Market Outlook

By Mark T Dodson, CFA

Short-Term Sentiment supported rally inside of an unhealthy market

Market Risk Index improved to 69%, the best reading since May of 2020, as the Psychology Composite edged into better than average readings. Investment surveys have been responsible for most of the improvement in Psychology, but it's unusual that we don't see more categories confirming those readings. Only four of the eleven categories of Psychology indicators we track have become tailwinds for equity markets.

Regardless, investment surveys have proven valuable and worth following. They support a further rally, as do some of our short-term breadth readings, but the most noteworthy developments this week (with stock market implications) were from one of our favorite longer-term measures of stock market breadth as well as the Consumer Confidence and ISM economic releases.

On the Psychology front, the NYSE High Low Logic Index signaled a new sell signal - indicative of a fractured market and not consistent with markets that have achieved significant market bottoms. In options markets, aggressive call buying has pushed the equity put/call ratio back into the extreme enthusiasm zone, a clear sign that the Jerome Powell-induced speculative era, like inflation, is also not transitory. Levered ETFs are the option market's first cousin, and assets chasing leveraged ETFs and funds surged into month-end, close to all-time highs, confirming the sentiment.

The Consumer Confidence survey revealed that consumers' confidence in the present job market hit a record high in March, consistent with a late-cycle environment full of inflation pressures. Similarly, the gap between consumers' confidence in their present situation and future expectations bounced to the highest level since February 2020.

The ISM release had similar implications as Consumer Confidence. The ISM Price Index shot back up toward the high from last June, providing no relief to the Inflation category of our Monetary composite. Perhaps more notable - ISM New Orders Index fell to the lowest level since May of 2020, indicating a sharp drop in economic activity.

Market Risk Index

Rec Allocation 25% Underweight

69.0%

Category Percentiles

Psychology - P3	48.9%
Monetary - M5	81.1%
Valuation - Extremely Overvalued	97.8%
Trend	18.9%

Largest Psychology Influences

Leveraged Investments	Negative
Surveys	Positive
Option Activity	Negative
Flow of Funds	Negative

Largest Monetary Influences

Inflation	Negative
Interest Rates	Negative
Exchange Rates	Positive

Valuation

7-10 Year Rtn Forecast	0.6%
10Yr US Treasury Yield	2.4%

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.

It's notable because of the combined readings from both ISM indices. We use the ISM Price Index and ISM New Orders index as inputs to two versions of an ISM Growth Quadrant matrix, one based on a rate of change in both indices and the other based upon raw index readings. (The rate of change version provides a better lead time for stock market investors.) Combined, they act as a simple but effective roadmap for the economic cycle. The March reading puts the rate of change version of the ISM Growth Quadrant model of the economy inside the Inflationary Bust territory – the poorest economic combination for stock market performance. It's an end-of-cycle reading that tends to occur before the onset of recession and deflationary bust readings.

ISM Readings crossed into the Inflationary Bust quadrant.

