Market Outlook

By Mark T Dodson, CFA

In-Active Investing

This week, the Market Risk Index dropped again on additional improvement to the Monetary and Psychology Composites.

Despite tight Fed policy, Monetary Conditions moved into bullish territory for equity markets. Conditions have improved enough to keep us from being surprised to see a stock market rally in the face of unfavorable sentiment and valuations (and official Fed policy). We aren't comfortable making a bet with our assets on that rally because Monetary conditions look more like the calm before the onset of recession than they do the formation of a new credit cycle. We believe the bullish shift will prove to be temporary.

It's also worth noting that at every point in the bear market thus far, when market conditions have started to behave in a way that eases liquidity, the Fed has come in with a hammer. Monetary Aggregates also continue to decline, with MZM growth at record lows, which is more a symptom of a high-velocity inflationary environment than it is of the Fed tightening campaign. The narrative from monetary aggregates is that households are still futilely trying to reduce their cash positions, passing it along to other households like it's a hot potato. Any flows into money market funds for higher yields have come at the expense of declines in paltry-yielding bank deposits. The Fed still hasn't shifted the view of the average household that they should hold more cash and pull it out of circulation in the economy.

Over a decade ago, we switched our perspective on how to view growth in monetary aggregates from one focusing on money demand instead of supply. This puts more attention on the collective mood of households instead of current Fed policy, as Fed policy is easy to discern without looking at M2 and MZM. While this view of "money supply" is not commonplace among stock market pundits, it better explains how the correlation generally works when looking at stock market returns. From a money demand perspective, you'll know when households start their recessionary pullback when aggregates like M2 and MZM start to shoot higher, and that will coincide with a reversion in the yield curve. That's when liquidity becomes seriously scarce in a bear market.

As confirmation of the demand side view of current record declines in M2 and MZM, Consumer Confidence remains buoyant. The Consumer Expectations Gap and Job Expectations Gap have stayed near record highs. The Consumer Confidence survey released this

Market Risk Index

Rec Allocation 25% Underweight

64.0%

Category Percentiles

Psychology - P5

84.7%

Monetary - M3

31.3%

Valuation - Extremely Overvalued

90.6%

Trend

31.5%

Largest Psychology Influences

Leveraged Investments	Negative
Consumer Confidence	Negative
Surveys	Positive
Option Activity	Positive

Largest Monetary Influences

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

Valuation

7-10 Year Equity Return Forecast	3.3%
10Yr US Treasury Yield	3.6%

Market Trends

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

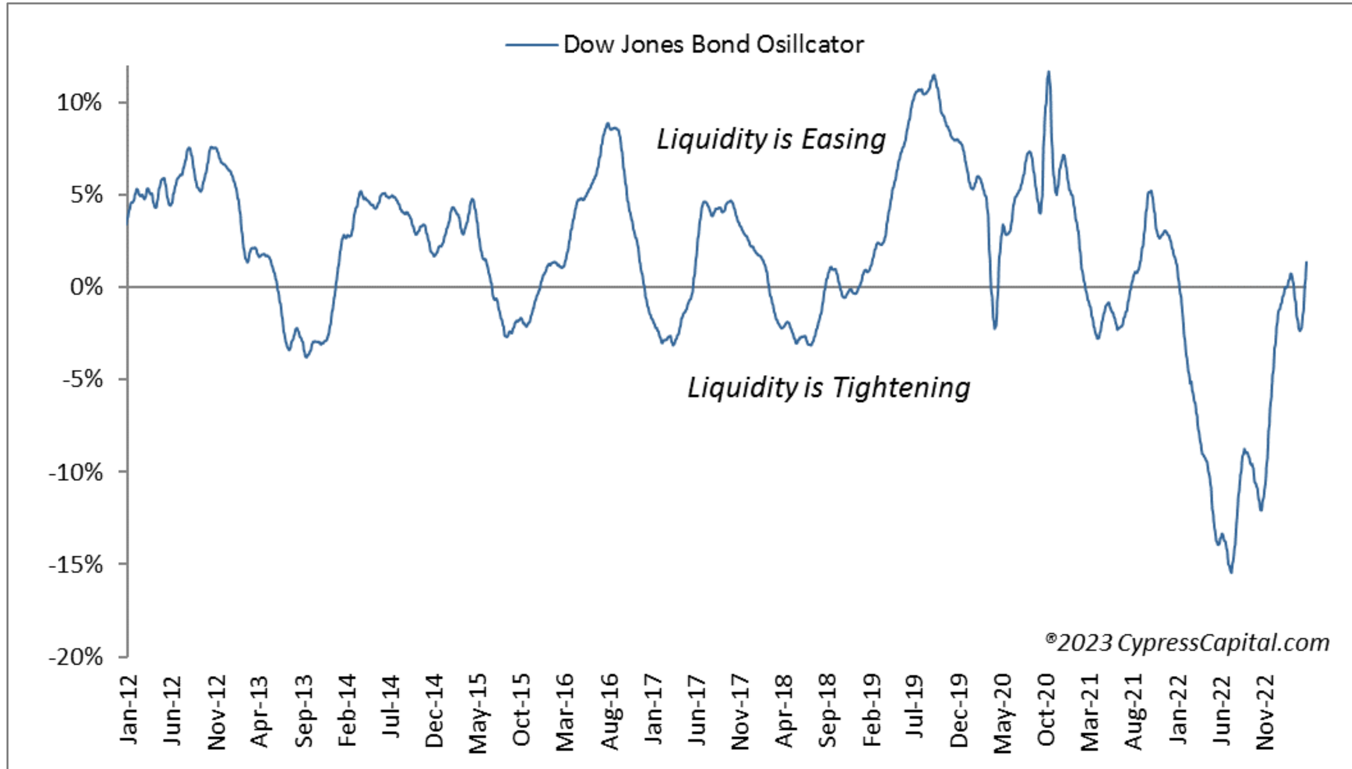
Market Risk Index scales from 0 to 100%. Higher readings correspond with higher risk markets. Scores below 25% are bullish. Scores between 25-75% are neutral, and scores above 75% are markets vulnerable to major drawdowns.

week was strong enough to become one of the most significant negative influences on the Psychology Composite. It kept notable improvements to the Surveys and Options Activity categories from moving the composite out of the worst quintile of readings.

