Market Outlook

By Mark T Dodson, CFA

No More Fish in the Barrel

Monetary Conditions worsened slightly again this week, driving Market Risk Index up to 78.0%. However, Monetary Conditions are still favorable, as is stock market breadth. Without a meaningful shift in either of those areas, we will not make any changes to our recommended equity allocation – aiming to be content that we at least have some exposure to equities in an AI-euphoria driven stock market run-up. Our cash position has become palatable with yields above 5%, knowing that the bull market's fundamental backdrop is fueled by wishful thinking more than a margin of safety or any notion of a wall of worry.

Within the Monetary Composite, the Interest Rates category continues to soften. Treasuries, Corporates and Municipals have all erased the temporary easy money conditions that came on the scene right as Silicon Valley Bank failed and the Fed's injection of $400 billion of liquidity over a matter of weeks. We've included a chart of the rate of change in the Dow Jones Composite Bond Index as a proxy for the category below.

Fitch's downgrade of the US Government debt didn't affect the ebullient mood of equity investors – the Psychology Composite didn't budge from the worst 2% of readings. All is not bad in the Psychology Composite, however. The most notable development was a substantial jump in Margin Debt growth, which shifted to a positive growth rate. Historically, that's bullish until the growth rate surpasses 30%, so at least one investment sentiment indicator votes in favor of the bull market.

Absolute valuations have been stretched for some time, but in the last few weeks, relative valuations have grown cautious for the first time since the post-Lehman QE era began. Last week, we highlighted how the forward earnings yield on stocks had fallen below US Treasury Bill yields for the first time since 2000, implying that cash is treating your money better than stocks. This week, the earnings yield has fallen below corporate bond yields for the first time since 2009. In the mid-2000s, we coined this spread the Buyback Indicator because when earnings yields are higher than corporate bond yields, it's a no-brainer for corporations to lever up their balance sheets and buy back stock with the proceeds from issuing corporate debt. The spread let corporations earn an easy profit, boosting stock prices in the process.

Market Risk Index

Rec Allocation 25% Underweight

78.0%

Category Percentiles

Psychology - P6: 98.2%

Monetary - M3: 35.2%

Valuation - Extremely Overvalued: 96.2%

Trend: 46.6%

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	4.1%

Market Trends

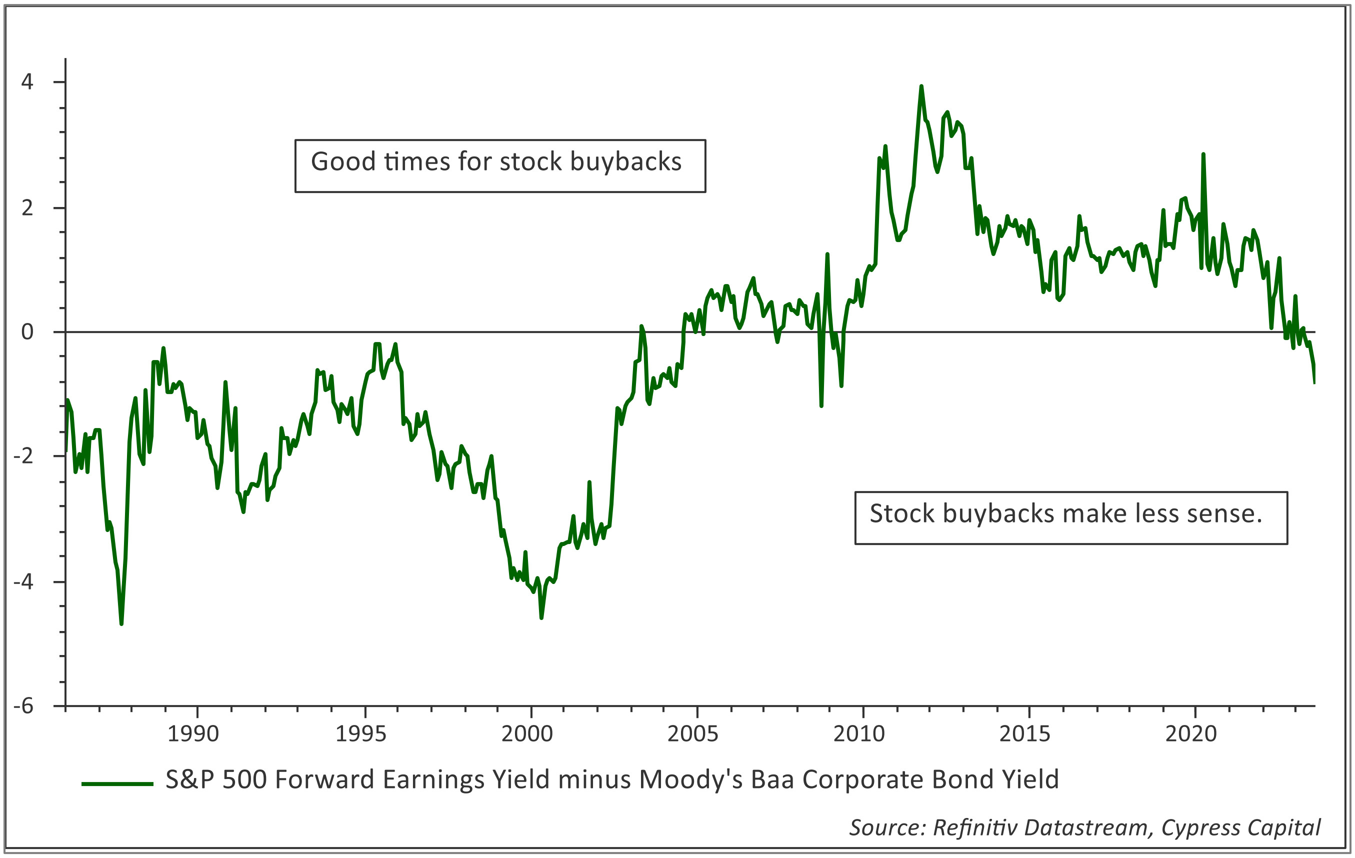
US Equities	Bullish Trade
Intl Equities	Bullish Trade
REITs	Bullish Trade
Broad Commodities	Bullish Trade

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.

