Market Outlook

By Mark T Dodson, CFA

Market Risk Index climbs to the highest level since February

Market Risk Index climbed another 5.1% to 88.9%, not far from the 91%+ reading near the bull market peak in January. Both the Monetary and Psychology composites deteriorated, but Psychology fared worse this week, with the risk score climbing back into the worst 10% of readings. It has been a rapid shift of the pendulum toward greed for stock market investors – a shift that has likely run its course with the market falling into a Jackson Hole on Friday.

For those still feeling some FOMO that a new bull market was underway, the NYSE McClellan Summation Index rolled over during the week. It failed to provide the third of our required four pieces of technical evidence suggesting a new bull market was in the offing.

Consequently, US Market Trend, the fourth and less discussed factor that comprises our Market Risk Index, is incredibly close to a shift from a Bullish to a Bearish Trend over the next few weeks. This shift would imply that the next leg down of the bear market is upon us.

It's worth a reminder here that there has never been an example in the US economy with inflation this high and unemployment this low avoiding a recession within a couple of years, especially in the wake of rapidly tightening monetary policy. The Conference Board's Leading Economic Indicators have already started the clock for a pending recession – the six-month decline in LEI has fallen to a threshold that has always preceded a recession. Once recession becomes evident to the masses, we will see a coincident increase in risk aversion amongst individual investors – the kind that shows up in allocations, not surveys. Bear markets that coincide with recessions are markedly worse, although that is the kind of information that only becomes evident in hindsight.

A tell-tale sign that recession is not yet on the minds of investors and consumers comes straight from our Monetary composite. The rates of change in Monetary Aggregates like M2 and MZM (which we calculate internally since the Fed has discontinued it) still indicate an increasing velocity of money, meaning inflation is still the main problem. There hasn't been even the first sign of an increase in money demand (falling velocity) that accompanies recession and a deflationary impulse.

Market Risk Index

Rec Allocation 20% Underweight

88.9%

Category Percentiles

Psychology - P6	92.8%
Monetary - M4	73.3%
Valuation - Extremely Overvalued	94.8%
Trend	76.8%

Largest Psychology Influences

Volatility	Negative
Leveraged Investments	Negative
Option Activity	Negative
Flow of Funds	Negative

Largest Monetary Influences

Interest Rates	Negative
Exchange Rates	Positive
Inflation	Negative

Valuation

7-10 Year Equity Return Forecast	2.1%
10Yr US Treasury Yield	3.1%

Market Trends

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

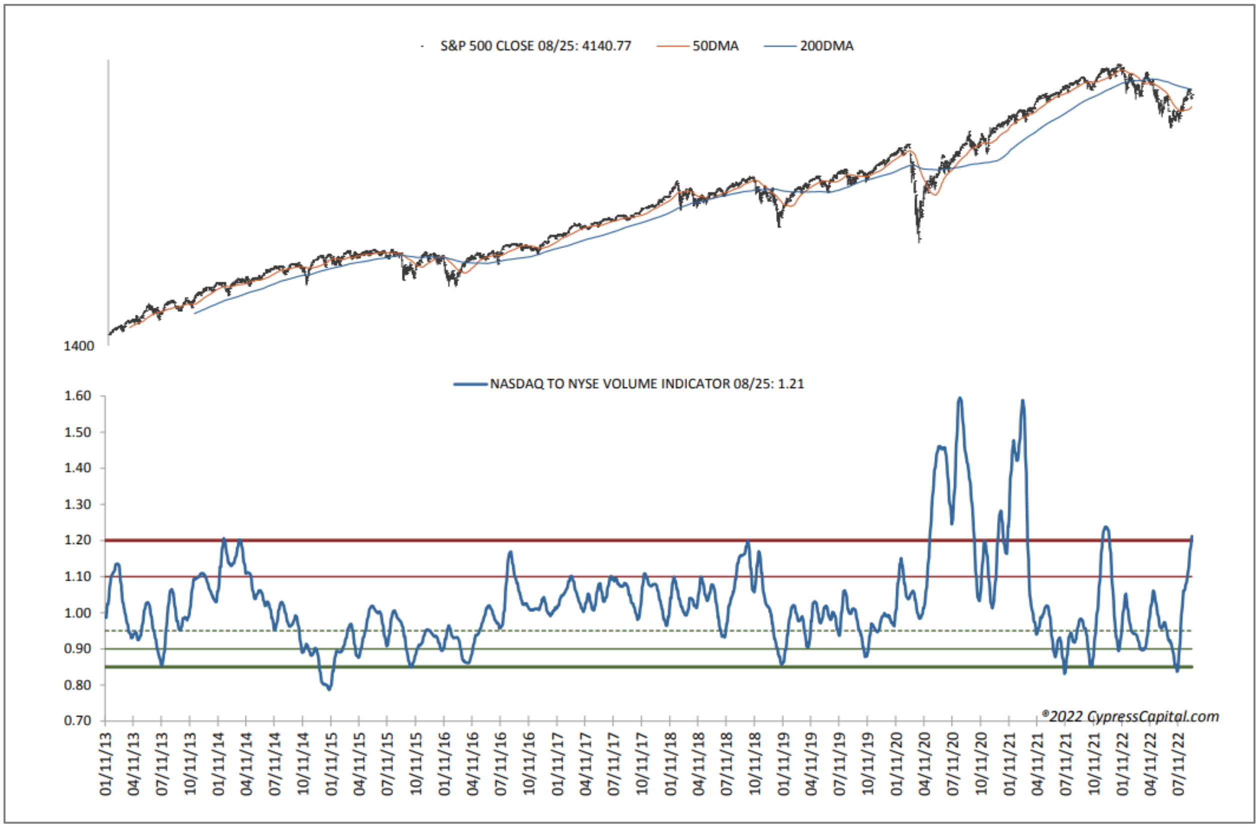
Market Risk Index scales from 0 to 100%. Higher readings correspond with higher risk markets. Scores below 25% are bullish. Scores between 25-75% are neutral, and scores above 75% are markets vulnerable to major drawdowns.

