Market Outlook

By Mark T Dodson, CFA

Central Banking Blunder

Market Risk Index climbed to 71.0% as improvements in the Valuation composite were not enough to offset the deterioration in the Psychology and Monetary Composites.

Risk scores from the Psychology composite have bottomed. They are moving back toward “greed” zones, with the daily readings inside the composite already hitting the worst 20% of readings this week (the composite score is a moving average of daily scores). A surge in call option buying has driven the Options category to become one of the largest negative influences, and Investment Surveys have eased off the extremely positive readings we saw during March. Corporate insiders are still notably absent on down days in the market. Also, the NYSE High Low Logic Index that we highlighted last week for its renewed sell signal has pressed further into bifurcated market region, indicating unhealthy stock market internals.

For the monetary composite, inflation concerns and rising interest rates on the price of credit instruments remain front and center. Our Dow Bond Oscillator indicator is a simple gauge to illustrate this, and it shows bond markets in the tightest liquidity period since 2008. Mortgage rates have shot higher, with implications that a mortgage payment on purchasing a new home has climbed approximately 30-35% in the last 6 to 9 months.

Every economic environment presents unique challenges, and this one is unprecedented when comparing the bond market's action to actions taken by the Federal Reserve thus far. Comparing the Fed’s Yield curve (10Yr Treasury minus the Fed Funds Rate), which has been steepening, to that of the bond market (10Yr Treasury minus 3Yr Treasury), which has inverted, reveals a Federal Reserve further behind the curve than any other. This Fed suffered from a combination of 2008 PTSD and an unappreciation for the Volcker’s work in breaking inflation expectations a generation ago.

In case you missed it, read what Bill Dudley, former president of the Federal Reserve Bank of New York, wrote this week:

> *It’s hard to know how much the U.S. Federal Reserve will need to do to get inflation under control. But one thing is certain: To be effective, it’ll have to inflict more losses on stock and bond investors than it has so far...*
>
> *...Investors should pay closer attention to what Powell has said: Financial conditions need to tighten. If this doesn’t happen on its own (which seems unlikely), the Fed will have to shock markets to achieve the desired response. This would mean hiking the federal funds rate considerably higher than currently anticipated. One way or another, to get inflation under control, the Fed will need to push bond yields higher and stock prices lower.*

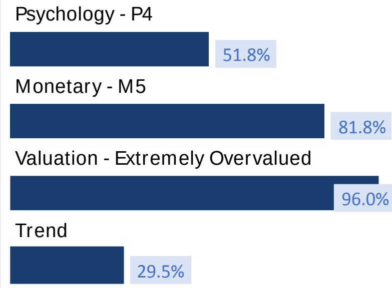
We can’t recall a former central banker speaking so bluntly. As we’ve repeated ad nauseam, it’s nearly impossible to break inflation expectations without breaking something else.

Market Risk Index

Rec Allocation 25% Underweight

71.0%

Category Percentiles



Largest Psychology Influences

Leveraged Investments	Negative
Option Activity	Negative
Technical Indicators	Negative
Flow of Funds	Negative

