Market Outlook

By Mark T Dodson, CFA

Reigniting Animal Spirits

Market Risk Index climbed to 81.3%, as the Psychology Composite edged less than once percent away from what we consider Euphoric readings, and deterioration in the Monetary Composite that kicked off last week picked up some steam. Valuations also worsened to the worst five percent of readings.

This week, the shift back to enthusiasm was palpable, with investment surveys moving firmly into net bullish sentiment. The pace of selling by smart money corporate insiders was the heaviest since the stock market peak in 2021, and volume in options markets is undergoing the largest about-face in terms of sentiment, from bearish to bullish, that we have ever seen in such a short period.

Monetary Conditions worsened as the yield curve could begin to impact the economy as early as this spring. Bank Sentiment followed the standard script of a credit cycle – the Senior Loan Survey release showed that the number of banks tightening lending standards continues to increase. Meanwhile, pundits point to benign conditions in credit markets as signs of a soft landing, but that’s not how the credit cycle timeline works. From the point that the yield curve inversion reaches its most extreme, lending standards tend to tighten for another three quarters, and charge-offs and defaults from borrowers generally don’t peak for another three quarters after that. Those headlines of high defaults and charge-offs are what coincide with excellent stock market opportunities.

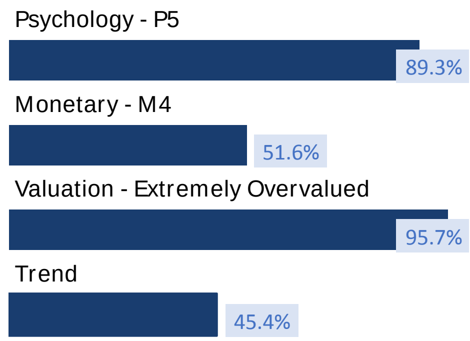
The most noteworthy bullish indications from the asset allocation model are purely Technical in nature, signals of strong breadth – some flashing signs that only come at the start of new bull markets. However, those technical signals lose some of their power without a wall of worry to climb, a Fed printing money, or valuations giving indications of an asymmetric risk-reward. While we don’t think the fundamentals are aligned for a robust new bull market, technicals may be pointing to a high probability that this current market will be able to reignite the Covid-stimulus era of animal spirits in a way that will surprise even the most seasoned stock market veterans. And, if policymakers aren’t careful, it will reignite another increase in the rate of inflation.

Market Risk Index

Rec Allocation 25% Underweight

81.3%

Category Percentiles



Largest Psychology Influences

Leveraged Investments	Negative
Option Activity	Negative
Volatility	Negative
Technical Indicators	Positive

