Market Outlook

By Mark T Dodson, CFA

Markets Wait and See

Market Risk Index finished the week at 68.0%. A slight improvement to the Psychology Composite due to corporate insider buying in small and midcap stocks was offset by deterioration in the Monetary Composite.

Monetary Conditions moved out of the best 20% of readings, but it's still historically bullish when looking at intermediate-term outcomes for equity markets on average. However, the yield curve inversion sticks out like a sore thumb in the composite, signaling that the overall improvement we have seen in many monetary composite categories is likely a precursor to recession.

Stock market internals are fracturing as mega-cap stocks drive nearly all the gains in cap-weighted indices in 2023. Relative performance and relative valuations of small-cap market segments are either on the cusp of setting new lows or at all-time lows. Consequently, the NASDAQ High Low Logic Index triggered its first warning of a split market since the October market bottom, with the NYSE version of the indicator still in a more neutral zone but edging higher. If you are in the camp of a new bull market, it's less than ideal to come so soon after a muted rally to signal the start of a new bull.

With the market seeming to be placing bets that we have seen the last of Fed rate hikes, the market mood has become more consistent with a wait-and-see approach. That wait-and-see is a coin toss between whether a budding slow-motion bank run leads to a credit-crunch driven recession or a Goldilocks' soft-landing with Powell riding off into the sunset high-fiving other central bankers. We believe equity positioning by the average household is a big red flag here. It appears too aggressive for such a binary outcome, likely because investors have been conditioned (burned) by 15 years of Fed policy punishing them for choosing asset allocations traditionally considered prudent. If karma has any say, central bankers don't deserve a round of high fives – they deserve a long walk out into the yard to pick a switch and take their licks.

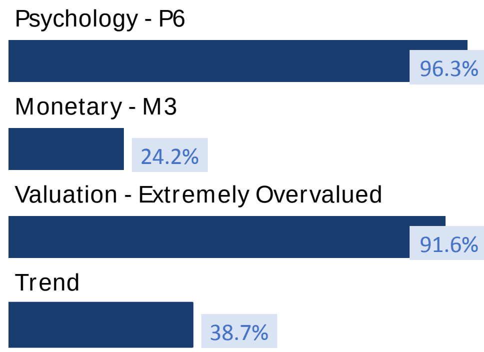
The weight of the evidence has us in a similar mood as markets, but we do so with an equity allocation that is consistent with the drawdown picture that equity market valuations are painting instead of any fear-driven notion that the Fed has the ability or willingness to open the monetary spigots so soon after such a massive wave of inflation for the first time in a generation.

Market Risk Index

Rec Allocation 25% Underweight

68.0%

Category Percentiles



Largest Psychology Influences	
Leveraged Investments	Negative
Flow of Funds	Negative
Consumer Confidence	Negative
Technical Indicators	Negative

Largest Monetary Influences	
Interest Rate Spreads (Yield Curve)	Negative
Inflation	Positive
Lending & Leverage	Positive

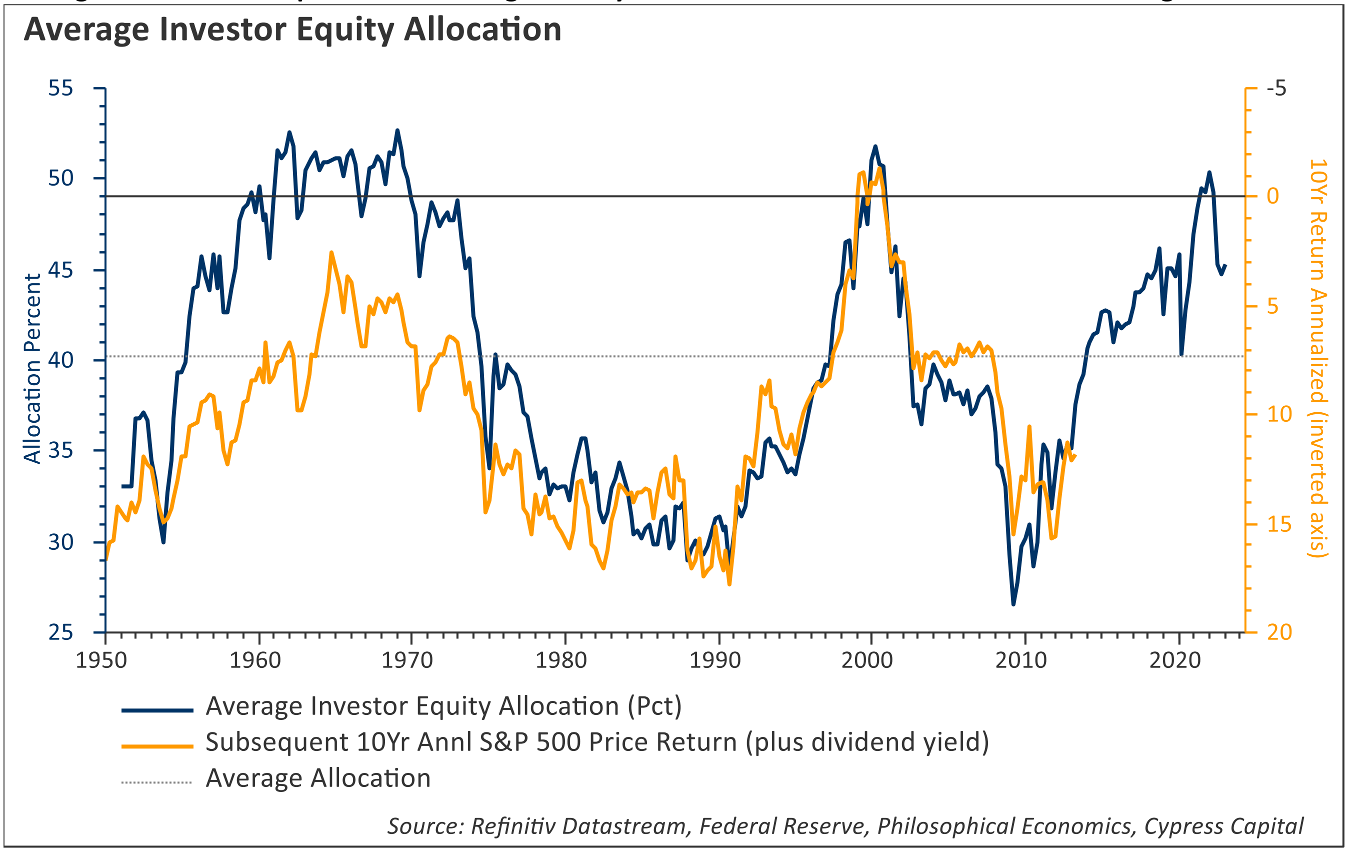
Valuation	
7-10 Year Equity Return Forecast	3.0%
10Yr US Treasury Yield	3.5%

Market Trends	
US Equities	Bullish Trade
Intl Equities	Bullish Trade
REITs	Bearish Trade
Broad Commodities	Bearrish Trade