Largest Monetary Influences

Inflation	Negative
Interest Rates	Negative
Exchange Rates	Positive

Valuation

7-10 Year Rtn Forecast	1.4%
10Yr US Treasury Yield	2.7%

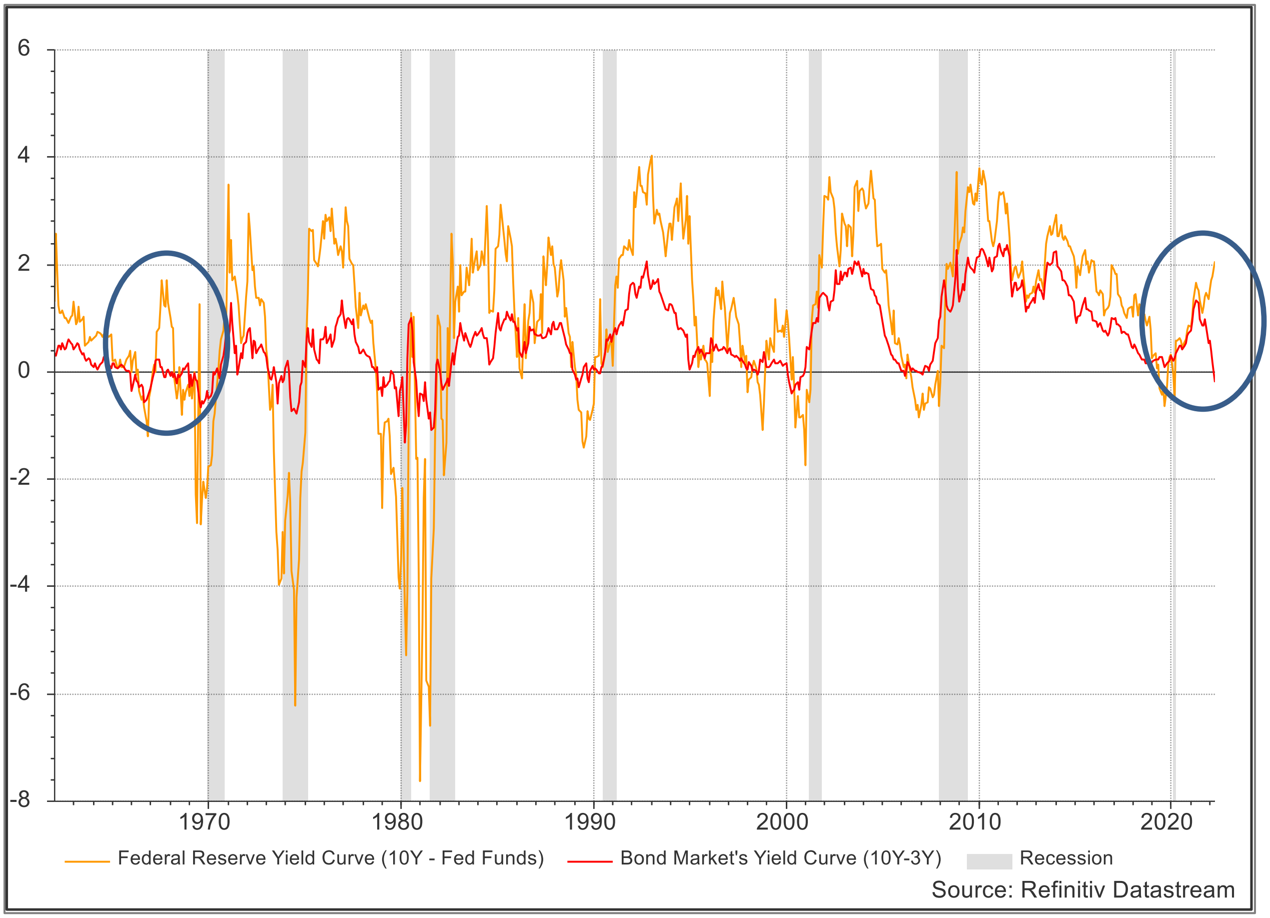
Market Trends

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

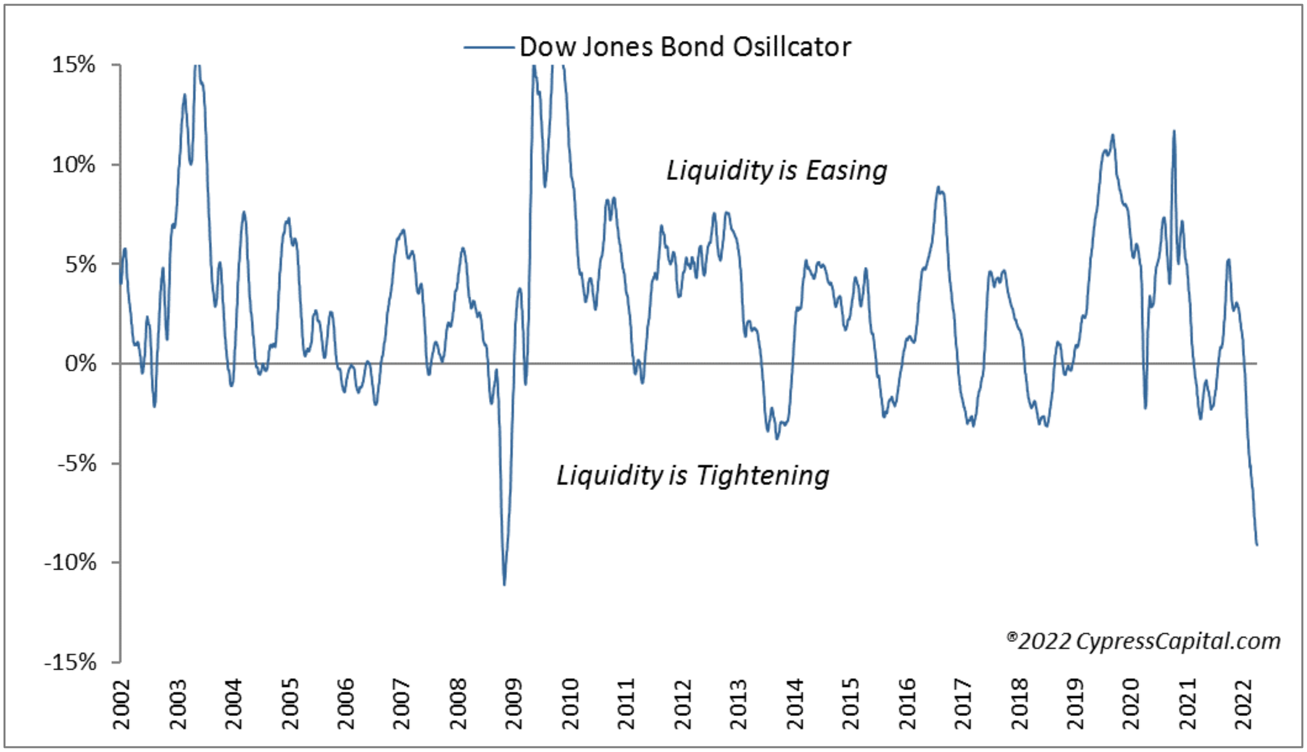
Market Risk Index scales from 0 to 100%. Higher readings correspond with higher risk markets. Scores below 25% are bullish. Scores between 25-75% are neutral, and scores above 75% are markets vulnerable to major drawdowns.

Charts of the Week

The Fed's Yield Curve versus the Bond Market's Yield Curve
This chart compares the Fed Yield Curve (10Yr minus Fed Funds Rate) with the bond market (10Yr minus Treasury yield). One curve is steepening while the other is inverted and signaling recession. It has happened before but not to this degree. This Fed has fallen further "behind the curve" than the central bankers of the late 1960s.

