Market Outlook

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Last week ISM – This week PPI

There are no recommended shifts in equity allocations to report. Market Risk Index jumped sharply to 48.7%, as investor fears have eased enough to push the Psychology composite firmly out of the best 20% of readings. More critical for investor psychology, none of the signs of capitulation we are looking for have occurred. One of those signposts, smart money corporate insiders' activity, has shifted dramatically in favor of selling, right as earnings season is upon us.

The Monetary Composite also deteriorated noticeably, as Producer Price Inflation re-accelerated in June. The six-month annualized growth in Producer Prices for all commodities climbed to 37%, the highest rate of inflation since 1947. The new peak in PPI inflation surprised us, as a declining six-month rate of change on CRB Raw Industrials (a basket of economically sensitive commodity spot prices) implied it would hold. The main reason for the divergence is Energy prices, whose outsized influence on inflation accelerated around the time of the Russian invasion of Ukraine. The Fed would likely be having an easier go of things now otherwise. Like ISM Price Index readings last week, the current rate of change of PPI inflation is not bullish for stocks, with stocks returning -8.8% annualized during periods where PPI inflation is running north of 15%.

While it's not so unusual to see producer price inflation hit double digits, that's not the case for CPI. CPI inflation accelerated to 9% in June, the highest inflation rate since 1981. You can bet that the proximity of inflation to the double-digits is making central bankers sweat, so a surprise tightening or more aggressive on-schedule tightening should be on all of our radars. T-bill yields are also starting to discount it, with the 90-day T-Bill yield climbing to nearly 2.4%, well above the current Fed Funds rate.

Consequently, our favored version of the Yield Curve (10Yr Treasury Yield minus the 3 Month T-Bill Yield) is shallowing out faster than we have seen as it plays catch up with the 10s minus 2s version of the Yield curve, which started ringing recession alarms in the spring.

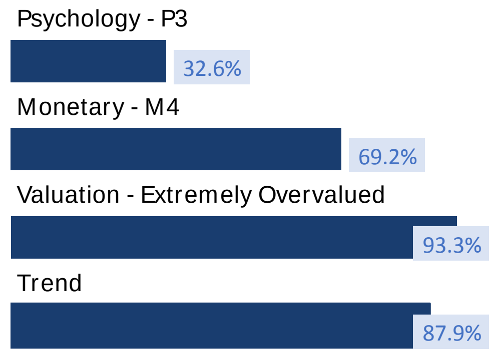
The implication for Monetary conditions is that even if the rate of inflation peaks, the yield curve (the most heavily weighted indicator in the composite) is likely to throw up red flags for the stock market and the economy. This is all a textbook progression of an economic cycle, but the only consistency of this post-Covid cycle is that it continues to surprise in both its record-breaking extremes and how rapidly it ages and unfolds.

Market Risk Index

Rec Allocation 15% Underweight

48.7%

Category Percentiles



Largest Psychology Influences

Surveys	Positive
Corporate Insider Sentiment	Positive
Flow of Funds	Negative
Option Activity	Negative

