Market Outlook

By Mark T Dodson, CFA

Peak Confidence in a Soft-Landing

Market Risk Index jumped back up above 75% - the level that indicates market environments vulnerable to substantial drawdowns. Relatively favorable Monetary Conditions are preventing a return to the above 90% readings we saw at the peak of the 2021 bull market for the time being.

However, the Monetary Composite was the key reason for the MRI increase, reversing recent improvements and moving out of the best third of readings associated with the most bullish monetary environments. The Interest Rates category was responsible, which shifted from neutral to bearish since our last update, the first indication that monetary conditions may be growing tighter since the Silicon Valley Bank failure led to easier conditions in the spring. The Inflation category also degraded a notch. Headlines of a rebound in inflation pressures shouldn't come as a surprise in the second half of the year.

The category that remained stronger for longer than usual in the present environment is the Velocity category, which measures Household and Corporate demand for money. Despite a steep and rapid bout of rising rates, the category hasn't budged – an indication that Households are still in a race to spend money and chase risk in their investments. We believe this reflects investor sentiment, conditioned to expect drawdowns to lead to rapid reversals to new highs (FOMO), and remnants of a massive $5 trillion stimulus, a magnitude of fiscal intervention that none of us have ever witnessed in our investing lives. Excess savings are taking longer than usual to dwindle, and the fear of missing out has kept money chasing pots of gold at the end of the rainbow.

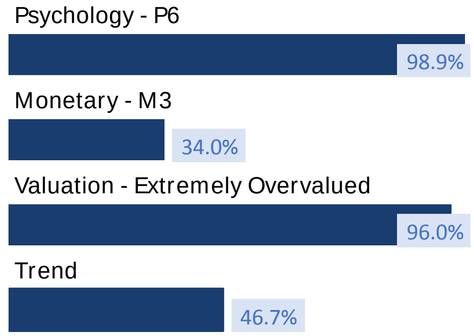
It is still worth noting that the most negative influence on our Monetary Composite, the yield curve, is just now opening the window where it traditionally begins to have an economic impact. The yield curve has always been a long-leading indicator in an investing world short on patience. A substantial stock market rally following the inversion is common, often coinciding with stories of Goldilocks and soft landings. The lagged effect is intuitive. The shock of a higher cost of money from higher interest rates only becomes apparent to a household when they decide to buy that car or next house or for businesses when they need to tap debt markets or take out a commercial loan, not something most of us do every day.

Market Risk Index

Rec Allocation 25% Underweight

77.5%

Category Percentiles



Largest Psychology Influences

Leveraged Investments	Negative
Option Activity	Negative
Consumer Confidence	Negative
Surveys	Negative

Largest Monetary Influences

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

Valuation

7-10 Year Equity Return Forecast	1.5%
10Yr US Treasury Yield	3.9%

Market Trends

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

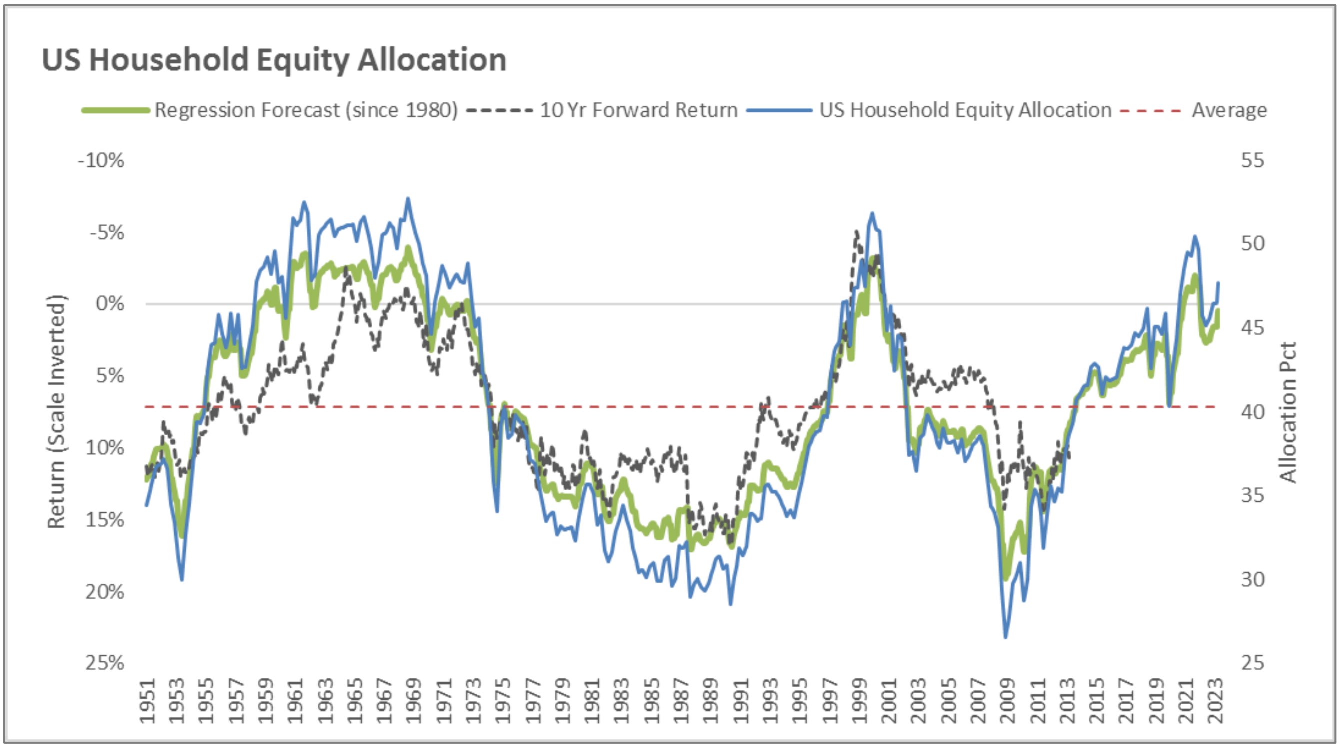
Meanwhile, our Psychology Composite has moved to a rounding error away from the worst 1% of readings since 1970. While the levels on most indicators are not as extreme as we saw in 2021, over-confidence is becoming pervasive across the composite. Consumer Confidence and Investor Surveys were the largest detractors over recent weeks.

