Market Outlook

By Mark T Dodson, CFA

You are not a Bum. Ignore bad pitches.

Market Risk Index improved to 42.6% this week, the lowest since April 2020. Investor psychology continues to improve, but significant headway by monetary conditions and valuations remains elusive. Also elusive are improvements in investor psychology that we could describe as capitulatory. For example, our Short-Term Sentiment composite continues to show bear market clustering behavior in fear extremes, but it has been unable to match the level of extremes seen in every correction in the last decade. It's unusual.

As we mentioned in a Market Outlook late last year, valuations had become so stretched and frothy, that a market decline meeting the technical definition of a bear market would only take us back to valuation extremes from previous bull market peaks. Record-setting euphoria makes this market more challenging to navigate simply because the decline meets the widely accepted definition of a bear market. Additionally, the simultaneous sharp correction in bonds and stocks has kept any relative valuation improvements out of reach. Money goes where it is best, and in 2022 that hasn't been in stocks or bonds. Playing defense has been the winning strategy.

The headwind for the monetary composite is still a toxic mix of a steady move toward tighter liquidity with persistently high inflation. The Producer Price Index for all commodities re-accelerated in May, with the six-month rate of change now tracing out a pattern similar to the 1973-74 inflationary bear market. Liquidity grows steadily tighter without signs of a substantial break in inflationary pressures – the kind of break that will get the Fed to take their foot off the brake pedal.

By some measures, the real Fed Funds rate as an example, the Fed hasn't even begun to tighten, as the real Fed funds rate is still firmly in negative territory. The extremes in monetary policy resulting from the pandemic are directly analogous to the extremes we saw in valuations. The Fed produced so much aggressive yield-seeking behavior in this short-lived cycle that Gamestop, AMC, things called SPACs, and an electronic currency with a dog mascot looked like wonderful investment opportunities.

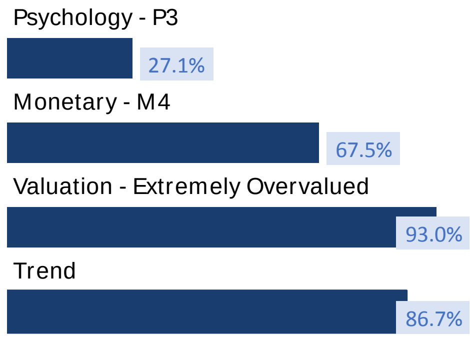
For all the folly that this era has brought us, we are optimistic that this environment will produce an incredible investment opportunity for those of us patient enough to call ourselves defensive investors. That means we think MRI has a good chance of going into the "back the truck up zone" if we're both patient and willing to put more of our capital at risk when others are not. Warren Buffett put it best - "the trick in investing is just to sit there and watch pitch after pitch go by and wait for the one right in your sweet spot. And if people are yelling, 'Swing, you bum! ' ignore them."

Market Risk Index

Rec Allocation 15% Underweight

42.6%

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	2.7%
10Yr US Treasury Yield	3.5%

