Cypress CAPITAL

Market Outlook

By Mark T Dodson, CFA

Animal Spirits in August

Animal spirits have re-ignited in August, driving our Psychology composite into the worst 20% of readings, pushing our Market Risk Index above 80%. We have lowered our recommended equity allocation by 5% to 20% underweight.

A big driver behind the rapid deterioration in Psychology has been the move from near-record bearishness in popular investment surveys to readings that are more neutral for markets. The Surveys category was the pillar for the solid readings we saw on the Psychology composite back in June. We have also seen a quick re-emergence of speculation - measured by the Leveraged Investments and Option Activity categories.

Only two of the four measures of market internals that we watch for confirmation that the current bear market is firmly in the rear-view mirror have signaled so. As mentioned last week, those were also the only two with false signals. With any follow-through over the next couple of weeks, there's a good chance the NYSE McClellan Summation index will join the first two and confirm a broad advance that we only see at the start of new bull markets.

That would leave the NYSE High Low Logic Index as the final holdout, an indicator that has not failed to give a buy signal marking the start of every new bull market going back more than 60 years, as far as our data exists. Notably, it has been moving in the wrong direction in recent weeks. The first three indicators are based on daily advance-decline statistics, while the High Low Logic calculation uses the number of new highs and lows recorded on the New York Stock Exchange.

We highlight this because it's a dilemma we have grown used to in the era of quantitative easing, advance-decline statistics giving signals of strength, while indicators based on new highs and lows don't confirm it. It has benefited us to lean heavier on the new highs and new low data. A case in point is the current bear market – the High Low Logic Index gave an advanced bear market warning at the end of 2021 – whereas technicians who relied heavily on advance-decline statistics were publishing bullish breadth readings at the start of 2022, right as the bull market was peaking.

Also worth repeating is that should a new bull market be confirmed, overall market conditions, as indicated by our Market Risk Index, imply that it will be an abbreviated one whose duration gets measured in months, not years. This is the most unusual

Market Risk Index

Rec Allocation 20% Underweight

83.8%

Category Percentiles

Psychology - P5: 84.9%

Monetary - M4: 71.9%

Valuation - Extremely Overvalued: 95.4%

Trend: 49.6%

Largest Psychology Influences

Volatility	Negative
Leveraged Investments	Negative
Flow of Funds	Negative
Technical Indicators	Positive

Largest Monetary Influences

Interest Rates	Negative
Exchange Rates	Positive
Inflation	Negative

Valuation

7-10 Year Equity Return Forecast	1.8%
10Yr US Treasury Yield	2.8%

Market Trends

US Equities	Bullish Investment
Intl Equities	Bearish Trade
REITs	Neutral 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.

cyclical backdrop for a new bull market to develop in the history of US financial markets – a tight labor market, high inflation, an inverted/shallow yield curve, and valuations that have only re-traced their way back to previous bull market peaks.

