Market Outlook

By Mark T Dodson, CFA

A Mid-Term November Bear Market Rally

Market Risk Index moved down to 50.1% on Monetary and Market Trend improvements. The improvement was nearly offset by a Psychology Composite move out of the best 20% of readings.

The Monetary Composite improvement came from the Velocity category, which is still accelerating in a bear market, something that hasn't happened since the 1970s. The hallmark of every bear market since 1982 (when Paul Volcker broke over a decade of higher and higher inflation expectations) has been falling velocity – disinflationary bear markets. We think it will likely take more than just this bear market to tame inflation expectations fully. It should be an interesting decade where being active and tactical with allocation decisions pays off for investors – an about-face from the ease of being a passive investor during the post-2008 QE environment.

You can see high-velocity headlines in the news. The stories talk about households being in the middle of a drawdown in their Covid-era savings, implying that consumers are being squeezed and forced into spending money to buy goods whose value has inflated. It's a distinctly different kind of headline than most of us have grown used to reading in bear markets, where the media talks about money moving to the sidelines. If the 1970s serve as a guide, we don't expect to see velocity falling again (higher demand for cash) until after the bear market has ended.

Also noteworthy - our favorite version of the yield curve, the 10Yr Treasury yield minus the 90 Day T-Bill yield, inverted this week. It's the version we have used most heavily for over 20 years – one of the most accurate when looking at likely GDP growth over the next 12 months and with the best lead times for recession. We are already nine months into this bear market, and this version of the yield curve just now suggests that a recession is in the cards over the next 6-12 months. This inversion is a big red flag for the economy in 2023. Investors obsessed with the idea of a Fed pivot to neutral policy as a rationale for getting aggressive are getting ahead of themselves.

This Fed Pivot FOMO appears to be bidding up markets. This is speculation because our positioning is still defensive, but we would not be surprised to see this ongoing bear market rally go far enough to make even some staunch stock market bears change their minds. Why? Partly because of the recent trough in our Psychology Composite, which is giving a bear market rally some breathing room, and also because the November to April

Market Risk Index

Rec Allocation 25% Underweight

50.1%

Category Percentiles

Psychology - P3

22.5%

Monetary - M3

46.8%

Valuation - Extremely Overvalued

92.8%

Trend

92.5%

Largest Psychology Influences

Surveys	Positive
Leveraged Investments	Negative
Fund Flows	Negative
Technical Indicators	Negative

Largest Monetary Influences

Interest Rates	Negative
Exchange Rates	Positive
Interest Rate Spreads (Yield Curve)	Negative

Valuation

7-10 Year Equity Return Forecast	2.8%
10Yr US Treasury Yield	4.0%

Market Trends

US Equities	Bearish Trade
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.

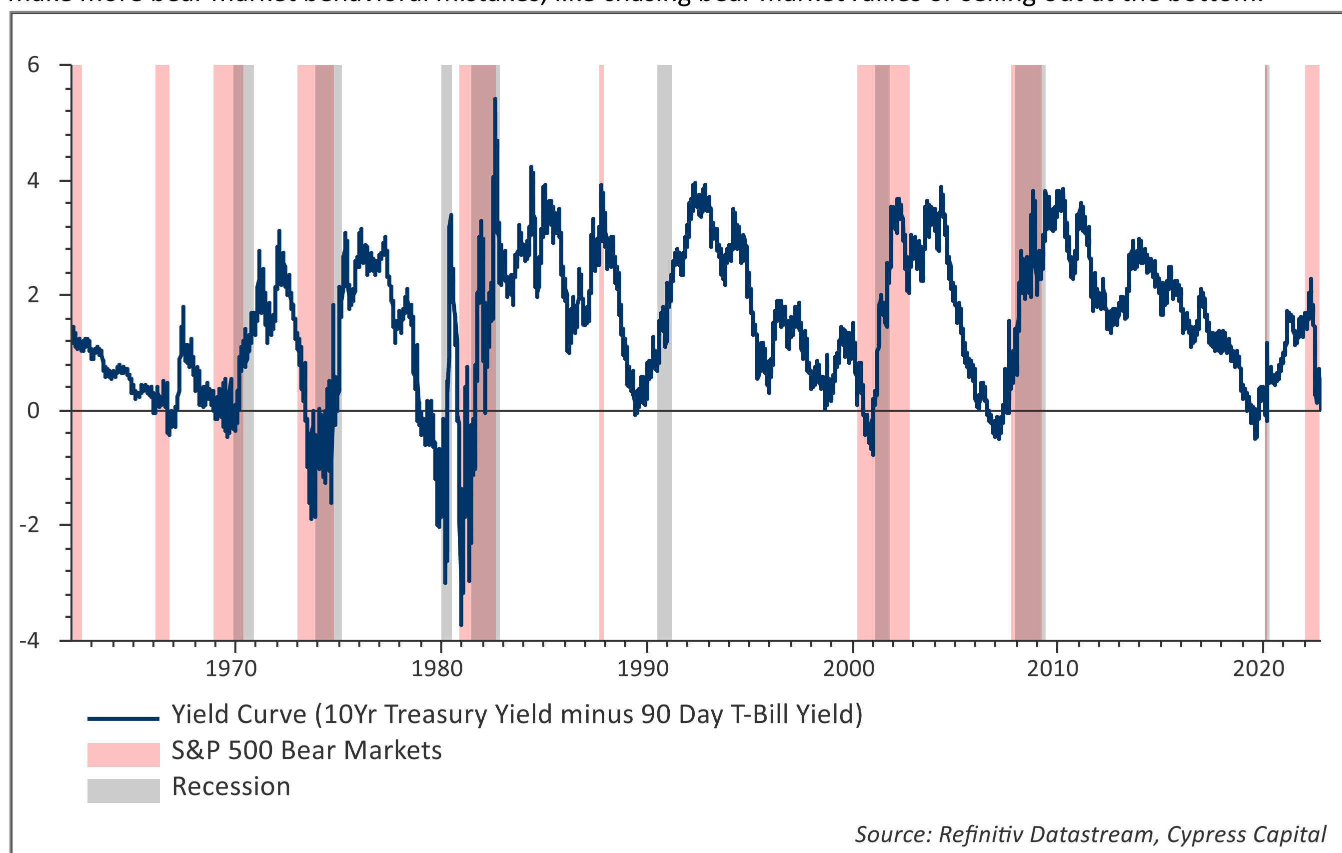
period after a mid-term election begins next week. It has a powerful bias toward higher stock prices, with an average return of 9% since 1900 (17.4% annualized). It also hasn't had a down period since 1946.

