Market Outlook

By Mark T Dodson, CFA

Powell's Pail of Cold Water

Market Risk Index increased to 57.4% this week on investor psychology deterioration. The Psychology Composite moved close to the 40th percentile, still on the bullish side of neutral but rapidly shifting from the good readings in October. The shift in favor of greed has impacted most categories of the Psychology composite equally.

Valuations have crept back into the worst decile of readings after briefly moving out of the most overvalued zone at recent market lows. The market rally off the lows combined with a move higher in bond yields has also put pressure on relative valuations. The yield on the 10Yr Treasury is 140 basis points higher than what valuations suggest are the likely expected return on equities. After more than a decade of "*There is no Alternative*," credible alternatives are rapidly emerging.

The Monetary Composite was unchanged, but we officially went on recession watch with the inversion of the 10Yr minus T-Bill version of the yield curve over recent weeks. It's unlikely that this bear market is over, regardless of whether Powell's language had instead sounded more "pivoty" than it did. The narrative of a pivot is only bear market rally fuel, as the yield curve says the recession is on its way. We should see growth in monetary aggregates begin to re-accelerate as recession fears increase and the appeal of Treasury bills yielding more than 4% becomes a tempting refuge from a long-lasting bear market.

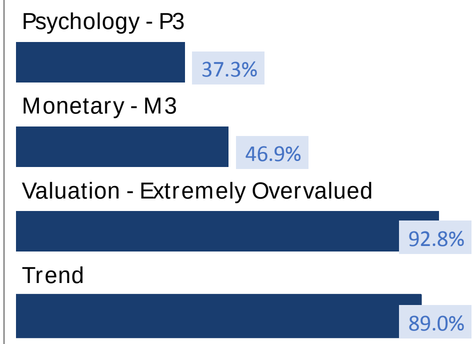
Markets hit mild overbought levels early in the week until Chairman Powell poured cold water on a market rally that was heating up. Still, the overbought readings weren't remotely close to what we saw in the bear market rally that ended in August. It also wasn't enough for us to entertain the idea of decreasing equity allocations further.

Market Risk Index

Rec Allocation 25% Underweight

57.4%

Category Percentiles



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	2.7%
10Yr US Treasury Yield	4.1%

Market Trends

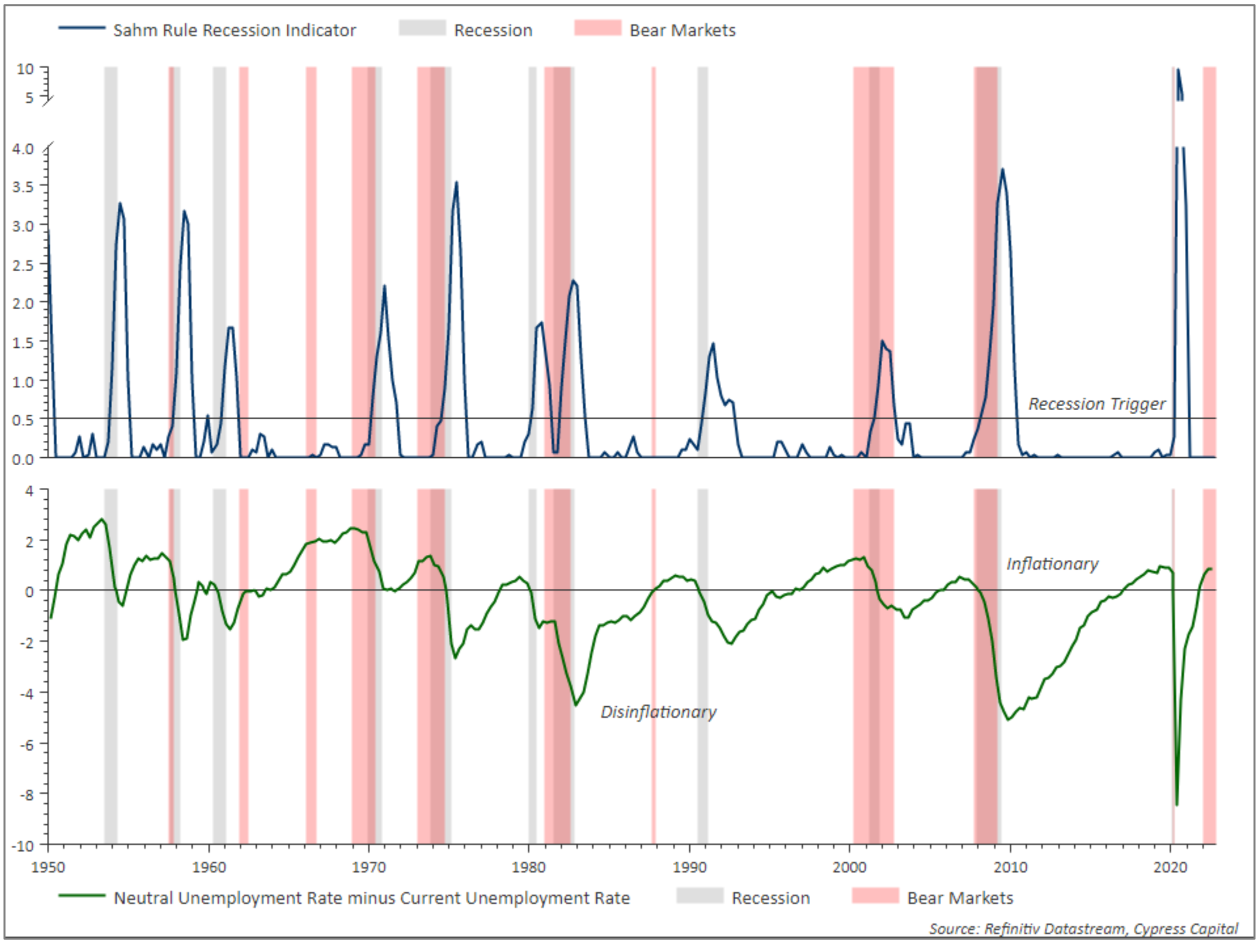
US Equities	Bearish Trade
Intl Equities	Bearish Trade
REITs	Bearish Trade
Broad Commodities	Bullish Investment

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.