With a sizeable cash hoard already, we are content to allow our equity allocations to drift higher and don't anticipate reducing exposure without a deterioration in the stock market's breadth & trend, or as a result of higher risk scores from the Monetary Composite.

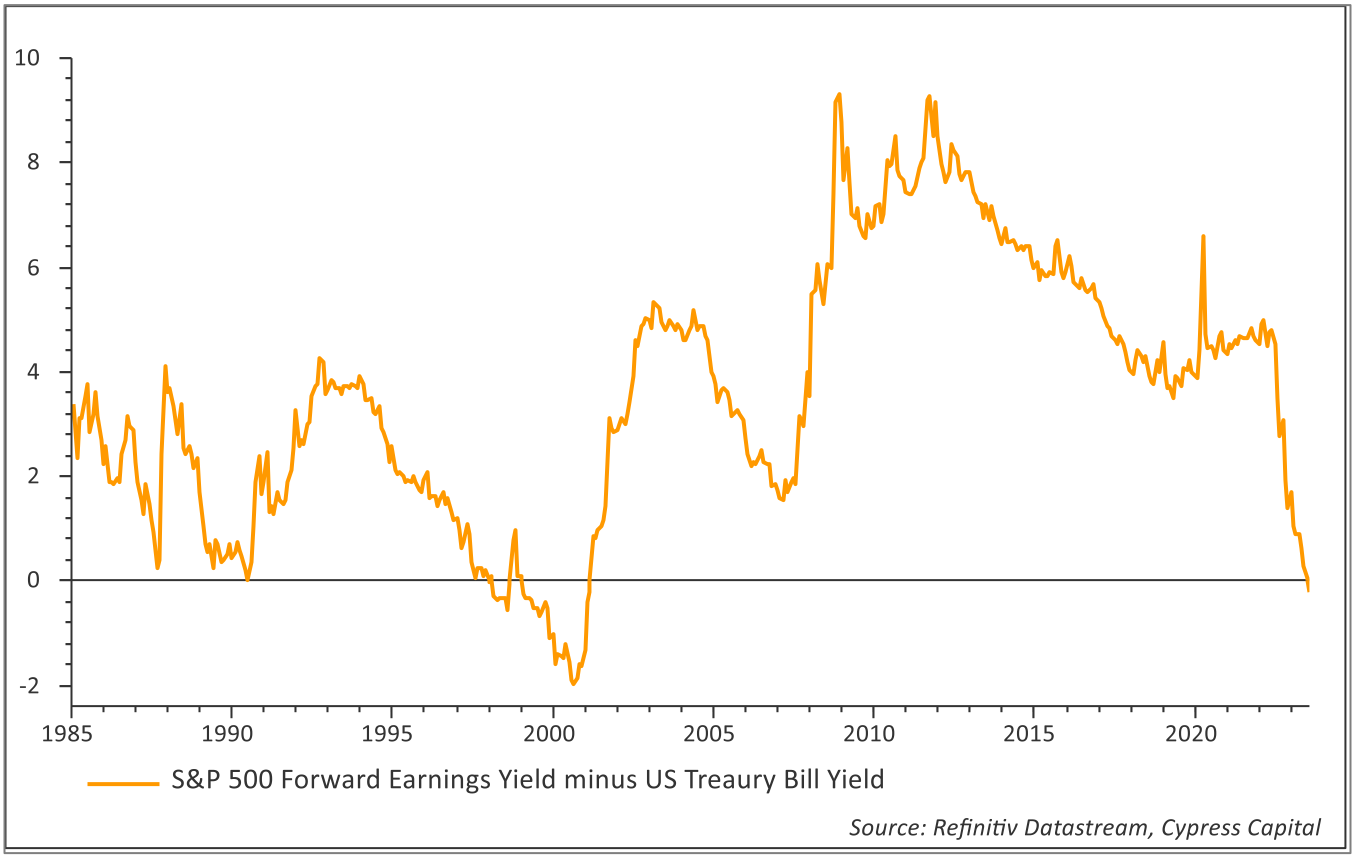
Charts of the Week

US Household Equity Allocations

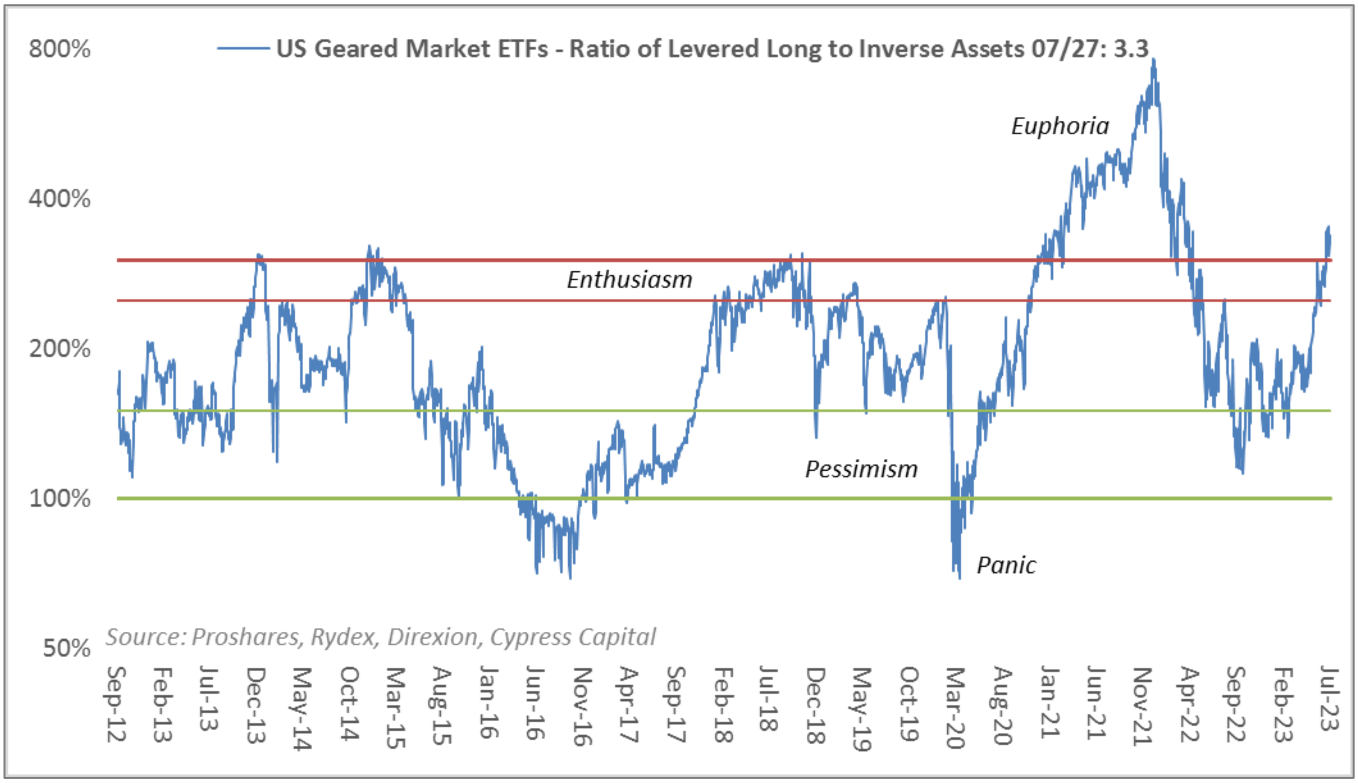
We recently added Household equity allocations to our valuation model. Since the data is released quarterly, we use the moves in the monthly AAII Allocation survey