Largest Monetary Influences

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

Valuation

7-10 Year Equity Return Forecast	1.6%
10Yr US Treasury Yield	3.6%

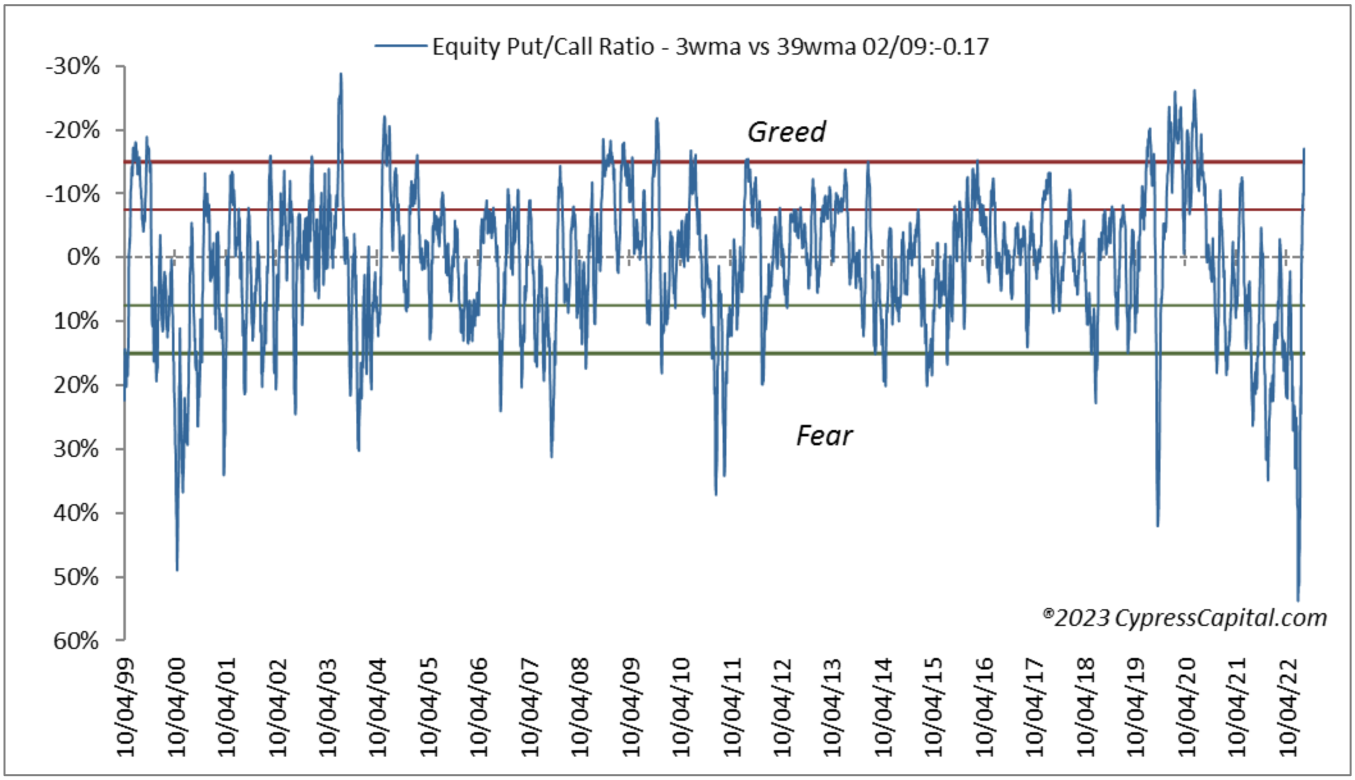
Market Trends

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

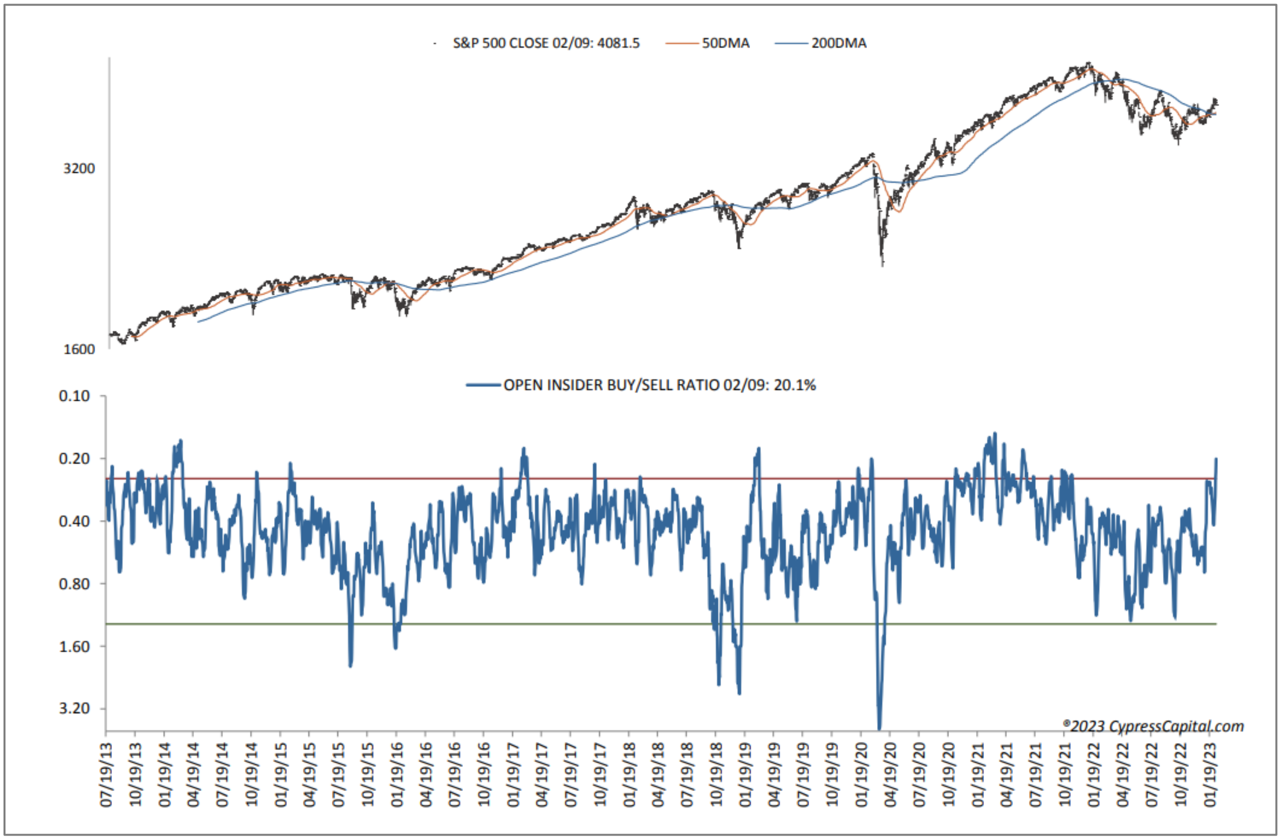
Market Risk Index scales from 0 to 100%. Higher readings correspond with higher risk markets. Scores below 25% are bullish. Scores between 25-75% are neutral, and scores above 75% are markets vulnerable to major drawdowns.

