Market Outlook

By Mark T Dodson, CFA

Chasing Leverage

Market Risk Index improved to 71.3%, edging further away from the worst quartile of readings that mark environments we deem most risky of a market drawdown. Monetary conditions moved further into their most bullish zone.

Bank lending has dropped sharply since peaking in February, with the first negative six-month rate change in bank credit since 2008-2010. A drop like this occurs typically late in a recession that has become obvious to everyone. However, the sequence of shifts by categories in the Monetary Composite remains out of sorts, unlike the typical cycle unfolding. Inflation peaked first, then bank lending, and only nascent signs of a shift in velocity or spreads – usually the two more leading categories.

Regardless of the sequence, to keep the current soft-landing and bullish stance of our Monetary Composite intact, it looks as if it will require the yield curve inversion to continue to steepen or avoid reverting to a positive slope – an impossible order. In this sense, the general lack of risk aversion among investors and households is doing the heavy lifting to keep our Monetary Composite on solid footing.

For investor psychology, the move to Euphoria became more official this week. Assets in leveraged long ETFs and mutual funds have doubled since their October low, causing the ratio of investments in Leveraged Long to Inverse funds to breach the extreme greed threshold this week – the same goes for the equity put/call ratio. It echoes the animal spirits period from 2021, except the Fed was actively encouraging speculative behavior with interest rate policy at the time.

The irony is not lost on us that the week we see these greed thresholds breached coincides with the announcement that the folks at NASDAQ will reign investors in and rebalance their indices because they have become too concentrated in mega-cap tech to be considered diversified investments.

Meanwhile, breadth improved, and the rally broadened. Our NYSE Overbought/Oversold indicator hit overbought status, which may mean softer market prices over a few weeks. But in a bull market,

Market Risk Index

Rec Allocation 25% Underweight

71.3%

Category Percentiles

Psychology - P6

98.1%

Monetary - M3

25.6%

Valuation - Extremely Overvalued

95.5%

Trend

40.6%

Largest Psychology Influences

Leveraged Investments	Negative
Option Activity	Negative
Technical Indicators	Negative
Flow of Funds	Negative

Largest Monetary Influences

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

Valuation

7-10 Year Equity Return Forecast	1.7%
10Yr US Treasury Yield	4.0%

Market Trends

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

overbought readings generally indicate higher prices are in the offing. We suspect that the Fear of Missing Out has yet to peak.

As crazy as the current environment has become, we aren't recommending any additional reductions in equity exposures. While Psychology and Valuation are doing their best to get us to call an Uber, Monetary Conditions want everyone to stay at the party a little longer.

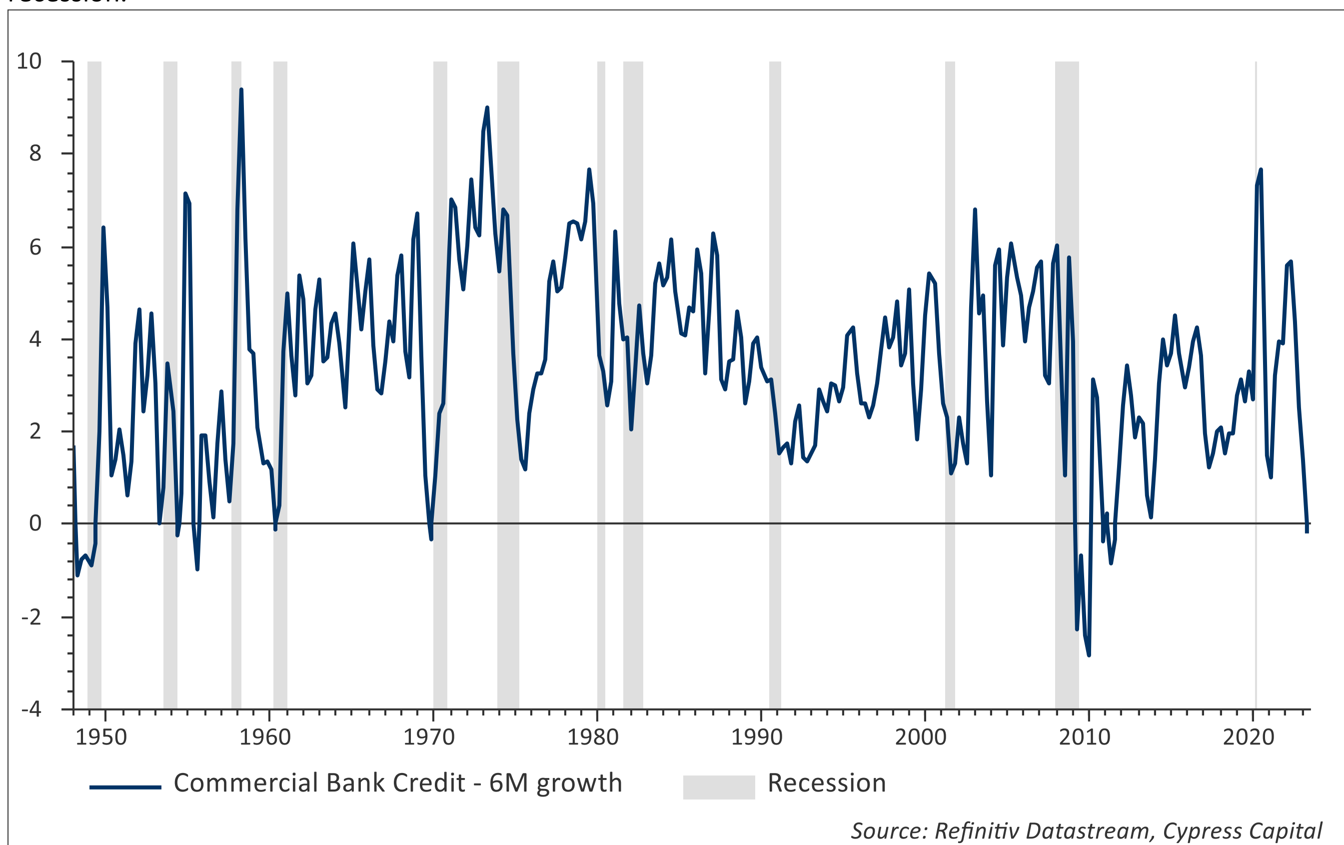
Note: We'll be traveling next week, so a Market Outlook will not be published unless unusual conditions warrant it.