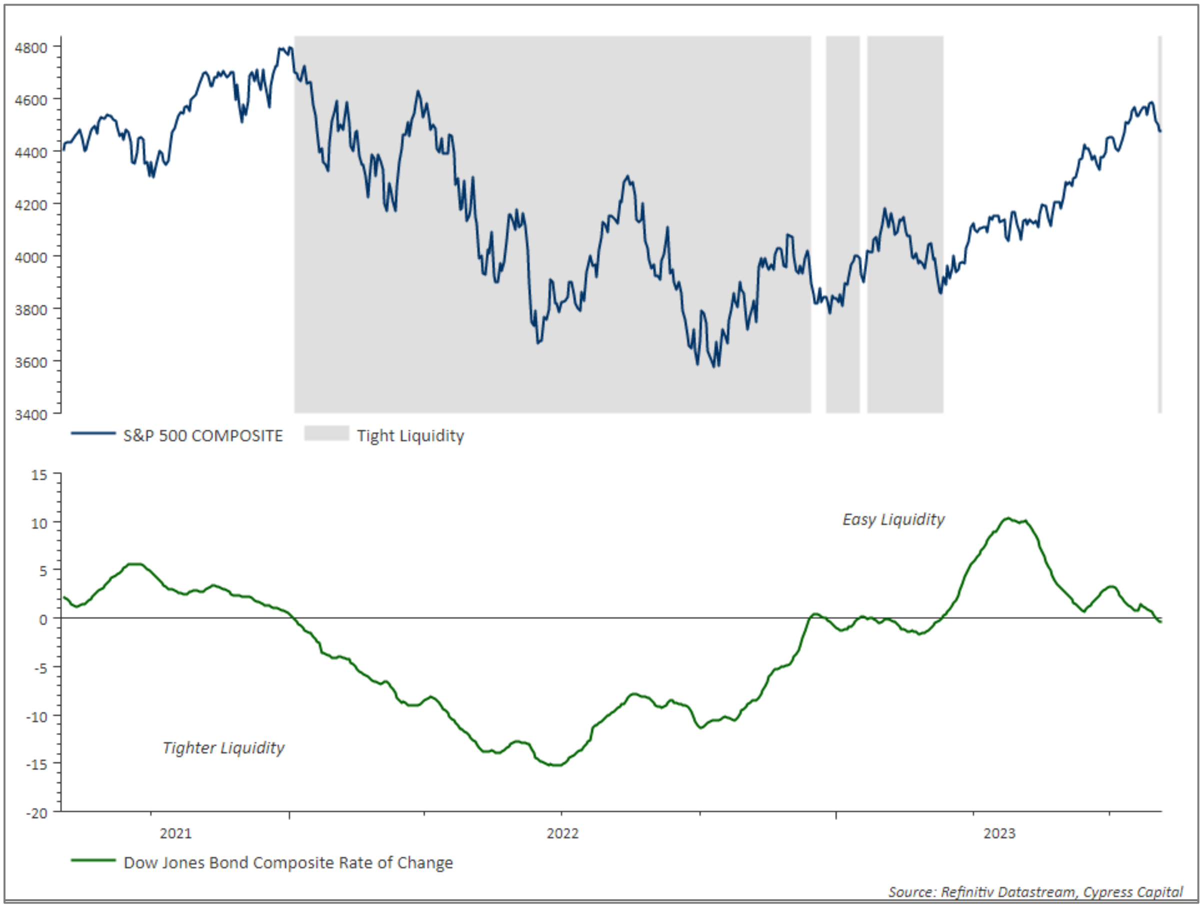
Should this shift prove more than temporary, we think this marks an official end to the profitable environment for stock buybacks. More importantly, it also implies that the tailwind that has benefited private equity investments is now a headwind – an area that retail money has clamored for in recent years for its perceived safety. It will mark a riskier world for corporate CFOs and private equity managers, as the barrel has abruptly run out of fish to shoot.

