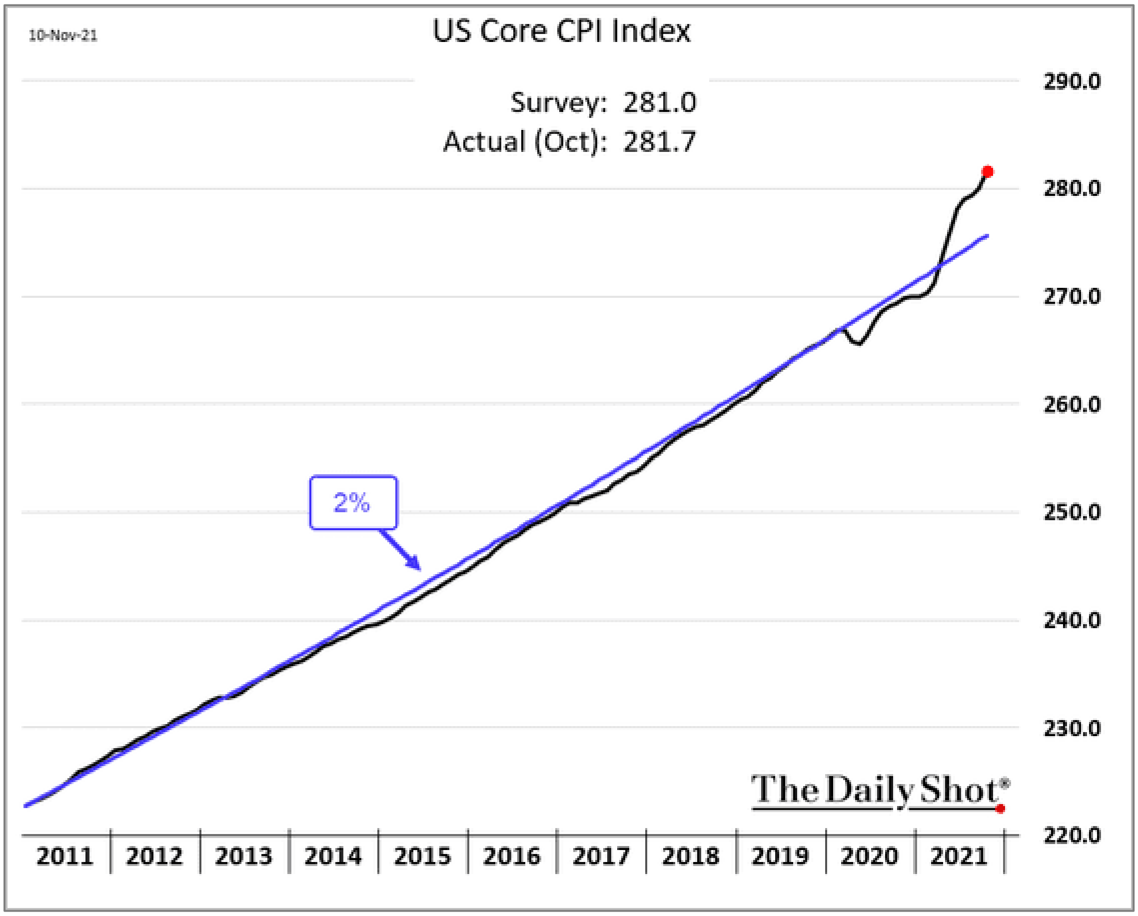
The Boom in Asset Prices leads to a surge in Retirees, leading to a shortage of Labor.