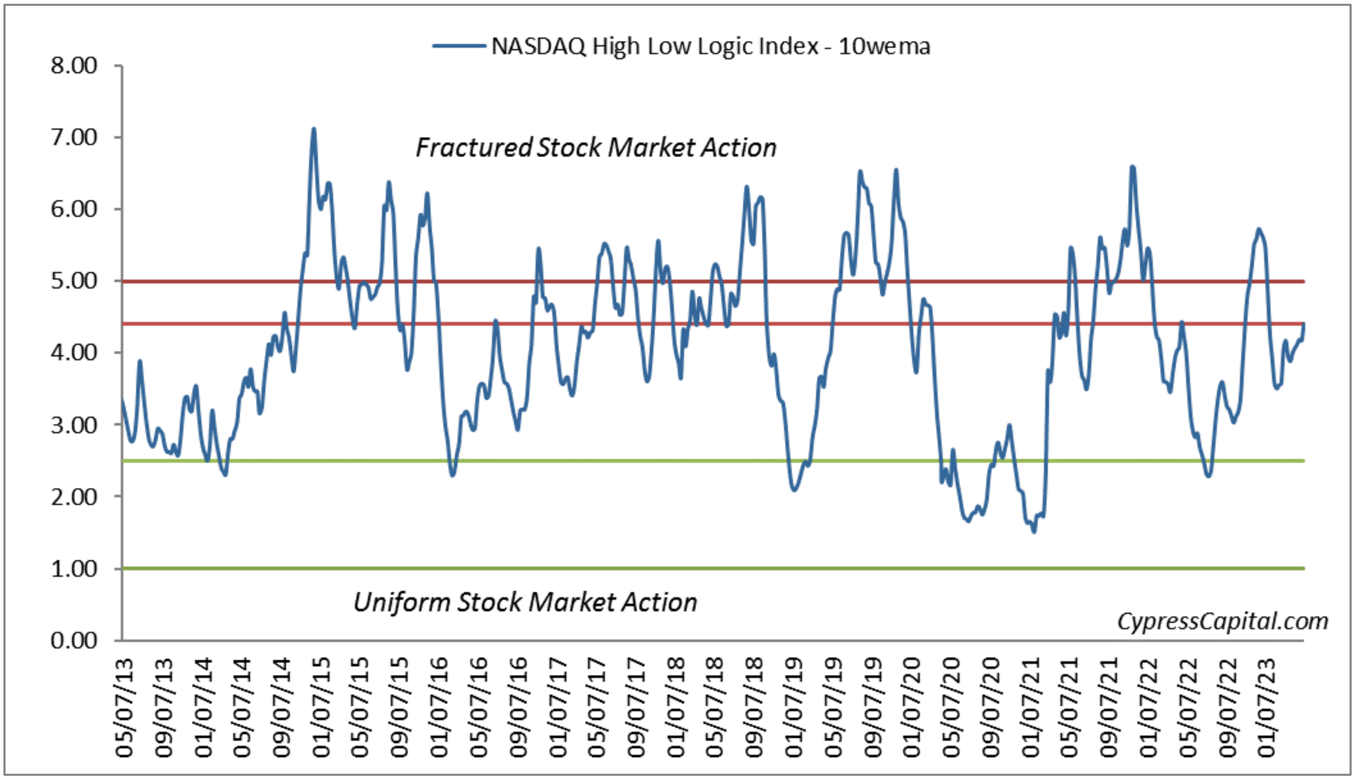
Market Risk Index scales from 0 to 100%. Higher readings correspond with higher risk markets. Scores below 25% are bullish. Scores between 25-75% are neutral, and scores above 75% are markets vulnerable to major drawdowns.

Charts of the Week

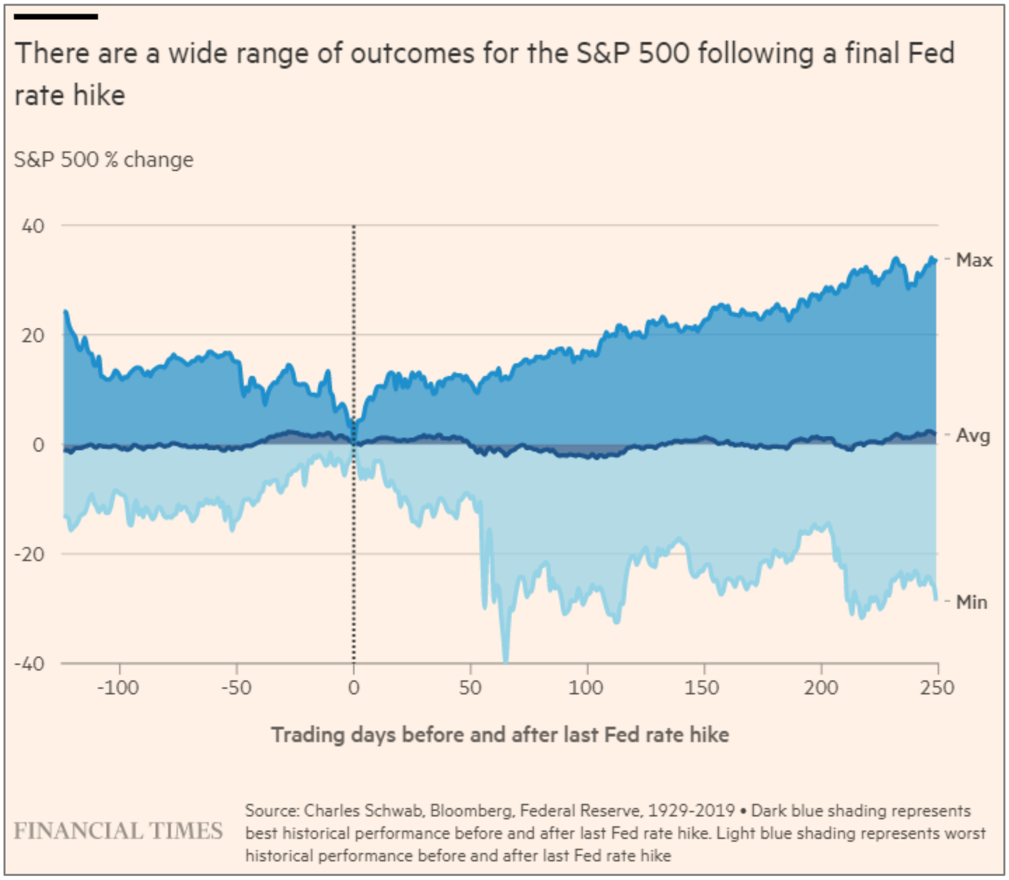
Average Allocation to equities remains high for any economic outcome other than a soft landing.



NASDAQ High Low Logic Index moves back to signaling a fractured stock market.



Final Fed-Rate Hikes have a wide range of outcomes for stocks.



Average US stock performance around a final Fed rate hike – down, then up.

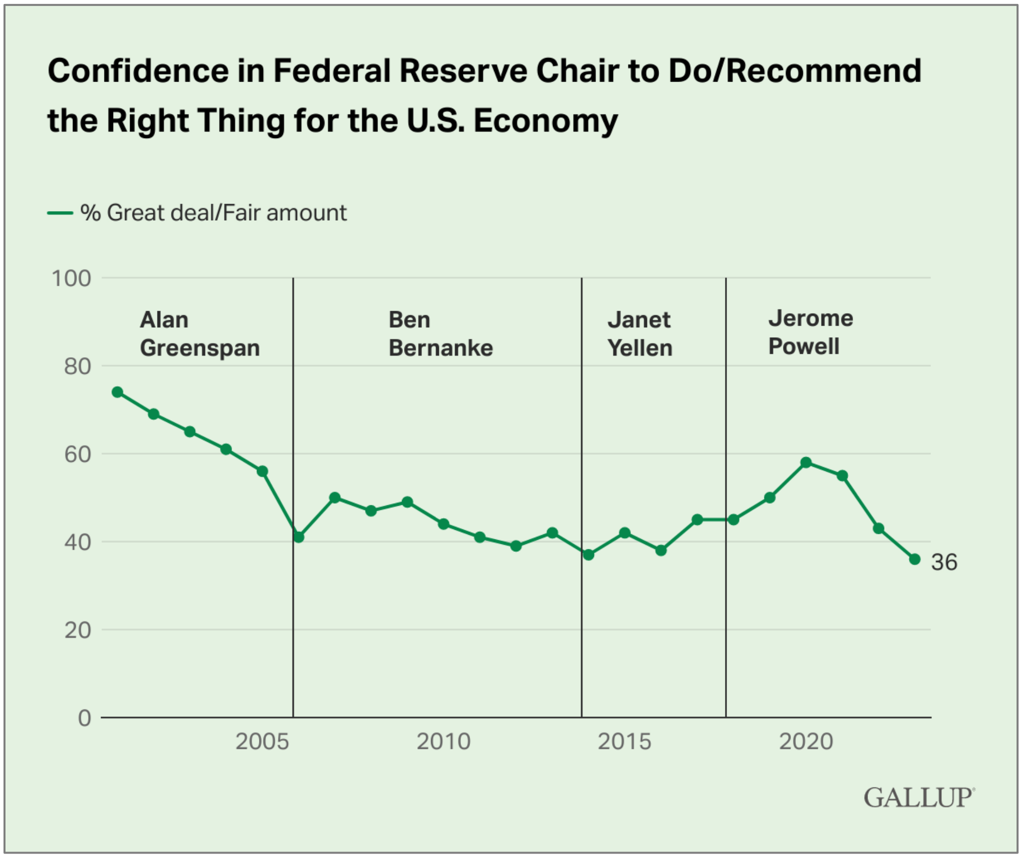
Final Fed Rate Hikes – Table of Outcomes since 1929