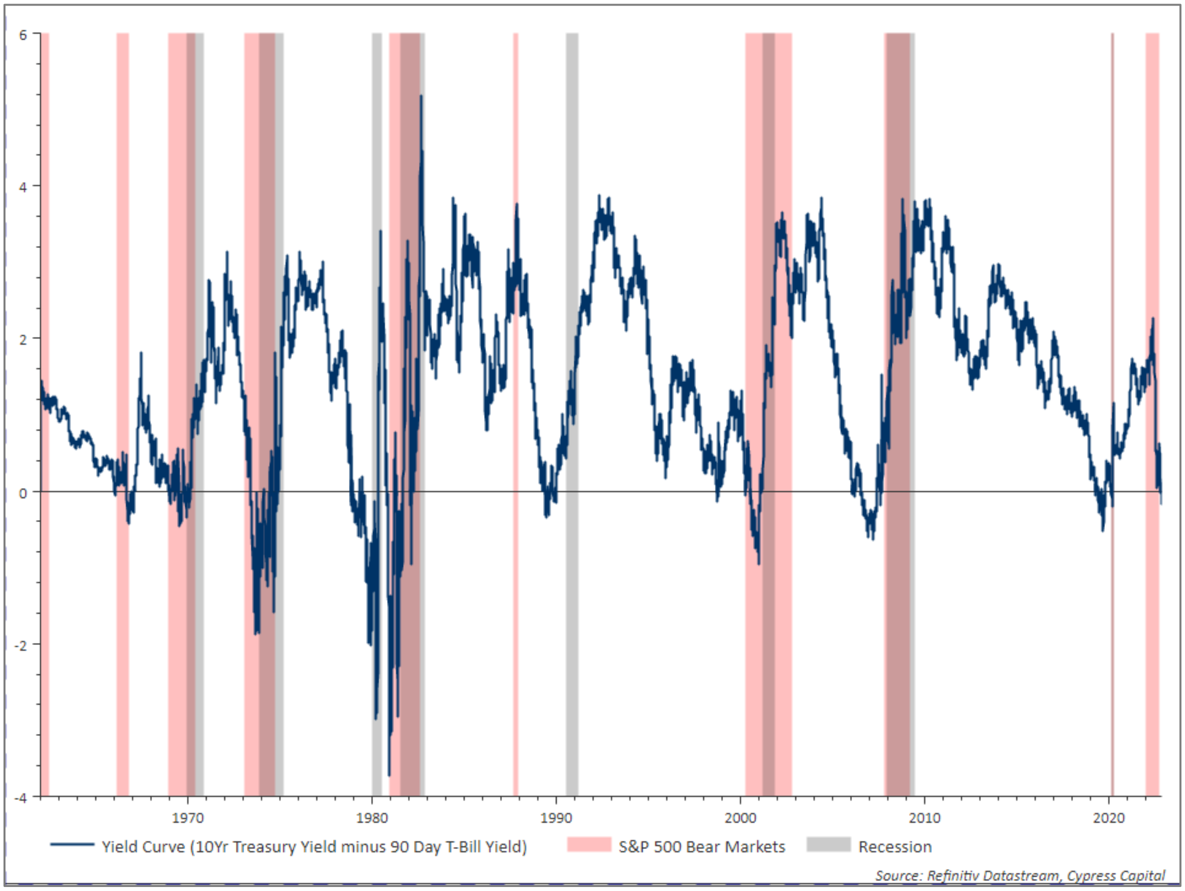
Charts of the Week

Inflation, Unemployment, and the Sahm Rule

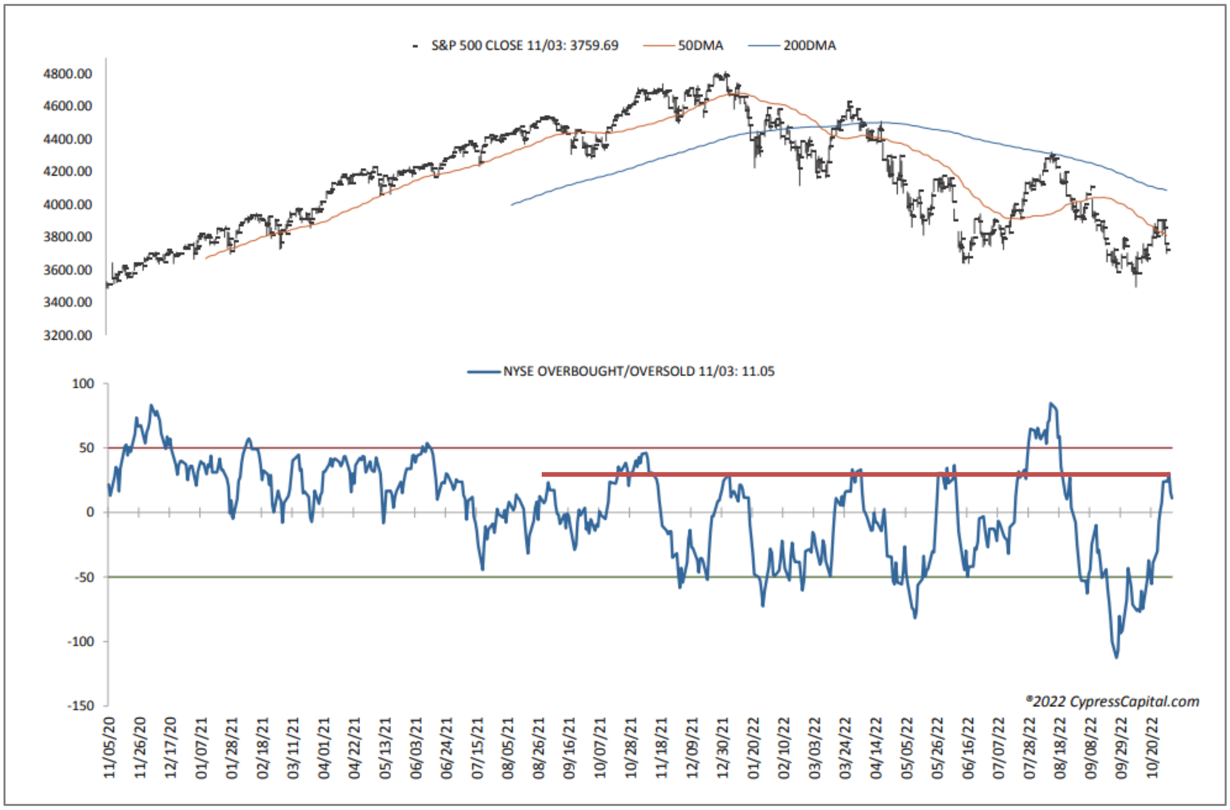
Getting the unemployment rate back above the non-accelerating inflation rate of unemployment is going to trigger a recession, according to the Sahm Rule, another strong argument against a soft landing. The Sahm Rule recession indicator signals recession when the three-month moving average of the unemployment rate rises by 0.5% above its low over the last 12 months.