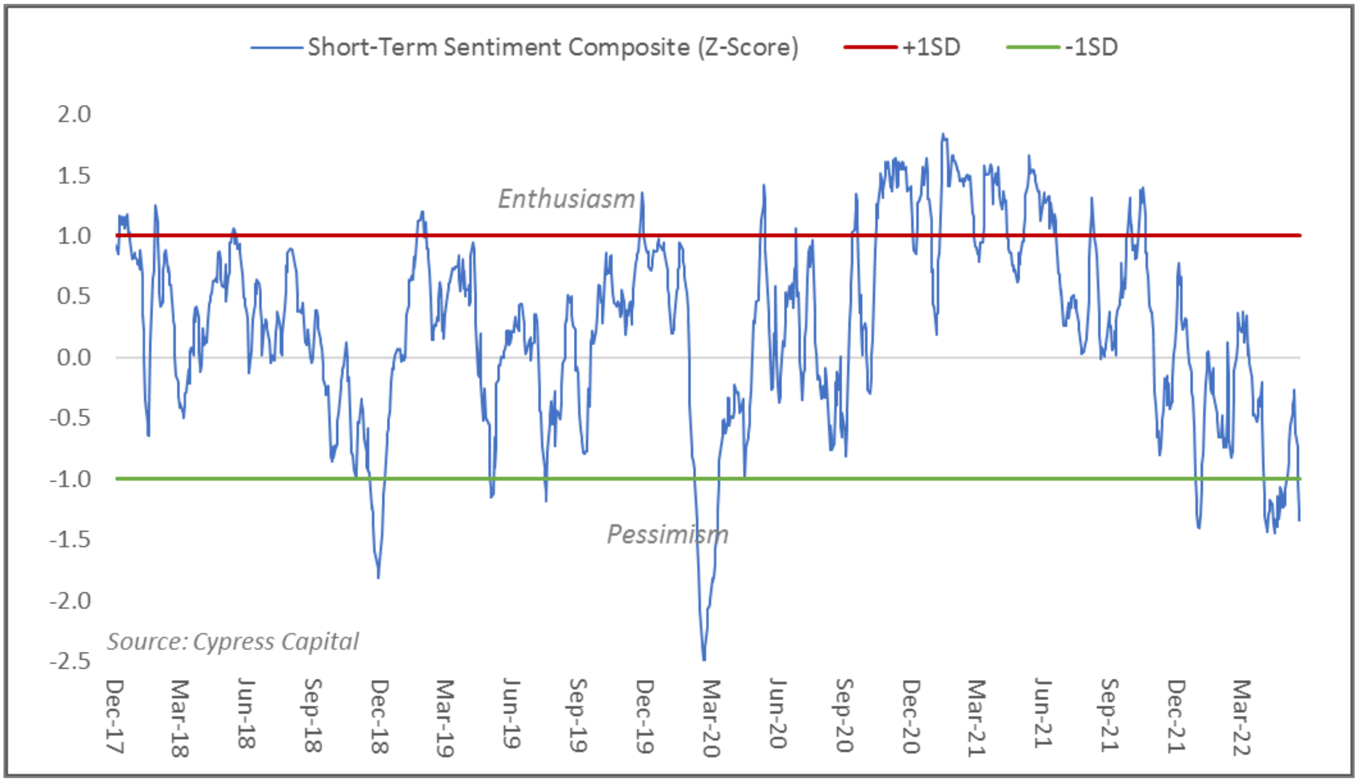
Market Trends

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

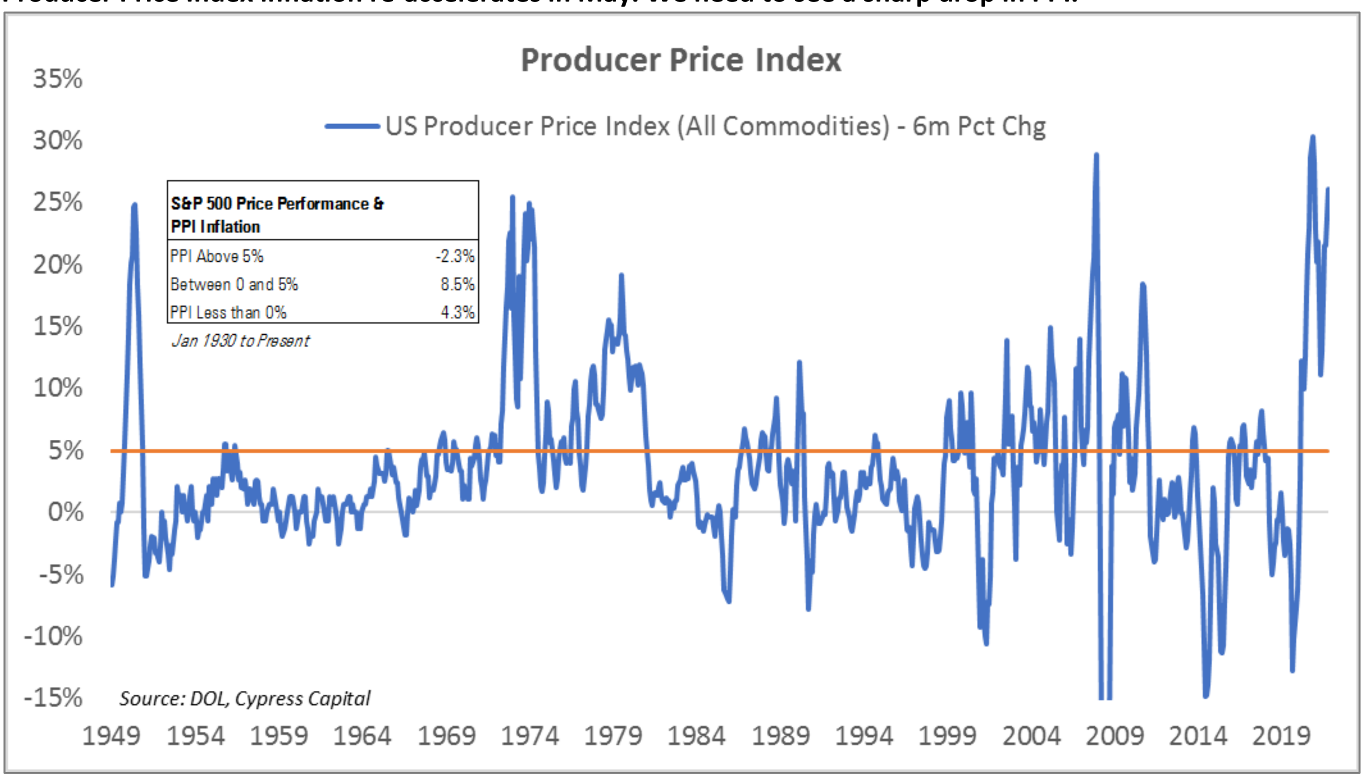
Market Risk Index scales from 0 to 100%. Higher readings correspond with higher risk markets. Scores below 25% are bullish. Scores between 25-75% are neutral, and scores above 75% are markets vulnerable to major drawdowns.