In fact, after expanding the study to include the 1900-1946 period, we find that the phenomenon clearly becomes a post-WWII anomaly. The average November to April return in mid-term years from 1900-1946 was a -0.2% decline, while the average November to April period in mid-term election years after 1946 was a whopping 15.2%. Maybe some of you historians out there have some theories on why there might have been a noticeable shift in the relative importance of mid-term elections after WWII for markets. We are stumped.

We will be patient in paring back equities further in anticipation of another leg down in the bear market. Look for some of our market breadth indicators to become overbought or signs from investor sentiment that burgeoning Fed pivot fever is on the cusp of reigniting animal spirits.

Charts of the Week

Our Favorite version of the Yield Curve (10Y minus 90D) inverted this week.
Historically, it's not unusual for a bear market to already be underway when this version of the yield curve inverts. The ensuing recession tends to cause more bear market damage. It's also when investors are likely to make more bear market behavioral mistakes, like chasing bear market rallies or selling out at the bottom.



Source: Refinitiv Datastream, Cypress Capital

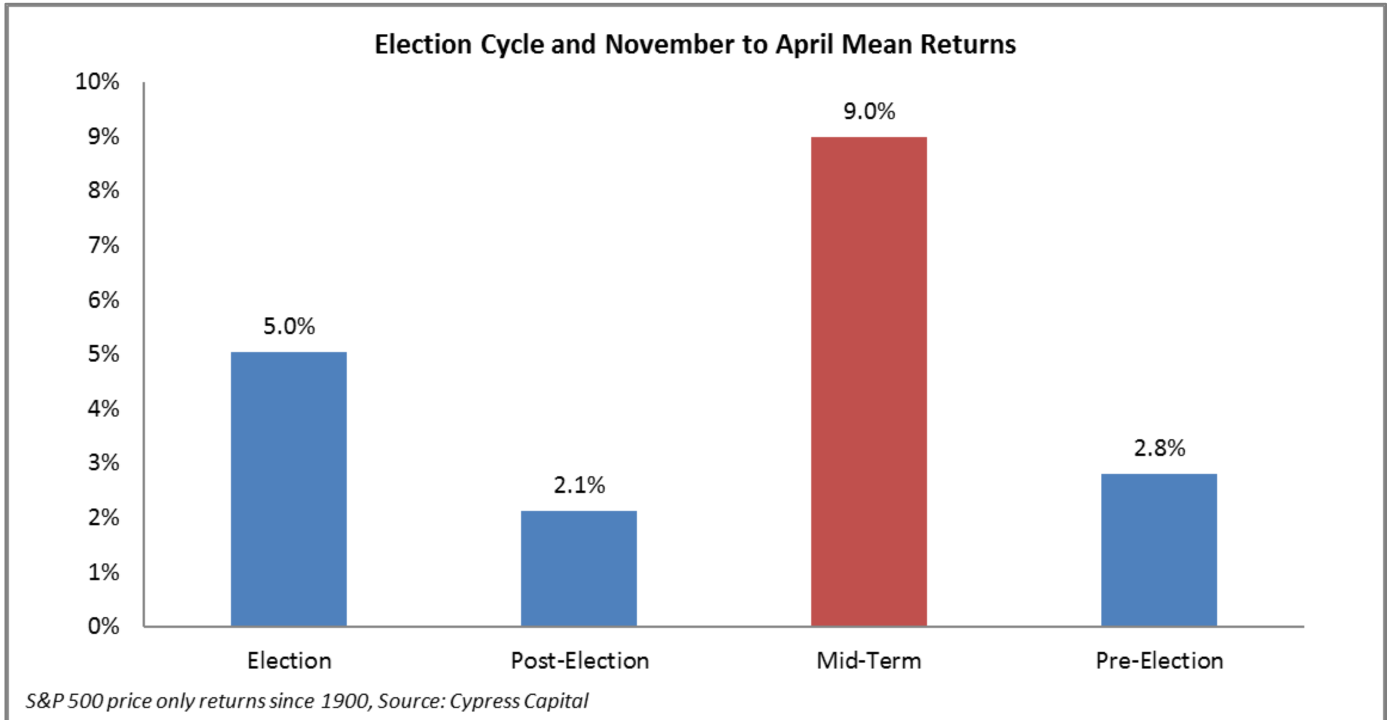
The Election Cycle and November to April Returns

Six months before and after the mid-term elections explains a large part of the Presidential Election cycle anomaly. The November to April period after a mid-term election year has had strong returns on average without a single down period since 1946. The Hirsch family originally discovered both the Presidential Election Cycle and Sell in May anomalies and published them in the Stock Trader's Almanac, a favorite book of mine when first learning about financial markets.