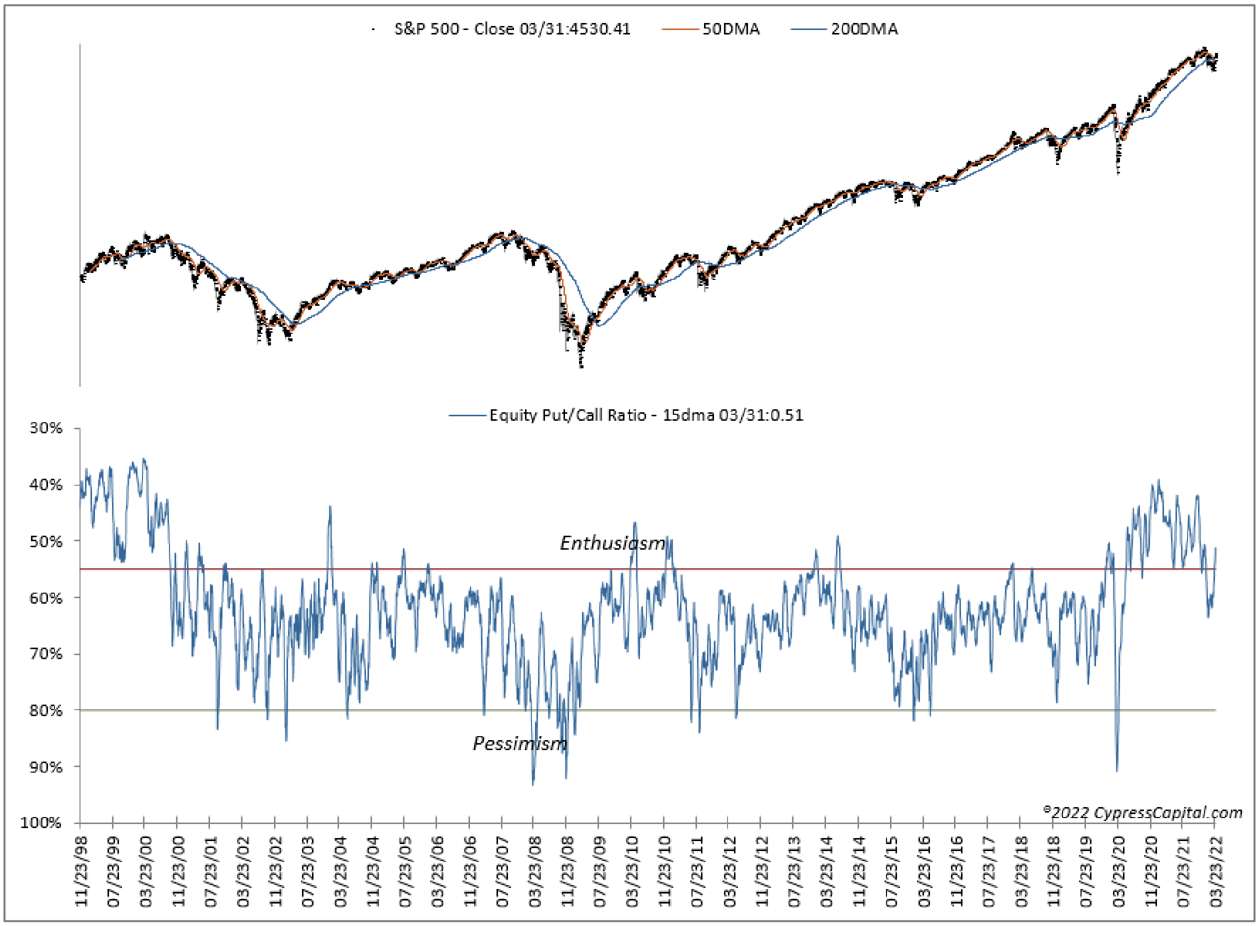
ISM Growth Quadrant (using rate of change)	Annualized Return	Freq	Avg 12M Fwd
Deflationary Boom	18.1%	15.4%	13.0%
Inflationary Boom	10.2%	32.2%	8.8%
Inflationary Bust	2.8%	19.0%	4.4%
Deflationary Bust	4.3%	33.4%	10.9%

S&P 500 annualized price returns since 1950

The bottom line for the model and the market this week – indicators that measure short-term breadth and investor sentiment are still supportive of a spring stock market rally. However, judging by a resurgence in levered plays on markets, investors appear too eager to move back into speculation mode. In contrast, longer-leading measures of stock market sentiment, stock market valuations, and monetary conditions imply this is a stock market rally within a broadly unhealthy and risky market environment.