Charts of the Week

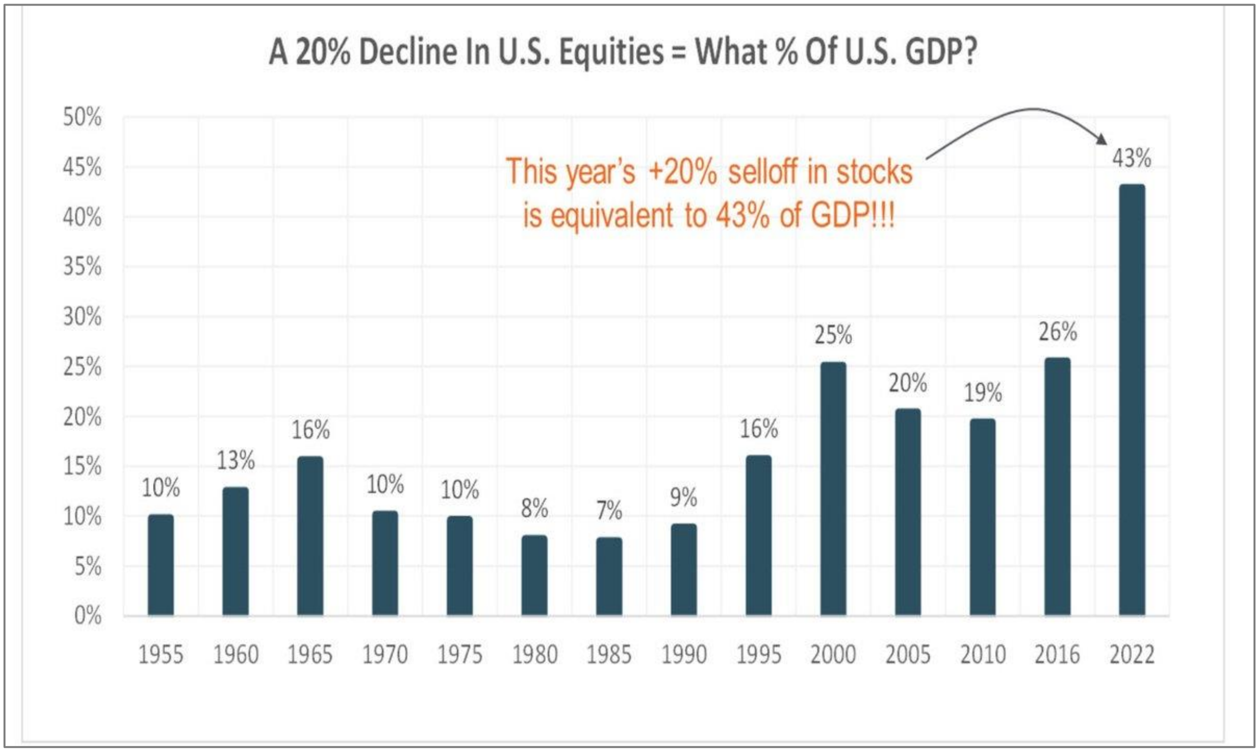
Short-Term Sentiment is pessimistic, but extremes are not consistent with the end of a bear market.



Producer Price Index inflation re-accelerates in May. We need to see a sharp drop in PPI.