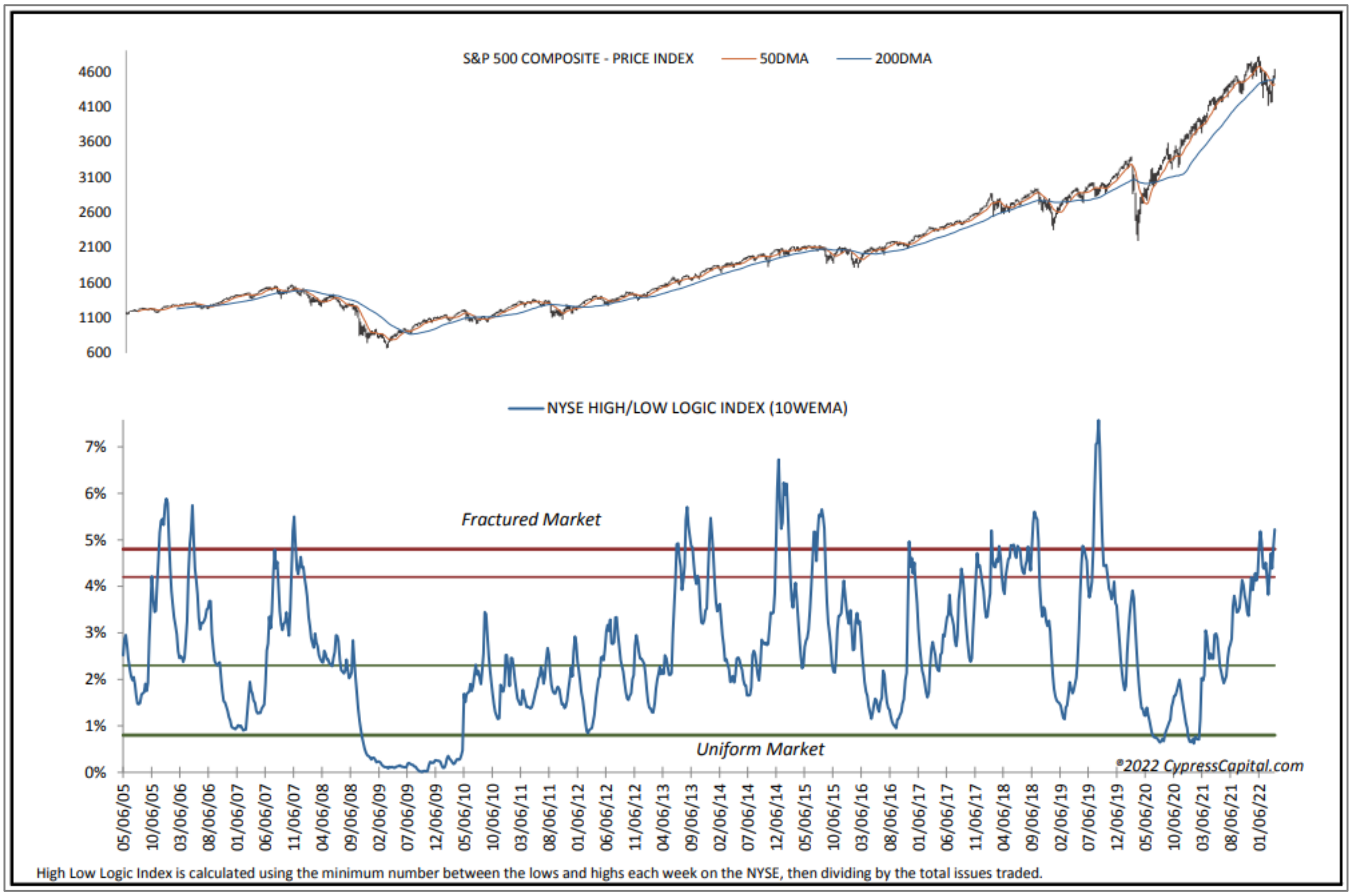


Bond Market continues to tighten.