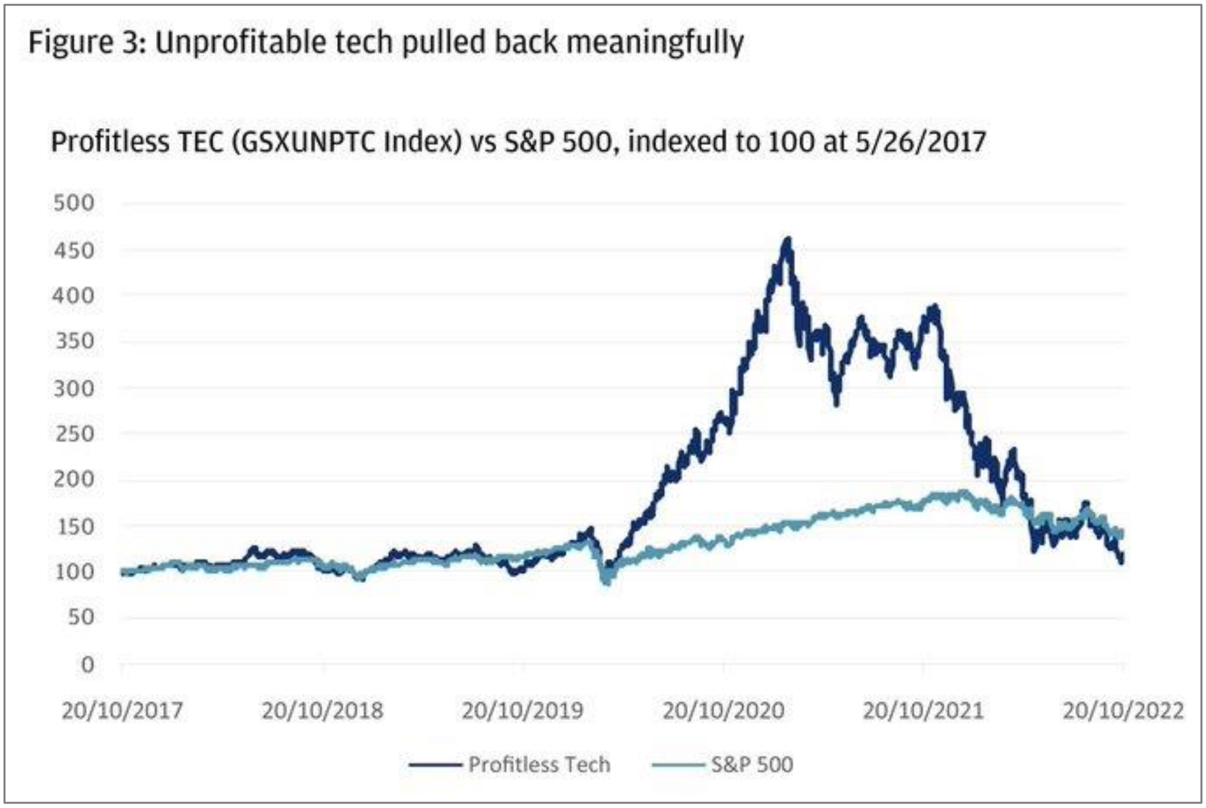
The Yield Curve that matters most (to us) is flashing a clear recession warning.



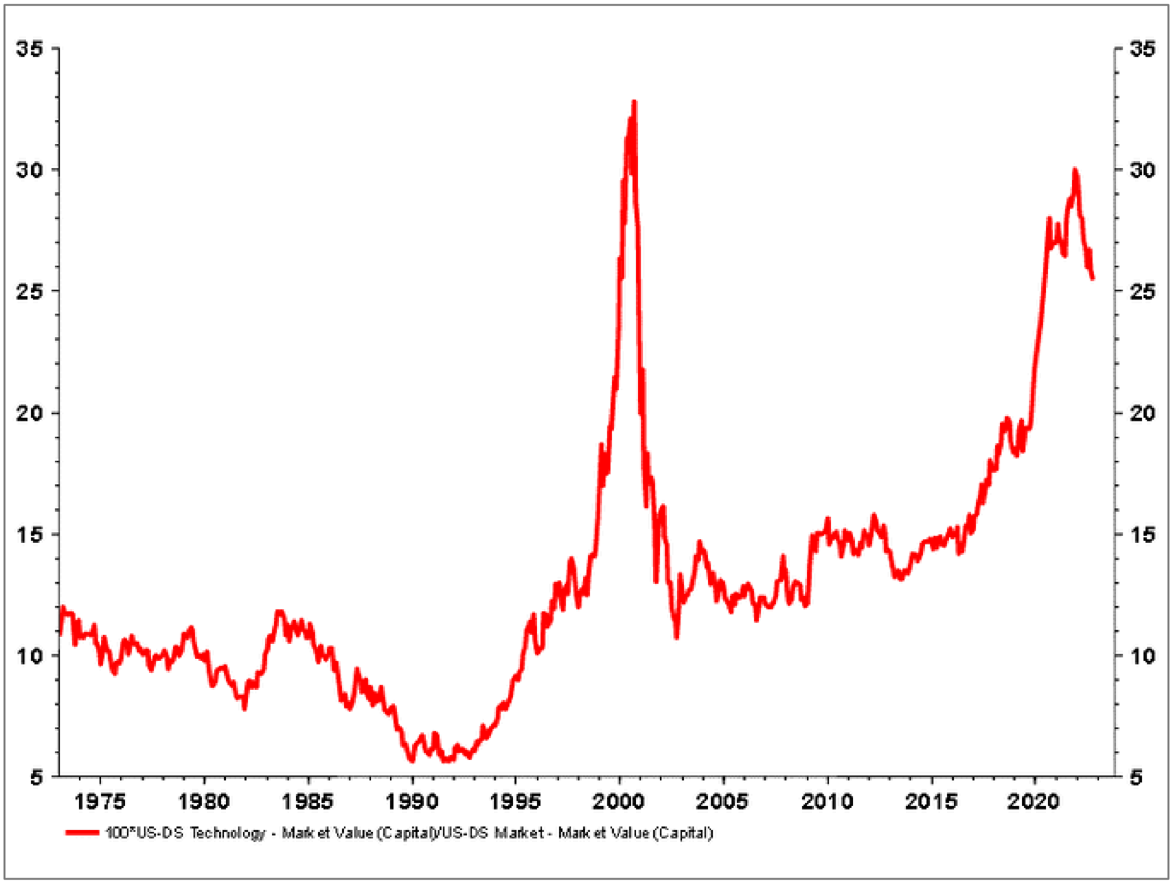
NYSE Overbought/Oversold Indicator



Unprofitable Tech Stocks have given up all their Covid stimulus era gains.

