Market Outlook

By Mark T Dodson, CFA

Market Risk Index climbs above 90%

Market Risk Index increased to 90.9% on deteriorating Monetary conditions. Consequently, we reduced US equity exposure in our Asset Neutral and Global Allocation portfolios during the last week of 2021, mainly reflecting a rebalancing to our asset allocation model target.

The deterioration in Monetary conditions resulted from higher rates of change on key interest rates, primarily credits, and municipals. In addition, the bond market has not only fully priced in three Fed Funds rate hikes this year but has also begun to flirt with the possibility of four hikes.

Long-duration Treasuries have lost some of their immunity in this regard. We are entering the third month since the Bond Momentum buy signal on longer duration Treasuries. After a solid start for the signal and quick initial gains, bonds have made a reversal, and yields have been working higher. While not impossible, another momentum reversal is improbable in January, so we don't anticipate shifting back into shorter duration Treasuries soon. Granted, given the present level of yields and current inflation rate, we didn't embrace this signal with as much fervor and capital as others in the past. Still, the bond momentum's bullish signal for Treasuries makes sense intuitively. All things equal, a more hawkish Fed is more likely to lead to lower yields on 10Yr and 30Yr Treasuries.

The good news on the inflation front is that the growth rates in the CRB Raw Industrials, ISM Price Index, and PPI inflation have peaked. The bad news is that inflation levels remain too high to begin upgrading the inflation category from negative to neutral, which would improve our outlook for the drawdown risk present in markets.

Investor psychology improved slightly, but our Short-Term sentiment composite shows a rebound in optimism, nearly moving one-standard deviation into greed. Leveraged Fund Sentiment hit FOMO territory on Monday, and equity put/call data continues to trace a pattern similar to the late 1990s.

Market Risk Index

Rec Allocation 25% Underweight

90.9%

Category Percentiles

Psychology - P6	95.9%
Monetary - M4	71.2%
Valuation - Extremely Overvalued	99.4%
Trend	0.0%

Largest Psychology Influences

Levered Investments	Negative
Option Activity	Negative
Volatility	Negative
Bank Sentiment	Positive

Largest Monetary Influences

Inflation	Negative
Velocity	Positive
Exchange Rates	Positive

Valuation

7-10 Year Rtn Forecast	-0.2%
10Yr US Treasury Yield	1.7%

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.

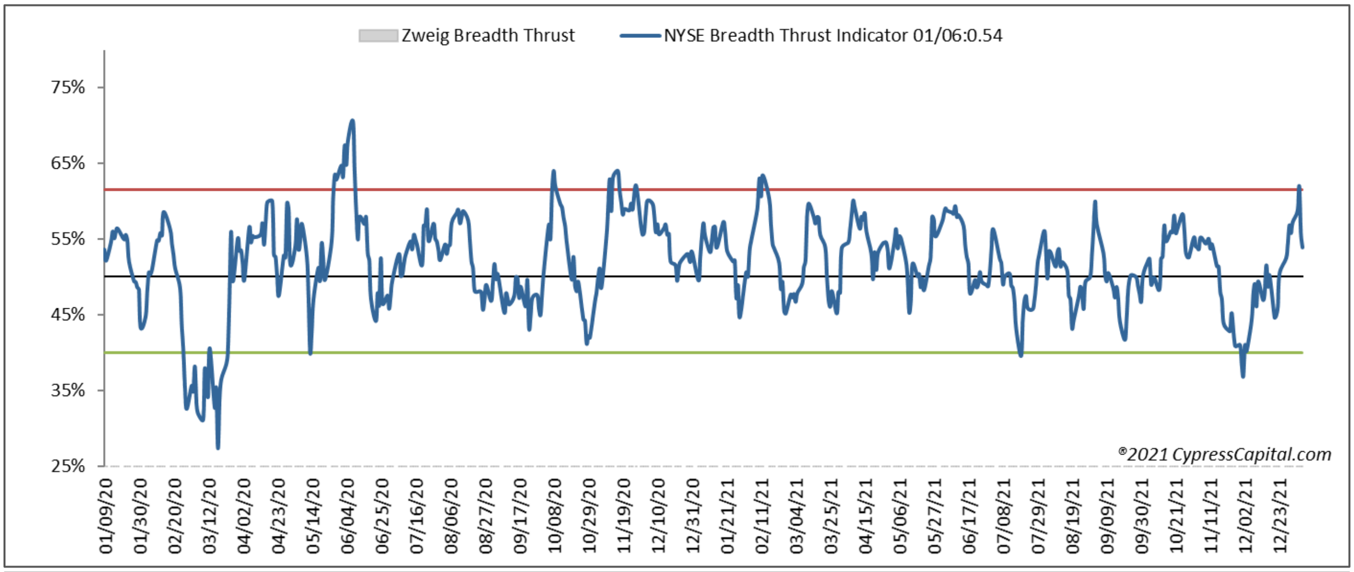
Stock market breadth is giving mixed signals. NASDAQ breadth has been terrible, having worsened steadily from the point of the NASDAQ High Low Logic sell-signal back in November. The retracement in many of the most speculative NASDAQ stocks is reminiscent of the early days of the dot-com bubble bursting. Yet, there was evidence of a rush to buy the December dip in the form of a thrust in breadth – a recurring pattern since the bull market's start. The first week in January kicked off with a more selective breadth thrust, this one in one in NYSE listed stocks and individual S&P 500 stocks. It occurred early in the week, right before the rug pull by markets after reacting to recent Fed minutes during the second half of the week.