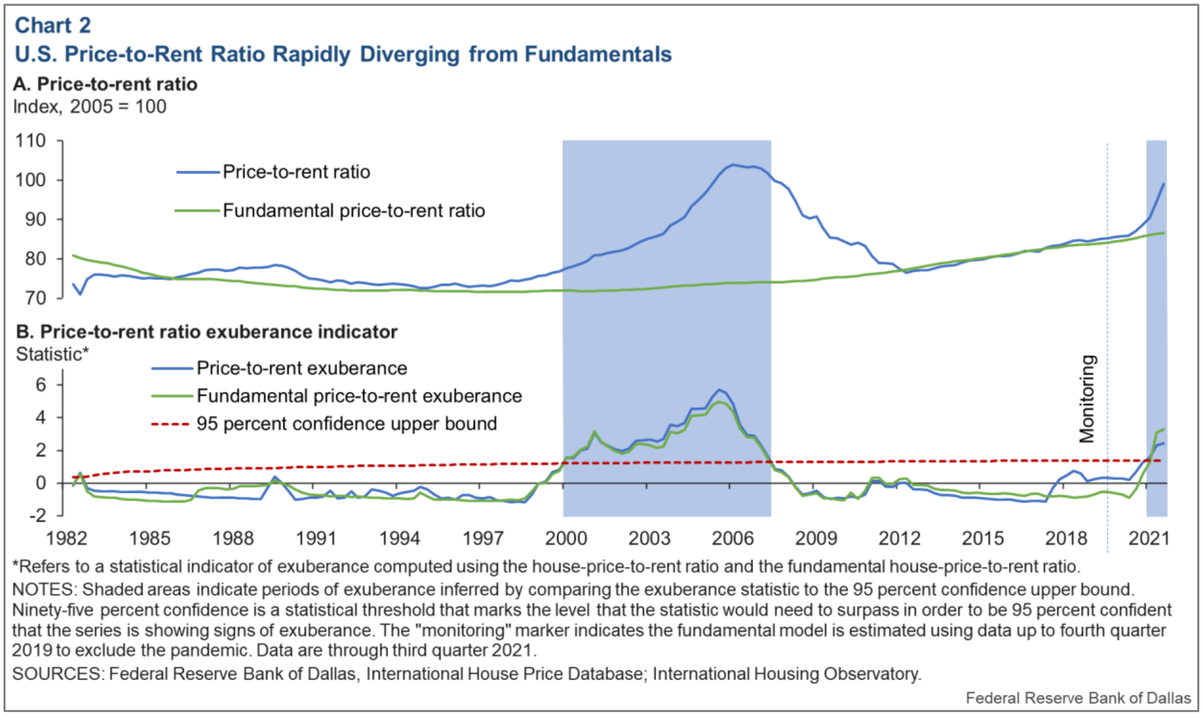


NYSE High Low Logic Index

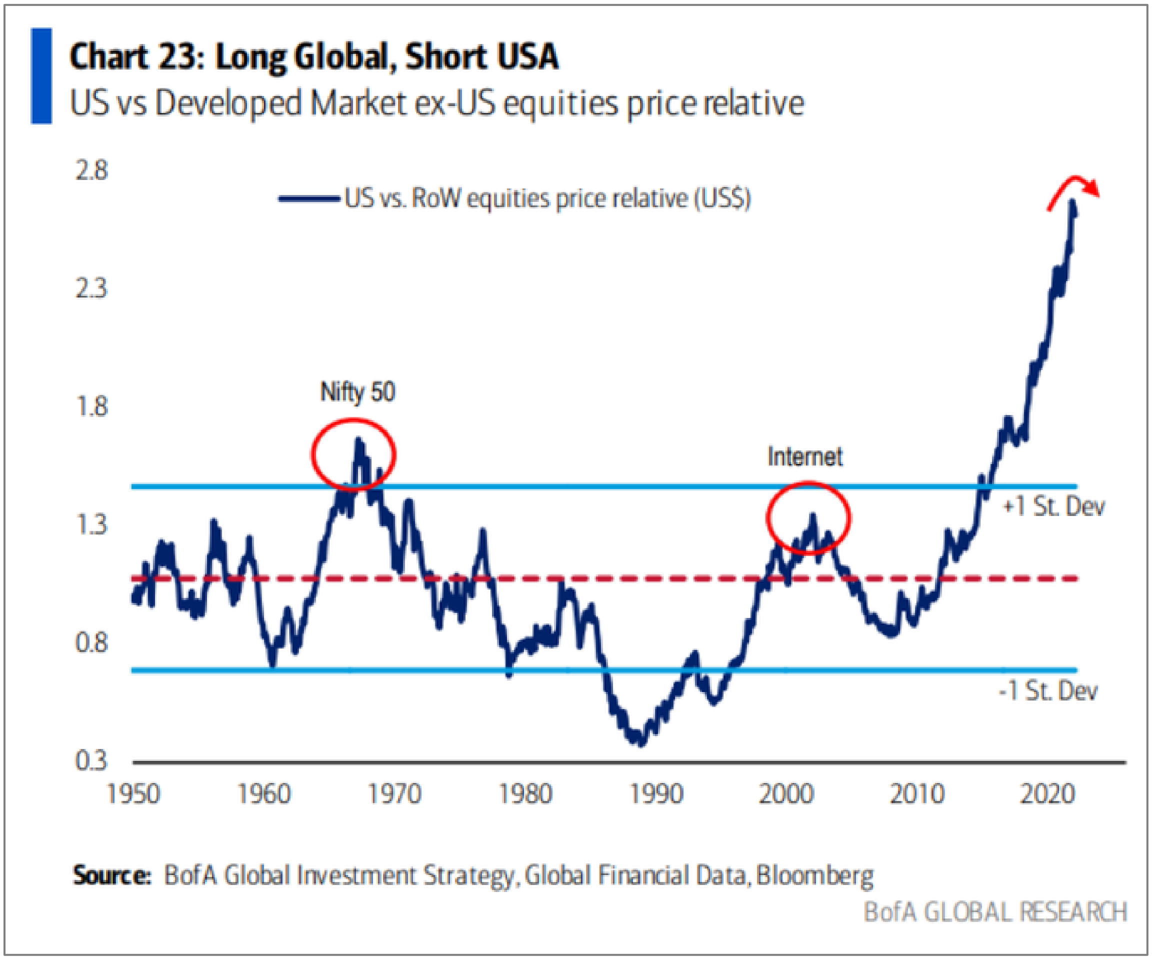
One of our favorite indicators of market internals worsened again this week.