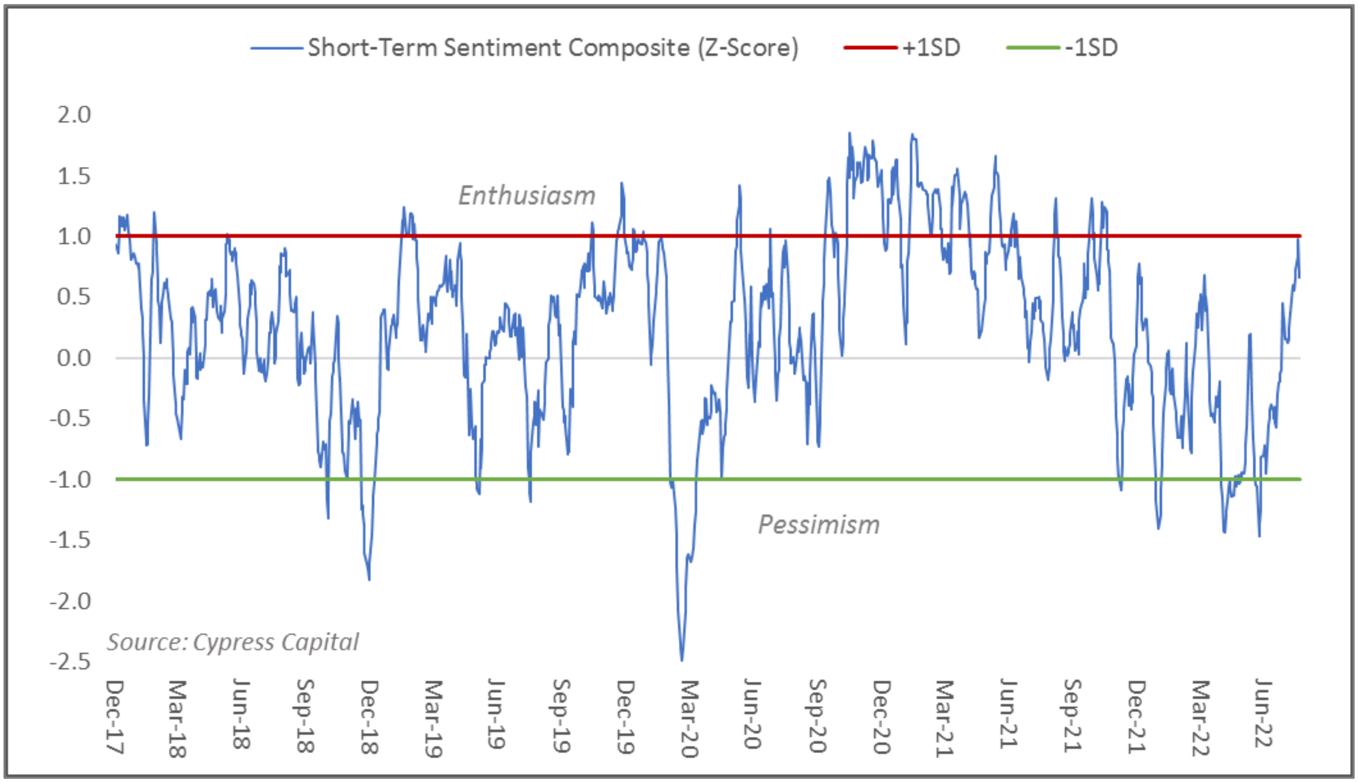
It's such an unusual mix of conditions for a new bull market to develop that we looked for analogs. We searched for every environment where the following metrics were all in their most unfavorable quintile of readings as they are today: the yield curve, unemployment rate, valuations, and inflation. Only one other period emerged before this one. It was in the year 2000, in a similar period of the emotional cycle nonetheless – after the bubble had peaked, but animal spirits had yet to be crushed.

Quick note – we were excited to learn this week that three of our investment portfolios have recently earned 5-star ratings from Morningstar. If you regularly read these weekly messages, you know we are exceedingly patient investors who only swing at fat pitches. If that sounds like a fit with your personality, please reach out to us. We would sincerely appreciate the opportunity to work with you.

