Market Outlook

By Mark T Dodson, CFA

Benny Button Jr.

Market Risk Index fell to 71.2% this week on notable improvements to both Psychology and Monetary Conditions. The Psychology Composite is on the cusp of moving out of the worst 10% of readings. It's a move in the right direction, but it's not an indication of a refreshed wall of worry by any stretch of the imagination. Valuations, which worsened slightly, don't get their fair share of print space in many of these weekly reports, and it's because they have been stubbornly elevated throughout the year, mired in the worst decile of readings.

The market rallied on cue from the oversold reading from our NYSE Overbought/Oversold reading last week, but NYSE Overbought/Oversold's efficacy runs around 2-4 weeks. It's a trading indicator. The equity put/call ratio spiked to very bullish levels for markets – a good development but highly unusual for such a minor pullback in stock prices. Options markets have become more speculative and retail trader driven post Covid. As a result, we have witnessed unusual volatility around readings coming from sentiment indicators based on options markets. At the same time that the equity put/call ratio is spiking, assets in leveraged ETF investments have shot back up into the Euphoria zone. It's a lesson for why it's good practice to build redundancy into any broad measures of investor psychology.

There were a couple of significant economic developments this week. Core PCE inflation turned up and came in hotter than expected. If it's not already priced in that inflation prints will accelerate through year-end, it should be. The comparisons are more difficult, and commodity prices have firmed up throughout the year.

The updated GDP estimate was also released this week. On the tail end of the press release, you may have noticed that year-over-year growth in Gross Domestic Income (GDI), the lesser-followed red-headed stepchild of GDP (which in theory should equal GDP), has now declined three quarters in a row. We discussed it after the last GDP update, but this kind of action has never happened outside of a recession. GDI isn't available as early as GDP, but it's always served as a superb economic canary in the coal mine when it gives a divergent message from GDP.

Market Risk Index

Rec Allocation 25% Underweight

71.2%

Category Percentiles

Psychology - P6: 90.5%

Monetary - M3: 33.7%

Valuation - Extremely Overvalued: 95.8%

Trend: 51.4%

Largest Psychology Influences

Leveraged Investments	Negative
Bank Sentiment	Negative
Flow of Funds	Negative
Option Activity	Positive

Largest Monetary Influences

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

Valuation

7-10 Year Equity Return Forecast	1.6%
10Yr US Treasury Yield	4.1%

Market Trends

US Equities	Bullish Trade
Intl Equities	Neutral Trade
REITs	Bearish 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.

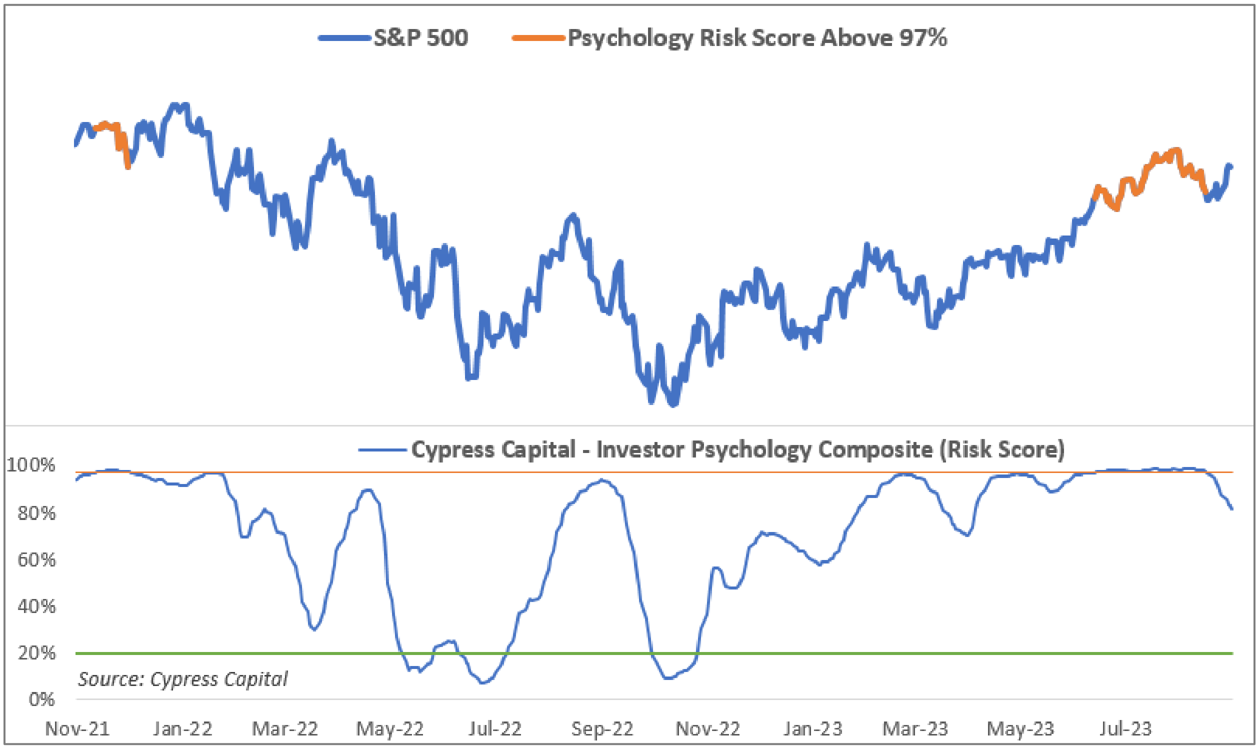
Don't be surprised if the NBER declares that a recession has already occurred in hindsight. However, the Fed's aggressive monetary tightening and the state of the yield curve also suggest that you should not be surprised if another recession gets declared next year as well – two recessions (and bear markets) book-ended, not unlike the 1980 and 1981 recessions.

Early on in the 2020-2021 bull market, we labeled it the Benjamin Button bull market because it looked geriatric in age from the day it was born – it didn't have the qualities to make it even a run-of-the-mill bull market that most of us have experienced in our careers. It ended up being the shortest bull market since 1947, over 75% shorter than the average, but it created Euphoria and a speculative environment unlike any other bull market.

