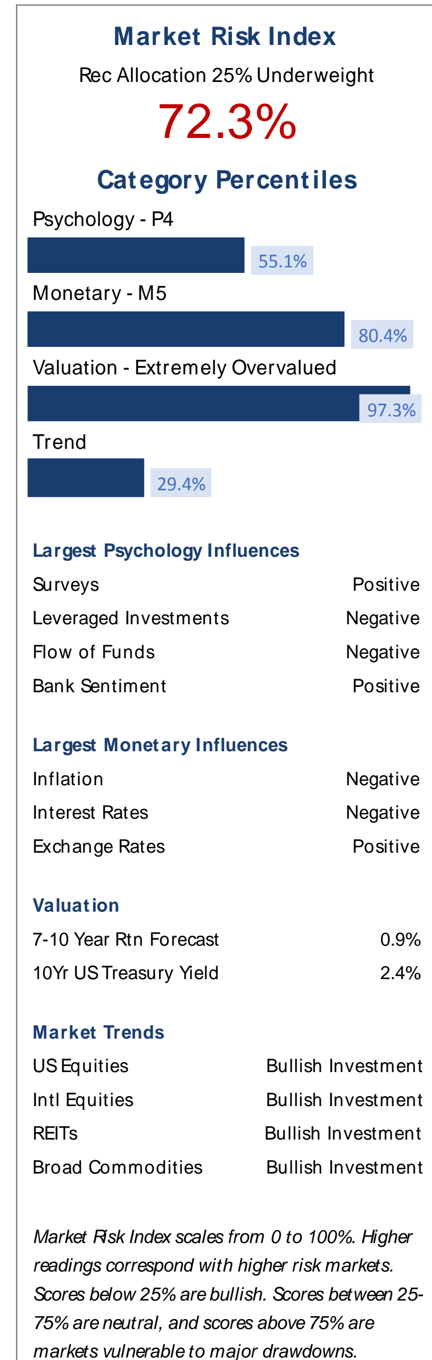
Market Outlook

By Mark T Dodson, CFA

Yield Curve Mixed Messages



Market Risk Index fell just below the 75th percentile to a reading of 72.3%. As a result of having crossed above 90% threshold on MRI late last year and the underlying nature of the improvement to MRI thus far, our recommended equity allocation has not increased.

The Psychology composite risk score fell 5.8% to 55.1%. Since the peak MRI reading in January, nearly all of the improvement has come from the Psychology composite. To be more specific, it has mainly come from a massive improvement to one category – Investment surveys. Both AAII and Investors' Intelligence surveys showed net bearish readings for several weeks in a row in March, pushing the category close to a maximum bullish reading. Even when those readings occur within the context of a broader bear market, they almost always provide short-term relief and trading opportunities.

Judging by daily internal readings of our Psychology composite and a move back toward enthusiasm in our Short-Term Sentiment composite, the improvement will be short-lived, as the Psychology improvement has not proven pervasive. Those signposts that we have been watching for signs of a substantial repair to the wall of worry – the ones that have proven fitting analogs to the late 90s speculative period – have quickly started to show some FOMO-like behavior again. In the last two weeks, massive amounts of call buying have driven the 15day moving average of the equity put/call ratio back toward the enthusiasm zone, and assets in levered ETFs have rebounded sharply. Market sentiment has thus far provided speculators with a trading opportunity to buy a short-term dip, but not much more.

The monetary composite risk score broke above the 80th percentile to 80.4%, the highest reading since the bull market began. It took eight years for the previous bull market to break above 80% on the Monetary score, whereas this one took less than two years. All things equal, an investor would fare better to pay more attention to our Monetary composite when in the worst 20% of readings than when our Psychology composite scores around the 50th percentile. Our monetary concerns are focused on the high rate of inflation and tighter money, as indicated by the rate of change of credit instruments.

Missing from our list of concerns is the yield curve. However, headlines this week have highlighted how close the yield curve is to inversion, with reports focusing on versions of the yield curve with longer durations – the 10Yr minus 2Yr as an example (2s10s). Yet, the yield curve that we rely on (10Yr yield minus T-Bill yield) made a higher high and has been steepening. It remains in neutral territory and does not raise any recession concerns.

