Market Outlook

By Mark T Dodson, CFA

Psychology's Good Timing

Market Risk Index improved to 73.3% on a drop in the risk score from the Monetary Composite, as a drop in yields on corporate bonds and 2Yr Treasuries since the start of November has been sharp enough to bring their respective rates of change back into a zone that is neutral for the Monetary Composite and financial markets. Consequently, falling yields have also pushed the yield curve's inversion to within just a few basis points of a negative slope of exceeding the dot com bubble. The yield curve will become more of a headwind for the Monetary composite early in 2023 and will remain so for at least the first half of 2023.

Last week's move by the Psychology Composite into Euphoria (the worst 20% of scores) proved timely for timing a stock market decline this week. This is a crucial level to watch during bear market rallies, as rallies are often at risk of failure when crossing into that zone. Below are some charts with examples from the 2000 and 2008 bear markets. The ends of bear markets also often coincide with prolonged indications of fear, meaning the Psychology Composite stays camped in the best quintile of readings for longer than what we have seen thus far.

The Options category has been moving in the opposite direction as the Psychology Composite over the last eight weeks, giving positive readings. A high equity put/call ratio is the main reason why. The equity put/call ratio has moved into a zone that we have been looking for as a precursor to the end of the bear market, among a handful of other indicators we hold in high regard. It's highly unusual to see equity put/call register extreme fear coincident with a stock market rally. It has only happened twice before – in 2008 during the bear market rally that ensued after the Bear Stearns collapse and in 2016 near the end of that correction. Regardless of the reason, it reinforces the lessons we have learned over the years to build redundancy into our process and avoid relying too much on any single indicator.

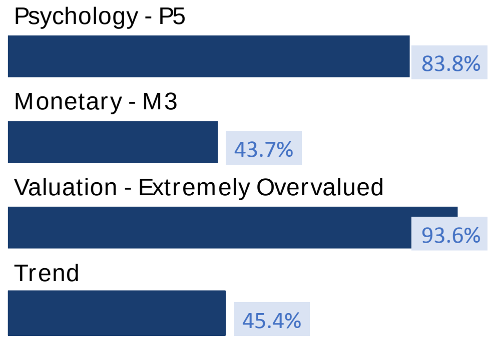
Also worth noting – the High Low Logic Index for the NYSE has joined the NASDAQ in giving a more severe warning of a bifurcated, unhealthy market. The indicator has provided an excellent road map throughout the bear market, helping avoid the noise from technicians who have quickly highlighted a bevy of breadth thrusts on every minor rally throughout 2022. High Low Logic has not

Market Risk Index

Rec Allocation 25% Underweight

73.3%

Category Percentiles



Largest Psychology Influences

Option Activity	Positive
Leveraged Investments	Negative
Flow of Funds	Negative
Surveys	Positive

Largest Monetary Influences

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

Valuation

7-10 Year Equity Return Forecast	2.5%
10Yr US Treasury Yield	3.5%

Market Trends

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

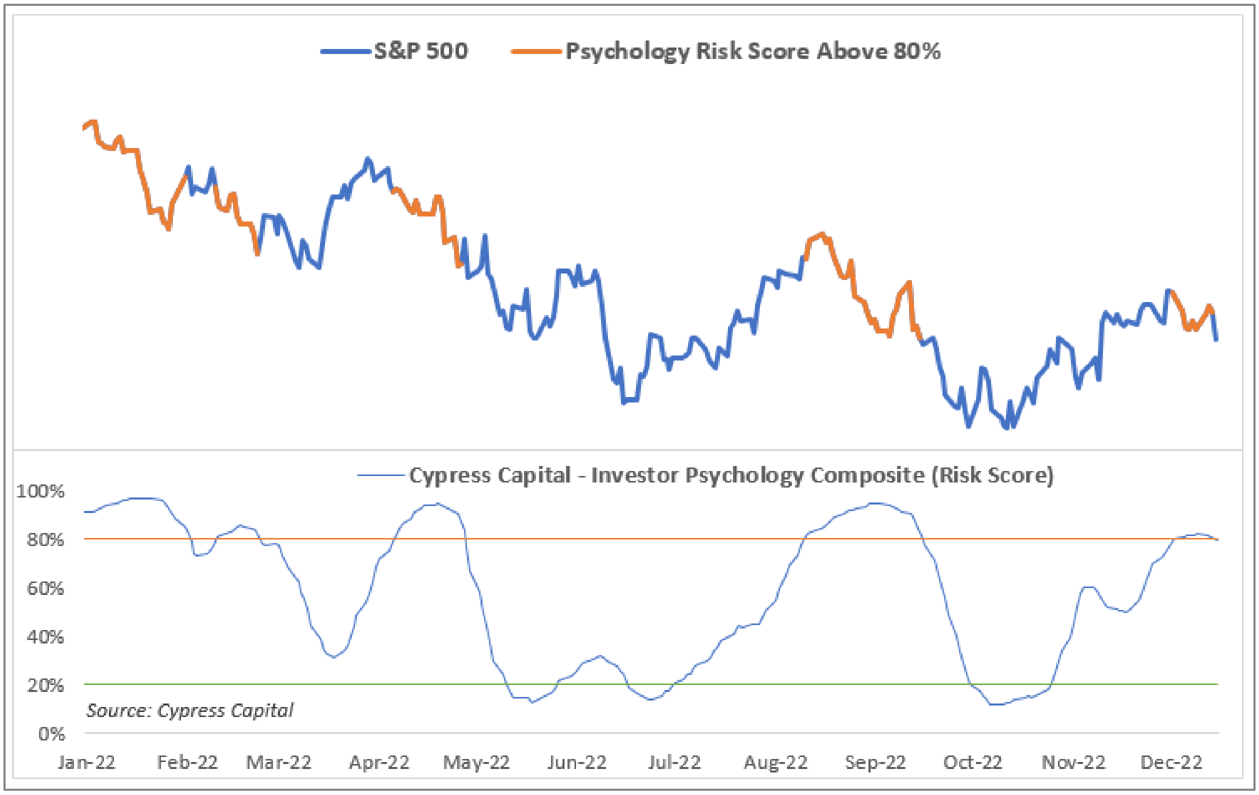
Market Risk Index scales from 0 to 100%. Higher readings correspond with higher risk markets. Scores below 25% are bullish. Scores between 25-75% are neutral, and scores above 75% are markets vulnerable to major drawdowns.

confirmed any of those breadth thrusts, and it has a perfect record signaling the start of every bull market for the last half a century.