Final Fed rate rises

Final Fed rate rise	S&P 500 performance — 6 months later	S&P 500 performance — 12 months later	Subsequent first Fed rate cut (no. of days)
8/9/1929	-17.8%	-28.6%	59
16/1/1953	-7.2%	-3.2%	320
23/8/1957	-8.2%	6.3%	58
11/9/1959	-5.5%	-2.8%	185
6/12/1965	-5.0%	-11.2%	331
3/4/1969	-7.4%	-10.5%	405
25/4/1974	-18.4%	-2.6%	155
15/2/1980	8.5%	11.1%	71
5/5/1981	-6.5%	-10.9%	874
24/2/1989	20.1%	14.2%	68
1/2/1995	19.0%	32.1%	104
16/5/2000	-6.8%	-15.0%	155
29/6/2006	12.1%	18.3%	297
19/12/2018	17.8%	27.3%	150
Average	-0.4%	1.8%	231

Source: Charles Schwab, Bloomberg, Federal Reserve

Confidence in Powell is lower than any Fed Chair for the last 30 years.



Confidence in Powell has taken the biggest hit of all the economic leaders over the last year.

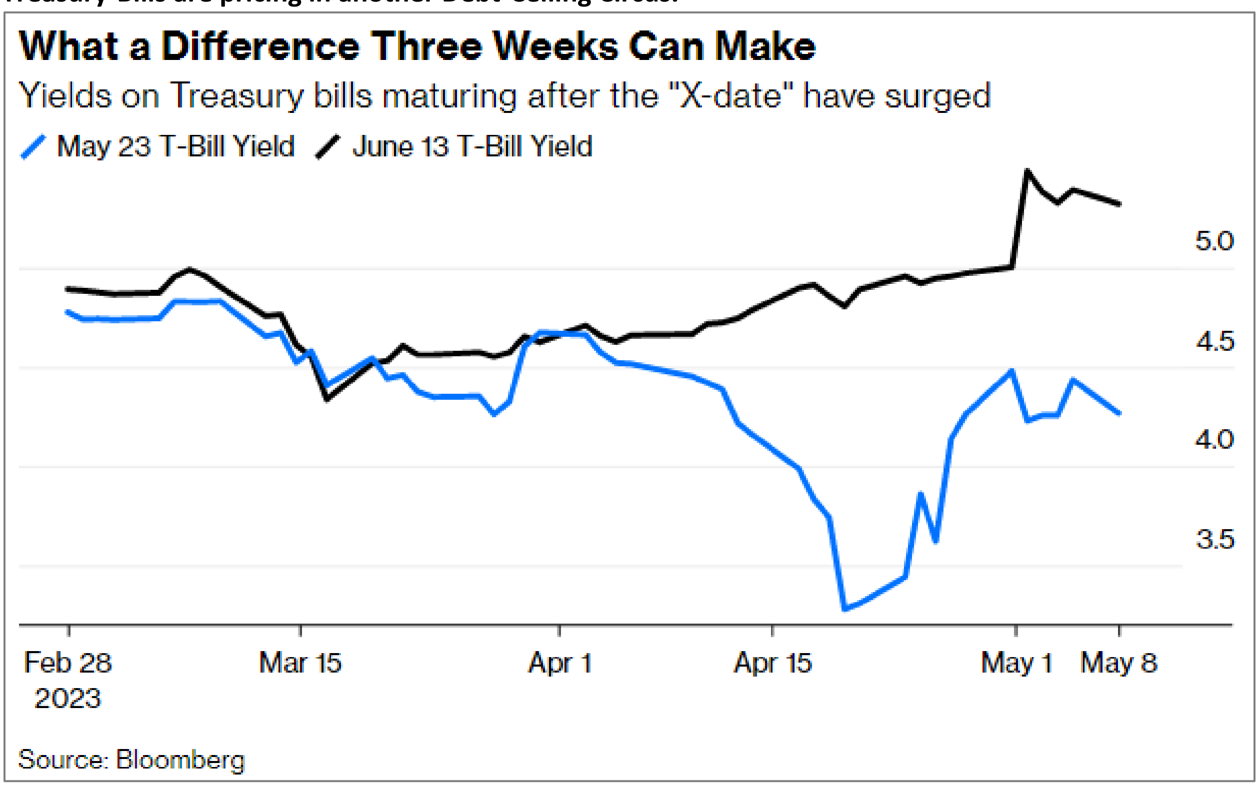
Changes in Confidence in Economic Leaders, 2022-2023

Figures are the percentage with a great deal or fair amount of confidence in each to do or to recommend the right thing for the economy

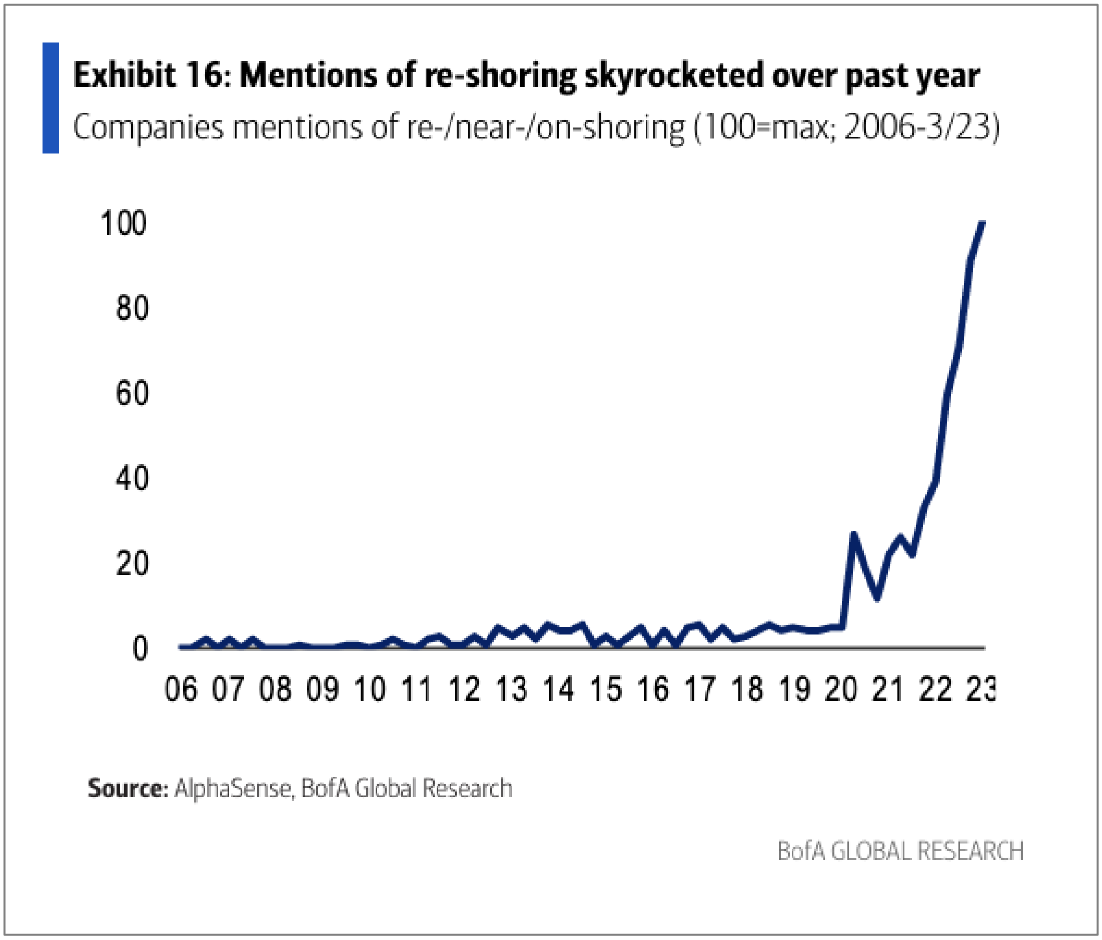
	2022 %	2023 %	Change pct. pts.
Federal Reserve Chairman Jerome Powell	43	36	-7
President Joe Biden	40	35	-5
The Democratic leaders in Congress	38	34	-4
The Republican leaders in Congress	40	38	-2