Largest Monetary Influences

Interest Rates	Negative
Exchange Rates	Positive
Inflation	Negative

Valuation

7-10 Year Rtn Forecast	2.6%
10Yr US Treasury Yield	3.0%

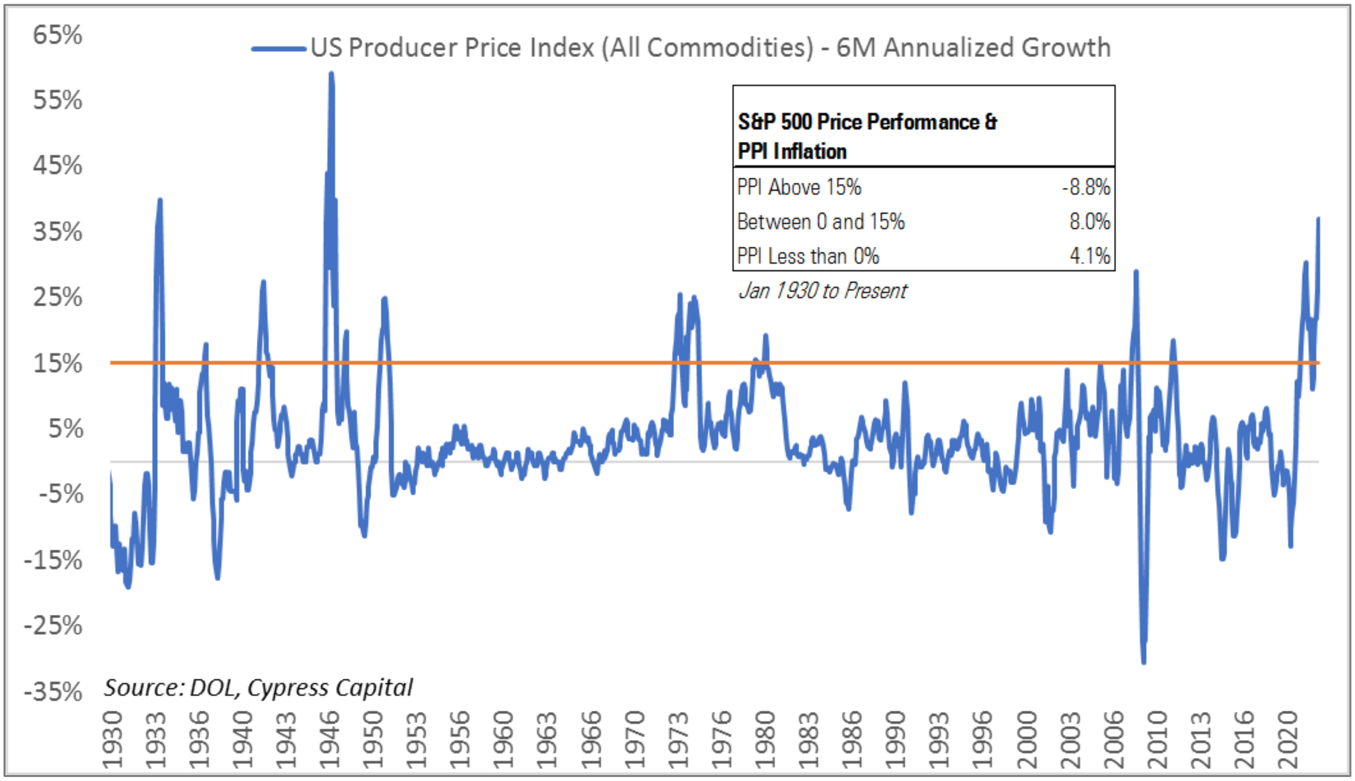
Market Trends

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

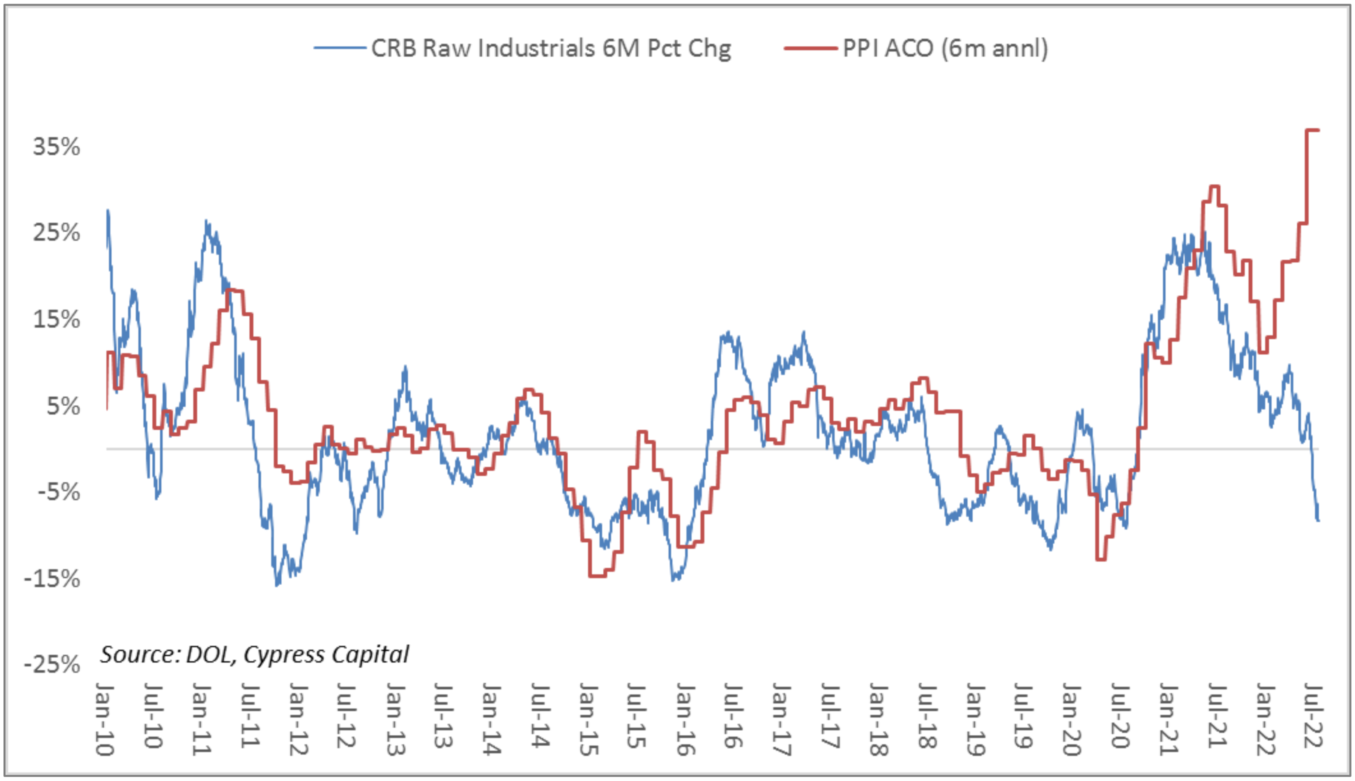
Market Risk Index scales from 0 to 100%. Higher readings correspond with higher risk markets. Scores below 25% are bullish. Scores between 25-75% are neutral, and scores above 75% are markets vulnerable to major drawdowns.

Charts of the Week

Producer Price Index inflation has accelerated to the highest level since 1947.

