Market Outlook

By Mark T Dodson, CFA

MRI falls under 70%

Market Risk Index fell to 68.4% on better Psychology and Monetary conditions. Monetary Conditions improved noticeably, and Psychology just edged out the worst 10% of readings.

The improvement in Monetary conditions took us by surprise, given the status of the yield curve and the current rate of change on Monetary Aggregates. No doubt in our mind it's a result of the financial market reaction surrounding Silicon Valley Bank and Credit Suisse headlines. It took us enough by surprise, and it's such a unique combination of conditions that we looked back to see other periods in history with a similar mix of Psychology, Monetary, and Valuation conditions. Those periods were February 1999, April 2002, and February 2004. All three periods saw improvements in MRI and better market entry opportunities over the ensuing weeks and months.

To keep this missive short, we'll summarize our opinion. We believe the analog from April 2002 is most similar to conditions today. In that instance, it was the middle of a bear market, and the next and final phase of the bear market was forthcoming.

Digging under the hood of the Monetary Composite, we recognize the conditions leading to the current improvement are more fleeting than the ones that reflect the formation of a new credit and market cycle. We are still in a massive tightening campaign by the Fed – one that has inverted the yield curve like it's the 1980s and brought short-term interest rates to levels that were considered your standard risk-free rate in our old college textbooks. It's an unwinding of the free money policy that quantitative easing represented for the last 15 years – a massive overreaction to the great recession in 2008. Central bankers only acted when their hands were forced by large amounts of unexpected inflation, which resulted from a surge in government spending amplified by political winds that had already turned against free trade policies.

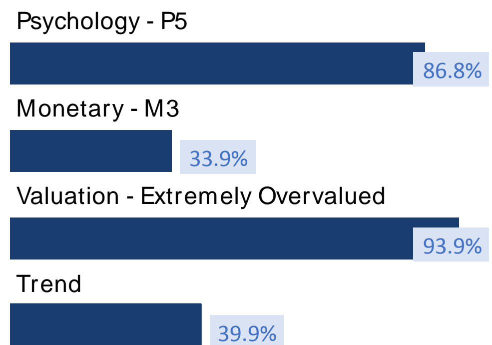
We repeat this next bit of narrative (again) because it will be how history remembers this time in stock market history. In 2020 and 2021, the government dropped more spending on the economy than most of us alive have ever seen, and they did it over a timeframe that even contemporaries of World Wars did not witness. It created bubbles in things that most of us didn't know bubbles were possible. As a byproduct, it also created unexpected inflation – a lot of it.

Market Risk Index

Rec Allocation 25% Underweight

68.4%

Category Percentiles



Largest Psychology Influences

Leveraged Investments	Negative
Volatility	Negative
Consumer Confidence	Negative
Surveys	Positive

Largest Monetary Influences

Interest Rate Spreads (Yield Curve)	Negative
Inflation	Positive
Lending and Leverage	Positive

Valuation

7-10 Year Equity Return Forecast	2.4%
10Yr US Treasury Yield	3.4%

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.

There was enough inflation and persistence in inflation that those Fed headlines declaring inflation “transitory” look so cartoonish that they don’t need the outside perspective of future historians to judge them.