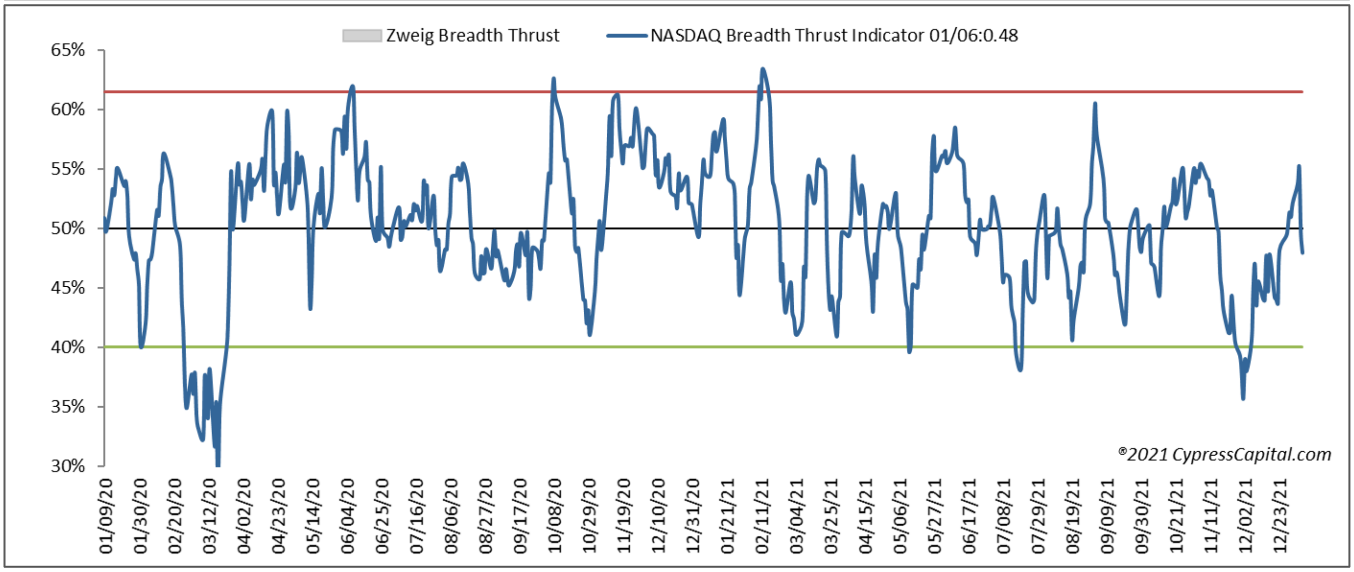
That leaves us with the current state of valuations, which begin 2022 incredibly stretched. If they were to simply correct to the average valuation of previous bull market peaks, it would qualify as a substantial bear market. It's unlikely that we'll see valuation signal a better risk-reward for defensive investors anytime soon. Instead, lowering the Market Risk Index – and the drawdown risk present in markets it implies – will require a simultaneous softening of animal spirits and inflationary pressures. That's rugged terrain for central bankers to navigate without running into more stock market volatility.

Charts of The Week

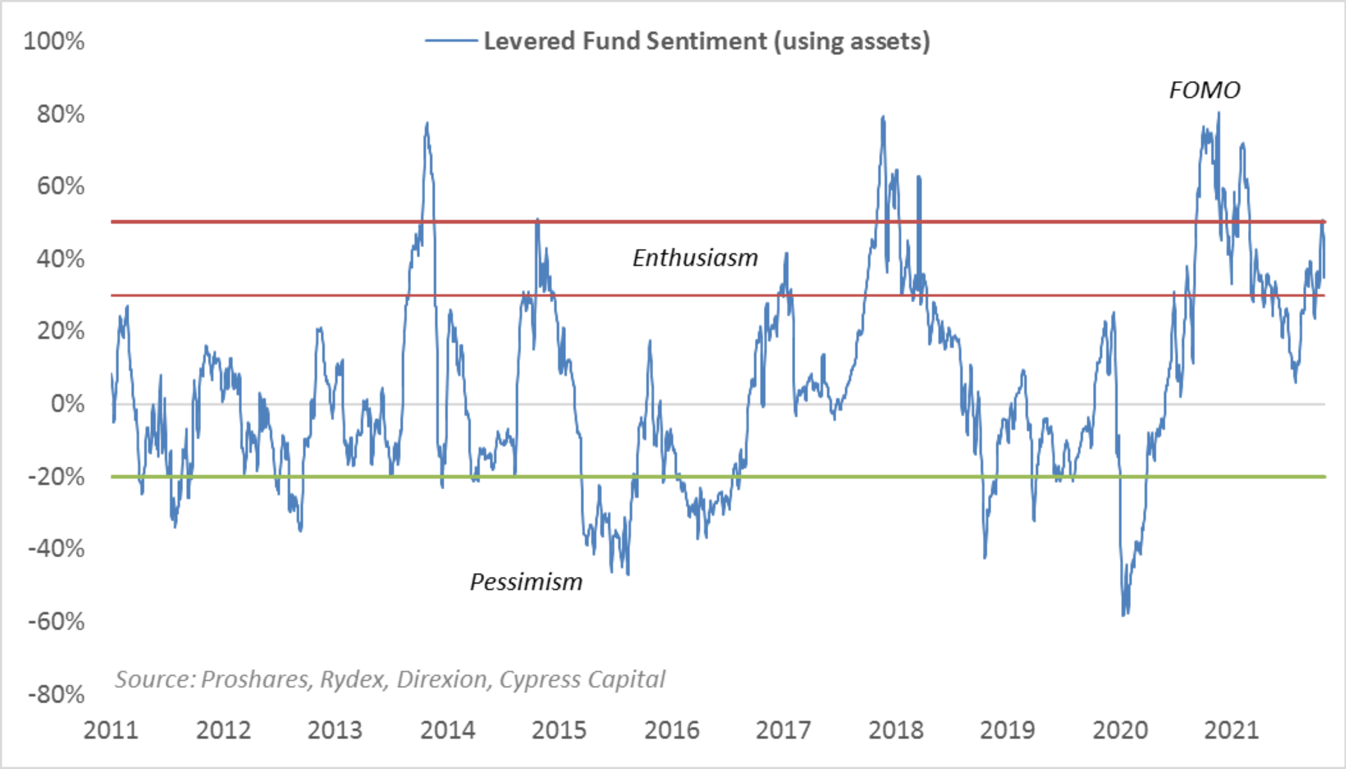
A Tale of Two Breadth Thrusts

While not achieving the threshold of a traditional Zweig Breadth Thurst, there was a surge in the number of NYSE advancing issues to start 2022. It tends to be associated with healthier market advances. Meanwhile, the NASDAQ has shown no such behavior, falling decidedly short.