Charts of the Week

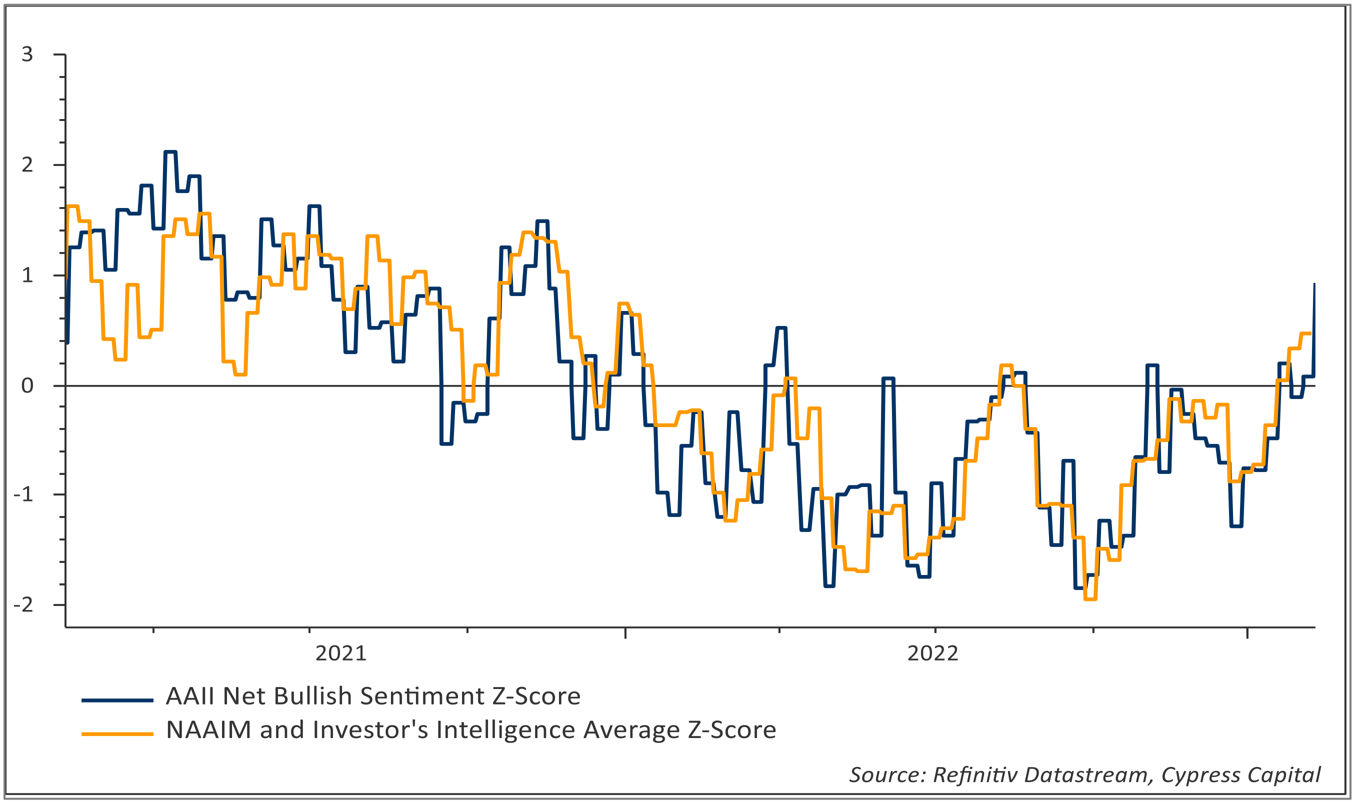
Equity Option markets are undergoing the fastest-ever shift from extreme fear to extreme greed.



