Market Outlook

By Mark T Dodson, CFA

Short-Term Investor Psychology is Bullish

Market Risk Index improved substantially this week to 53.4%, the best reading on MRI since May 2020, as Investor Psychology moved firmly into the best half of possible readings. The recommended equity allocation has increased, but we would discourage investors from chasing the market aggressively.

Fear is becoming more prevalent – it's not capitulation or bear market killing fear – but these are the best readings on our Psychology composite that we've seen since the early days of the pandemic. The improvement to psychology was sharp thrust by the McClellan Oscillator to very overbought levels in recent days – levels that serve as broad indications of buying interest and are often followed by higher stock market prices over ensuing weeks. Investor psychology is giving a bullish message for markets in the short term; however, it's a lone standout.

If we are arguing that the nature of any stock market rally is likely temporary, it's because psychology has improved while Monetary conditions and Valuations have not. It's also related to the nature of the improvement in sentiment, which has relied predominantly on investor surveys – AAII, Investor's Intelligence, and the Consumer Confidence survey on consumer expectations for stock prices in the most recent week. Surveys are fickle and change with short-term moves in prices, meaning the improvement to the Market Risk Index could prove as fleeting as they were in the March stock market sell-off. MRI readings that are both bullish and sticky rely on more substantive improvement to monetary conditions, valuations, or some of our long-leading measures of investor psychology.

For the first time that we can remember, Fed officials are openly targeting the wealth effect to bring inflation down, hitting news wires with hawkish messages when they sense animal spirits might be about to reignite. Given the Powell Pivot in 2018 and his tsunami of liquidity during the pandemic, markets don't believe that he has that inflation-killer Paul Volcker gene in him and are anxious to front run his next panic-induced liquidity dump.

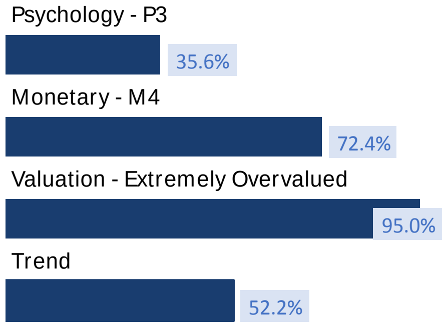
Yet, Powell has neither pivoted nor announced any measures that might be aimed at pushing markets higher. Quite the opposite, quantitative tightening started this week, and another Fed official went public with a hawkish message on nascent signs of stock market strength. Any summer stock market rallies are fighting the Fed.

Market Risk Index

Rec Allocation 15% Underweight

53.4%

Category Percentiles



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	2.0%
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.

This environment is unfamiliar for most of us, with more than a decade of unprecedented monetary stimulus, followed by a $5 trillion Federal government dump of cash to the public to fight a pandemic. The result is the tightest labor market in a generation, inflation rivaling the 1970s, and a Fed in inflation denial now forced to tighten into an oil supply shock and a slowing economy.