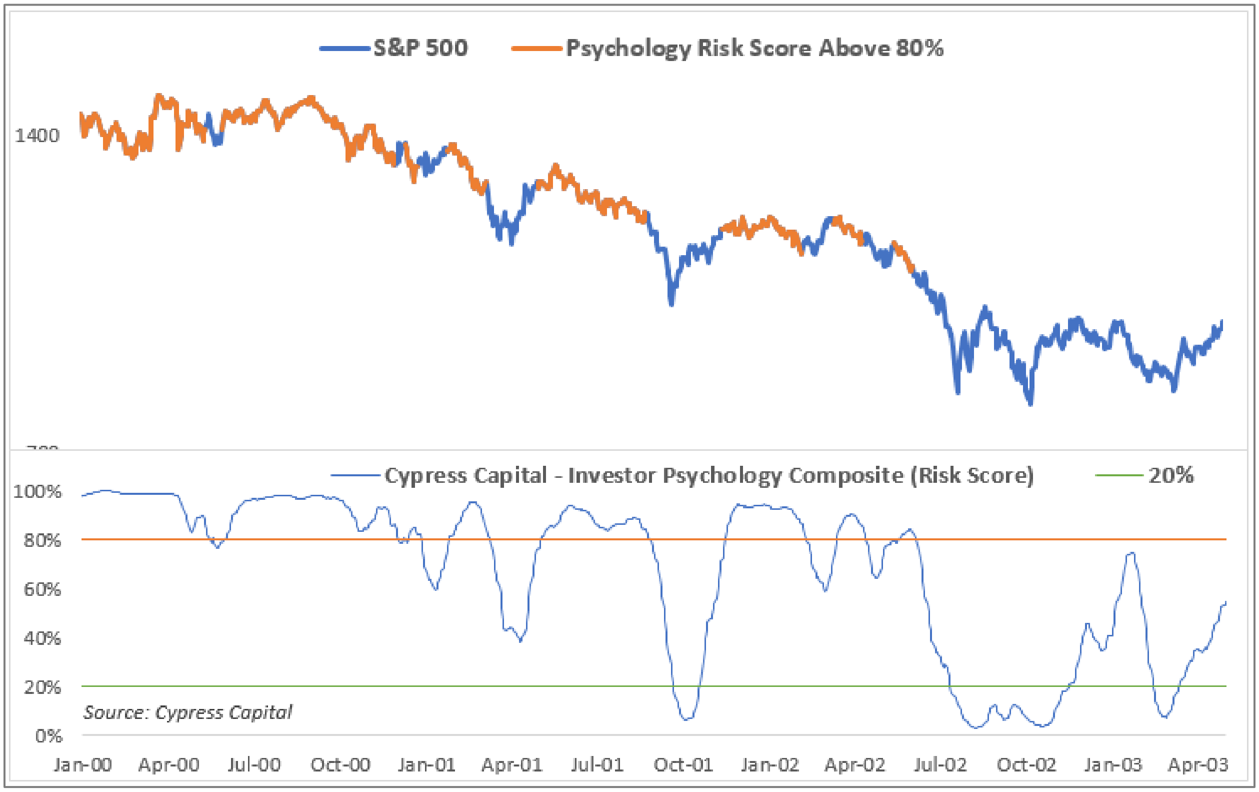
The weight of the evidence still leads us to believe that the bear market will take out its lows in 2023, and our game plan is to lean heavily on our process to tell us when to move off the sidelines and deploy assets back into financial markets.

Charts of the Week

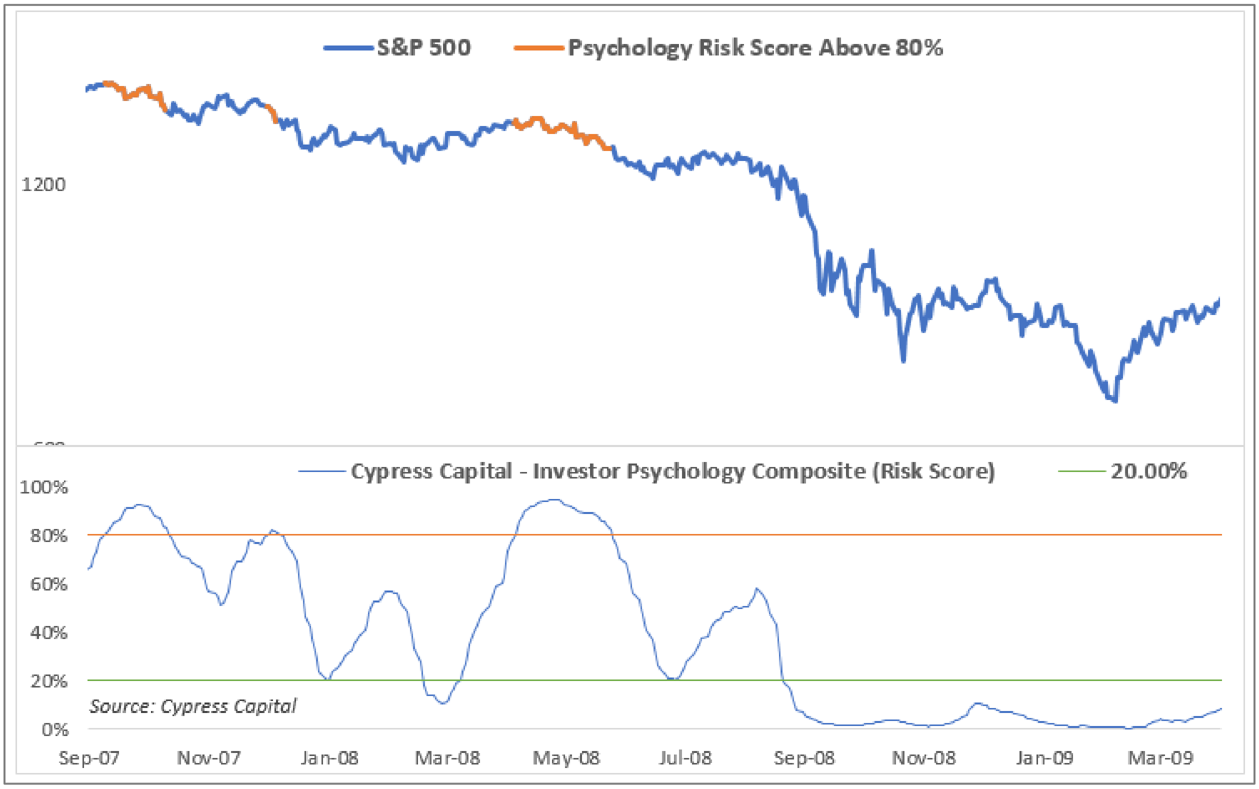
Psychology Composite Risk Score (2022 Bear Market)