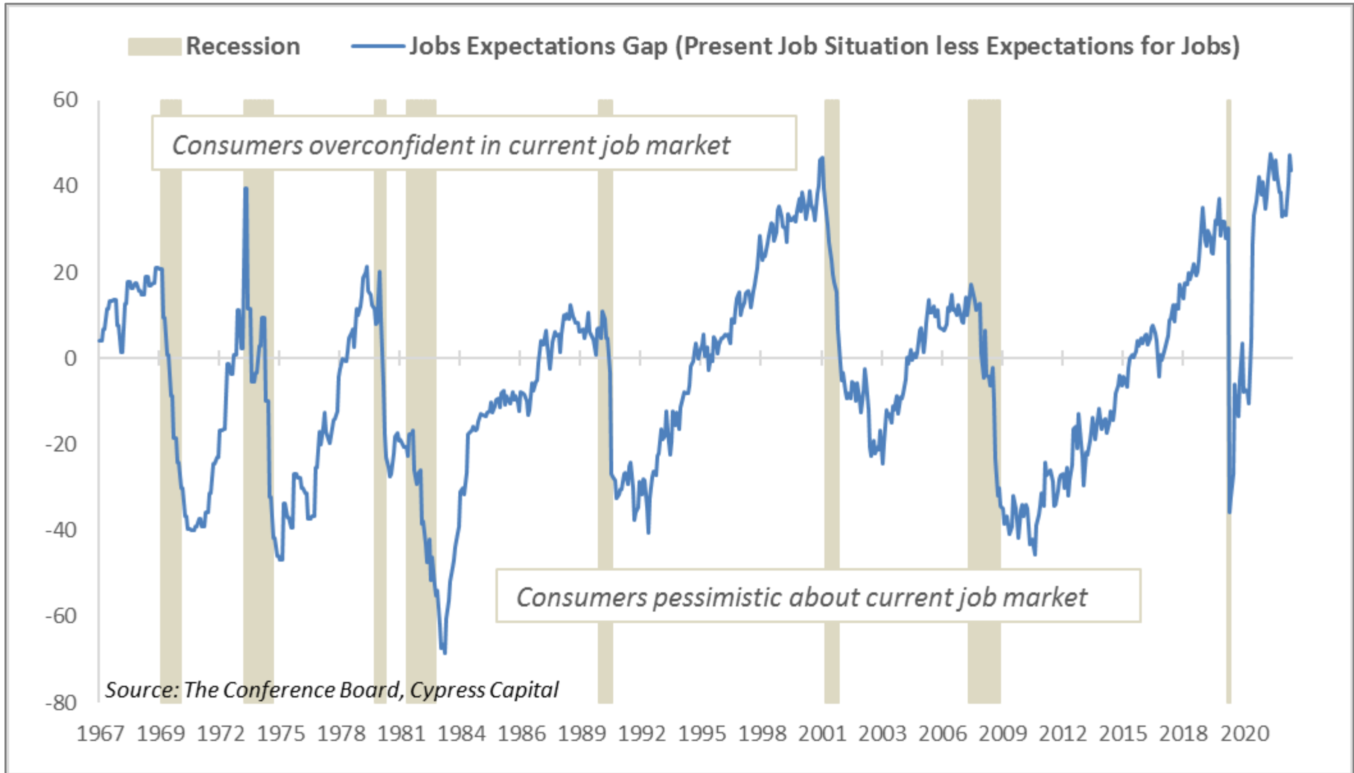
We always look forward to improvements in Market Risk Index, but we need much more of it to be convinced of both the prospects and potential of a new bull market. In the meantime, we will twiddle our thumbs. Inaction in investing is often the best action.

Charts of the Week

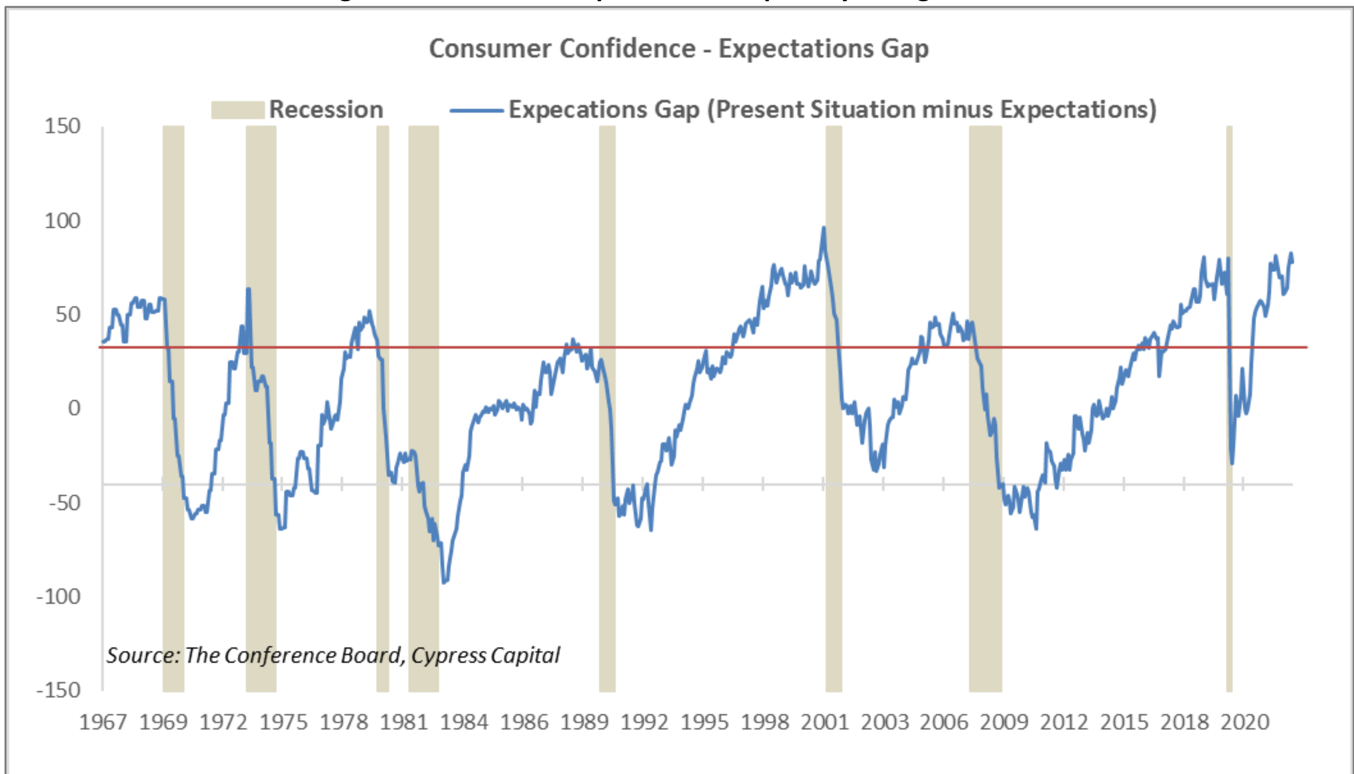
Dow Jones Bond Oscillator says liquidity is easing.