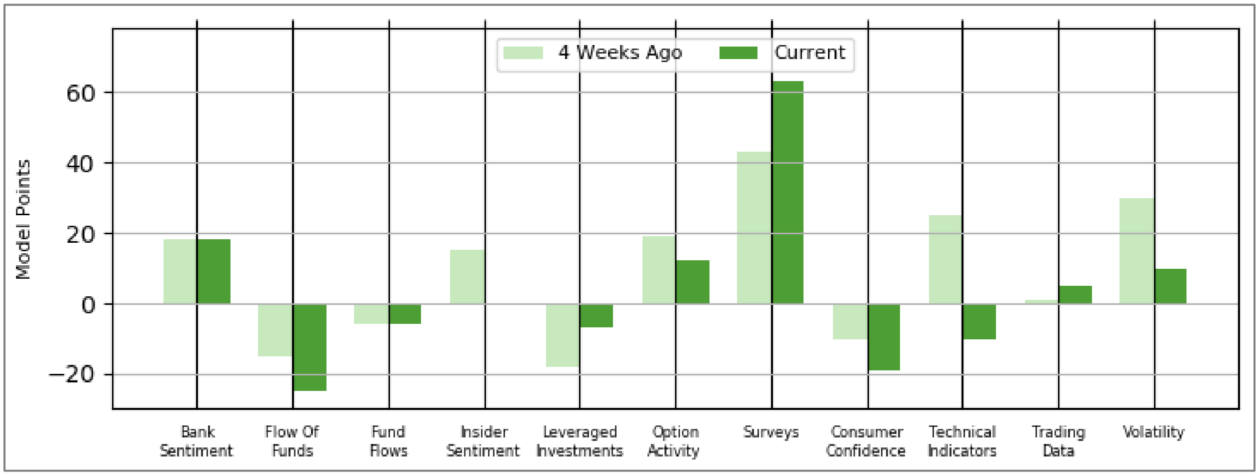
The Consumer Confidence survey captured the dichotomy perfectly - late cycle, overheated economy readings from consumers who expect higher interest rates and lower stock prices. Since the Conference Board started asking questions about interest rates and stock markets in 1987, we have never had a combination of consumers expecting so little for stocks while at the same time being so confident that interest rates are going higher. This has been a bullish combination in the past, occurring mid-cycle as the Fed was shifting from easy to tight money, but the question has never been asked when inflation was running this hot. We suspect this particular response combination would have been more common should the survey have gone back into the 1970s.

Until we see clear signs of capitulation or even conditions where equities are priced to return a premium over Treasury bonds again, we cannot in good conscience be aggressive buyers and overweight equities in investment portfolios. We are fading our FOMO.