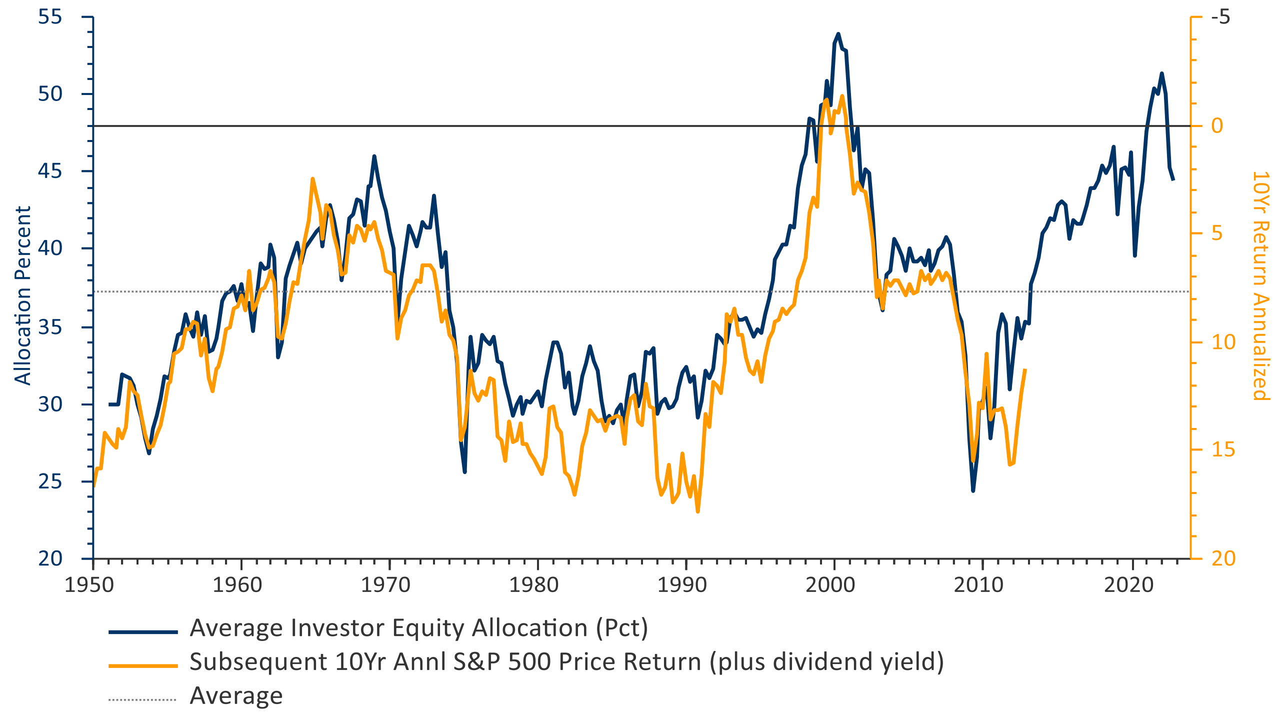
Psychology Composite Risk Score (2000-2003 Bear Market)



Psychology Composite Risk Score (2008 Bear Market)