GALLUP

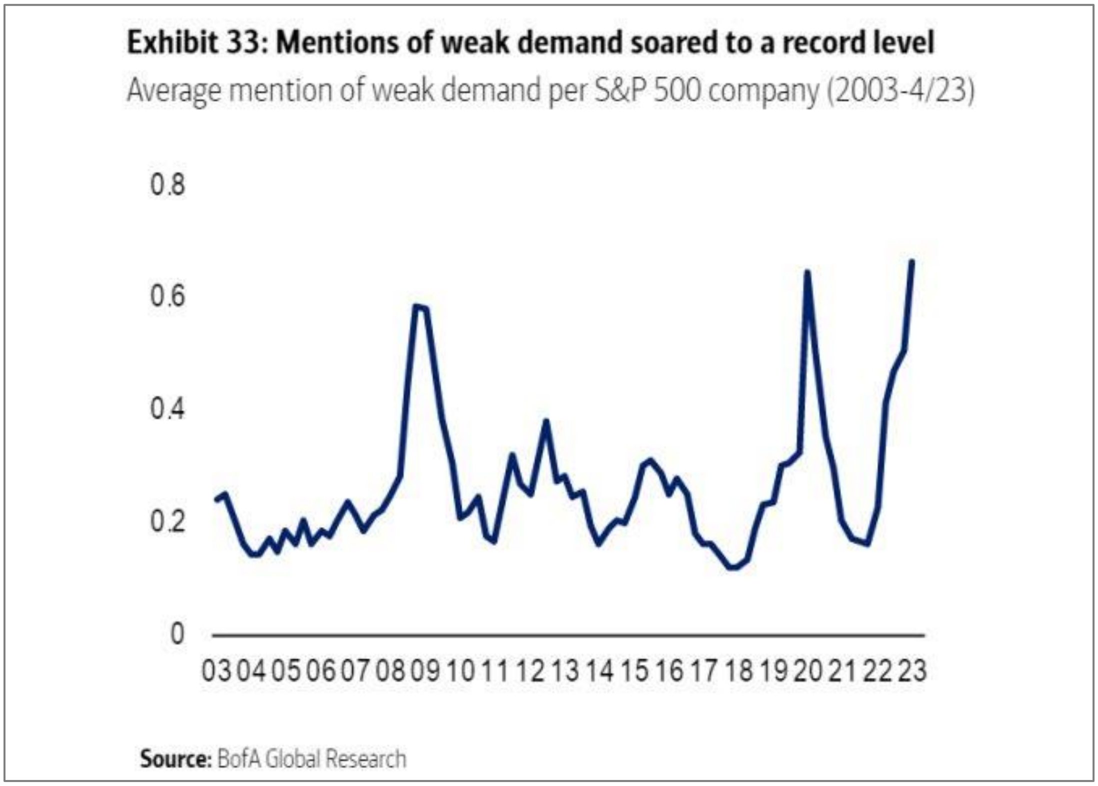
Treasury-Bills are pricing in another Debt-Ceiling Circus.



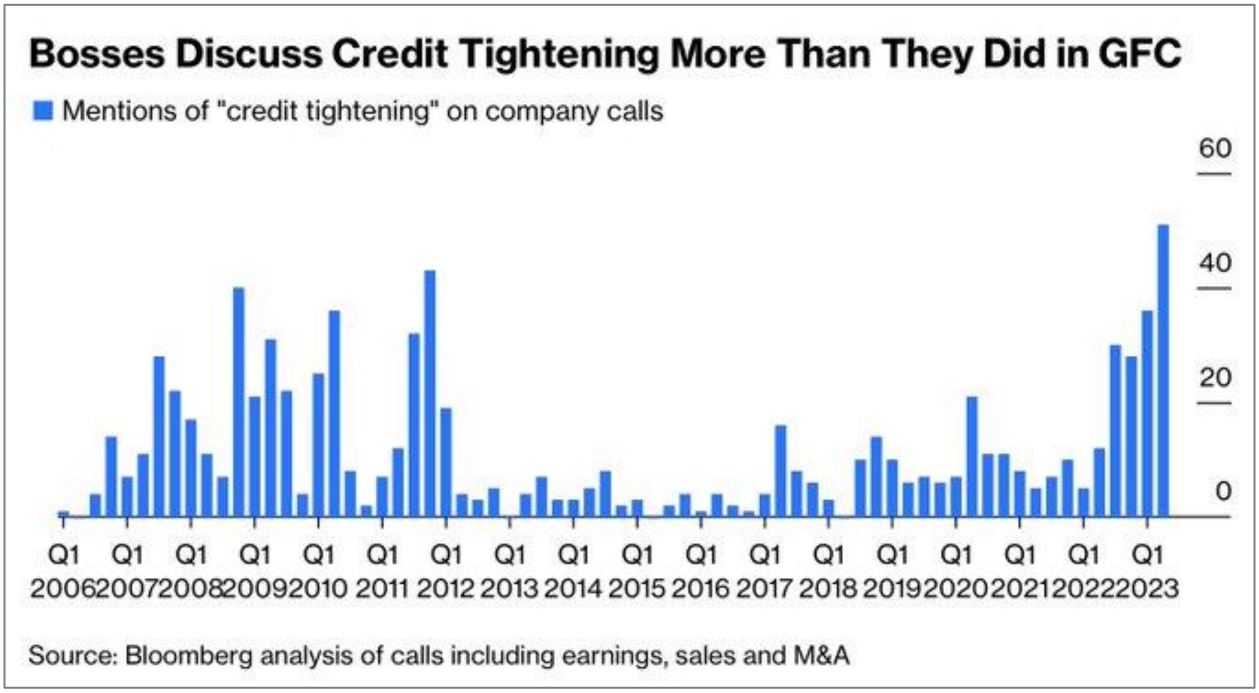
Earnings Calls – Re-Shoring is the most popular topic, one that reverberates with inflationary implications.



Earnings Calls – Weak demand is another popular topic.