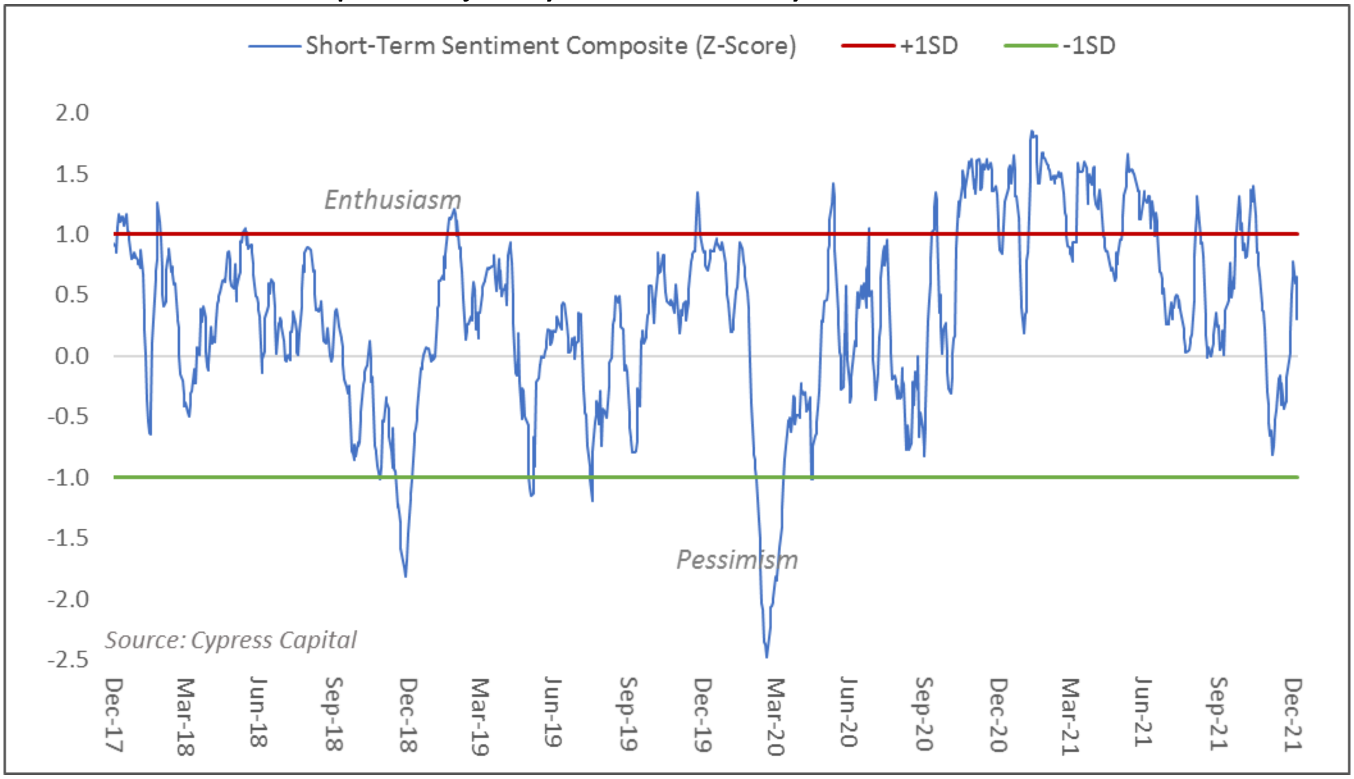




Levered Fund Sentiment hit FOMO levels on Monday.



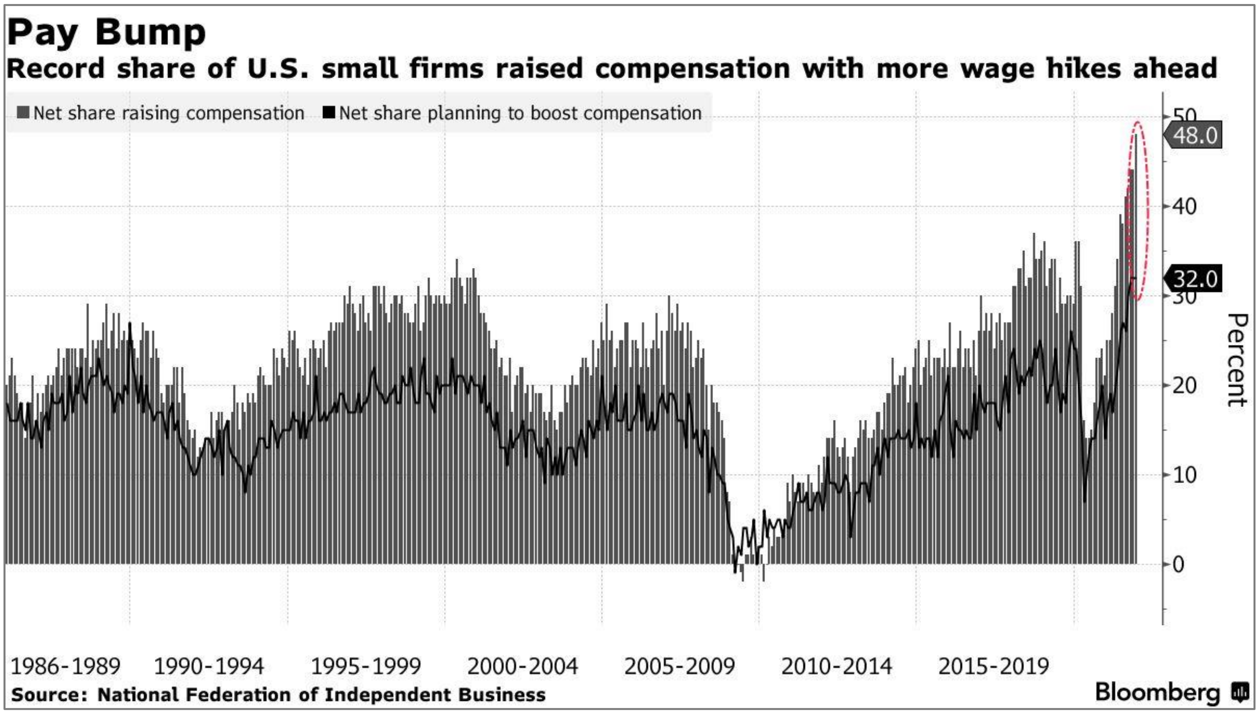
Short-Term Sentiment Composite fell just shy of Enthusiasm early in the week.