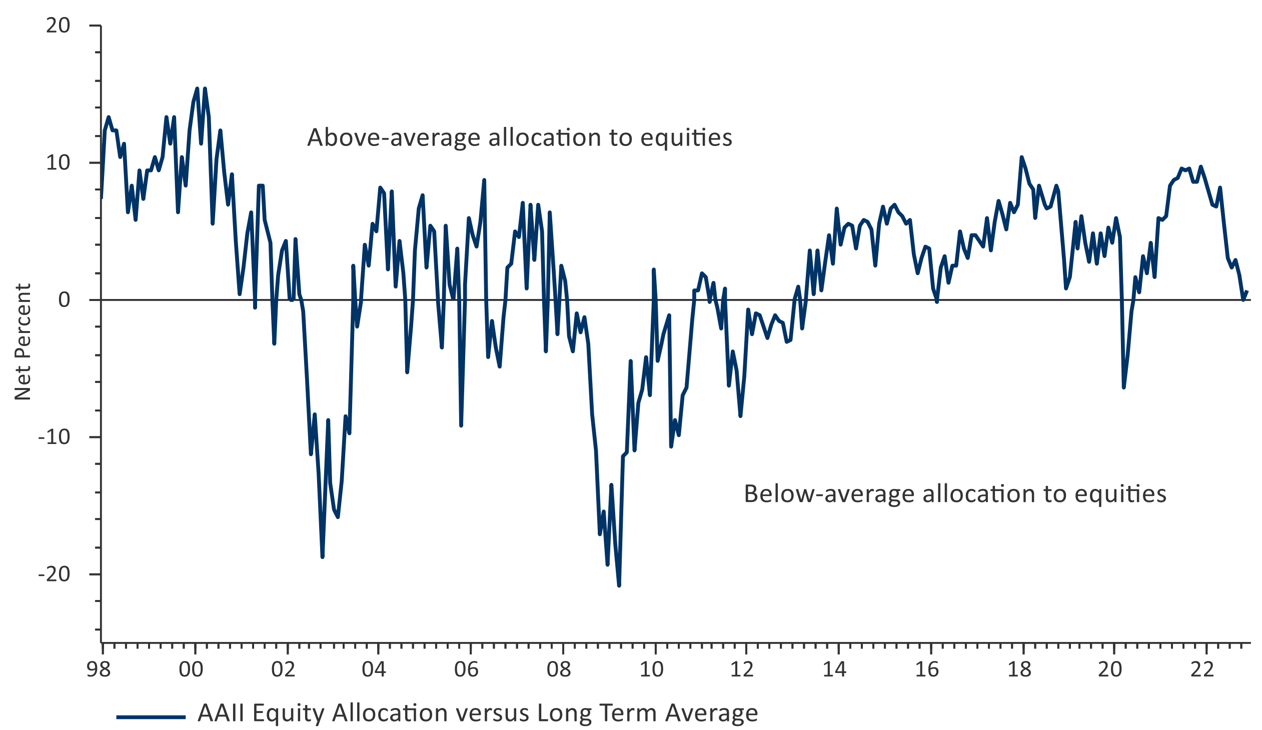


Household's Average Equity Allocation is where it was at the first stage of the 2000 bear market.
The forward market return implied by current positioning is within a few basis points of the equity return forecast coming from our Valuation composite.



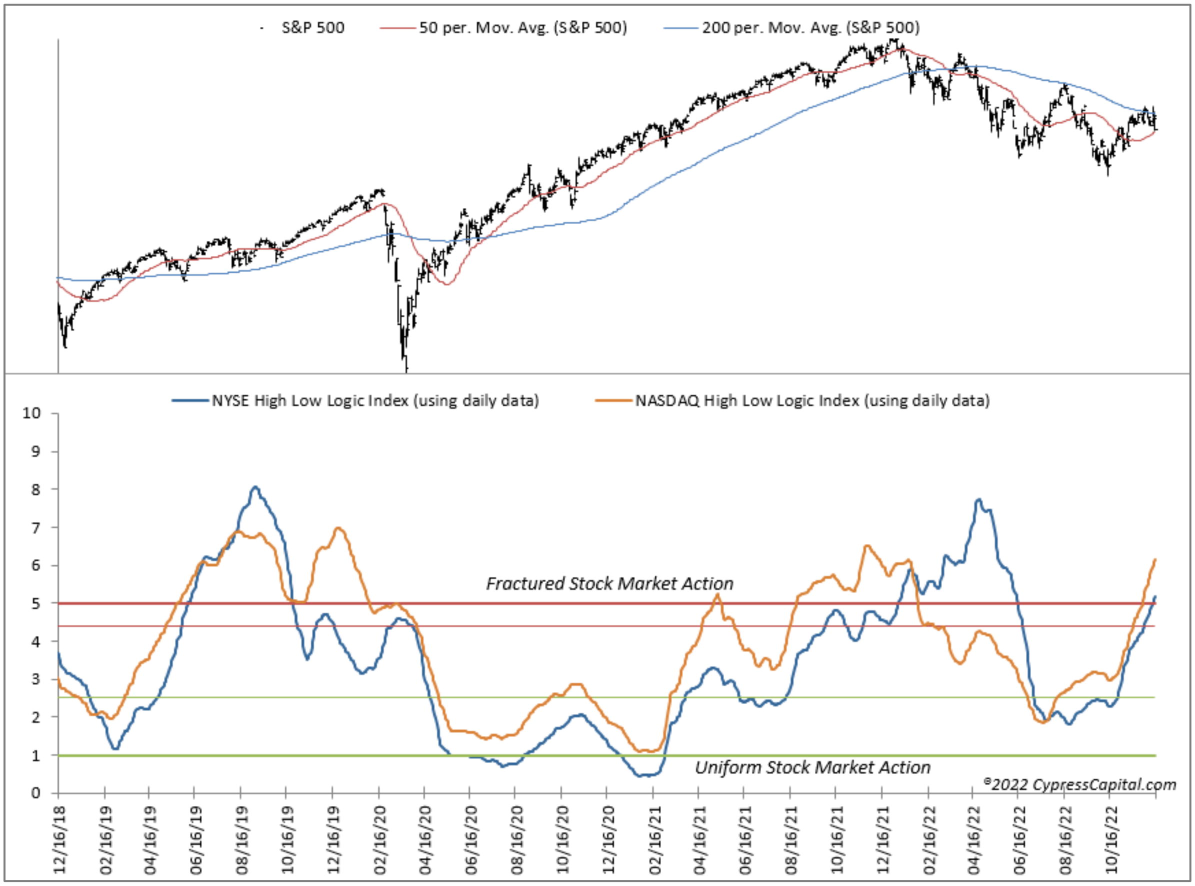
Source: Refinitiv Datastream, Federal Reserve, Cypress Capital

AAII Allocation Survey – equity allocations are above average and well above previous bear market bottoms.