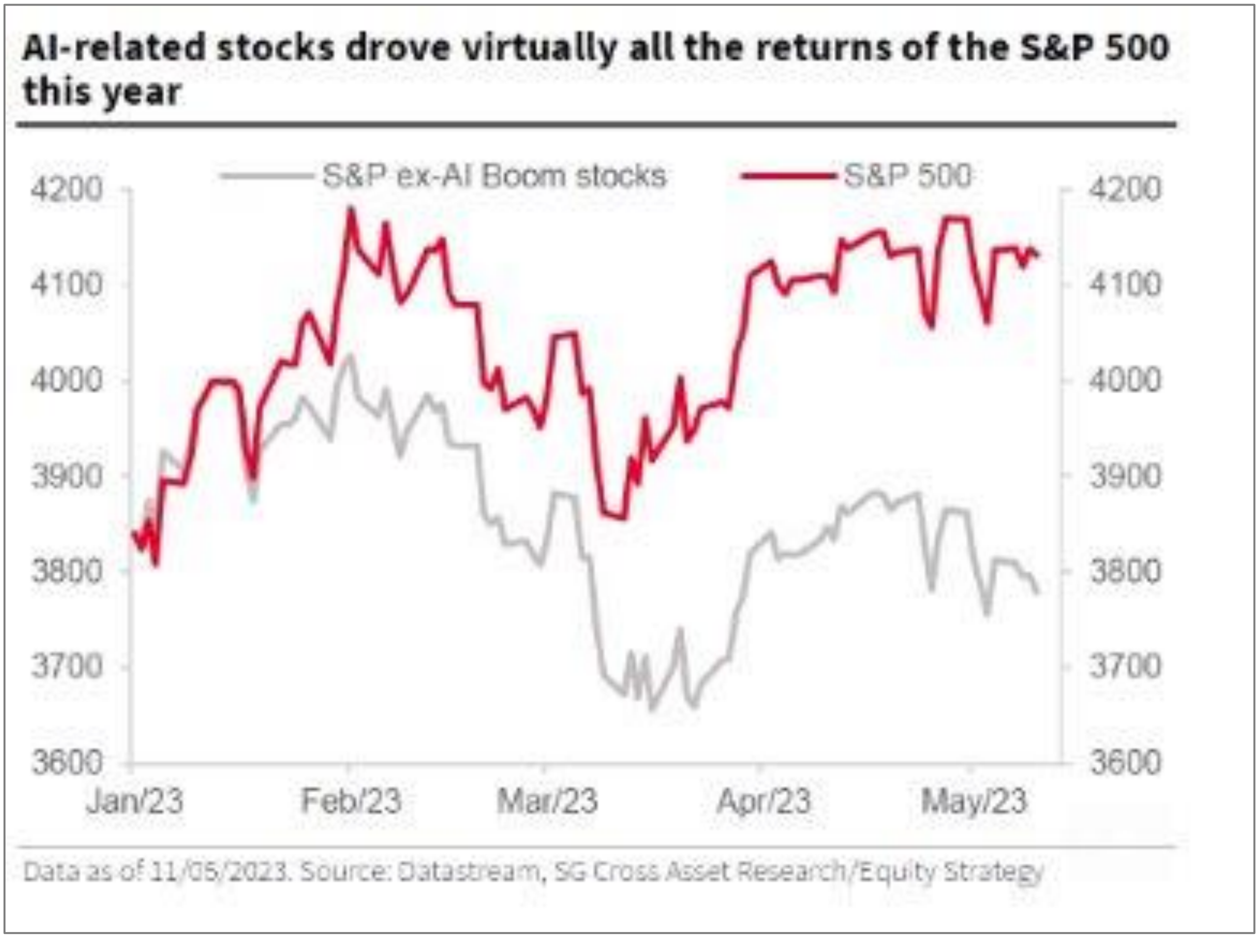


Earnings Calls – Credit Tightening is a concern of corporate executives.

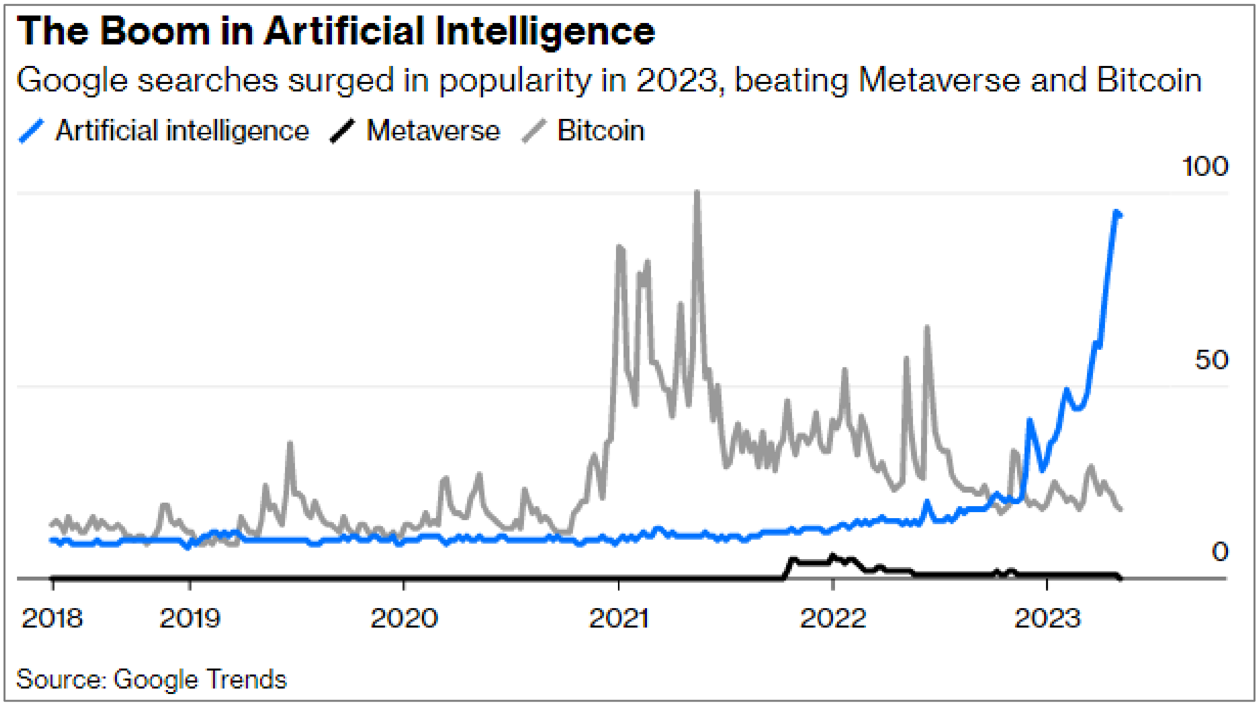


Earnings Calls – Mentions of Artificial Intelligence surge to a record.

