Market Outlook

By Mark T Dodson, CFA

The Wall of Worry is improving.

Market Risk Index increased to 91.6%. Both investor psychology and valuation improvements were insufficient to offset another sharp increase in the Monetary composite risk score. It's the continuation of a recent trend of rapid monetary deterioration – a shift that coincided with the change in tone by the Federal Reserve late in 2021. Money is growing tighter well before a single Fed Funds rate increase.

This tightening cycle is not likely to be as steady or easy to game as in the past. This Fed shift is only initiating well after reaching full employment, with inflation running beyond levels that anyone would consider healthy or even possible. That's not the playbook of the Federal Reserve we have known. This is flying by the seat of your pants Fed policy.

Turning points in the Velocity component of our Monetary composite tend to coincide, within a month or two, with changes in the direction of the inflation rate. Today, velocity is still in acceleration mode. There is no magic wand to reduce the level of inflation. It requires a combined hit to the wealth effect and economic activity – an environment where uncertainty and volatility increase – a recipe for a more sustained risk-off environment.

We expect the inflationary environment to last longer than consensus expects, as we are conditioned by decades of disinflationary trends. The pendulum has been swinging away from long-term secular drivers of disinflation like free trade and immigration for half a decade, with few signs of reversal.

Broad valuations remain too stretched to make a defensive investor salivate, but we were encouraged to see some significant investor sentiment improvements. The short-term wall of worry is nearly rebuilt, as judged by our Short-Term sentiment composite, which shows the most stock market pessimism since March 2020. Corporate insiders stepped up in the last week, and the AAII survey has had persistent bearishness – moving nearly two standard deviations into the "fear" zone. All of this increases the likelihood of a short-term bottom. Longer-term concerns about the wall of worry and too much speculation remain, but even the riskiest stock market environments get reprieves.

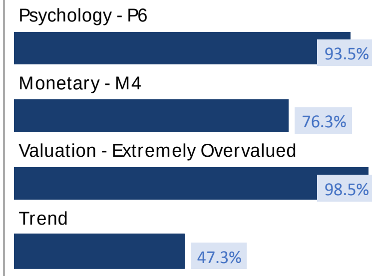
While we do not anticipate any major shifts to broad equity allocations with the MRI still above 90%, there has been enough devastation under the surface to present some opportunities in individual equities. Case in point – we initiated a partial position in Starbucks within our Select Dividend accounts early in the week.

Market Risk Index

Rec Allocation 25% Underweight

91.6%

Category Percentiles



Largest Psychology Influences

Levered Investments	Negative
Surveys	Positive
Bank Sentiment	Positive
Consumer Confidence	Negative