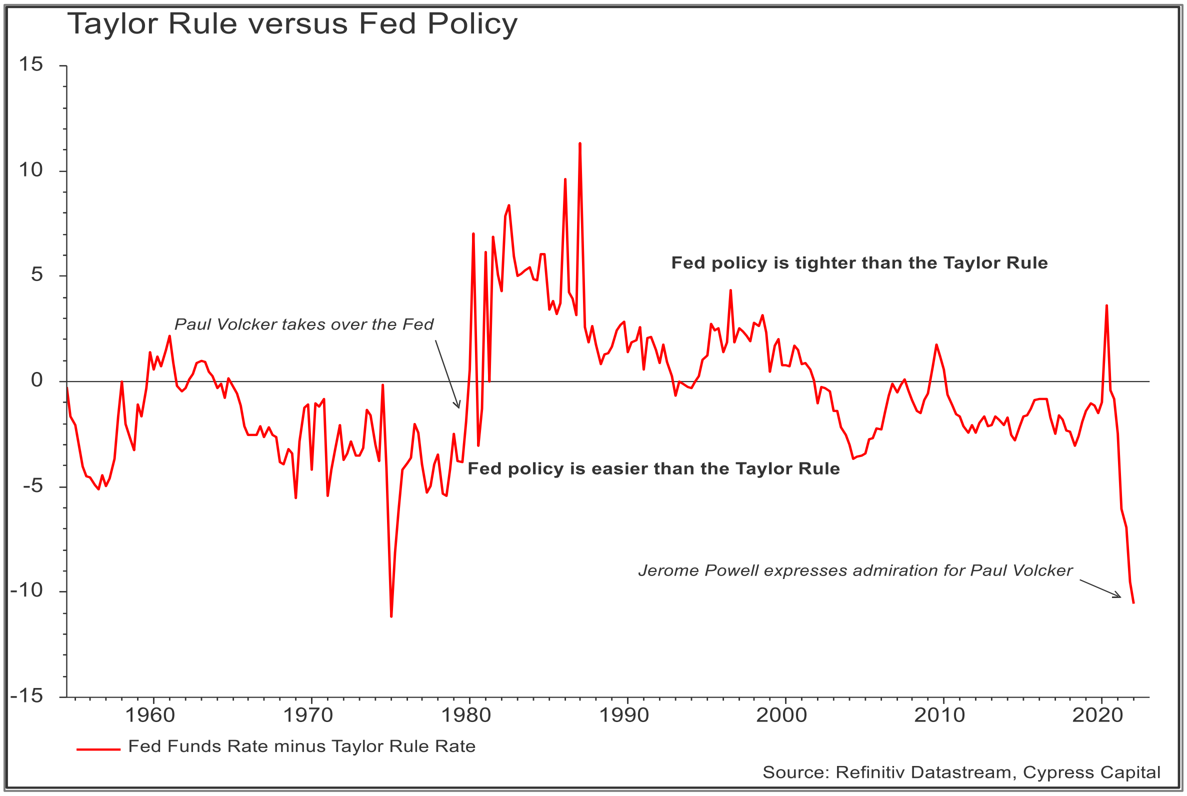


A wide gap has opened up between CRB Raw Industrials and Producer Prices.
The Russian invasion of Ukraine, and the resulting sanctions, have made the Fed's job much more difficult.