Charts of the Week

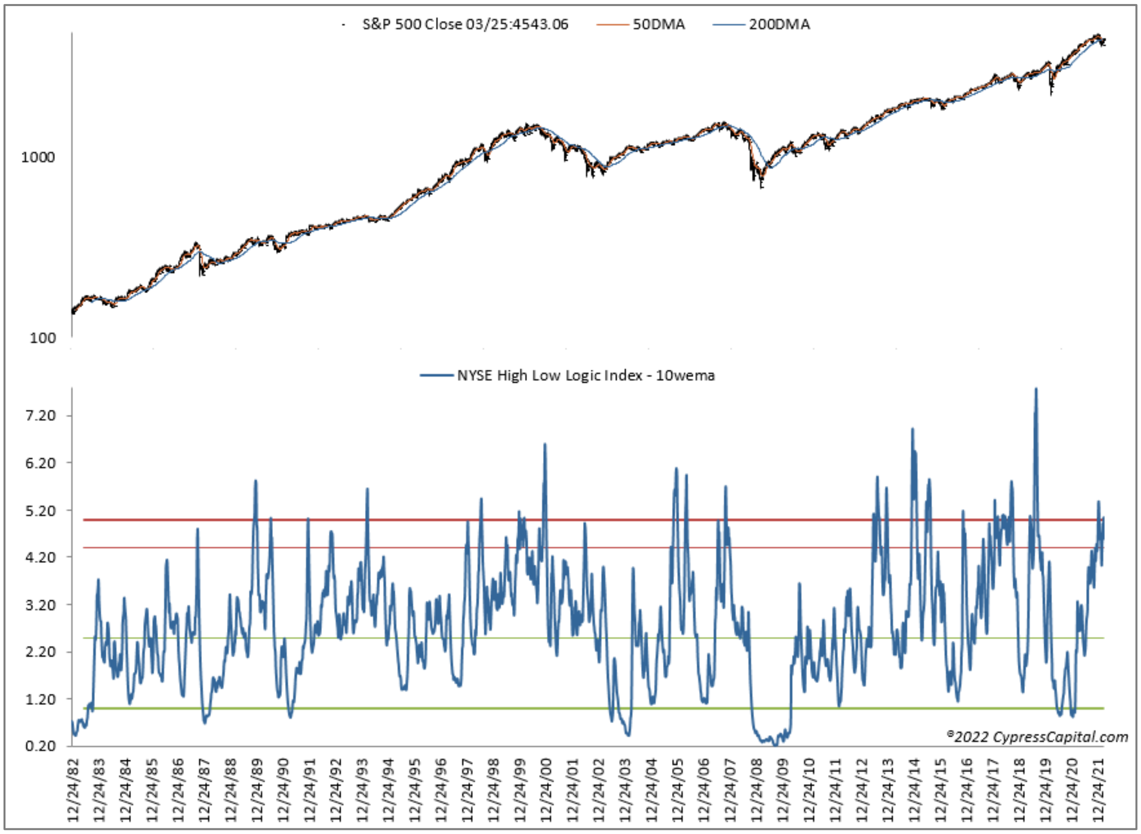
Equity Put/Call Ratio moves back into the Enthusiasm zone.