Largest Monetary Influences

Inflation	Negative
Interest Rates	Negative
Velocity	Positive

Valuation

7-10 Year Rtn Forecast	0.5%
10Yr US Treasury Yield	1.8%

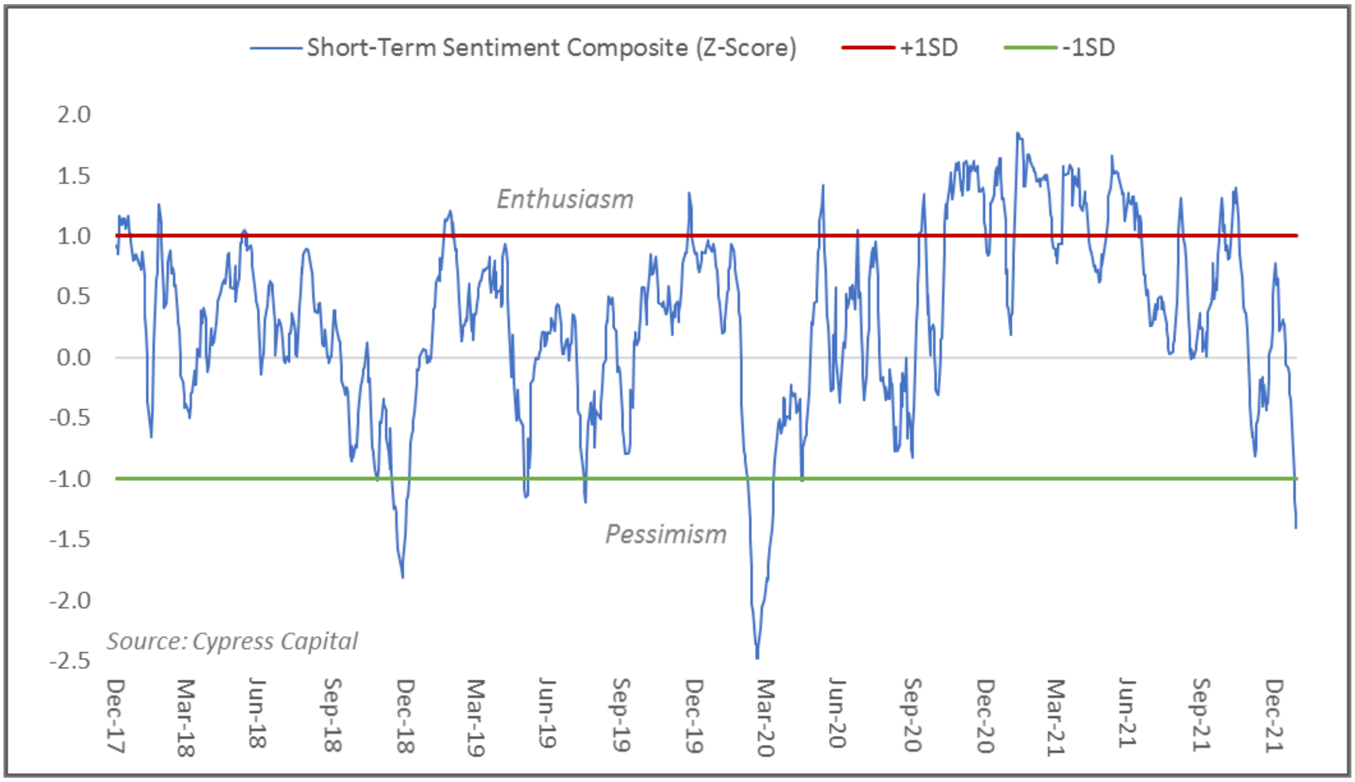
Market Trends

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.