Quote of the Week

"The spirit of the times is 'Don't worry about the markets crashing. They will come back up and set new highs.'" – Robert Shiller, Nobel Prize-winning economist

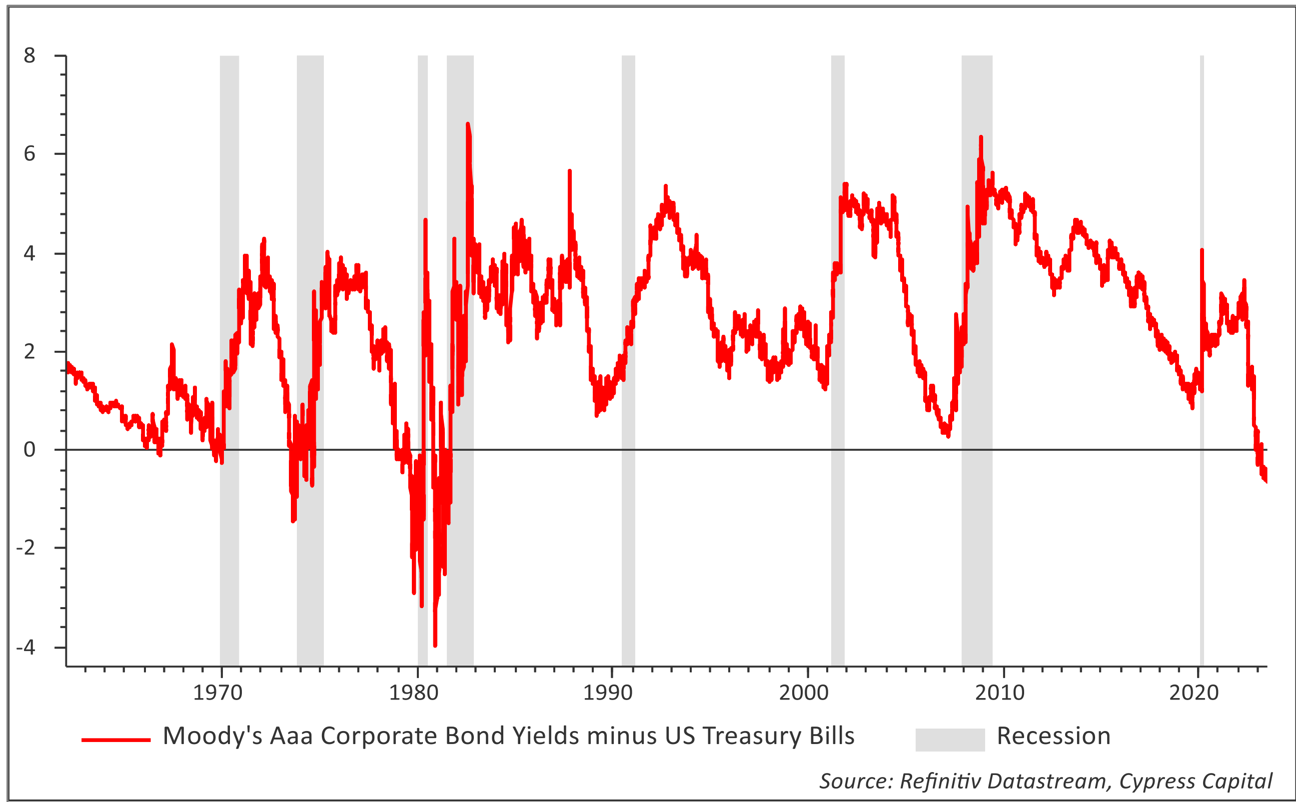
Charts of the Week

Six-month growth in bank credit turns negative for the first time since 2011.
Bank credit was a leading indicator of recession in the 1950s and 1960s, but it has typically been a lagging indicator since the 1974 recession, with downturns occurring well after most would agree the economy was in recession.