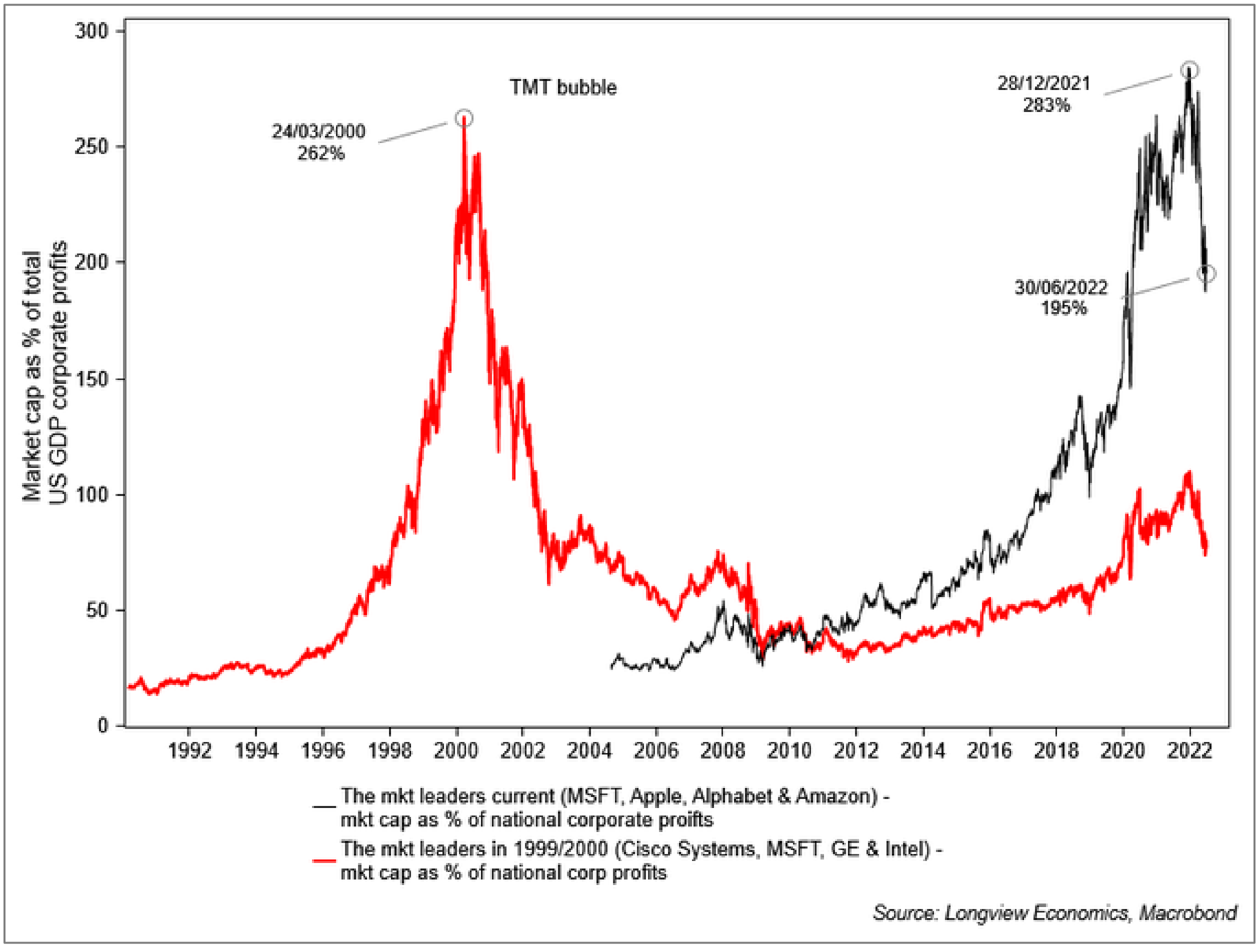


The retreat in Tech Valuations doesn't look like it is over.