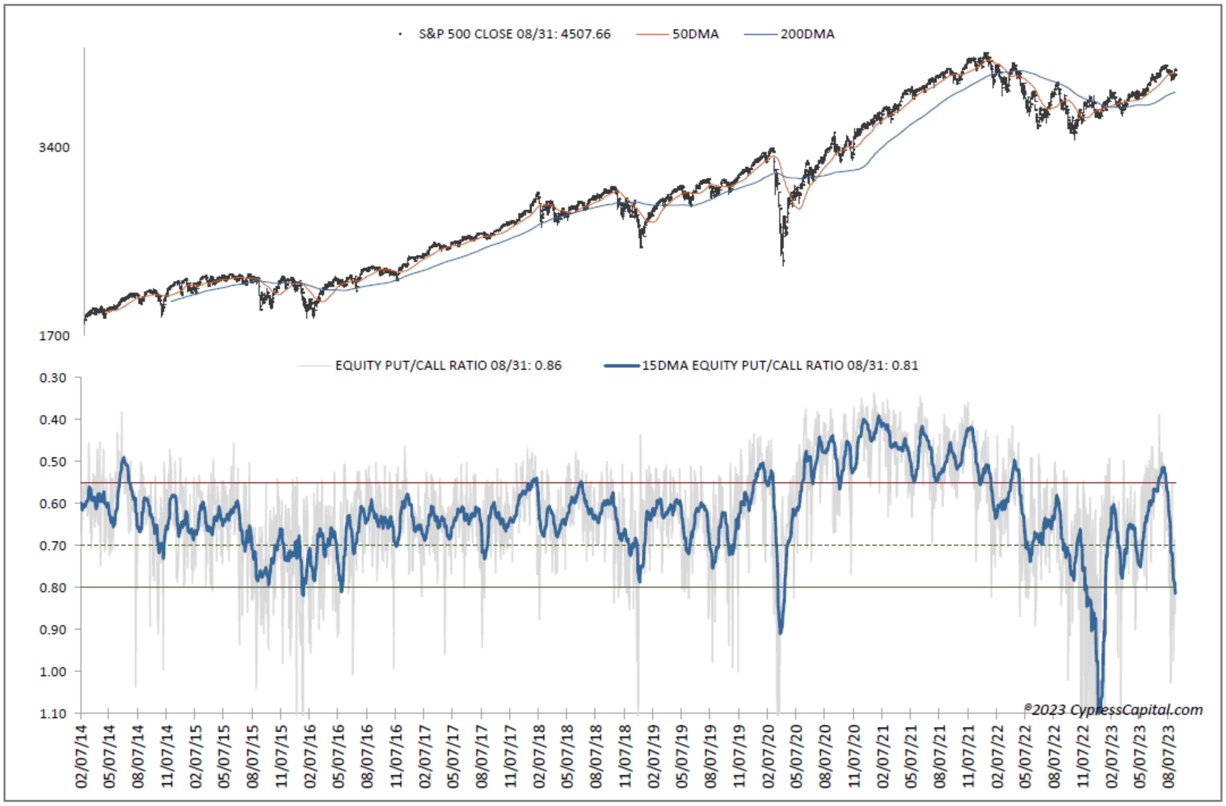
We've taken to calling this bull market Benny Button Jr. Benny is breaking even more rules – being born with an inverted yield curve while the Fed was still tightening. This bull started with the most expensive valuation to mark the start of a bull market in US history, after following the first bear market never registering a VIX reading over 40. The 2022 bear market didn't reload the fear or credit cycle cannon for much beyond a speculative interlude. Too many investors seem to speculate that a return to easy money Covid stimulus times are back. They want their bubble back, with or without the Fed's blessing.

Charts of the Week

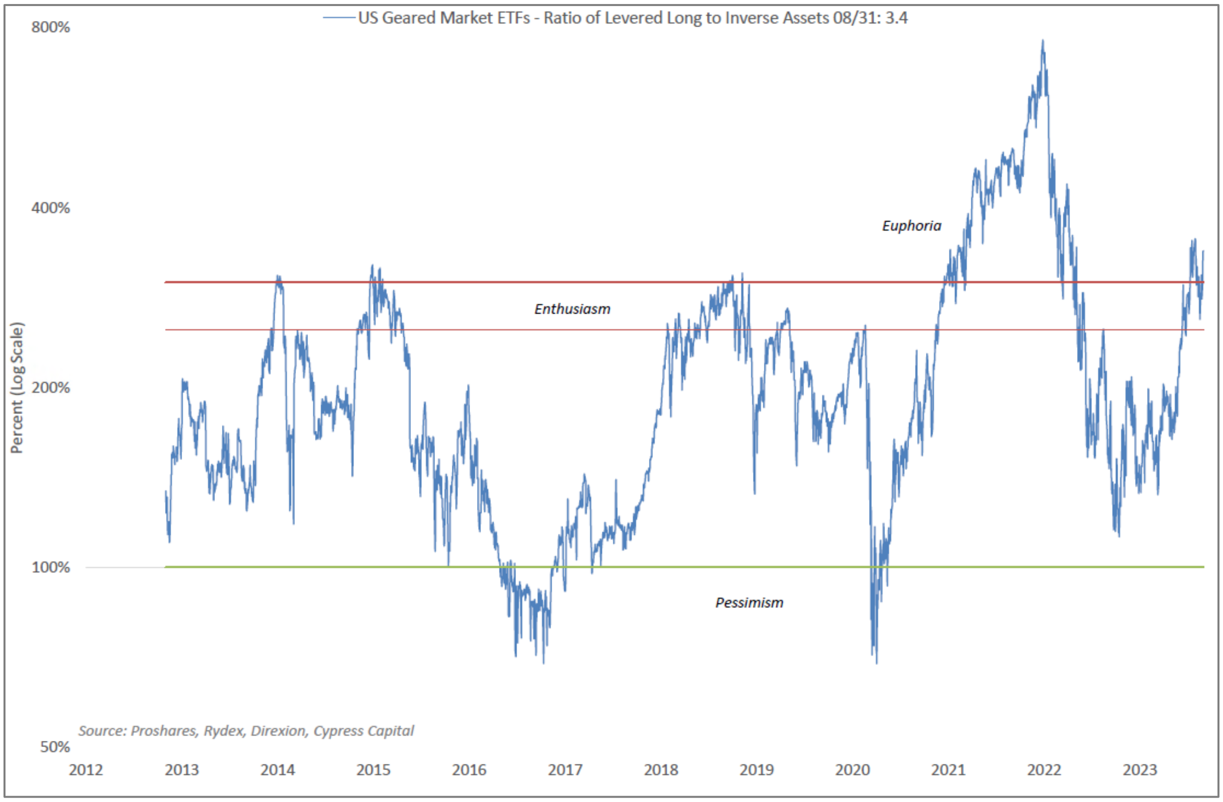
Psychology Composite is moving away from the worst 10% of readings.