Charts of the Week

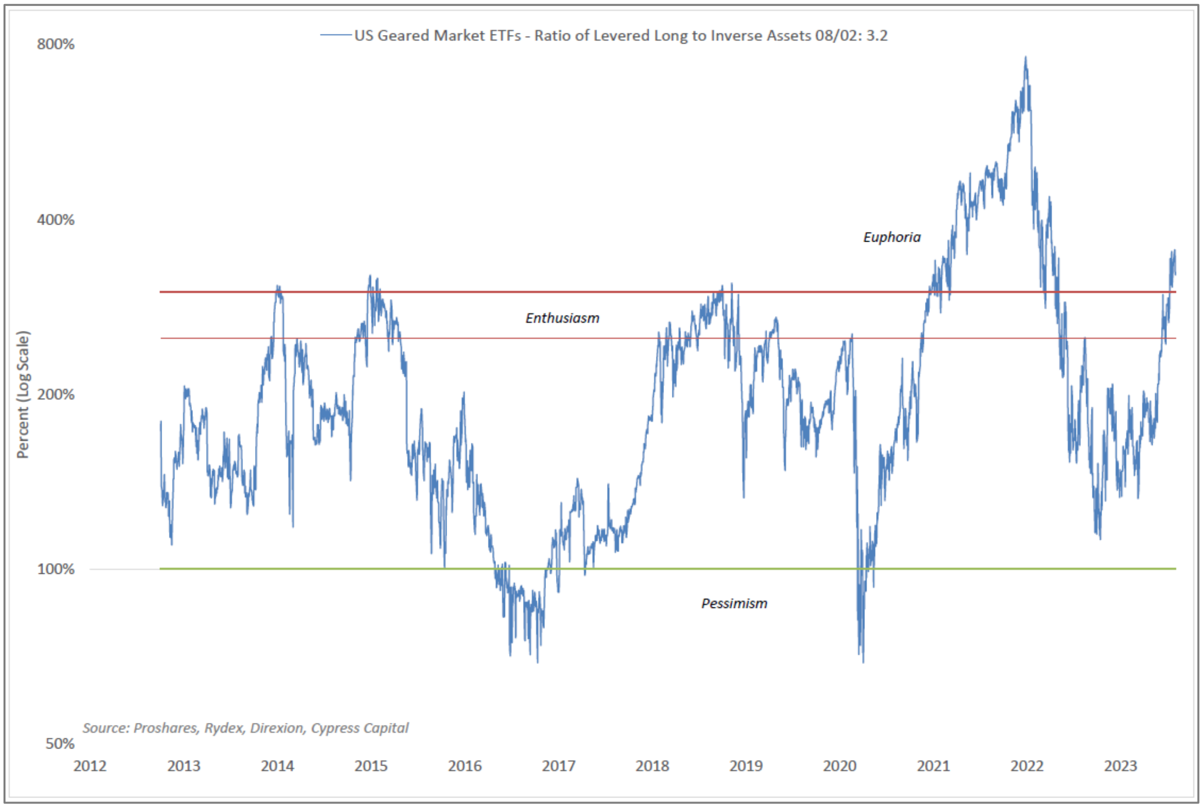
Buyback Indicator Turns Bearish - Earnings Yield on stocks has fallen below Corporate Bond Yields.
The intuitive explanation is when the earnings yield is higher than corporate bond yields, you can issue corporate bonds and earn a positive spread by buying back your stock. With this reversal, expect buybacks to dwindle over coming months and headlines of struggles for the less disciplined private equity funds who got out over their skis in the frothy times.



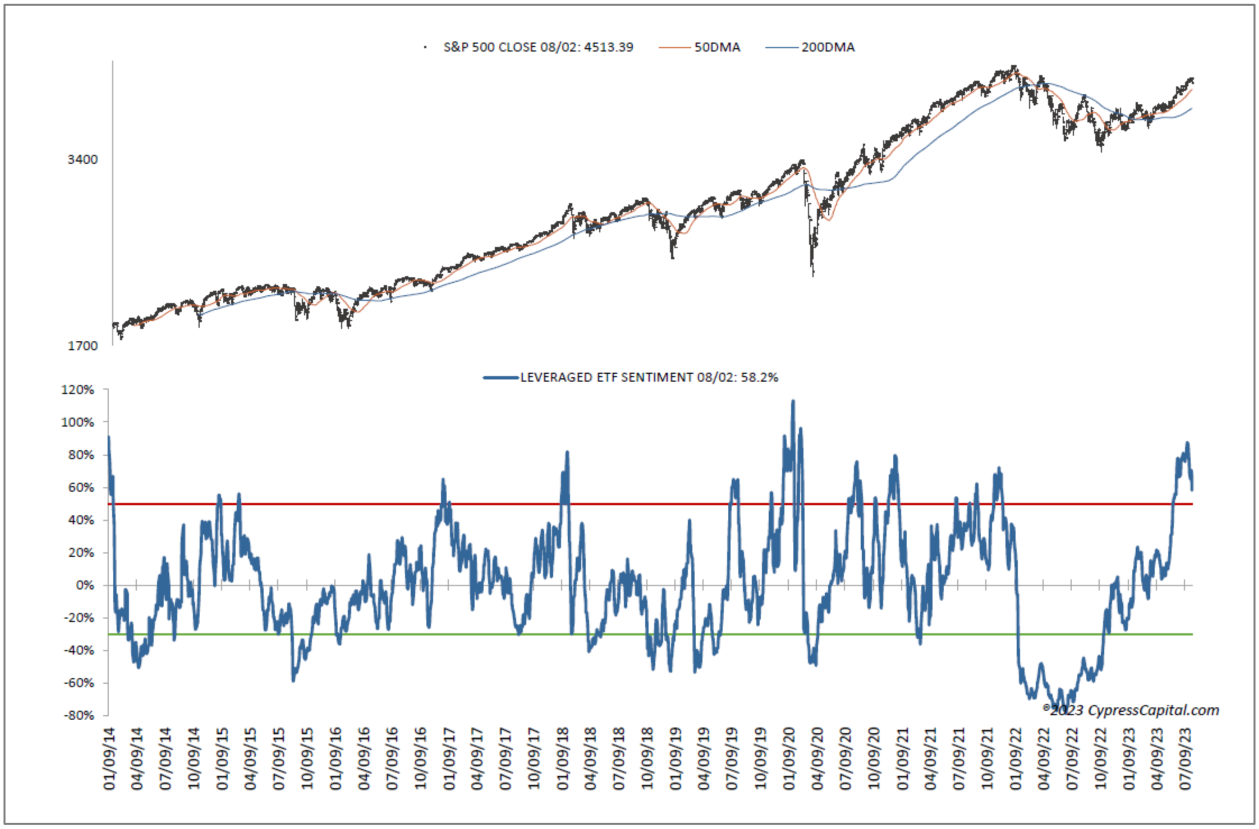
Bond Markets have shifted back to signaling tight money.