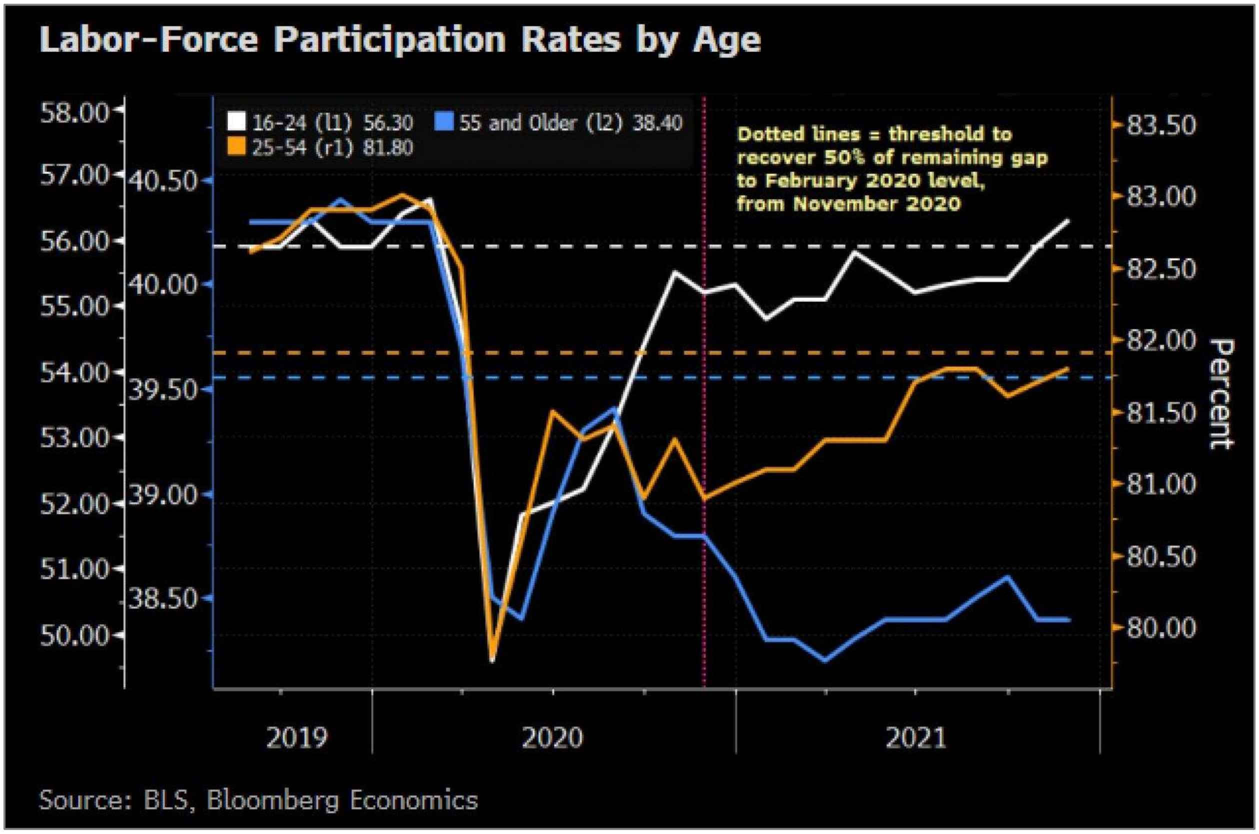
Wage/Price Spiral? Wages growth surpasses the Unemployment rate for the first time ever.