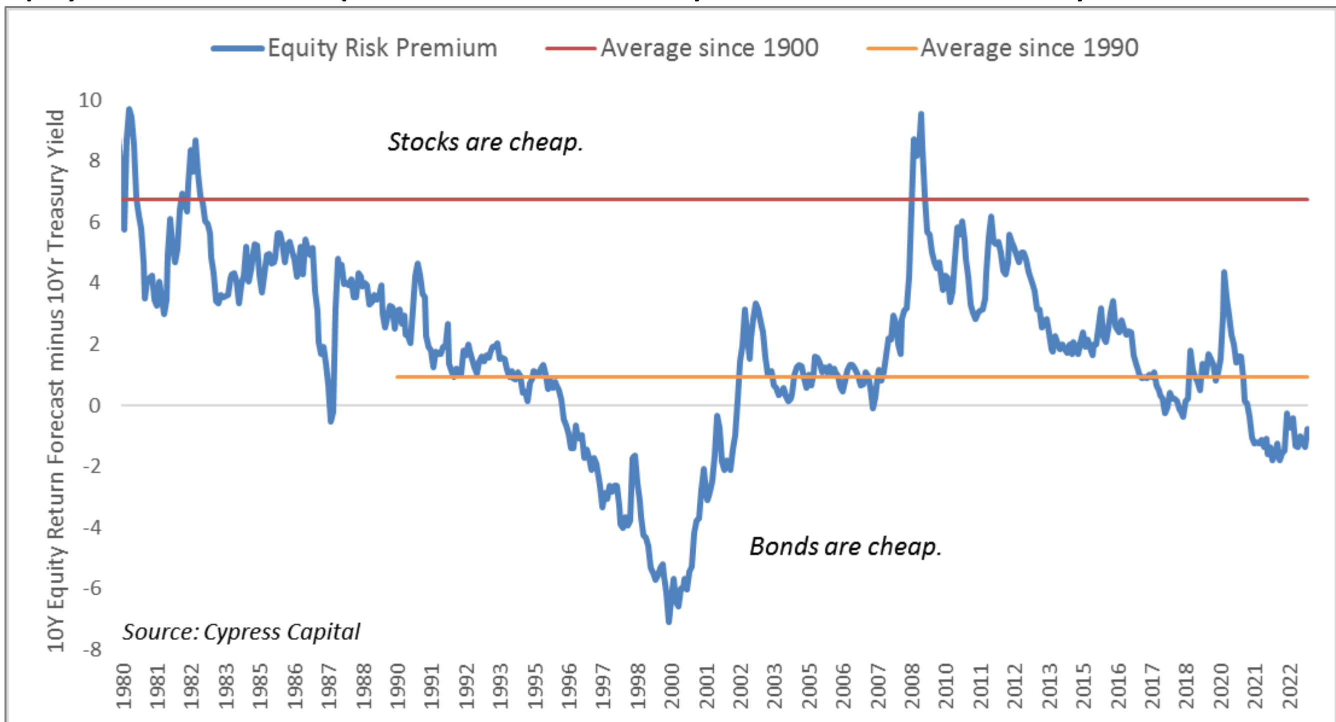
Regardless, that government money is here and isn’t going away. The Fed’s only choice to curb inflation was to raise interest rates high enough to encourage households to hold more of that cash on the sidelines instead of spending it. A typical soft-landing Fed policy picks off just the right amount of risk-averse households, encouraging them to hold more cash, and bringing down the rate of economic growth and inflation without causing a recession.

However, too many investors have been conditioned by 15 years of policy that has made holding cash a trash strategy. We believe a plurality of households shares that same QE-conditioned group mentality, making a soft landing nearly impossible. We are approaching a point where investors will make the same decision, en-masse, to increase those cash balances at the same time. Silicon Valley Bank and Credit Suisse headlines were the shot across the bow.