Consumer Confidence in the Job Market stays near record highs.

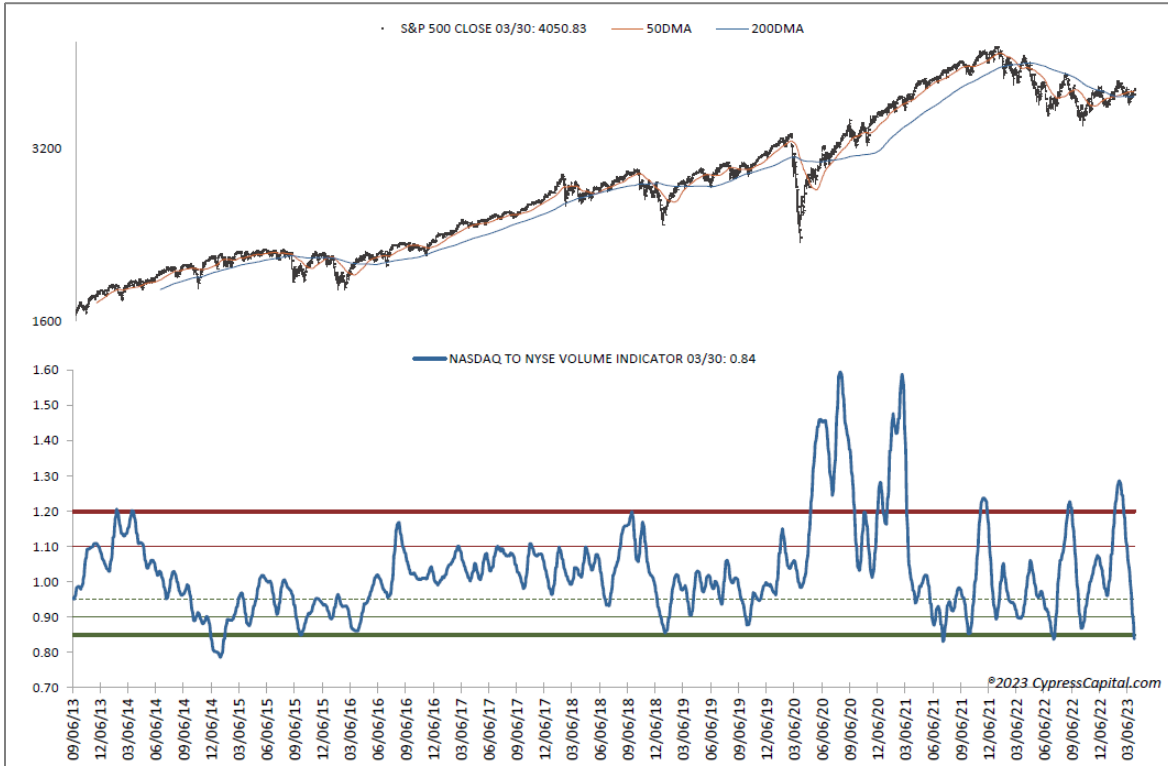


The bear market hasn't budged the Consumer Expectations Gap off cycle highs.



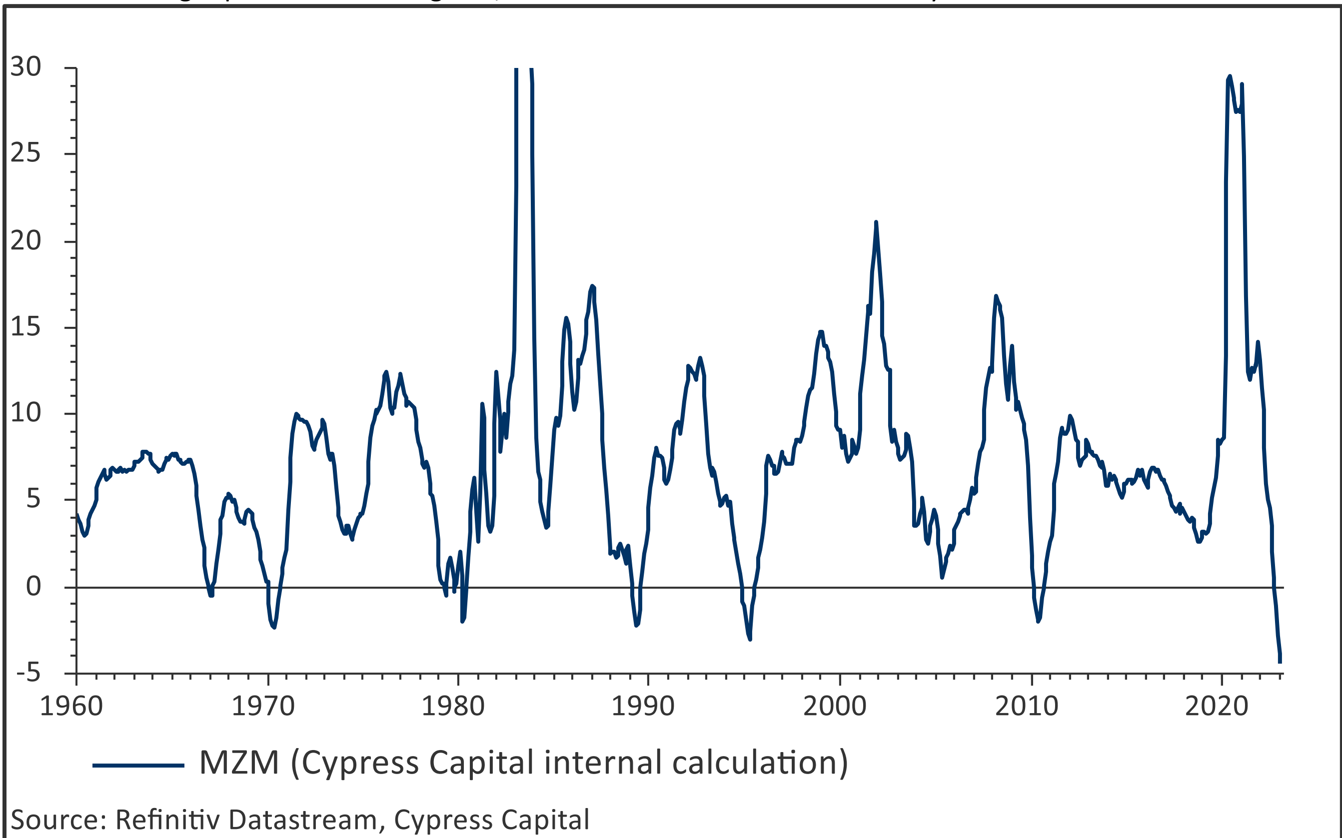
NASDAQ to NYSE Volume Indicator turns bullish.