to forecast equity allocations intra-quarter. The information gleaned from the data in forecasting expected equity returns and highlighting drawdown risk is valuable and complements the other factors in our valuation model. Based on current Household allocations, return expectations have fallen to 0.5%.



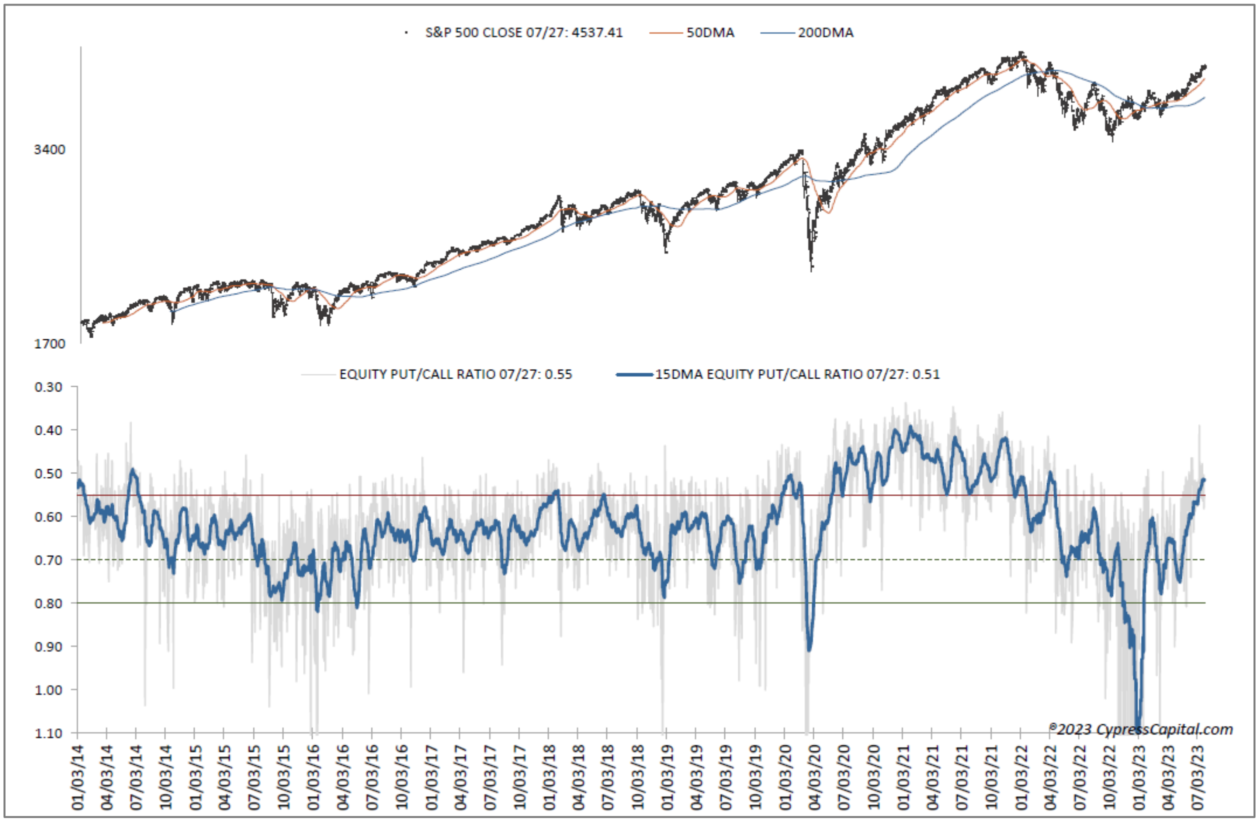
Earnings Yield on the S&P 500 falls below Treasury Bill Yields for the first time since 2000.
Money is being treated better by investing in T-bills instead of stocks for the first time since the dot-com bubble.