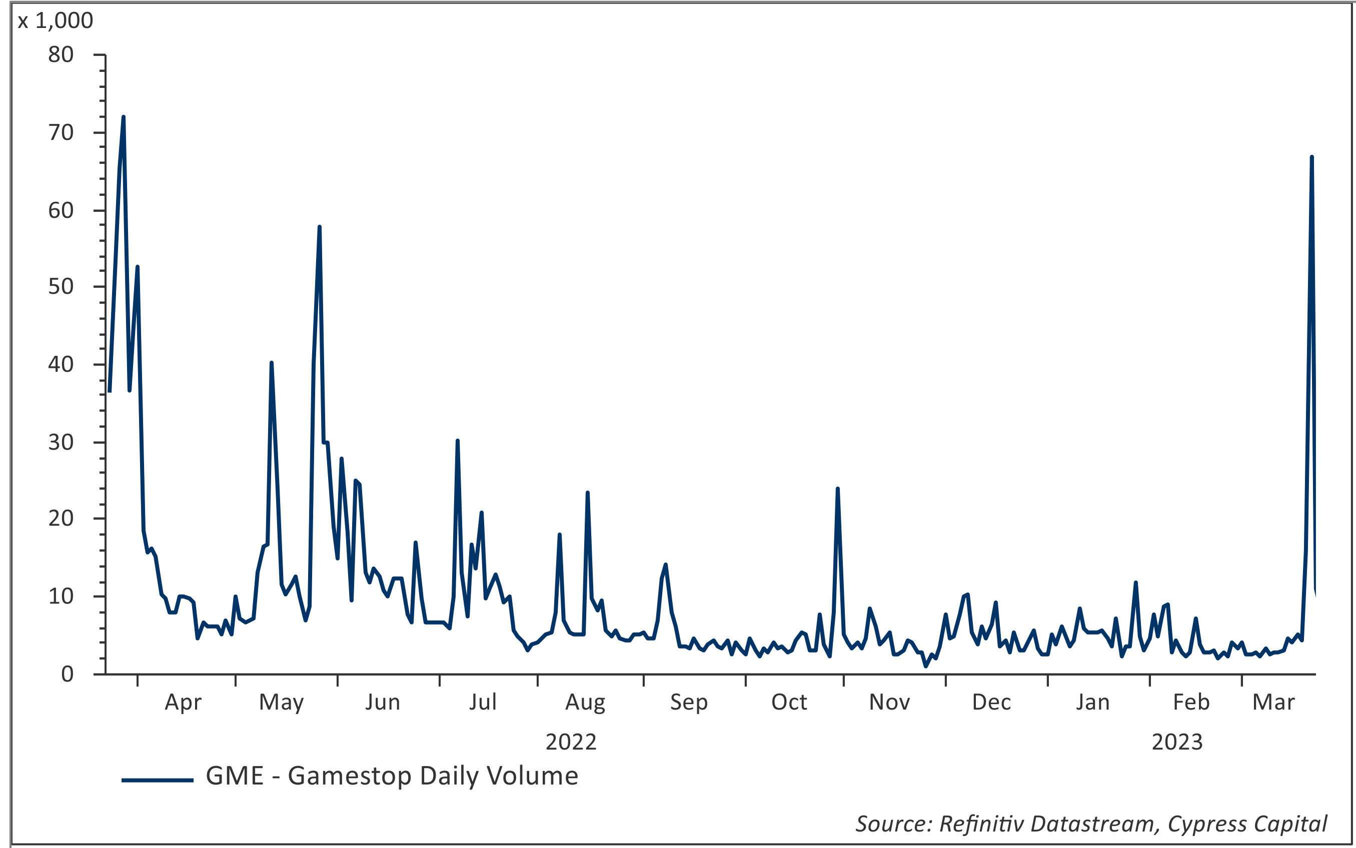
If you are investing alongside us, you are already prepared for this possibility, guided by MRI. Regardless of our narrative or our expectations, we don’t need a confluence of perfect conditions to take more risk from here – we only need Mr. Market to compensate us appropriately for taking that risk.

Charts of the Week

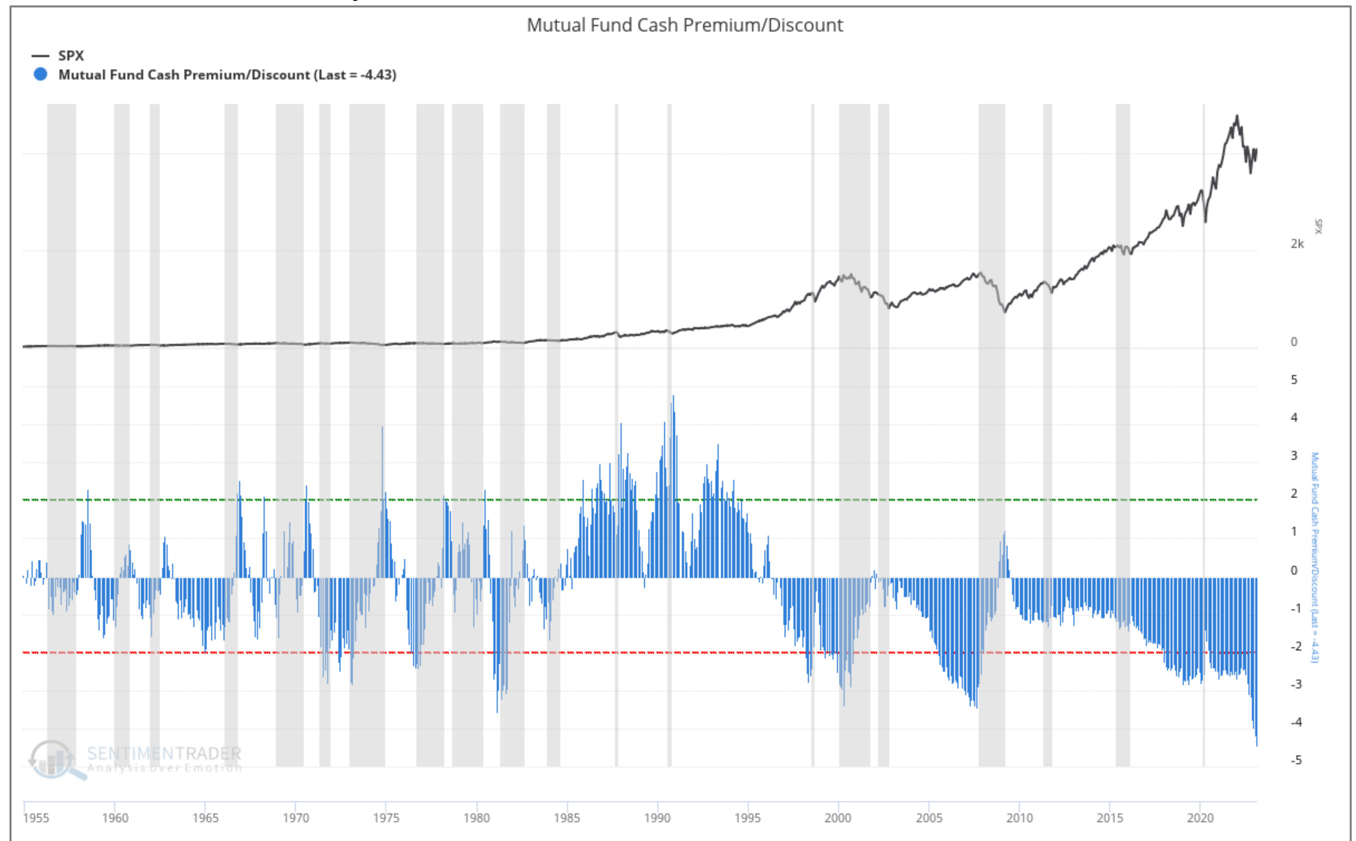
Equity Risk Premium – the spread between our return expectations for stocks and bond yields favors bonds.