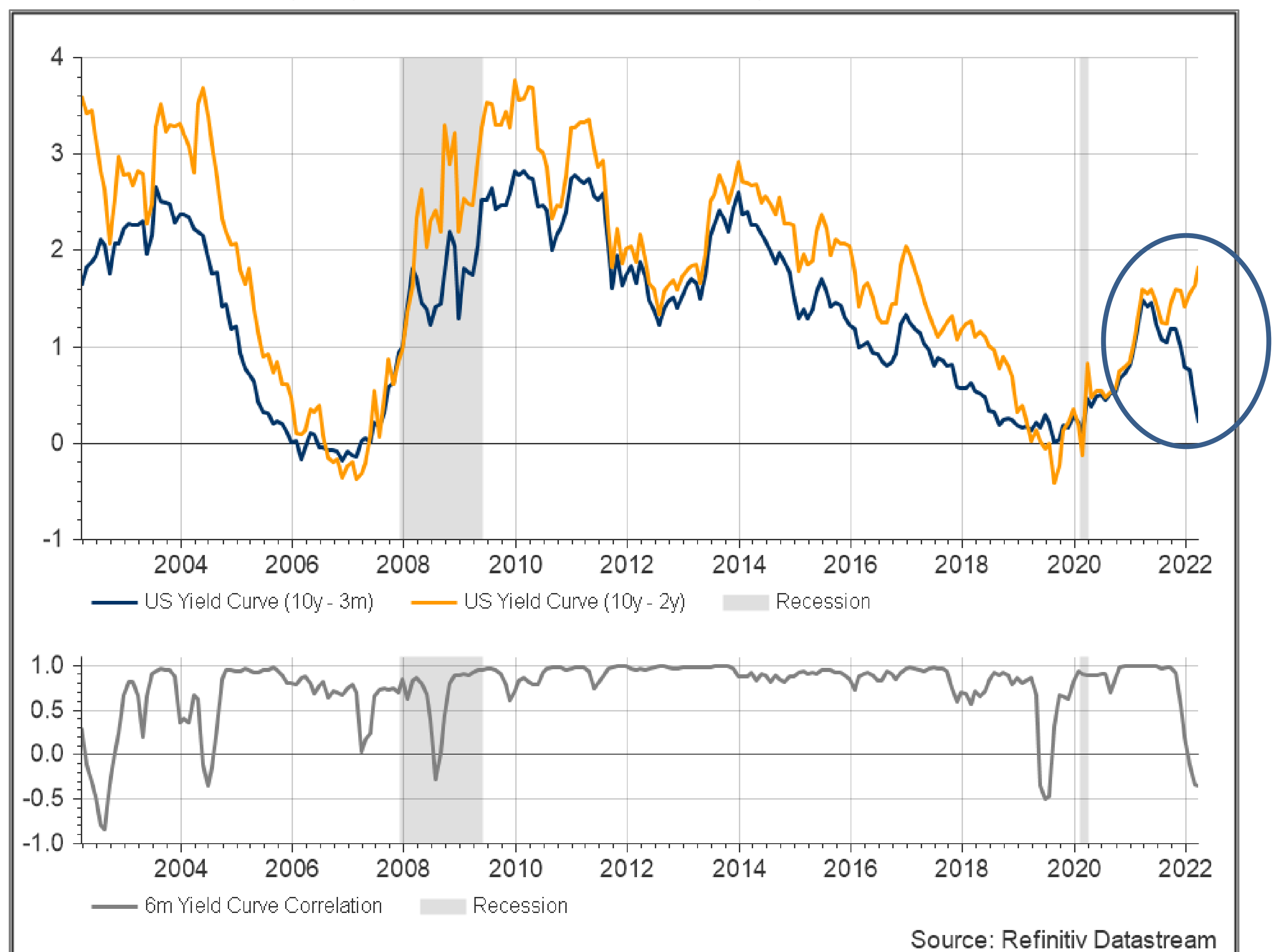
We rely on the 10Y minus T-Bill version of the curve, because it is usually the last curve to invert, producing shorter lead times to bear markets and recession. In short, the timing has been better. The 2s10s curve often leads and inverts sooner, as it reflects more of the influence of the bond market while the T-bill is more tightly bound to actual Fed policy and the Fed Funds rate.