Investors should buckle up and be mentally prepared to navigate a bear market that goes well into 2023. We will be patient and avoid significant allocation shifts without the weight of the evidence moving considerably in our favor – this goes for both decisions to buy and sell within the bear market. For those of us who have come into this bear positioned defensively, in addition to peace of mind from limiting our drawdown, it also means that we will likely be afforded an opportunity over the coming year to put large swaths of cash to work at bargain prices.

We look forward to a time to pound the table as raging bulls in a market with a clear margin of safety.

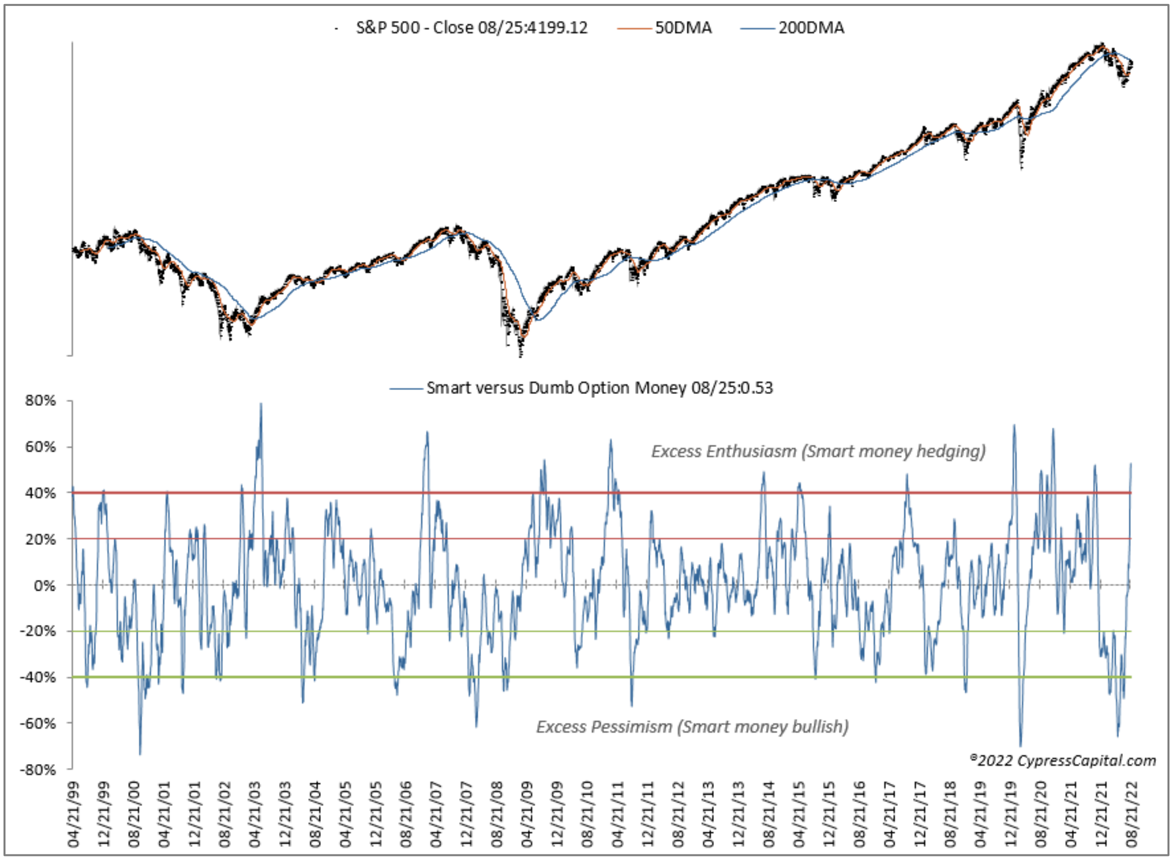
Charts of the Week

NASDAQ to NYSE Volume Indicator – rapid shift from fear to greed over a matter of weeks.