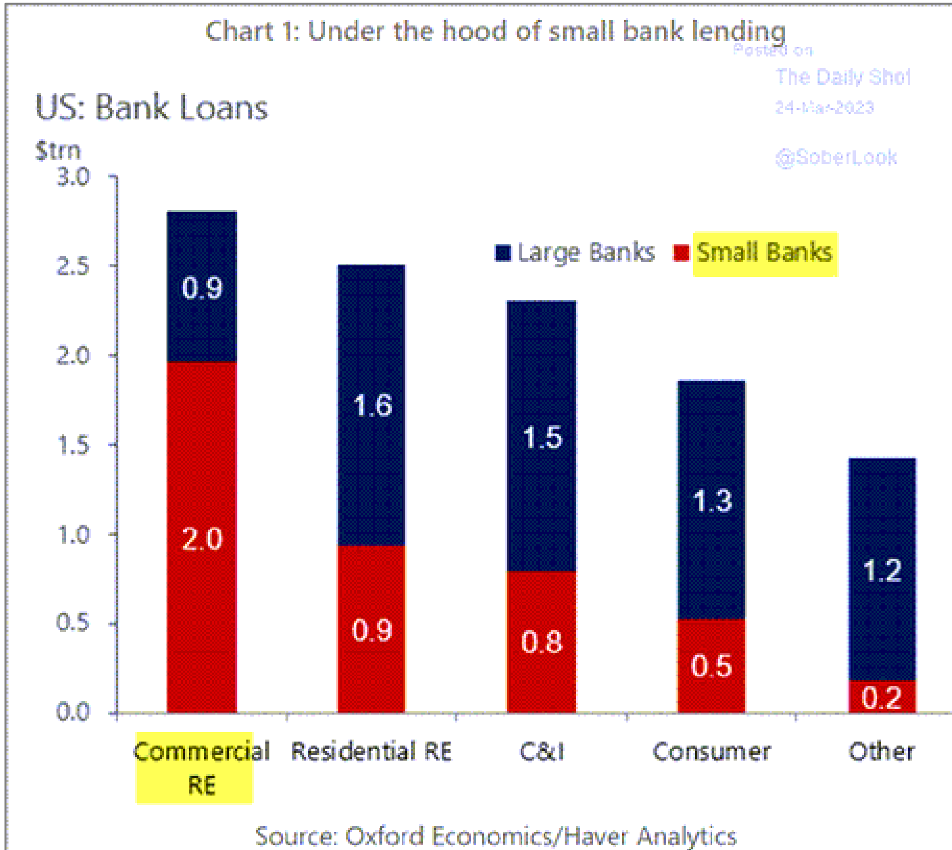
Speculators not giving up on Gamestop– volume in the stock surged to levels not seen since peak Euphoria.