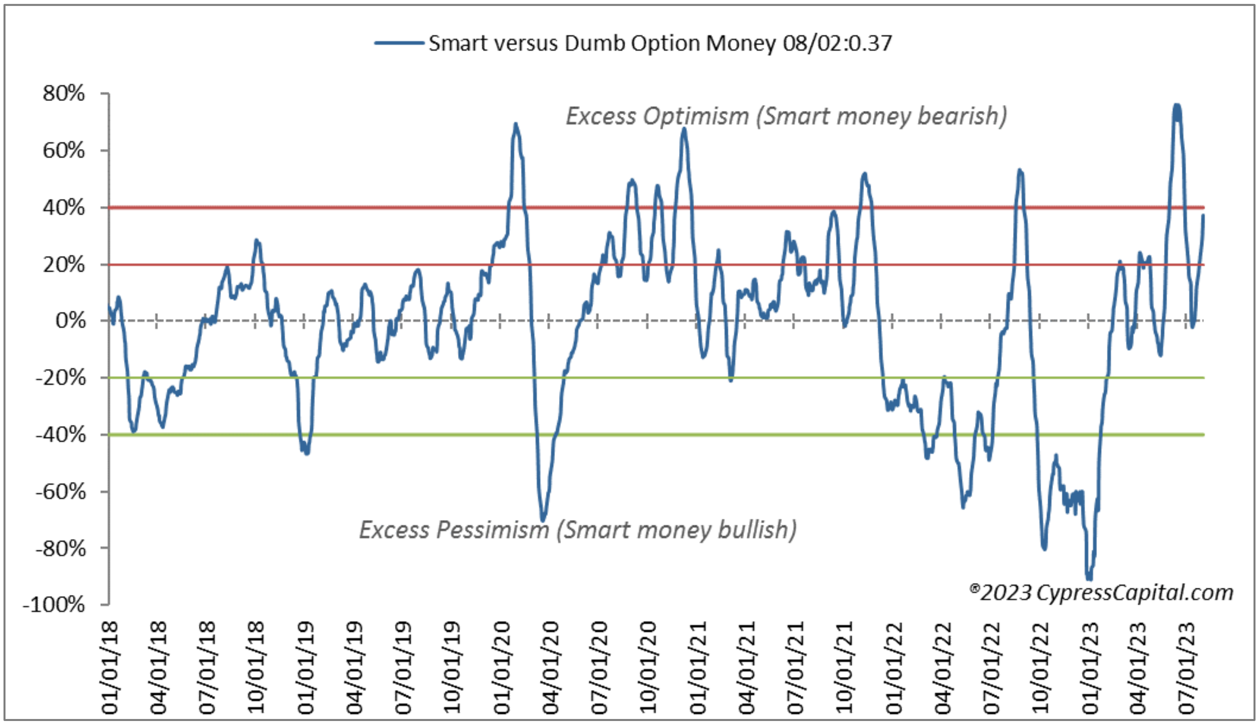
Fitch downgrade of US Treasury Debt didn't sway Leveraged ETF investors from Euphoric positioning.



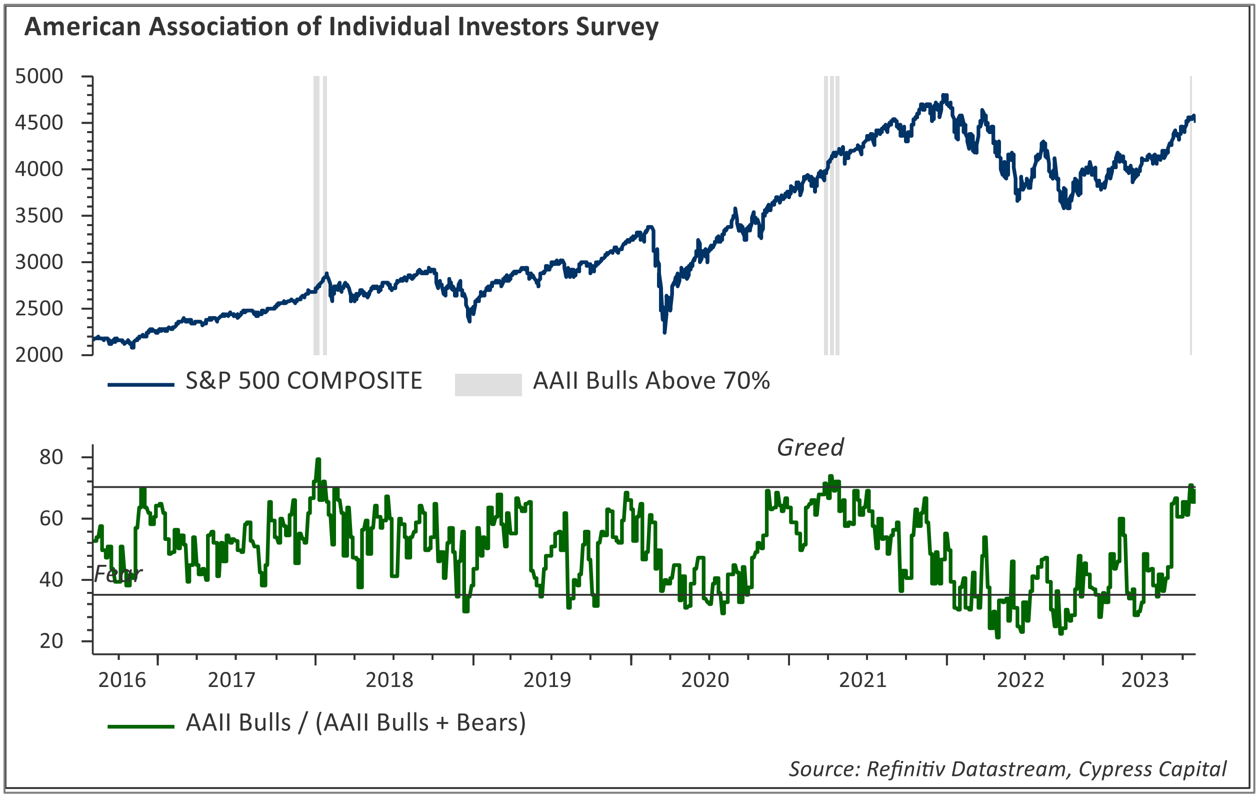
Daily Dollar Volume in Leveraged ETFs showed signs of a peak this week.