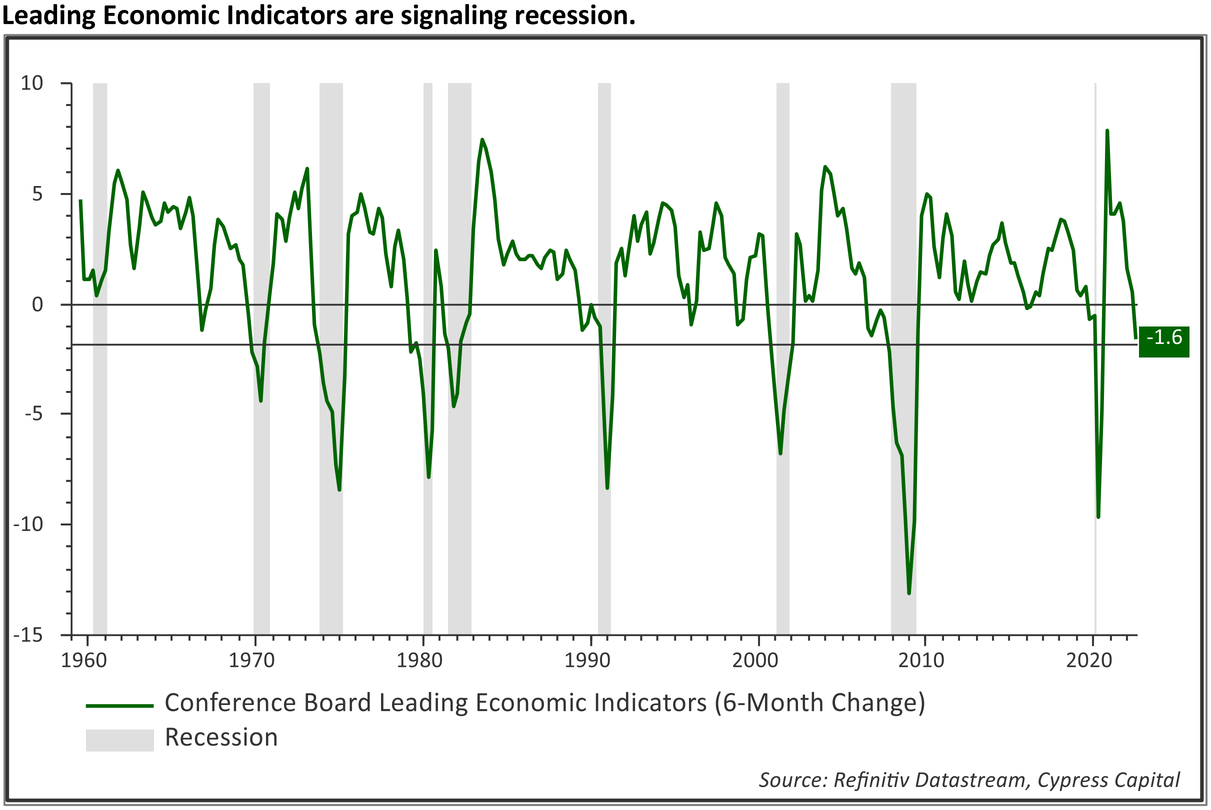


Smart versus Dumb Option Money

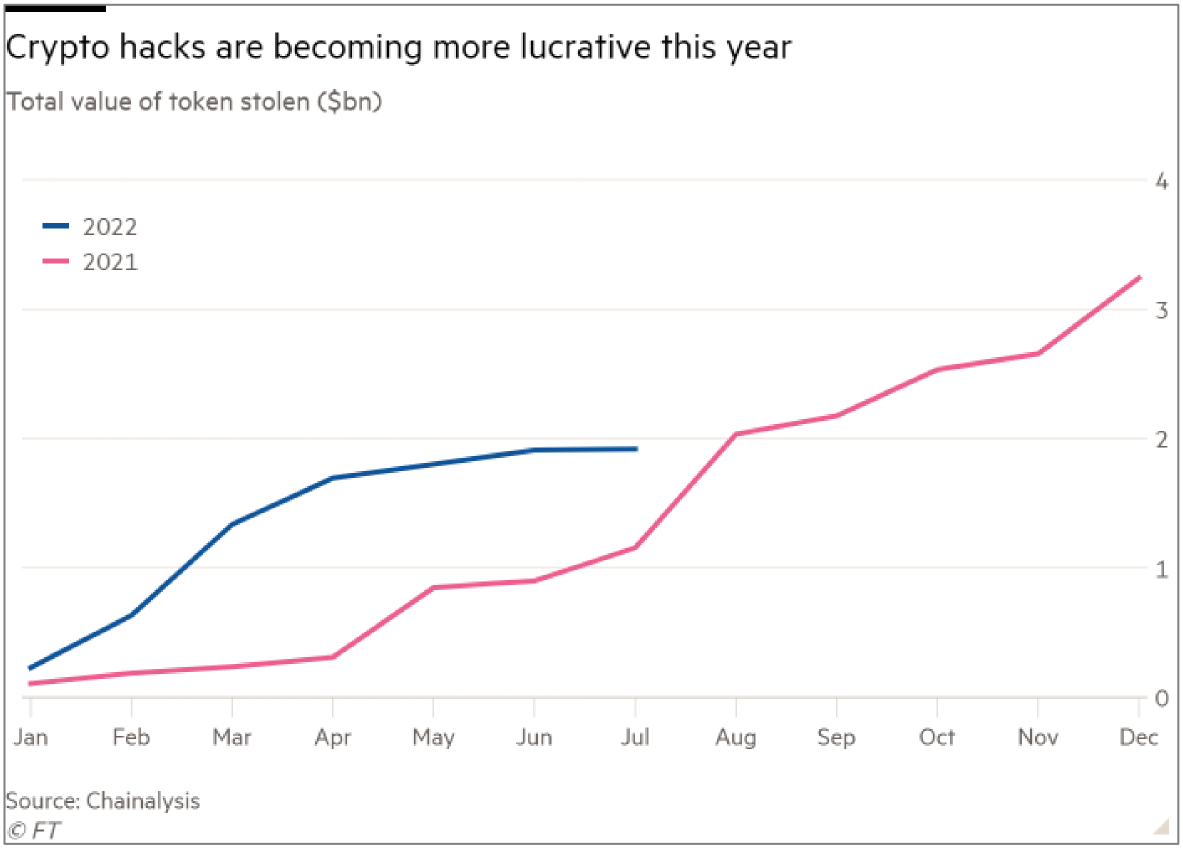
Similar to NASDAQ to NYSE Volume, the sentiment