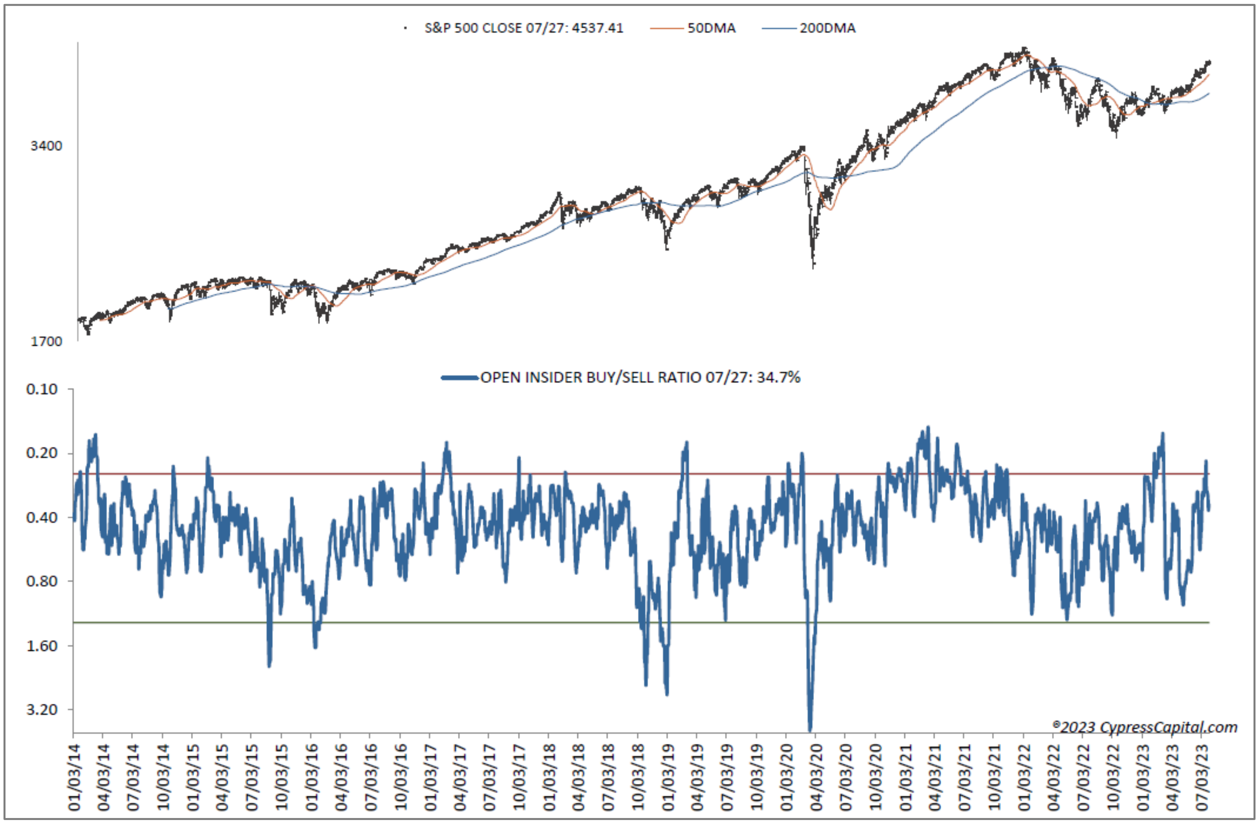
Investor appetite for leverage ETFs has remained high throughout July.