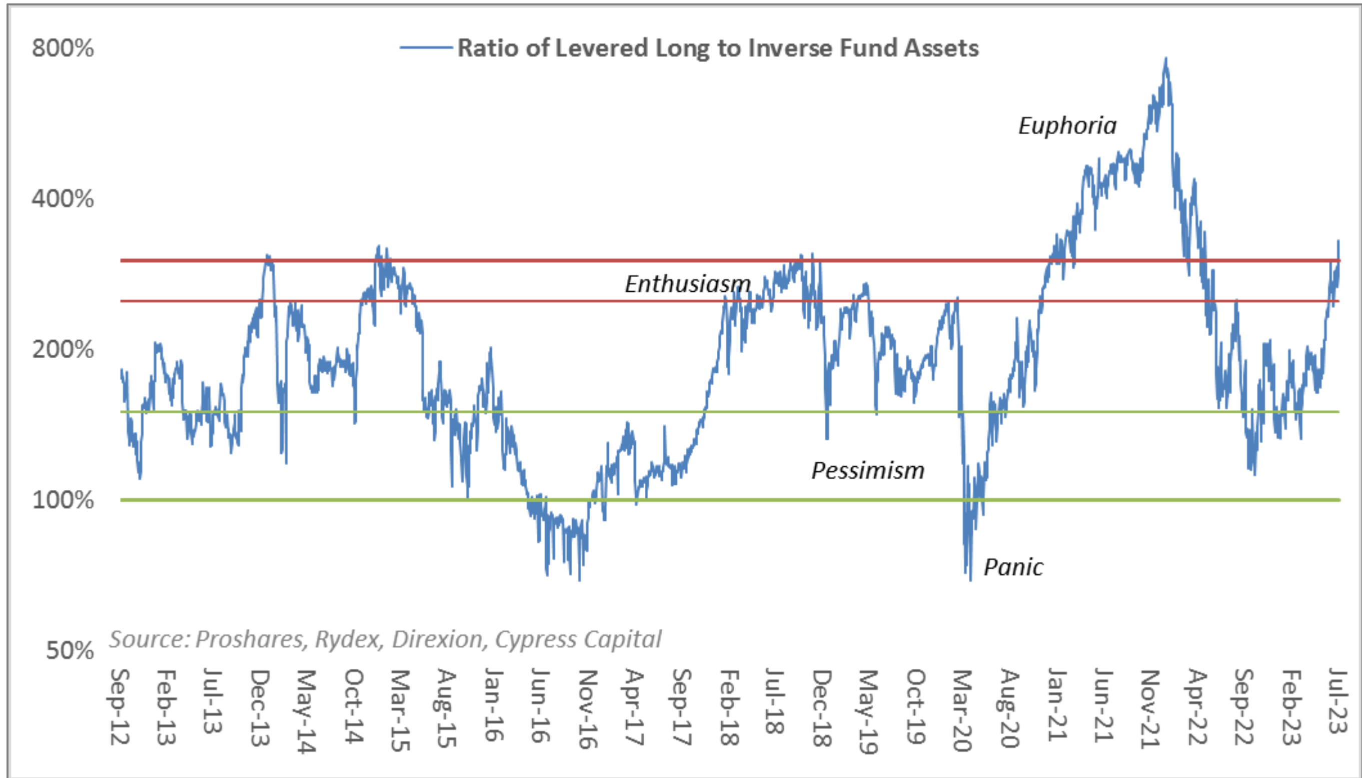


Moody's Aaa Corporate Bond Yields minus US Treasury Bills

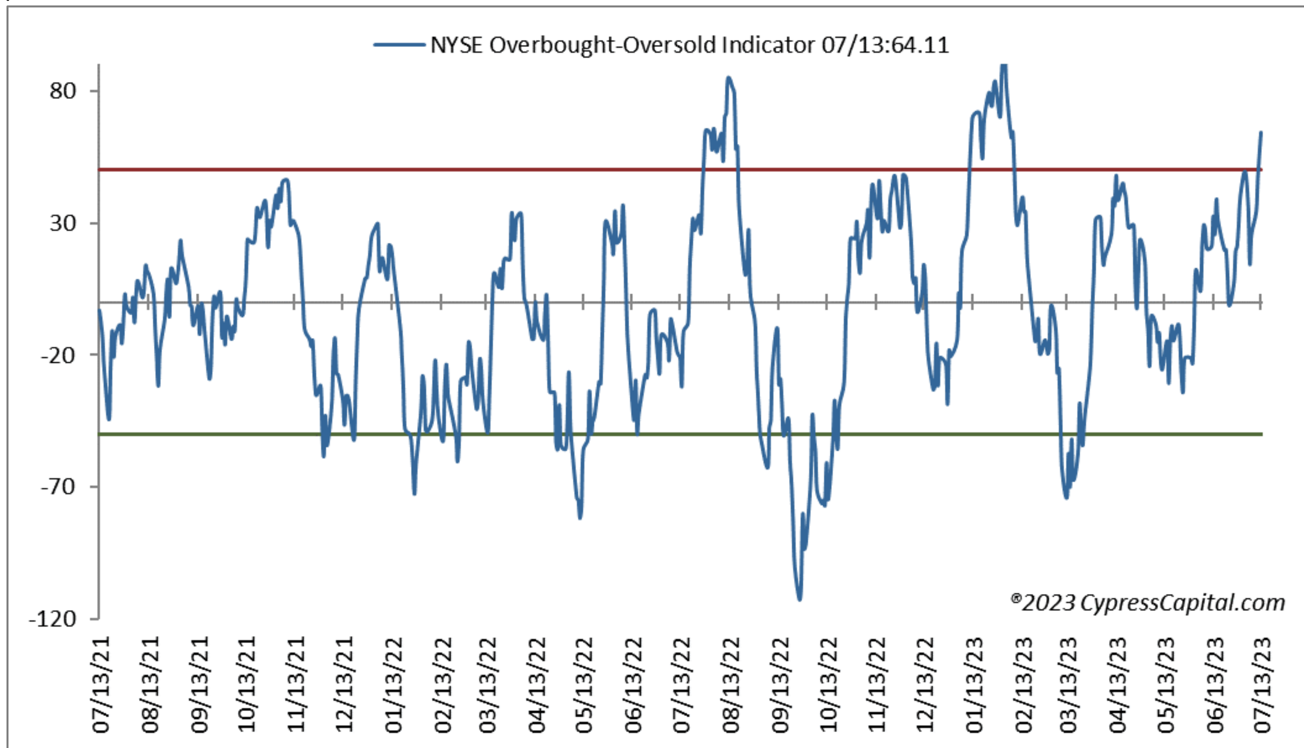
Bankers may be apprehensive to lend, but corporate bond investors are not. Yields on Investment Grade Corporate bonds fell below Treasury Bills for the first time since 1981. 2022 was the first bear market to see this measure fall instead of rise.