The two curves typically move tightly in sync, but their six-month correlation has turned negative. That's not so unusual, but the disconnect between the messages of the two popular measures of the yield curve has never been this pronounced—the disconnect results from a historic lag and bout of thumb-twiddling by the Federal Reserve. The good news is that we have taught future generations that calling inflation transitory a hundred times doesn't make it go away.

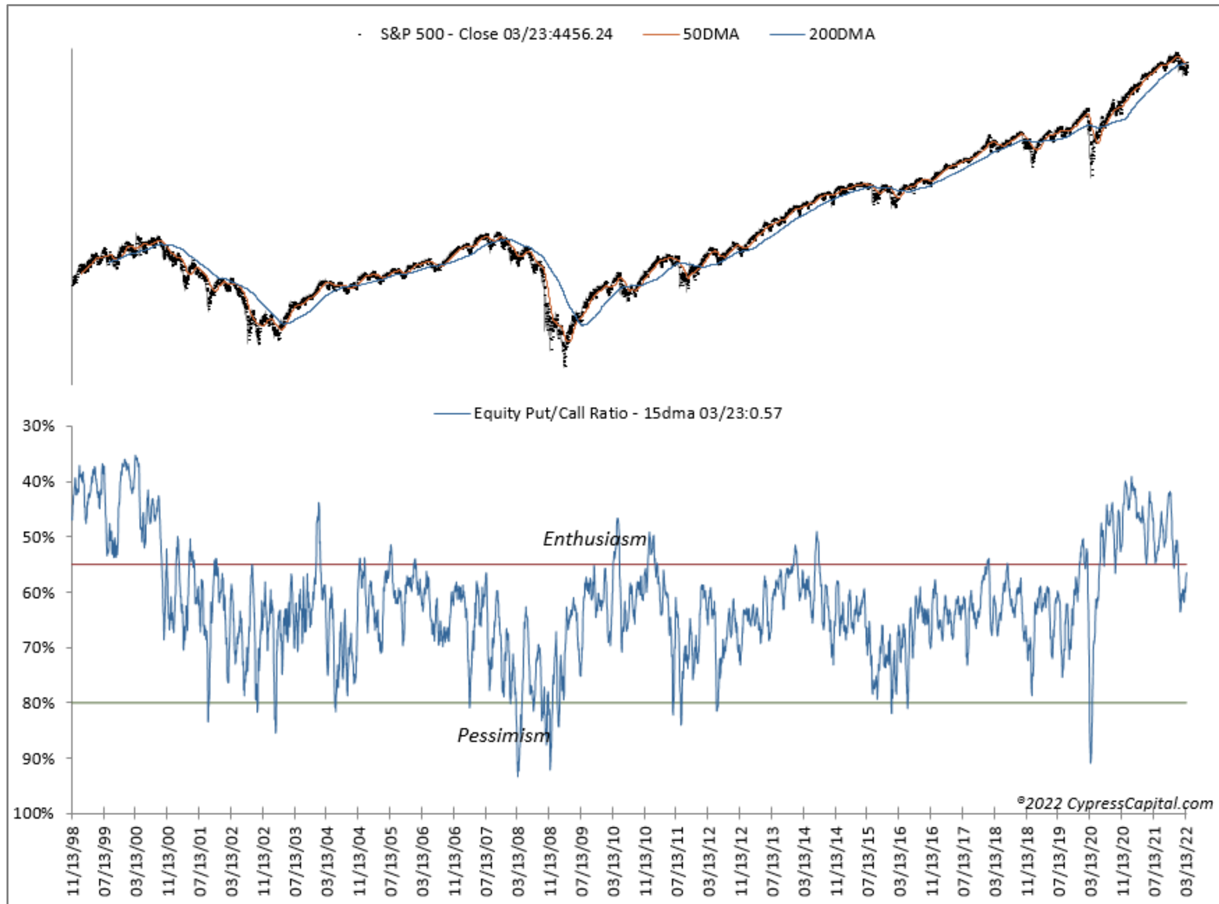
The bond market has been front-running the Fed driving the 2Yr yield higher for the last six months, while the Fed has only managed a meager 25 basis point increase. In almost every case that the two become unsynced, the T-bill version gives way to the action in the 2s10s, meaning the T-bills version of the yield curve is set to shallow sharply over the coming months. Until then, our monetary focus remains on inflation and the difficulty of the Fed's task in breaking inflation without breaking something else in the process.