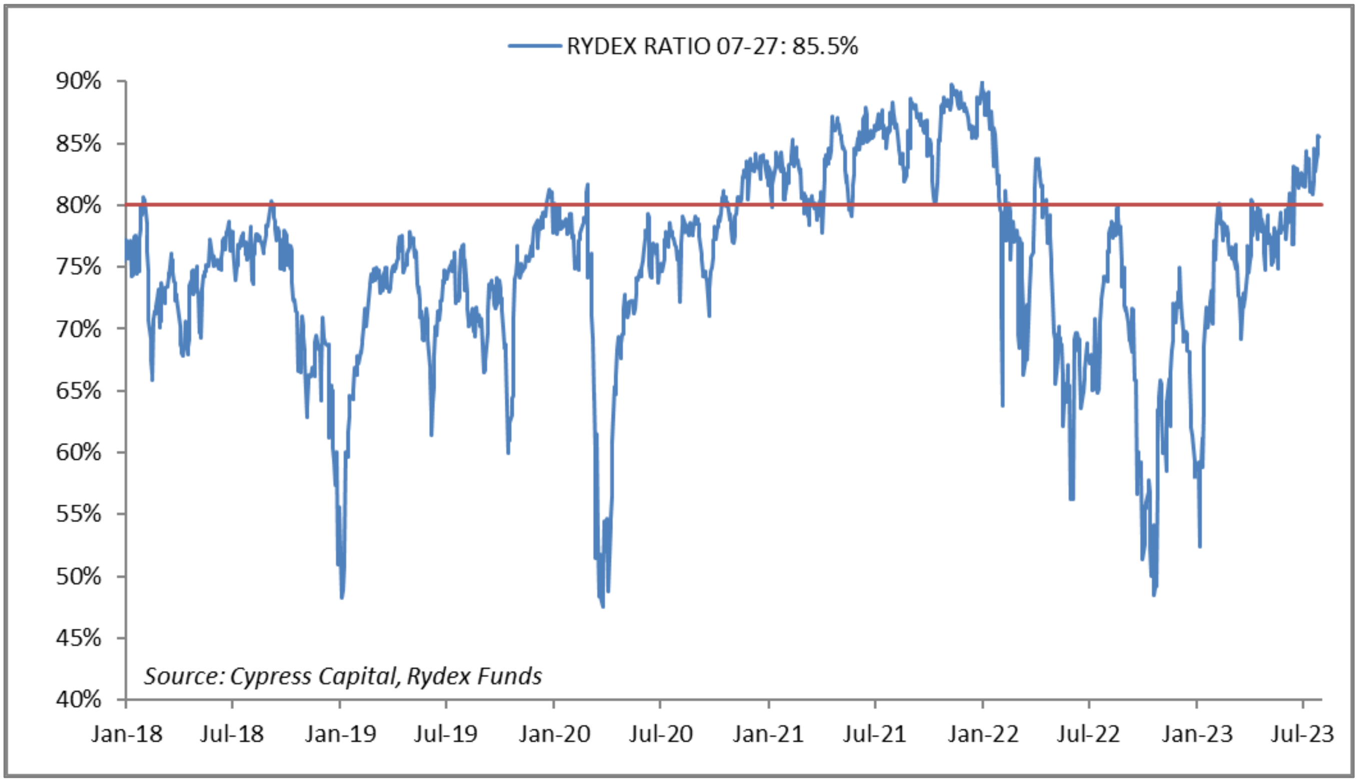
Equity Put/Call continues its move into the Greed zone.



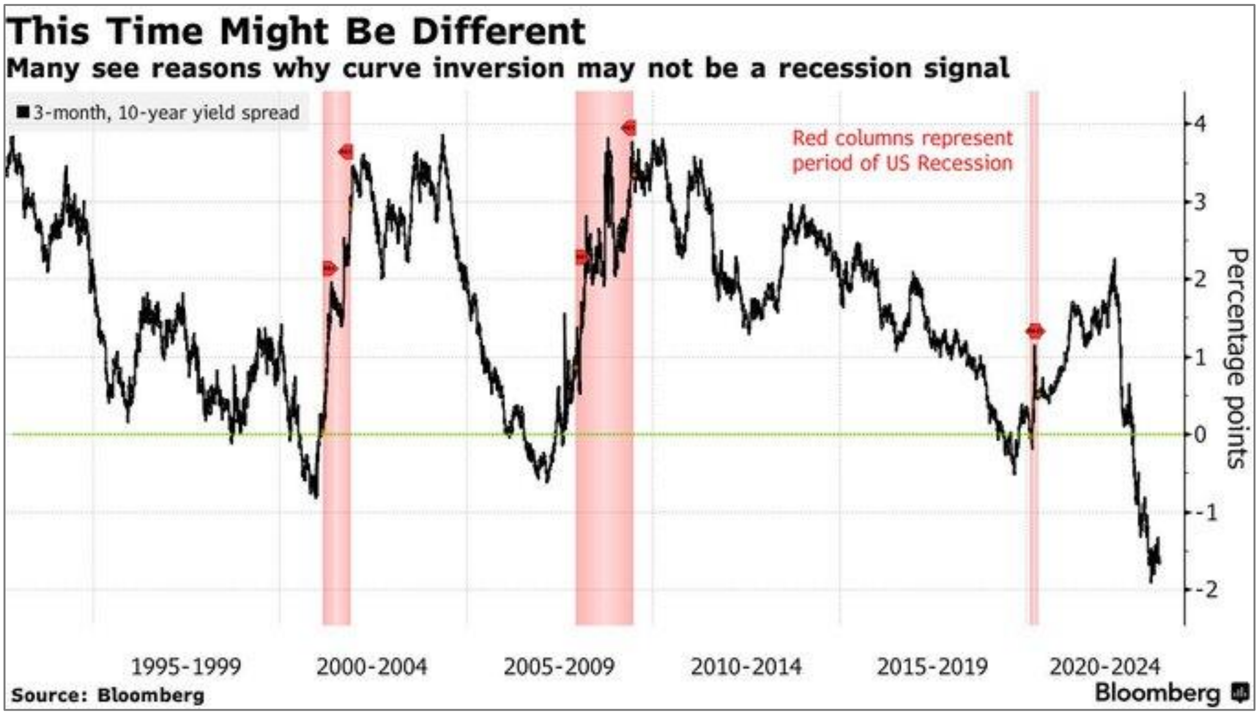
Smart money corporate insiders started cashing out of the rally during the last two weeks of July.



