Market Outlook

By Mark T Dodson, CFA

Fed hemmed in by inflation.

Another sharp weekly drop in the Market Risk Index brings it to 83.6%, better than the ultra-high risk readings from the beginning of the year but still above levels that put a defensive investor at ease. The Psychology composite improved by nearly 10% over a single week, which was enough to overcome an increase in the Monetary composite risk score of 2.1%.

This week was a significant one for the asset allocation model as categories within both Psychology and Monetary began to shift into different regimes. The Volatility category went from one of the most negative Psychology influences to the category with the single best score. Market volatility moved out of a range that has bearish market implications to levels that pinpoint short-term bottoms, even when operating under the assumption that you are in a bear market. The Leveraged Investments category also improved significantly after spending most of the post-Covid meme stock era as the most prominent negative influence on psychology.

Monetary conditions deteriorated as the Velocity category (what we use to measure the Velocity of money chasing both goods and services as well as financial assets) worsened. It's the first sign from Velocity that consumers are becoming risk-averse due to a combination of high inflation and geopolitical fears. With GDP growth estimates rapidly approaching 0%, it implies that the real growth in money supply is bottoming out, which often coincides with a peak in the inflation rate. High oil prices and the Russian invasion have ramifications that look a lot like rate hikes - meanwhile, the Federal Reserve continues to twiddle its thumbs.

The ISM Survey release this week didn't alleviate inflation concerns. ISM Price index ticked down slightly, but still north of 75, where stocks returned -3.6% on average since 1950. At this point of a geopolitical panic, the Fed would have already announced a shift to easier money, but this Fed is hemmed in by inflation and policy that still has the gas pedal mashed to the floor. But markets, in an ode to Pavlov's dog, are salivating for more. Outside of an inverted yield curve, the environment has all the characteristics of an economy overheating late in its cycle.

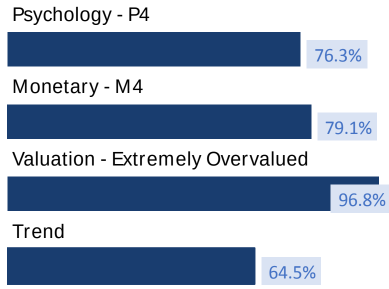
You may also notice that the Trend risk score in the chart to the right has climbed above 50%, meaning that our measure of the market's trend is growing vulnerable to shifting bearish in 2022, something that hasn't occurred since 2016. It's a long lagging indicator, and the Trend score only impacts Market Risk Index when it makes a

Market Risk Index

Rec Allocation 25% Underweight

83.6%

Category Percentiles



Largest Psychology Influences

Volatility	Positive
Surveys	Positive
Flow of Funds	Negative
Leveraged Investments	Negative