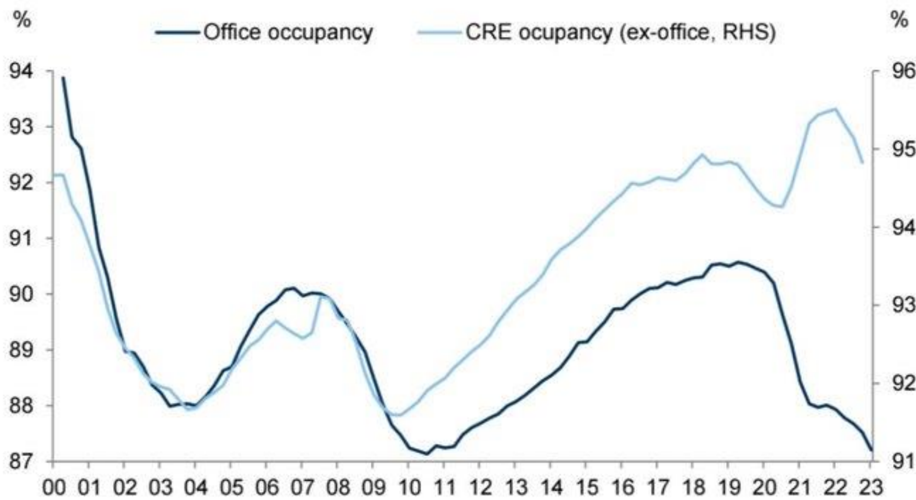
Mutual Fund Cash Levels, adjusted for the level of interest rates, are at all-time lows.



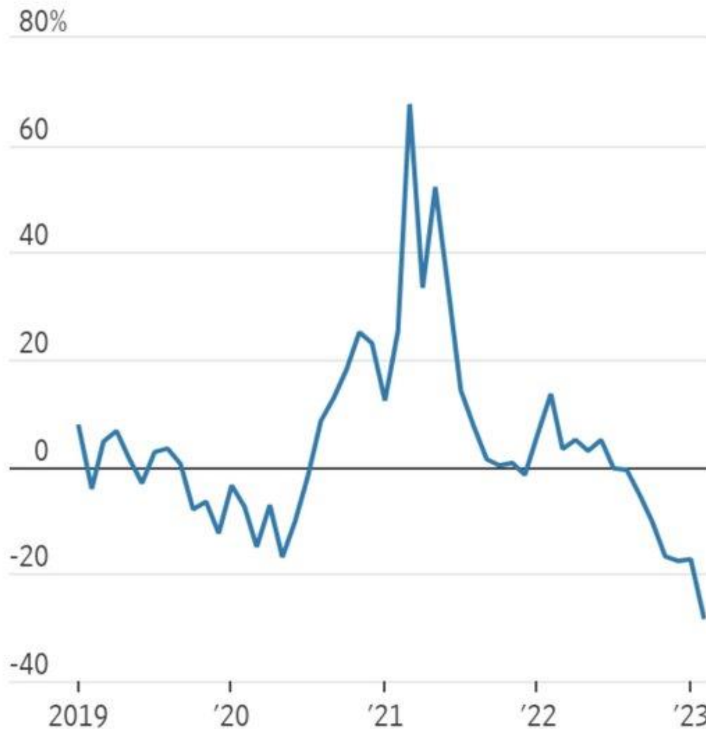
Small banks are particularly susceptible to weakness in Commercial Real Estate.