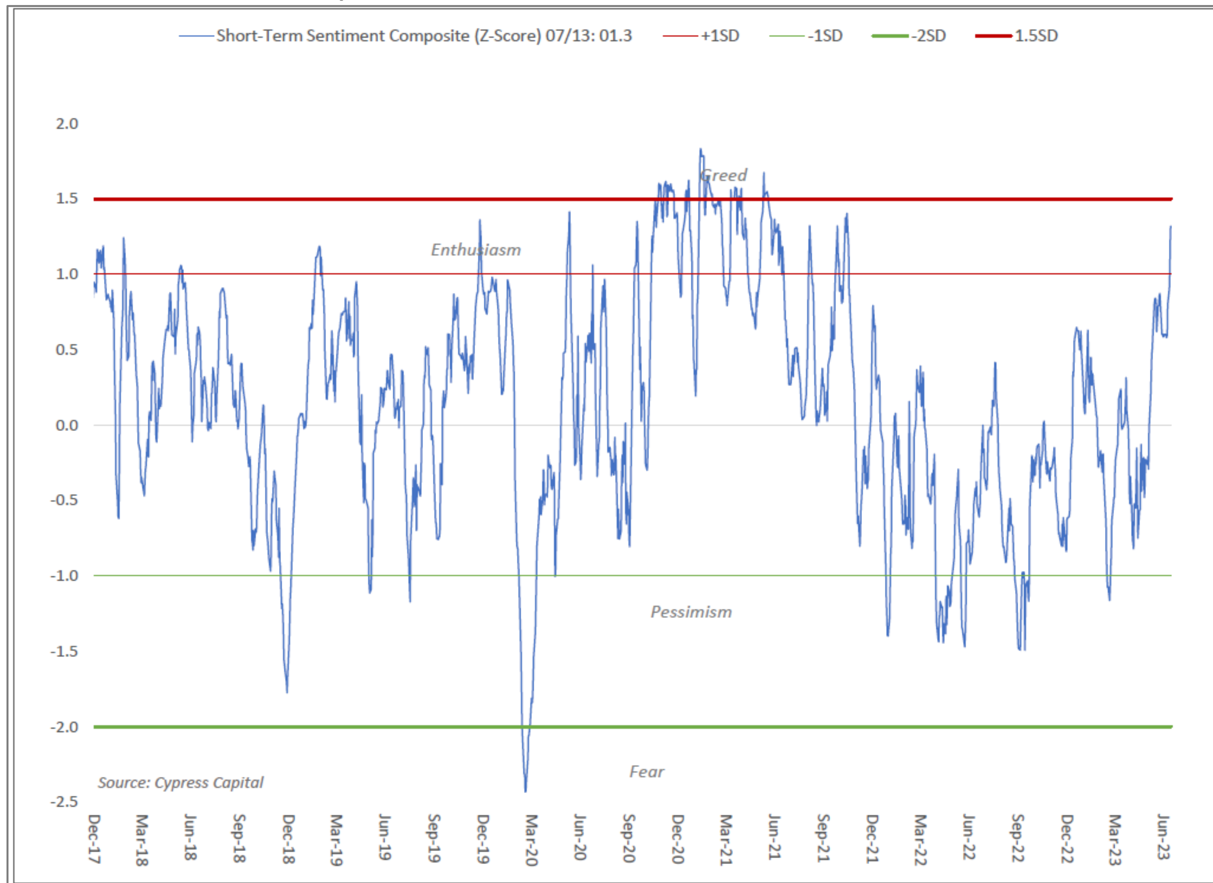
Ratio of Leveraged to Inverse Fund Assets went Euphoric this week.



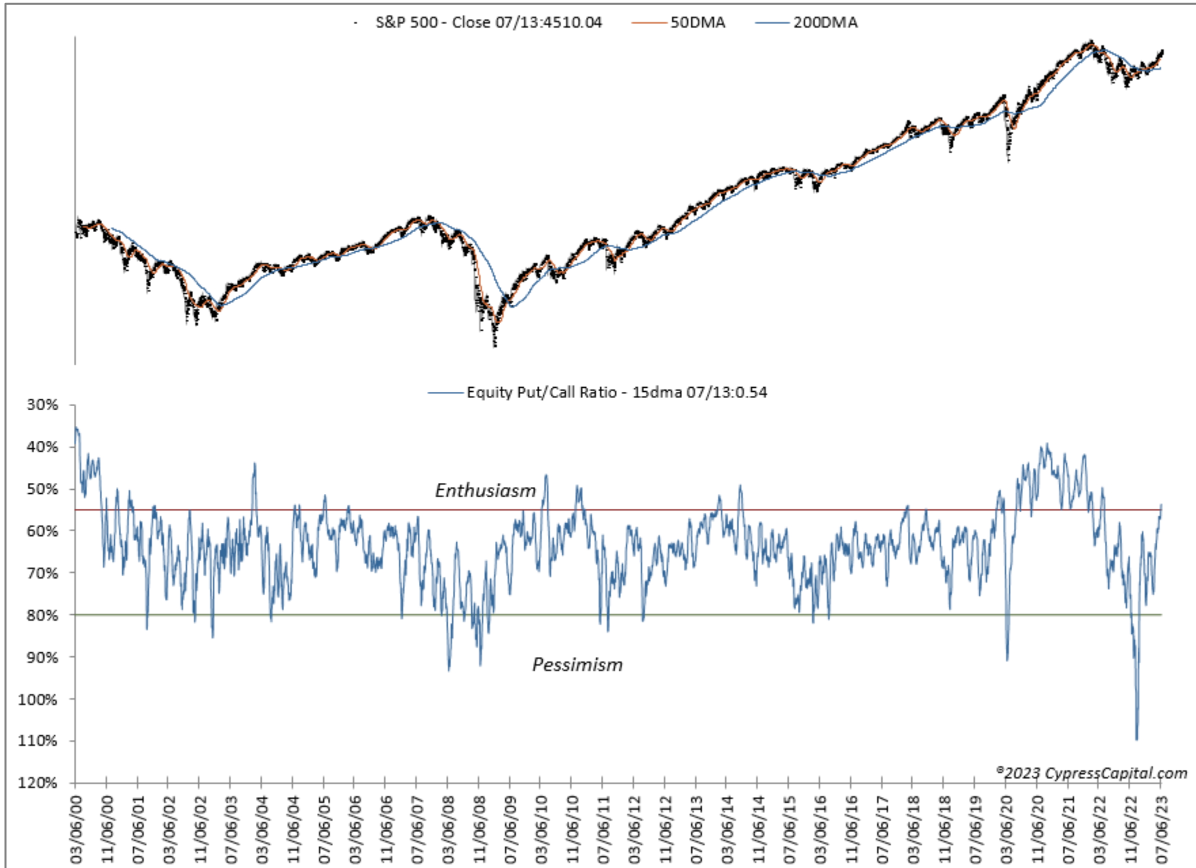
First Overbought reading since February.
In bear markets, it means a bear market rally is ending. In bulls, it means a short reprieve followed by higher prices.