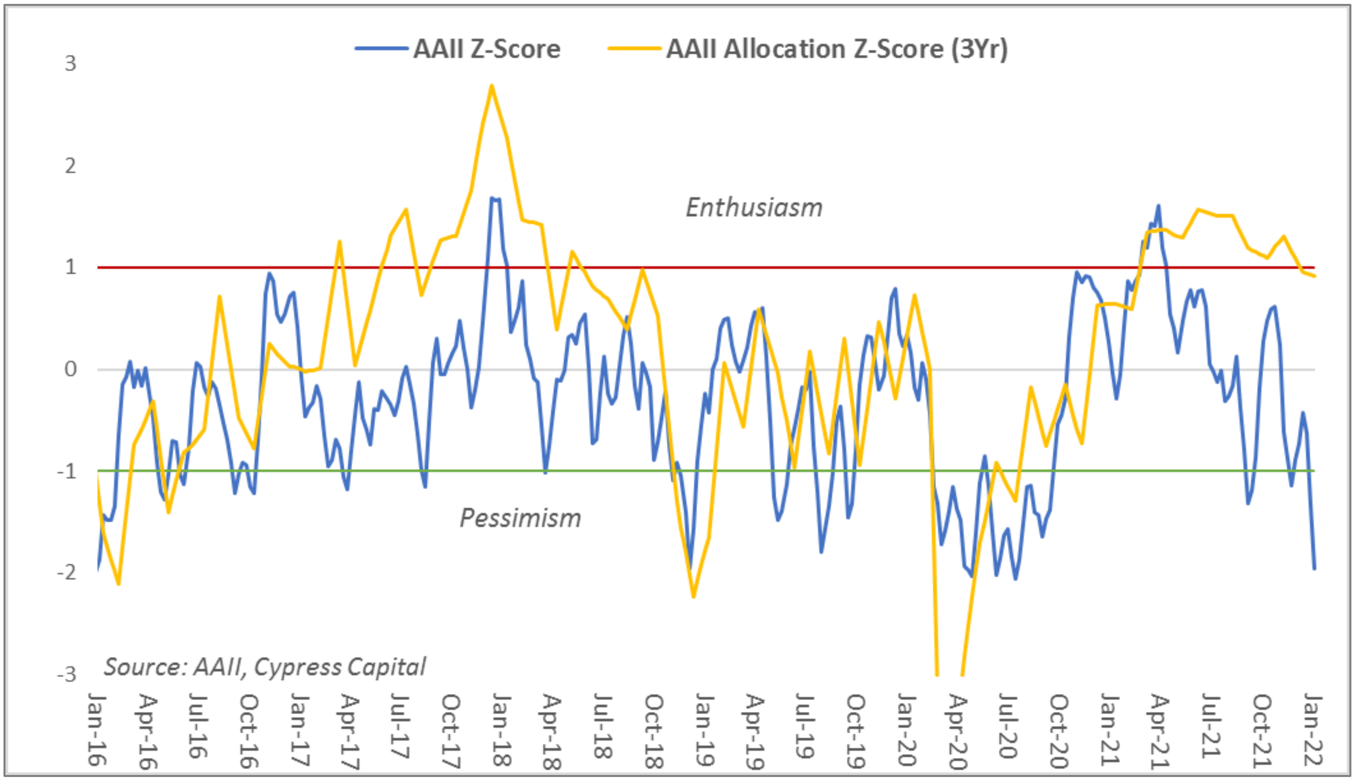
Charts of the Week

Short-Term Sentiment Composite has improved to the best condition since March 2020.