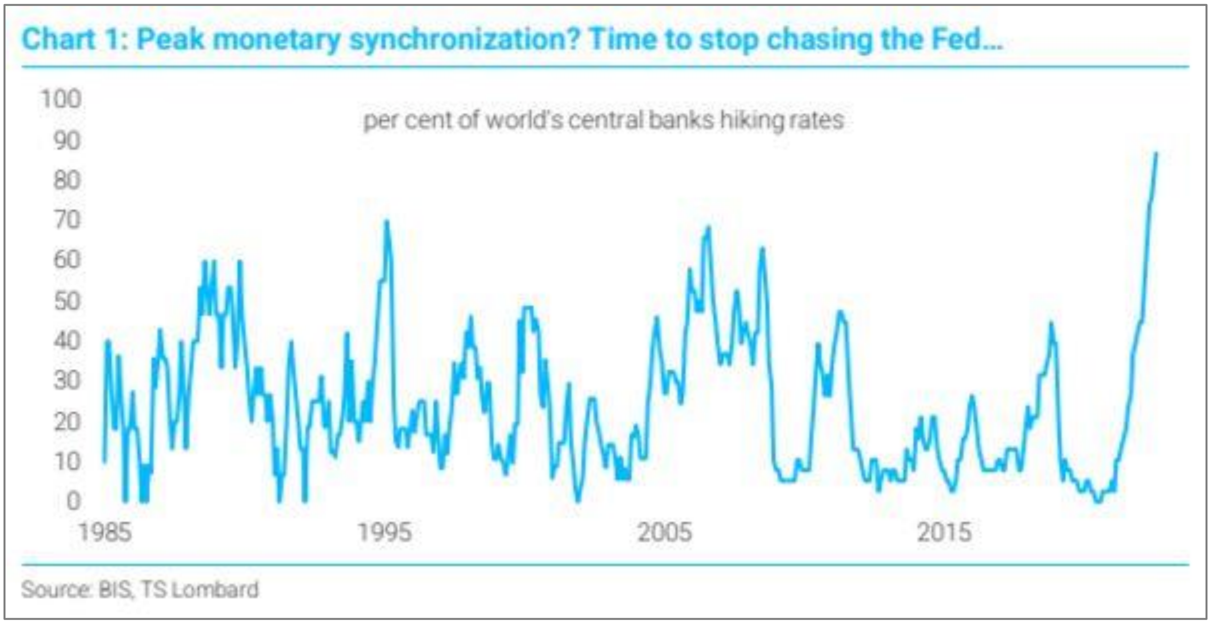


Source: Albert Edwards

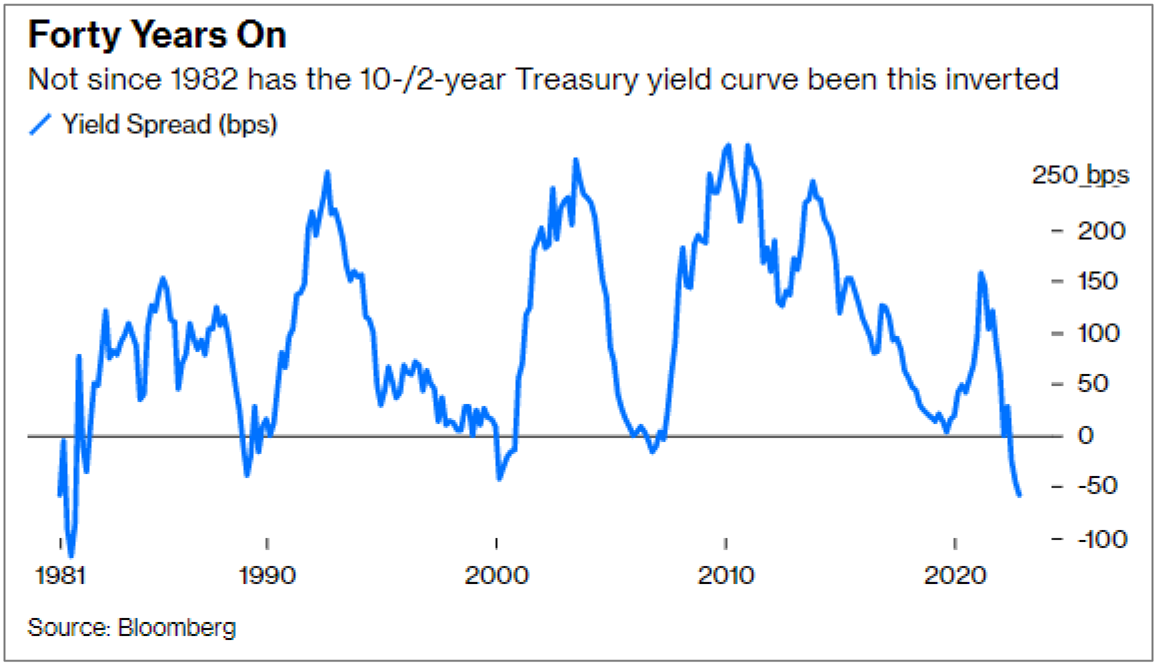
TMT Bubble versus FANG Bubble



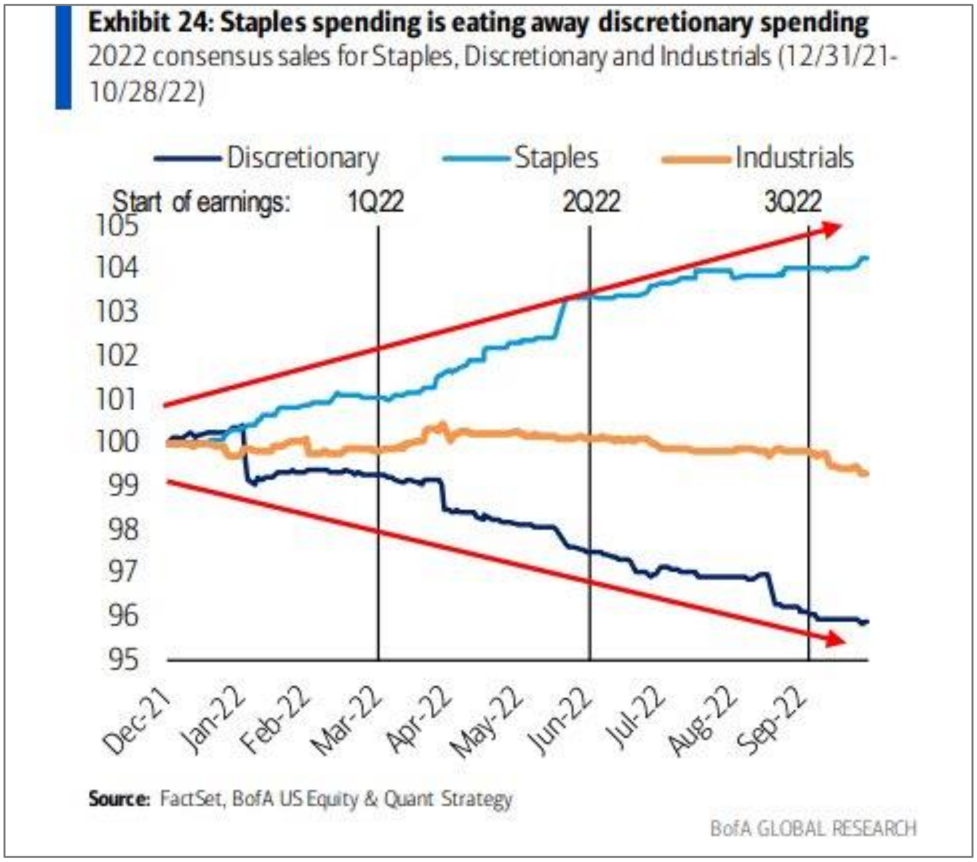
New high in the percentage of the world's central banks that are increasing interest rates.