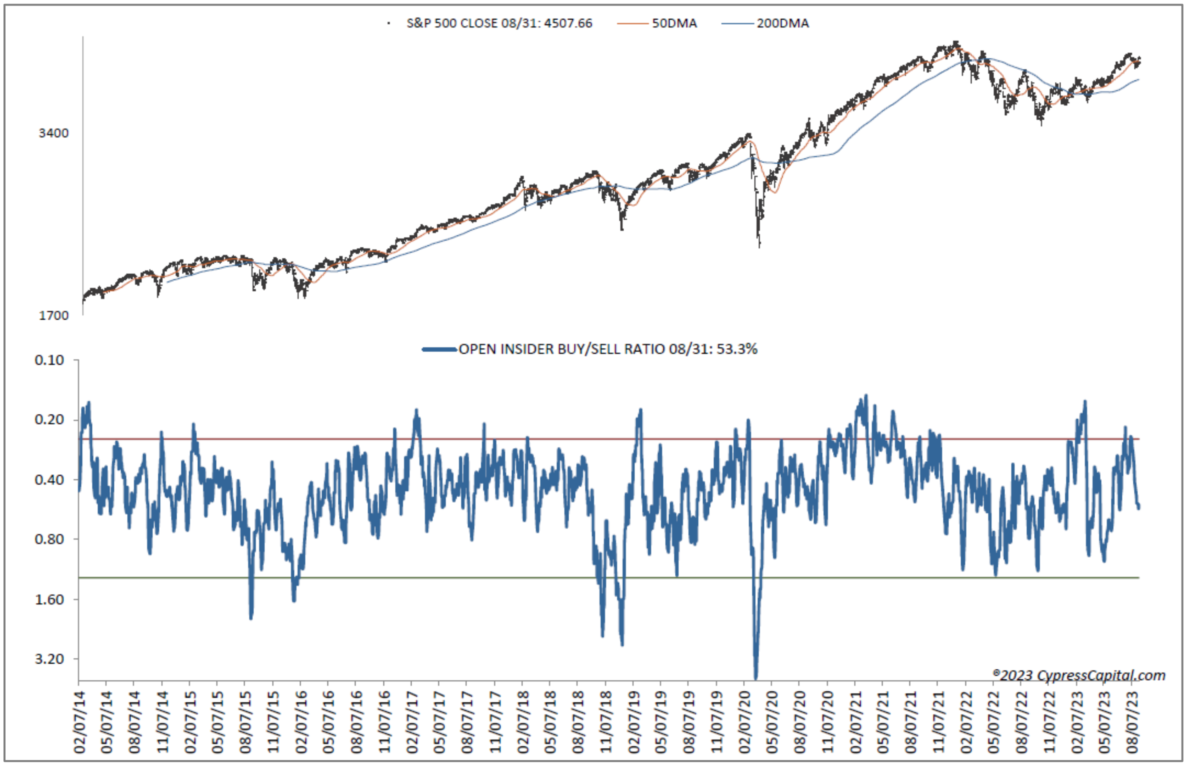
The Equity Put/Call Ratio swings back to fear.
It's incredibly unusual to see this level of fear on a pullback of less than 5%. Retail trading and the surge in zero days to expiration trading have led to more volatility in put/call readings.



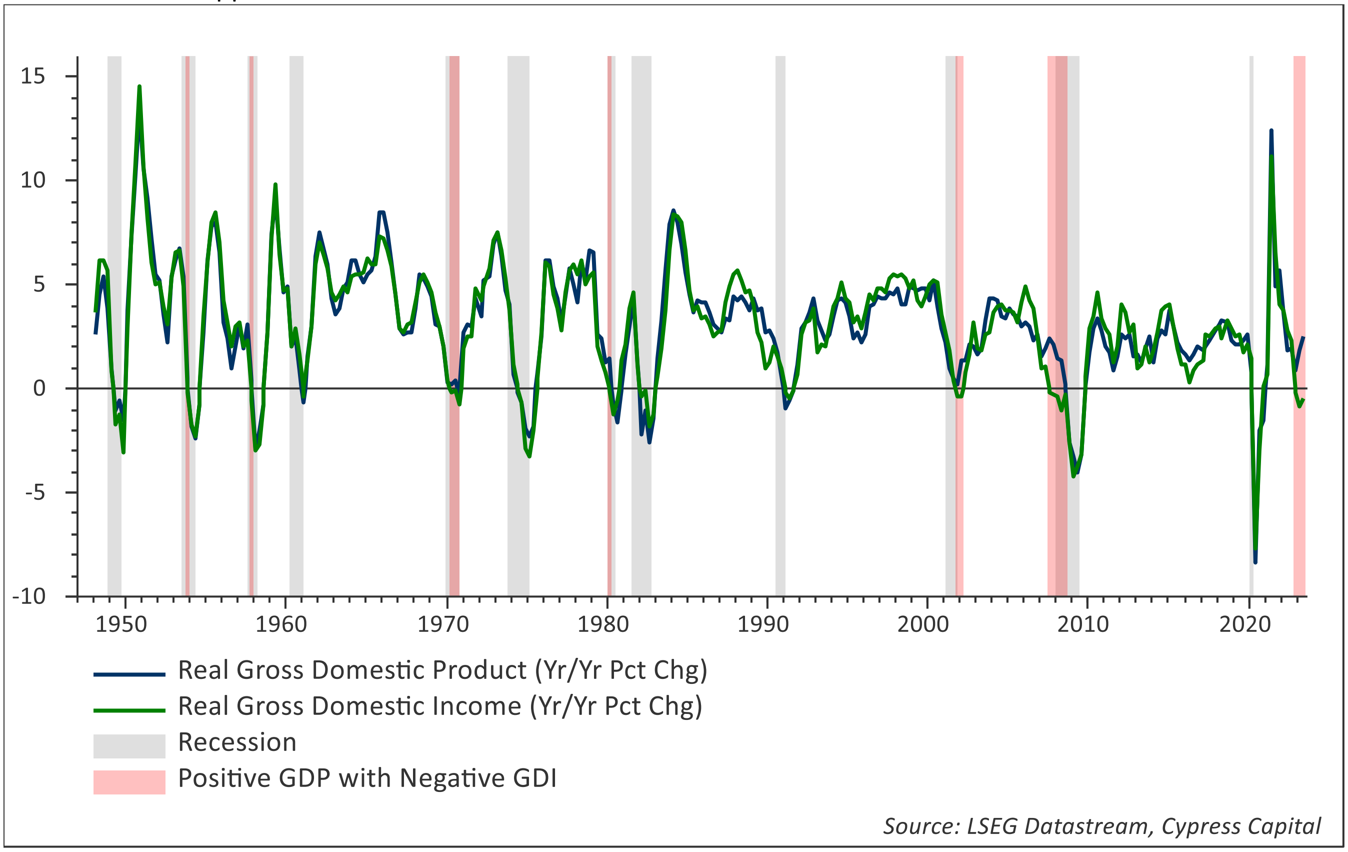
Meanwhile, Leveraged ETF investors swung back into Euphoria.