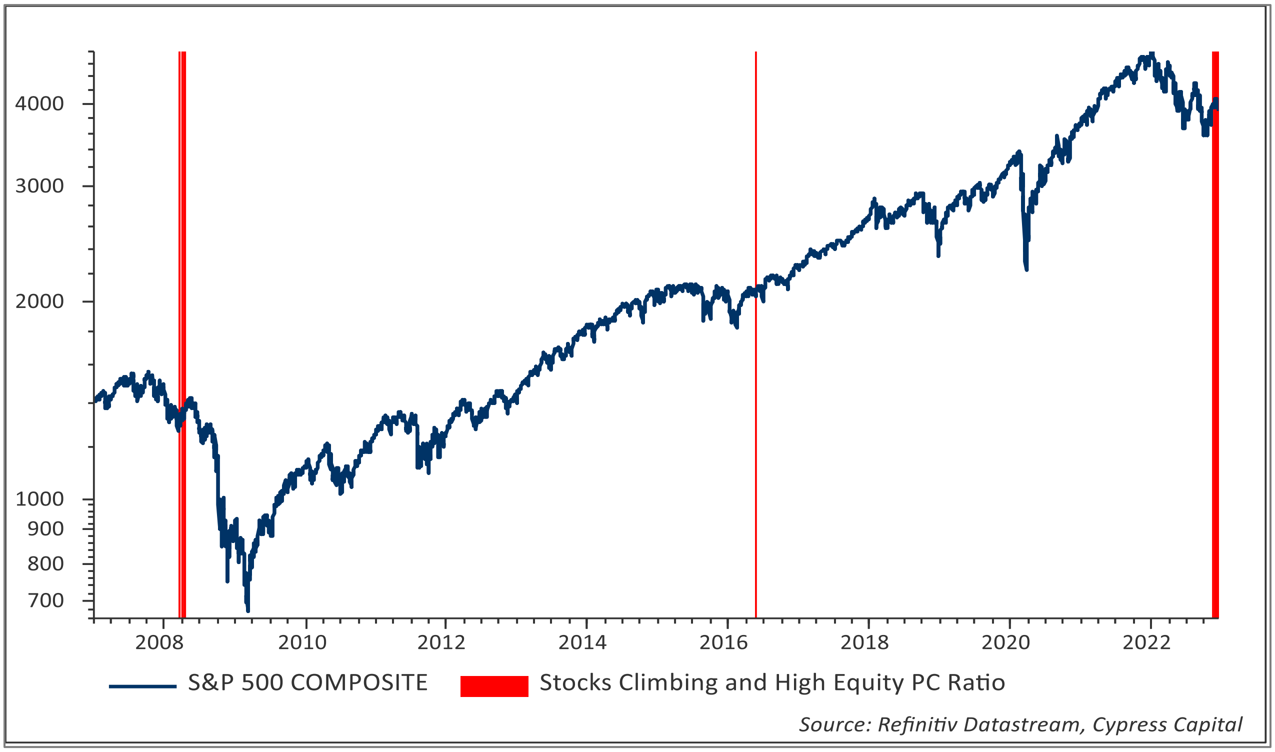
Source: Refinitiv Datastream, Cypress Capital

High Low Logic Index – Both NASDAQ and NYSE versions of the indicator are flashing red.

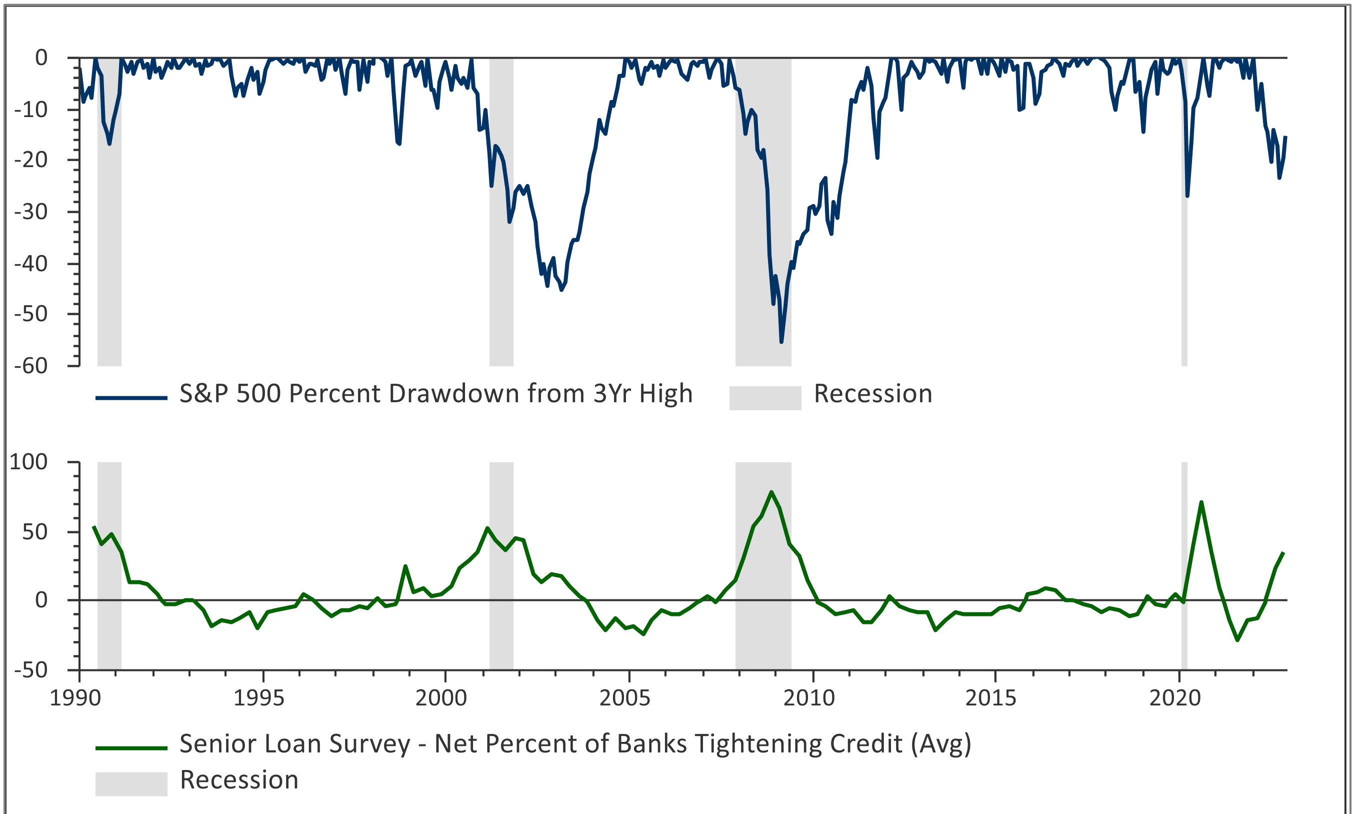


High and rising Equity Put/Call Ratios during market rallies

The equity put/call ratio has been high and rising during a stock market rally on only two other occasions – during a bear market rally early in the 2008 bear market and after the lows of the 2016 correction.