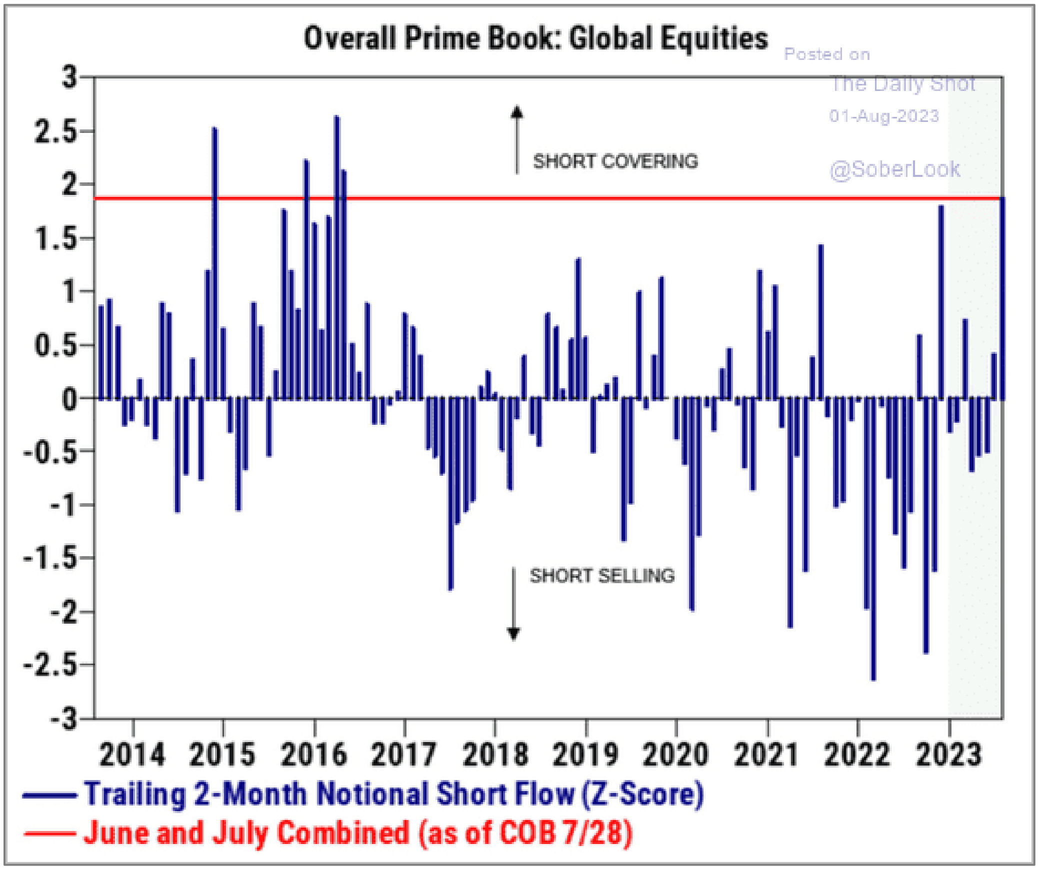
Smart versus Dumb Option Money is climbing back toward Excess Optimism.



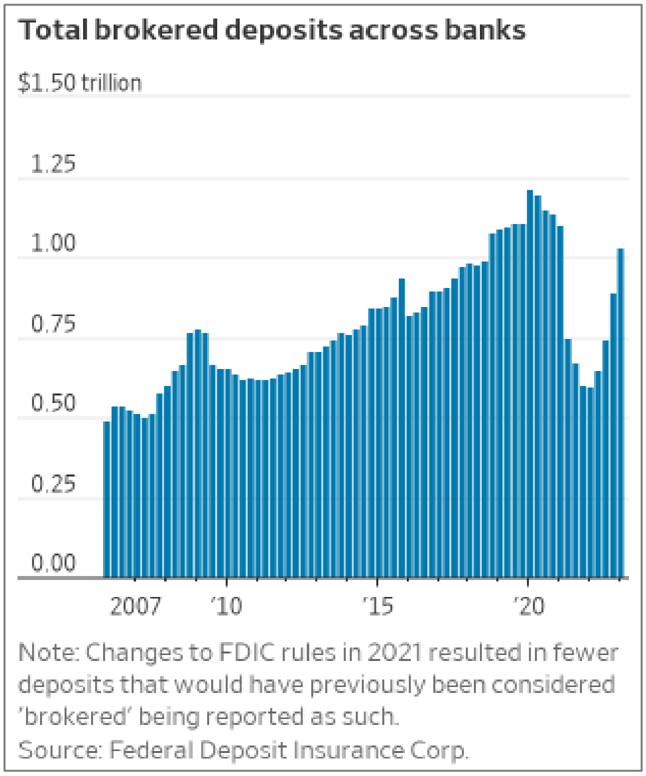
Individual Investors have only been this bullish a couple of times over the last seven years.