Largest Monetary Influences

Inflation	Negative
Interest Rates	Negative
Exchange Rates	Positive

Valuation

7-10 Year Rtn Forecast	1.2%
10Yr US Treasury Yield	1.7%

Market Trends

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

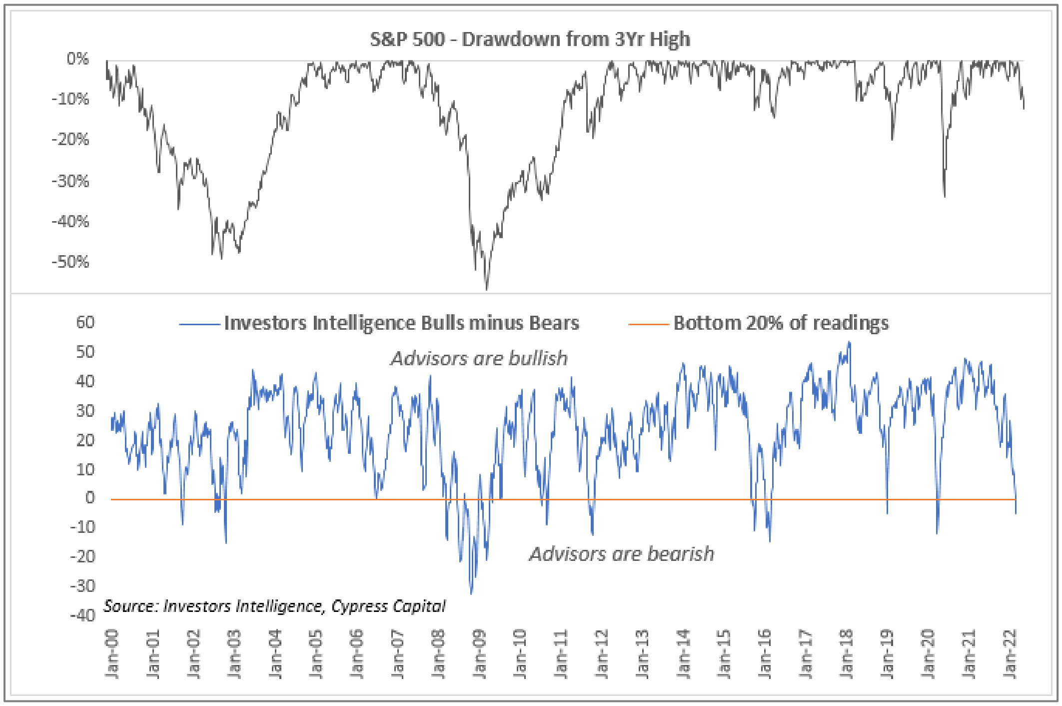
Market Risk Index scales from 0 to 100%. Higher readings correspond with higher risk markets. Scores below 25% are bullish. Scores between 25-75% are neutral, and scores above 75% are markets vulnerable to major drawdowns.

bearish transition. Its goal is to keep the rest of our model from pushing us too soon into catching a falling knife while a feedback loop of panic selling is ongoing within an extended bear market.

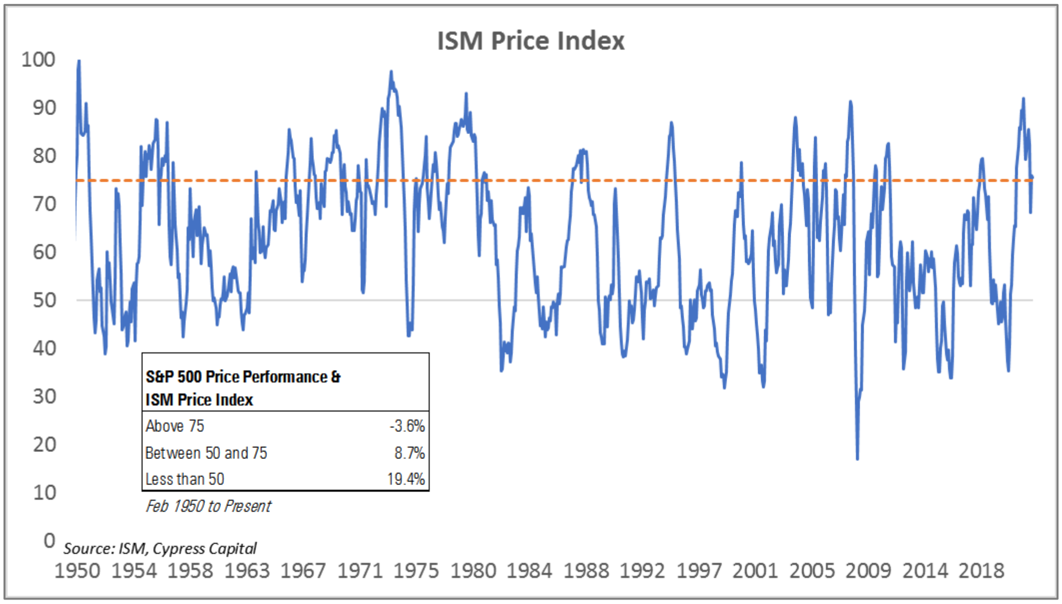
Market Risk Index, made up of all the tools we know to help us navigate risky markets, keeps us objective in an endeavor fraught with emotion. With high bearish readings from investment surveys and high volatility, an impressive market rally would not be a surprise, but we can resist the urge to pick bottoms. This risk of being an aggressive investor outweighs the reward in this environment.