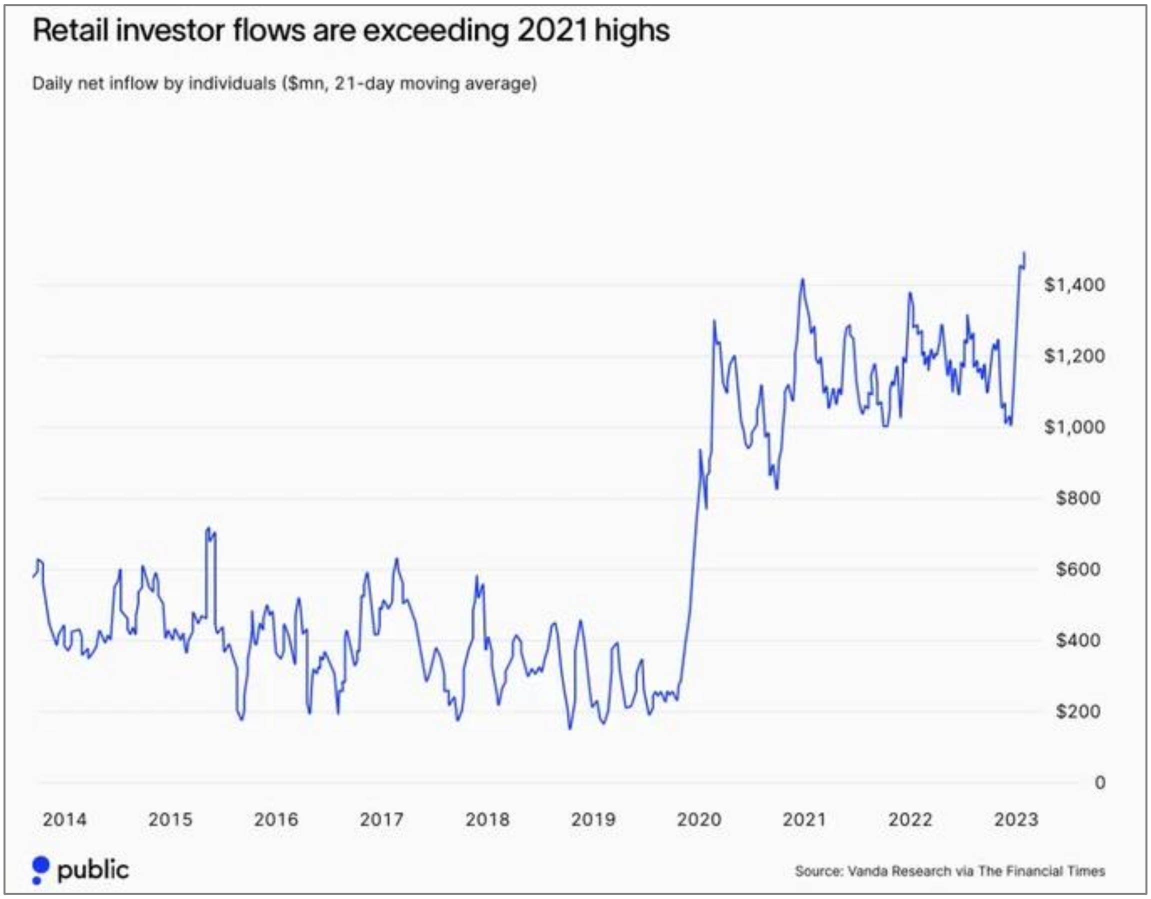
Corporate Insiders are neutral – not aggressively buying or selling in this environment.



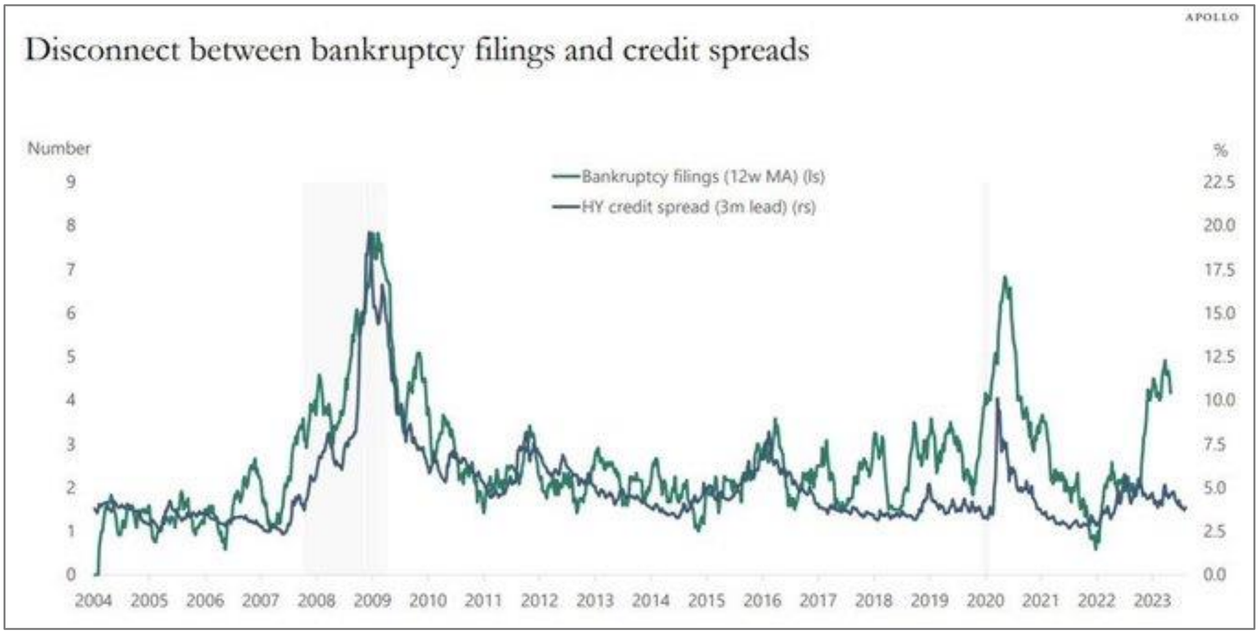
Gross Domestic Income Y/Y Growth has declined for three quarters in a row.
That has never happened outside of a recession.