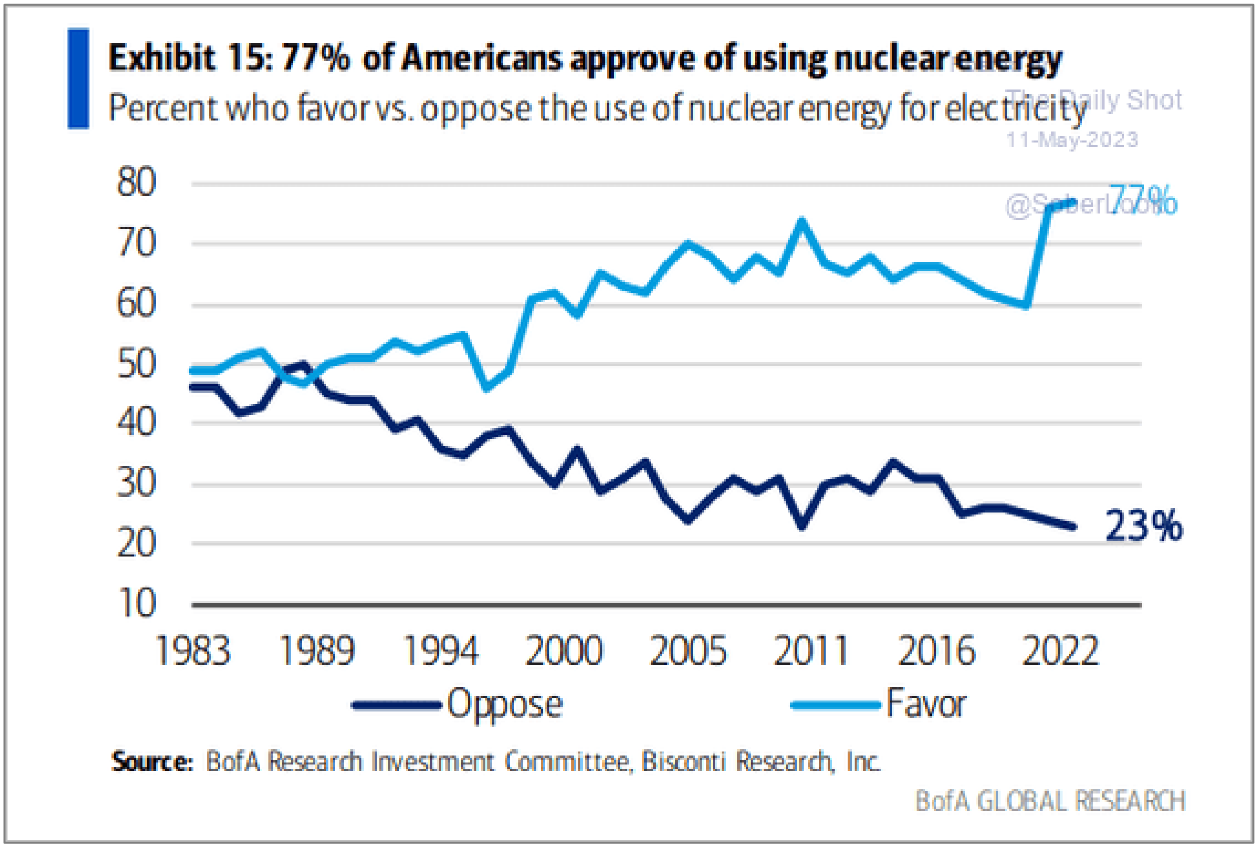
Stocks with a connection to Artificial Intelligence have driven S&P 500 returns in 2023.



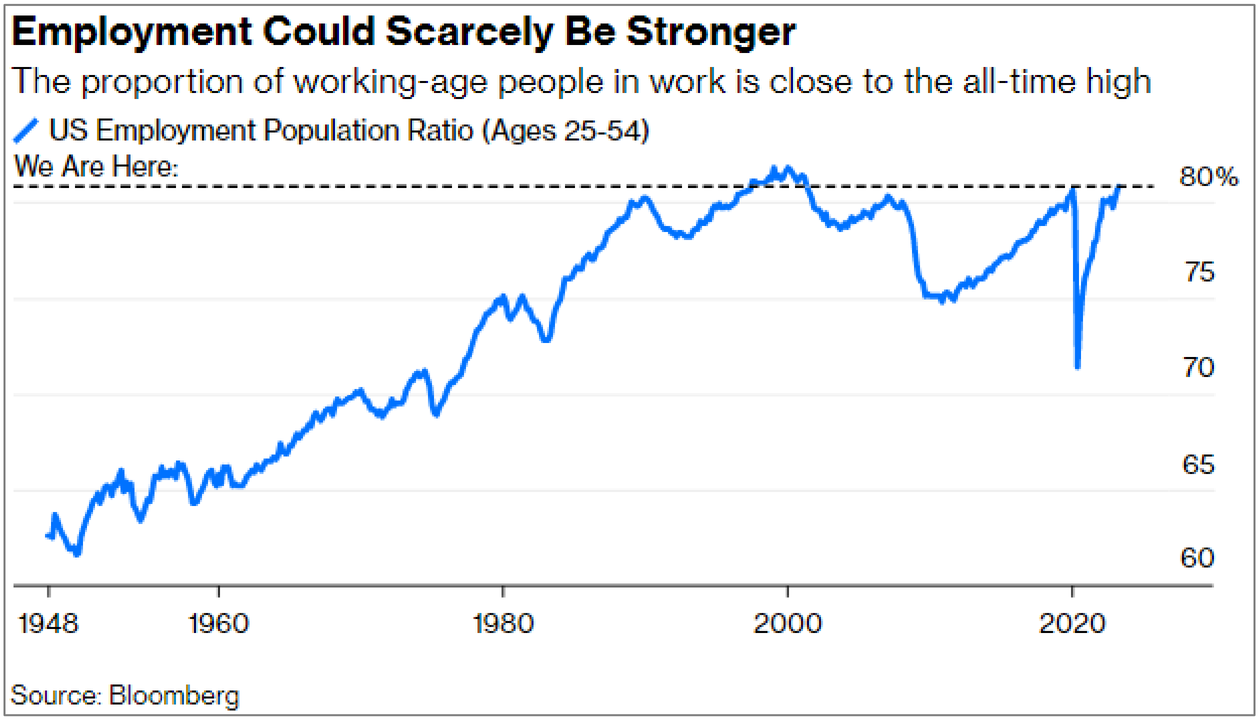
A surge of interest in Artificial Intelligence



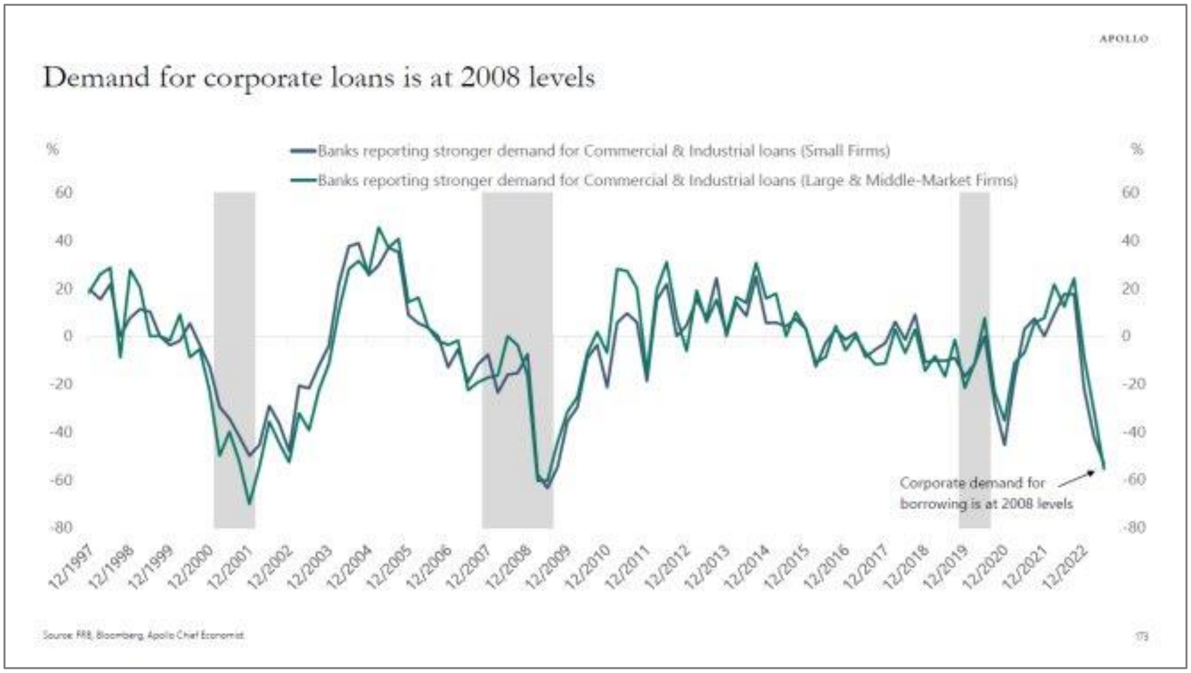
A Clean Energy Layup – A significant plurality of Americans approve of using Nuclear Energy.



