Market Outlook

By Mark T Dodson, CFA

Psychology moves into the worst quintile of readings.

Market Risk Index increased 7.5% to 68.5% on a 10% jump in the Psychology Composite risk score. Most notable about that jump is that it has taken our Psychology Composite back into the worst quintile of readings, the level for us that denotes environments that are developing excess enthusiasm.

As a brief refresher, we increased our equity allocation modestly in October on the move by Psychology into the best quintile of readings, comforted with the knowledge that the S&P 500 hasn't fallen over the six months from November to April after a mid-term election since before World War II. The period averages a double-digit return – it's the single best six-month seasonal period to be a stock market investor based on calendar anomalies. We reversed that decision in December as the Psychology Composite moved into that worst quintile of readings. The repairs to Psychology early in January were inconsequential, as the stock market rally has driven Psychology back into the red zone.

At the same time, the Technical Indicators category of the Psychology composite has become the single largest positive influence on Psychology, so much so that two of our four "bull market watch" indicators are again signaling the start of a new bull market. The same two indicators also gave new bull signals during the August bear market rally, which proved to be failed signals soon after. Still, our favorite of those four, the NYSE High Low Logic Index, is also improving rapidly.

Despite an improving technical picture, we are not suffering from a case of FOMO, as the fuel to power a new bull market is paltry. We quantify this as well, having observed that bull markets that began with higher readings on MRI have had substantially lower returns and shorter durations. For example, the median bull market return since 1970 is 75%, whereas the median bull market return when MRI falls below 25% climbs to more than 320%.

An example is the technical bull market that began after 9-11. We often muddle history and think of that as one long bear market from 2000-2003, but it was technically two bear markets. The rally off the September 11 lows was powerful enough to push the stock market into a new bull market by early 2002, after which it soon failed with a 29% overall return. The ensuing bear market continued into 2003 despite the recession officially ending in late

Market Risk Index

Rec Allocation 25% Underweight

68.5%

Category Percentiles

Psychology - P5

81.6%

Monetary - M3

38.9%

Valuation - Extremely Overvalued

94.5%

Trend

51.6%

Largest Psychology Influences

Technical Indicators	Positive
Leveraged Investments	Negative
Volatility	Negative
Option Activity	Positive

Largest Monetary Influences

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

Valuation

7-10 Year Equity Return Forecast	2.1%
10Yr US Treasury Yield	3.5%

Market Trends

US Equities	Bullish Trade
Intl Equities	Bullish Trade
REITs	Bullish 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.

2001. In that bear market, it was a matter of curing the excesses of the dot com bubble. We believe it remains a relevant analog for the current environment.

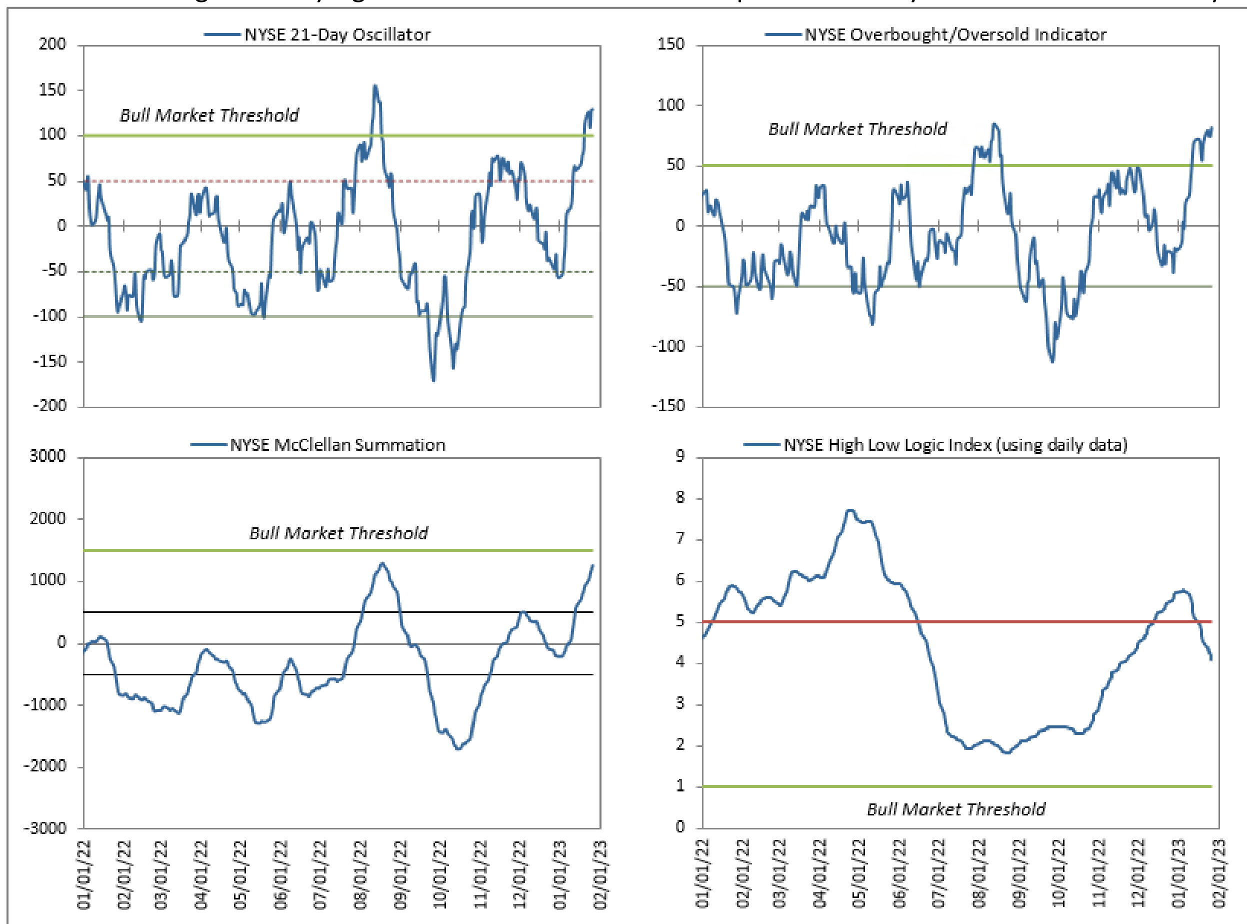
Strong bull markets are built on a combination of an economic backdrop that can fuel an extended credit cycle, reasonable equity valuations, and a Federal Reserve that is aggressively easing. We have none of those today. This market continues to rally on the narrative of a Fed pause, a soft-landing, and economic stimulus resulting from China's reopening. Instead of pricing in economic or earnings recession, the consensus is taking a contrarian position that we likely won't have one because too many investors expect it. We are skeptical of this notion based upon the average investor's above-average equity positioning.