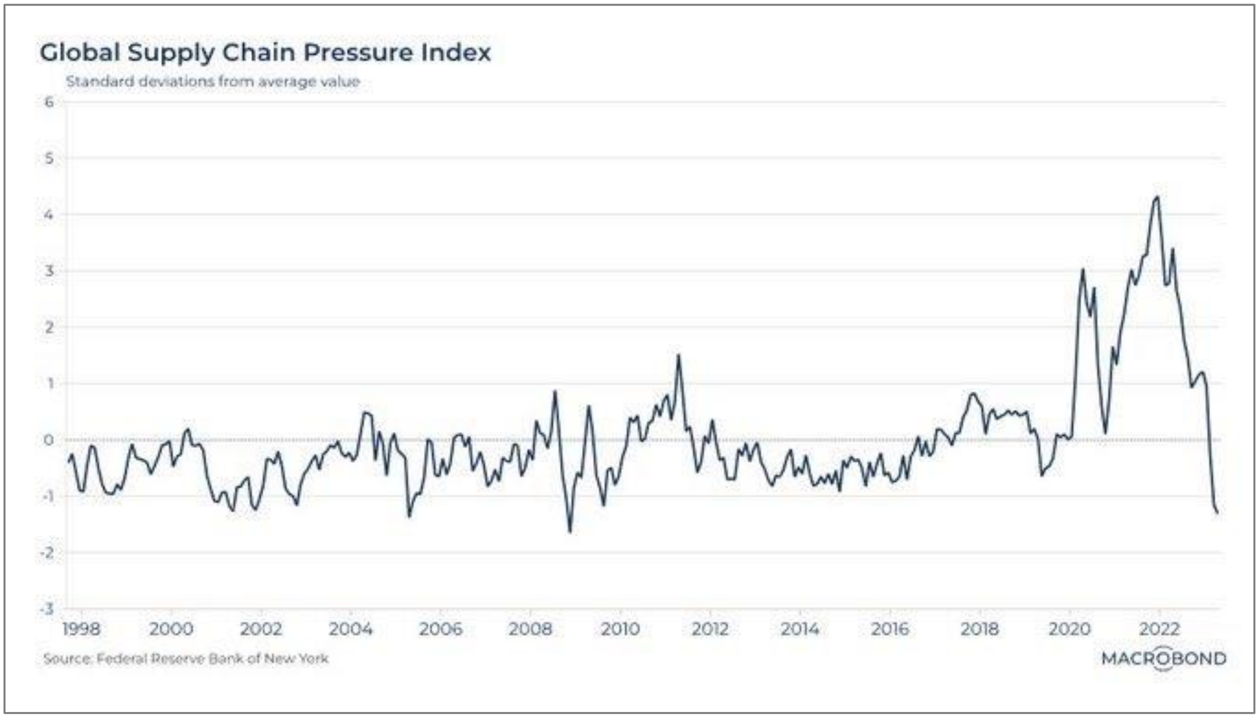
Retail Investor Flows have surged to a record high.
The bear market in 2022 appears to have had little impact on retail investor behavior.



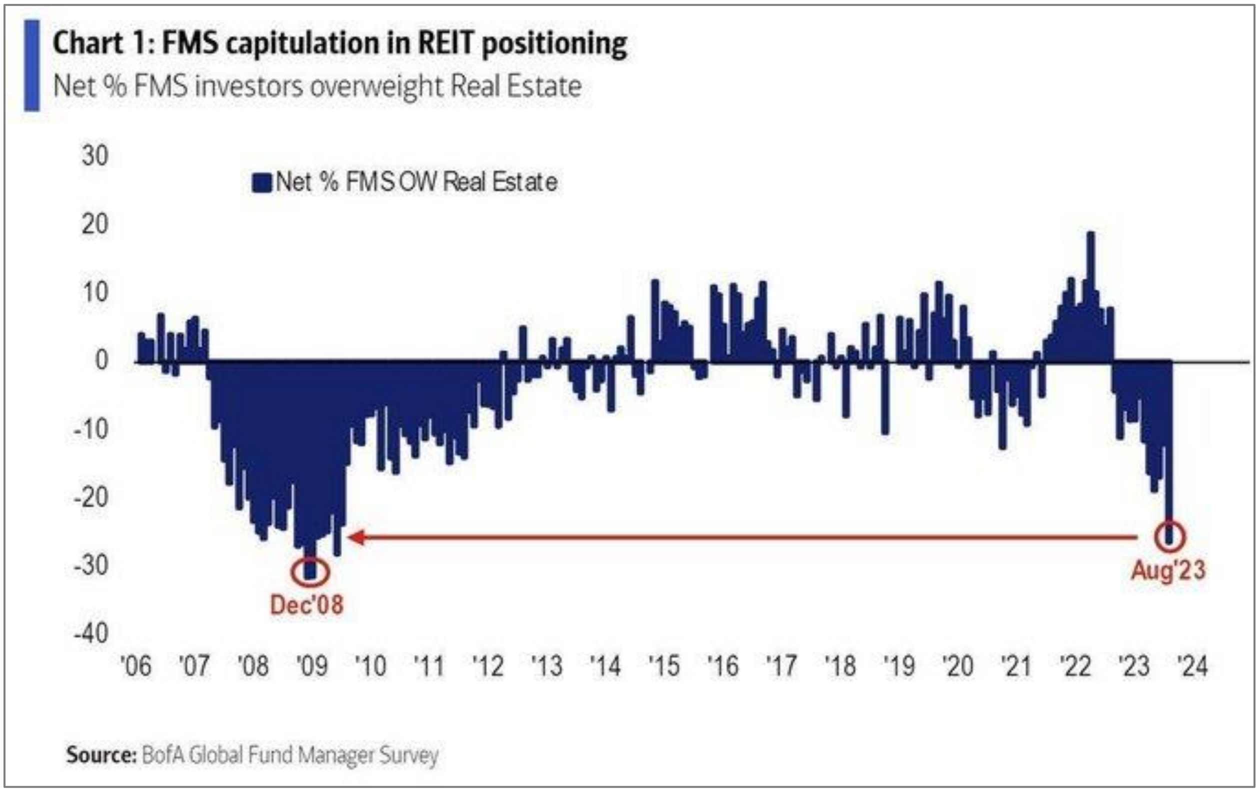
Credit market investors are ignoring the trend in bankruptcy filings.