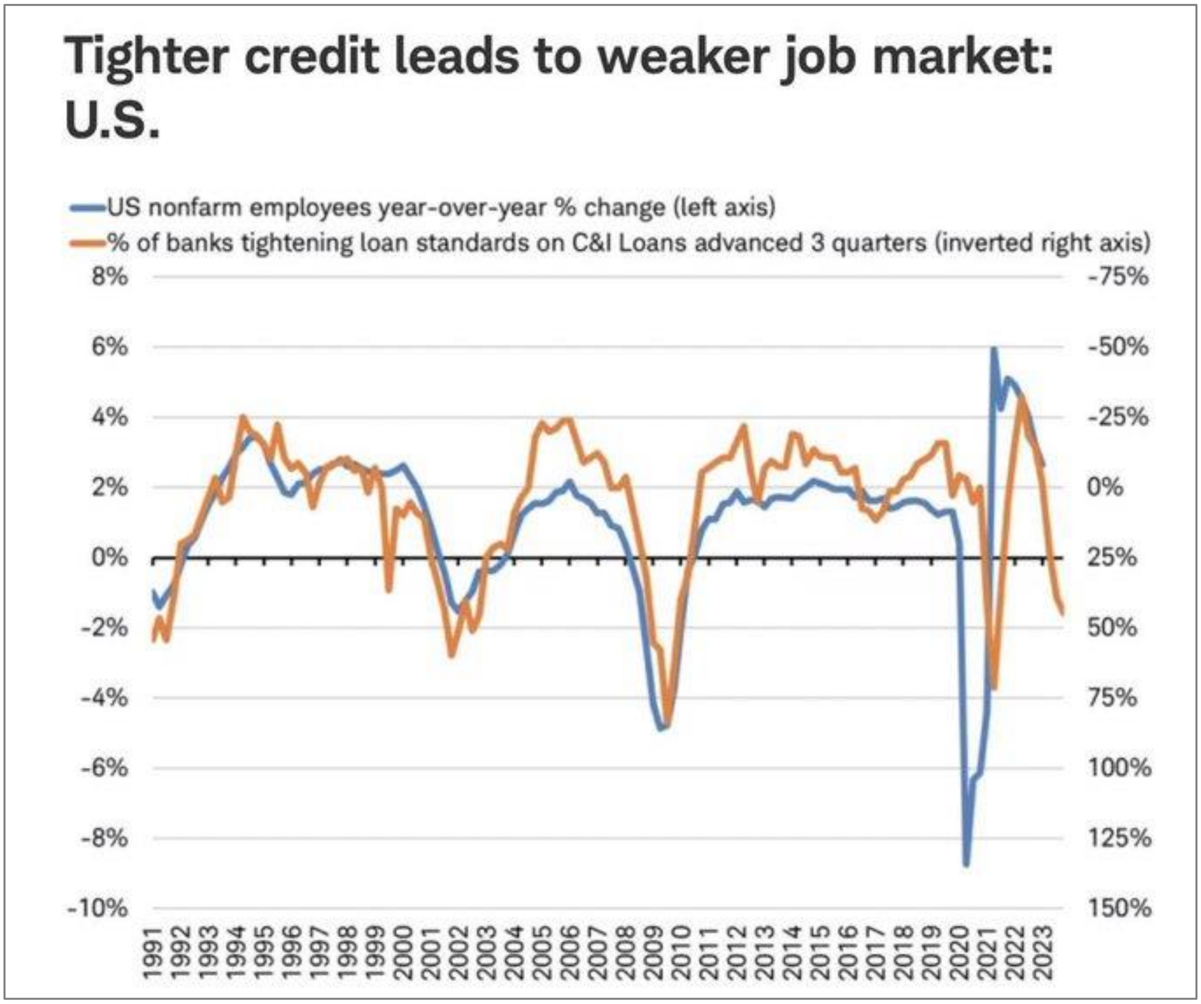
Employment could scarcely be stronger.



Corporate demand for loans looks recessionary.

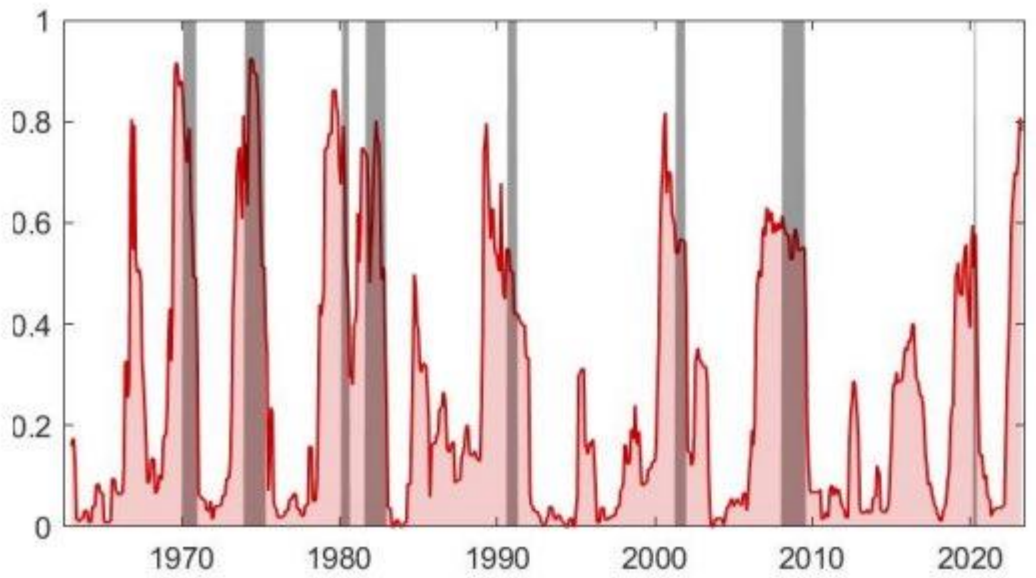


First comes tighter credit, then comes a weaker job market.



Recession probability model based on yield curve and credit fundamentals is signaling recession.

Figure 1: Overall recession probability at 78% in March (average of 3 models).



Source: Haver, UBS [Note: average of hard data, yield curve and credit fundamentals models.]

Final Rate Hikes and stocks – Sell in inflationary environments but Buy in disinflationary ones.

Chart 13: Sell the DJIA in inflation, buy in disinflation

DJIA returns after last rate hike: inflation vs. disinflation

		Dow Jones return post-hike	
Date of last Fed hike	**Fed Funds %**	**3-mo**	**6-mo**
5/1/1974	13.0%	(10.3%)	(22.8%)
3/3/1980	20.0%	(0.4%)	9.2%
5/8/1981	20.0%	(2.4%)	(12.0%)
1/4/1982	15.0%	(5.0%)	(9.7%)
8/21/1984	11.75%	(4.4%)	3.4%
Average return - inflationary period		**(4.5%)**	**(6.4%)**
2/24/1989	9.75%	10.6%	21.8%
2/1/1995	6.0%	12.5%	22.2%
5/16/2000	6.5%	2.2%	(3.8%)
6/29/2006	5.25%	4.5%	11.8%
12/19/2018	2.375%	11.0%	13.5%
Average return - disinflationary period		**8.1%**	**13.1%**

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Source: BofA Global Investment Strategy, Bloomberg

Final Rate Hikes and the US Dollar – Buy in inflationary environments but Sell in disinflationary ones.