Years	Election	Post-Election	Mid-Term	Pre-Election
1900-1903	35.4%	7.2%	-9.6%	6.1%
1904-1907	15.4%	0.7%	-13.8%	9.0%
1908-1911	12.7%	-5.0%	-0.4%	10.0%
1912-1915	-10.7%	-1.7%	6.0%	-0.8%
1916-1919	-8.1%	-6.1%	6.7%	-9.2%
1920-1923	-12.3%	22.5%	-1.7%	5.9%
1924-1927	12.6%	-3.4%	9.1%	18.4%
1928-1931	19.6%	3.1%	-10.9%	-44.1%
1932-1935	12.2%	18.2%	5.3%	10.5%
1936-1939	-4.6%	-20.8%	-16.8%	-5.0%
1940-1943	-16.0%	-19.4%	23.8%	-0.3%
1944-1947	16.0%	12.7%	-1.8%	0.3%
1948-1951	-10.8%	11.6%	14.8%	1.7%
1952-1955	0.4%	15.2%	19.8%	14.3%
1956-1959	0.4%	5.8%	12.2%	-5.5%
1960-1963	22.3%	-4.9%	23.5%	7.4%
1964-1967	5.0%	-1.5%	17.2%	4.5%
1968-1971	0.3%	-16.1%	24.9%	14.3%
1972-1975	-4.1%	-16.6%	18.1%	14.2%
1976-1979	-4.3%	4.9%	9.2%	4.4%
1980-1983	4.2%	-4.5%	23.0%	-2.1%
1984-1987	8.3%	24.1%	18.2%	3.8%
1988-1991	11.0%	-2.8%	23.5%	5.7%
1992-1995	5.1%	-3.6%	9.0%	12.5%
1996-1999	13.6%	21.6%	21.5%	6.6%
2000-2003	-12.6%	1.6%	3.5%	5.4%
2004-2007	2.4%	8.6%	7.6%	-10.6%
2008-2011	-9.9%	14.5%	15.2%	11.5%
2012-2015	13.1%	7.3%	3.3%	-0.7%
2016-2019	12.1%	2.8%	8.6%	-4.1%
2020-2023	27.9%	-10.3%		
Mean	**5.0%**	**2.1%**	**9.0%**	**2.8%**
Median	**5.0%**	**1.6%**	**9.1%**	**4.9%**
Geo Mean (Annl)	**8.8%**	**2.9%**	**17.4%**	**4.1%**
Std Dev.	**12.7%**	**12.0%**	**11.8%**	**11.4%**
C.V (SD/Mean)	**2.5**	**5.7**	**1.3**	**4.1**
Pct Positive	**71%**	**58%**	**87%**	**65%**

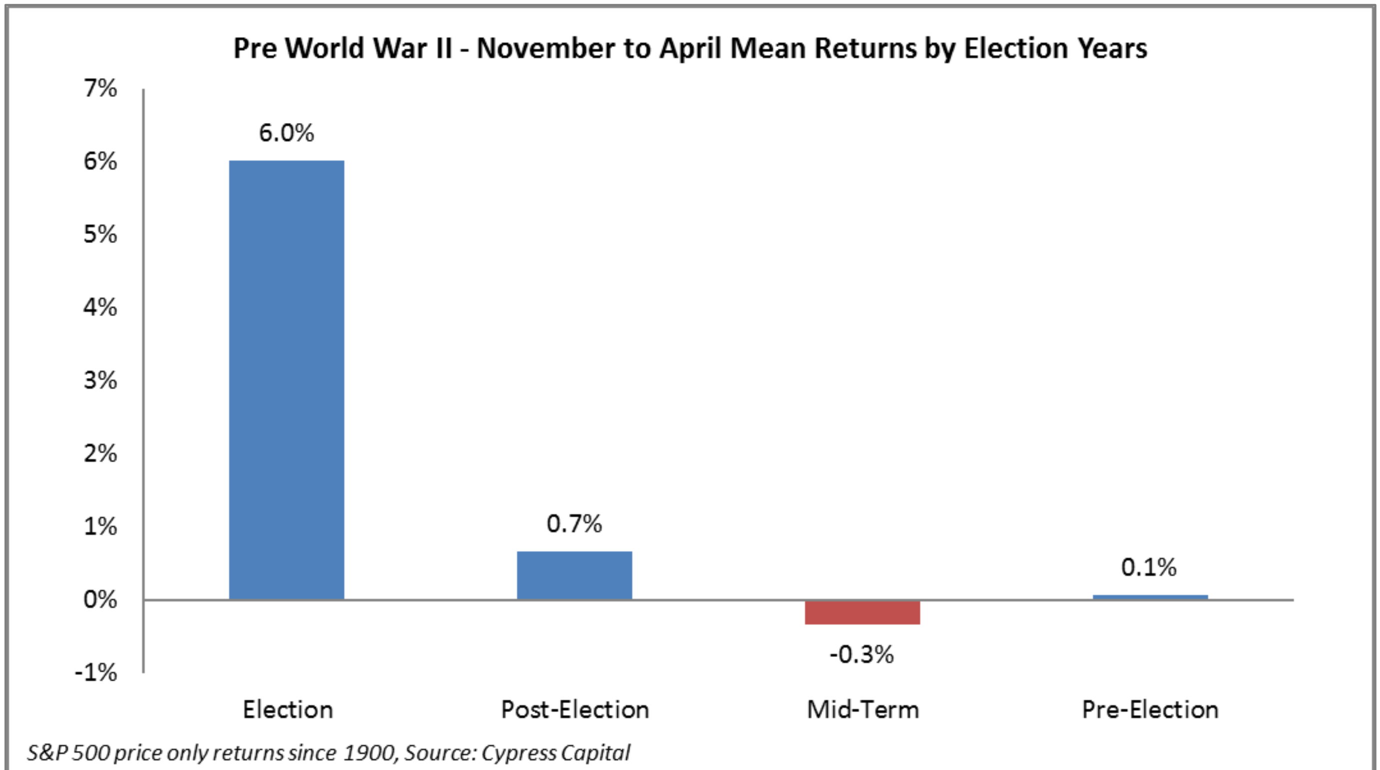
S&P Price Only since 1900 *Source: Cypress Capital*