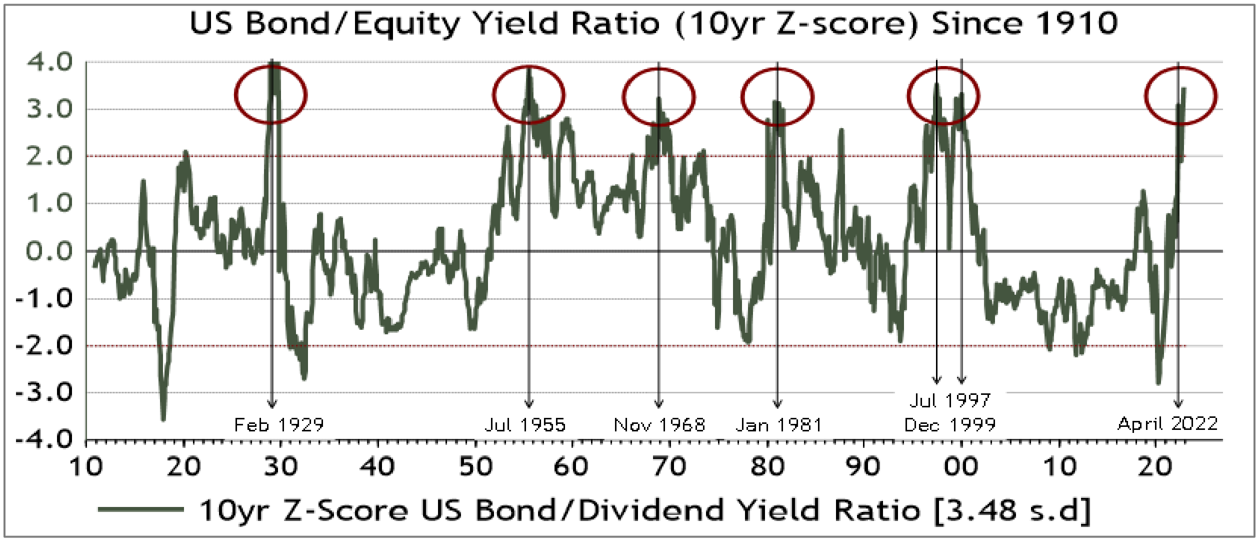
Deepest Yield Curve Inversion (for 10s2s) since 1982



Inflation is causing spending on necessities to eat away at spending on fun stuff.

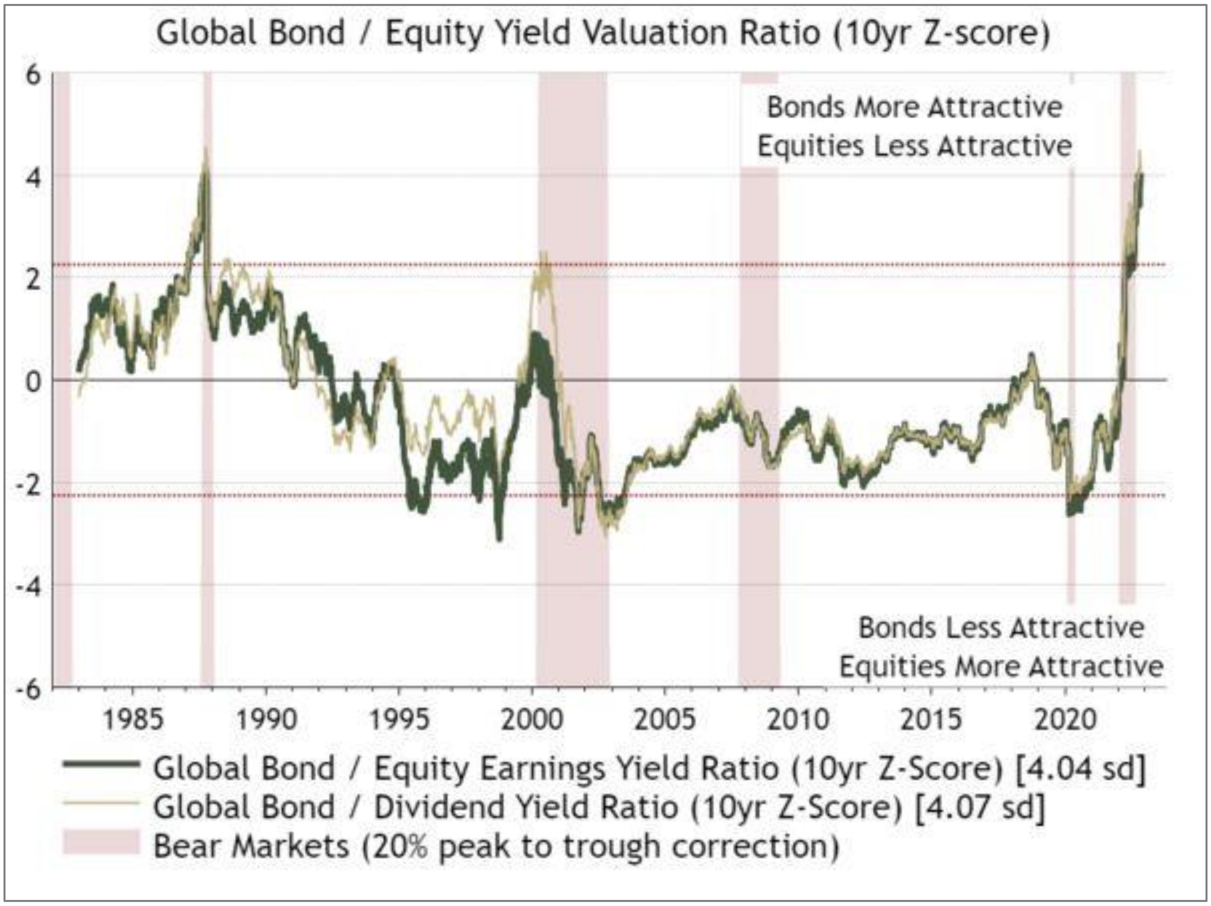


Bond yields versus Dividend Yields – bonds haven't been this attractive since the late 90s.