Charts of the Week

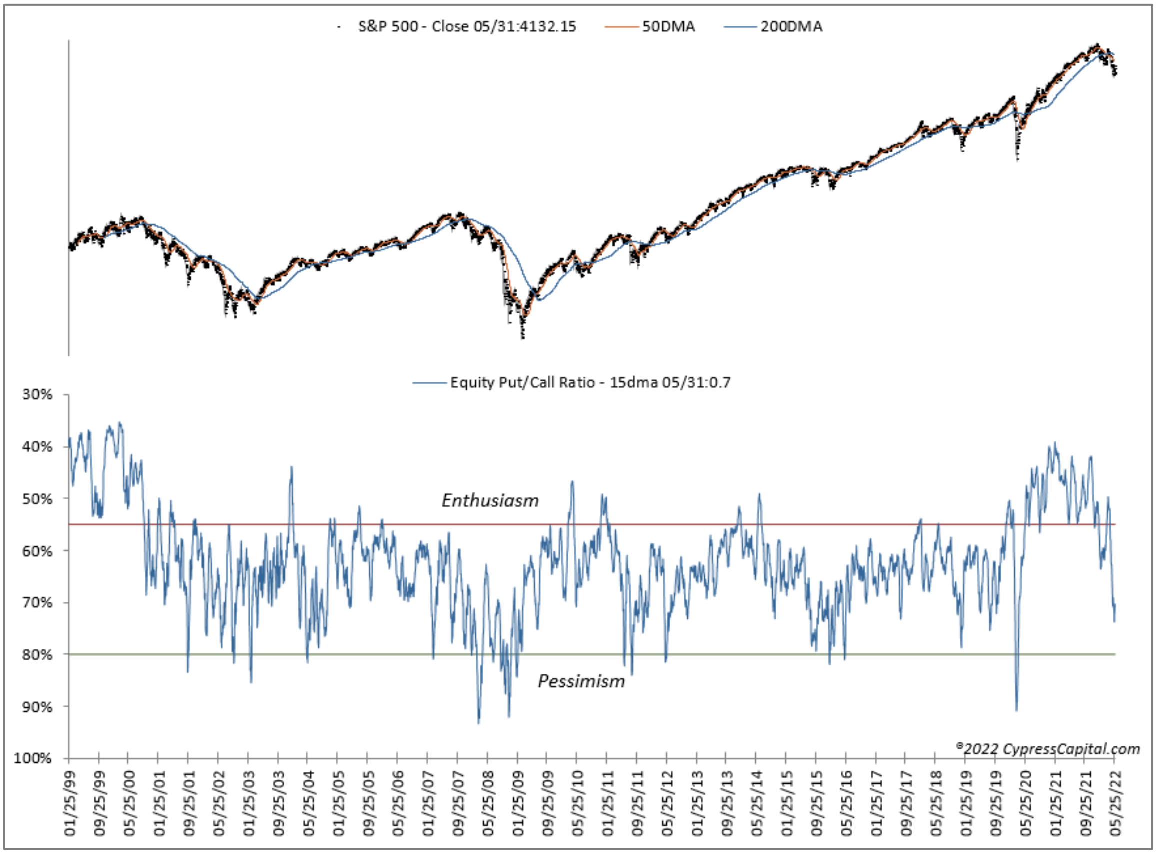
Psychology Composite Categories

We don’t show this chart often, but the massive improvement in Investor Psychology is heavily skewed toward how investors are responding to surveys.



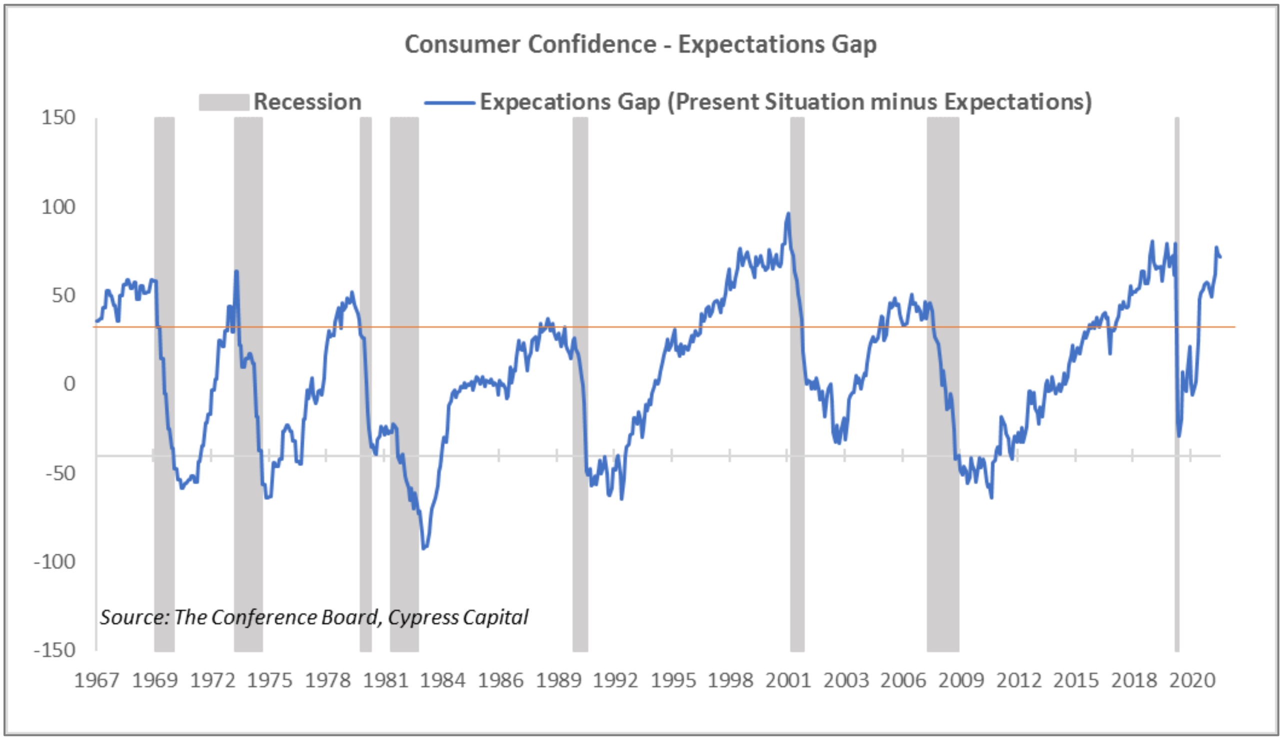
Equity Put/Call Ratio

No capitulation yet, but more steady improvement here points to signs that the speculative environment created by the pandemic stimulus is drawing to a close.