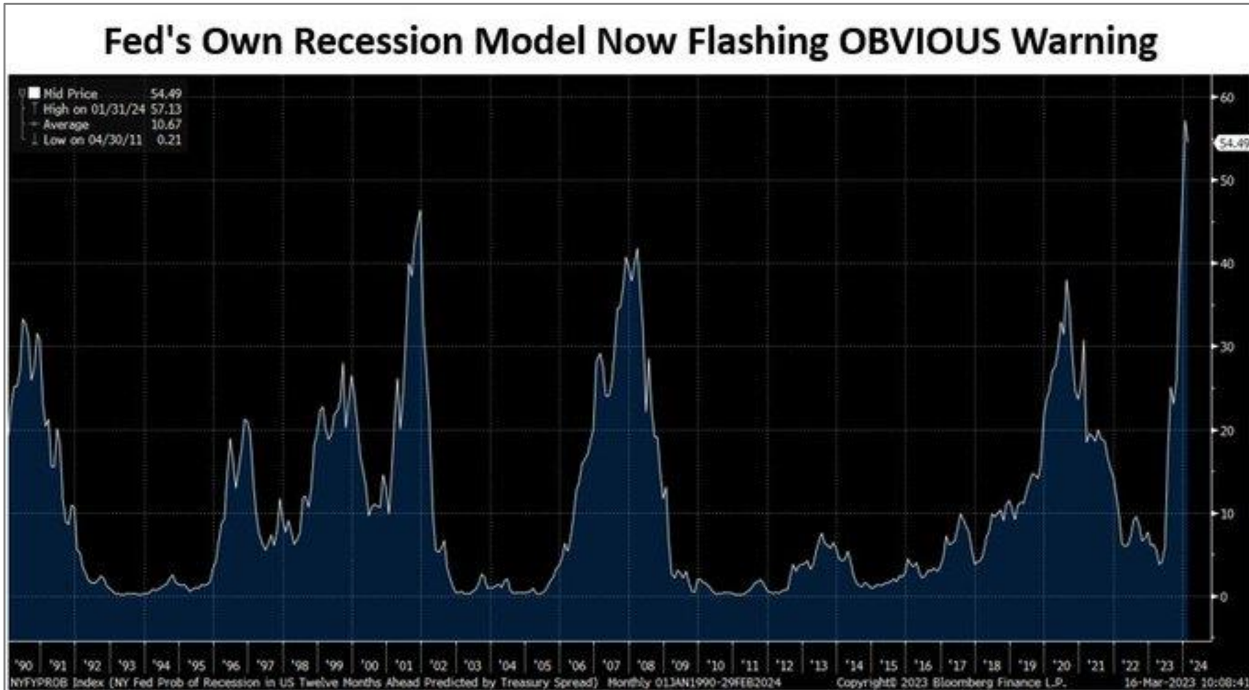
Vacancy in Office Commercial Properties was growing before Covid came on the scene.



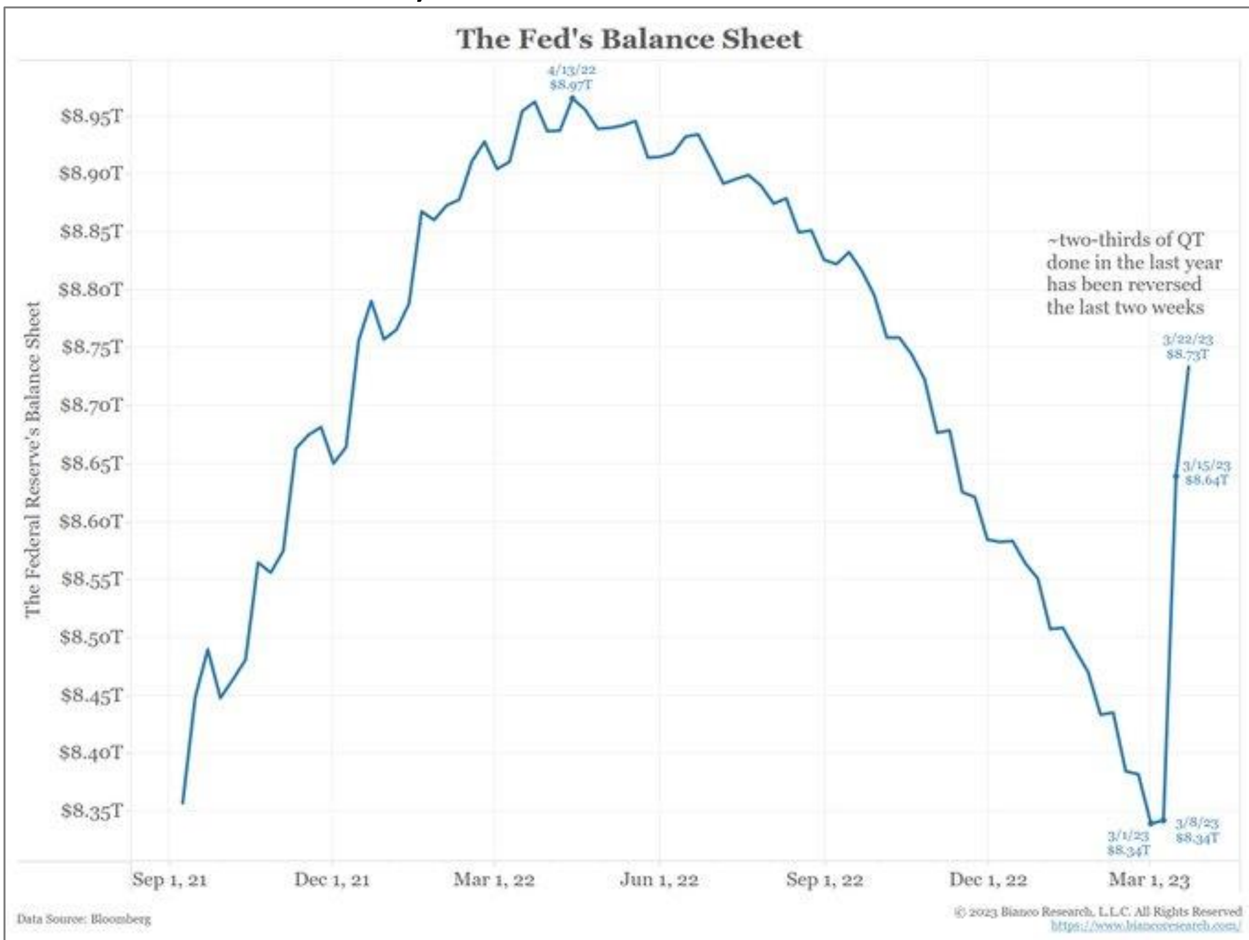
Imports are falling.