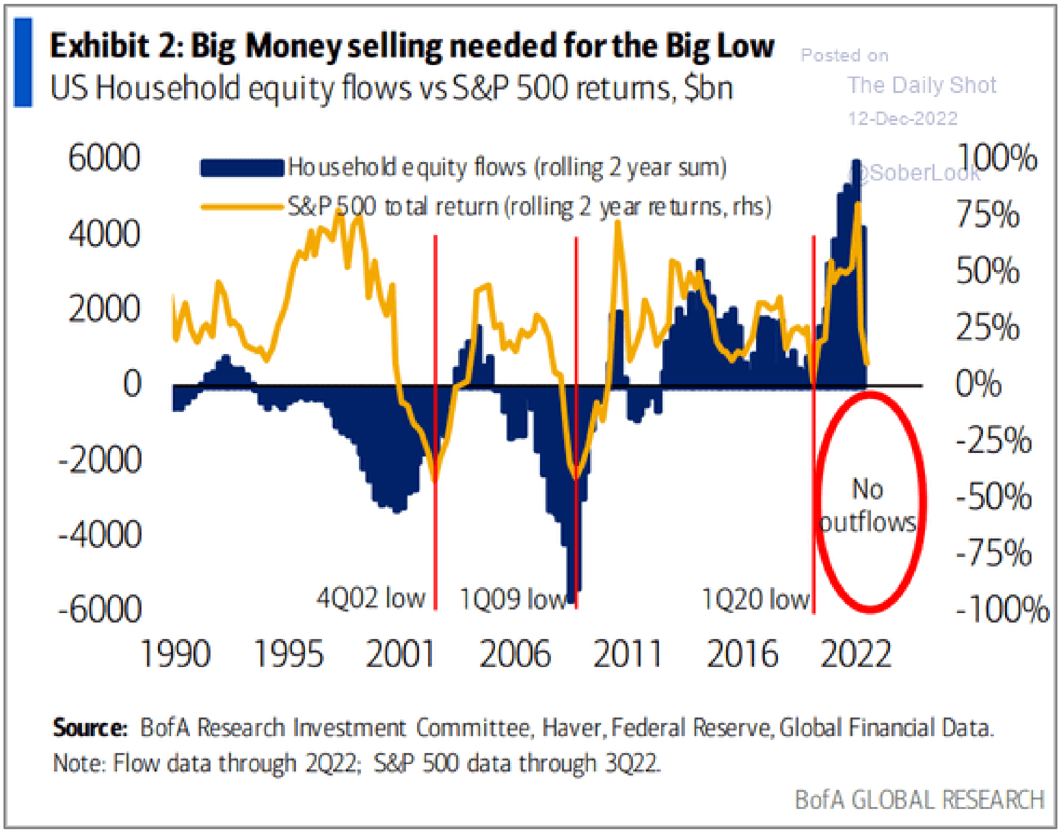


Commercial Bank Sentiment has soured enough to have recessionary implications.