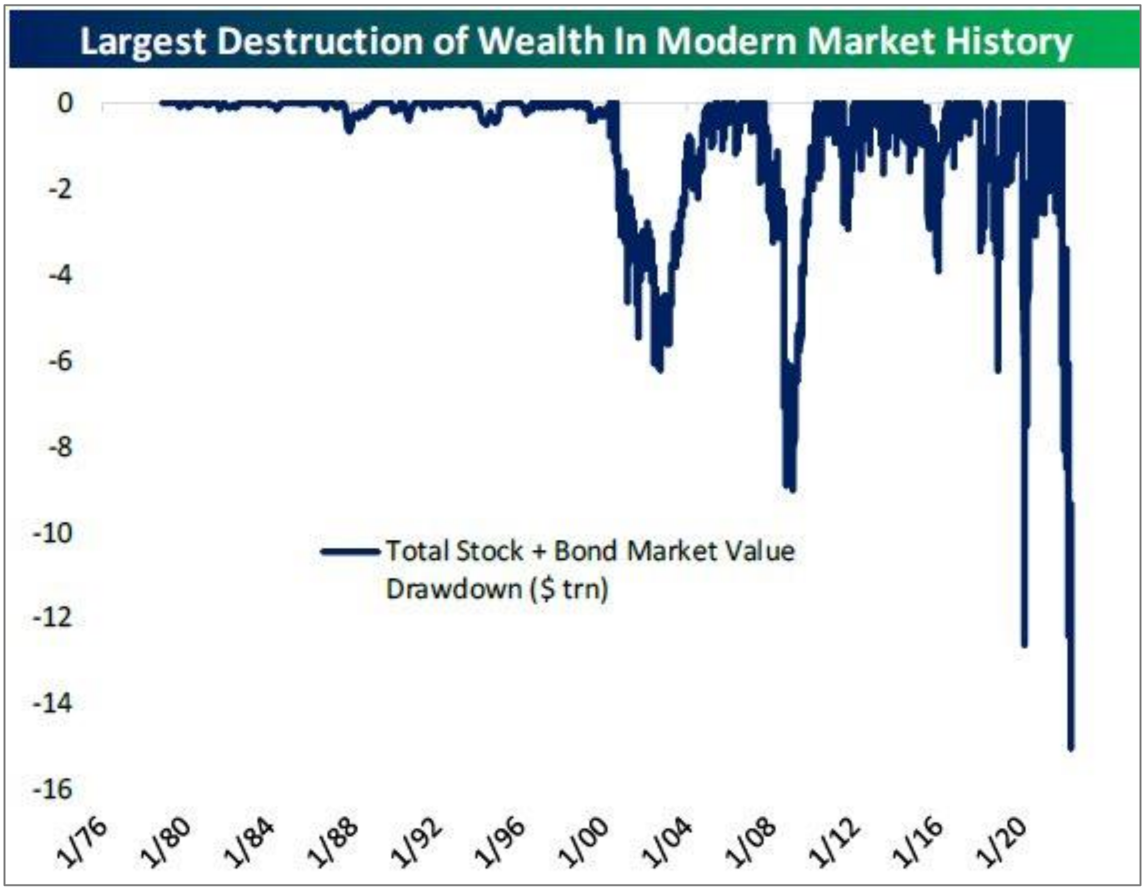


The Wealth Effect is taking a record hit.