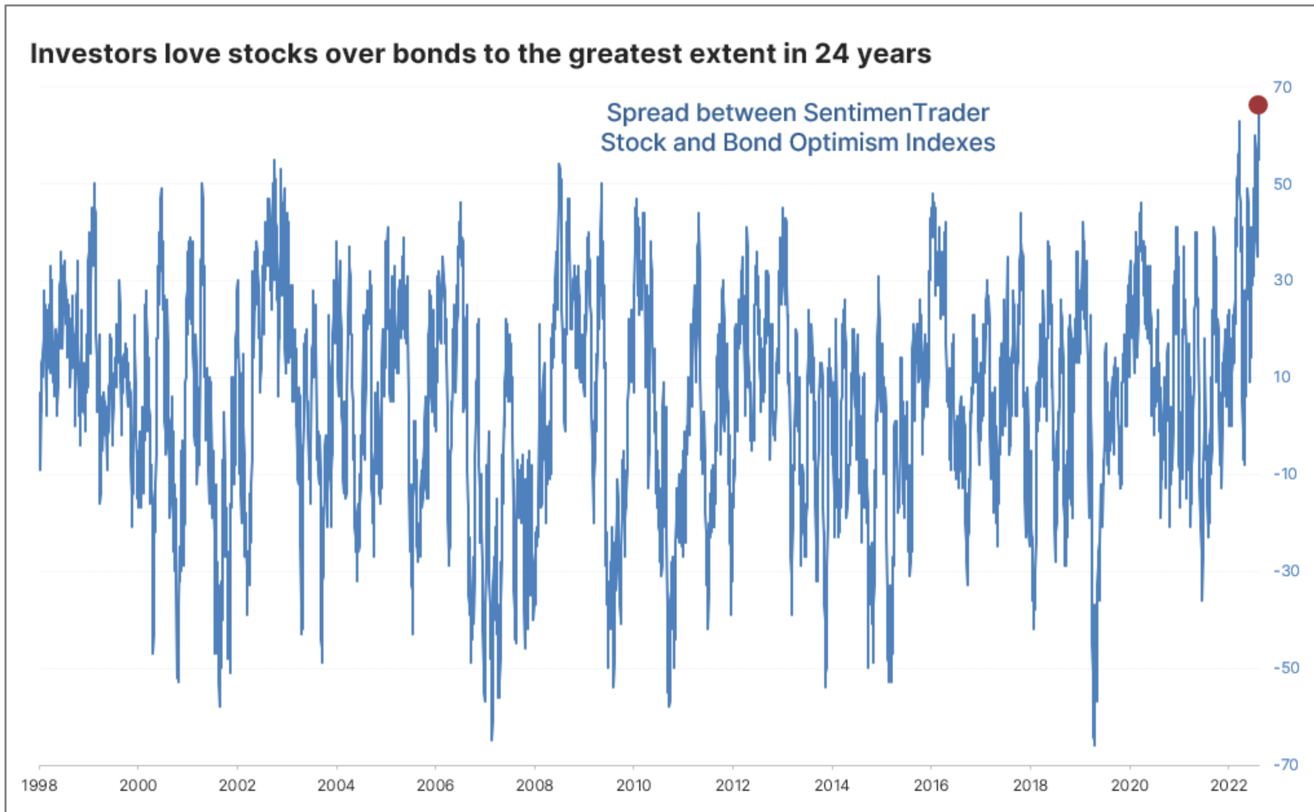
Short-Term Sentiment Composite broke into Enthusiasm this week.



The Equity Put/Call Ratio has gone greedy.

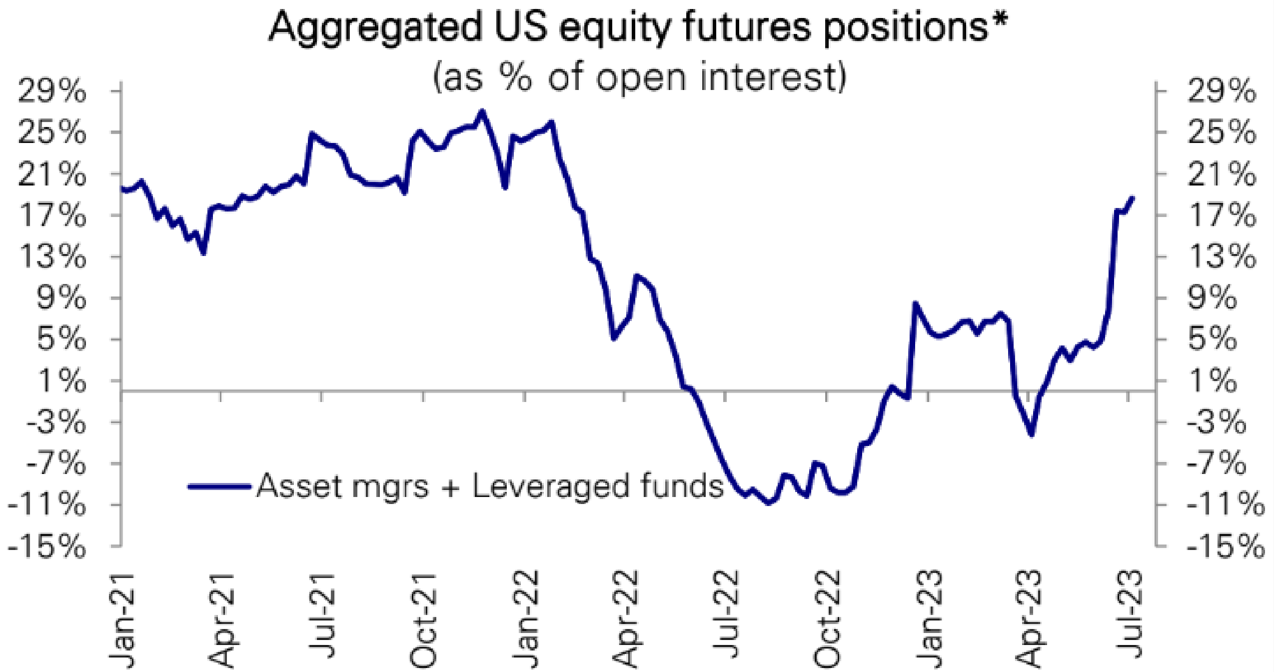


Investor sentiment spread between the stock and bond markets is the widest ever.