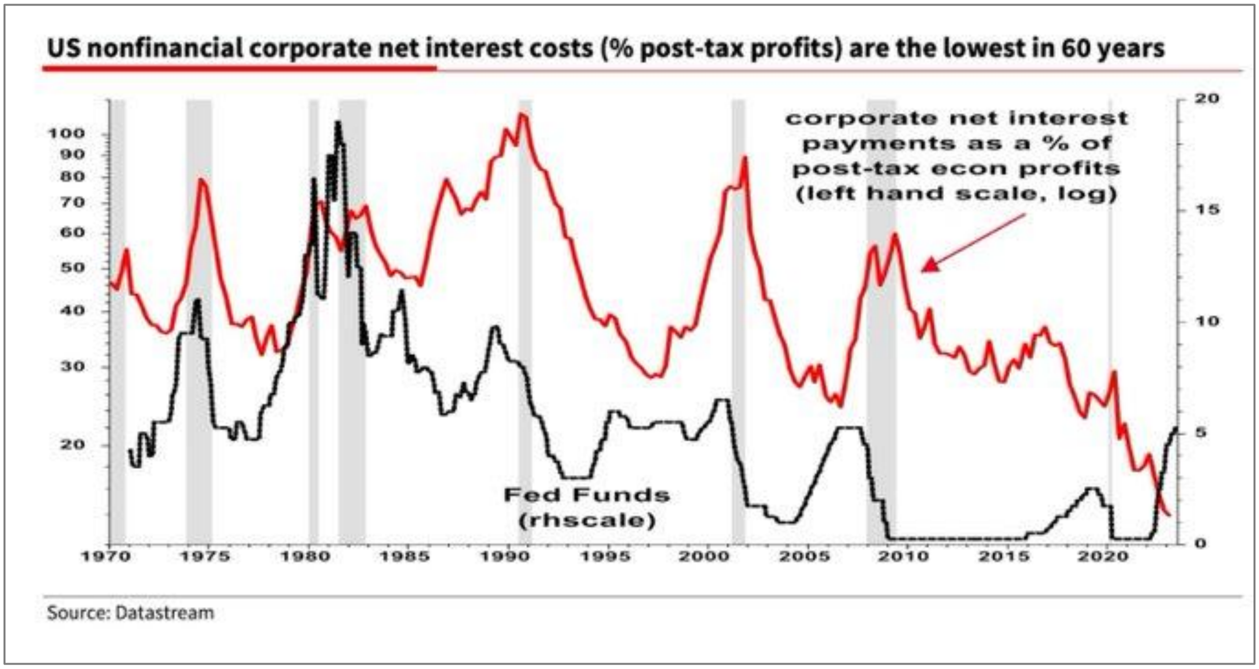
Rydex Ratio is within five percent of the all-time high set on December 30, 2021.
Rydex funds are the original leveraged and inverse family of mutual funds, and the Rydex Ratio measures the risk appetite of speculative investors.



Like Clockwork...This Time Might Be Different
We have lived through all the yield curve inversions on the chart. Every inversion has led to plenty of intelligent economists or strategists explaining why this yield curve inversion is different. Every inversion was also followed by headlines of Goldilocks and soft-landings.



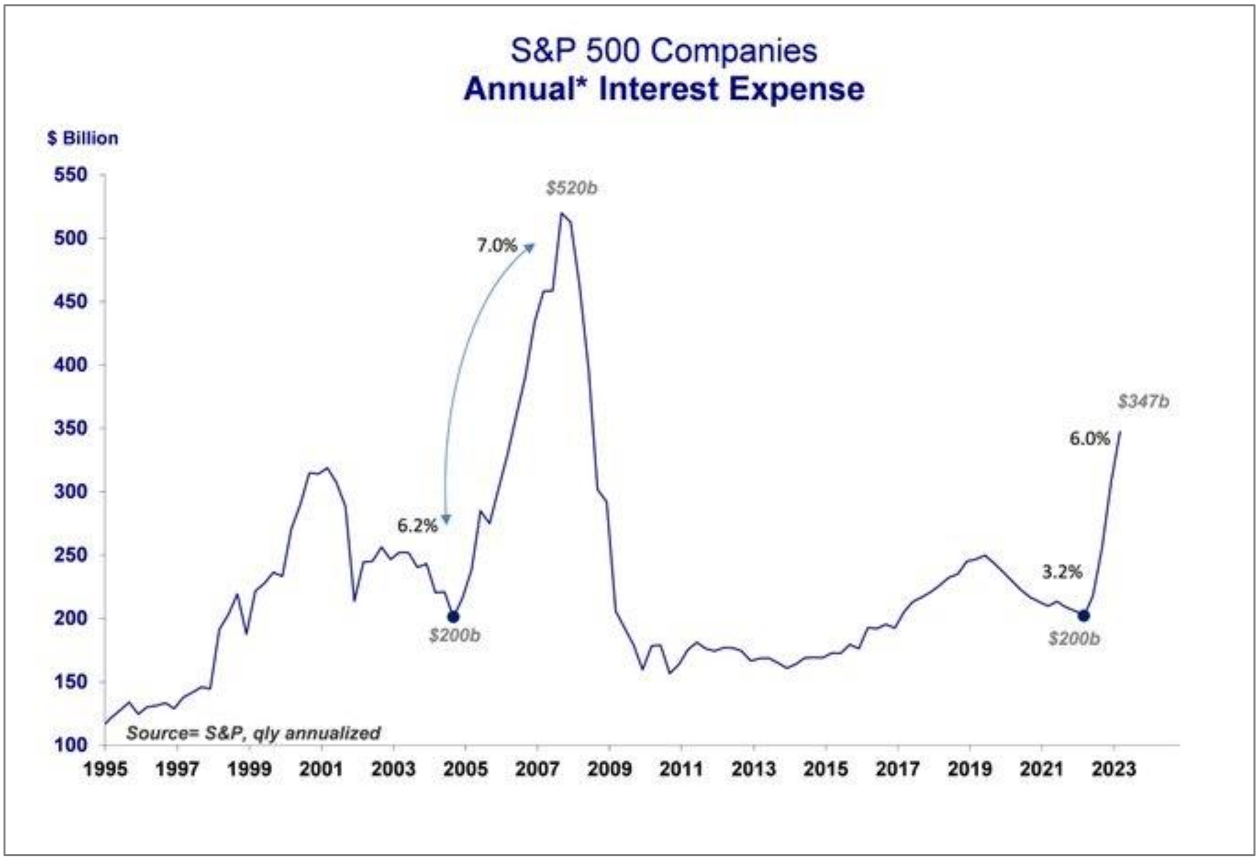
NIPA Corporate Net Interest Costs have fallen to record lows...