Source: @RBAdvisors

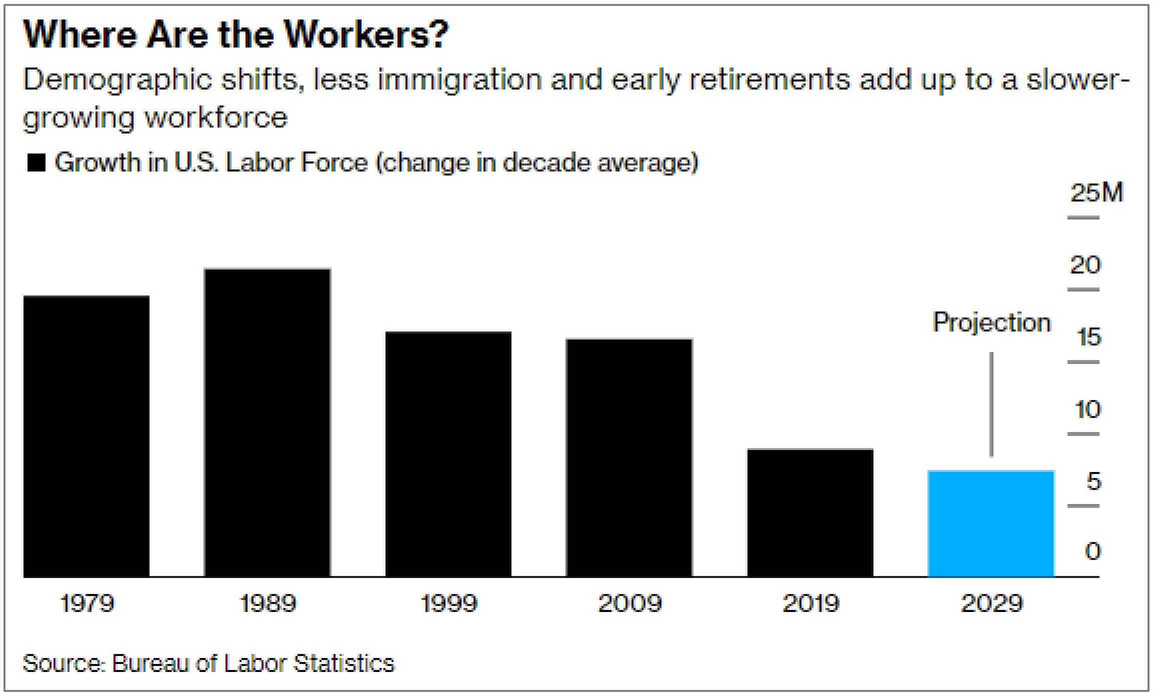
Record number of small businesses raised compensation.



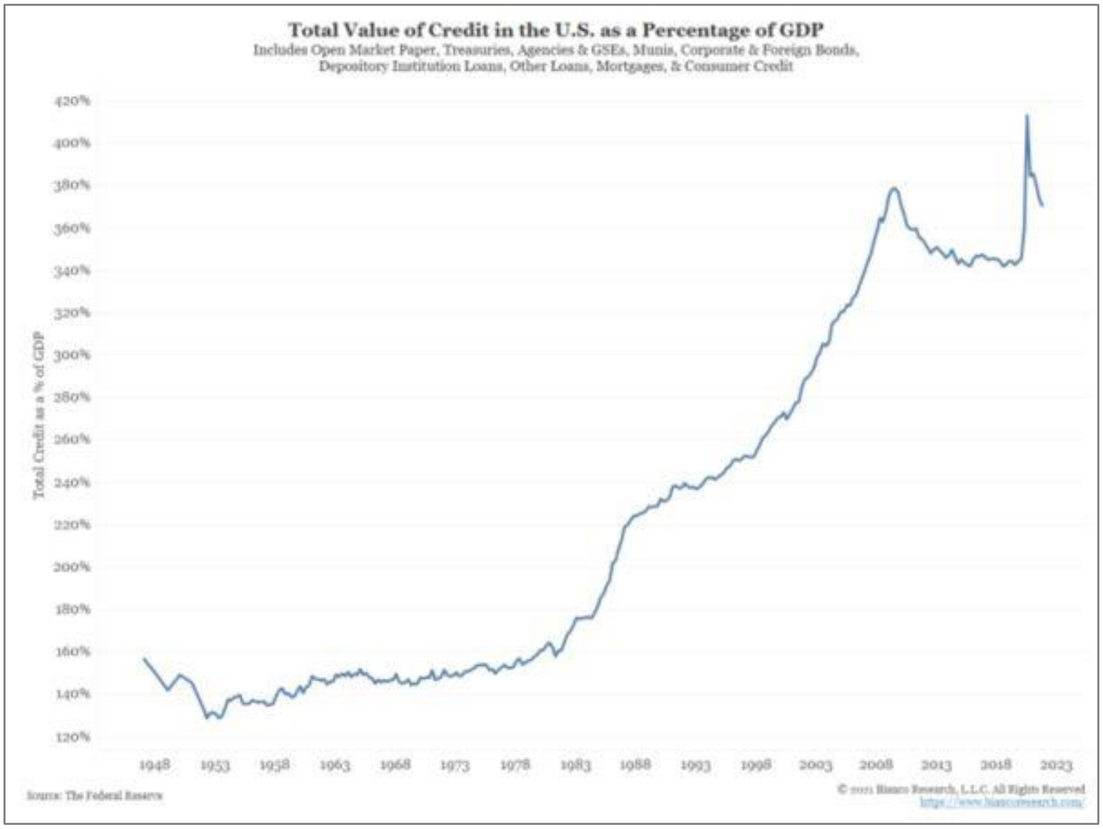
Stimulus-driven stock market boom drives the 55 and Older cohort into early retirement.