Over short periods, this indicator has been beneficial in pinpointing inflection points within the bear market.



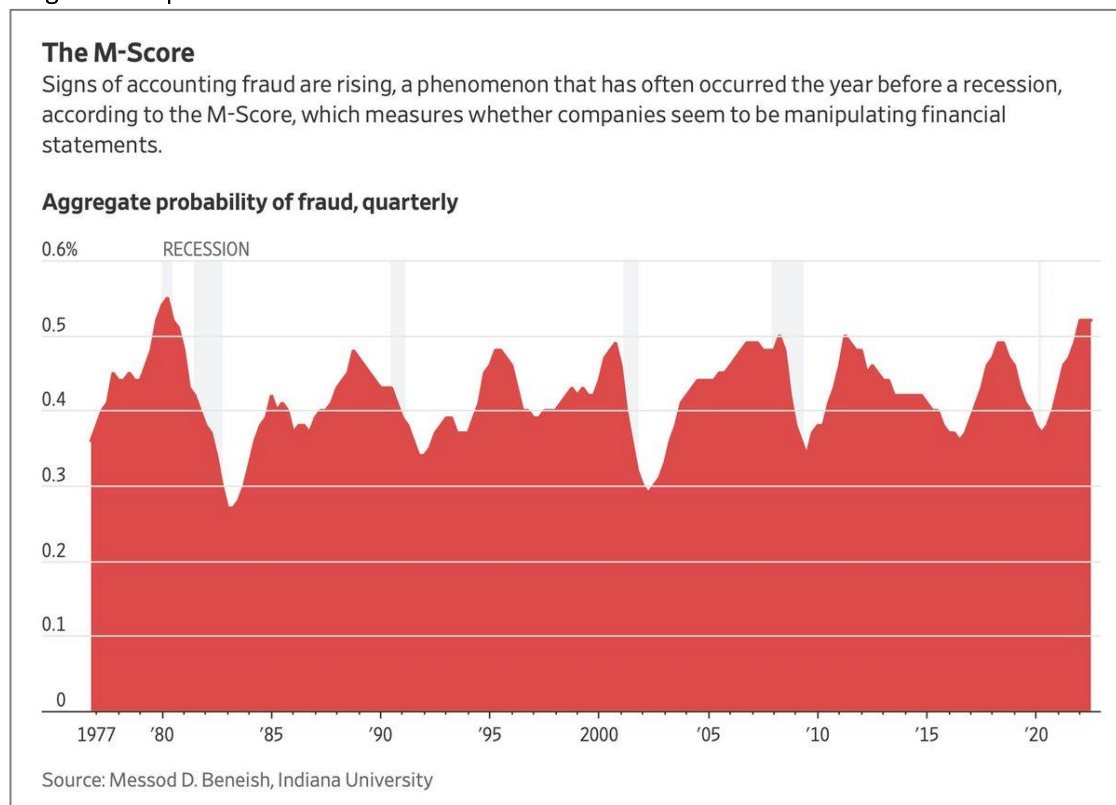
MZM Growth is at record lows – Fed tightening has yet to make households grow cautious.

The Fed no longer publishes MZM figures, but we still calculate them internally.

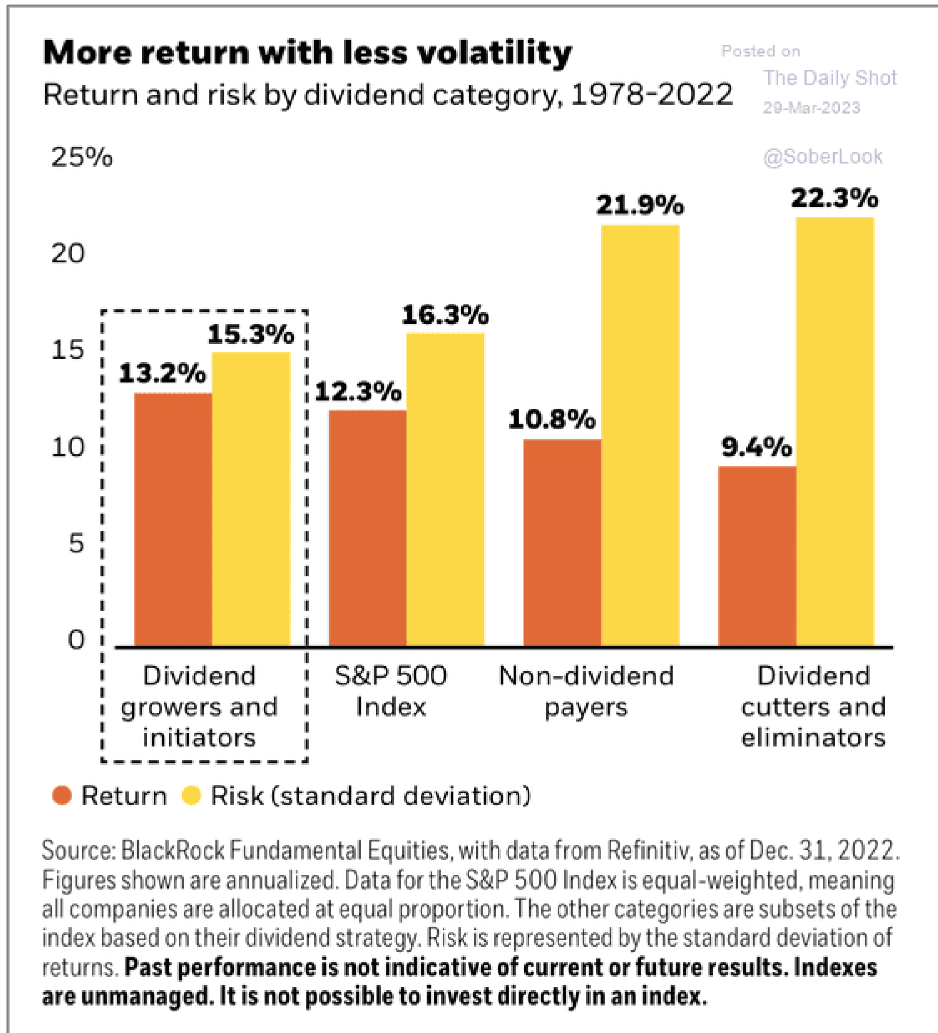


Rate hikes have caused losses on bank balance sheets. Losses don't make banks more willing to lend.