Source: Albert Edwards

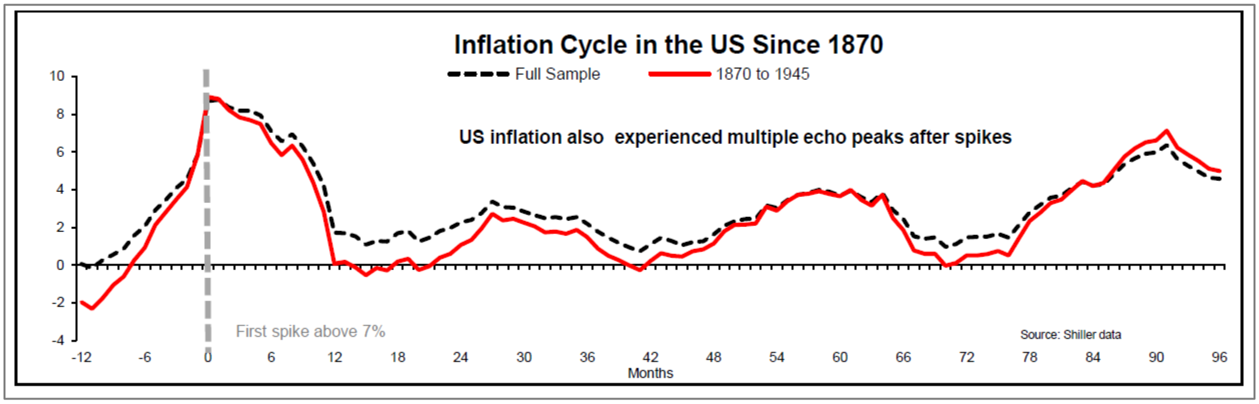
...But S&P 500 Interest Expense is climbing.

Is the NIPA version highlighting rising bankruptcies for private companies?



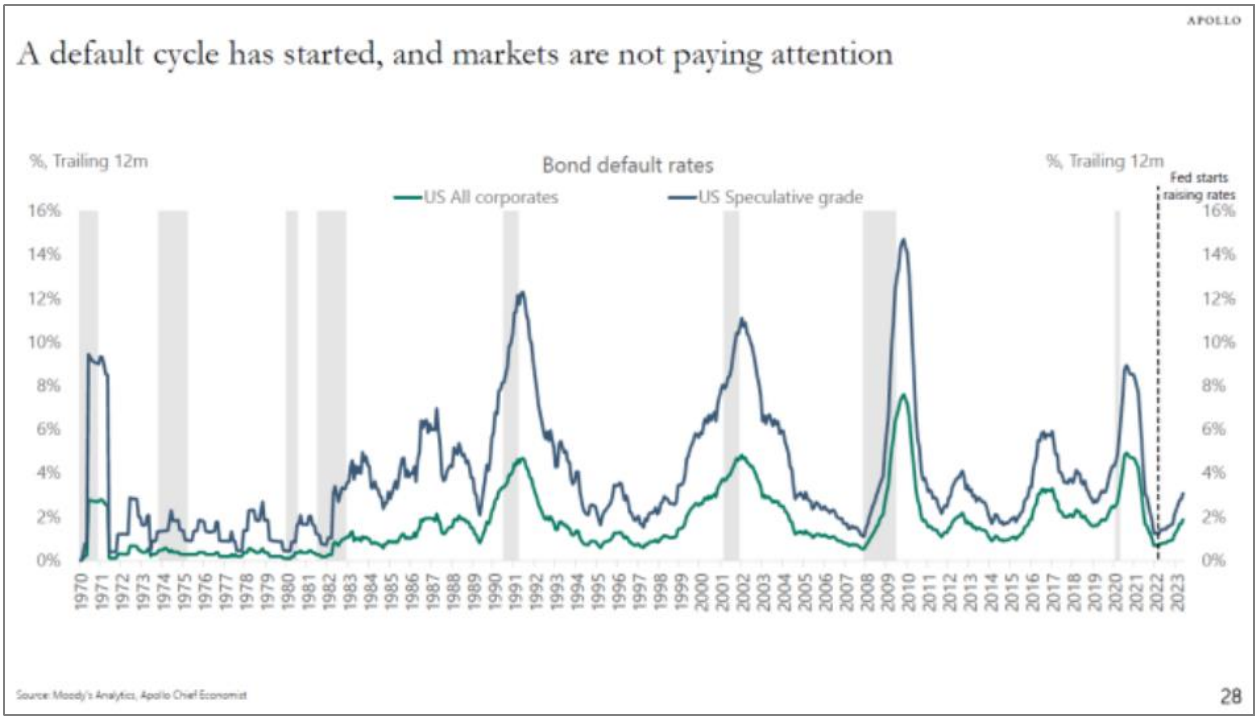
Source: Steph Pomboy

History lesson – Sudden spikes in the rate of inflation are often followed by several echo peaks.