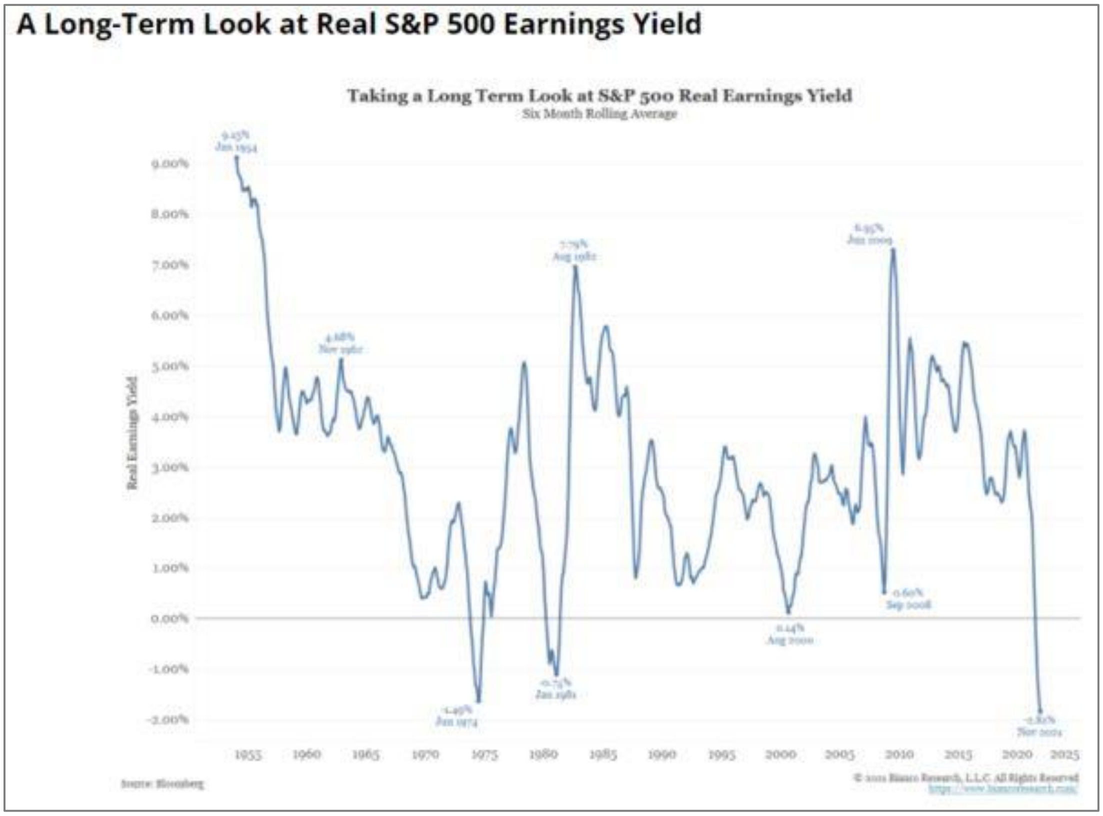
Slower projected growth in Labor Force



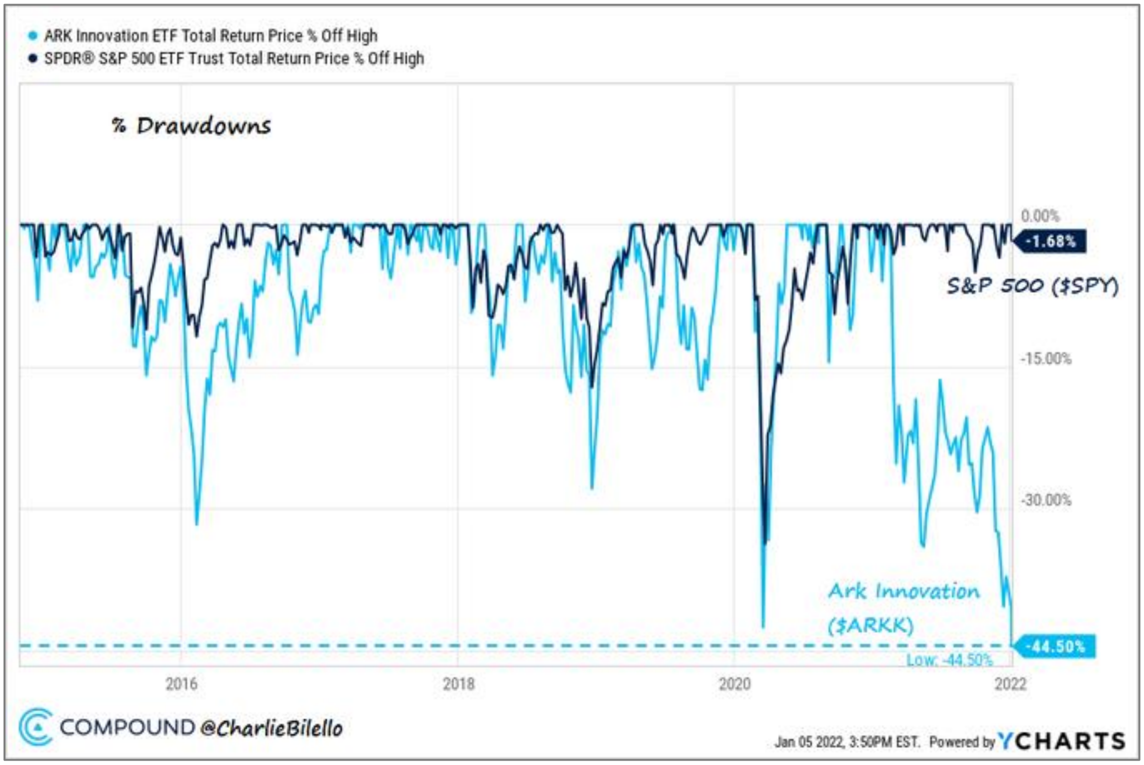
Covid stimulus drove the Value of Credit Outstanding to all time highs.