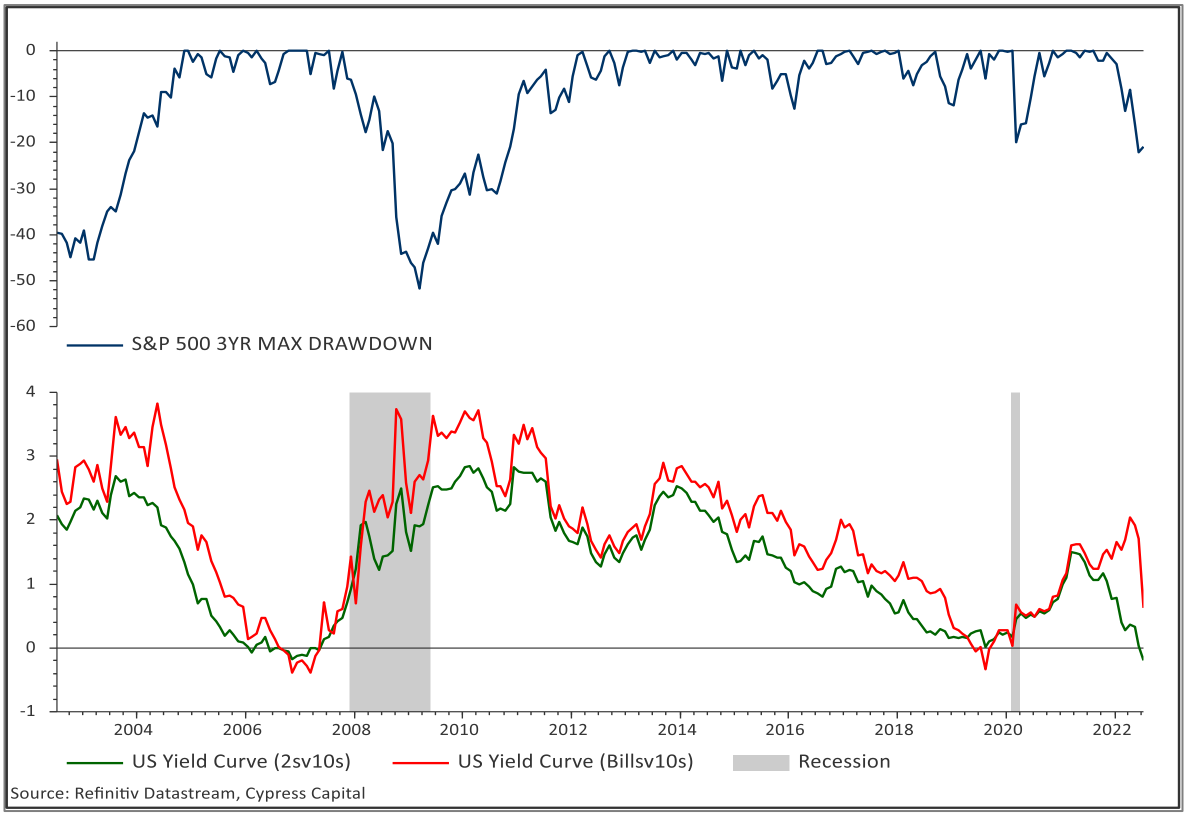


The Taylor Rule versus Fed Policy

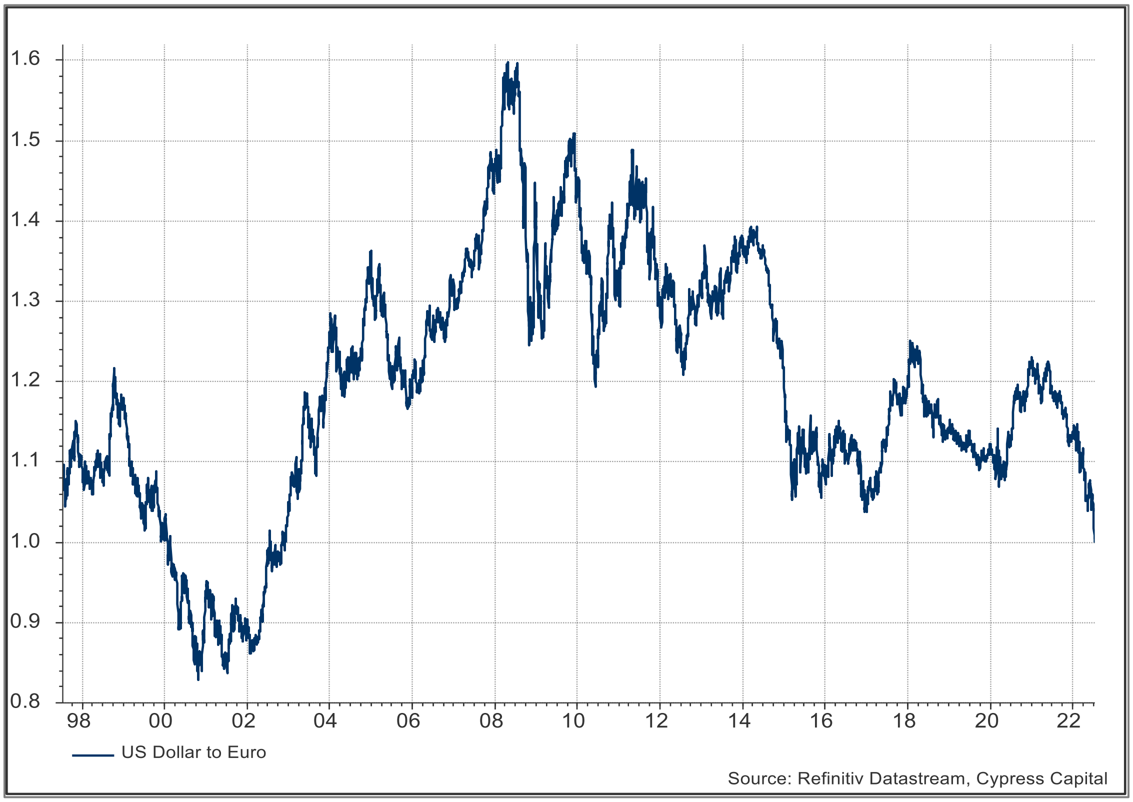
The Taylor Rule (this version) calculates what the Fed Funds rate target should be if the Fed were targeting a rate of inflation of 2%. This Federal Reserve is close to setting a new record for being behind the curve.