Charts of the Week

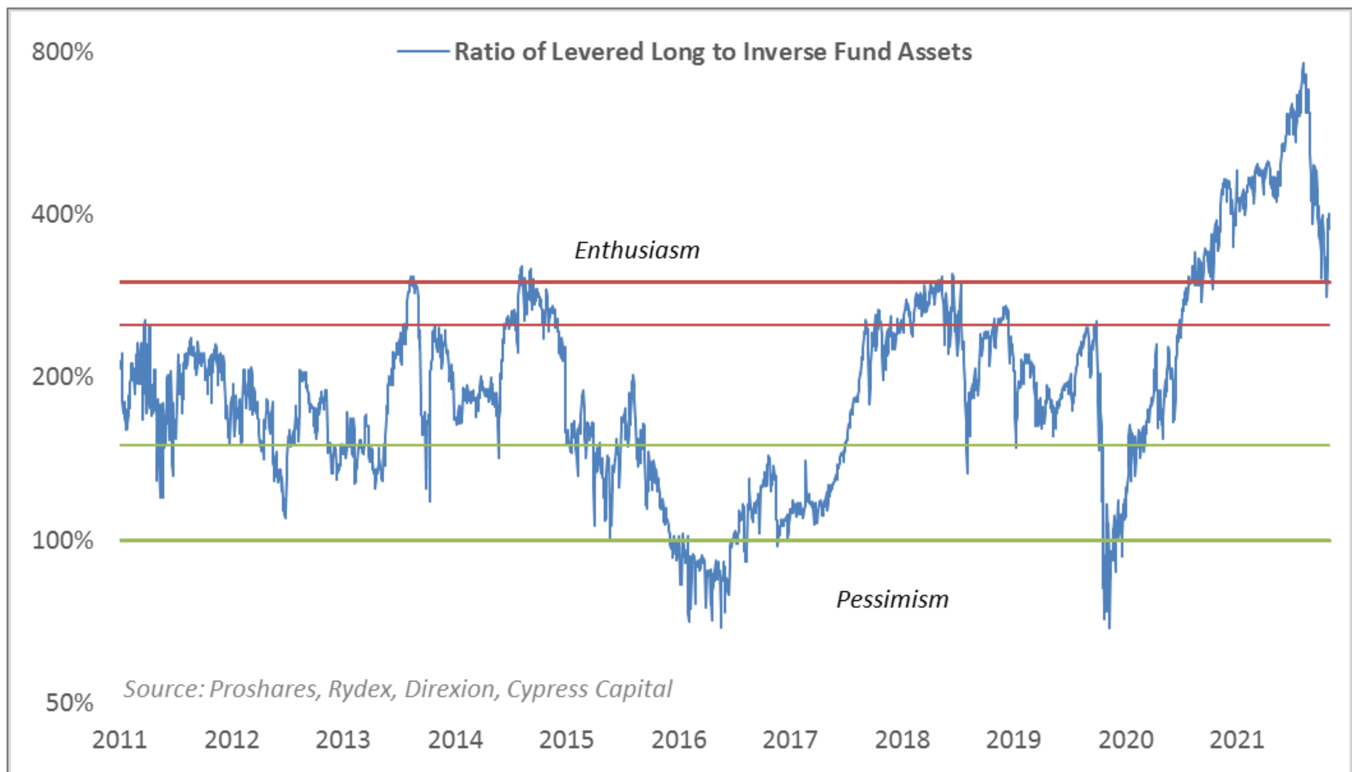
Yield Curve Mixed Messages signal that the Fed has a lot of catching up to do.