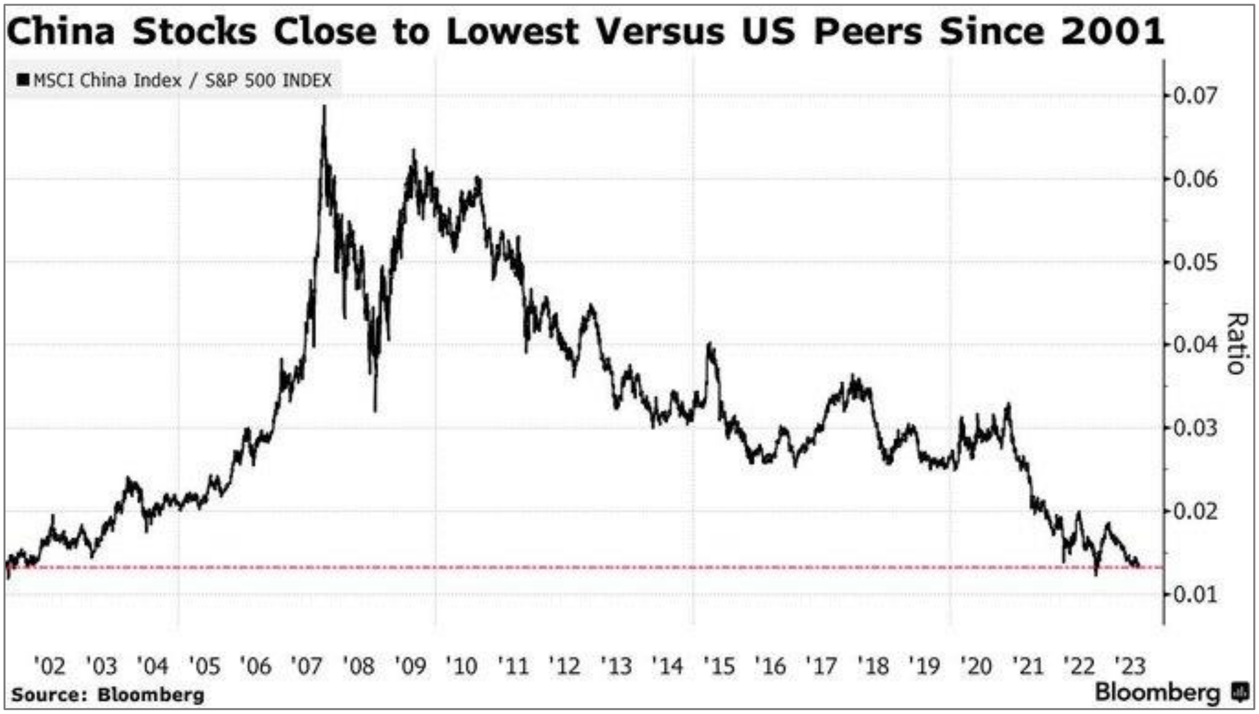
Global Supply Chains are seeing the opposite of pressure today.



REITs are as unloved as they were in 2008.

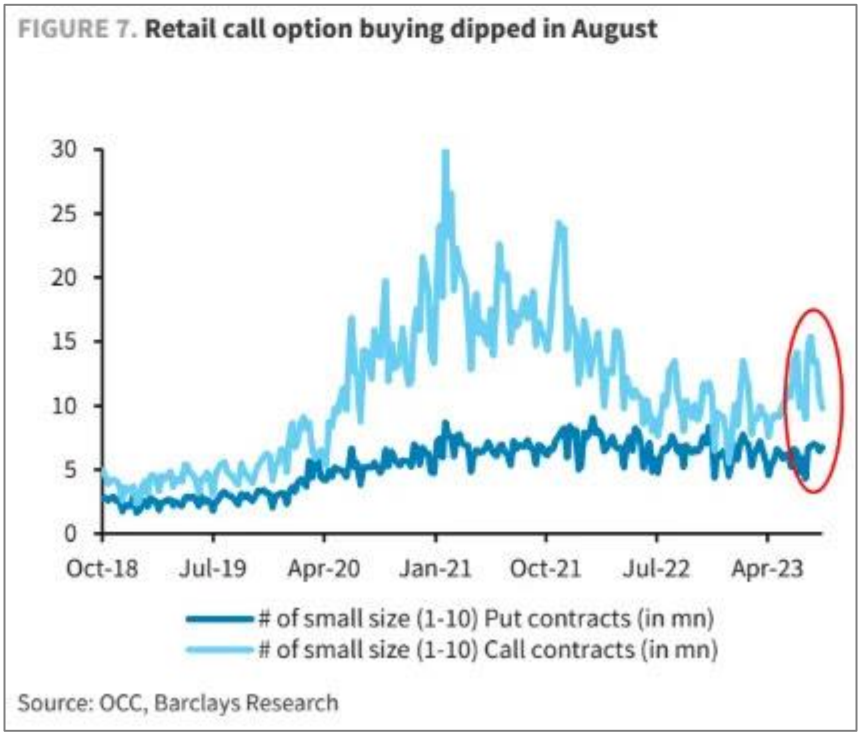


China has erased all of its relative price outperformance since it entered into the WTO.