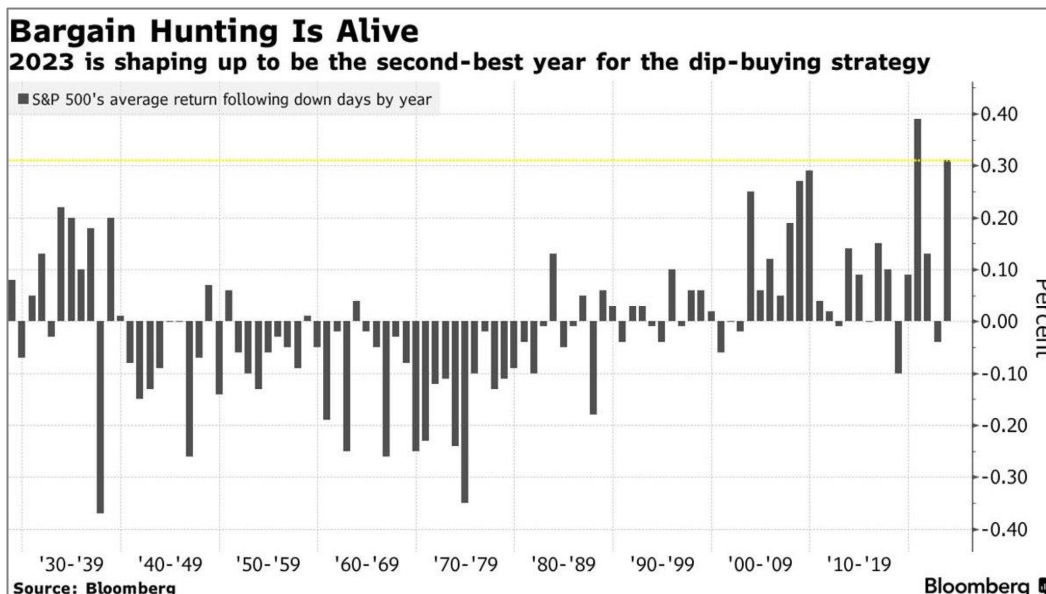
The corporate Manipulation Score has hit the highest level in over 40 years.
We are huge fans of the Beneish M-Score, which uses financial statement metrics to calculate the probability that a corporation is cooking the books. We have used it to filter out potential holdings for our portfolio for a long time...it predicted Enron.



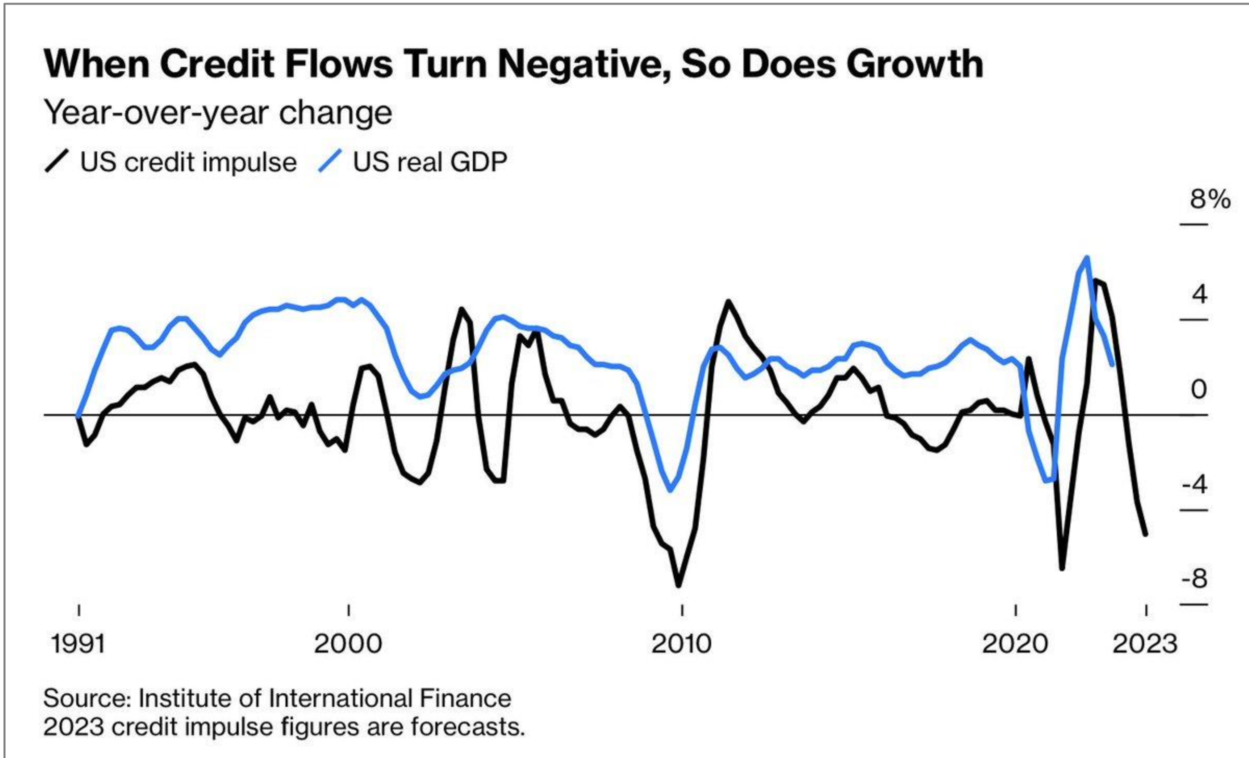
Stocks that paid dividends outperformed, with the least amount of volatility.
As managers of a dividend-focused equity portfolio, this chart gives us a nice rush of confirmation bias.