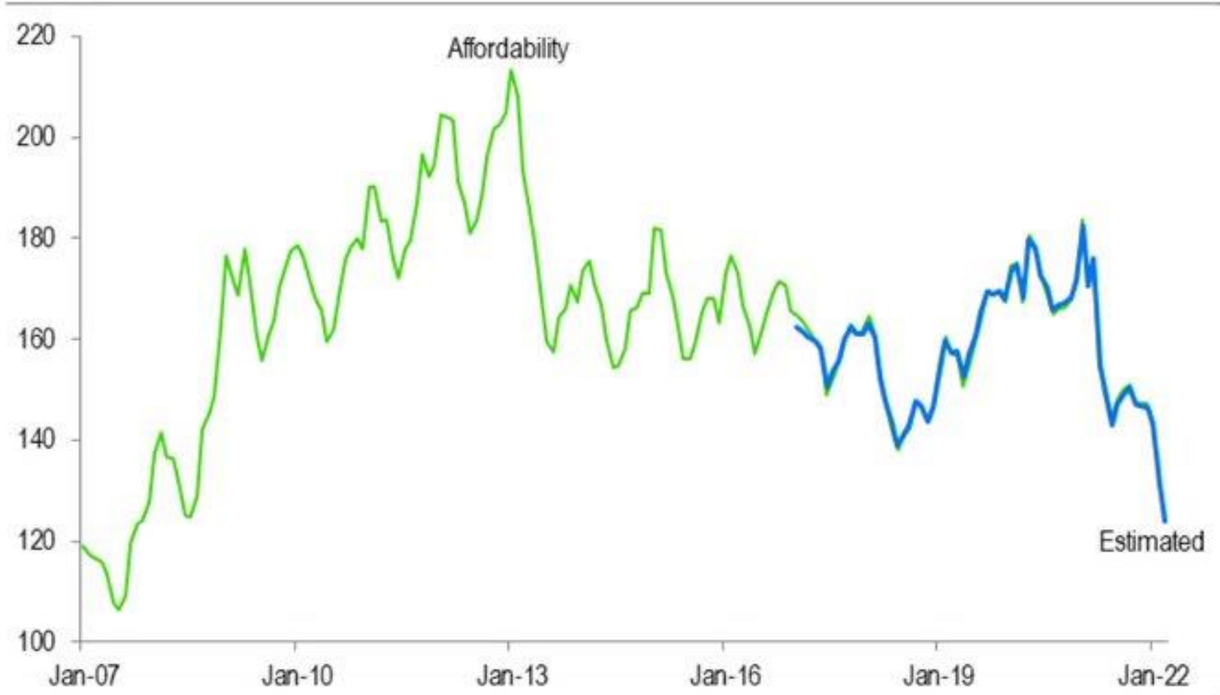
A sudden surge in call buying has driven the Equity Put/Call ratio back toward the Enthusiasm zone.