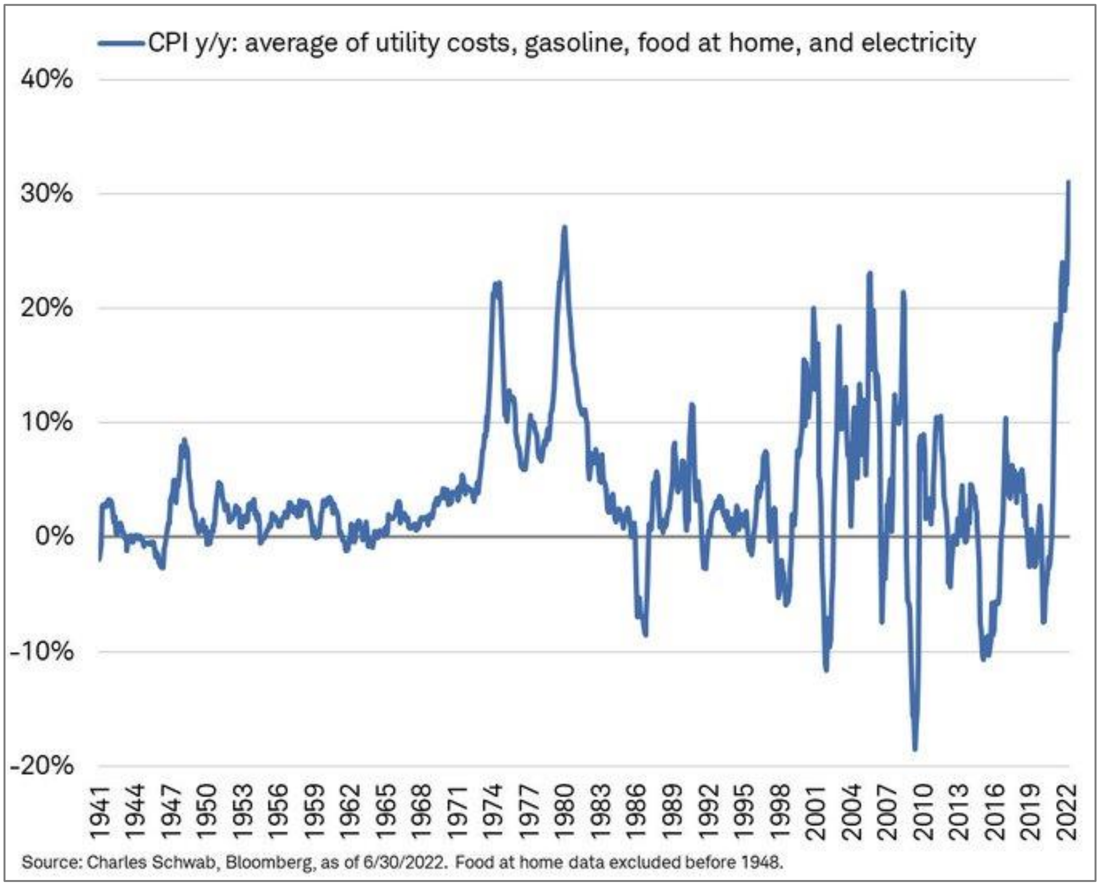
Yield Curves - The 10Yr minus 3M T-Bill version of the curve shallowed sharply this week.



The Euro is set to cross below parity with the US Dollar for the first time since the 2000-03 bear market.