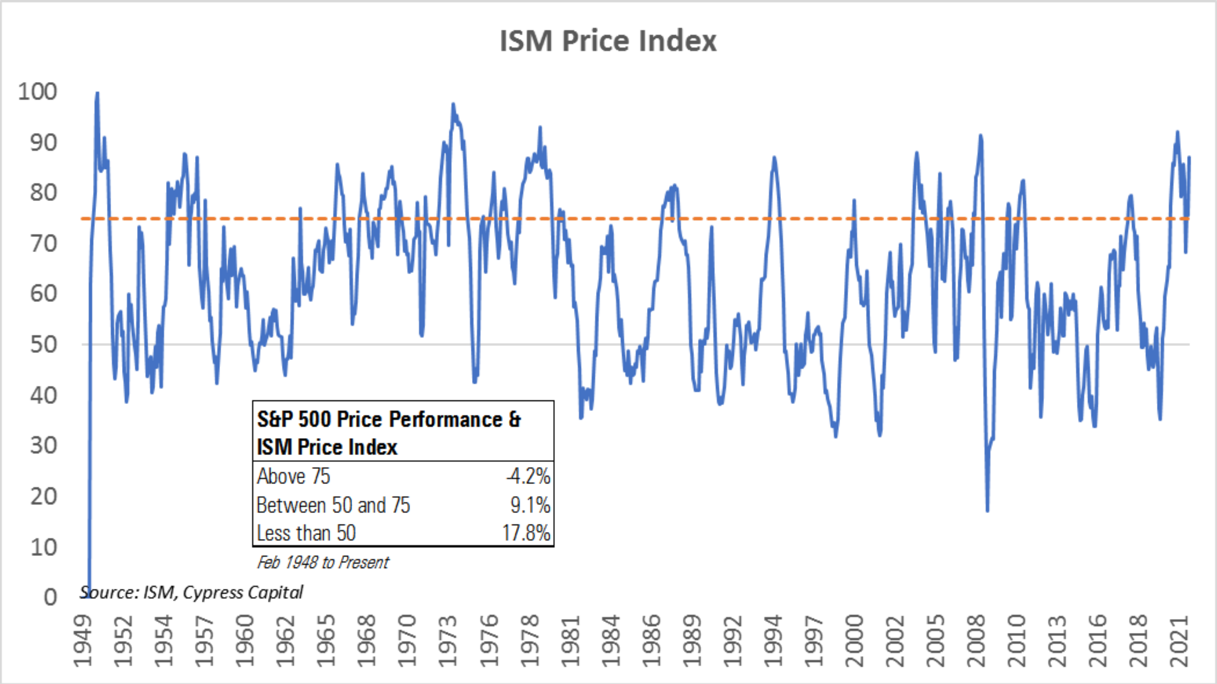
Quote of the Week

The Fed's application of its framework has left it behind the curve in controlling inflation. This, in turn, has made a hard landing virtually inevitable. – Bill Dudley, Former President of the Federal Reserve Bank of New York

NYSE High Low Logic Index gives another sell signal.