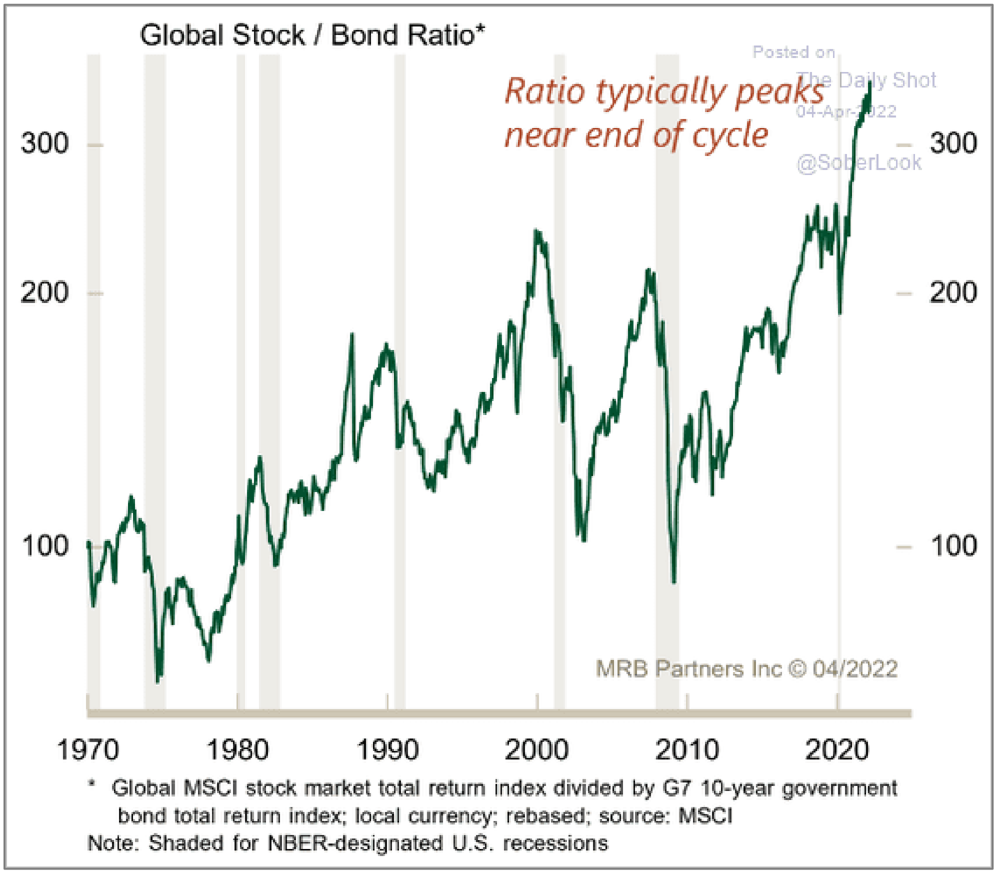
Overheated Real Estate - Price to Rent Index is the highest since the housing bubble.