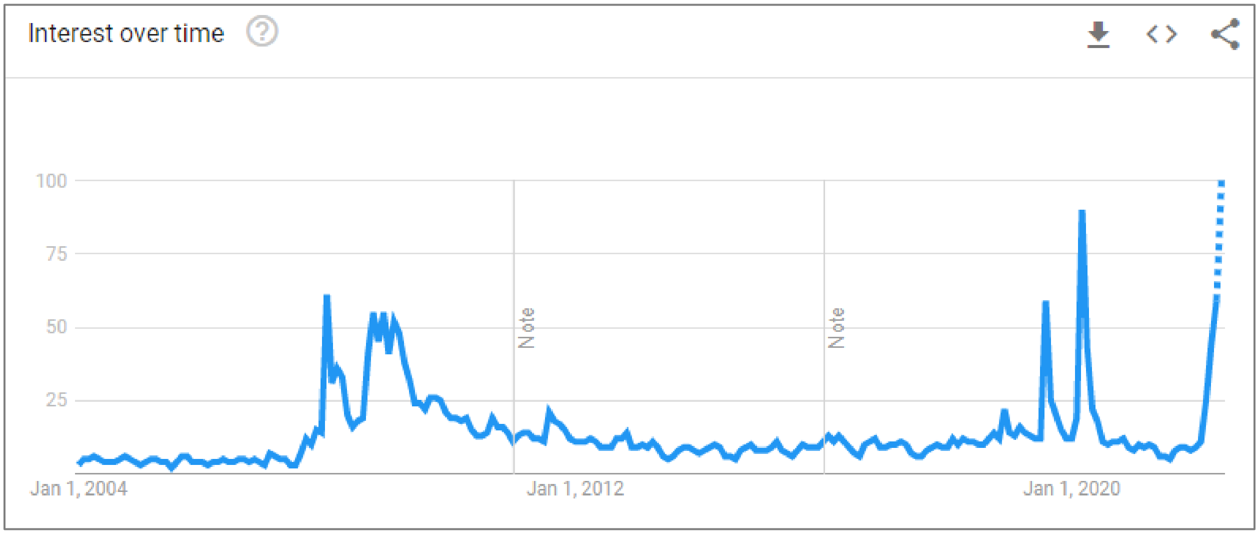
Source: @MichaelKantro

Largest combined drawdown in stock and bond markets since 1980.

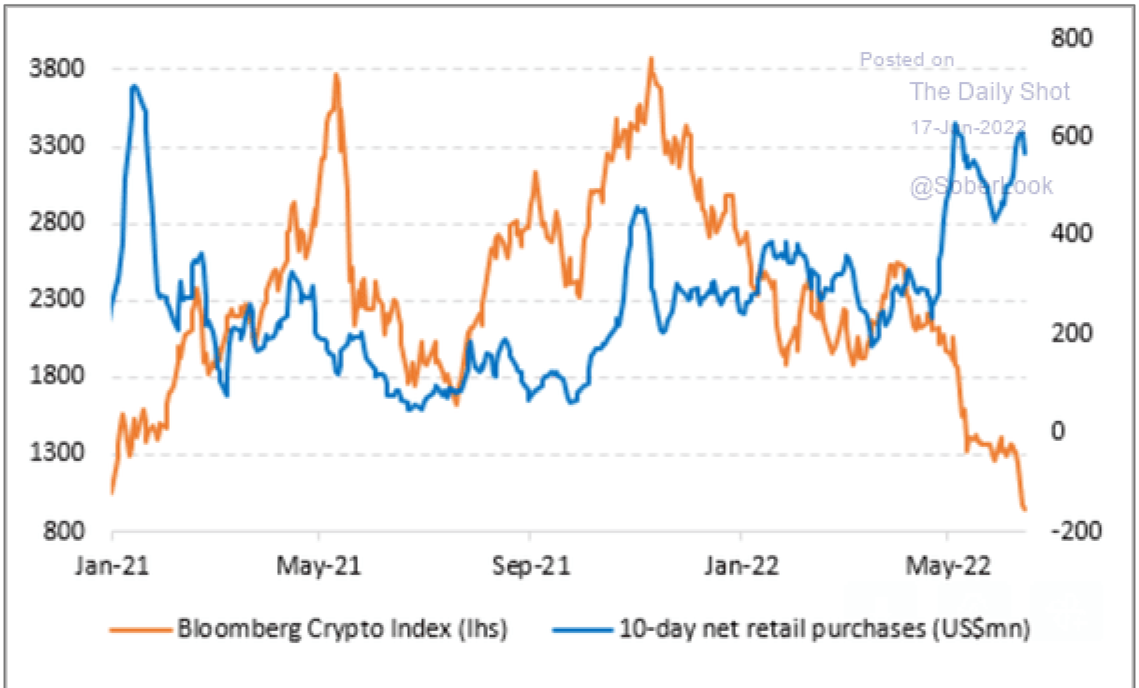


Source: Bespoke Investment Group

Google searches for 'Recession' are setting a record.