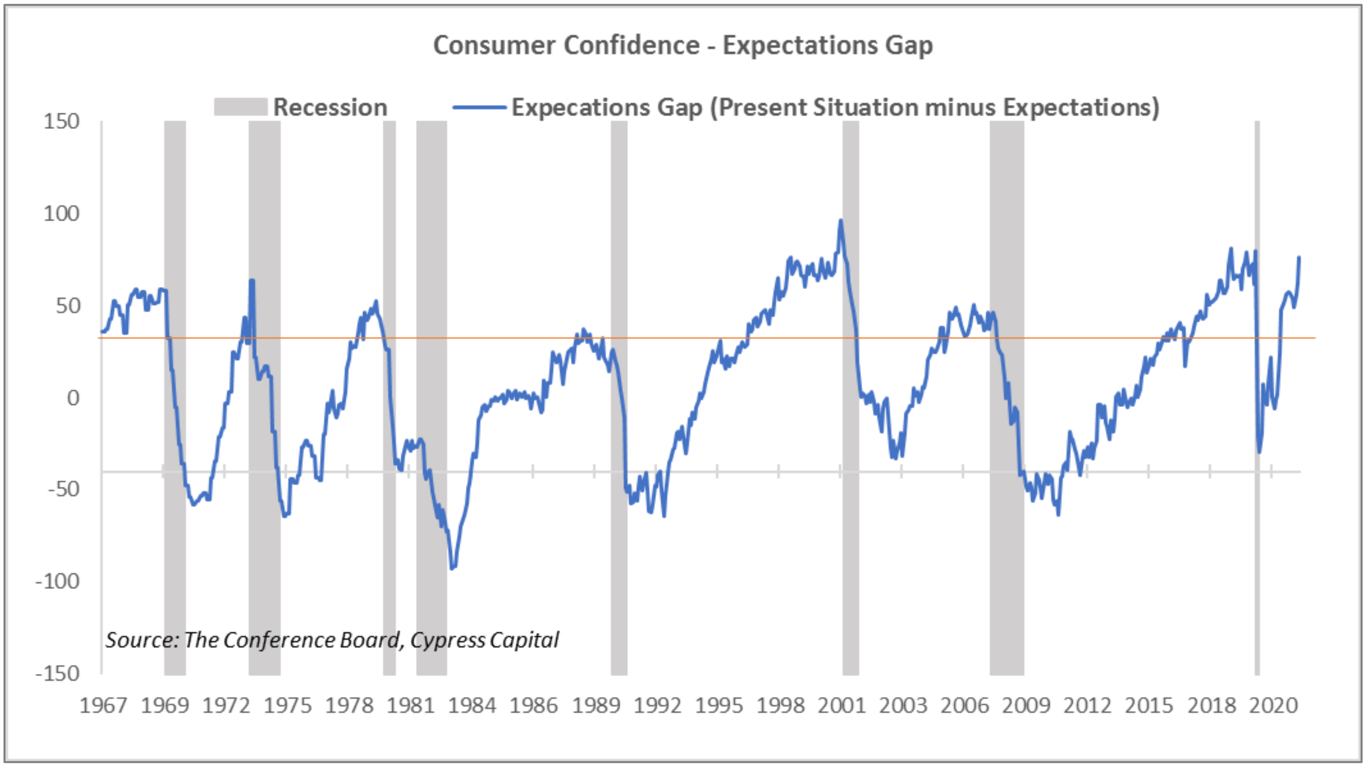


ISM Price Index – no relief from inflation pressures.

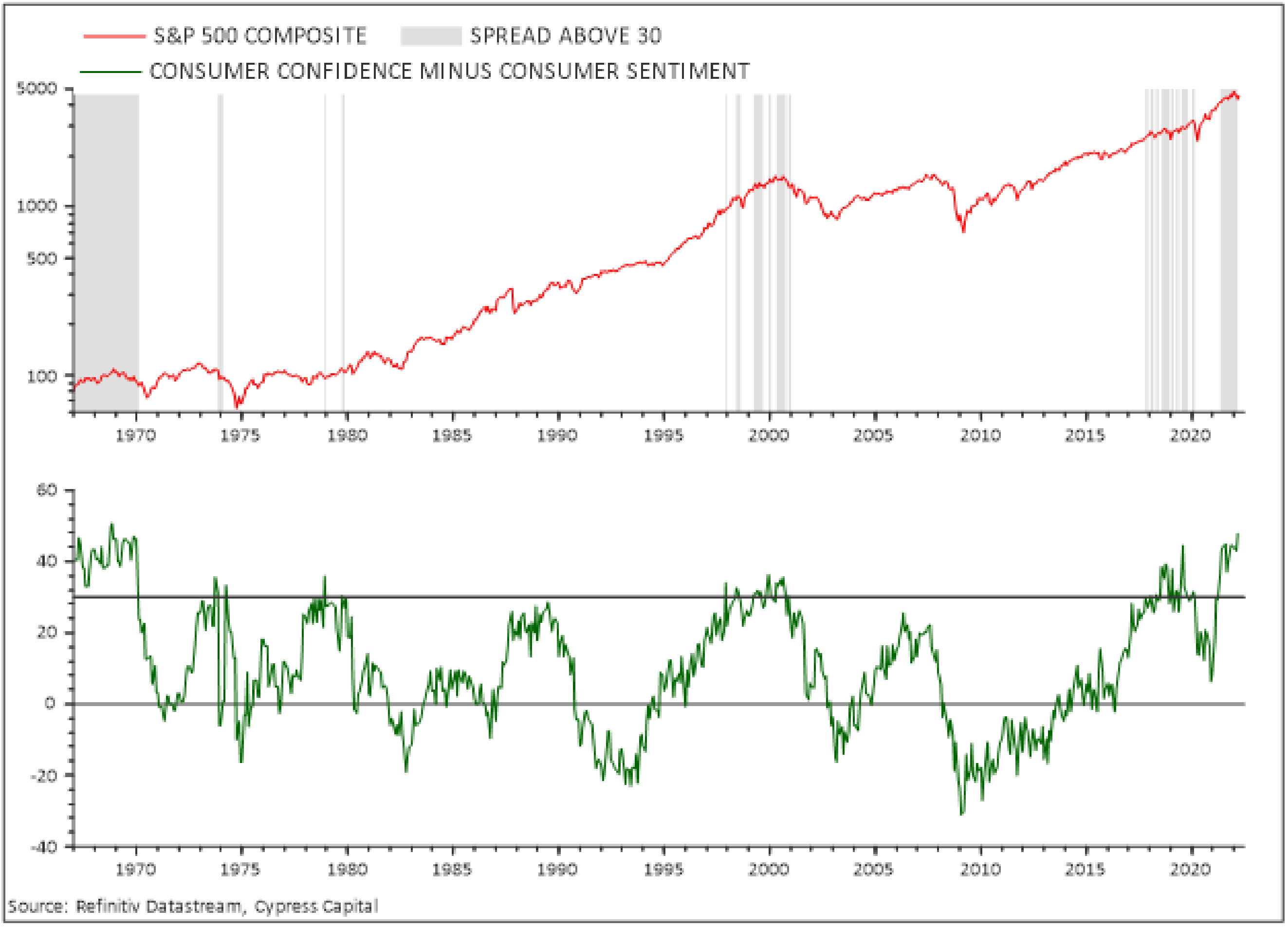


Jobs Confidence set a new record this month.