Charts of the Week

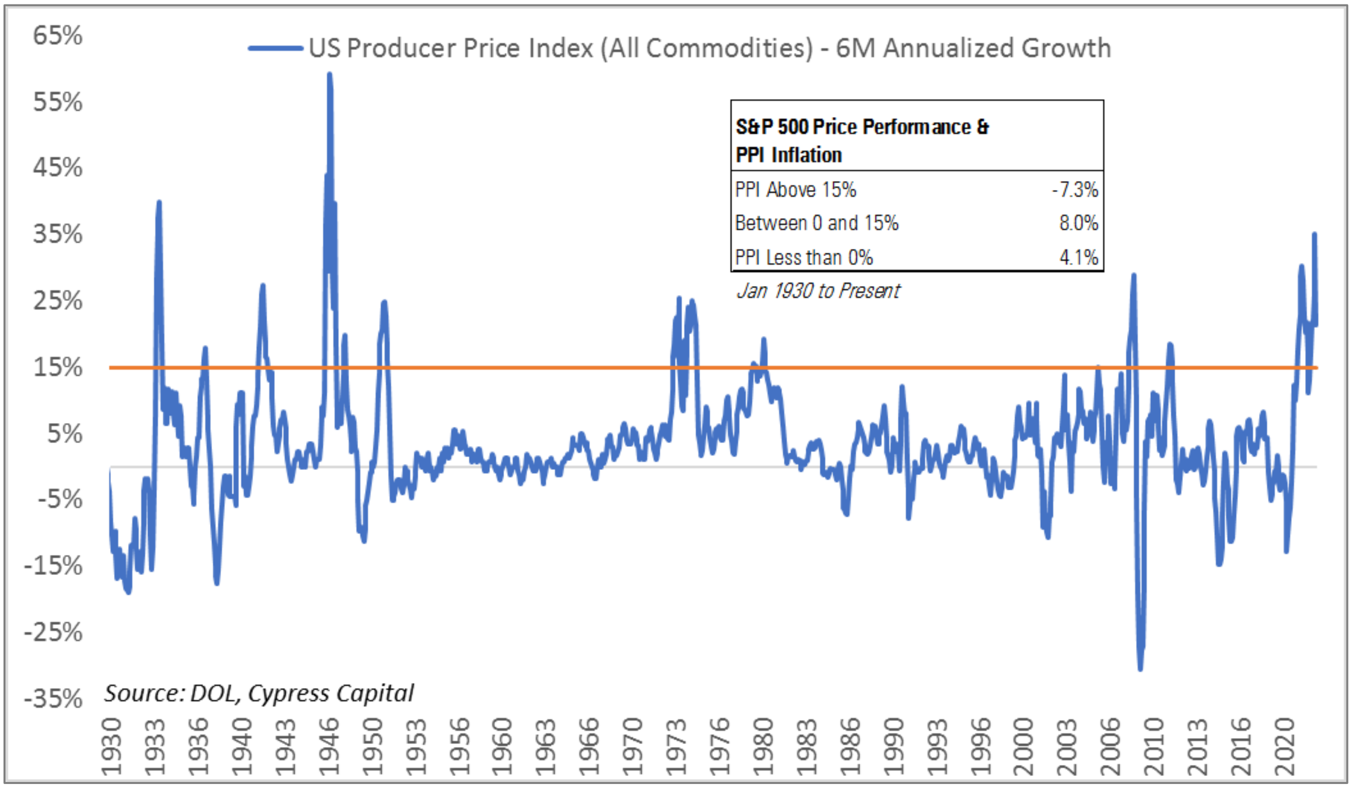
Short-Term Sentiment Composite

Short-Term sentiment briefly hit the Enthusiasm zone early in the week before the market retreat reigned it in some.