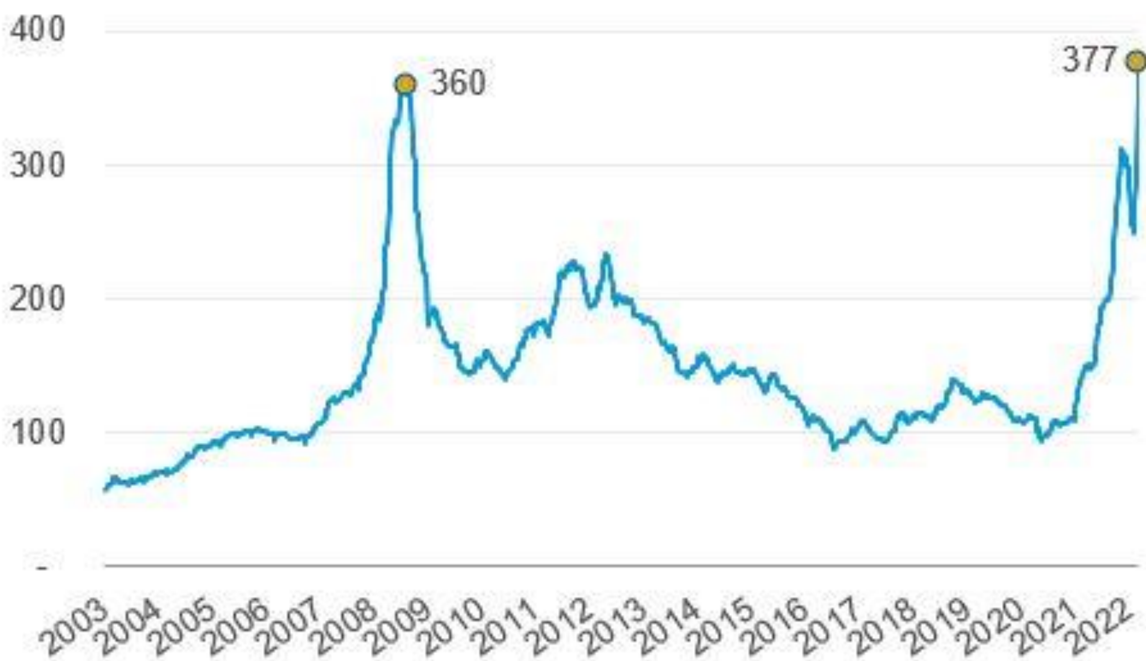
Assets in Levered to Inverse ETFs rebounded – firmly in enthusiasm zone.



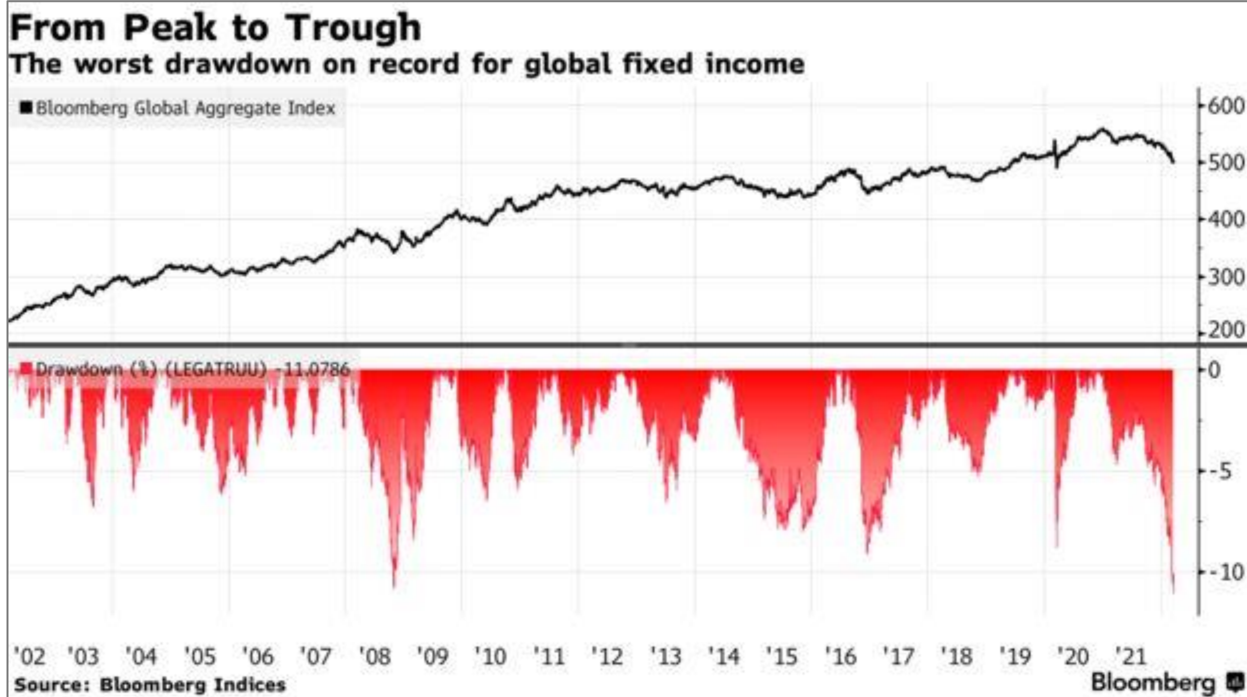
Housing affordability has fallen to 2007 levels.