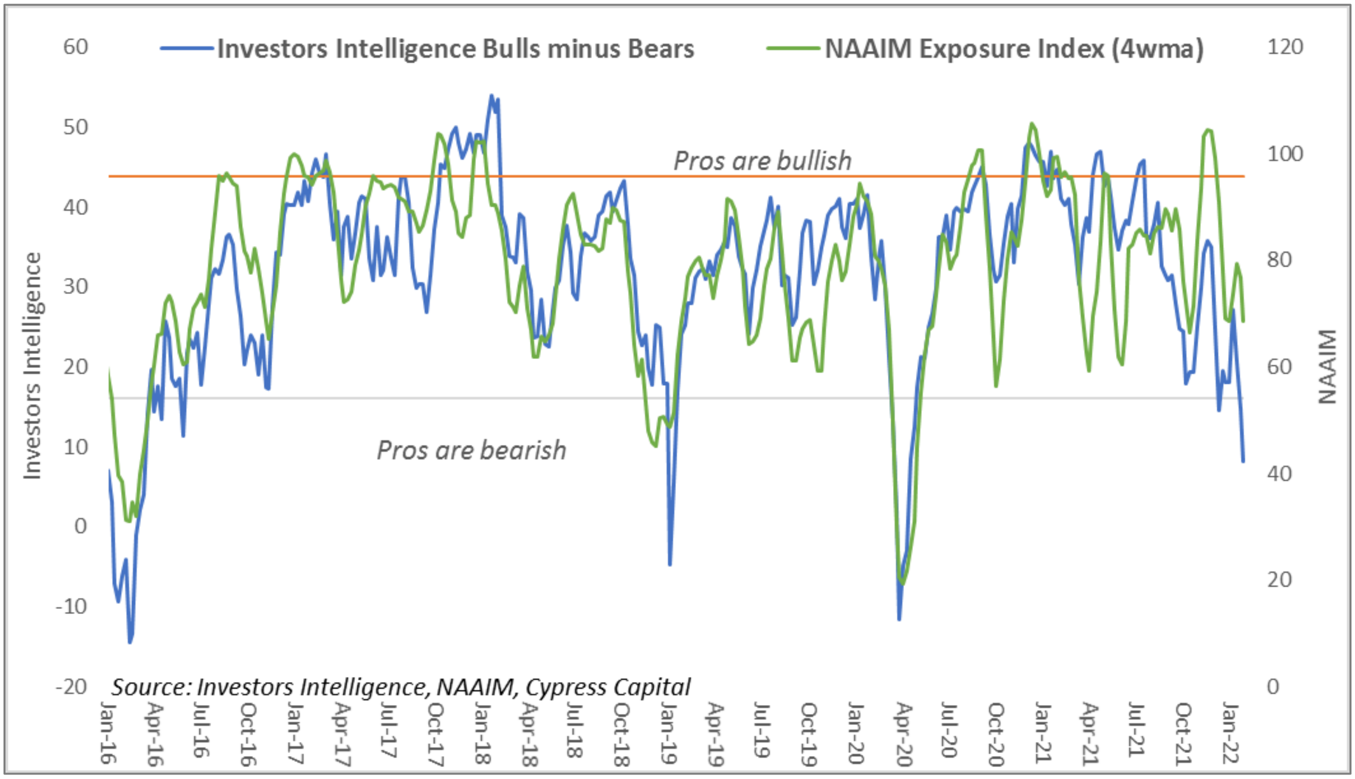


AAII Sentiment Survey vs. AAII Allocation Survey

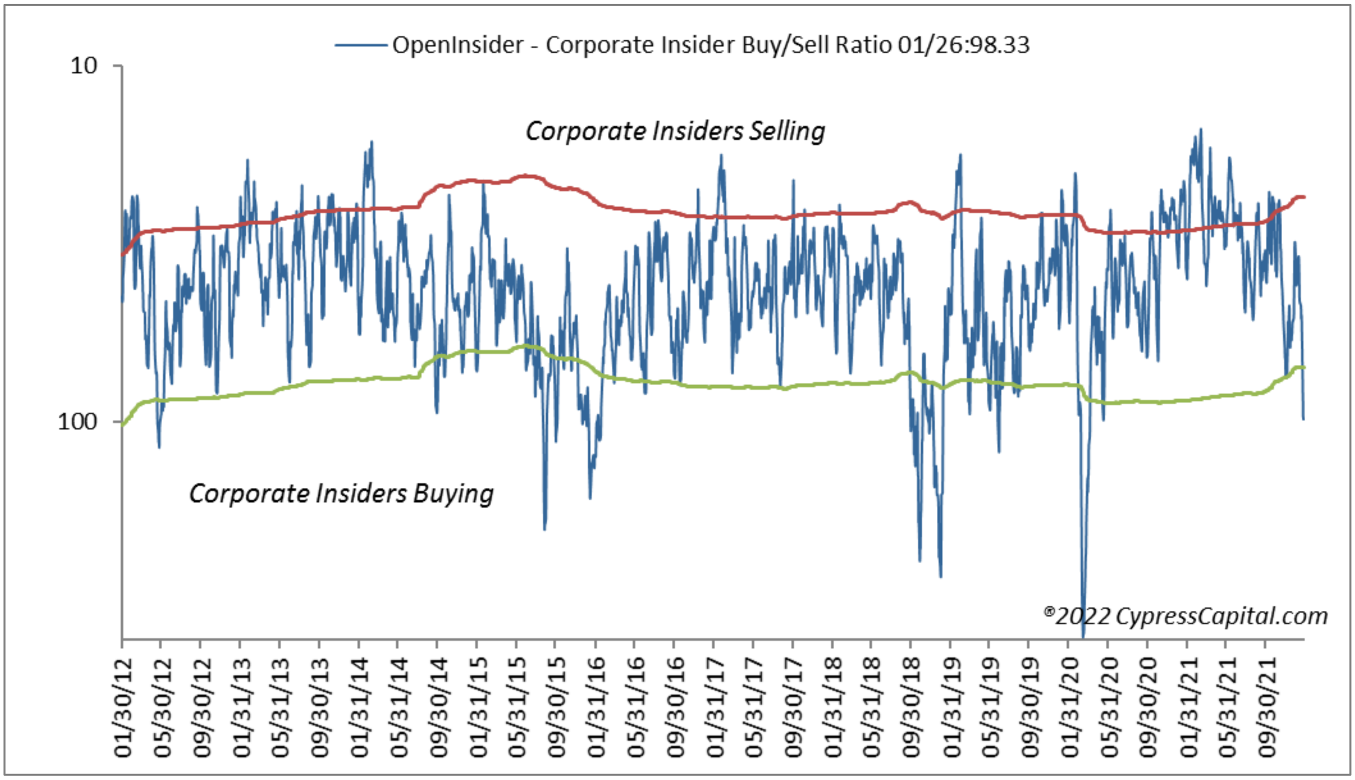
Individual investors are polling bearish, but their allocations are still enthusiastic. Big opportunities knock in markets when investor positions match their survey responses.