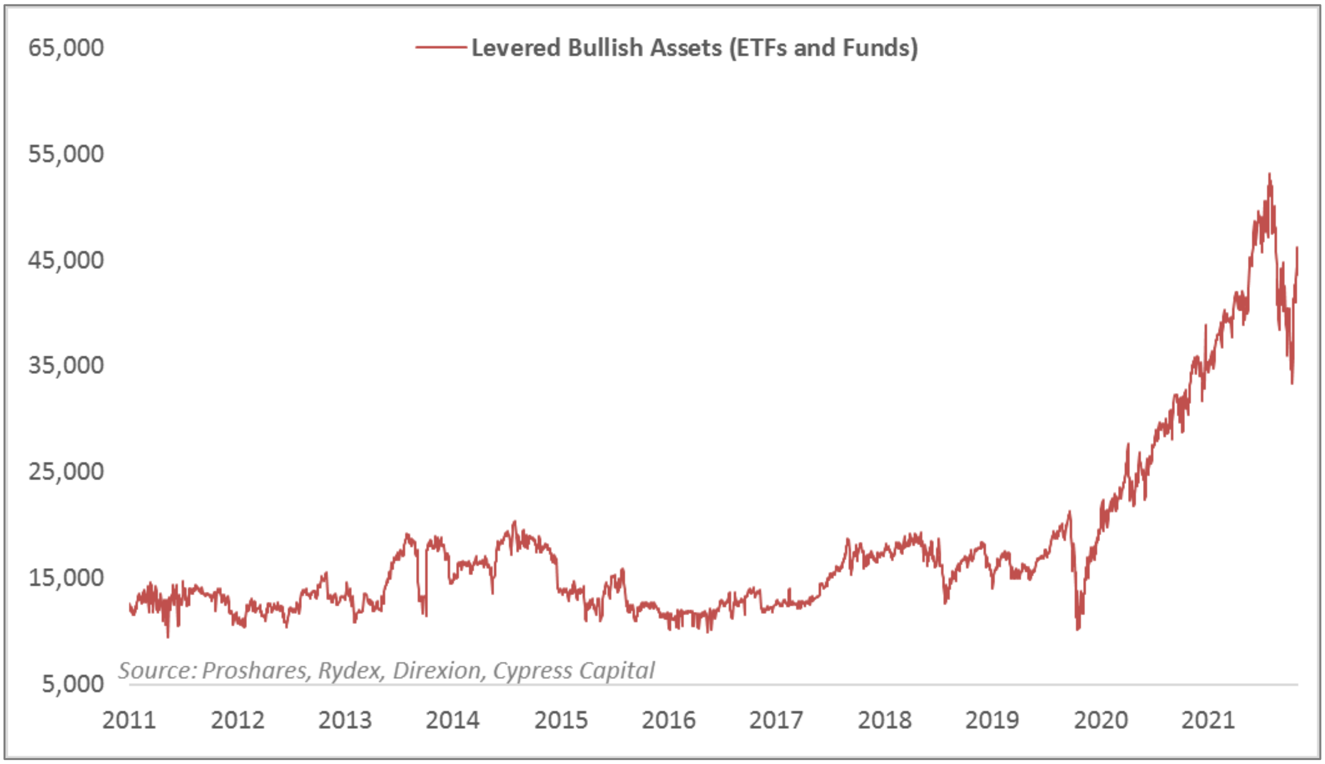
The Expectations Gap reached an extreme, climbing to the highest level since February 2020.



Spread between Consumer Confidence and Consumer Sentiment hit the highest level since Nov 1968.



Assets in Levered Long ETFs and Funds surged into month end.



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.

Contact us for more information.