Market Outlook

By Mark T Dodson, CFA

Psychology Composite improves to the Bullish side of neutral

Market Risk Index readings are growing neutral for stocks, as investor psychology implies a favorable short-term environment with higher prices. The Psychology composite risk score fell 9.3% to 44.2%, which is on the bullish side of neutral and the best reading for investor psychology since May 2020, after bottoming at 21% during the worst of the Covid included panic.

Investor Surveys is the most bullish category for the Psychology composite. Both the Investor’s Intelligence and American Association of Individual Investor surveys show persistent bearish extremes from retail and professional investors. Although positioning doesn’t yet align with sentiment, it supports higher stock prices over the short to intermediate term. But, the current state of monetary conditions and valuations should temper the desire to play a short-term rally too aggressively.

Monetary conditions improved modestly, as a clear peak in industrial commodities continues to strengthen the inflation category readings. Inflation was our most significant monetary concern for much of last year in that it implied that the Fed would have to tighten monetary conditions sharply. In recent months, this concern is giving way to fears of tighter money, as the Interest Rates category moved to the top spot as the largest negative Monetary influence. That shift and the current condition of both categories imply that aggressive buyers of equities are fighting the Fed.

The sharp rebound in equity markets didn’t help the Valuation composite and our bottom-up return forecast for stocks. Stock market return expectations are up dramatically from the end of 2021 but still fall short of the 10 Yr US Treasuries yield. Even if we rely on the new-era period of higher average stock market valuations after 1995 and regress post-1995 era valuations with future returns, the increase in returns implied by the stock market sell-off still falls shy of longer duration Treasury Yields.

Return expectations have improved by a whopping 400 basis points in five short months. Despite the improvement, the speculative froth was so extreme in 2021 that broad market valuations still don’t show a clear margin of safety for aggressive investment in equities.

Market Risk Index

Rec Allocation 25% Underweight

59.2%

Category Percentiles

Category	Percentile
Psychology - P3	44.2%
Monetary - M4	72.8%
Valuation - Extremely Overvalued	94.1%
Trend	85.1%

Largest Psychology Influences

Surveys	Positive
Volatility	Positive
Flow of Funds	Negative
Bank Sentiment	Positive

Largest Monetary Influences

Interest Rates	Negative
Exchange Rates	Positive
Inflation	Negative

Valuation

7-10 Year Rtn Forecast	2.3%
10Yr US Treasury Yield	2.8%

Market Trends

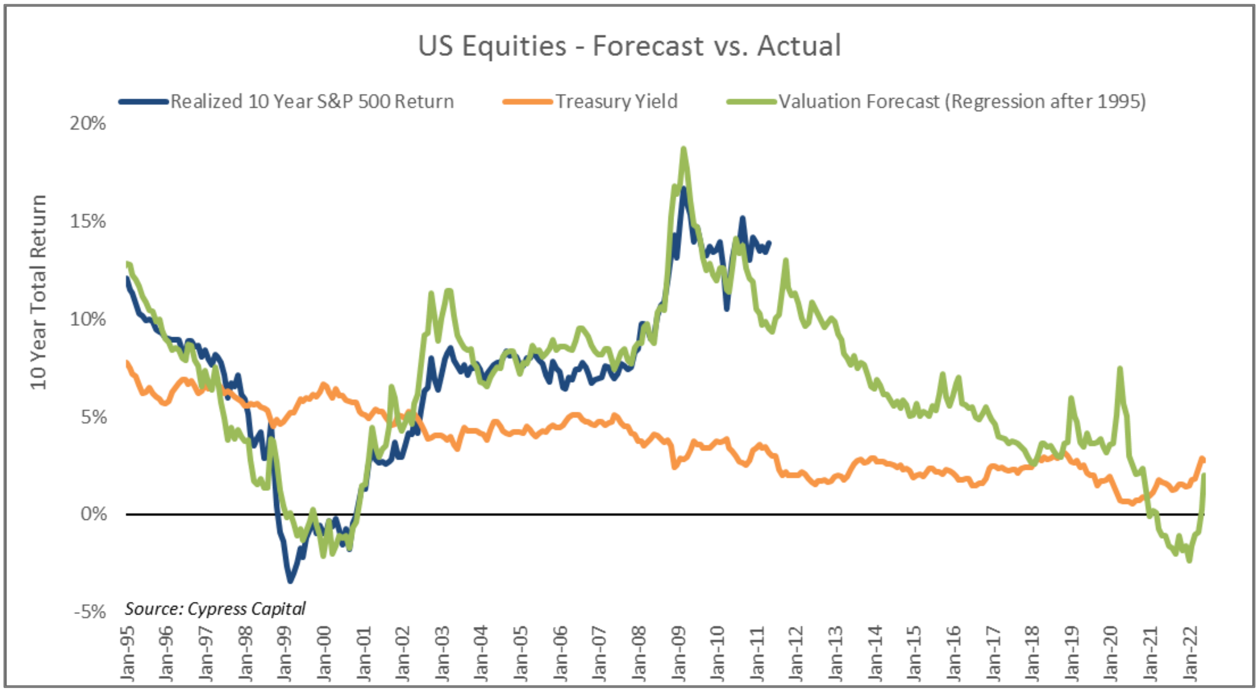
US Equities	Bullish Investment
Intl Equities	Bullish Investment
REITs	Bullish Investment
Broad Commodities	Bullish Investment

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.