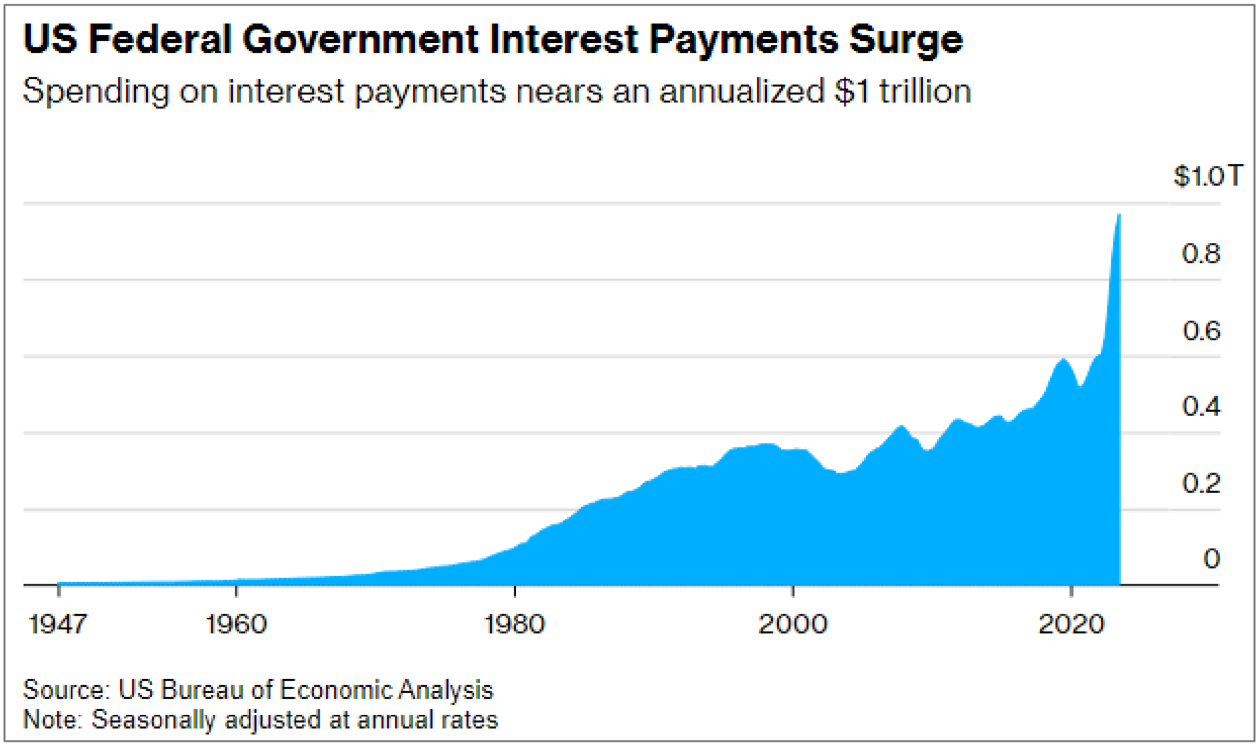
Hedge Funds were tripping over themselves to cover their shorts at the end of July.



Banks are relying heavily on brokered deposits (think hot money deposits) in the current environment.

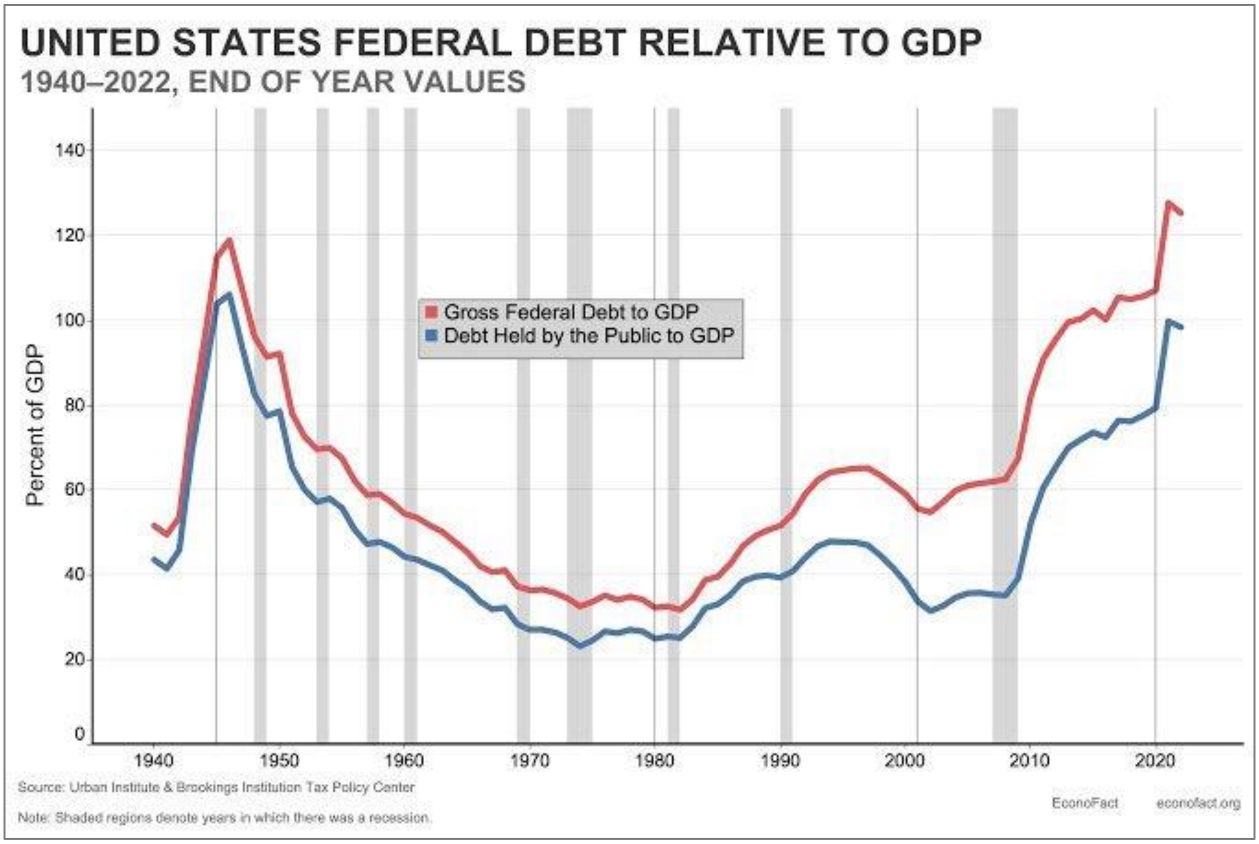


Federal Government Interest Payments have surged to nearly $1 Trillion.