Charts of the Week

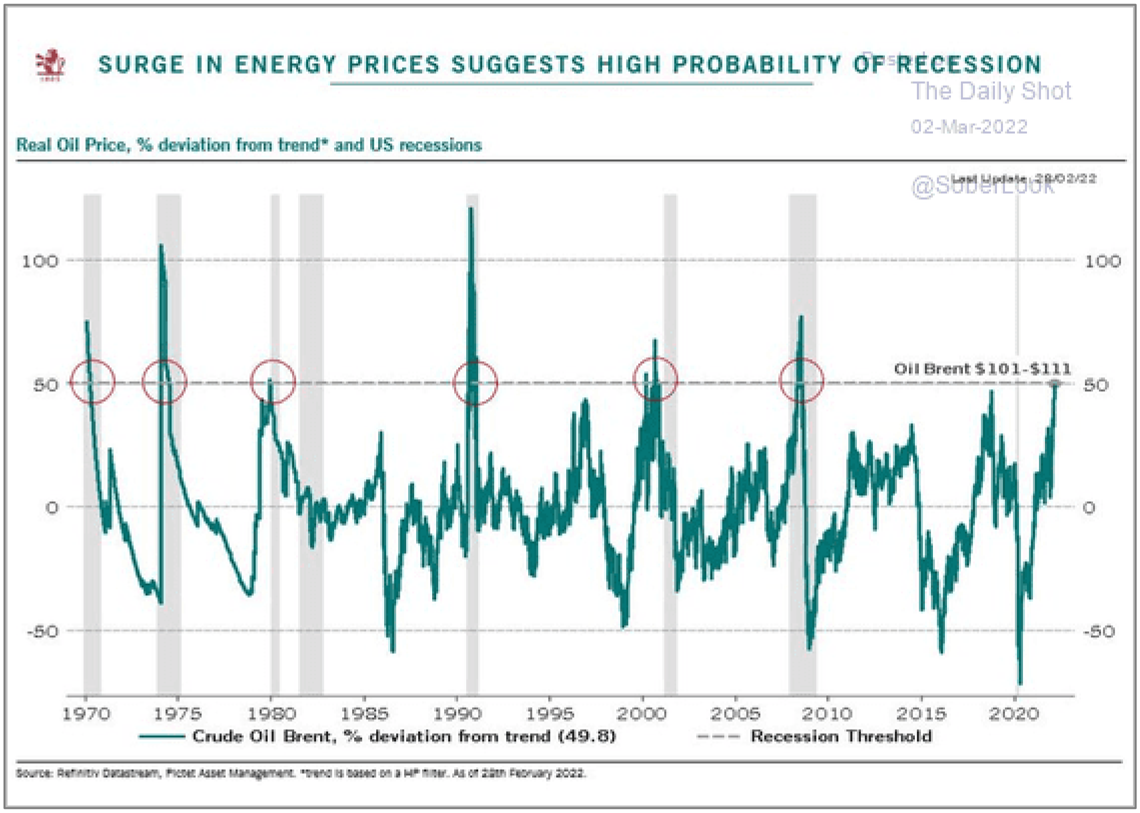
Investor's Intelligence – Bears outnumber Bulls for the first time since March 2020.