However, markets never follow a neat script – we've learned from being humbled by financial markets to avoid "all or none" investing and to instead allocate assets to equities on a continuum based upon prevailing conditions. It's why we have maintained some allocation to equities despite a bearish message coming from MRI in 2022, and it's also why we'll patiently wait for a better setup to take a more aggressive posture.

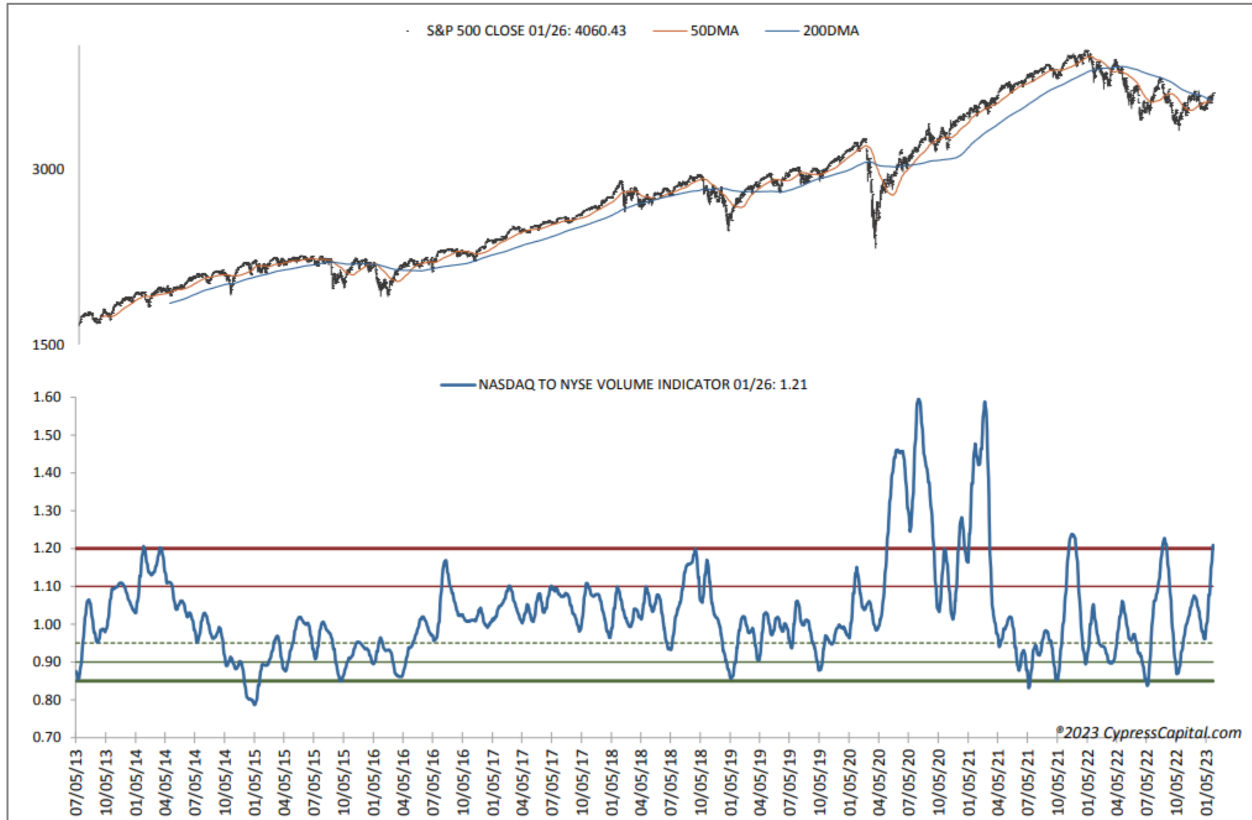
Charts of the Week

Improving Technical Picture has us on new bull market watch

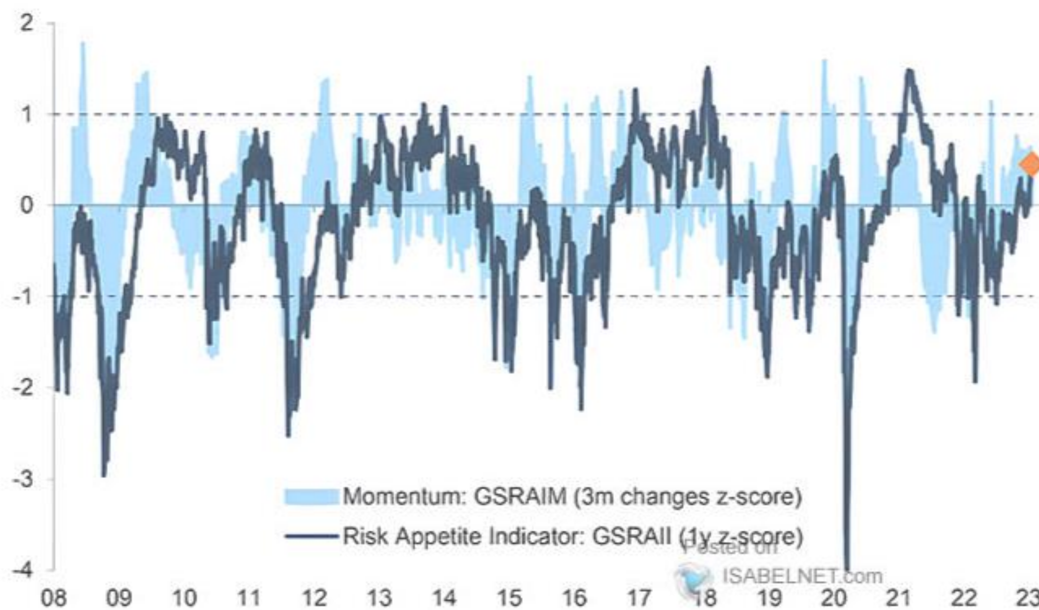
Two of our four favorite indicators for heralding new bull markets have reached their threshold, the same two that failed in August. A buy signal from all four indicators has preceded every bull market for over 60 years.



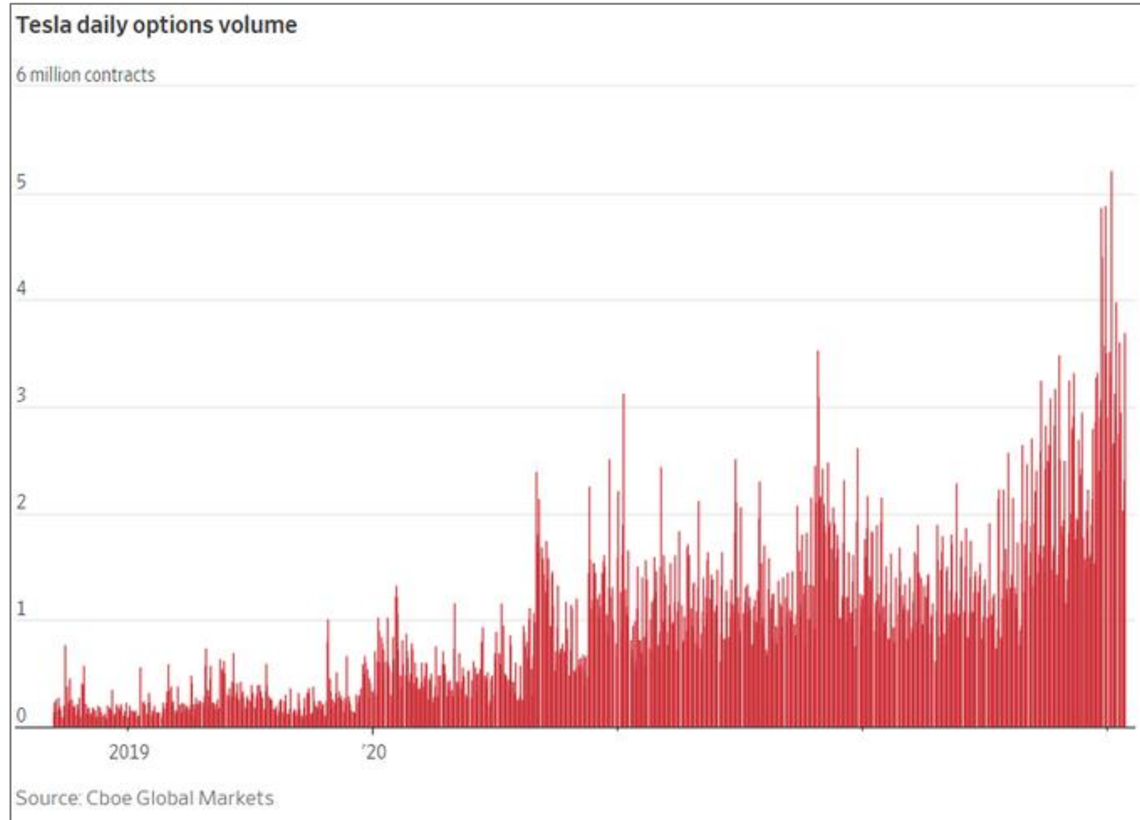
NASDAQ to NYSE Volume Indicator is registering similar enthusiasm as the August bear market rally.