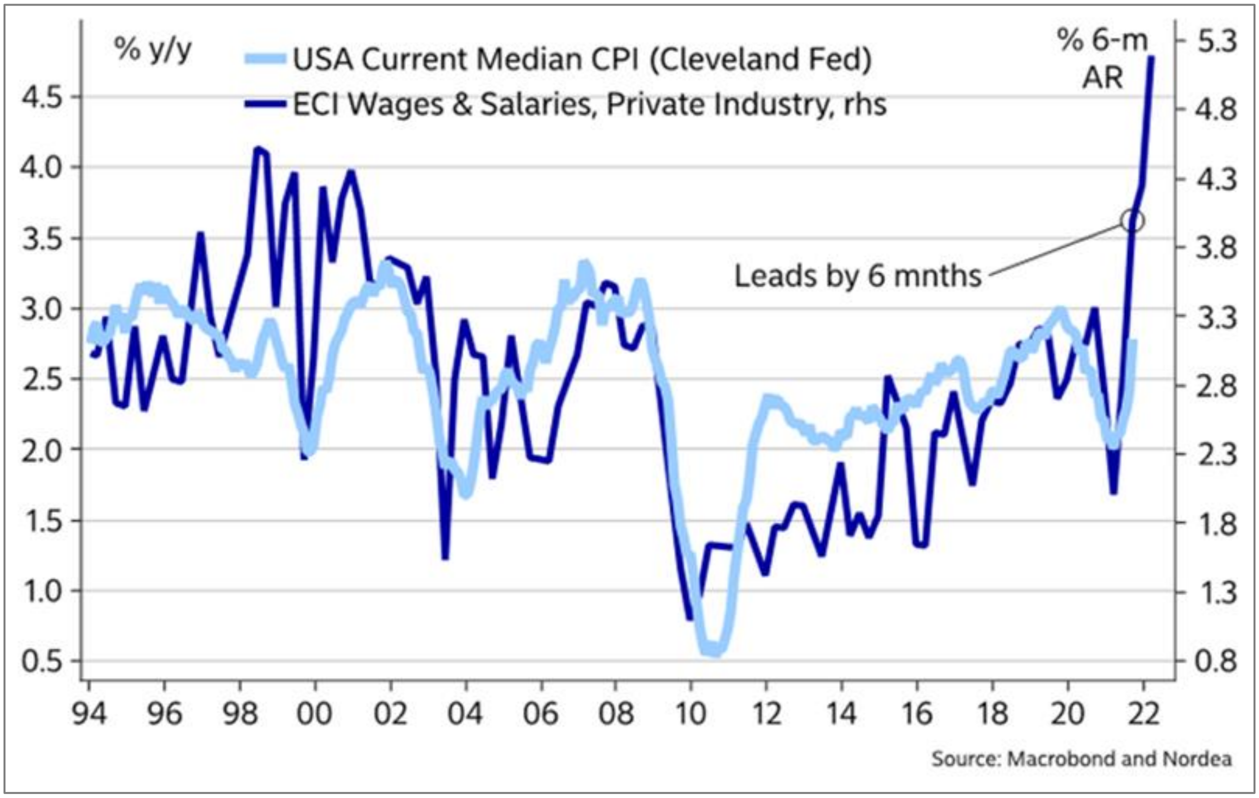
Source: St Louis Fed

Real Fed Funds Rate hits record low.