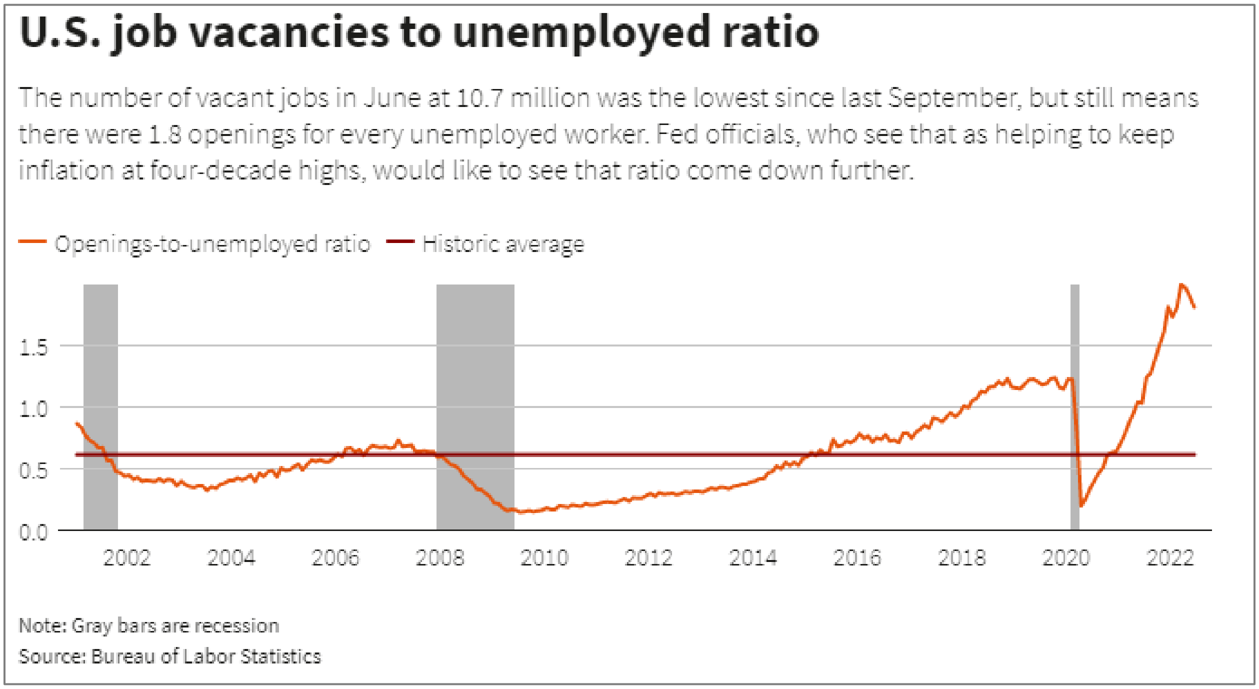


Producer Price Inflation

ISM Price Index has reached a distinct peak, as has the CRB Raw Industrials index. Producer prices appear to be doing the same, but rates of inflation this high aren't associated with new bull markets or stock markets that see higher prices.