Goldman's Risk Appetite Indicator shows risk-taking is on the rise.

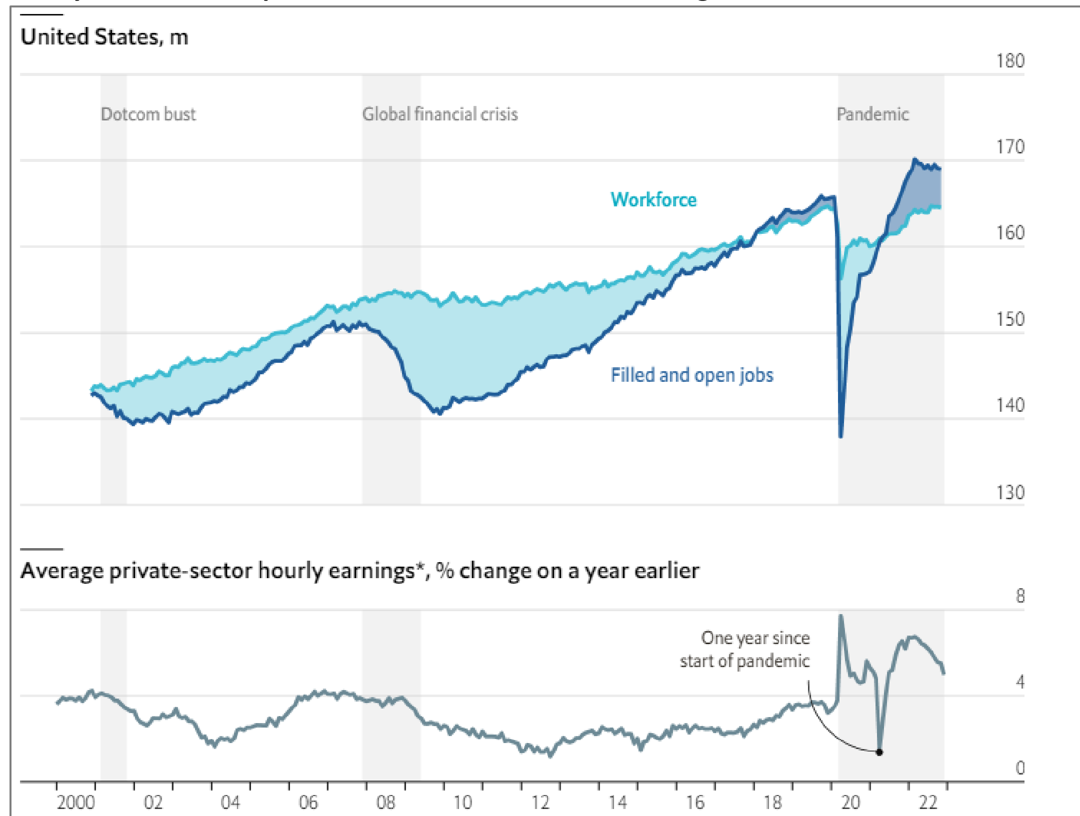


According to the WSJ, speculation in TSTLA now accounts for 7% of all options trading on an average day.