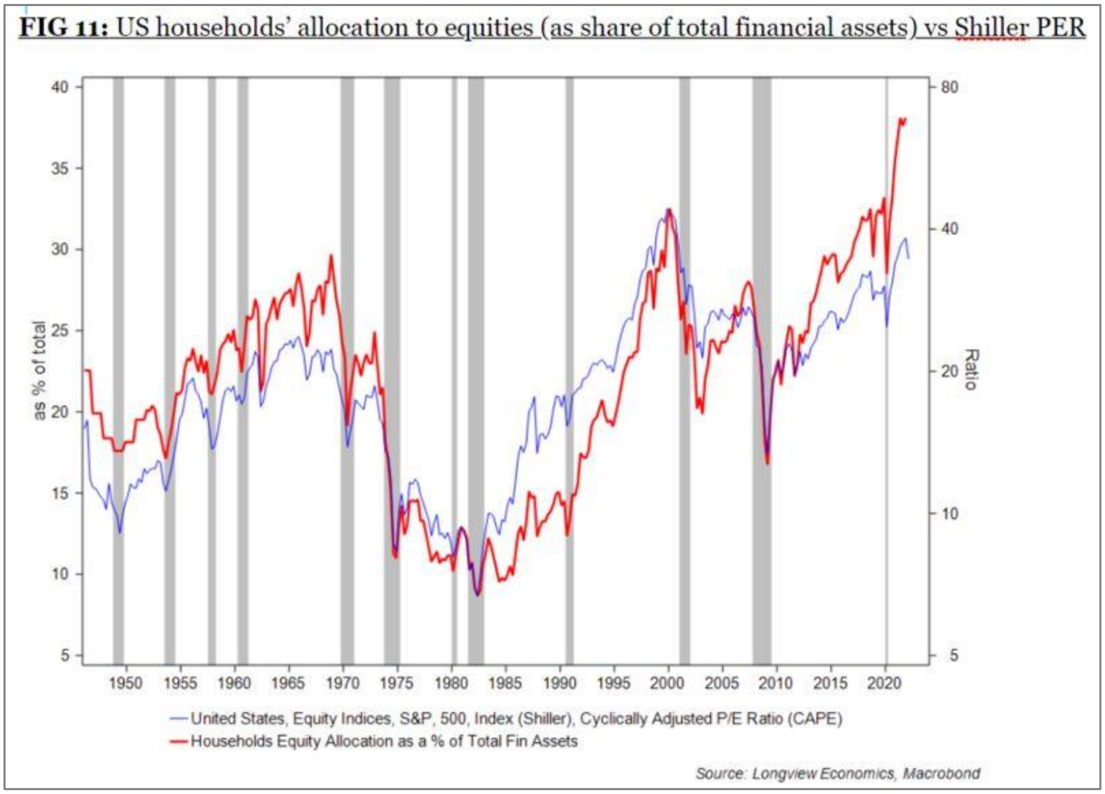
Charts of the Week

New Era – Best Fit Stock Market Valuation

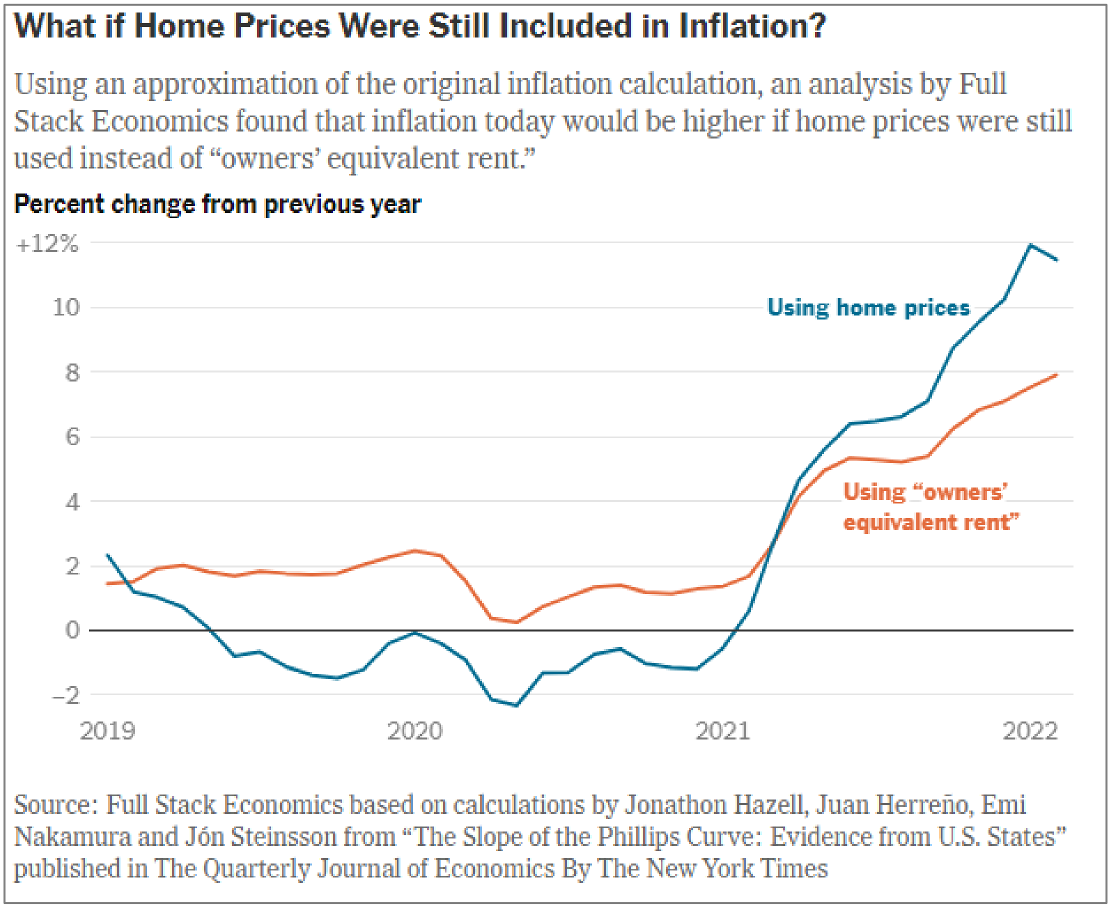
The chart below uses only average valuations after 1995 of our seven favorite valuation metrics and calculates a line of best fit with total returns over the ensuing ten years. A falling stock market has dramatically improved expected returns, from a -2.3% expectation at the end of 2022 to a +2% return today. That's more than 400 basis points in a matter of months. However, that still falls shy of the current return on Treasuries and is a testament to just how frothy the market had become in 2021.



Household Allocations to Equities set new records in 2021.