shift in smart versus dumb money in options markets has been swift.



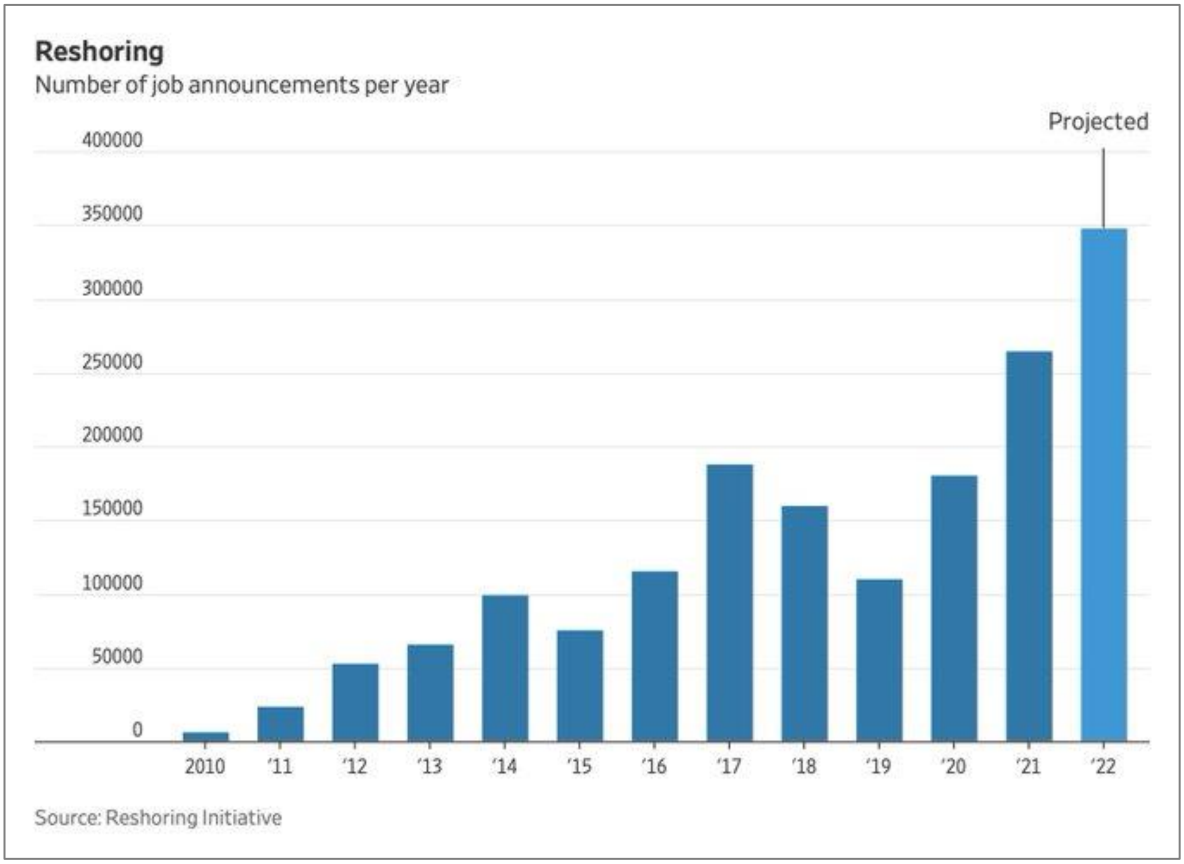
Leading Economic Indicators are signaling recession.