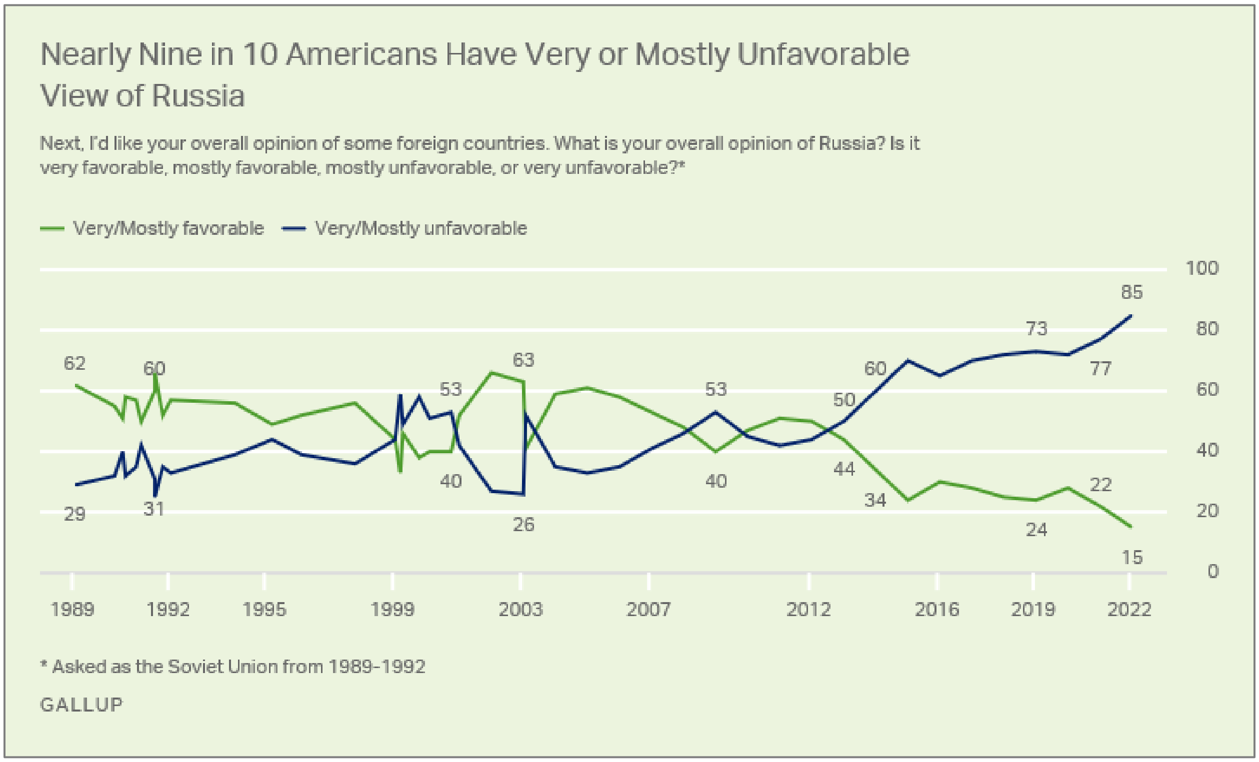
ISM Price Index is too high to be an aggressive stock market bull.