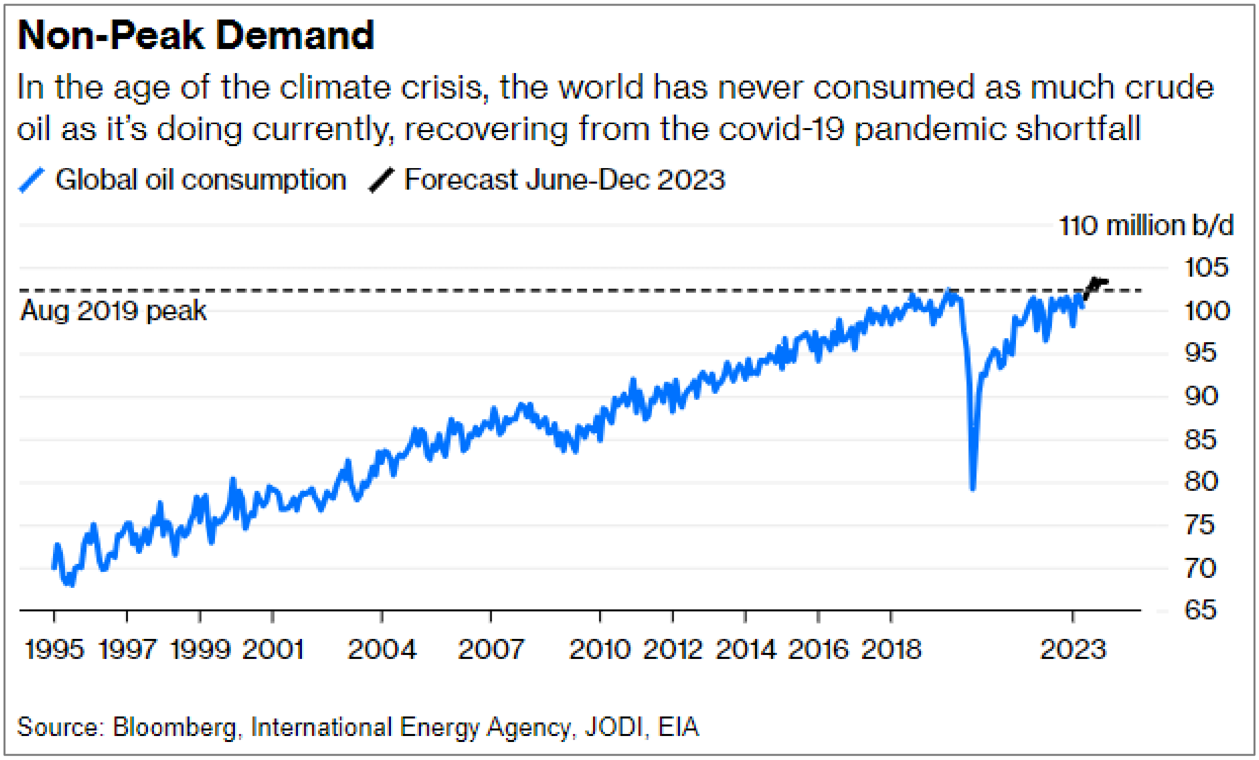


Source: Bloomberg

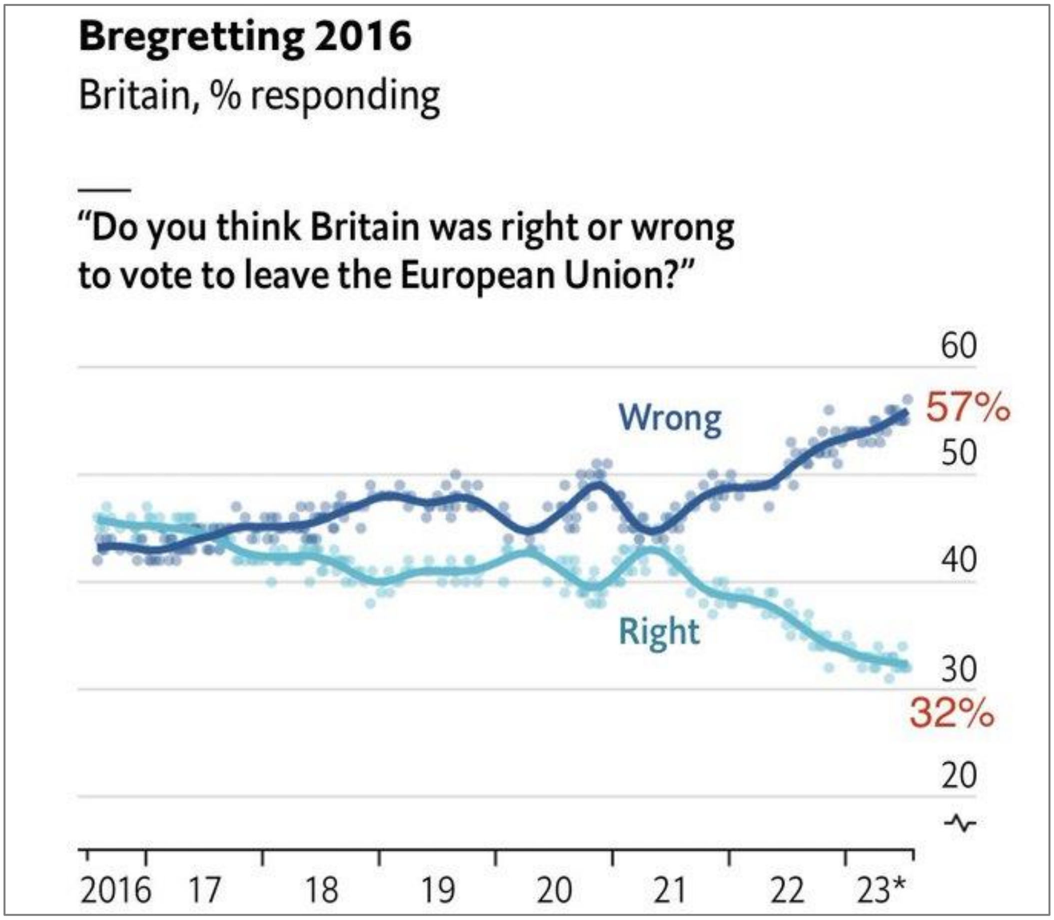
Bond defaults have started to tick up from lows.



Global Oil Demand set a new record during the first four months of the year.



Brits have come to regret Brexit.



Source: Bloomberg

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.