Corporate Insiders are selling the 2023 stock market rally in a big way.

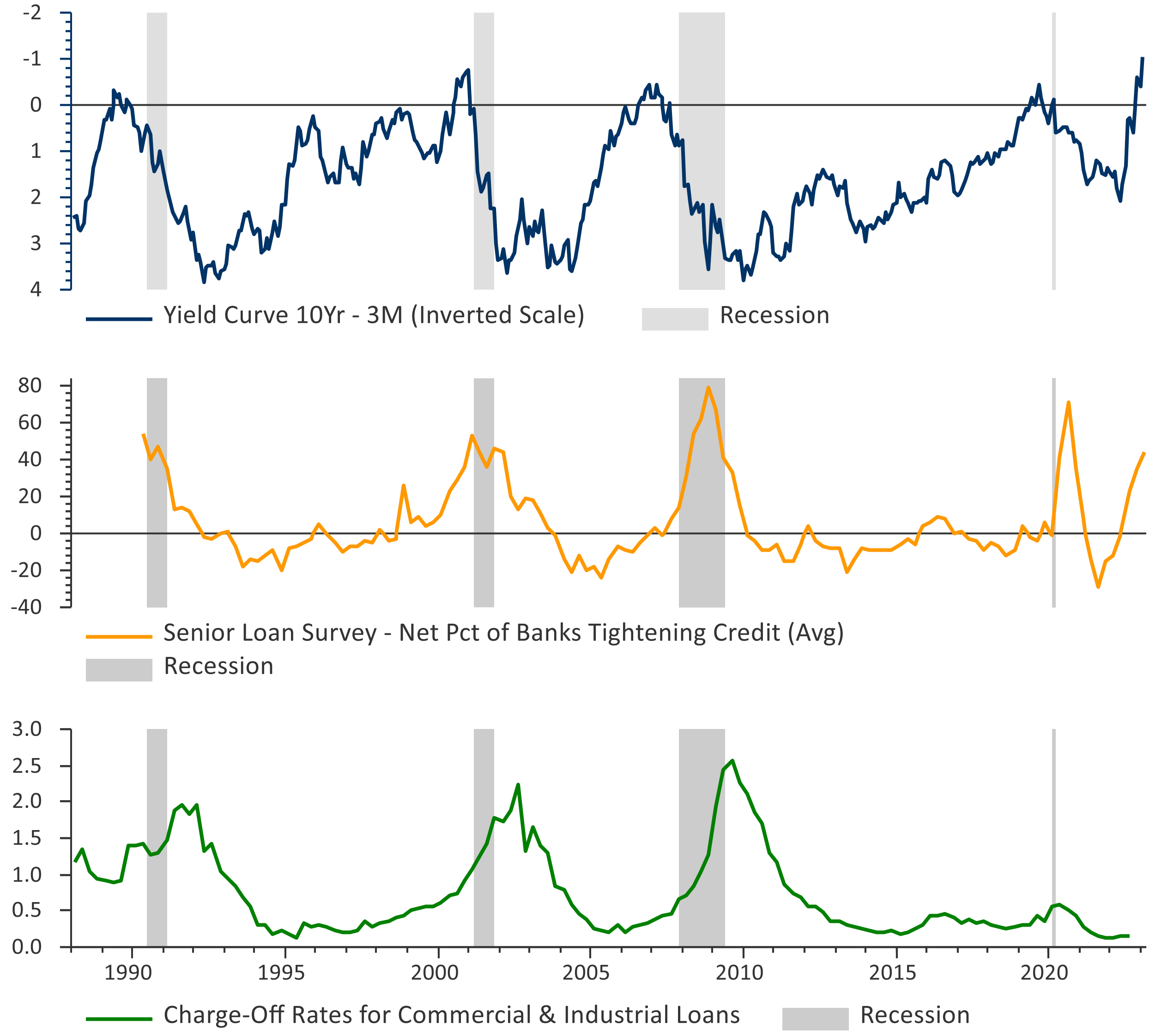


Advisor and Retail Investor Sentiment is more bullish than at any time since the start of the bear market.