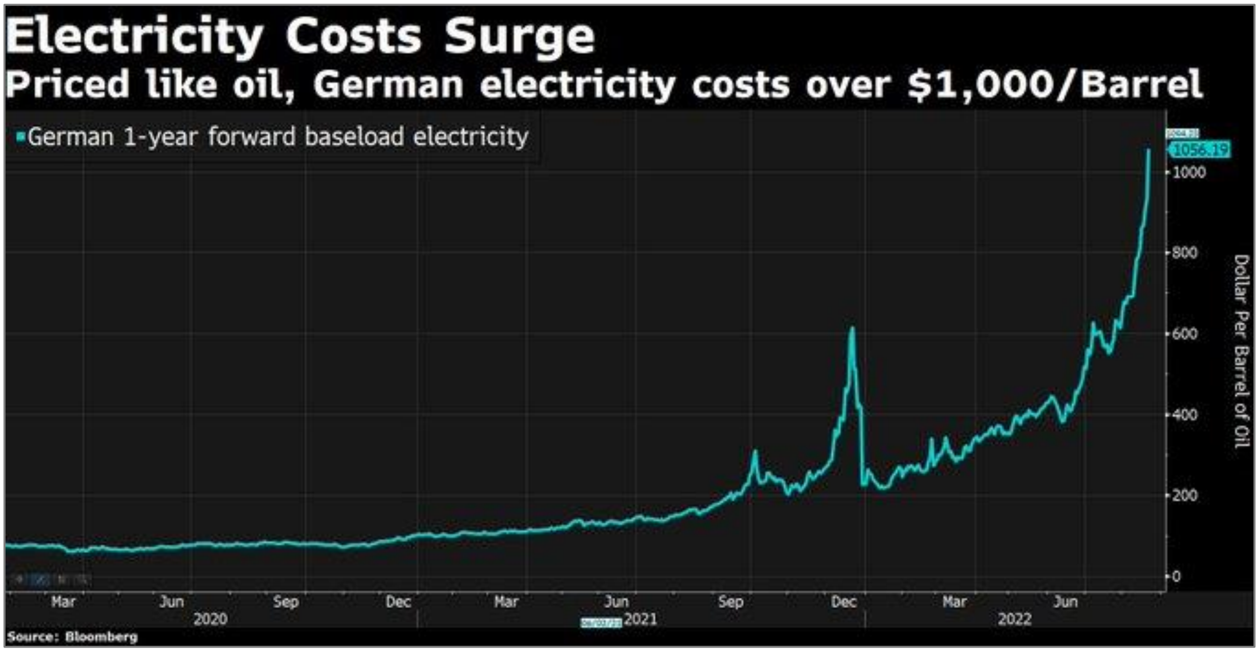
Crypto hacks appear to be accelerating in the crypto bear market.