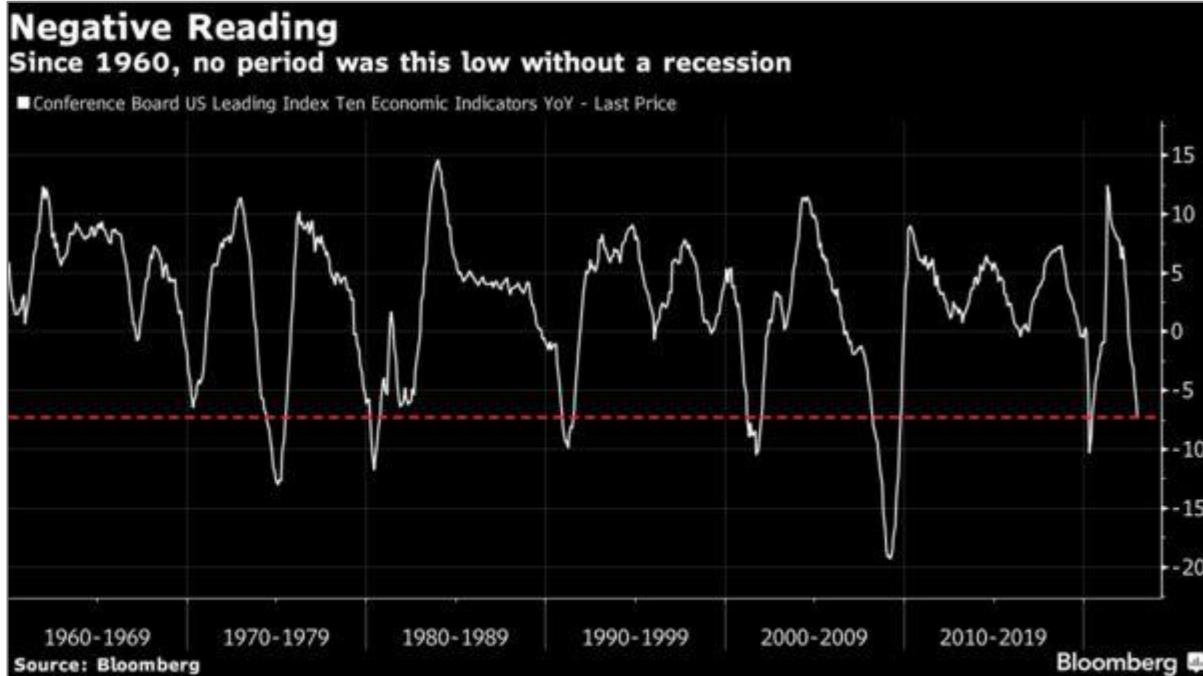
Source: WSJ

The cyclical inflation peak has not cured the labor shortage.