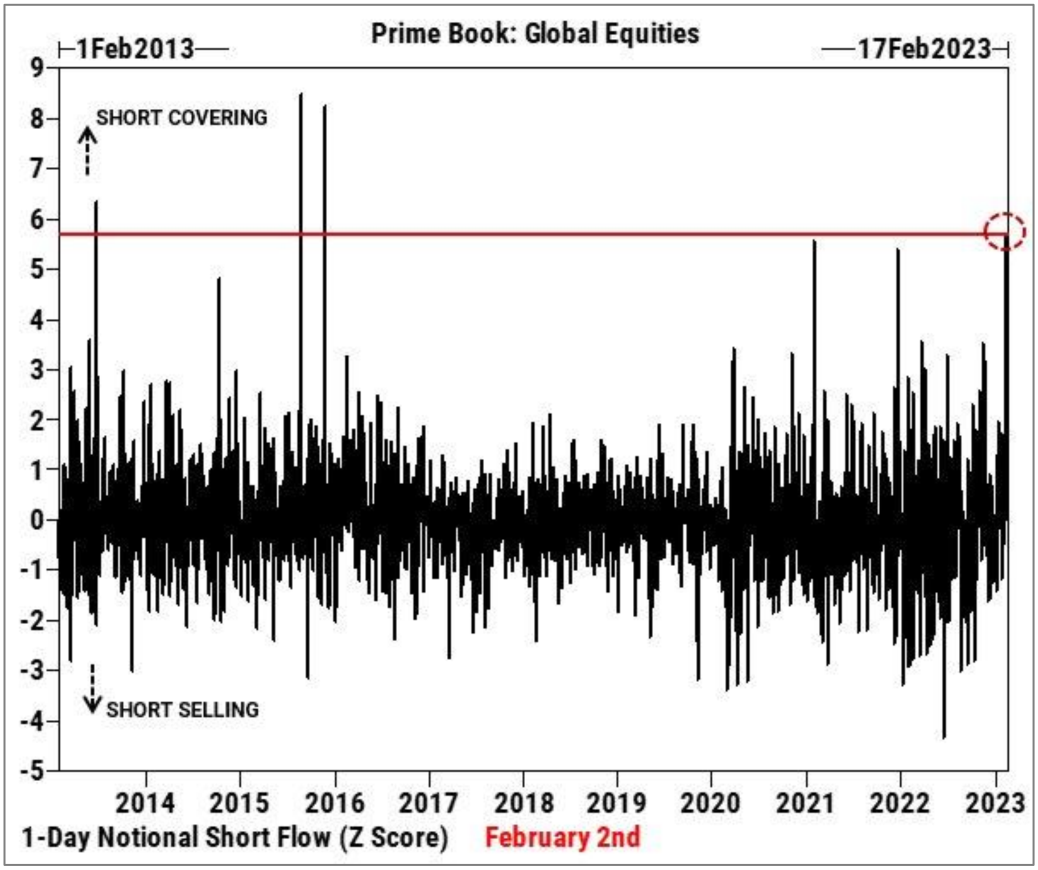
The growth in forward S&P 500 earnings estimates declined for the first time since the Covid recession.

Banks continued to tighten credit in the last quarter.
Notice the progression of how a credit tightening cycle plays out—the yield curve inversion peaks before banks reach their tightest conditions, and finally, credit defaults peak. The yield curve is the leading indicator for the cycle.



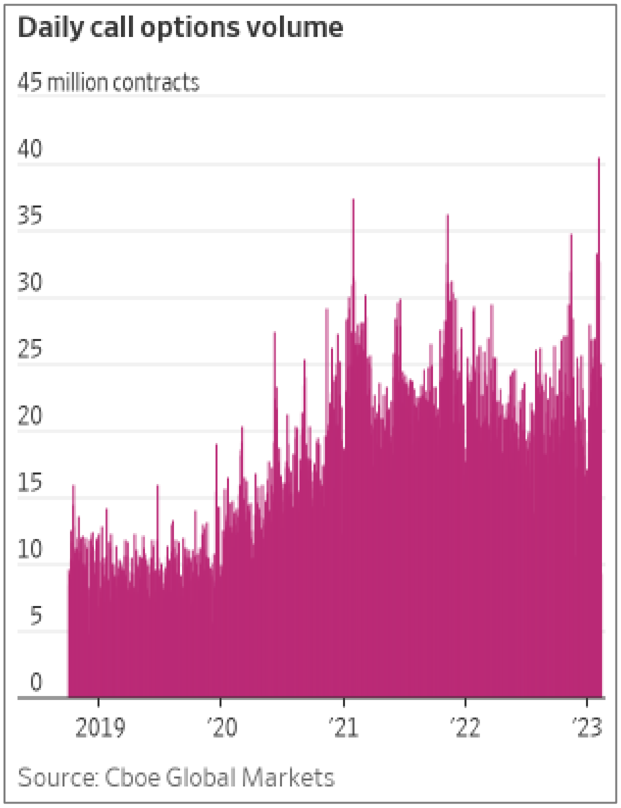
Source: Refinitiv Datastream, Cypress Capital