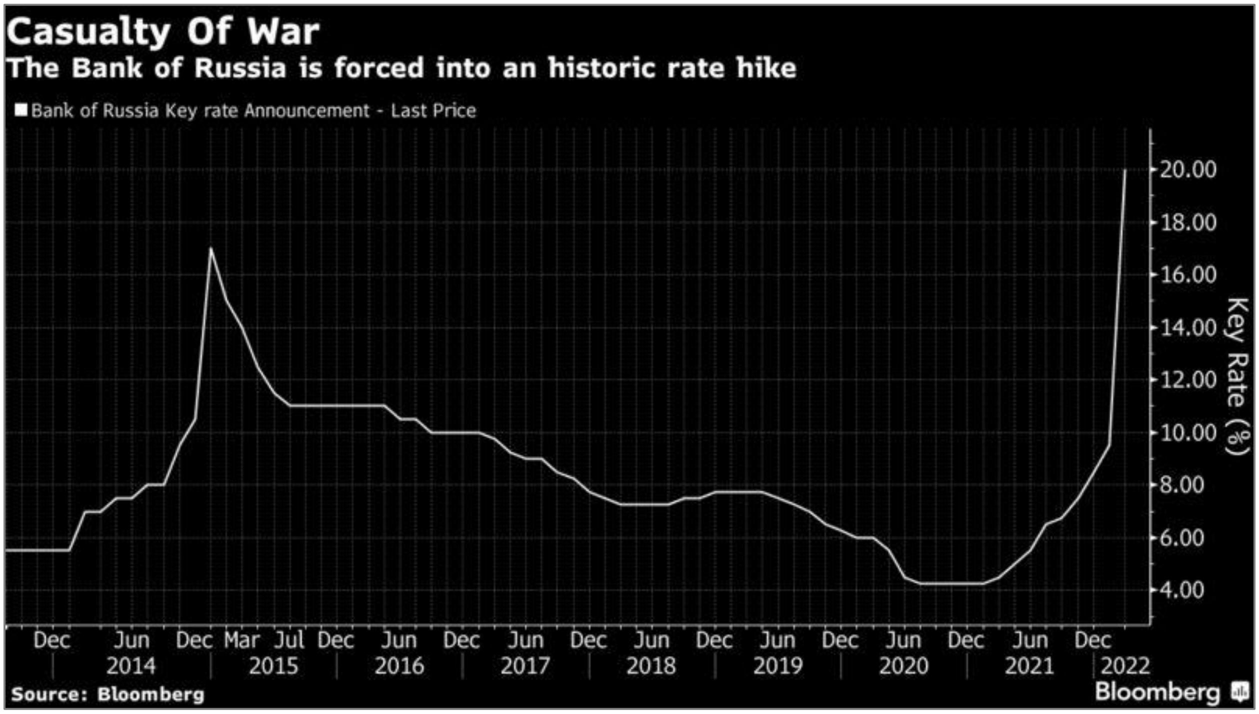
Oil Price surge increases recession odds.



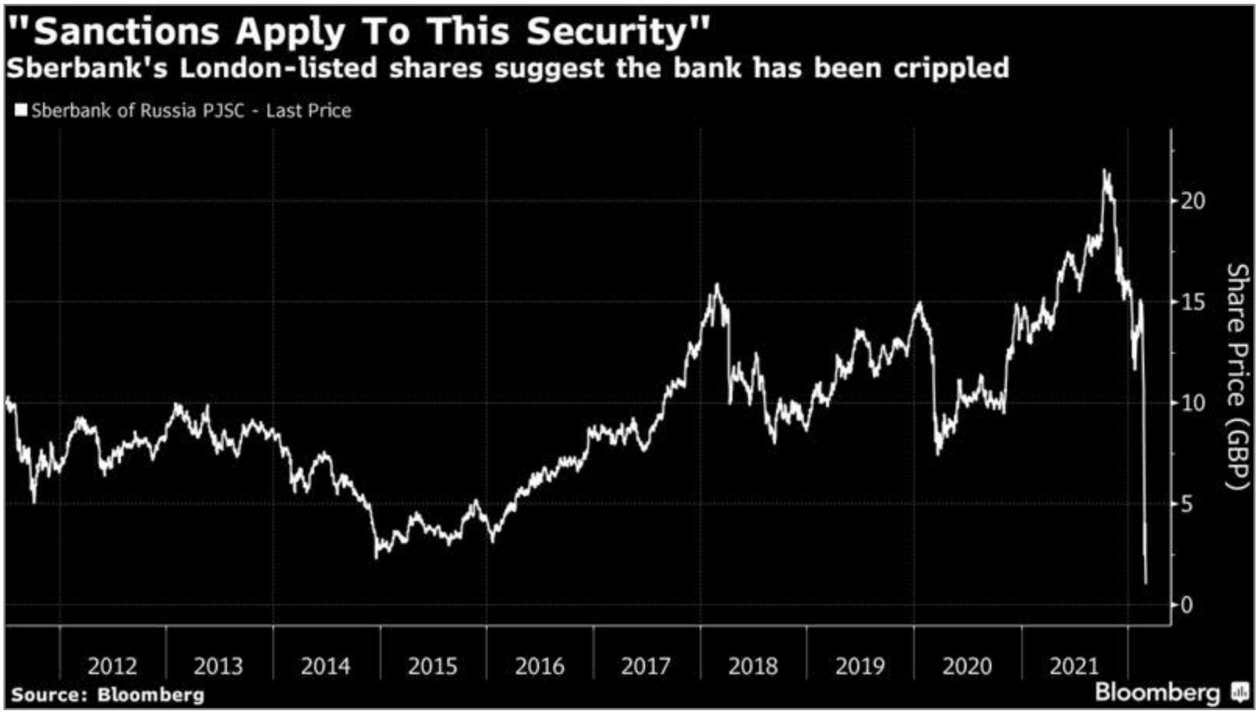
Americans finally agree on something – Russians are the bad guys again.