Chart 16: Buy US dollar in inflationary period
US$ returns after last rate hike: inflation vs. disinflation

	US $ return post-hike	
Date of last Fed hike	3-mo	6-mo
5/1/1974	2.2%	2.7%
3/3/1980	(2.2%)	(2.3%)
5/8/1981	11.2%	3.1%
1/4/1982	8.9%	14.3%
8/21/1984	3.2%	11.9%
Average - Inflationary Period	**4.7%**	**6.0%**
2/24/1989	8.5%	7.5%
2/1/1995	(7.3%)	(7.5%)
5/16/2000	(0.2%)	3.9%
6/29/2006	(0.3%)	(2.3%)
12/19/2018	(0.7%)	0.6%
Average - Disinflationary Period	**0.0%**	**0.5%**

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Source: BofA Global Investment Strategy, Bloomberg

Final Rate Hikes and the US Dollar – Buy in inflationary environments and Hold during disinflationary ones.

Chart 17: US 30-yr Treasury outperforms after the last Fed hike
US 30-yr Treasury returns after last rate hike: inflation vs. disinflation

	US 30-yr Treasury return post-hike	
Date of last Fed hike	3-mo	6-mo
5/1/1974	(1.8%)	(6.5%)
3/3/1980	20.7%	14.5%
5/8/1981	1.1%	2.0%
1/4/1982	3.3%	5.1%
8/21/1984	13.6%	21.2%
Average - Inflationary Period	**7.4%**	**7.3%**
2/24/1989	1.5%	15.3%
2/1/1995	6.4%	14.7%
5/16/2000	4.1%	5.6%
6/29/2006	6.5%	13.4%
12/19/2018	5.0%	17.0%
Average - Disinflationary Period	**4.7%**	**13.2%**

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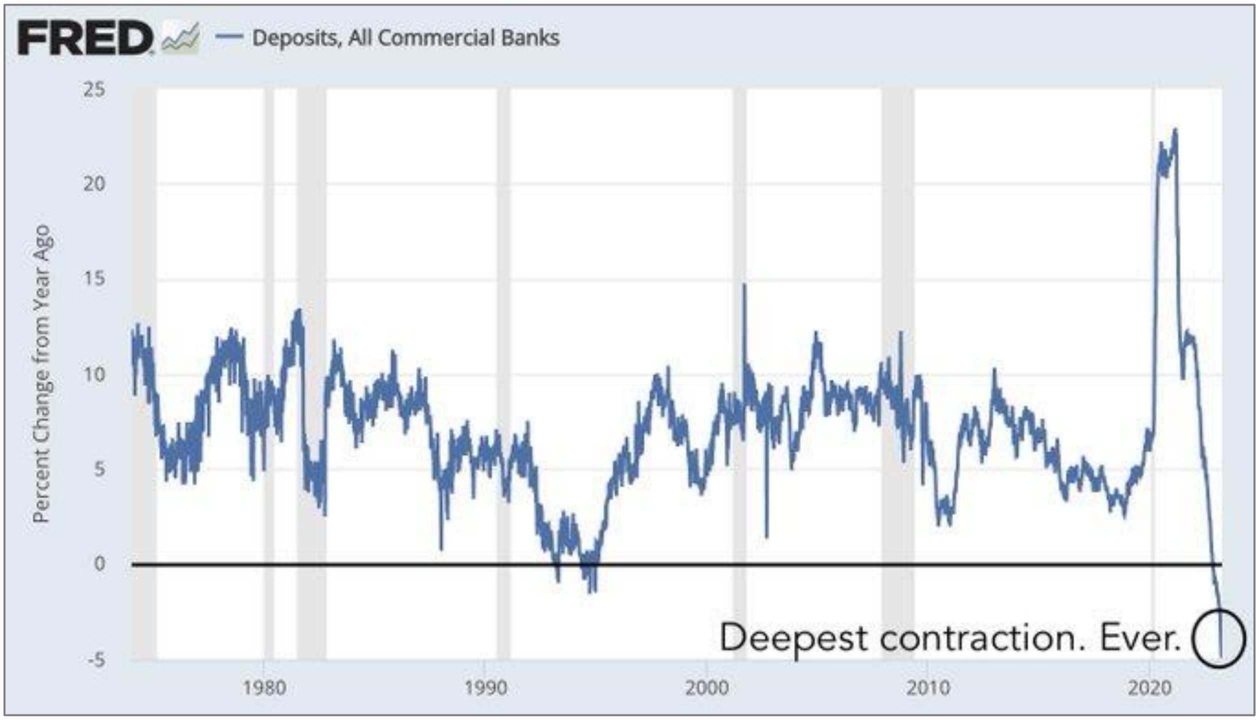
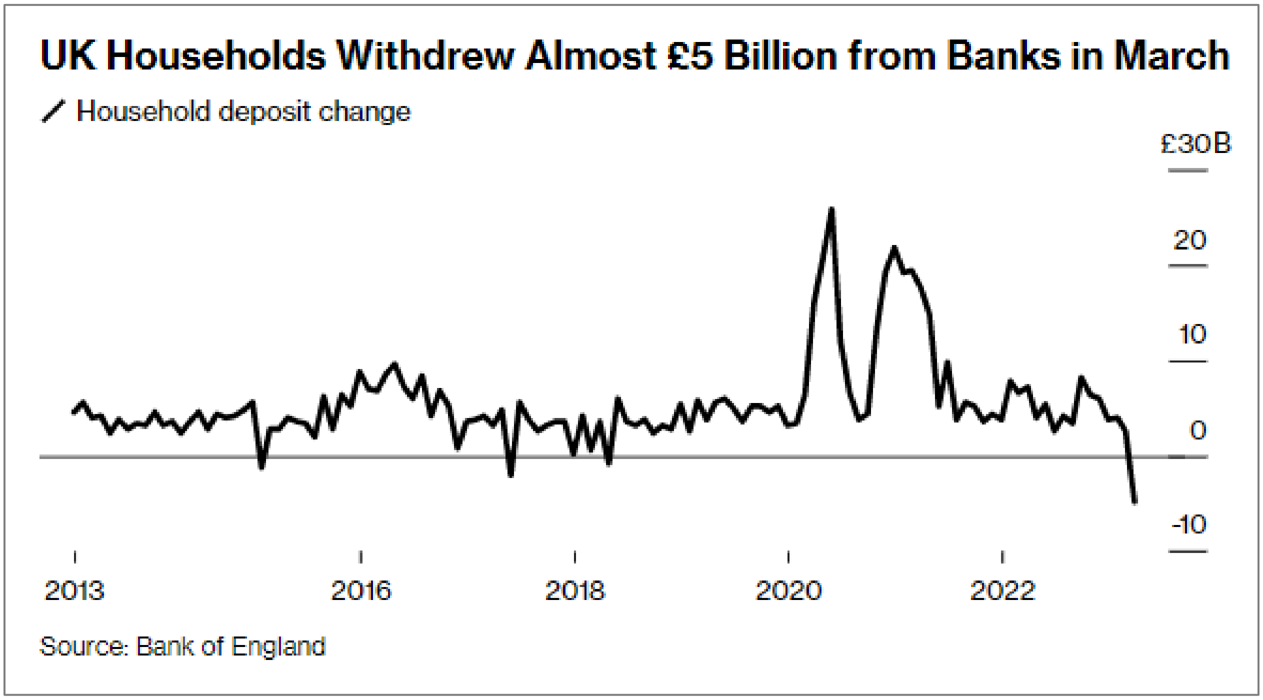
Source: BofA Global Investment Strategy, Bloomberg

Bank Deposits - deepest contraction on record follows deepest spike on record.



The decline in bank deposits is a global phenomenon.



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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