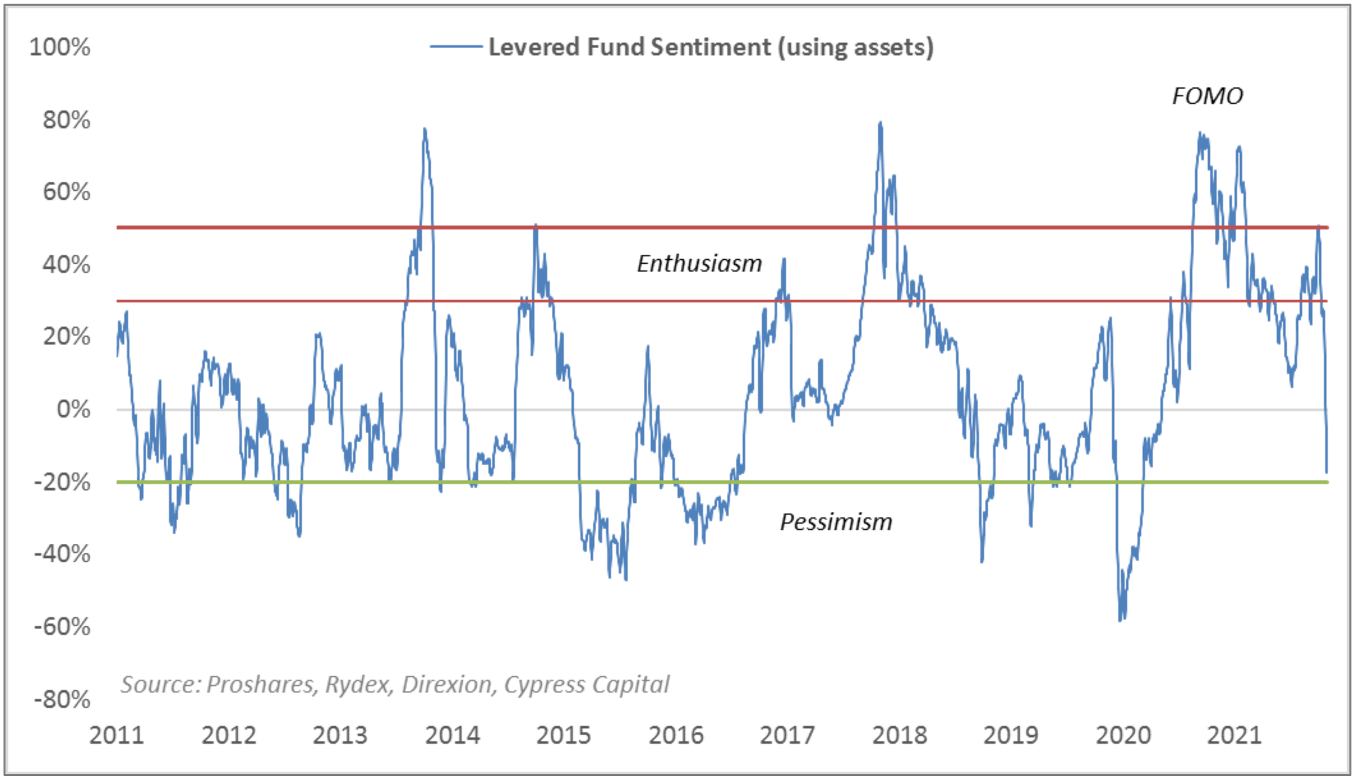
Investor's Intelligence Survey is registering the most fear since early 2020.