November to April periods in a Mid-Term Election year have averaged 9% returns.



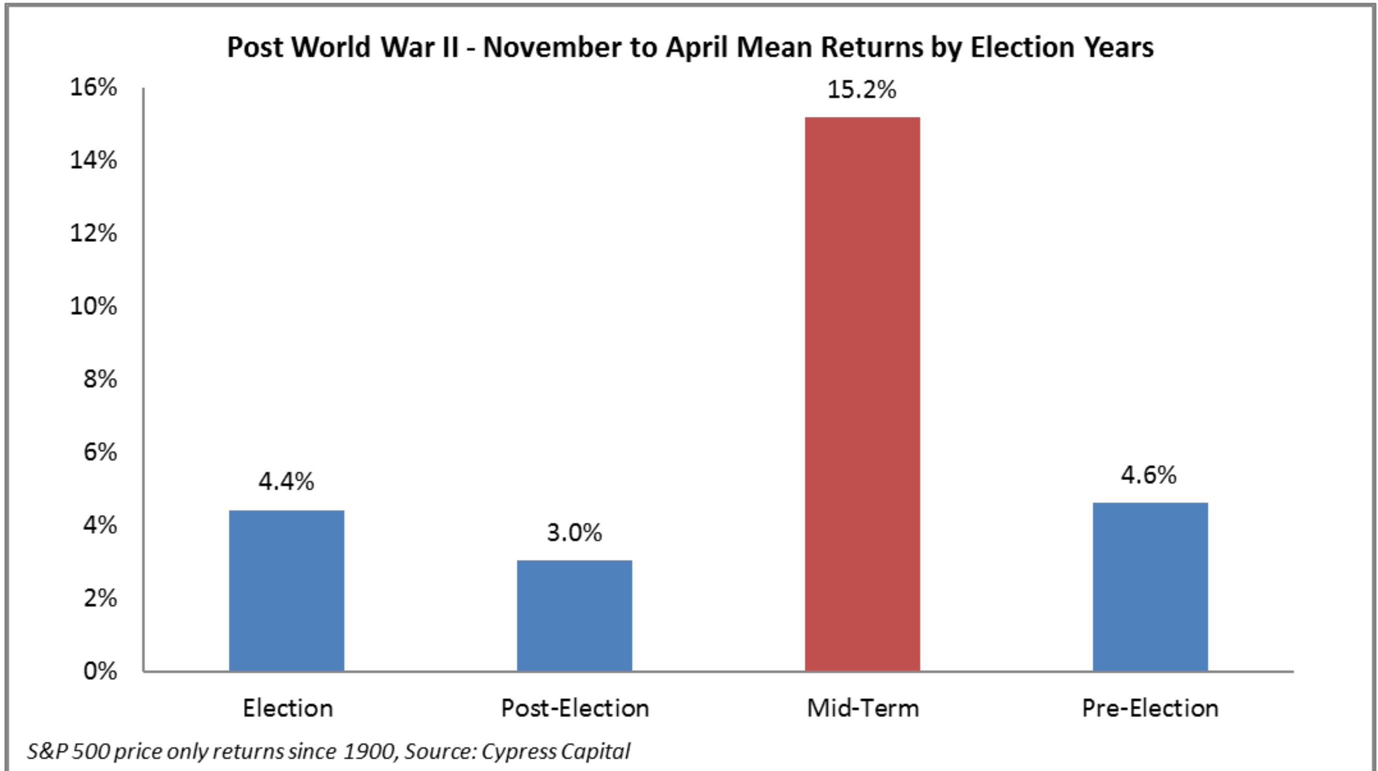
S&P 500 price only returns since 1900, Source: Cypress Capital

Prior to World War II, November to April periods in Mid-Term Election years were money losers.