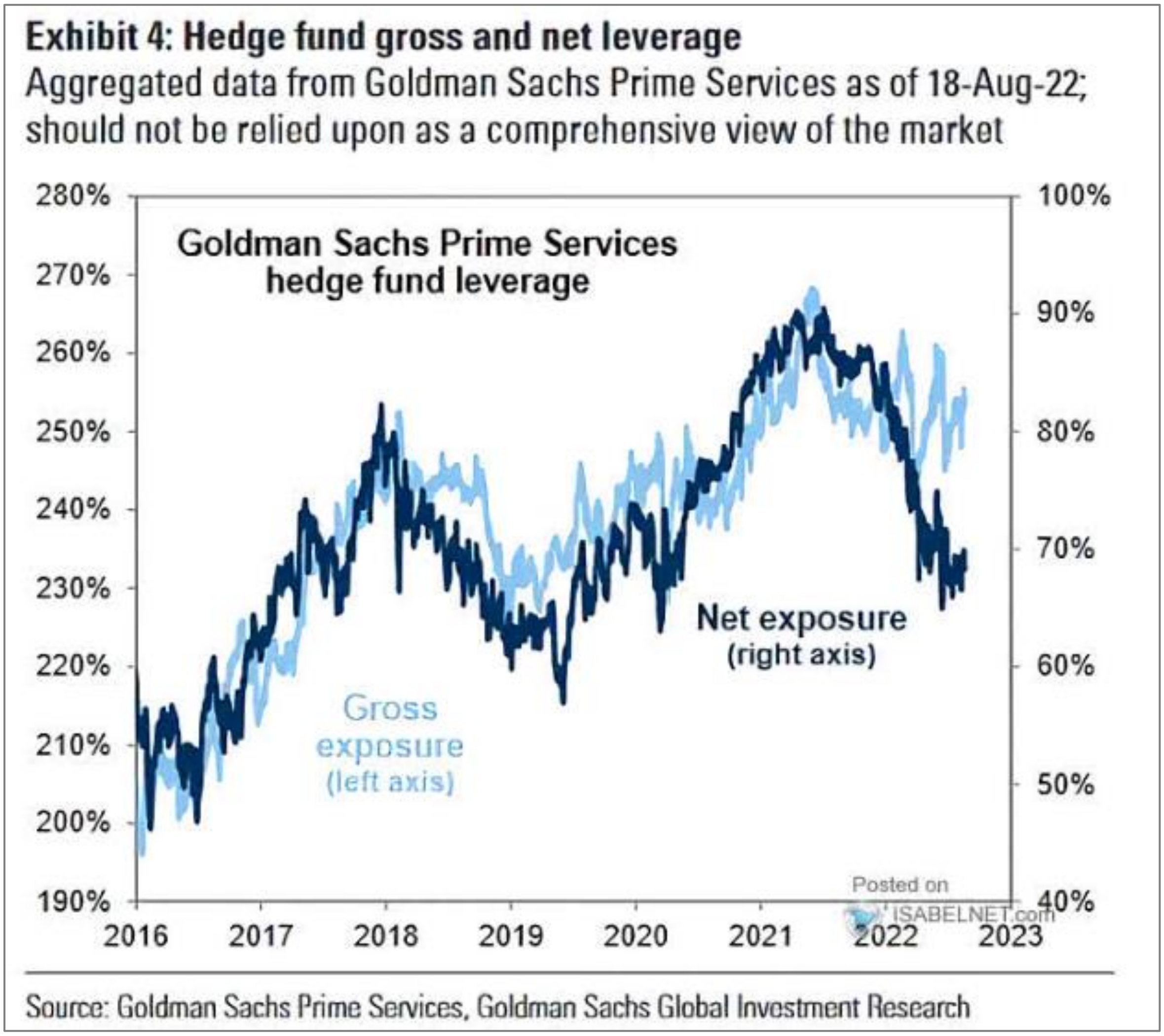
A surge in reshoring. That's good for jobs, but it's also an inflationary headline.