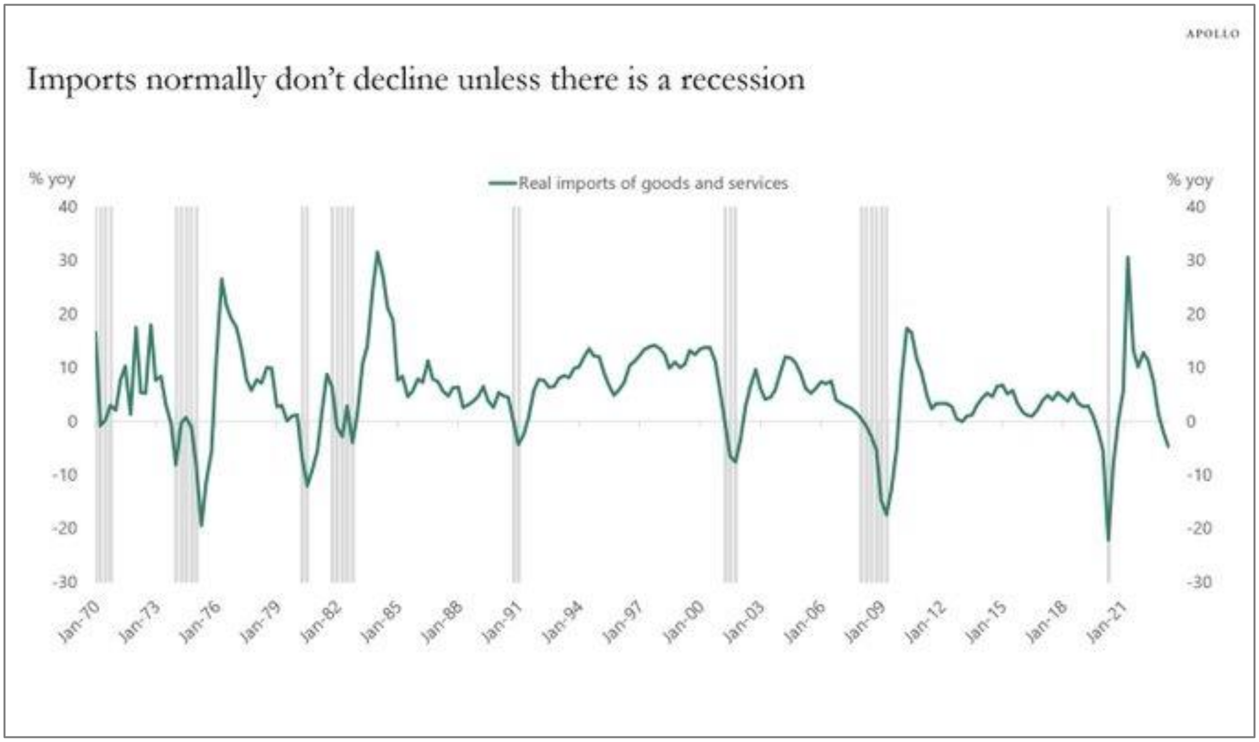


Stock ETF Flows are at FOMO Levels.

Gross Federal Debt has surpassed World War II Levels

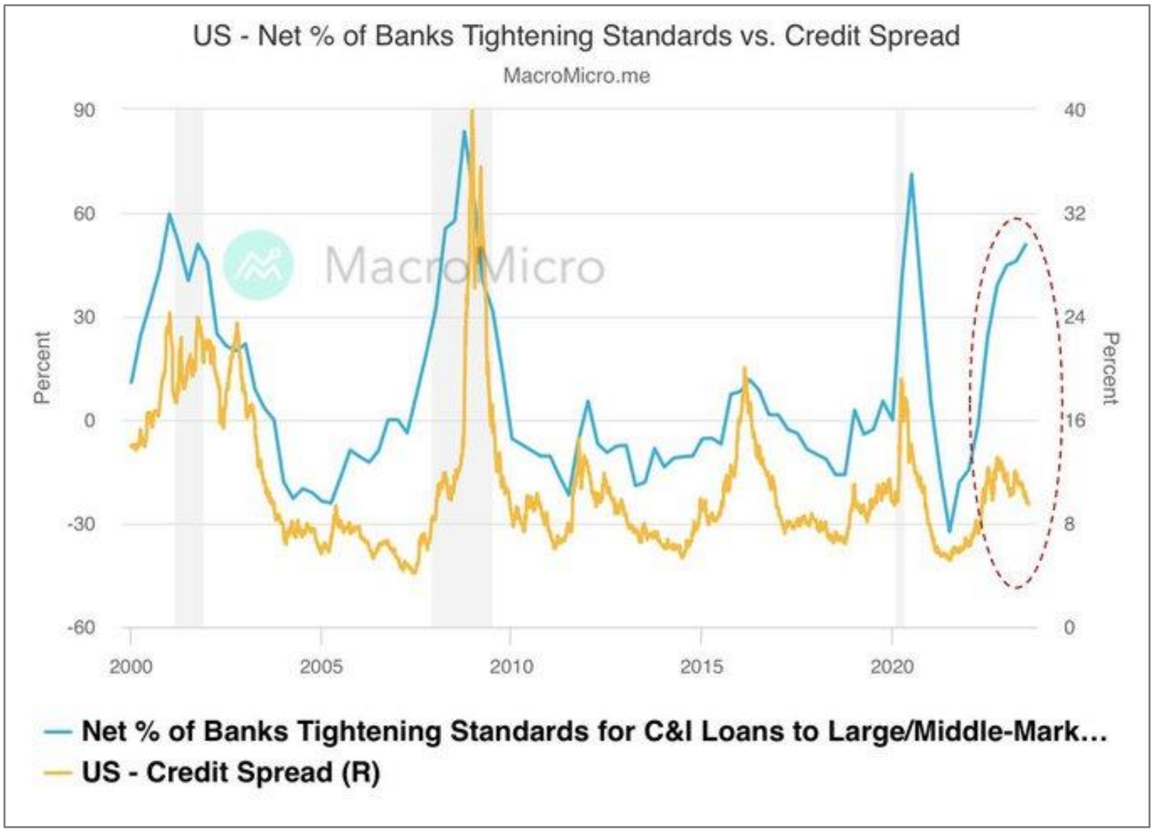


Imports look recessionary.