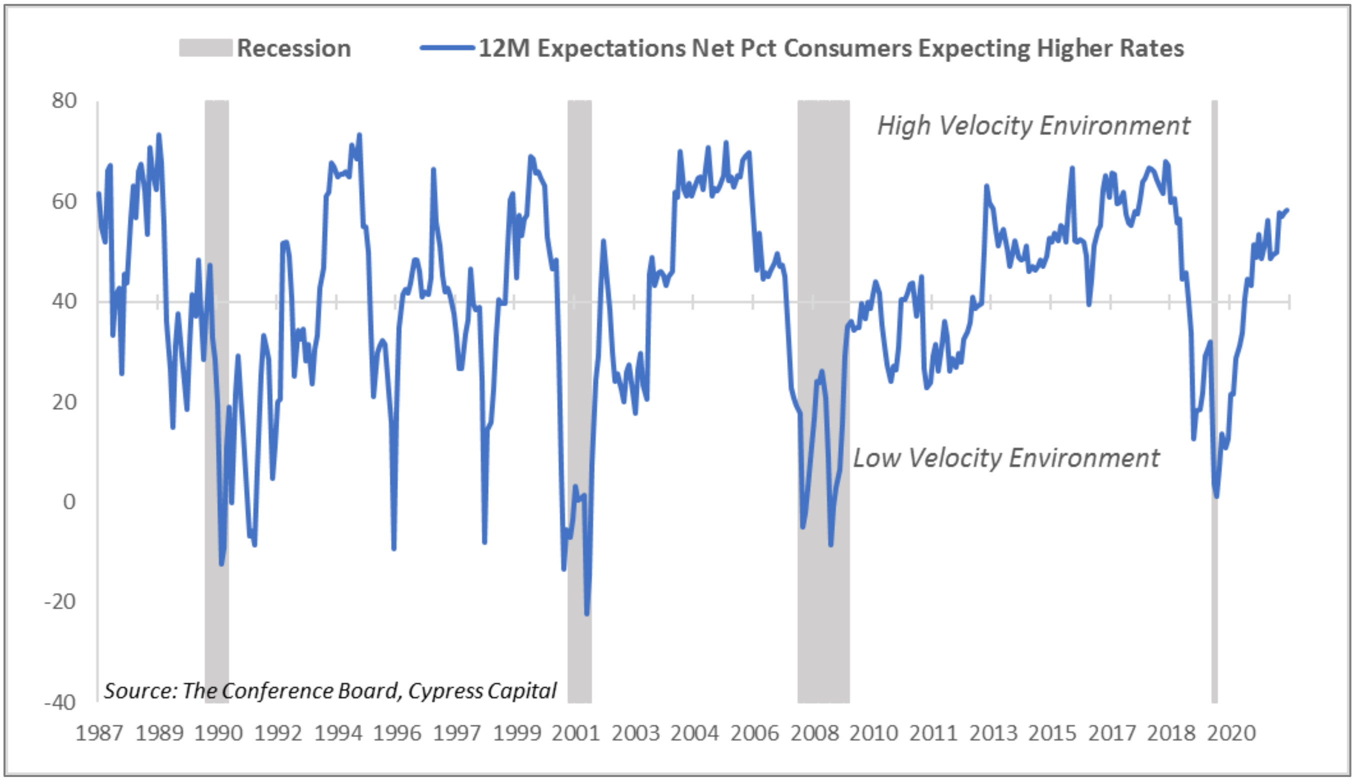


Consumer Confidence – Gap between Present Situation and Future Expectations

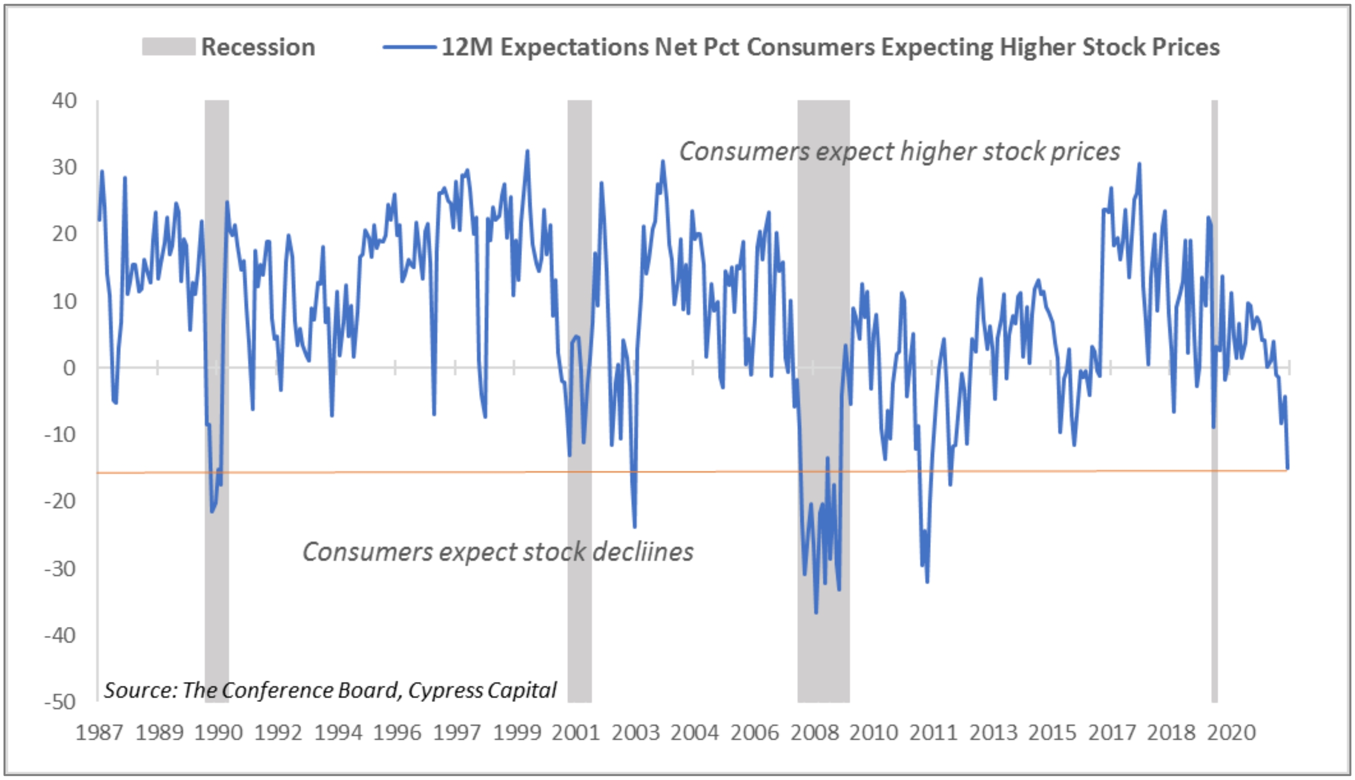
This measure of consumer confidence still indicates a late-cycle, overheated, economy.



Consumer Confidence – Net percentage of consumers expecting higher interest rates
Unlike most stock market corrections in recent history, consumers still expect higher interest rates. Rising inflation expectations won't break until this chart shows a sharp decline.