It was a big week for short covering.

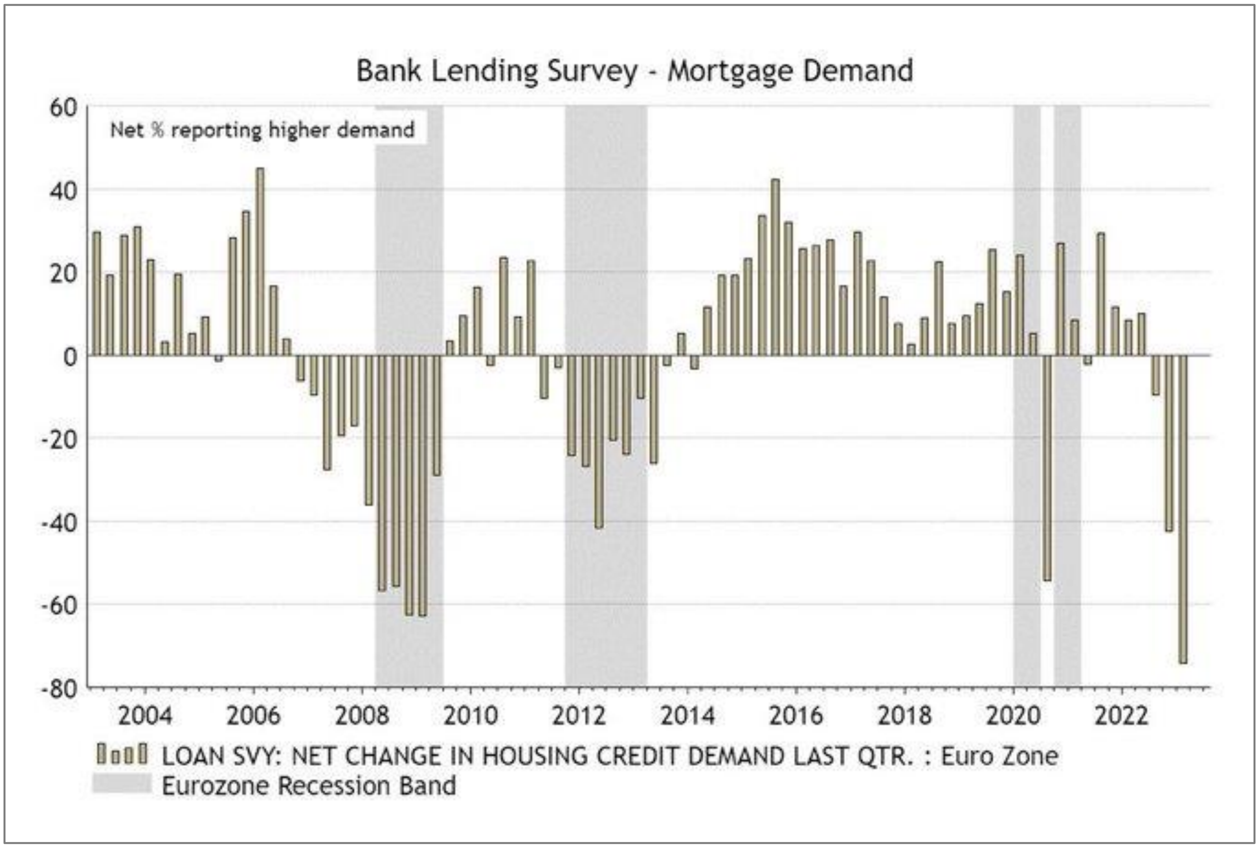


Durable Goods – Too much inventory

Volume in Call Options set an all-time record high.



Mortgage Demand sank to a new low last quarter.



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.