Corporate Insiders took the plunge and started buying stock this week.

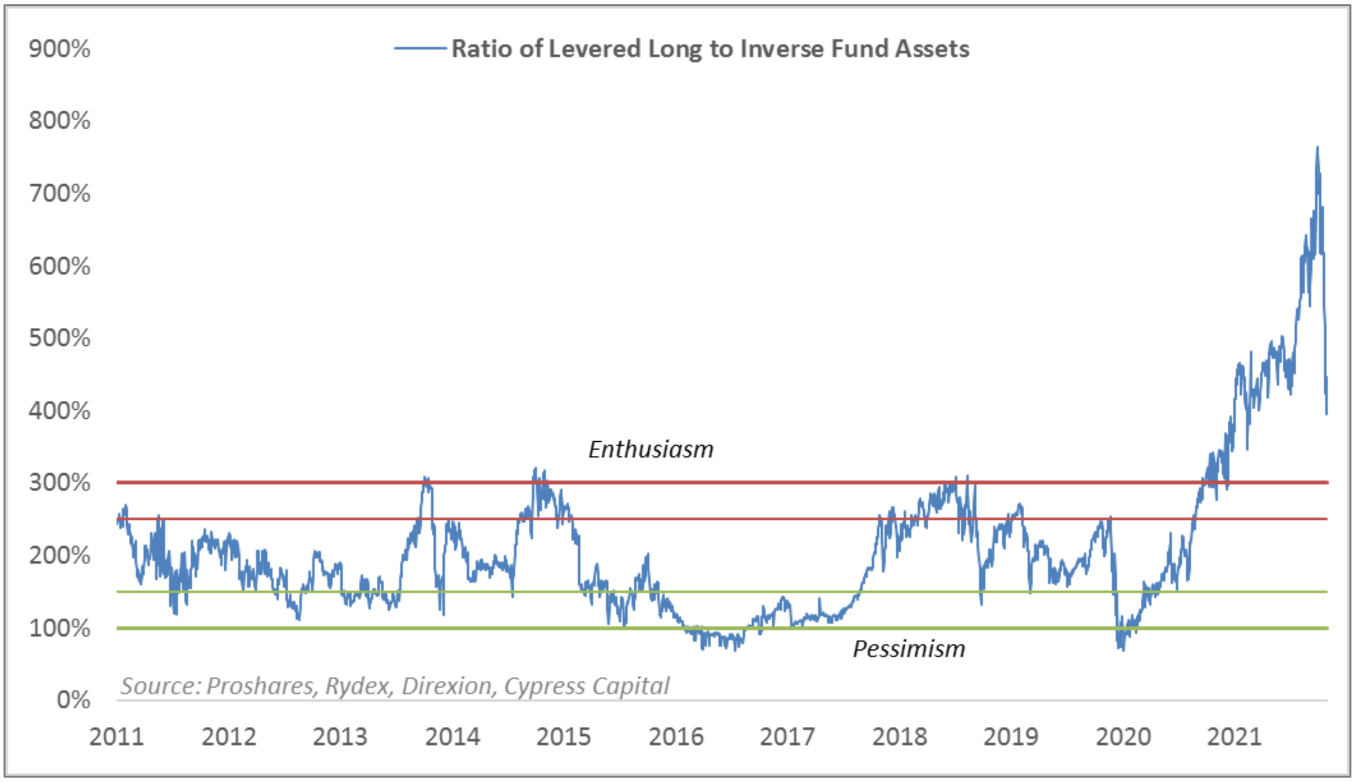


Levered Fund Sentiment experienced a sharp drop in enthusiasm.