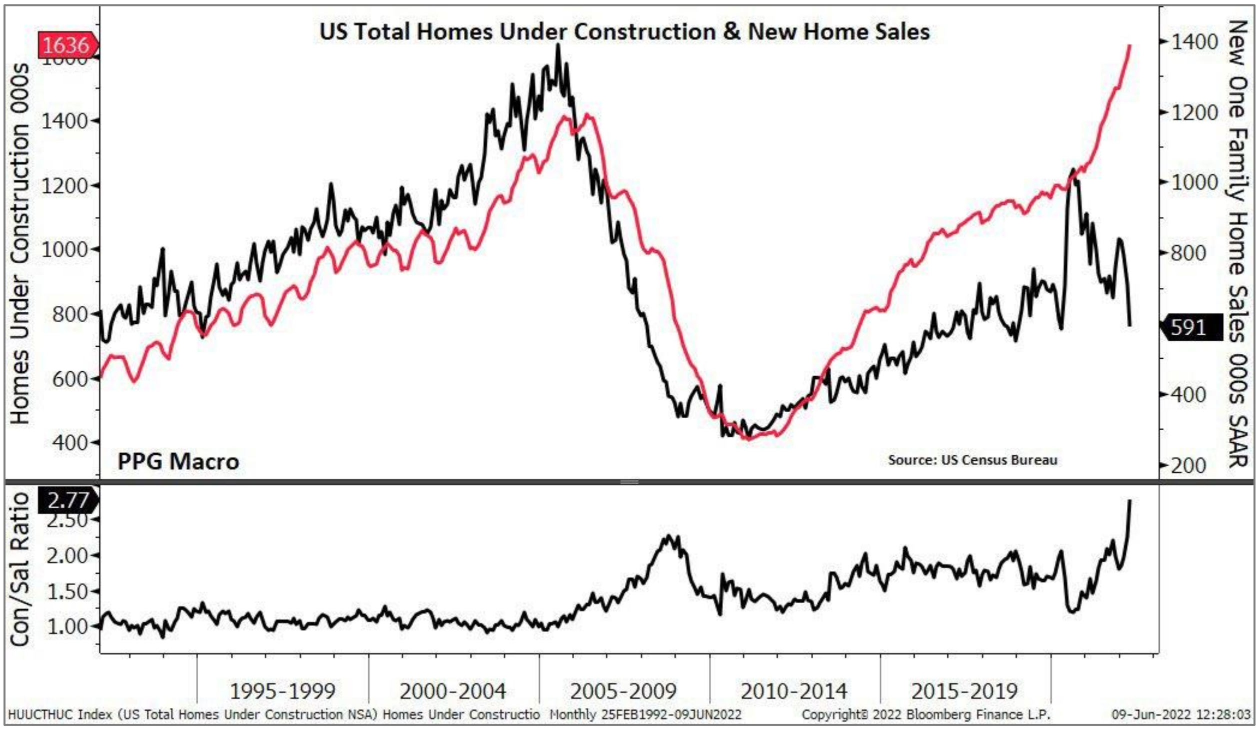
Retail investors are still buying the dip in Crypto.