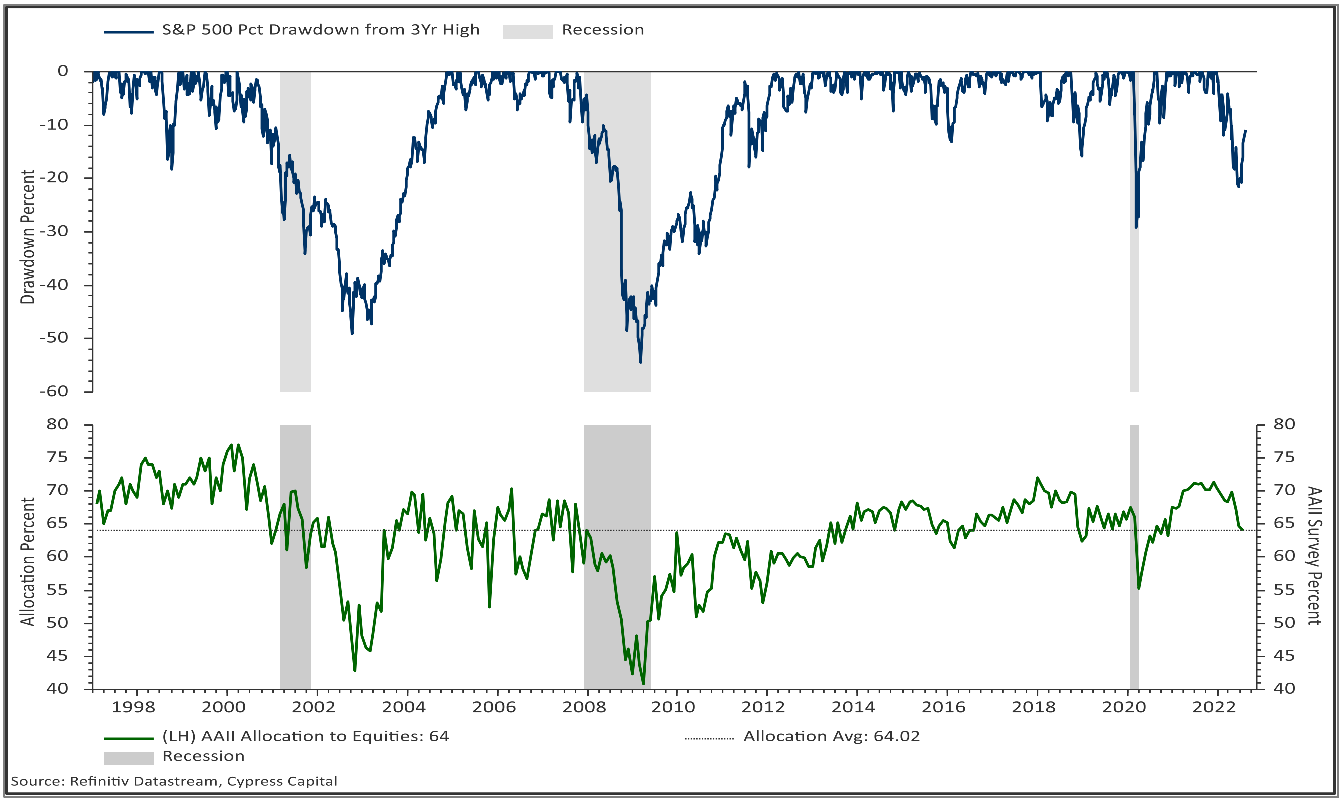


This labor market is still record-tight.



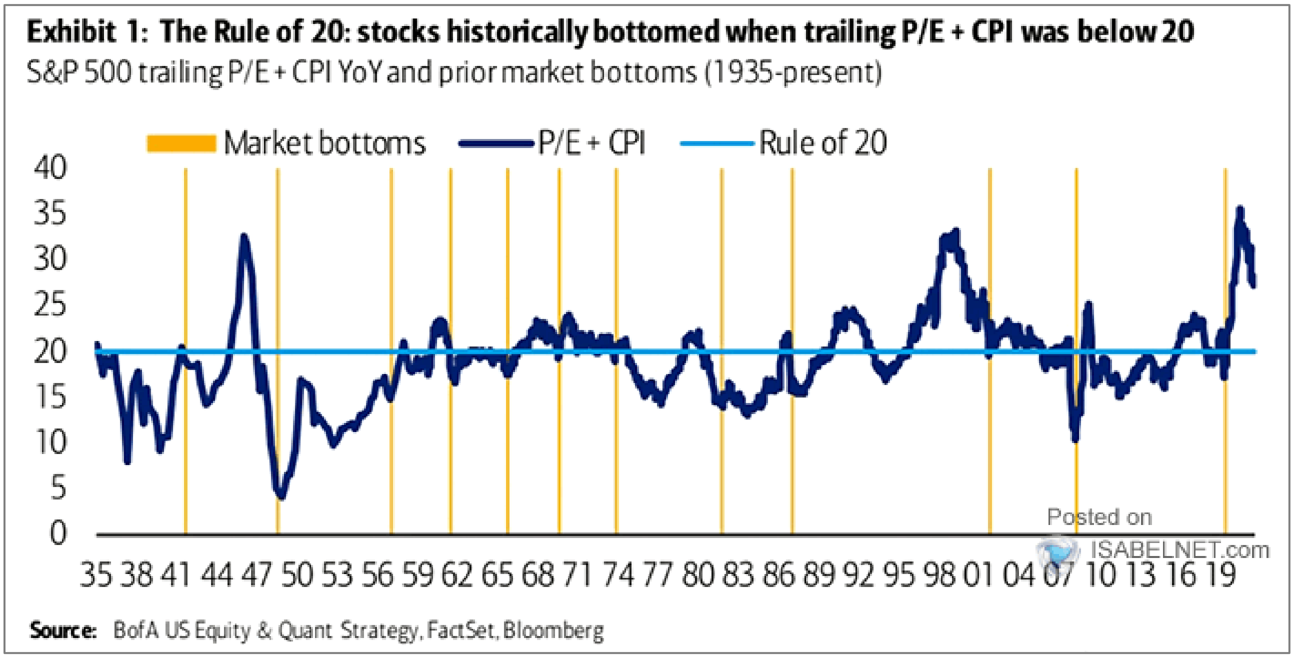
AAII Allocation Survey – what investors are saying versus what they are doing...