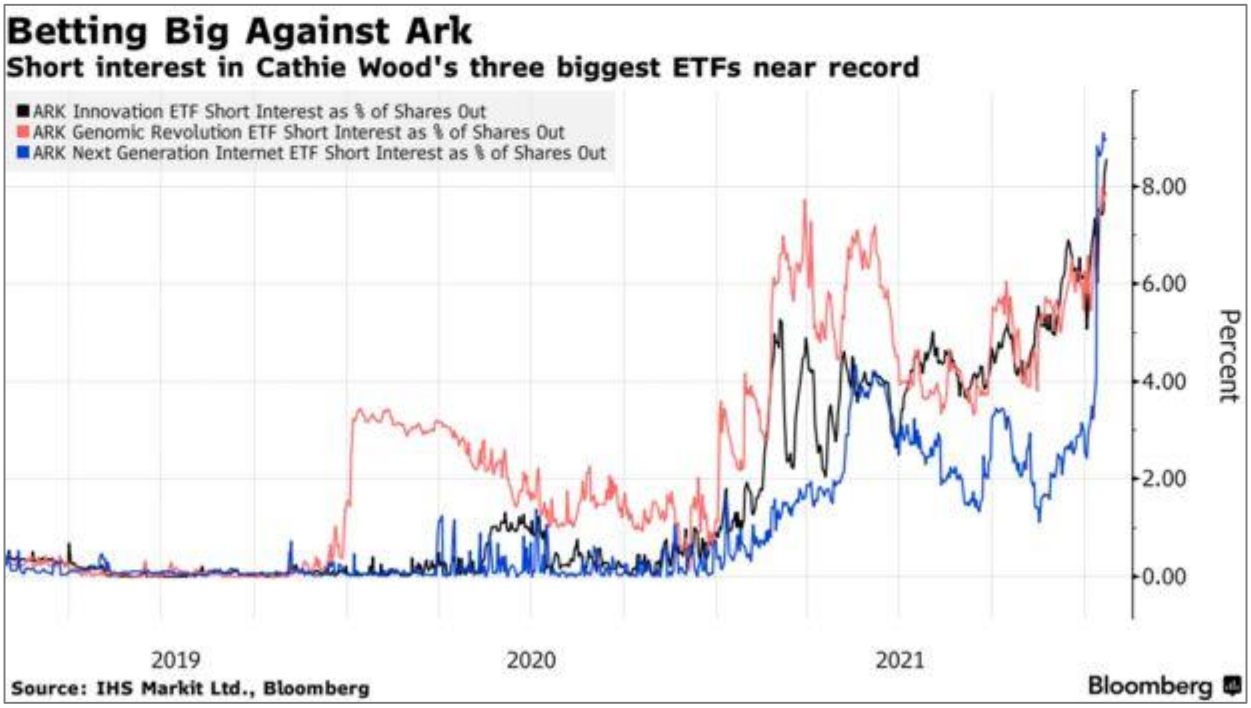


Ratio of Leveraged to Inverse Fund Assets

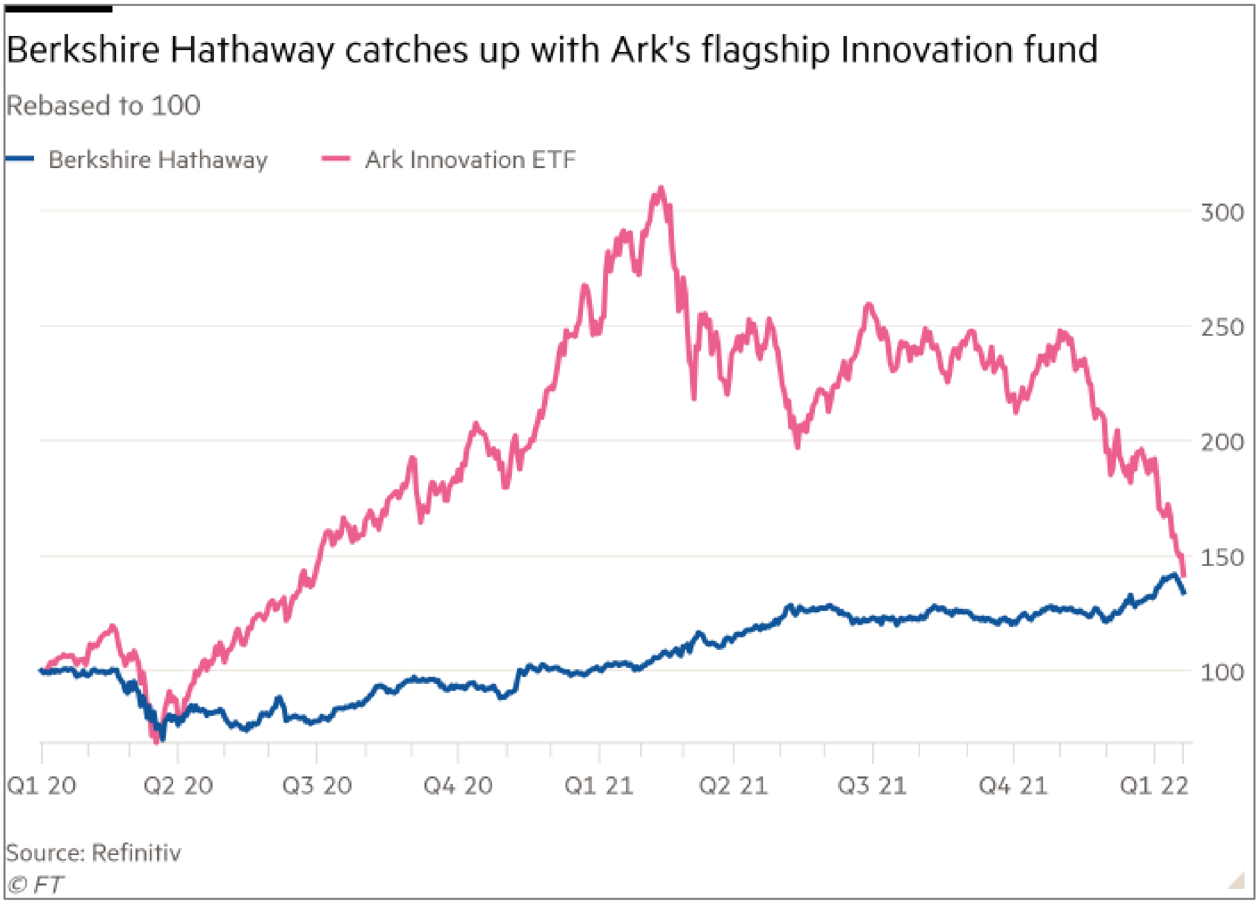
The indicator above is based upon a detrended version of the ratio of the assets in both long and inverse funds. Consequently, the fear registered above is relative. On an absolute basis, the level of assets in levered funds relative to inverse funds is still well above anything in the last ten years – a fiscal and monetary stimulus-funded stock market casino.



Short-Interest is growing extreme in Ark – setting up what could be a sizeable short-covering rally.



Berkshire versus Ark Innovation ETF - the Tortoise and the Hare



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.