S&P 500 price only returns since 1900, Source: Cypress Capital

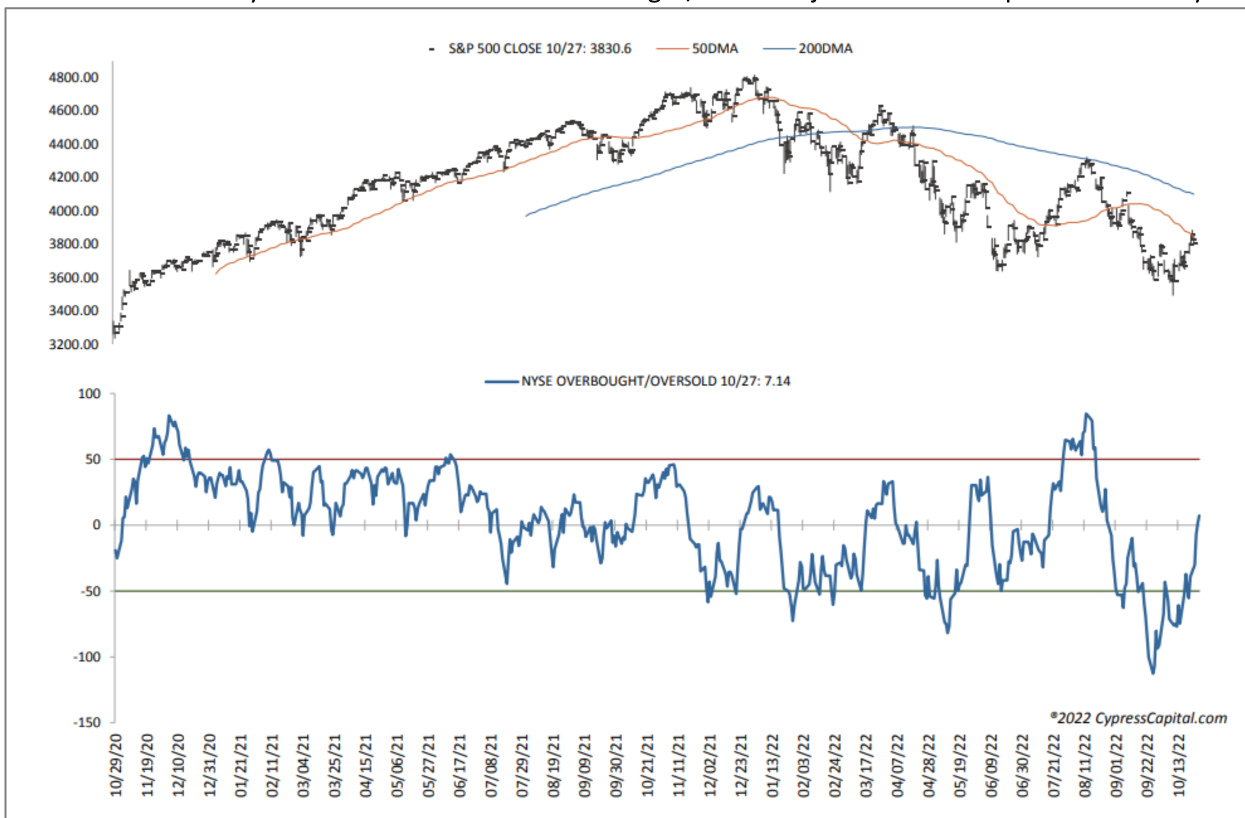
Post-WWII, the Mid-Term November to April period has averaged 15.2%, with no declines.



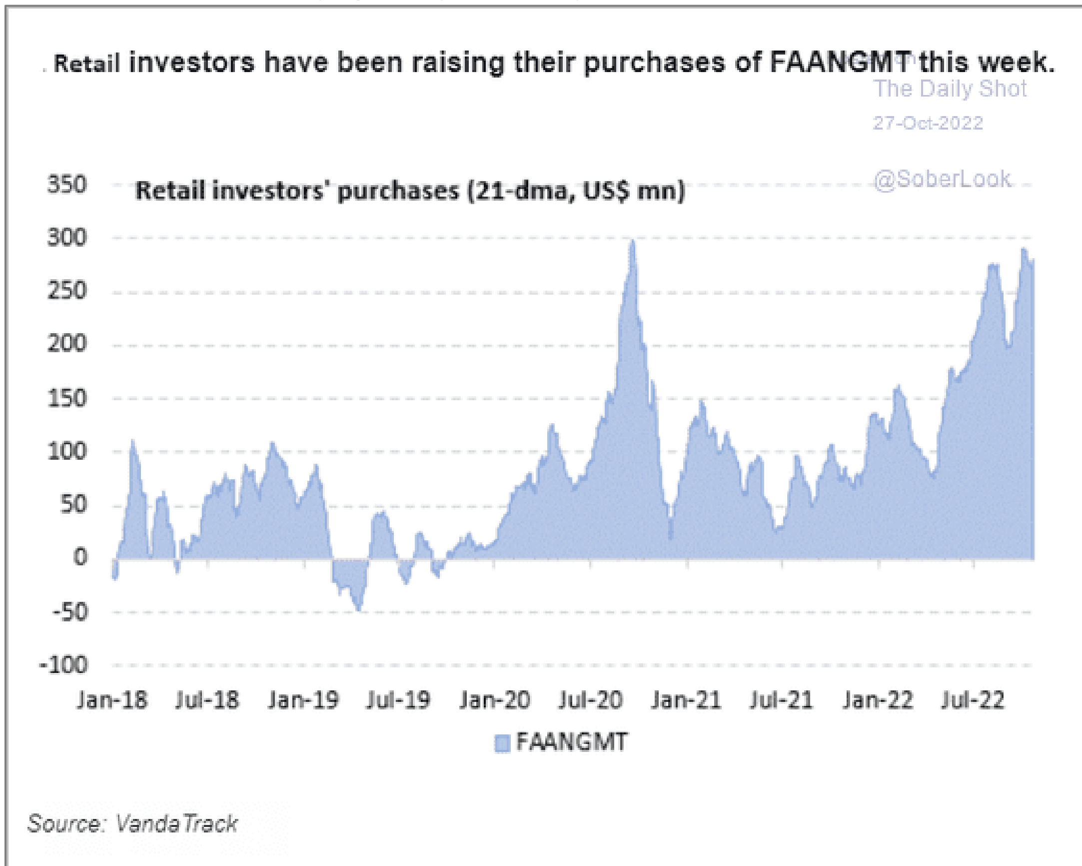
S&P 500 price only returns since 1900, Source: Cypress Capital