AAII weekly survey readings were as extreme in July as they were in the worst of the 2008-09 bear market, which seems excessive given what most of us have felt and witnessed during the 2022 bear market. From personal experience, the March 2009 and March 2020 bottoms felt much worse. The AAII Allocation Survey paints a more realistic picture of individual investor sentiment - among older, more conservative investors – in our opinion. Individual investor equity allocations have fallen from their November 2021 peak to slightly above average.

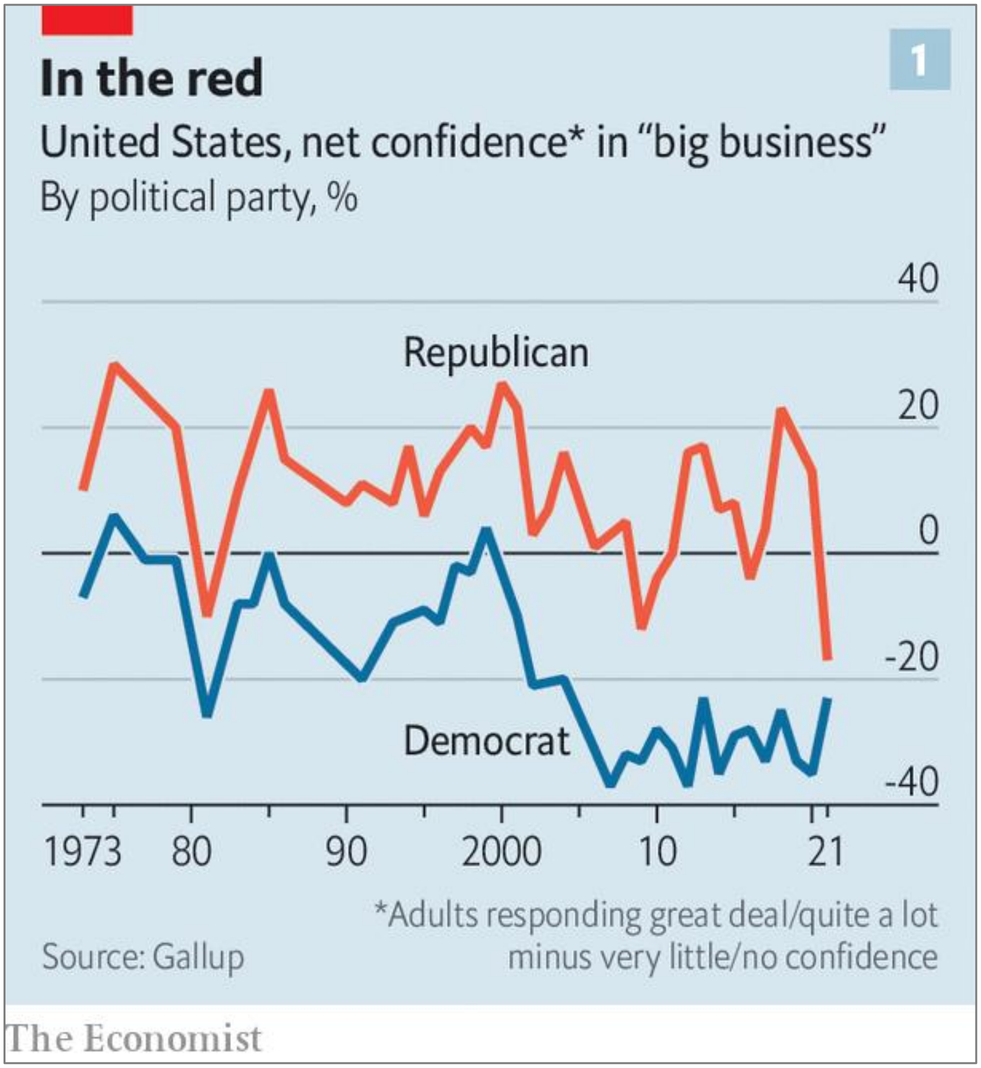


Rule of 20 Valuation and Bear Market Bottoms

If the bear market has already bottomed, it will violate the Rule of 20 for the first time in history.



Democrats and Republicans seem to agree on one thing right now – they both don’t like “big business.”



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.