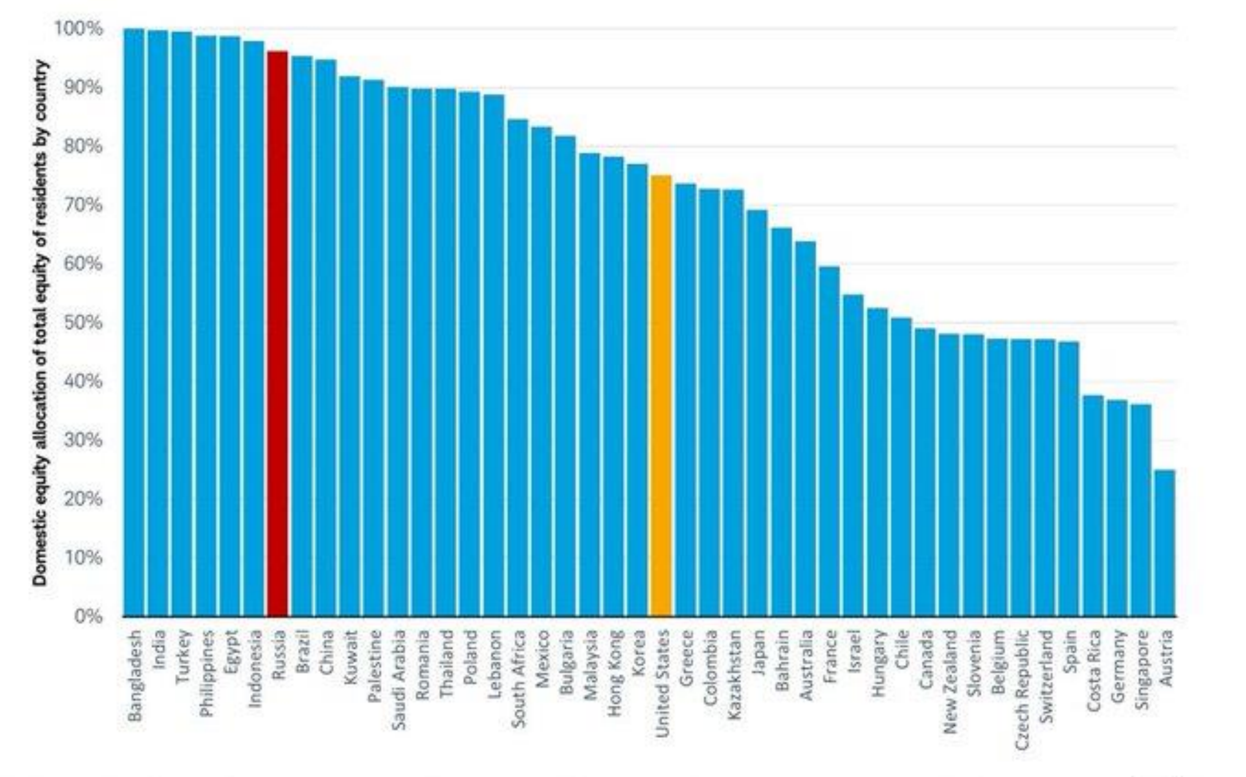
Bank of Russia forced to hike rates to 20% after sanctions devastate their banking system and currency.



Russian bank stocks were “crippled” in the last week.



The risk of home country bias – Russian stock market investors allocated more than 90% to Russian stocks.



Source: Charles Schwab, Macrobond, World Federation of Exchanges, IMF, World Bank as of 2/10/2022

Source: Jeffrey Kleintop

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 porfolio 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.