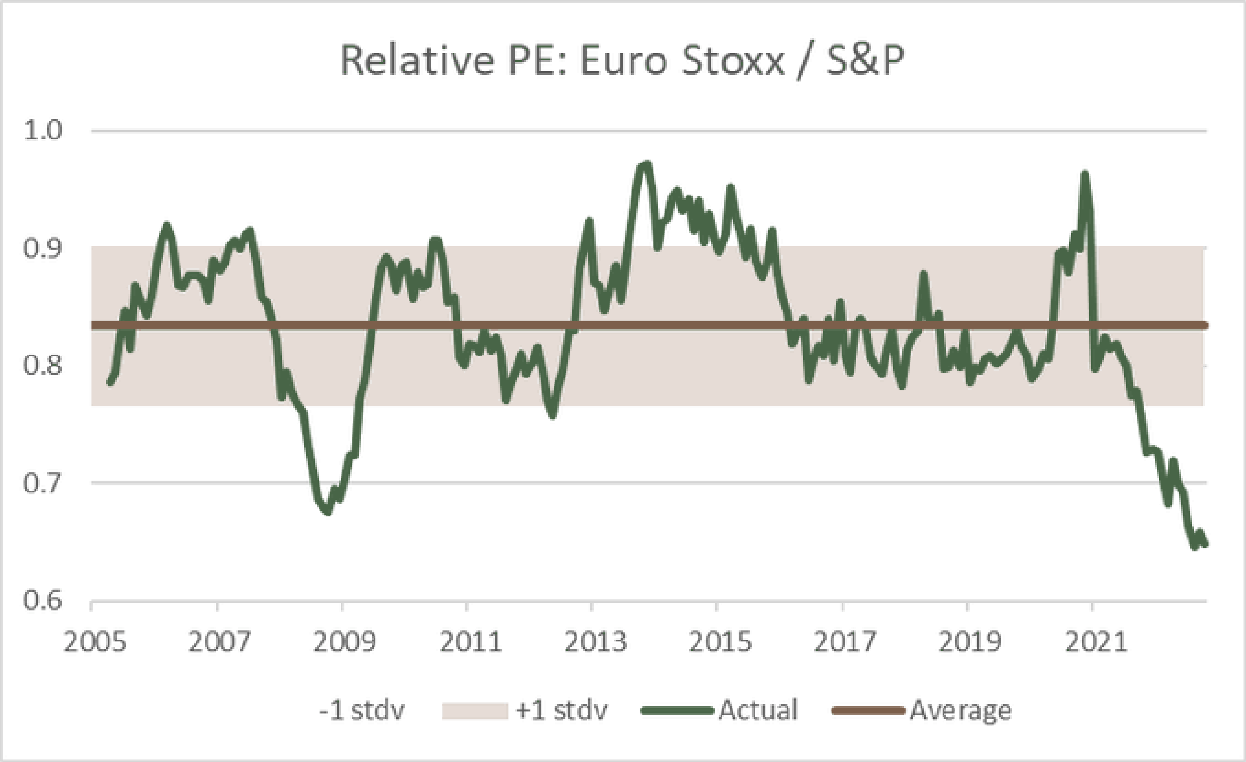


Source: Refinitiv Datastream, Cypress Capital

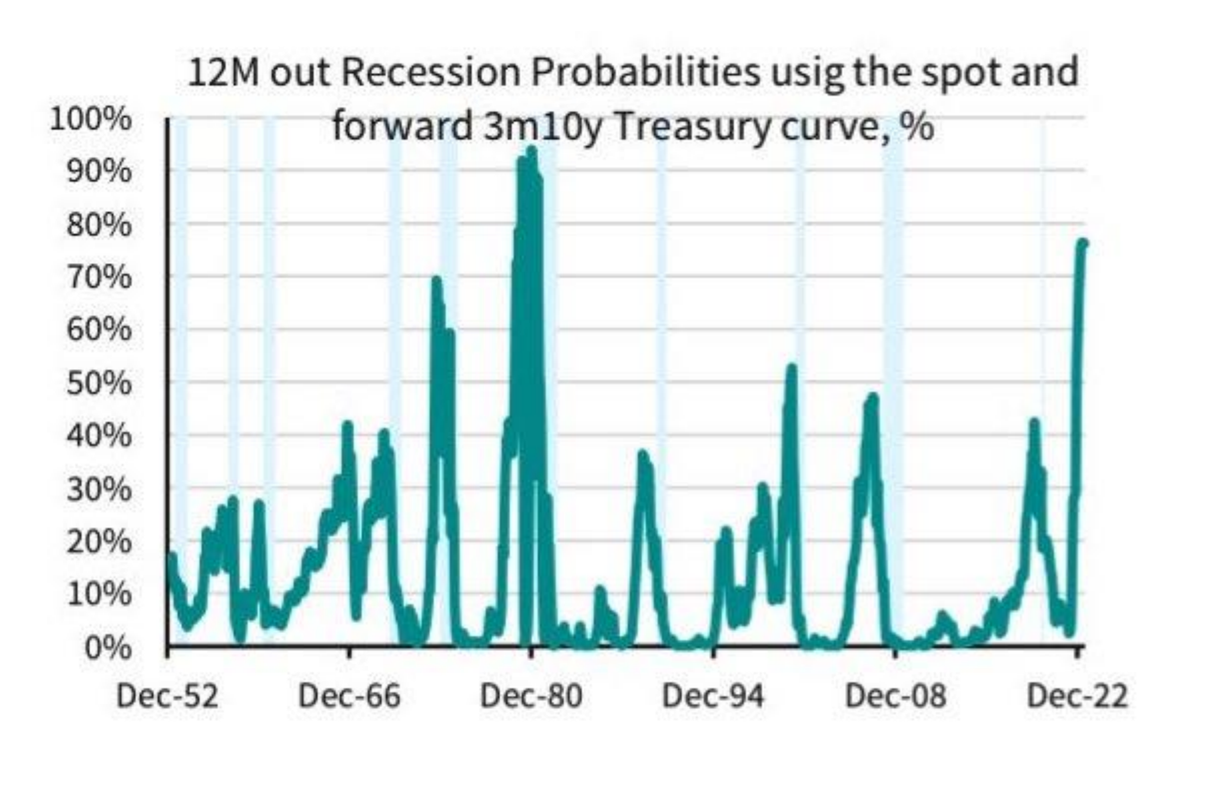
Household equity flows have stayed positive thus far in the bear market.