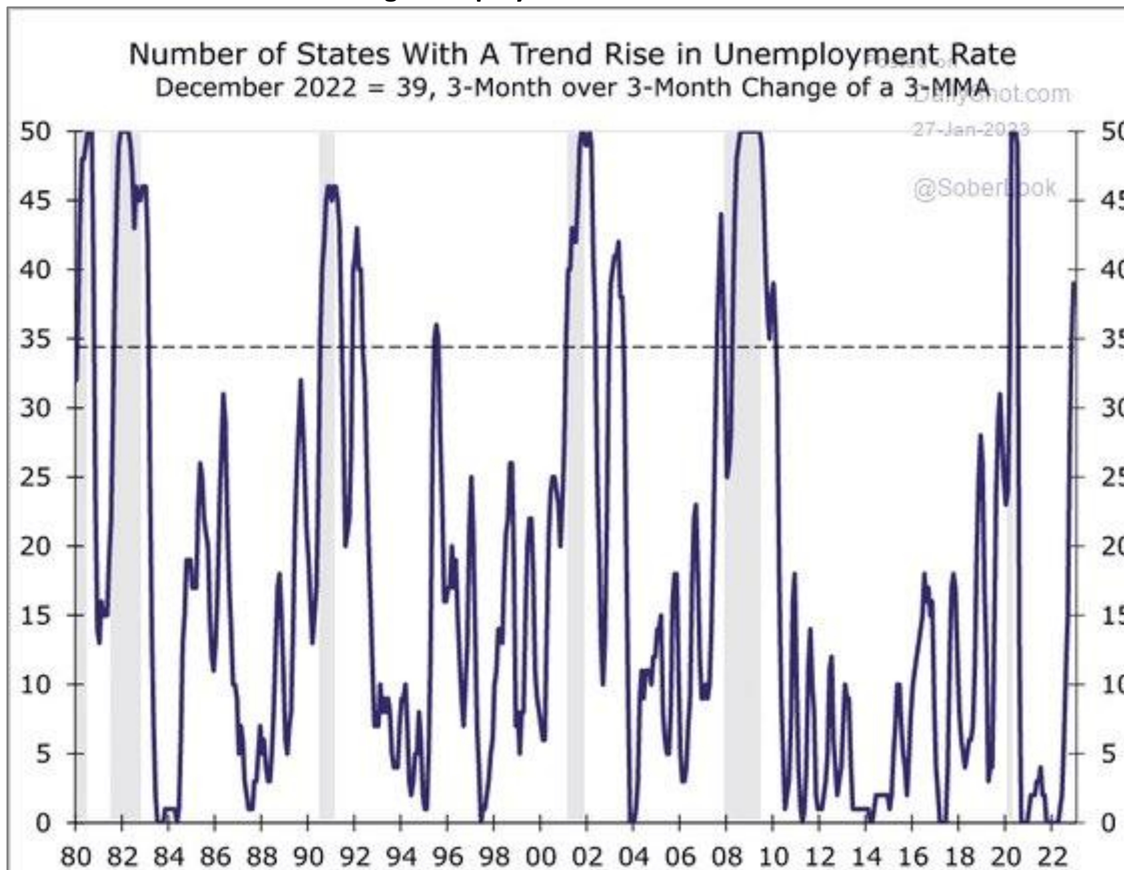


Source: The Economist

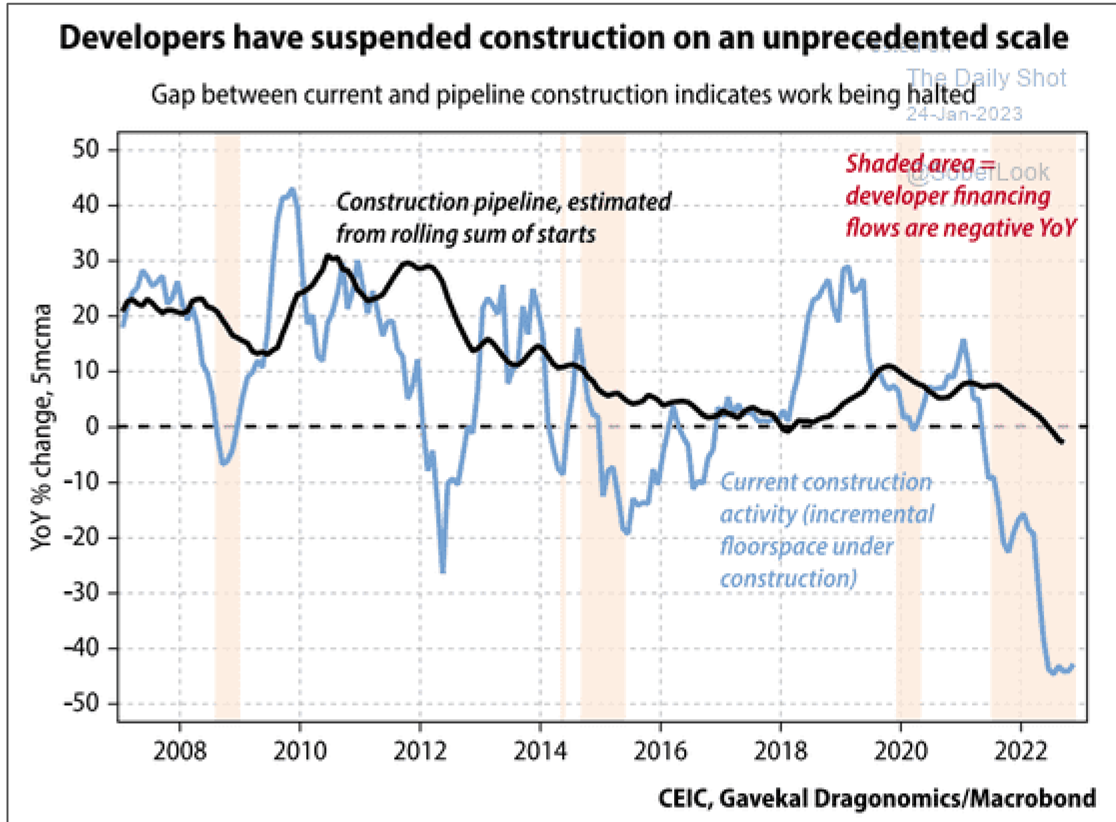
Since 1960, Leading Economic Indicators have never fallen