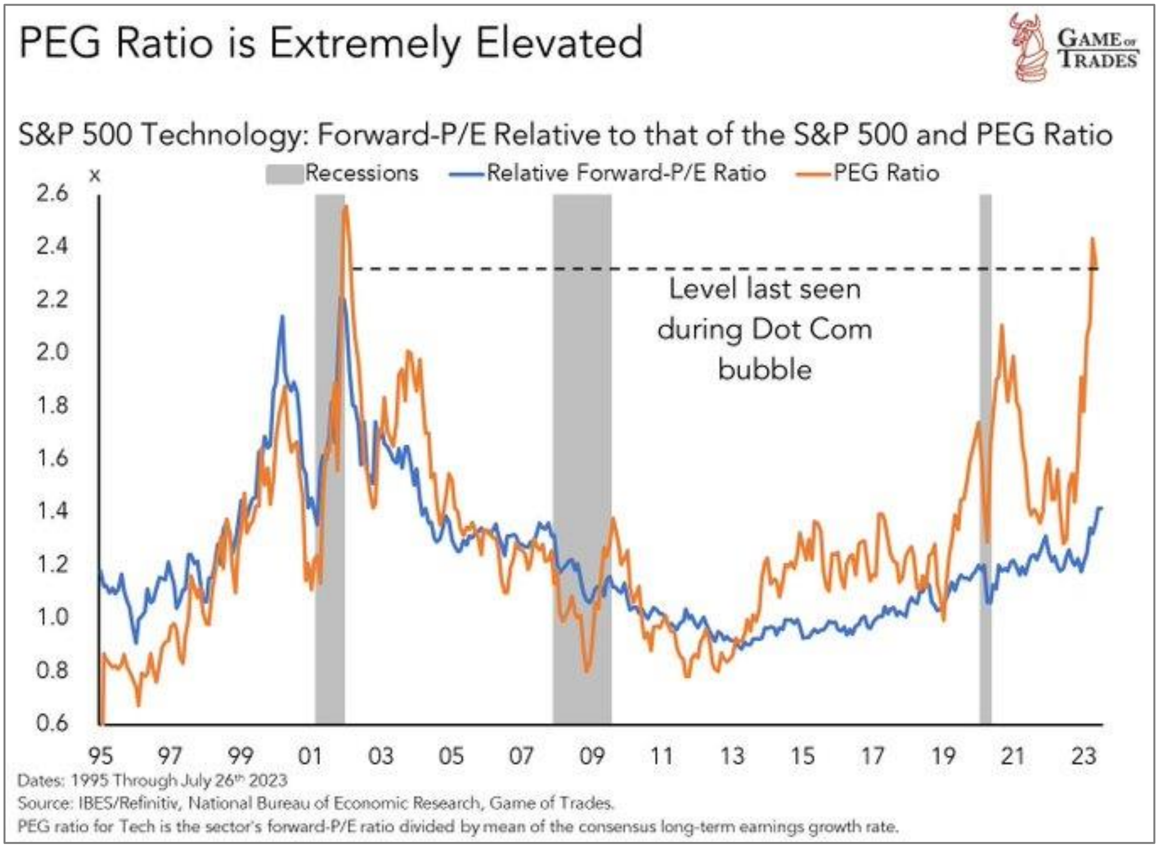


An Unusual Spread in Risk Appetite

Banks are super tight, but investors are still more than happy to provide credit to corporate borrowers.



PEG Ratio (Valuation to Growth) on Technology Stocks are hitting Dot Com Bubble Levels.



Odds that NVIDIA will outperform when selling at more than 40x Price to Sales

"At 40x trail 12m sales, 25x fwd sales, Nvidia is highest valuation stock of any stock in top 500. Odds it out-performs now? 231 companies reached similar multiple last 50+years Only 20% beat market next 12m. >90% fail 3/5/10 years. Median stock loses by 36% next 12 months" - Jeremy Schwartz

Figure 4a: Probability that Stocks Outperform the Market at Higher Valuations

P/S	# Of Companies	% of Time Stock Outperforms Market				
		1 Yr	3 Yr	5 Yr	10 Yr	20 Yr
>25	231	21%	9%	8%	8%	4%
25-30	139	24%	9%	8%	7%	7%
30-40	137	20%	6%	4%	6%	3%
>40	148	21%	10%	9%	9%	3%

Source: Jeremy Siegel with Jeremy Schwartz, research for Stocks for the Long Run, 6th ed., 2022. Past performance is not indicative of future results.

Figure 4b: Median Relative Performance of Stocks at Higher Valuations

P/S	Stock - S&P (Median)				
	1 Yr	3 Yr	5 Yr	10 Yr	20 Yr
> 25	-36%	-30%	-23%	-11%	-7%
25 - 30	-28%	-23%	-13%	-6%	0%
30 - 40	-37%	-31%	-23%	-10%	-7%
> 40	-38%	-33%	-26%	-12%	-12%

Source: Jeremy Siegel with Jeremy Schwartz, research for *Stocks for the Long Run*, 6th ed., 2022. Past performance is not indicative of future results.

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.