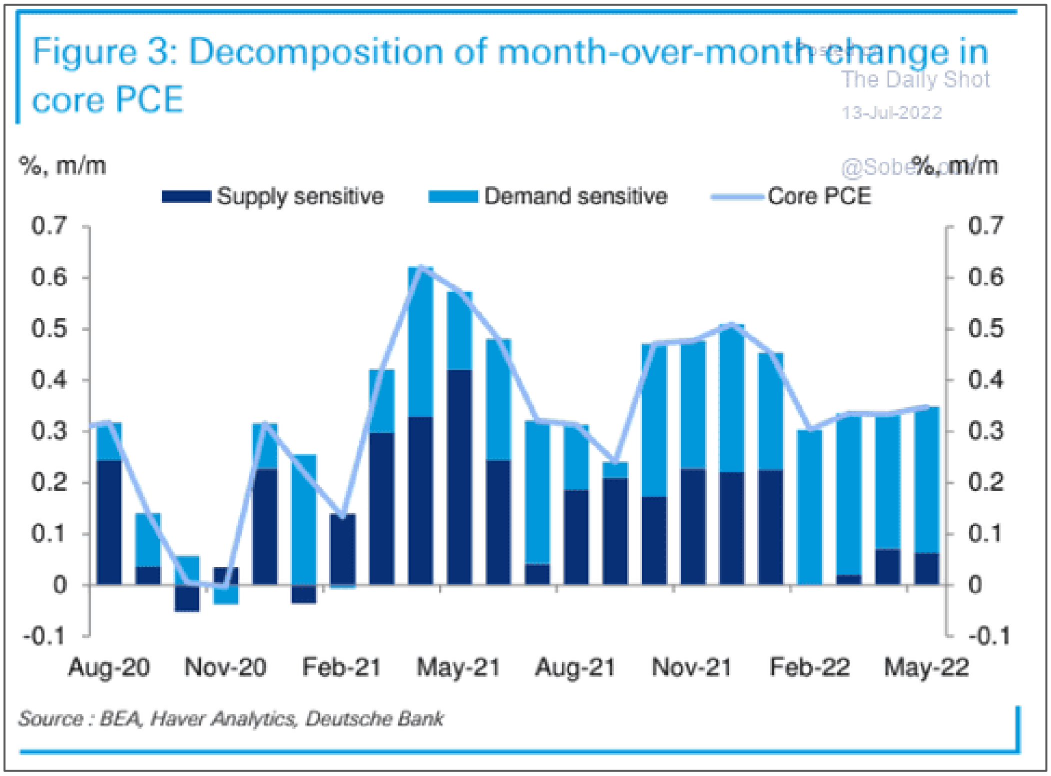


Modern Necessity Inflation hits a record high.

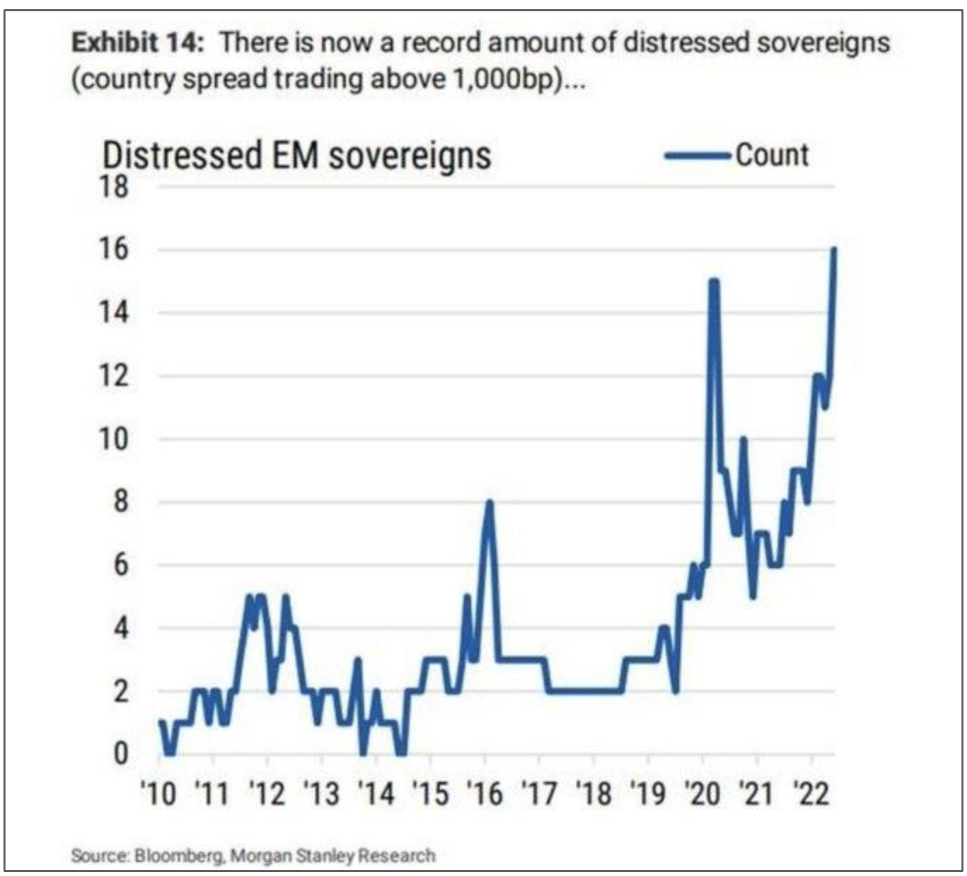


The Supply Chain constraints argument for inflation has evaporated.