Cheap relative valuations on European stocks

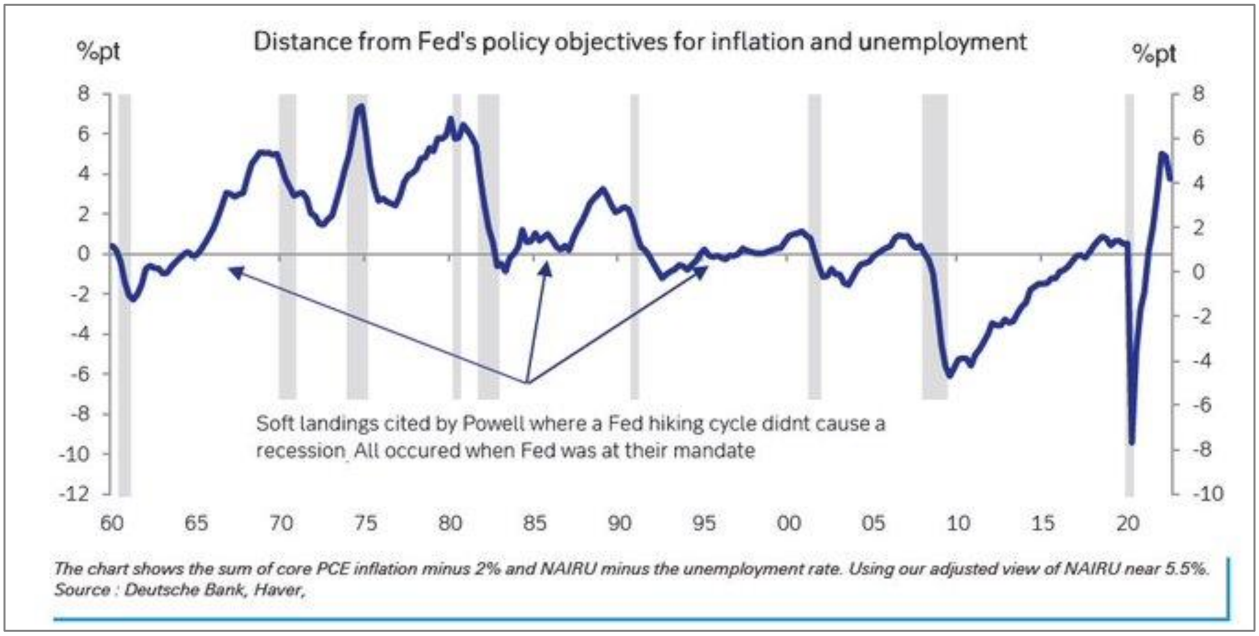


Yield Curve implied recession probability climbs above 70%

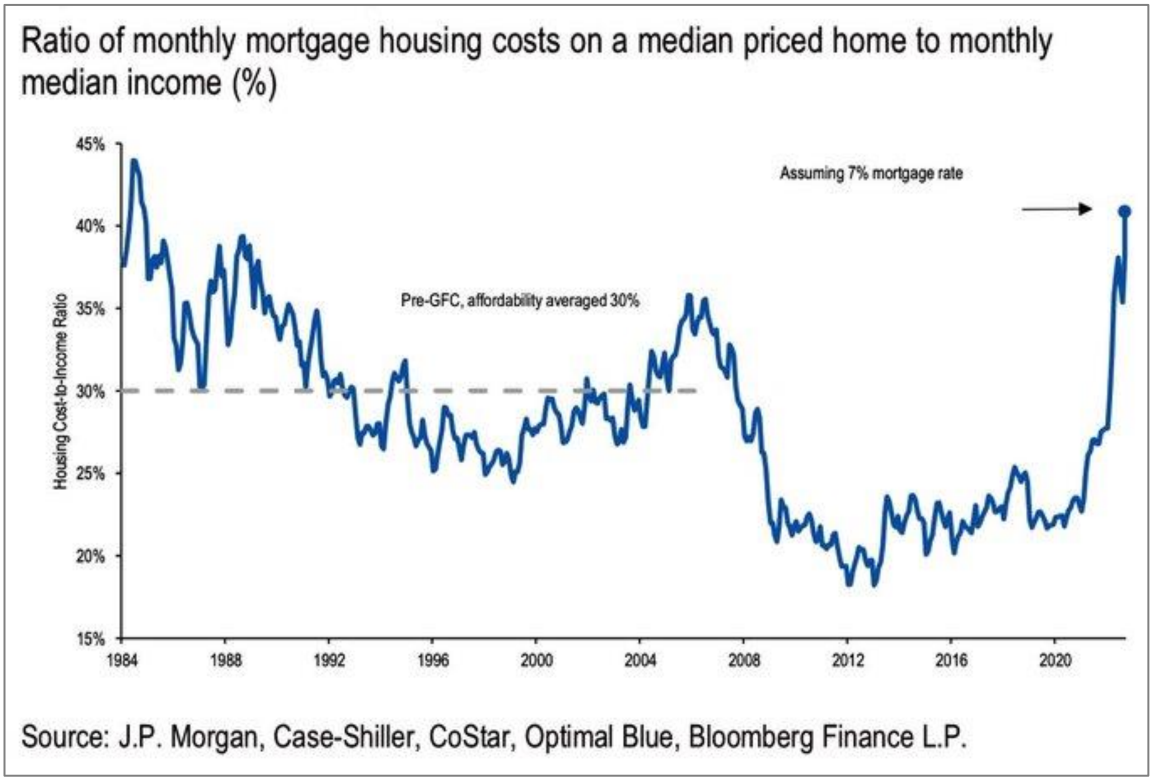


Source: Bloomberg, Barclays Research

Fed is too far away from their dual mandate to suggest a soft landing is possible.



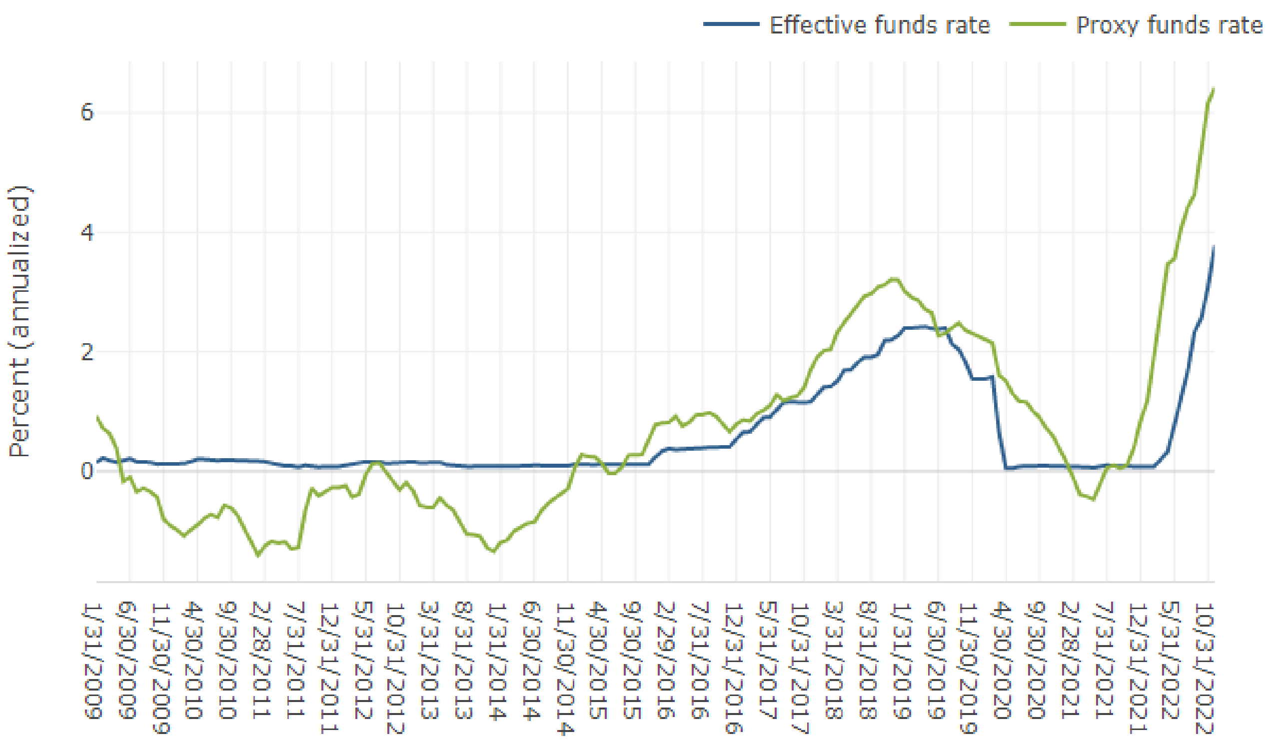
Higher mortgage rates have set housing affordability back to the 1980s.



Proxy Fed Funds Rate climbs above 6%.

Proxy funds rate attempts to incorporate the impact of forward guidance and changes in the Fed's balance sheet on monetary policy in addition to the Fed setting a Fed Funds rate target.

Chart 1: Proxy funds rate and effective federal funds rate



Source: Federal Reserve Board of Governors, Freddie Mac, The Bond Buyer, Moody's, and Choi et al. (2022).

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.