**Retail purchases of crypto-linked stocks and ETFs*

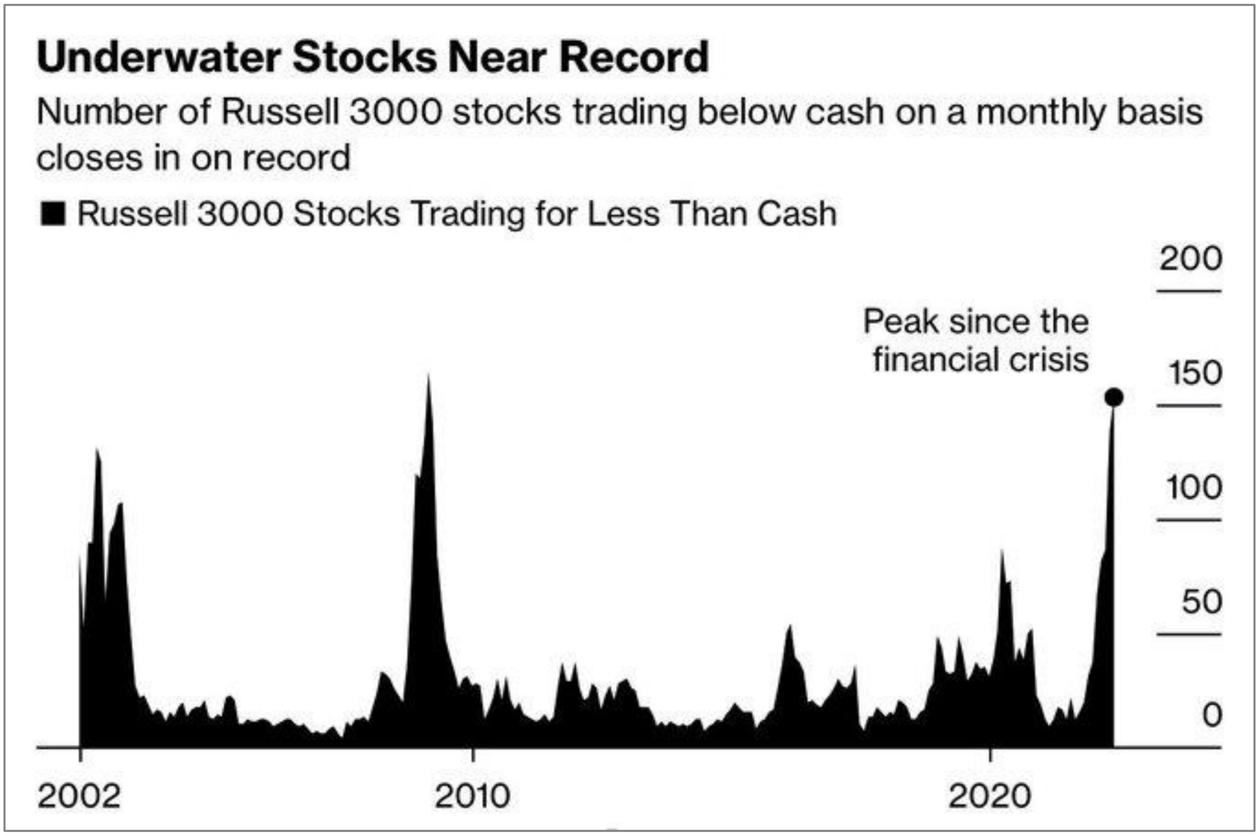
Source: VandaTrack

Record gap has formed between homes under construction and sales.