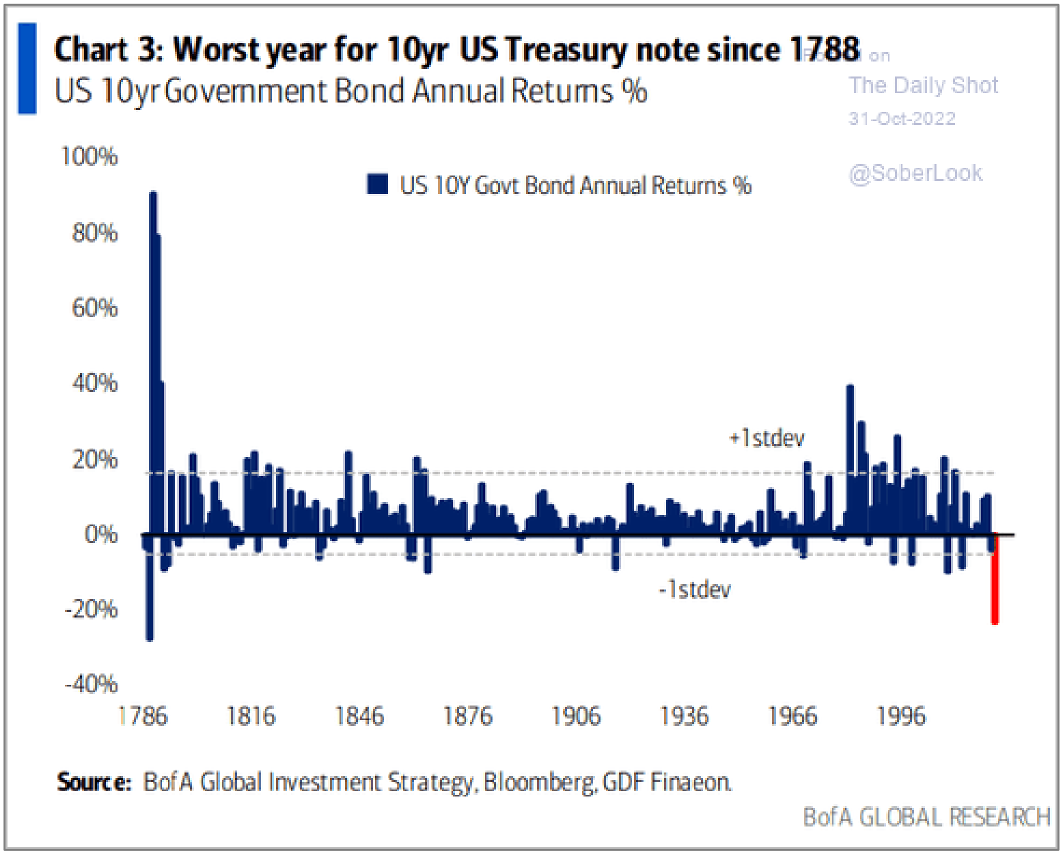
Source: John Authers

The relative attractiveness of Global Bonds over Stocks is the highest since 1987.