this much without a recession.



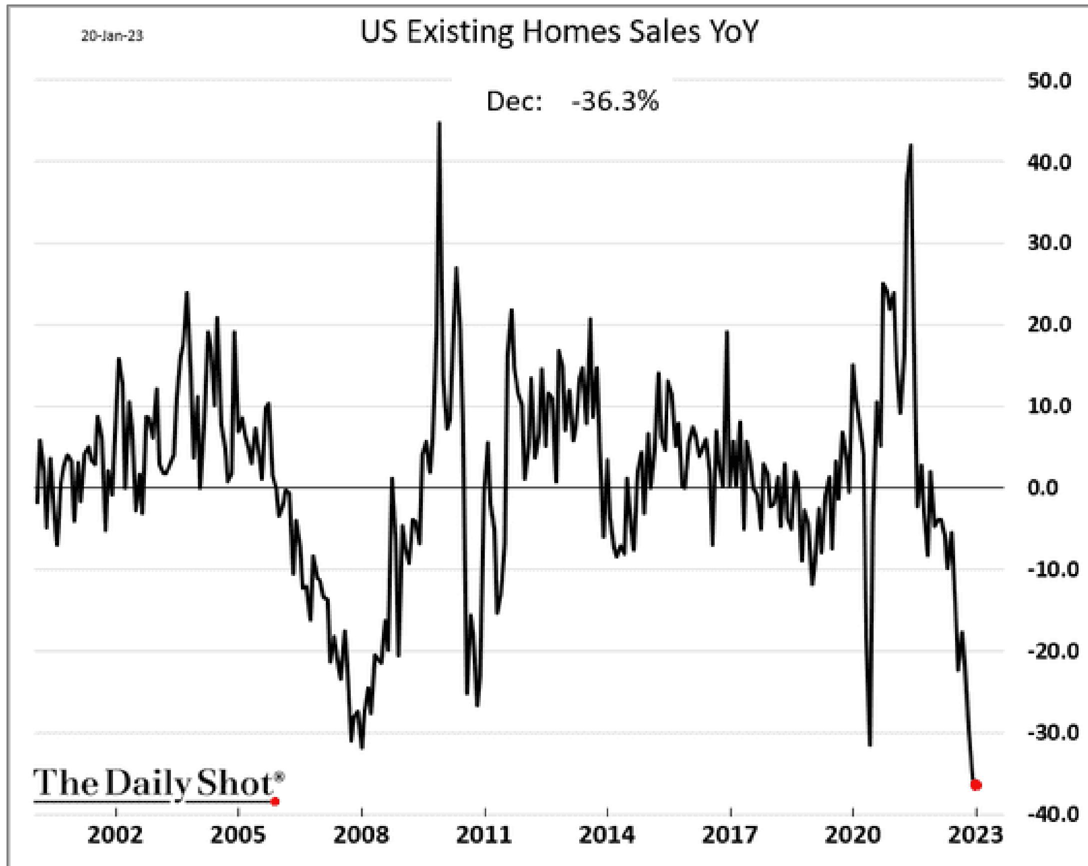
The number of states with rising unemployment has breached the recession threshold.