Equity Futures Positioning shifted bullish in the last few weeks.

Figure 94: Aggregate US equity futures positioning



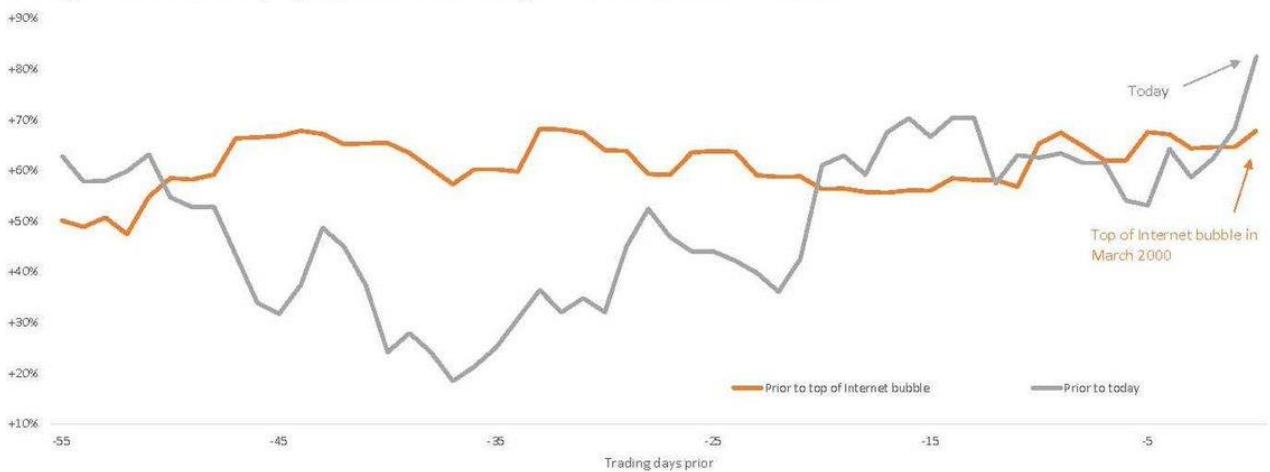
*Based on futures positions in S&P 500, Russell 2000, NASDAQ 100, S&P 400 and DJIA
Positioning data as of 04 Jul 2023

Source : CFTC, Haver, Deutsche Bank Asset Allocation

Recommended equity exposure of short-term timing newsletters broke the dot-com era record.

Ominous parallels

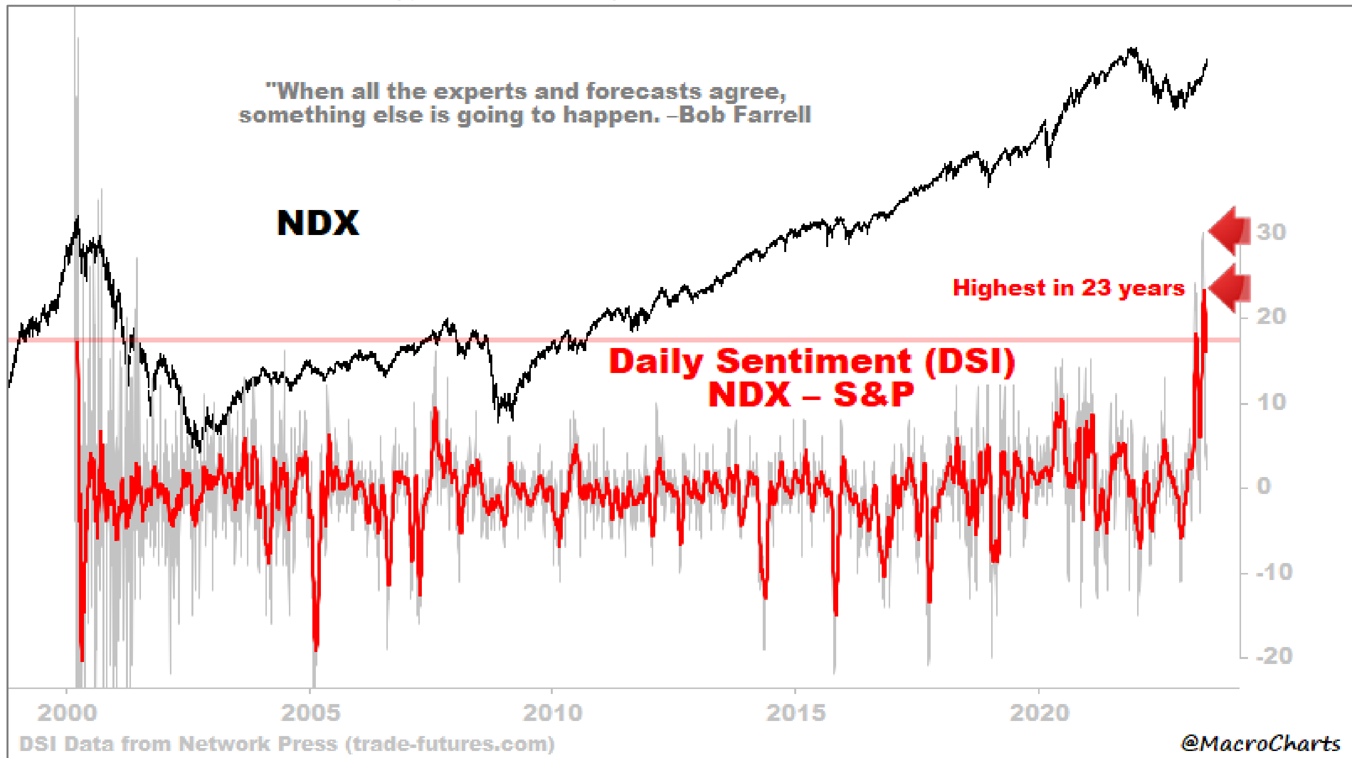
Average recommended equity exposure level among short-term stock market timers*