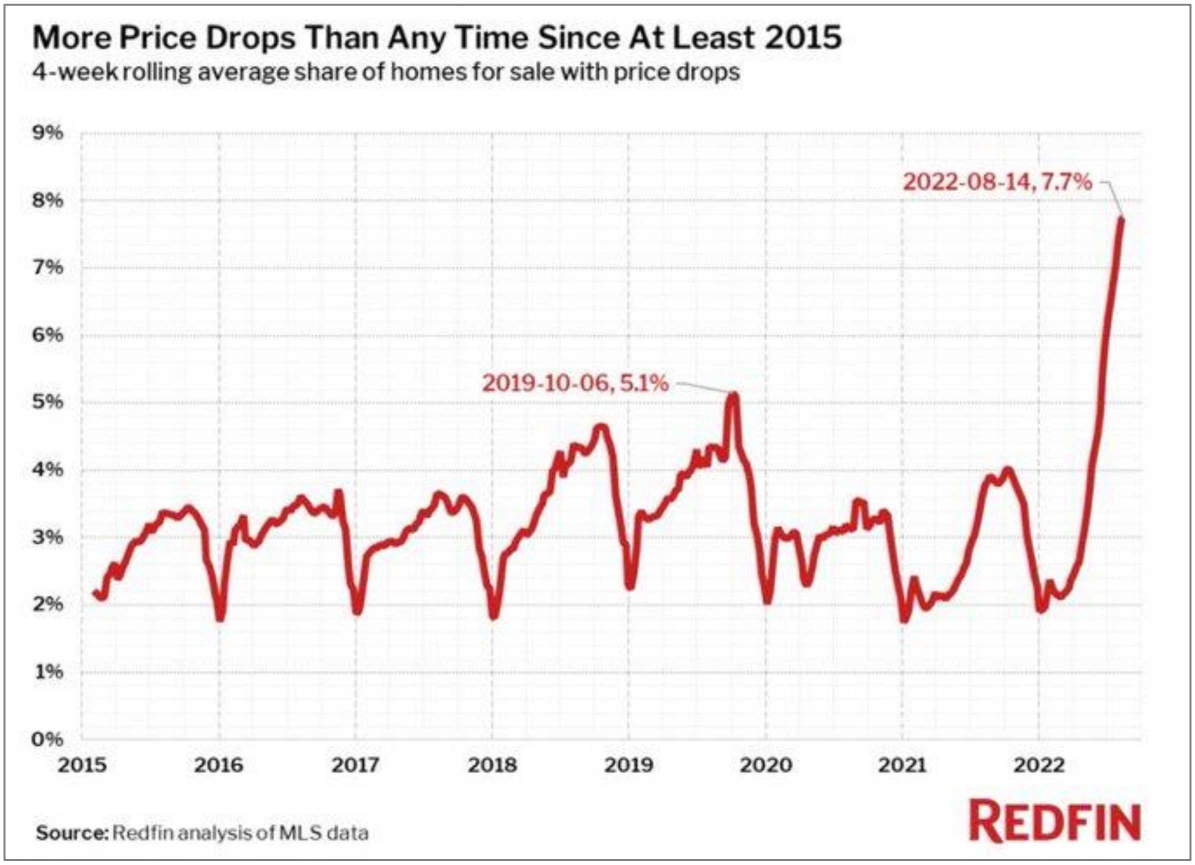
German electricity costs exceed $1000/Barrel when priced like oil.



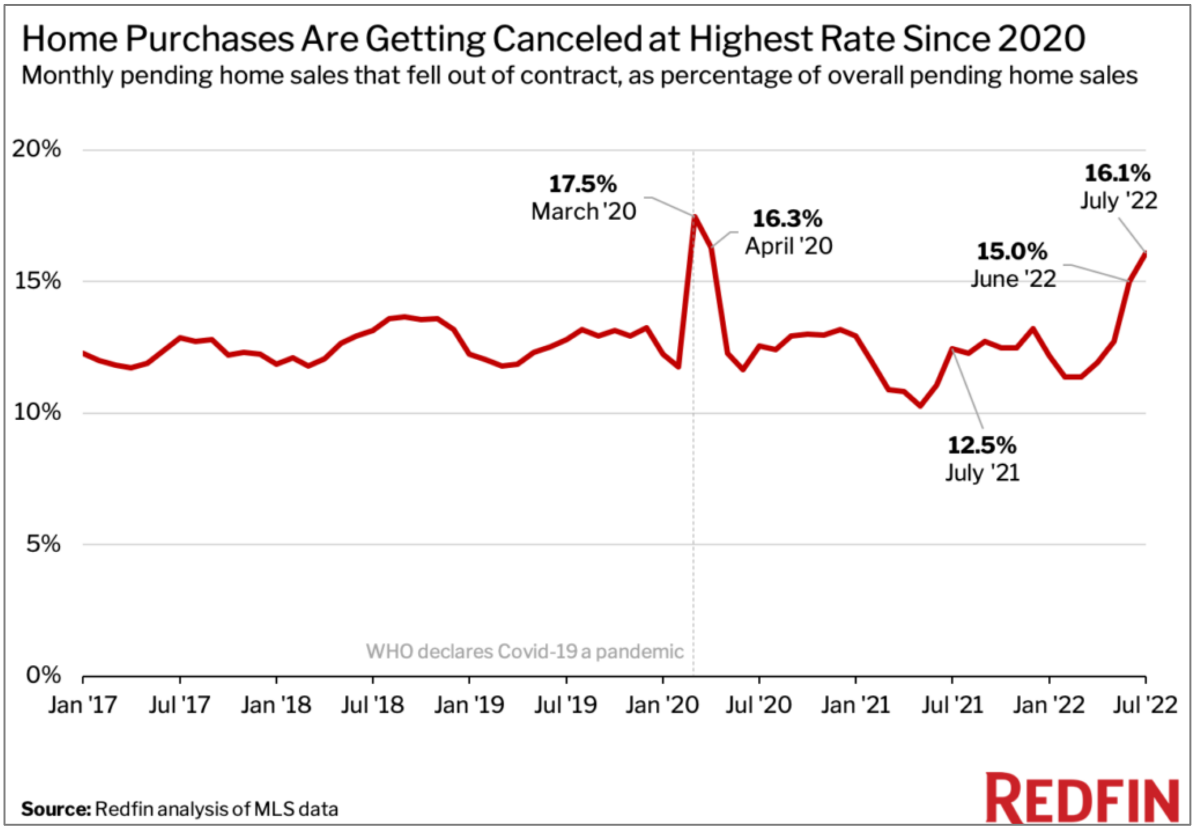
The pattern in Hedge Fund Leverage doesn't look all that different from shifts in retail investor sentiment.