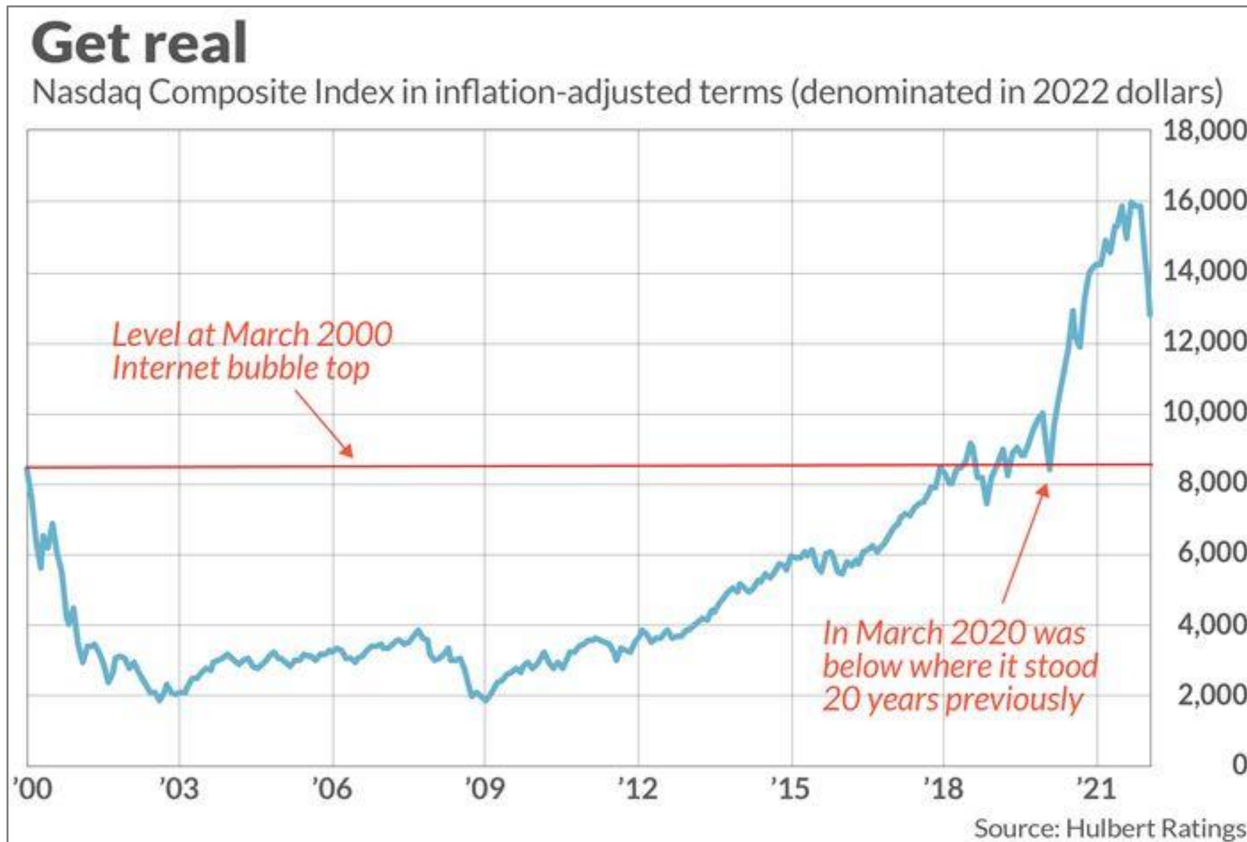
Fertilizer prices hit an all time-high.



Largest global bond correction in 20 years.



It took pandemic stimulus to finally drive the real level of the NASDAQ above the dot-com era.



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.

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