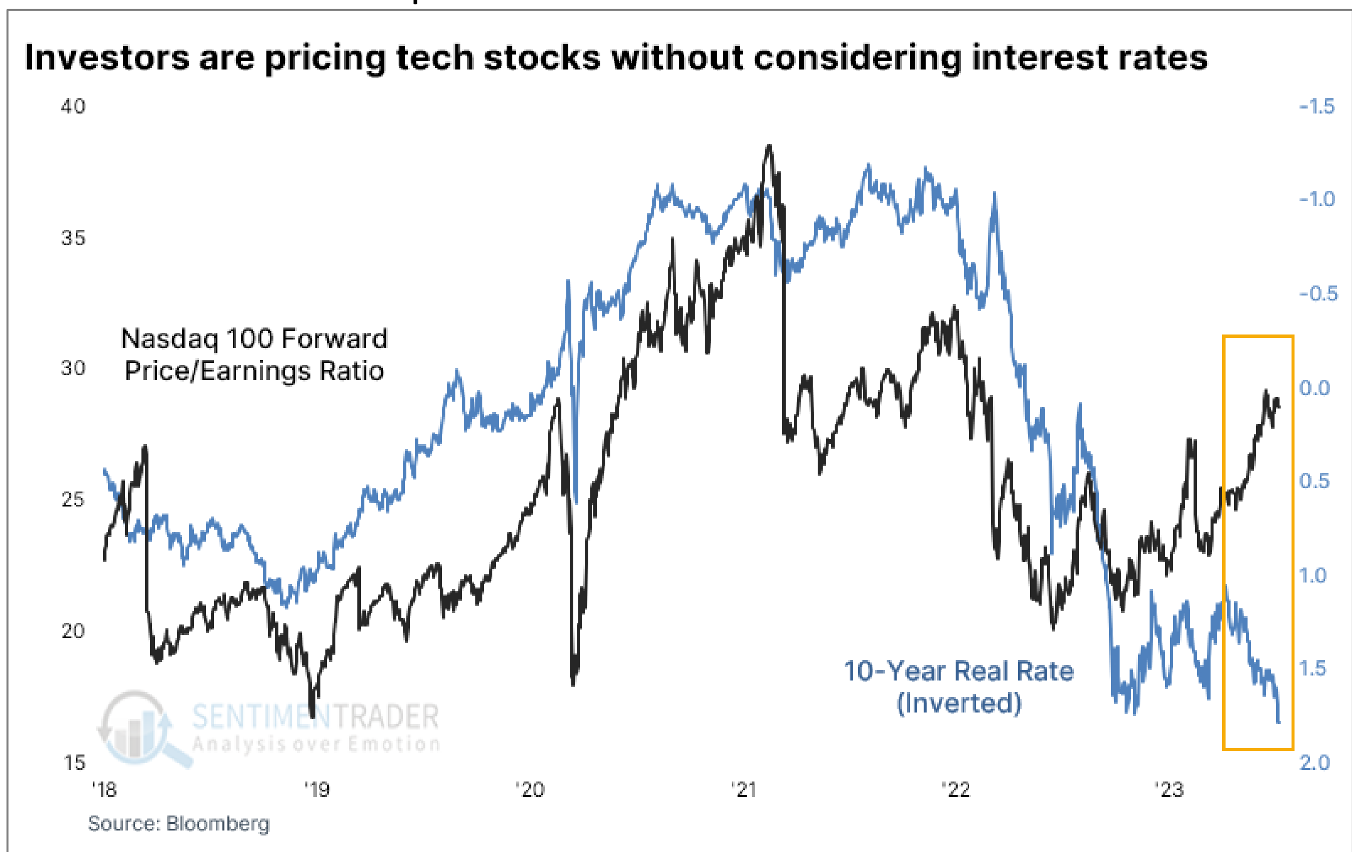
As measured by the Hulbert Stock Newsletter Sentiment Index

Source: Hulbert Ratings

Relative Sentiment on Technology Stocks is the highest since the Dot-Com Peak.

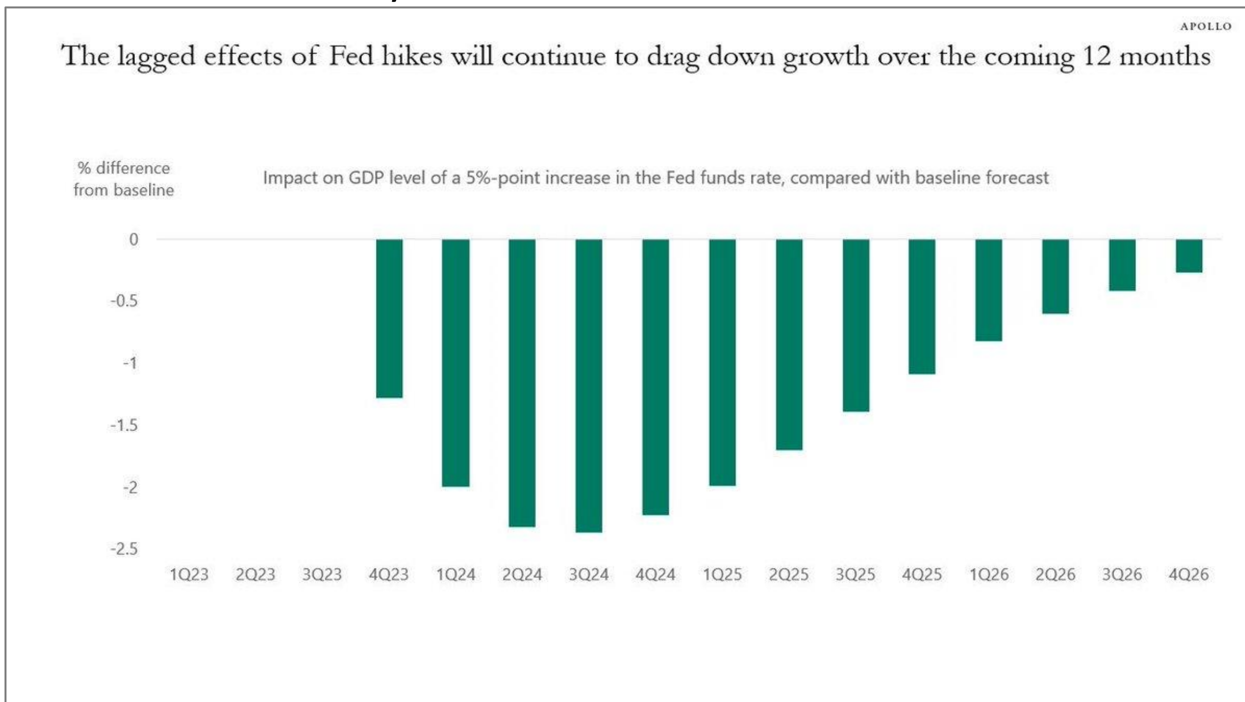


Tech stock valuations have decoupled from real interest rates.