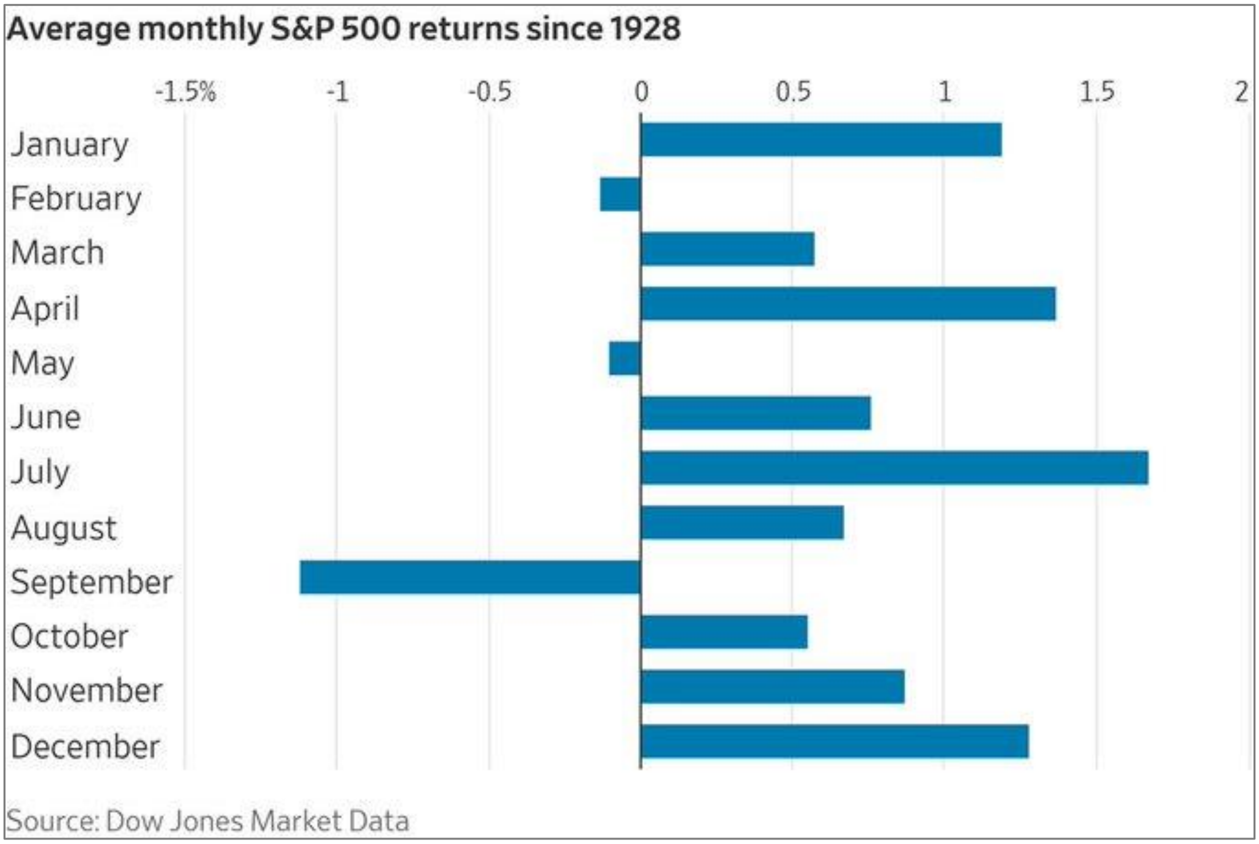


Will US Treasuries see negative returns for three years in a row for the first time in US history?

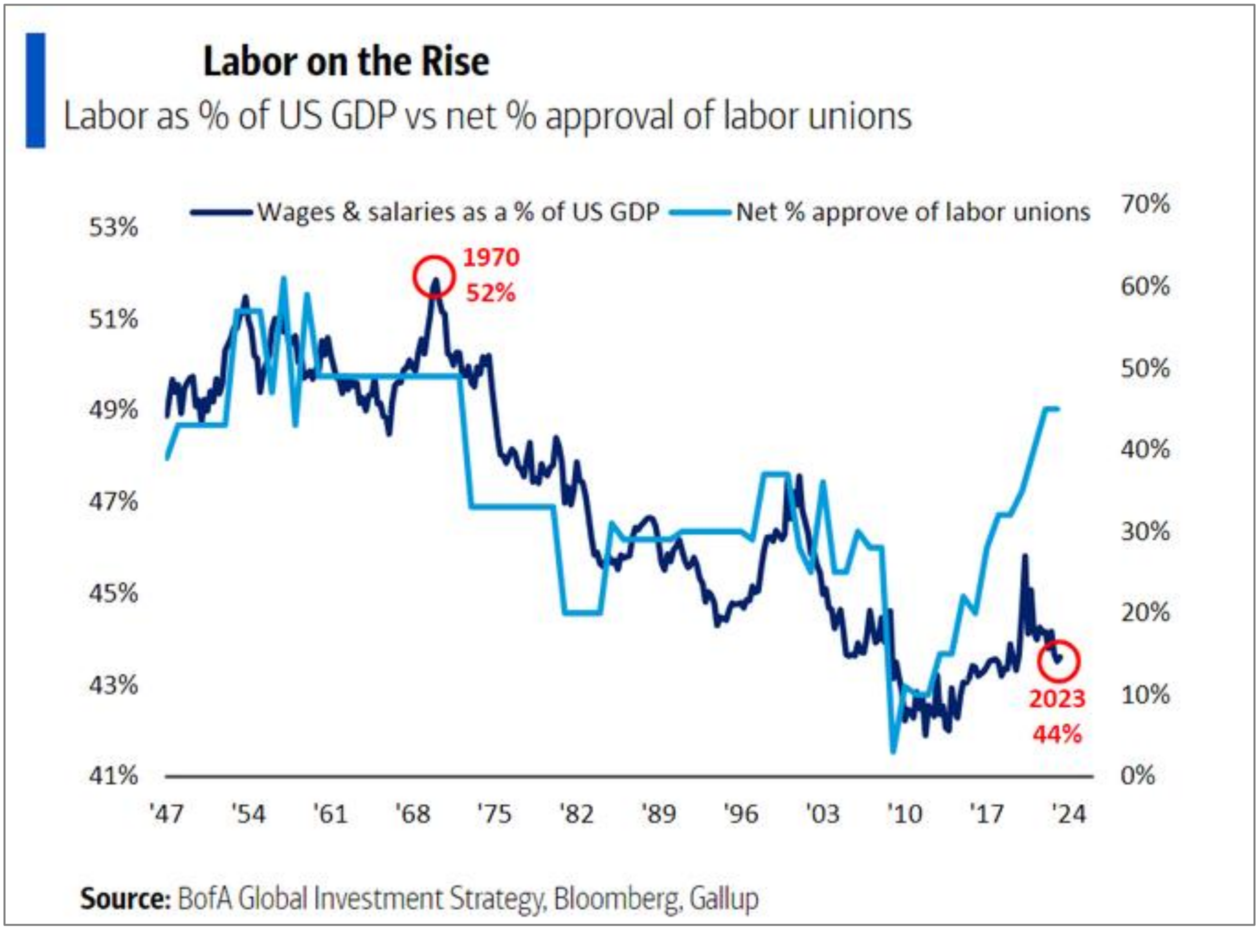
Retail call option buying dipped in August...but option trading is still well above the pre-Covid levels.