NYSE Overbought/Oversold Indicator

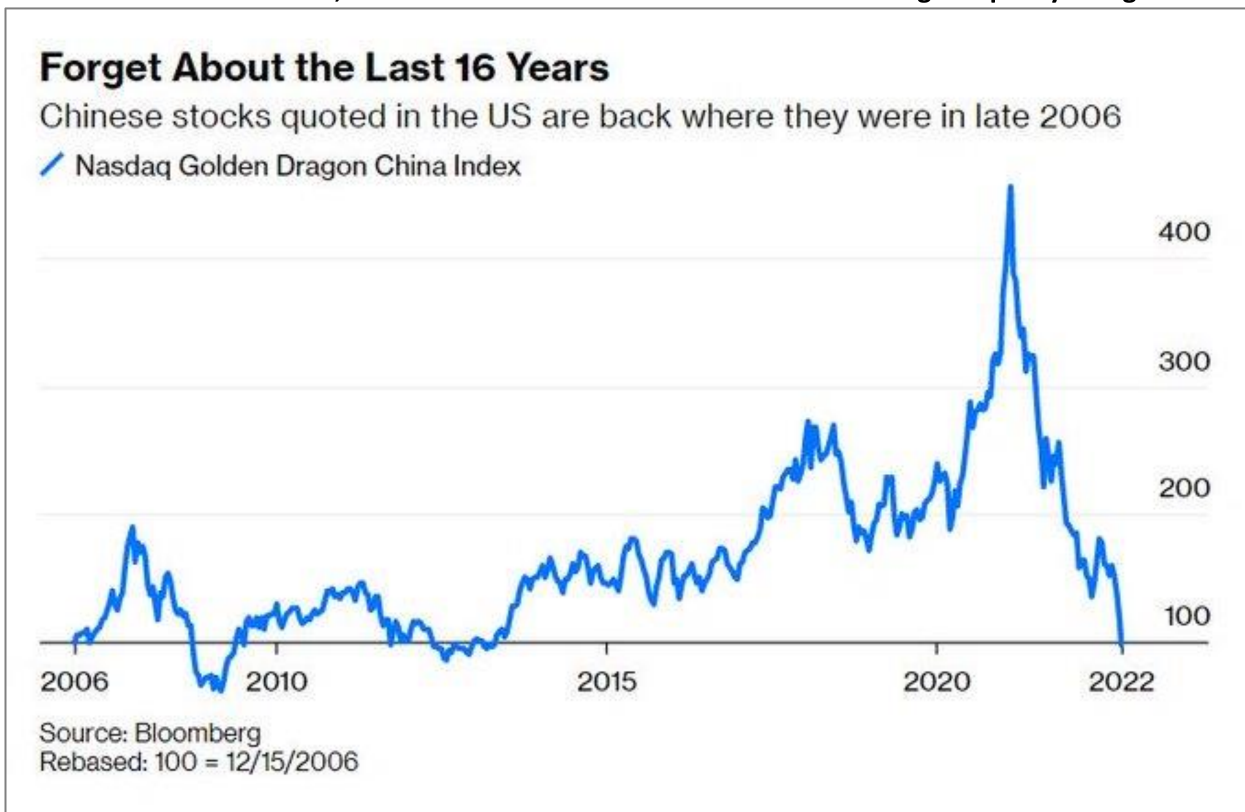
This bear market rally has more room to run. Overbought/Oversold just moved into positive territory this week.