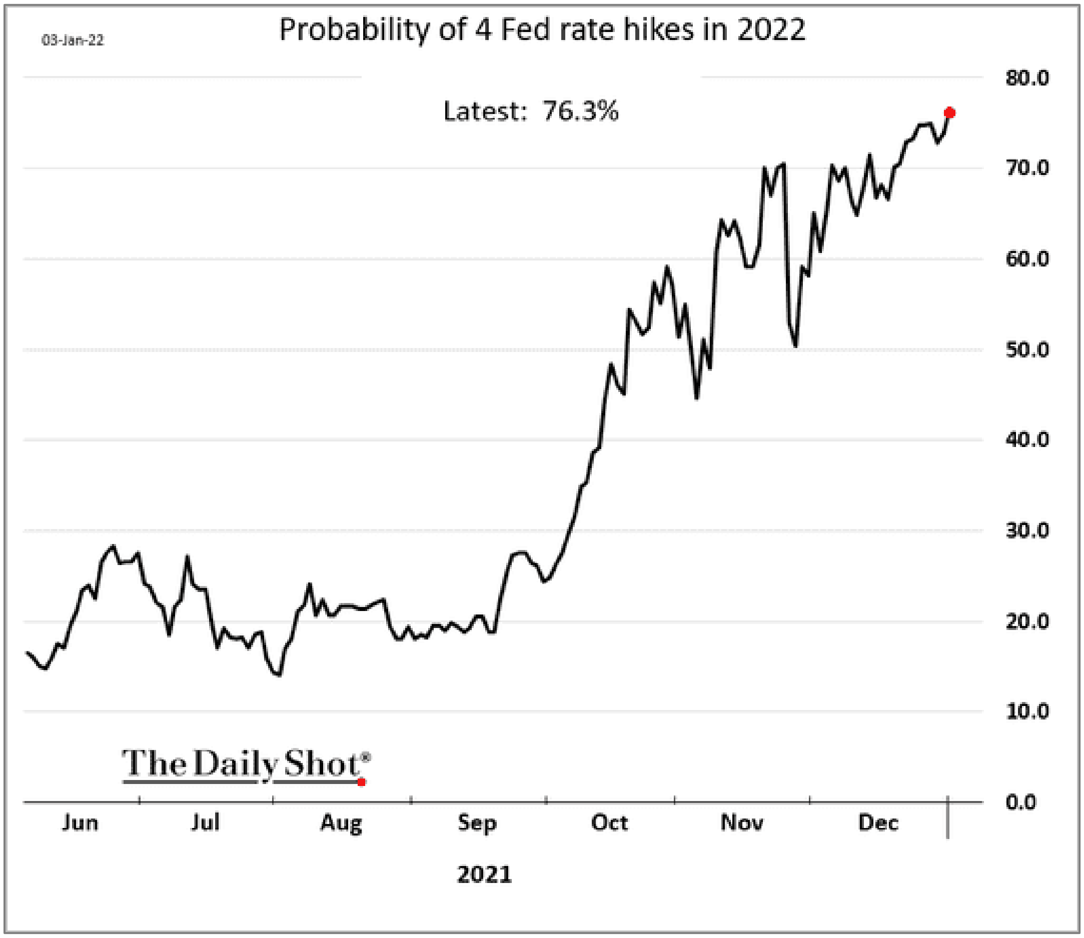
Real earnings yield on stocks falls below -3%, beating 1974's previous record low.



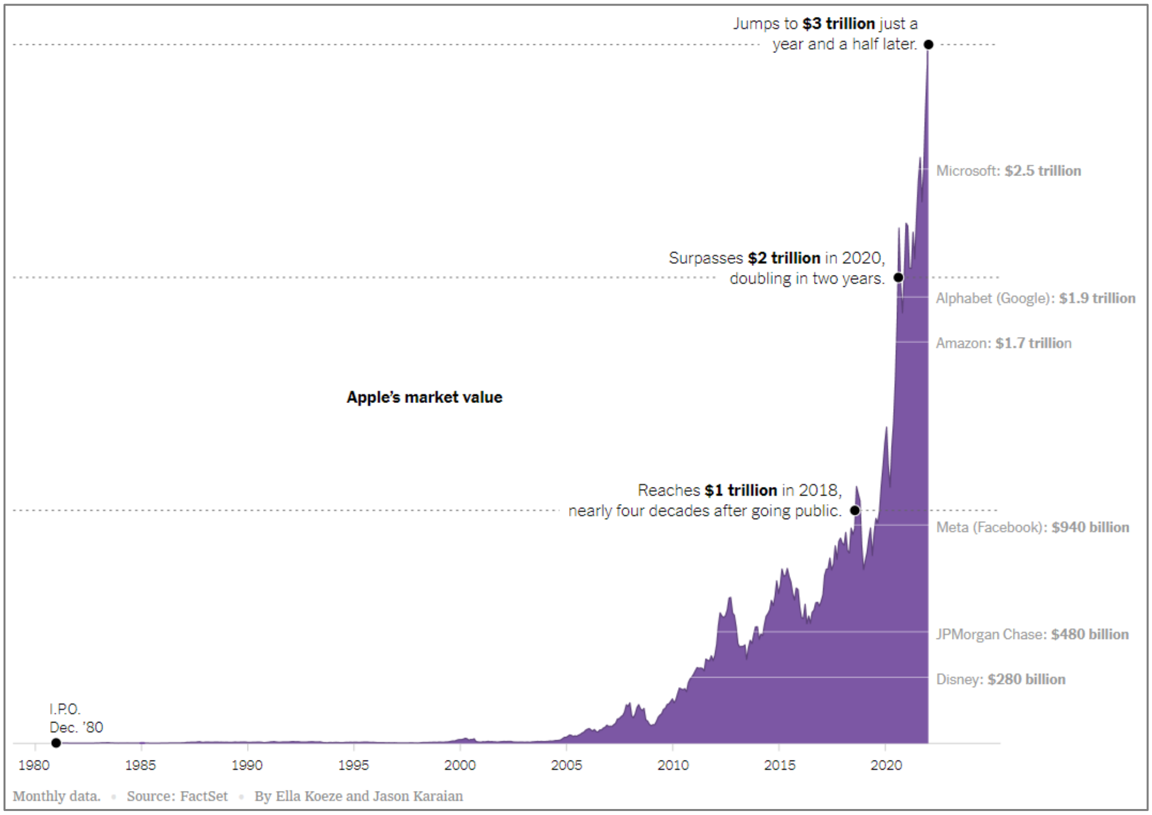
ARK's bear market has exceeded its drawdown from March 2020.