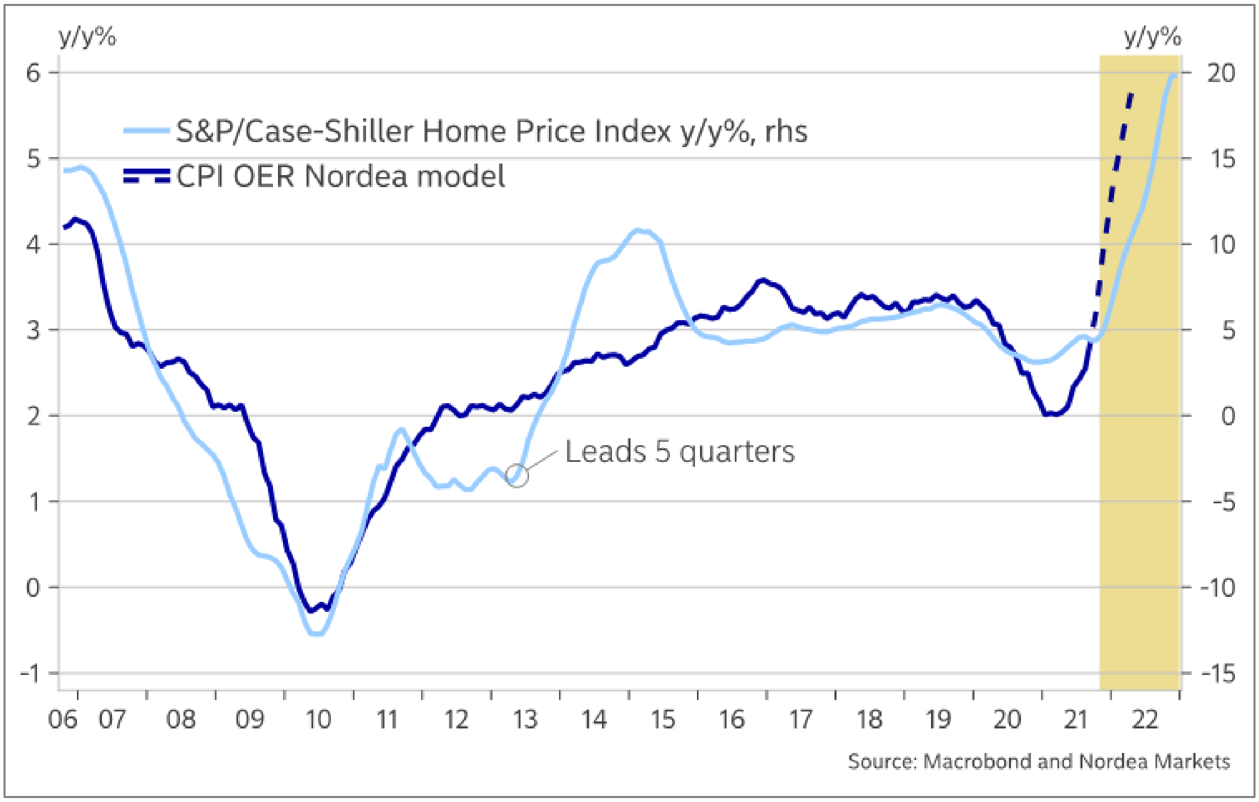
Core CPI is running well above trend.



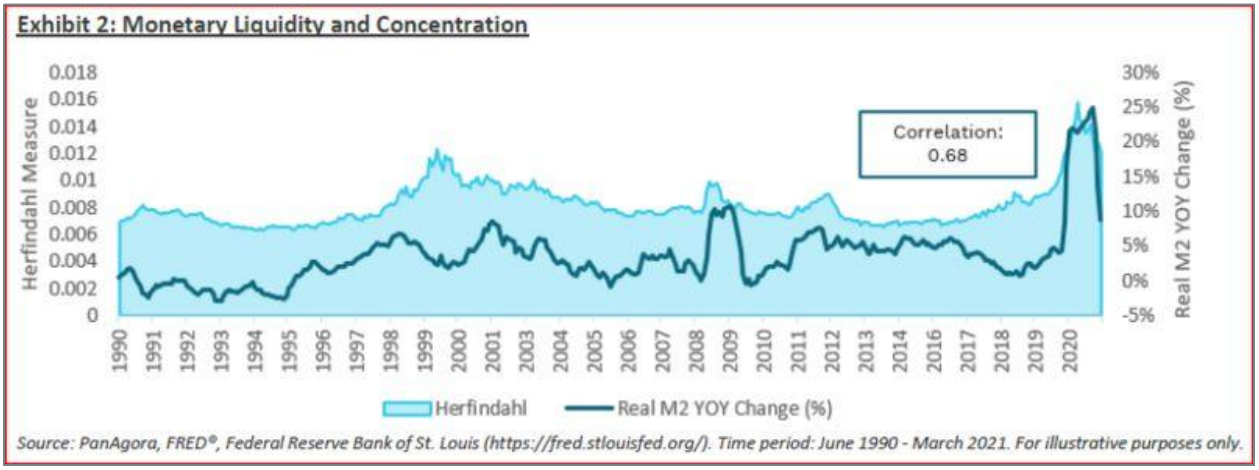
Wages & Salaries imply even higher Median CPI readings over the next Six Months.