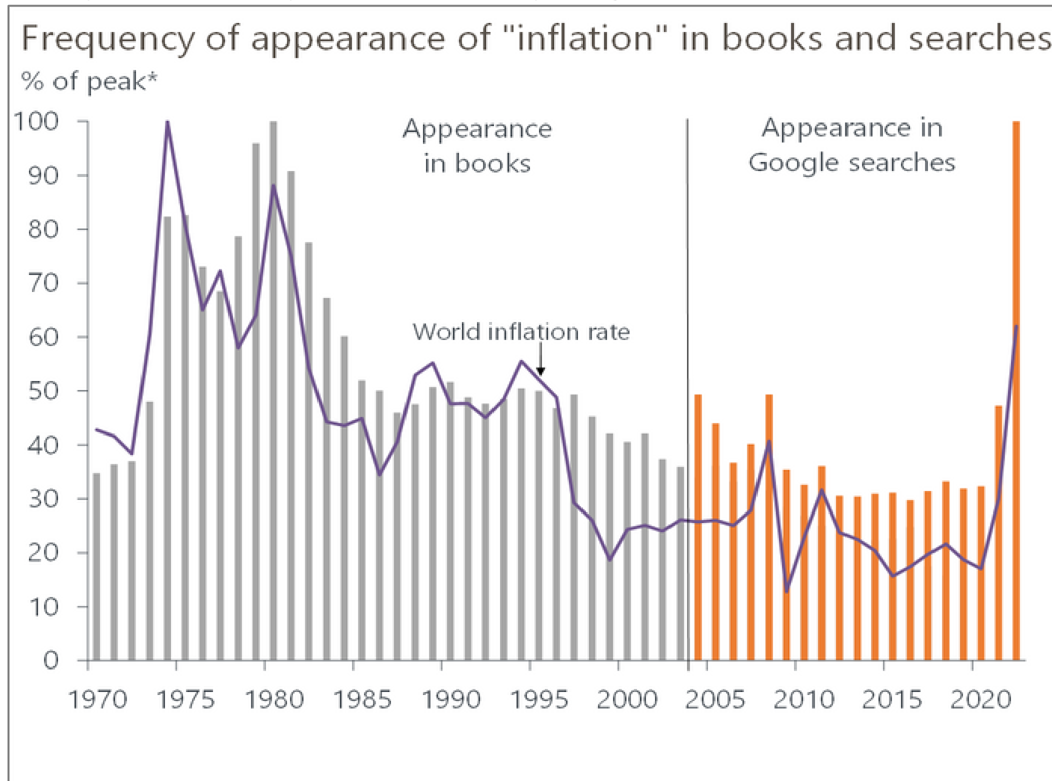
Retail Investors are still trying to buy FAANG dips...



Bull markets take the stairs, and bear markets the elevator. Chinese stocks give up 16 yrs of gains.



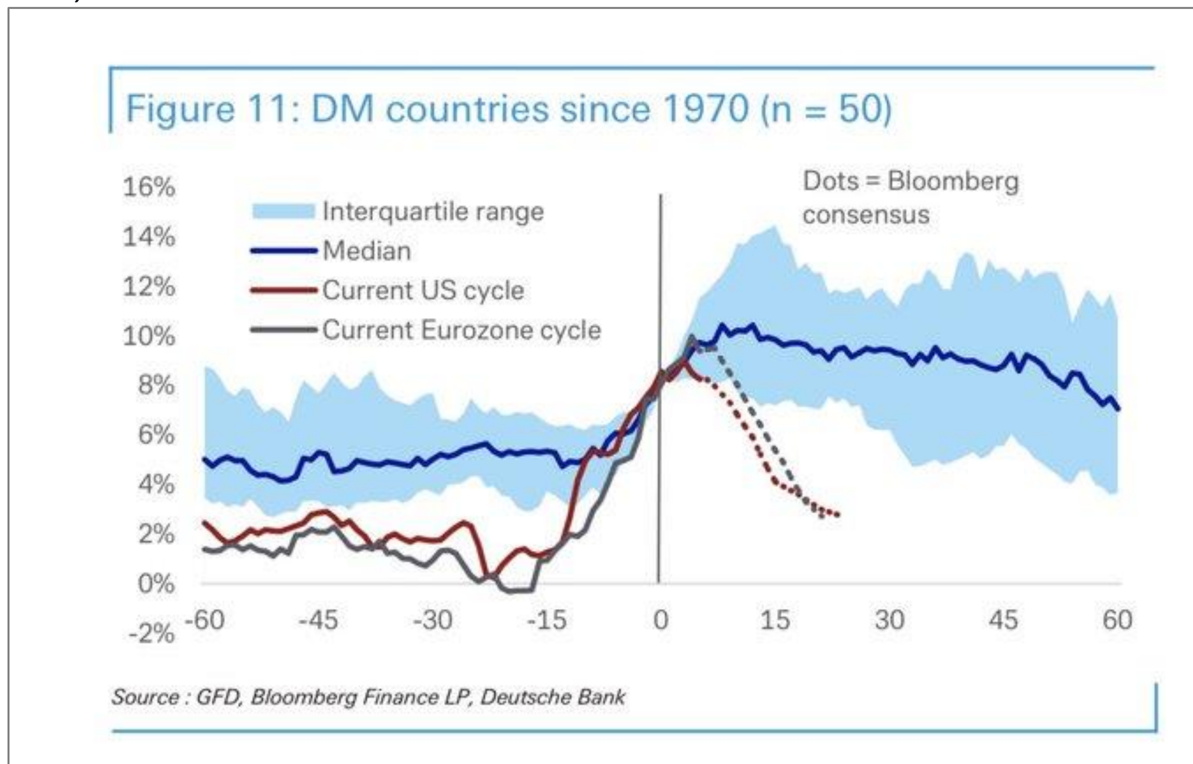
We hope this chart keeps central bankers up at night. It should.