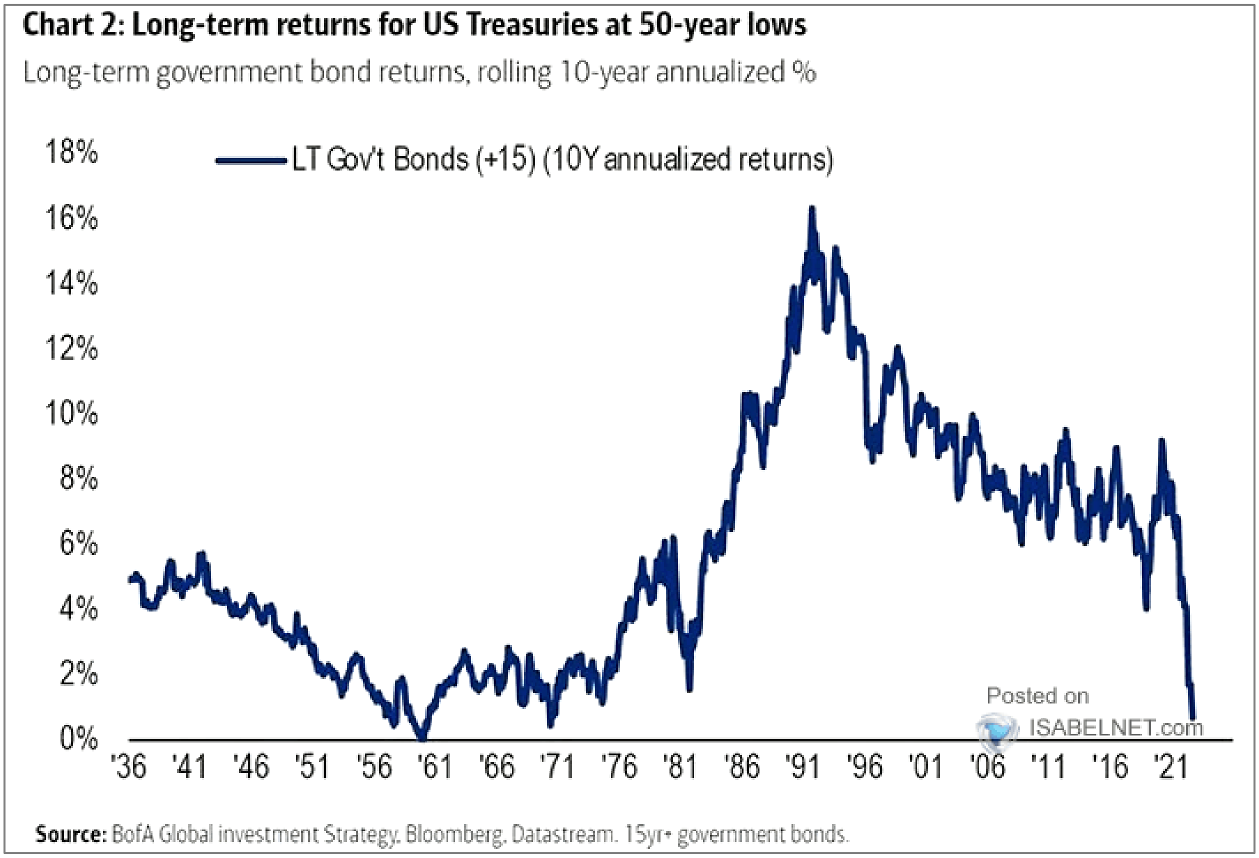


Source: John Authers

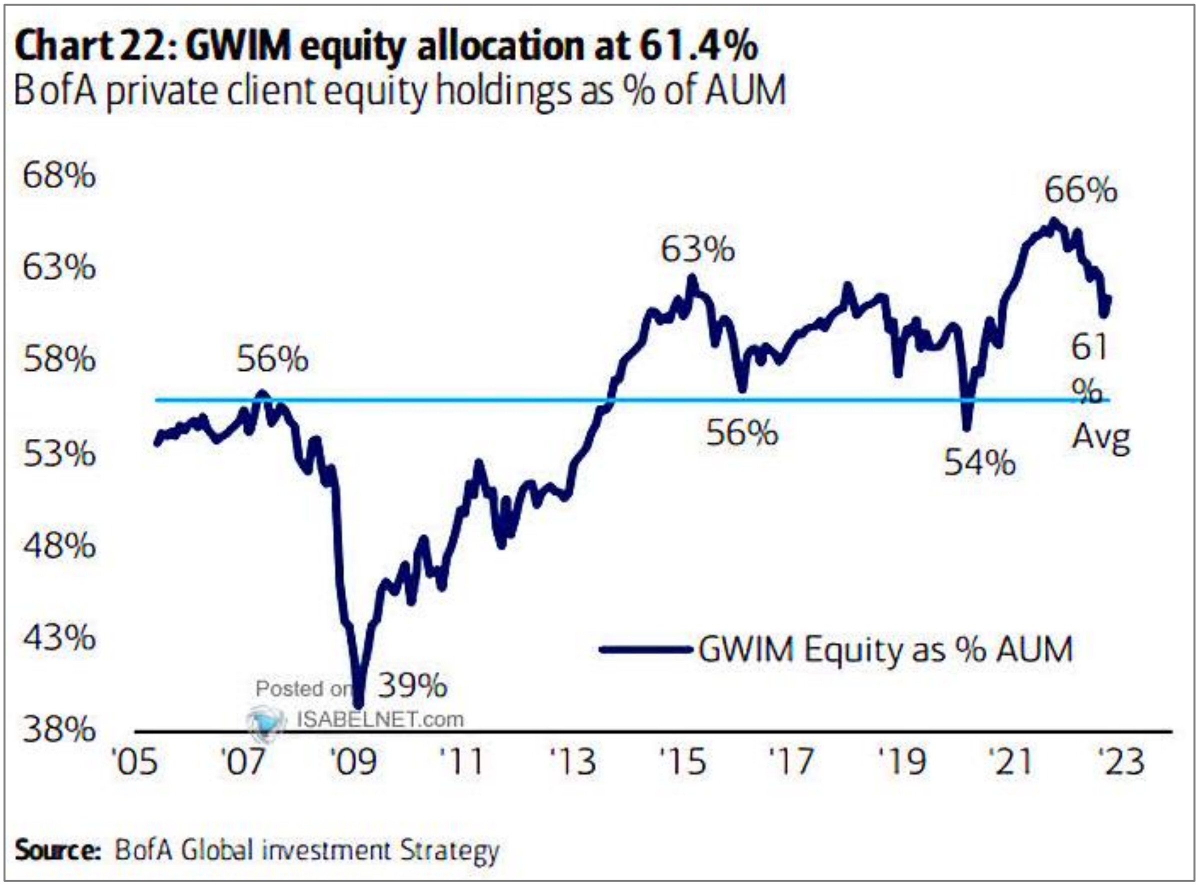
Only George Washington and his contemporaries lived through a worse rout in Treasury Bonds.



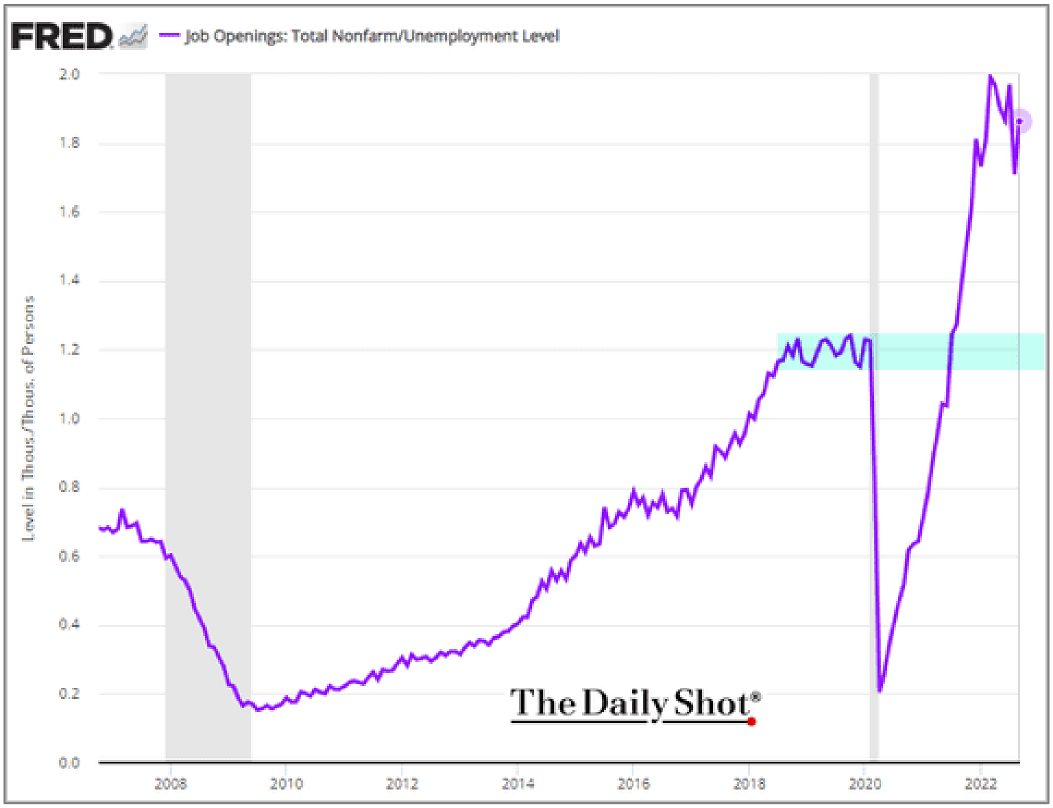
Realized Long-term Returns for US Treasuries have fallen to 50-yr Lows



Equity Allocations are still well above average.



Ratio of Job Openings to Unemployment is running too hot.



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.