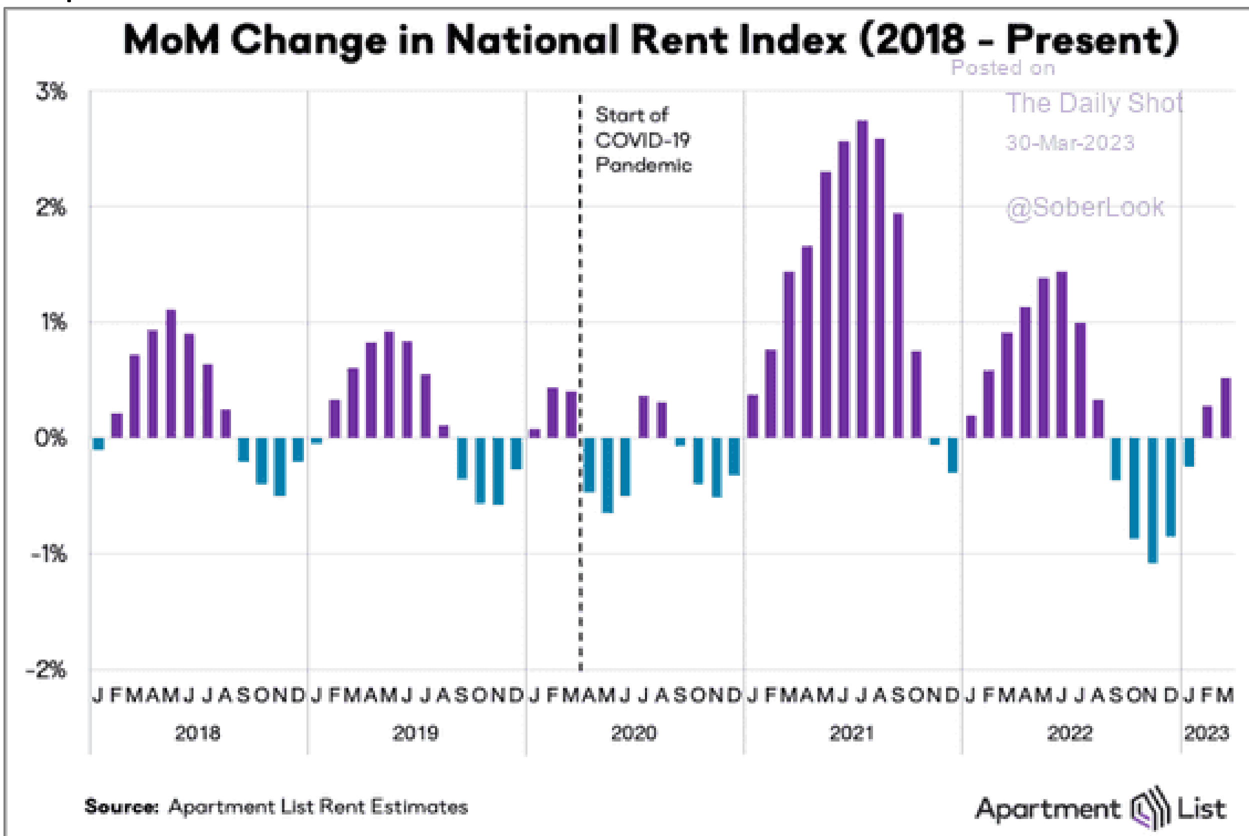
Buying the Dip is tempting FOMO Buyers again.



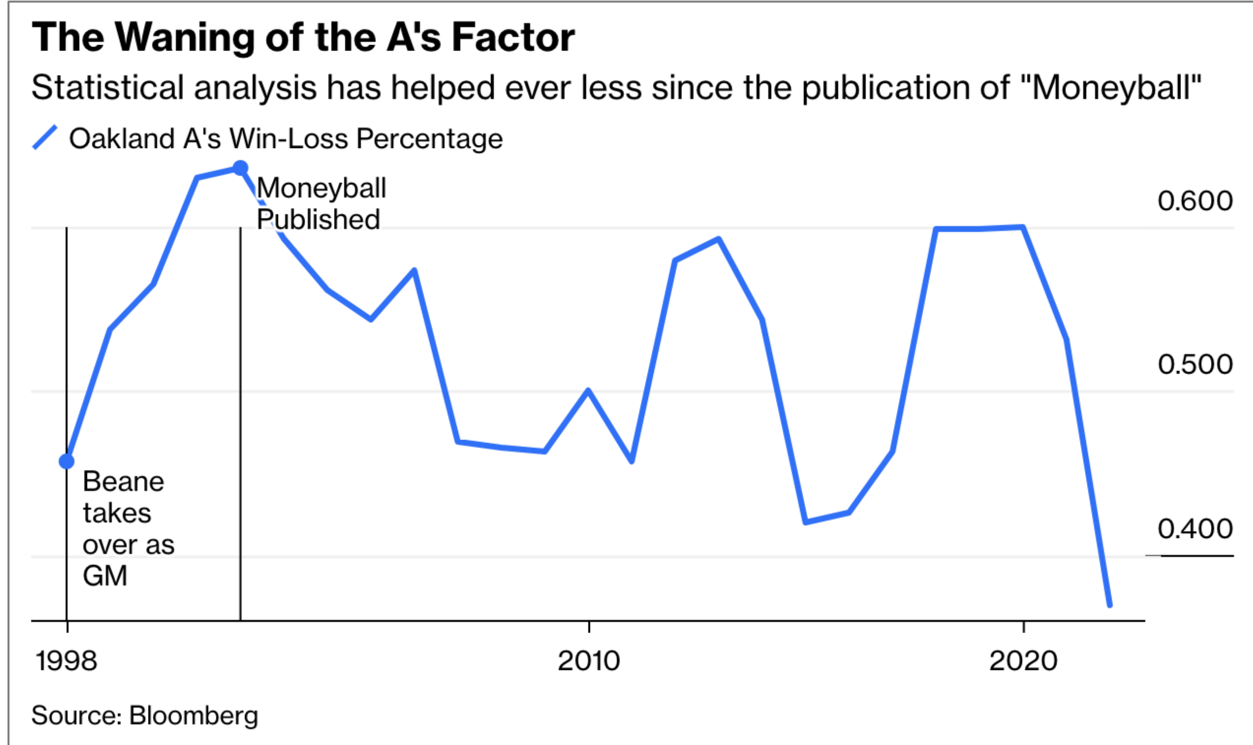
When Credit Flows Turn Negative, So Does Growth