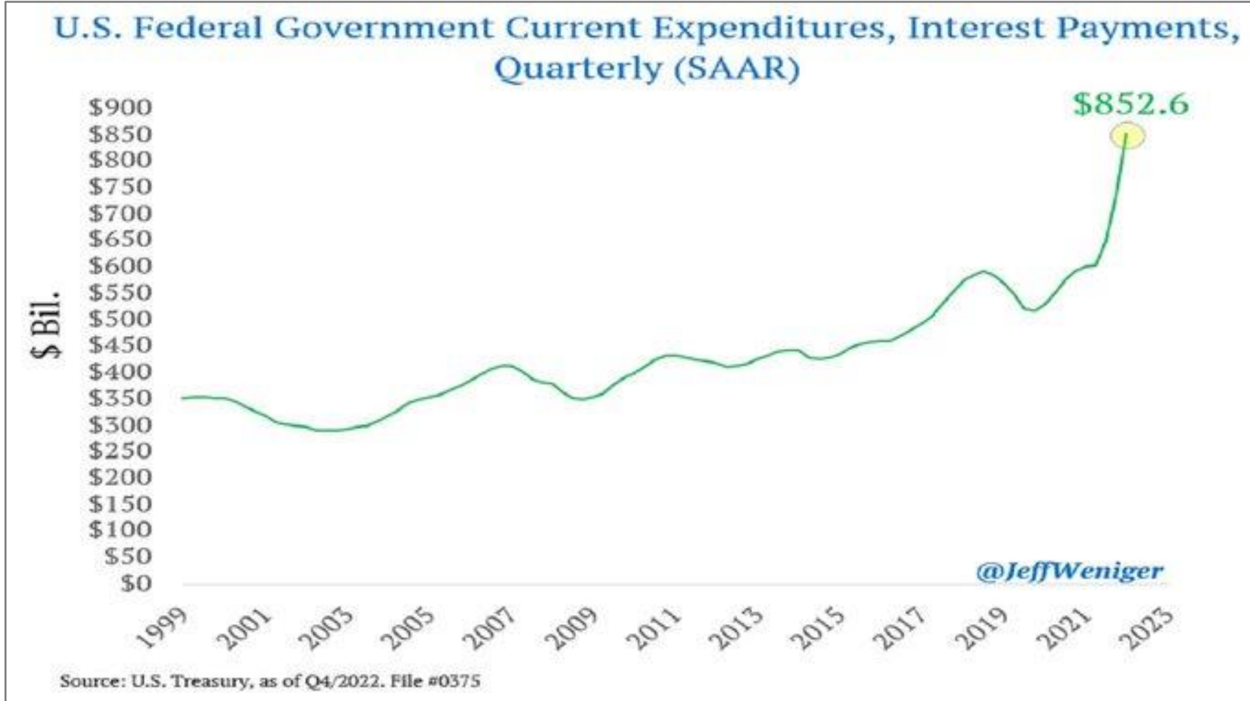
NY Fed's Recession Probability Model is clearly warning of recession.