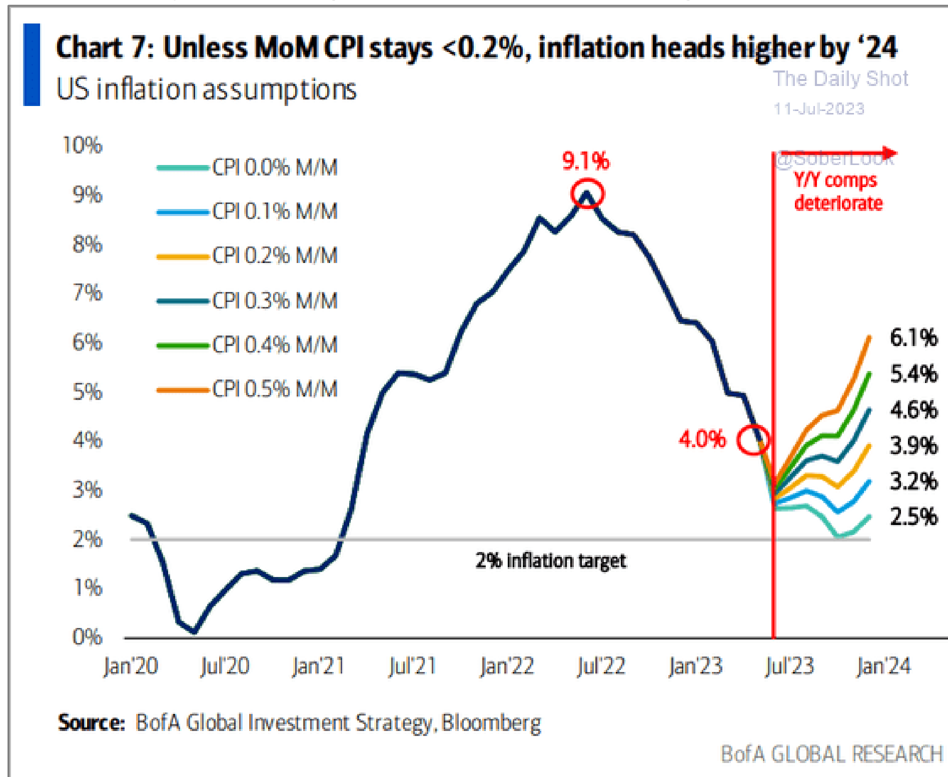


Growth to Value Performance is hitting another extreme.

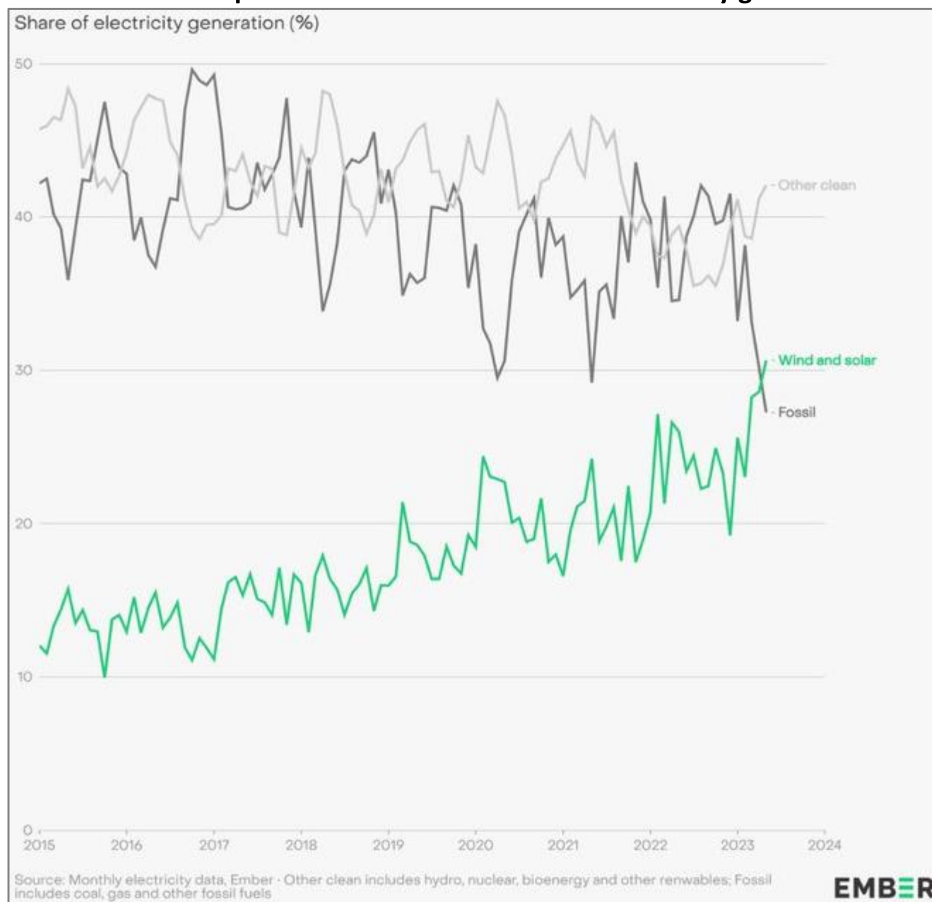
The brunt of Fed rate hikes likely to be felt in 2024.



Inflation Comps are set to get more difficult over coming months.



Wind and solar surpassed Fossil fuels for share of electricity generation.



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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