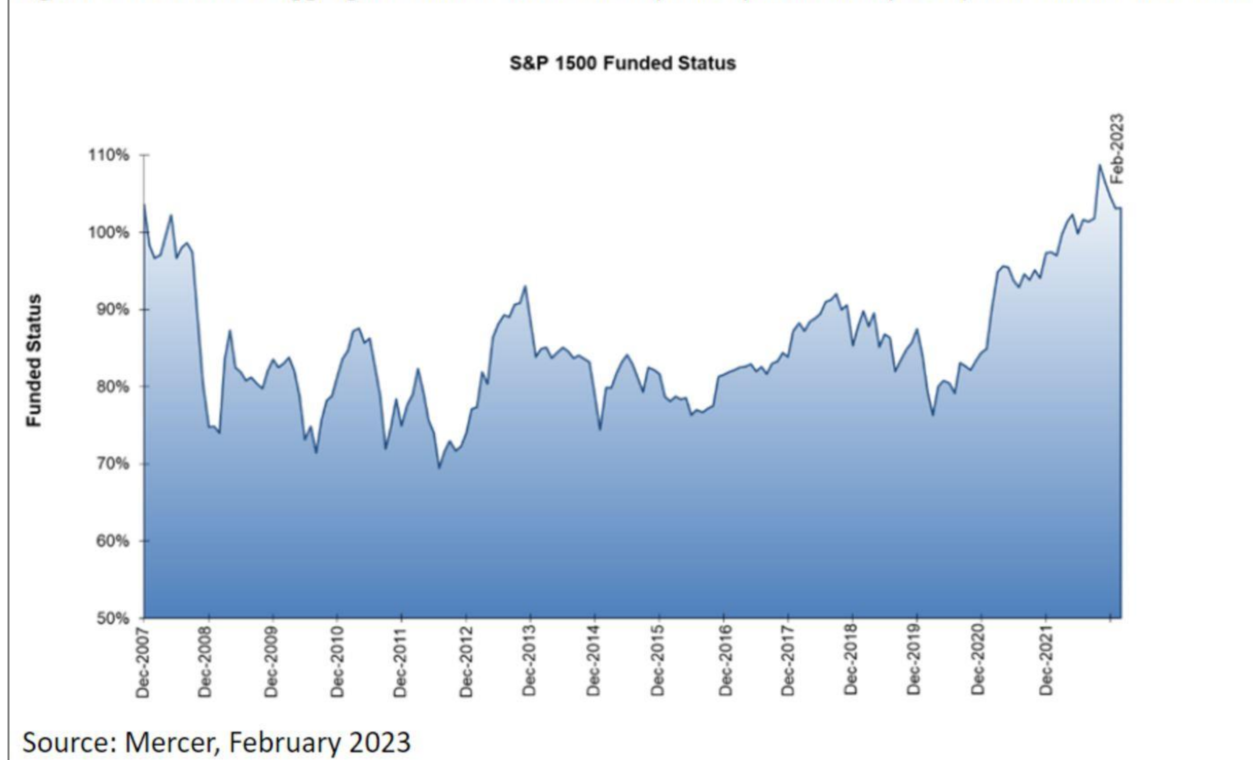
Rent prices are back on the rise.



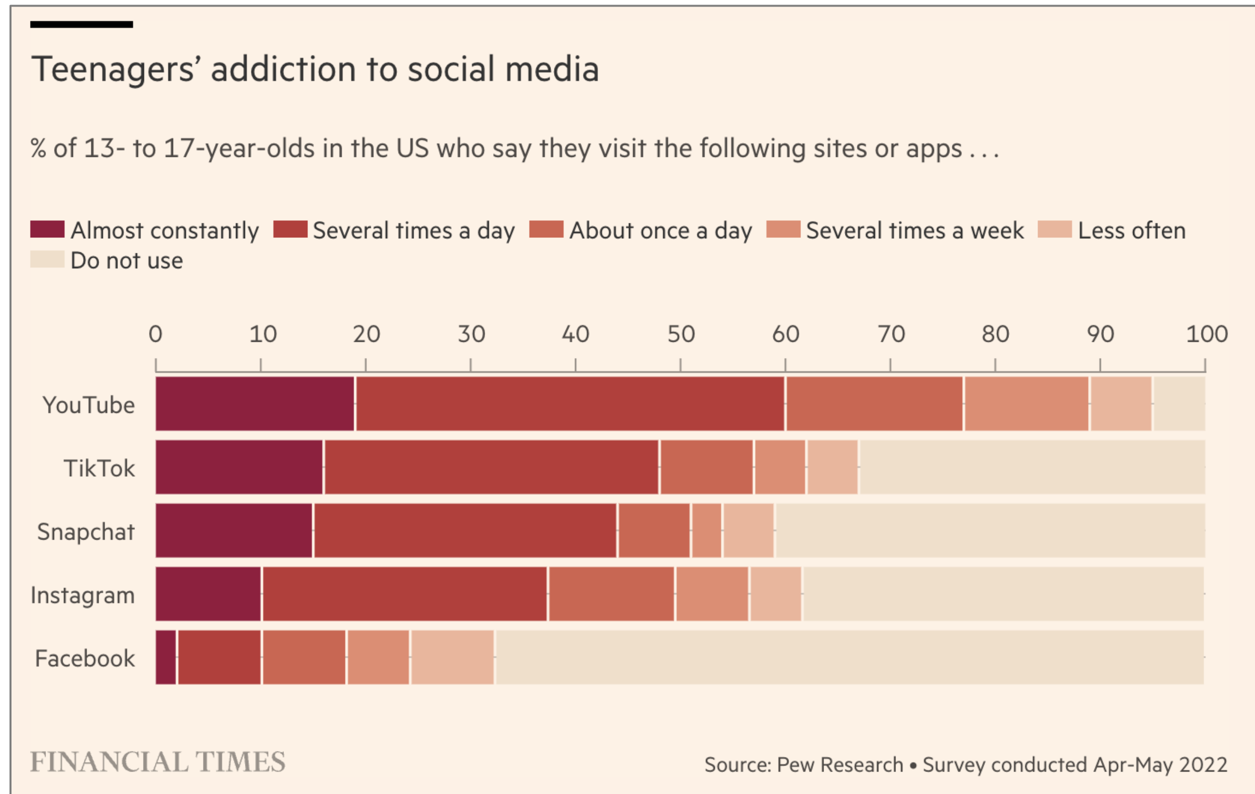
Baseball is just like the Stock Market.
The Oakland A's quantitative edge peaked right as Moneyball was published.