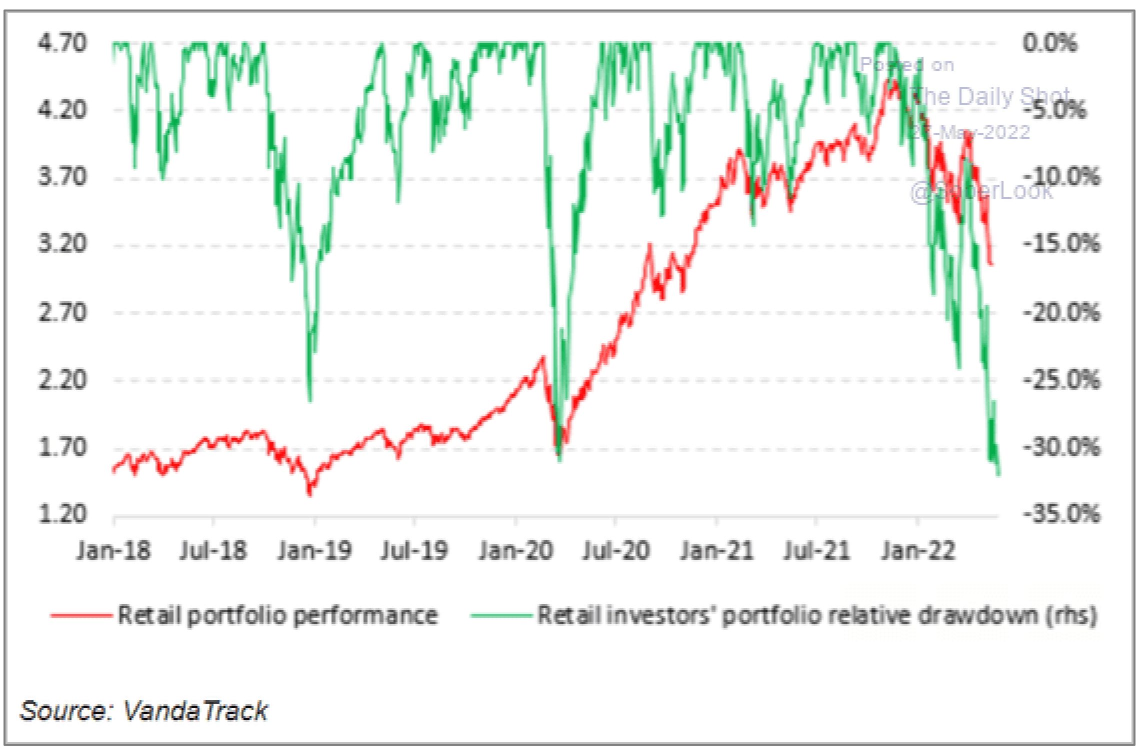


Inflation is running about 4% higher if calculated as it was prior to 1983, using actual home prices.

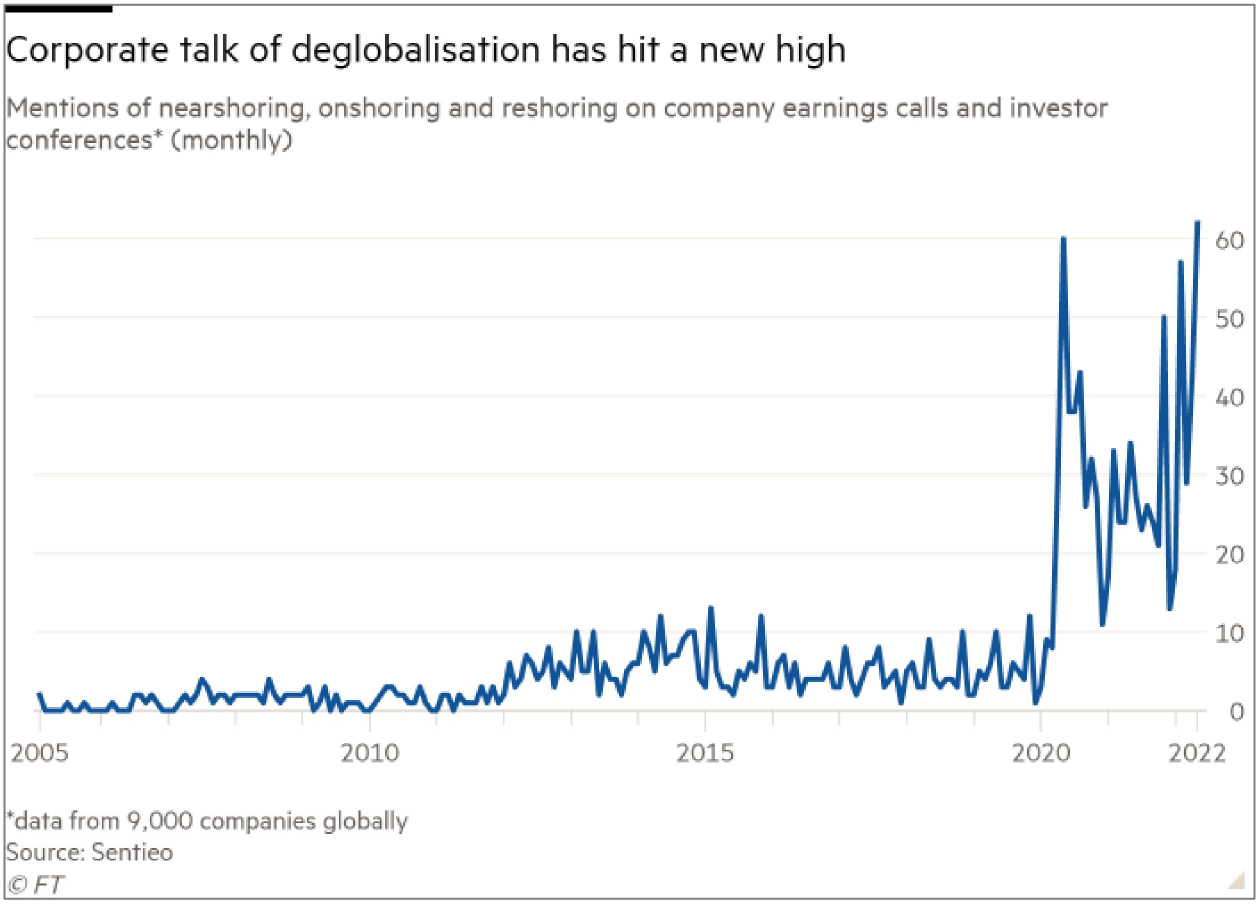


Source: New York Times

Retail investor drawdowns have been more severe than the broad market.



The World is growing less flat - deglobalization talk hits a new high.



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.