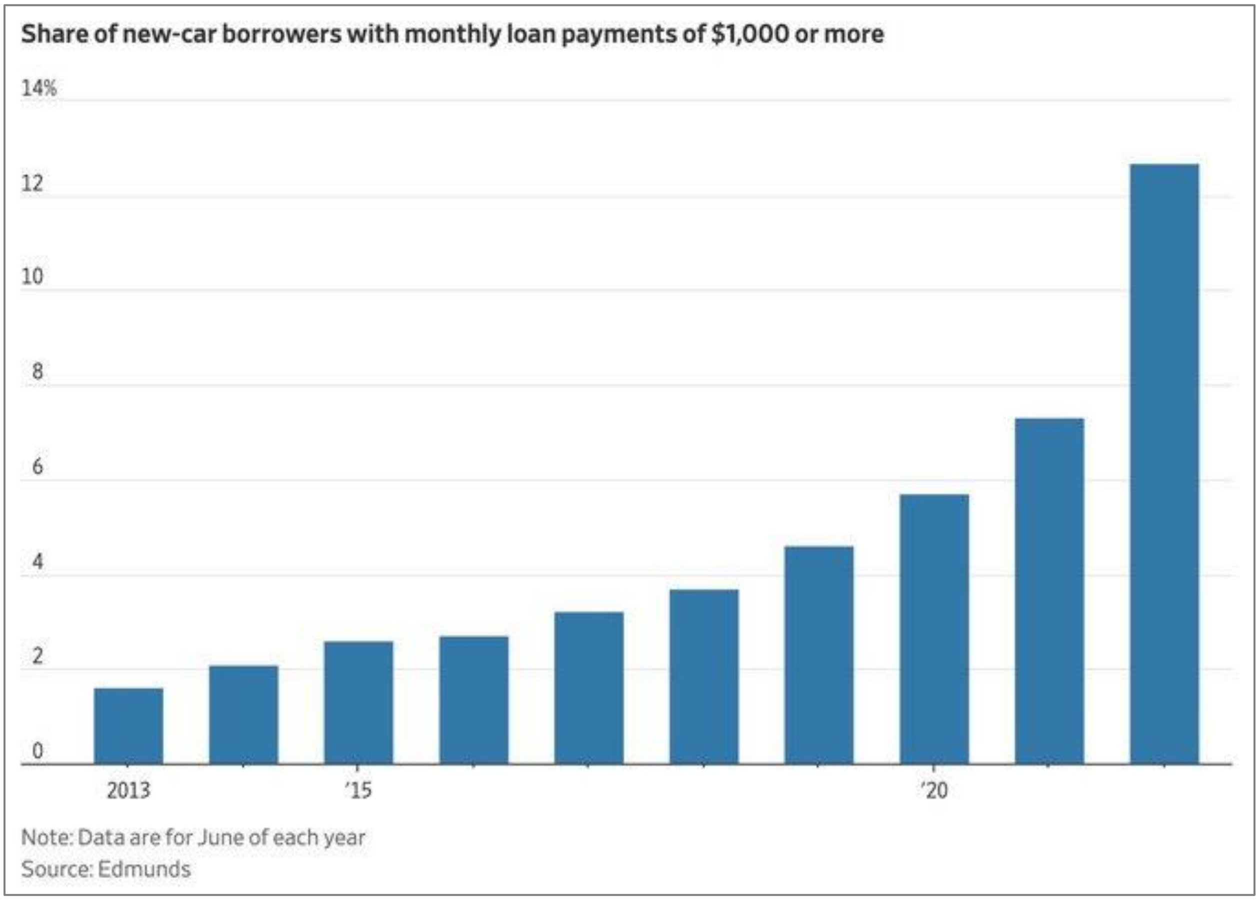
It's clearly a demand (too much money chasing too few goods) problem.



Emerging market debt is becoming extremely distressed.



Share of new-care borrowers with loan payments above $1,000 rockets to a new all-time 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.

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