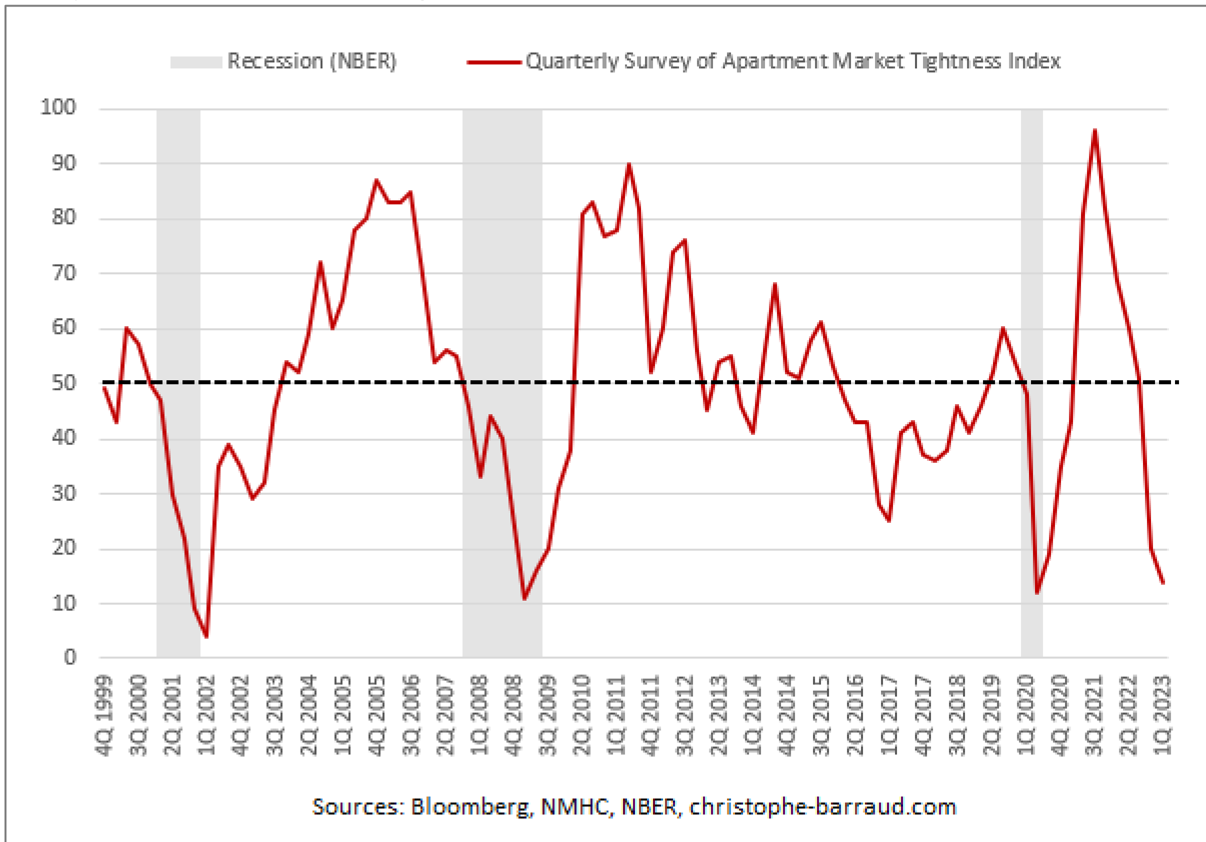
Developers are suspending construction on an unprecedented scale.