Probability of 4 Fed rate hikes this year is climbing

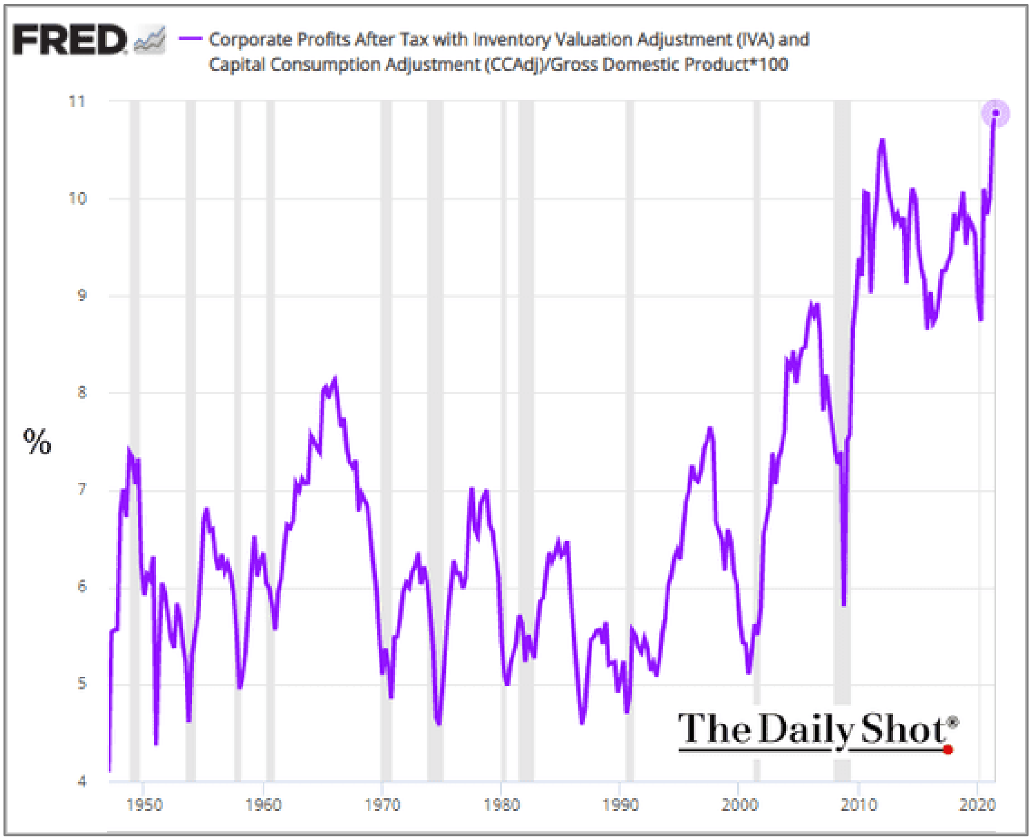


Apple becomes the first company to be worth more than $3 Trillion

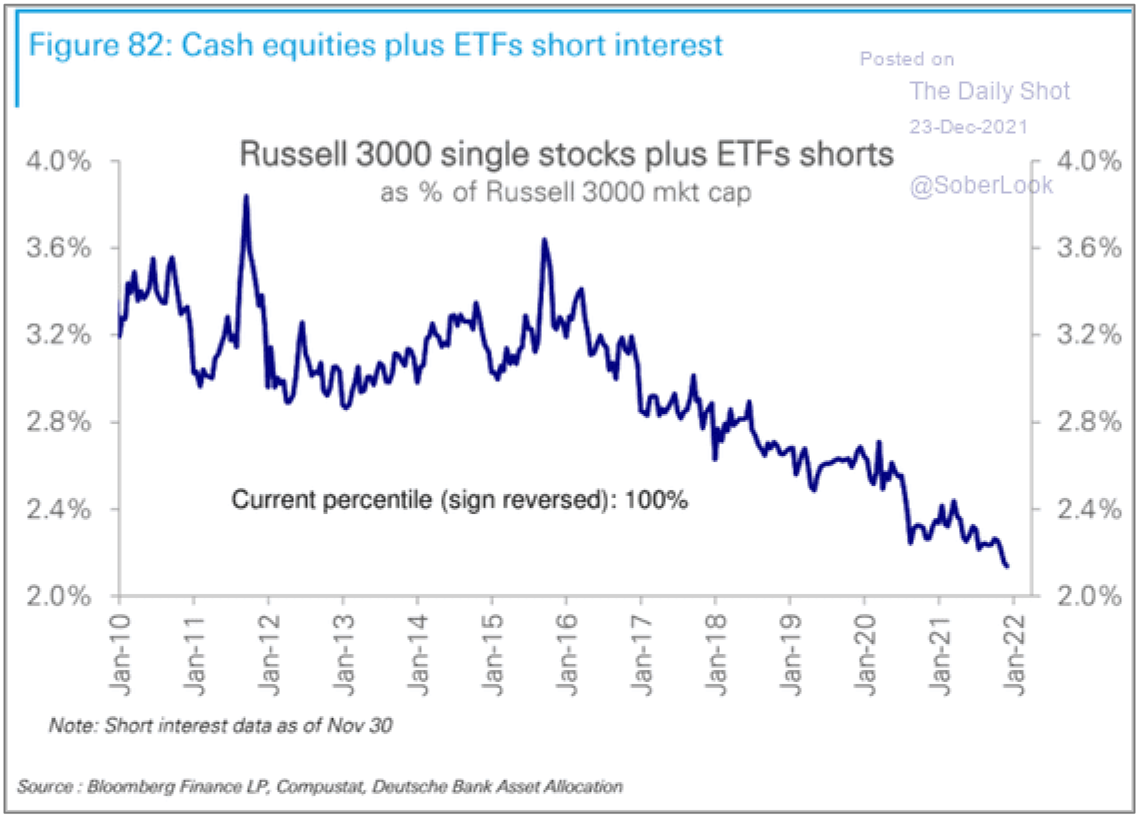


Source: NYTimes

Corporate Profits as a percent of the economy set a new record.



Short-Interest falls to new lows.



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.