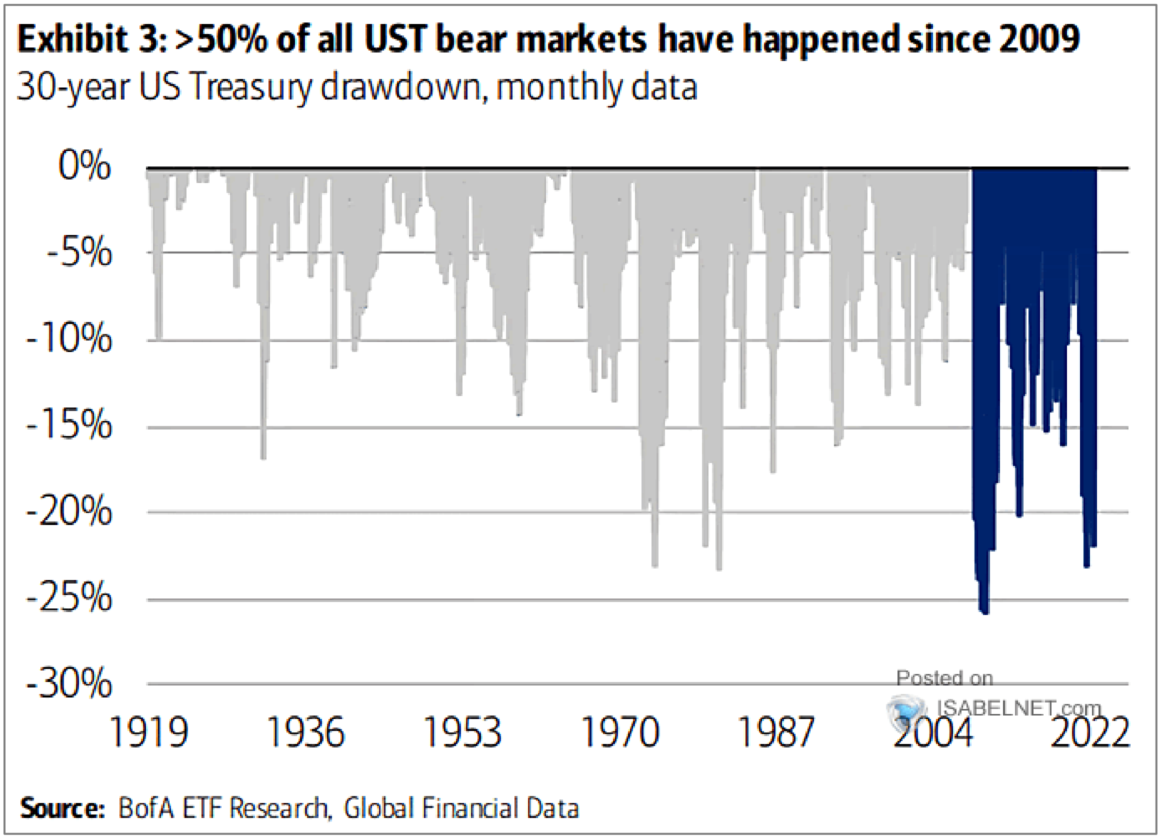
Longest stretch of US equity dominance since 1950.



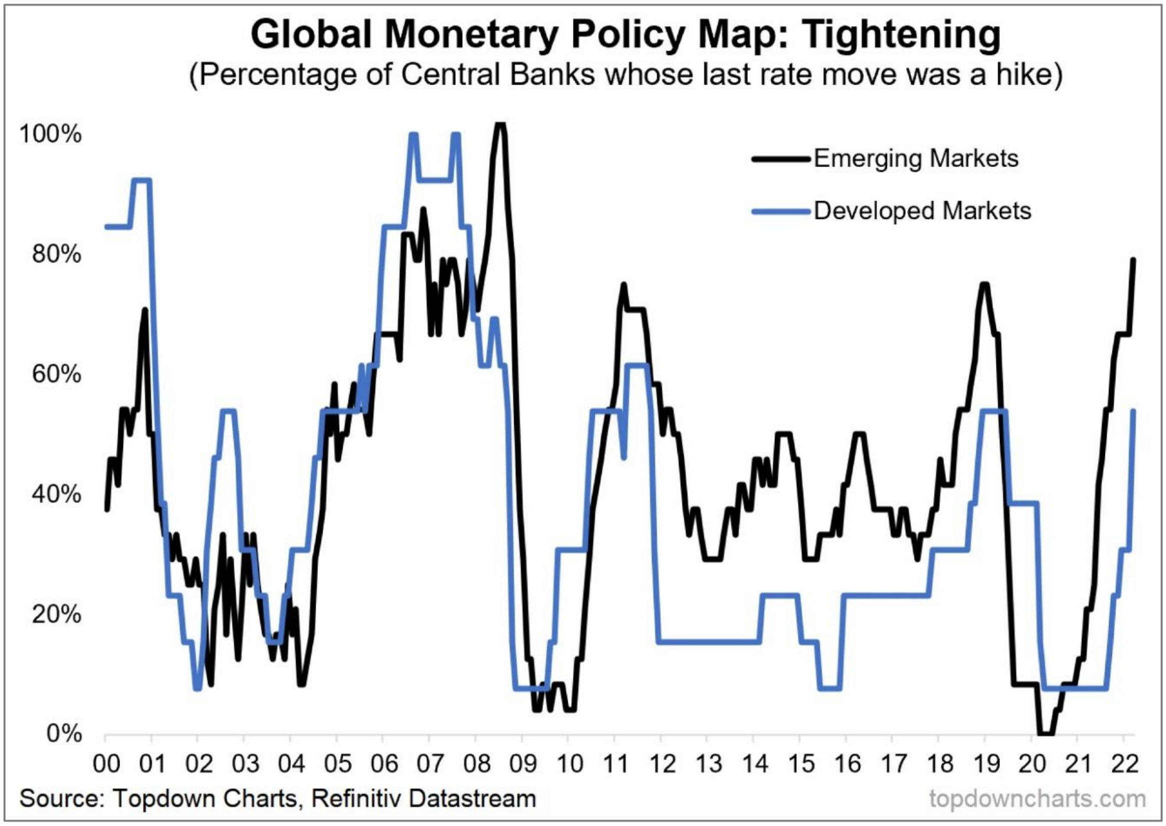
New record in the ratio of Global stocks to bonds.