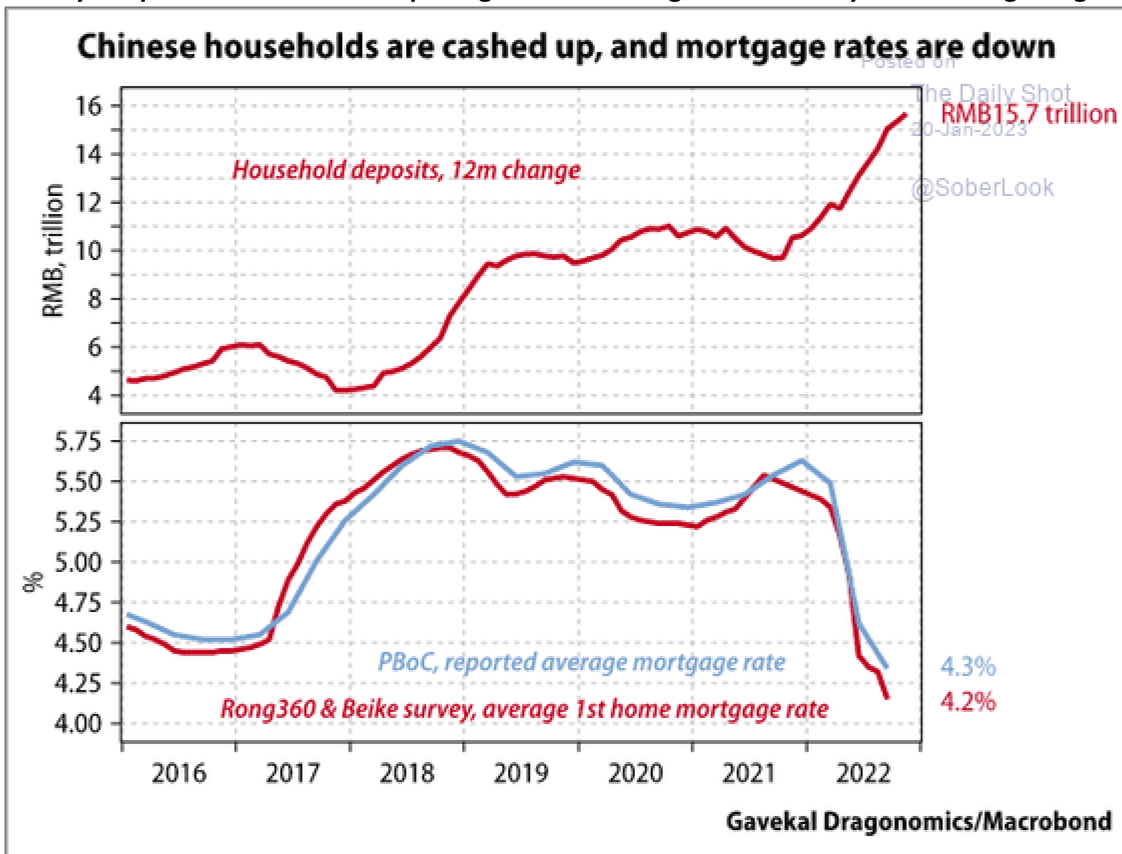
Sharp drop in US Existing Home Sales



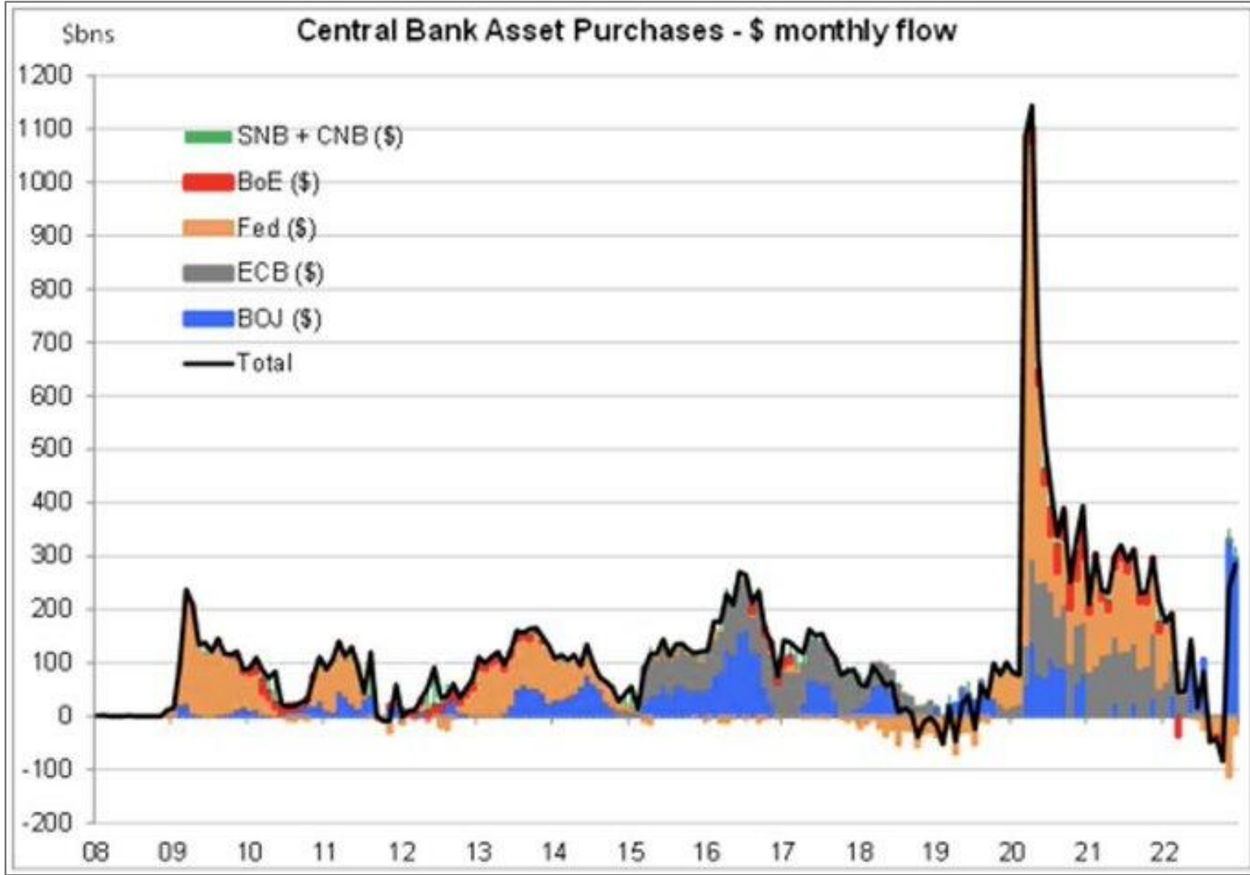
The Apartment Market is softening.



Money to spend - will China's reopening stimulate the global economy without reigniting inflation?



Central Bankers can't shake the habit. The Bank of Japan is back to printing money...and at a record pace.



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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