Two-Thirds of QT done in the last year has been reversed in two weeks.



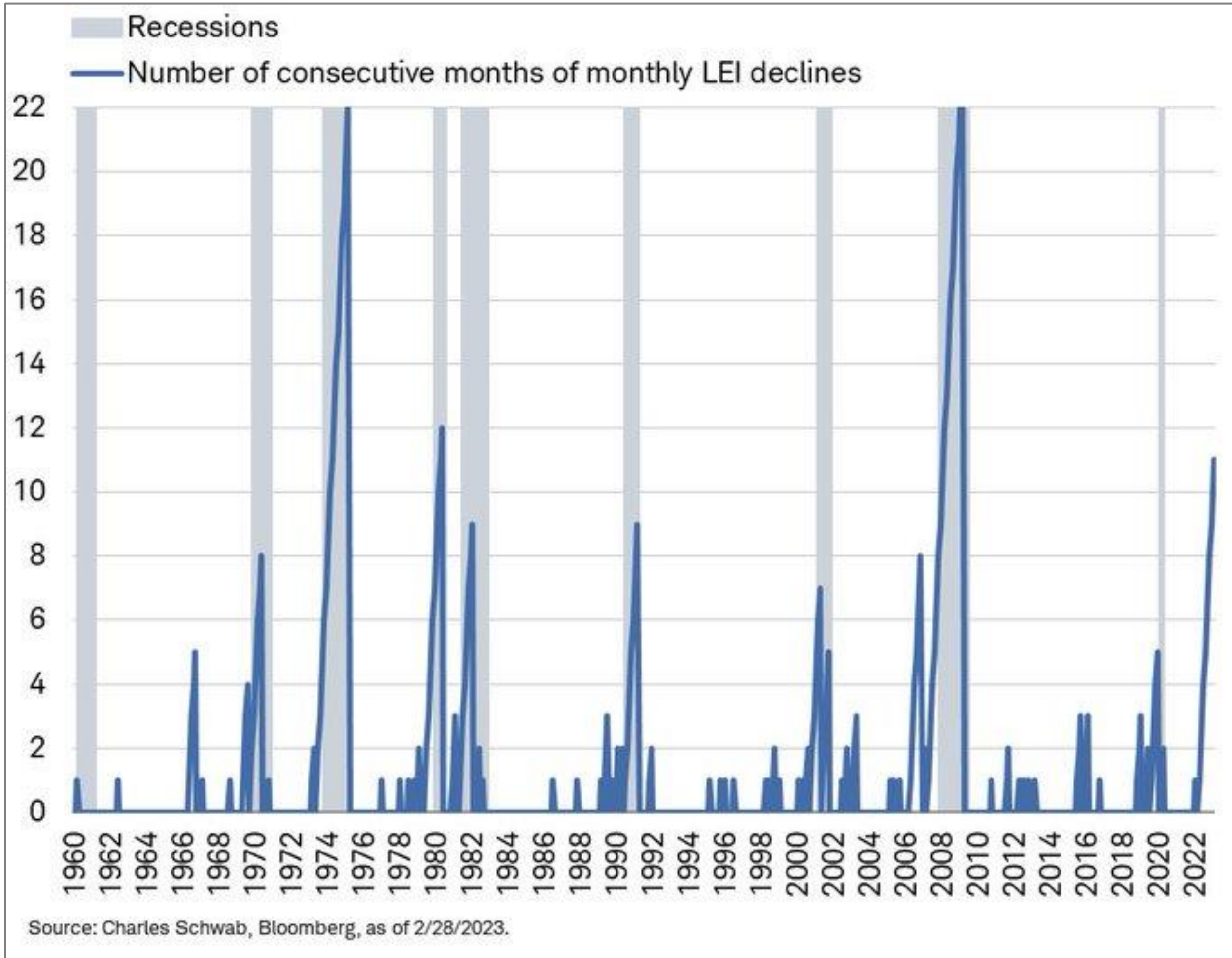
Higher interest rates have added about $250b in Federal stimulus, courtesy of higher interest payments.



The weight of the two largest stocks in the S&P 500 (AAPL and MSFT today) set a new high.

Source: GIR

Leading Economic Indicators have never declined this many months in a row without a recession.



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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