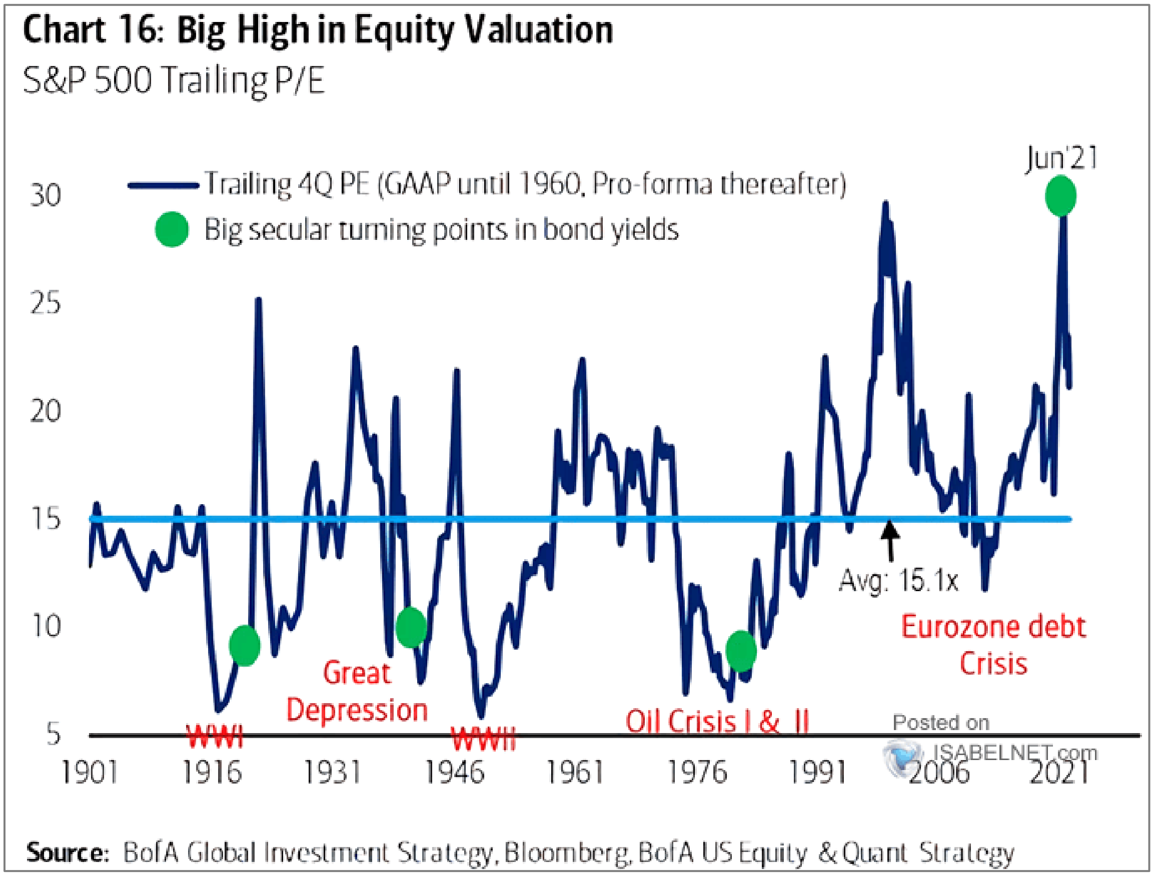
QE Era of ultra-low yields brings more frequent bear markets in US Treasuries.



Central Banks are tightening across the globe.



US Equity Trailing P/E set an all time record in 2021



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.