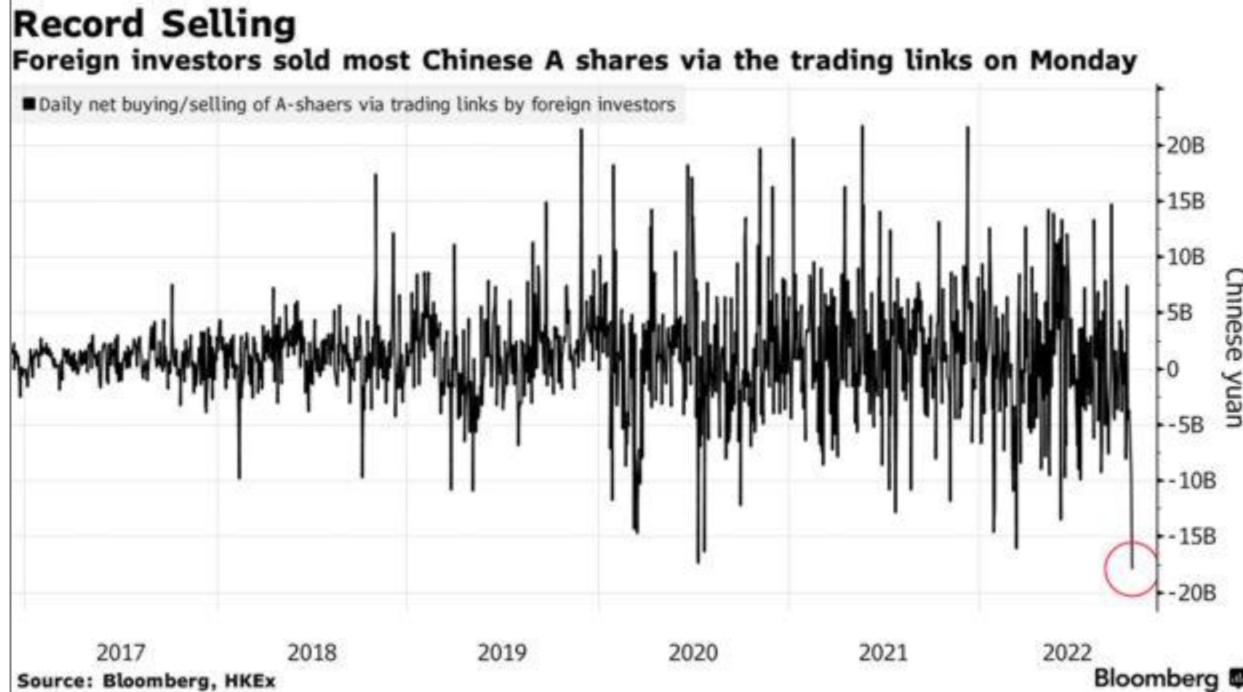
SOURCE: OXFORD ECONOMICS, GOOGLE, OTHERS.

Expectations for a quick and neat retreat from high inflation aren't reasonable.

"Almost never does high inflation come down fast. Today's consensus view that inflation will come way down is, as this figure from Jim Reid at Deutsche illustrates, outside the range of normal historical experience."
– Larry Summers

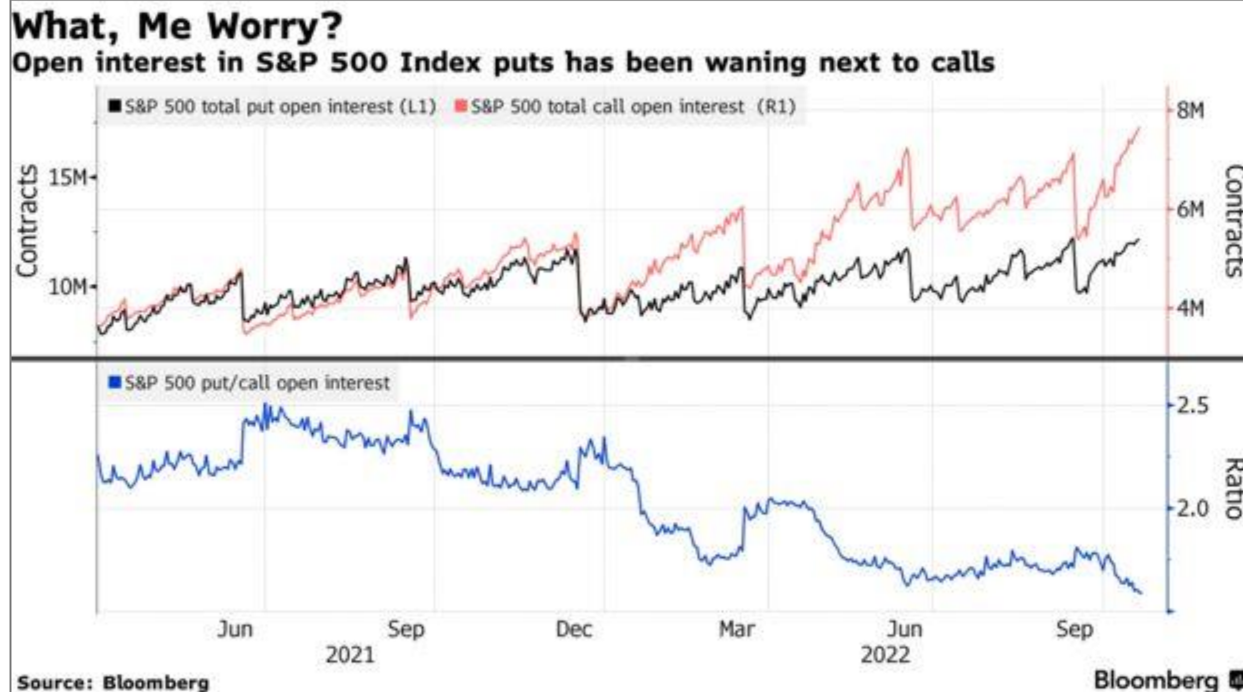


Investors are dumping Chinese stocks.



So much so that China is now selling below Book Value.

Complacency? Open Interest in S&P 500 Call Options is surging relative to Put Options.



Most significant Drop in Pending Home Sales in at Least 8 Years.

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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