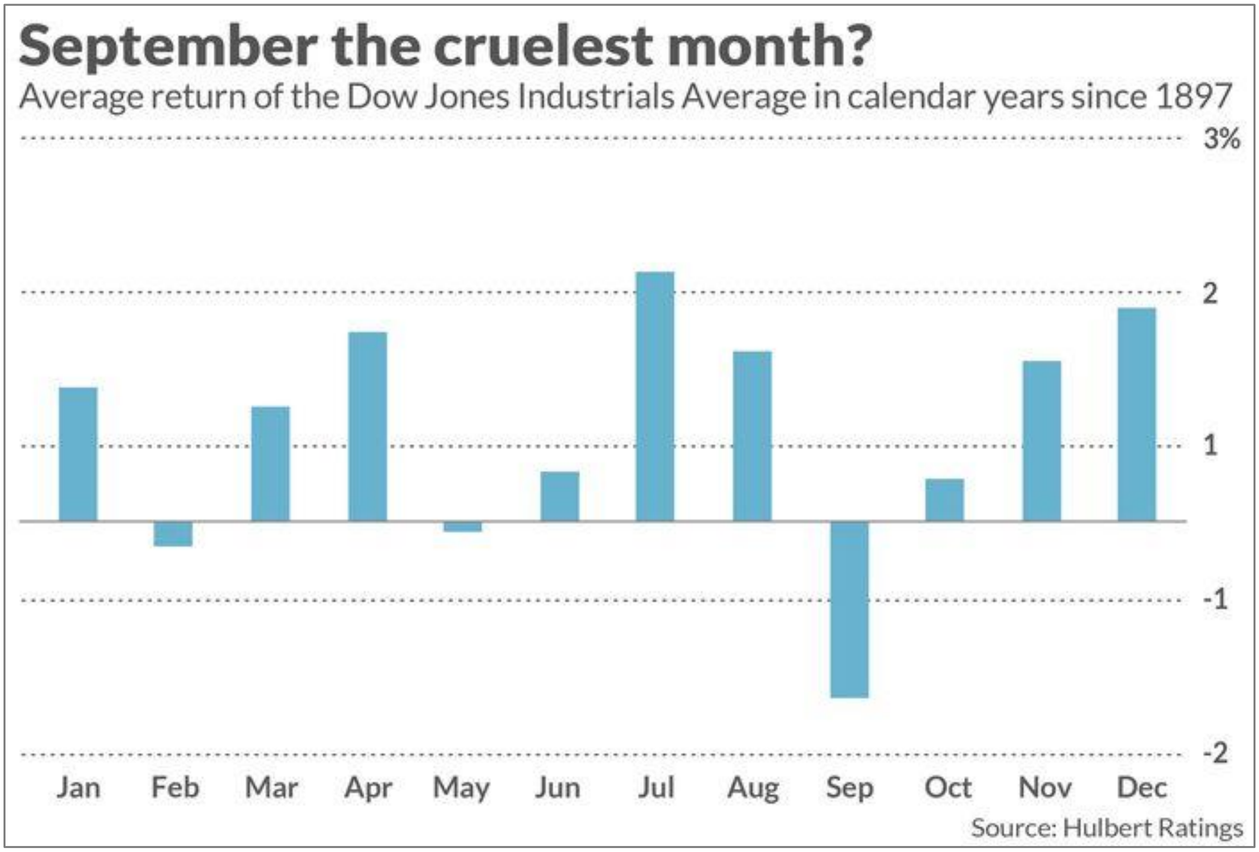
Price drops in real-estate listings are becoming more common in the wake of higher mortgage rates.



Pending home purchases are getting canceled at the same rate as during the height of the pandemic.



September is the "cruelest month" for the stock market on average.



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.