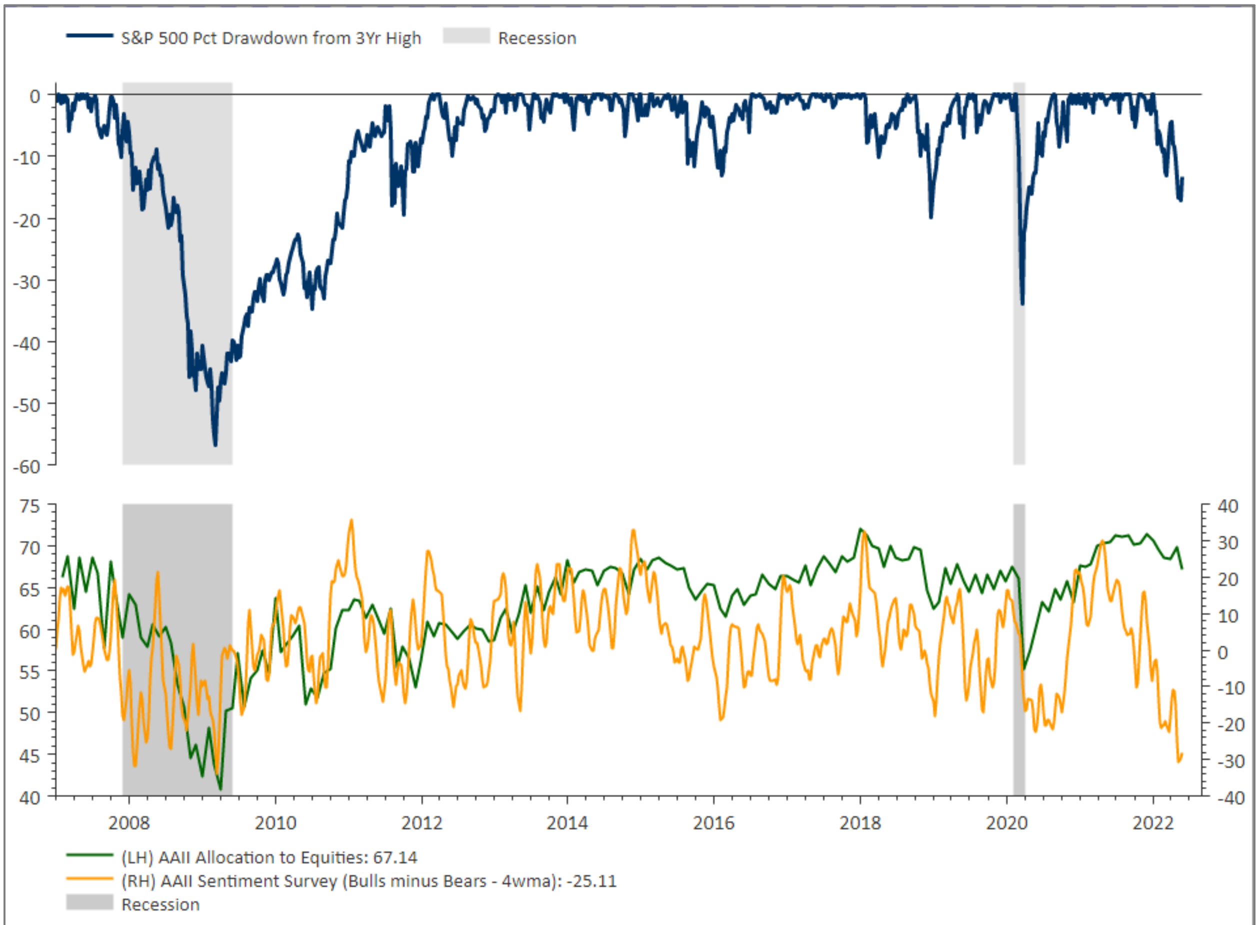


Consumer Confidence – Net percentage of consumers expecting higher stock prices
Consumers turned the most bearish on stocks since 2012. Readings this extreme are often bullish for markets.



AAII Surveys – Allocations versus Sentiment

The four-week average of the AAII sentiment survey rivals the 2008 lows, while the monthly poll of equity allocations only retreated modestly in May. The divergence in messages between the two surveys is the widest since January 2008, well before the 2008 recession was on the radar of most investors.



Source: Refinitiv Datastream, Cypress Capital

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.