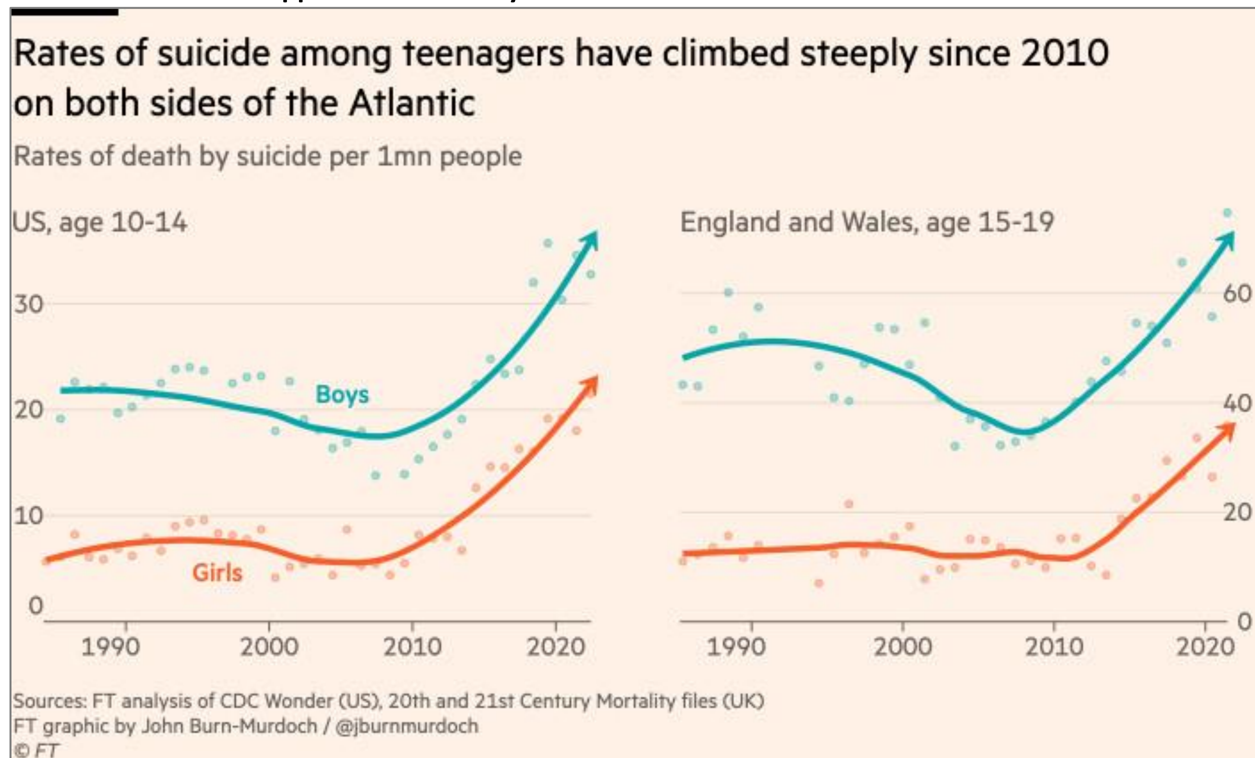
Fed Rate Hikes are great for Corporate Pension Funded Status. Lots of pensions are fully funded now.



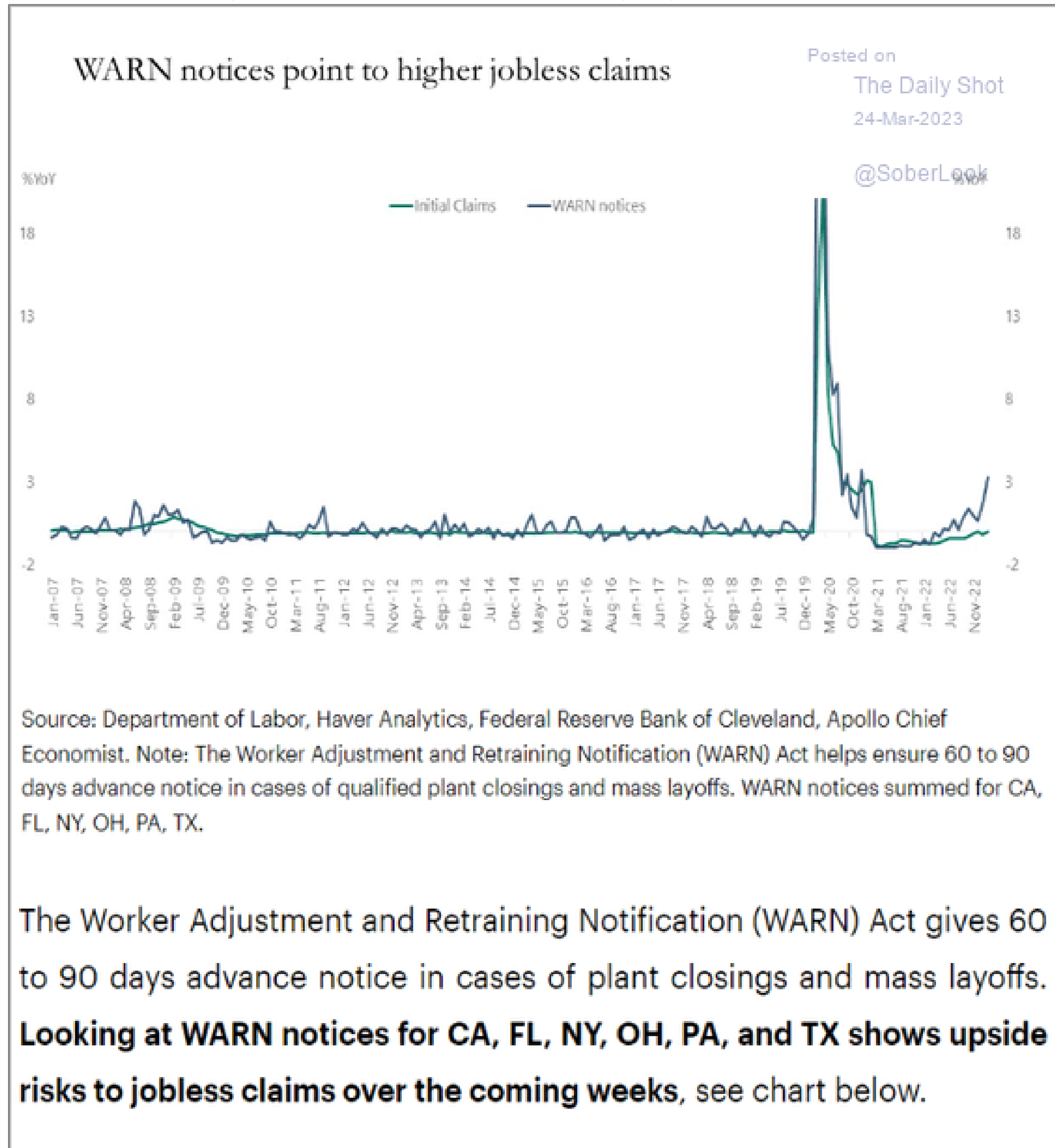
Teens are hooked on social media.



Social Media doesn't appear to be healthy for our children.



How does WARN not go with this lede? -> Warn warns of higher jobless claims.



Source: Department of Labor, Haver Analytics, Federal Reserve Bank of Cleveland, Apollo Chief Economist. Note: The Worker Adjustment and Retraining Notification (WARN) Act helps ensure 60 to 90 days advance notice in cases of qualified plant closings and mass layoffs. WARN notices summed for CA, FL, NY, OH, PA, TX.

The Worker Adjustment and Retraining Notification (WARN) Act gives 60 to 90 days advance notice in cases of plant closings and mass layoffs. **Looking at WARN notices for CA, FL, NY, OH, PA, and TX shows upside risks to jobless claims over the coming weeks**, see chart below.

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.

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