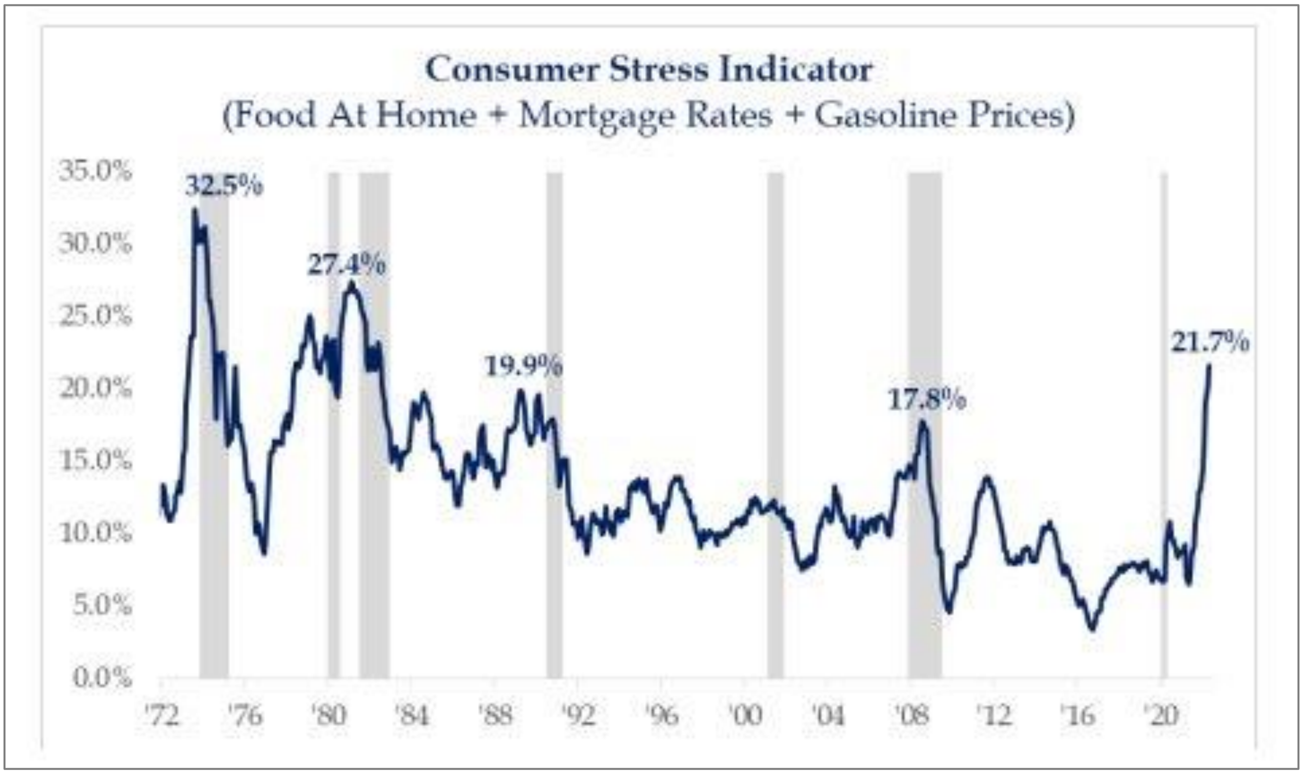


Source: Michael Arouet

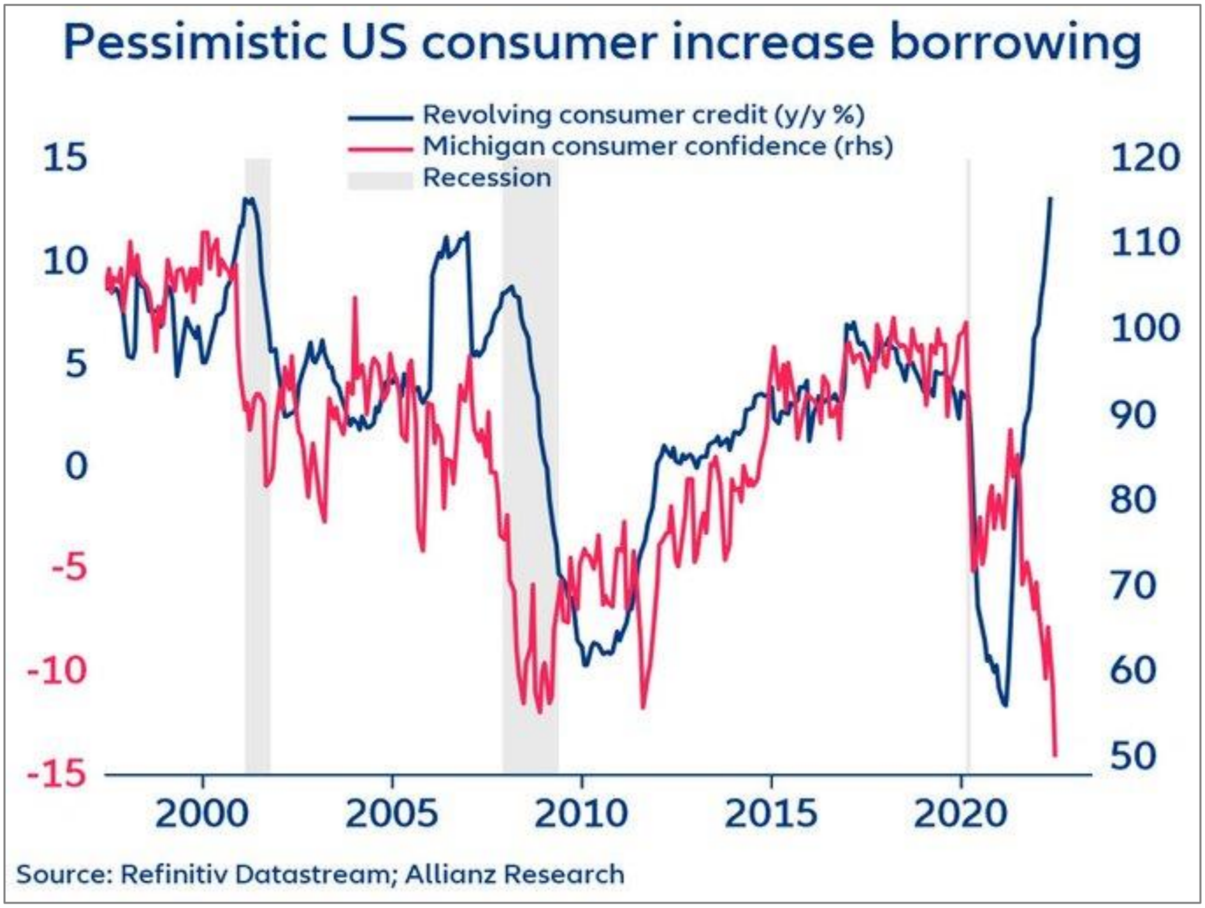
The largest number of stocks are trading below cash value since 2008 decline.



Consumer Stress is the highest since the early 1980s



Inflation has driven consumers to a combination of higher credit and lower confidence.



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.