Current Home Price Inflation implies even higher CPI over the next 15 months.

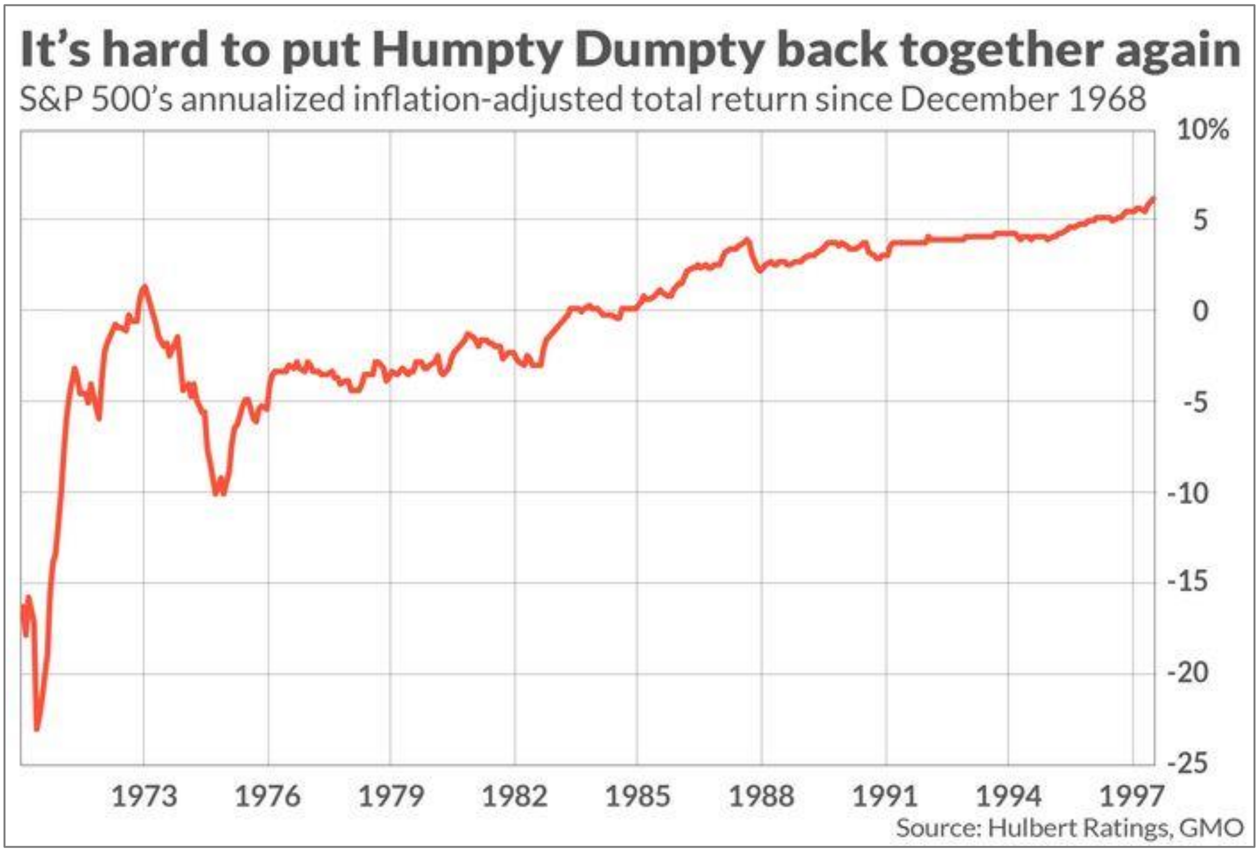


More Money Supply coincides with less Competition and higher Industry Concentration.



Source: John Authers

It took 30 years of Buy and Hold to earn the historical 6% real return on stocks if you bought at the 1968 peak.



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.

for more information.