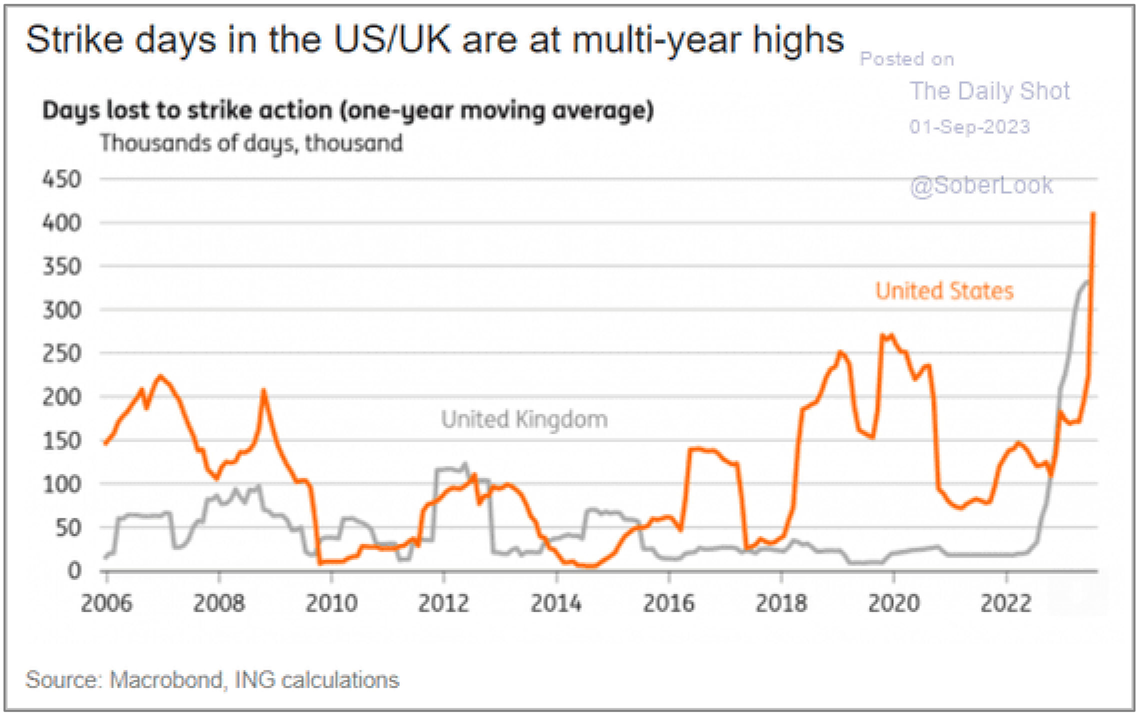
September is the worst month for stocks on average.



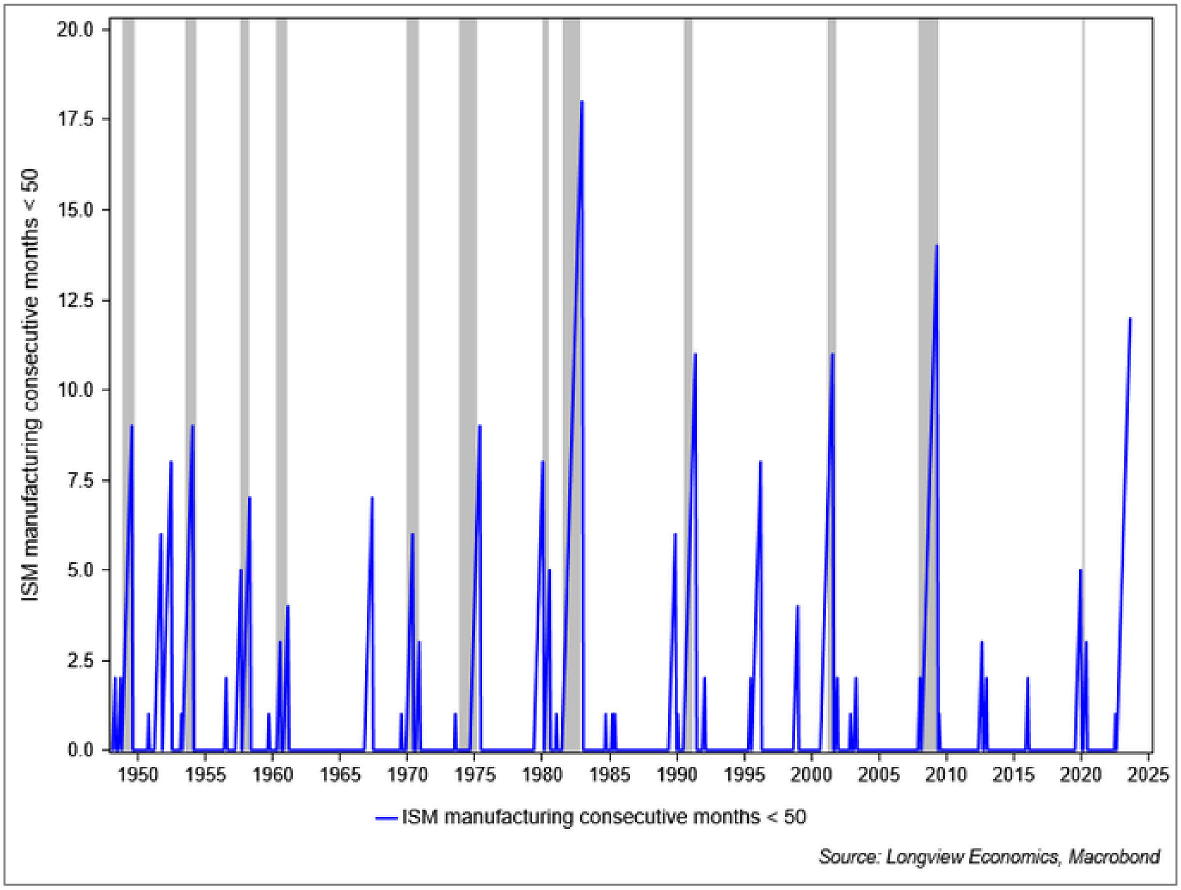
Labor Unions haven't had approval rates this high since the 1970s.



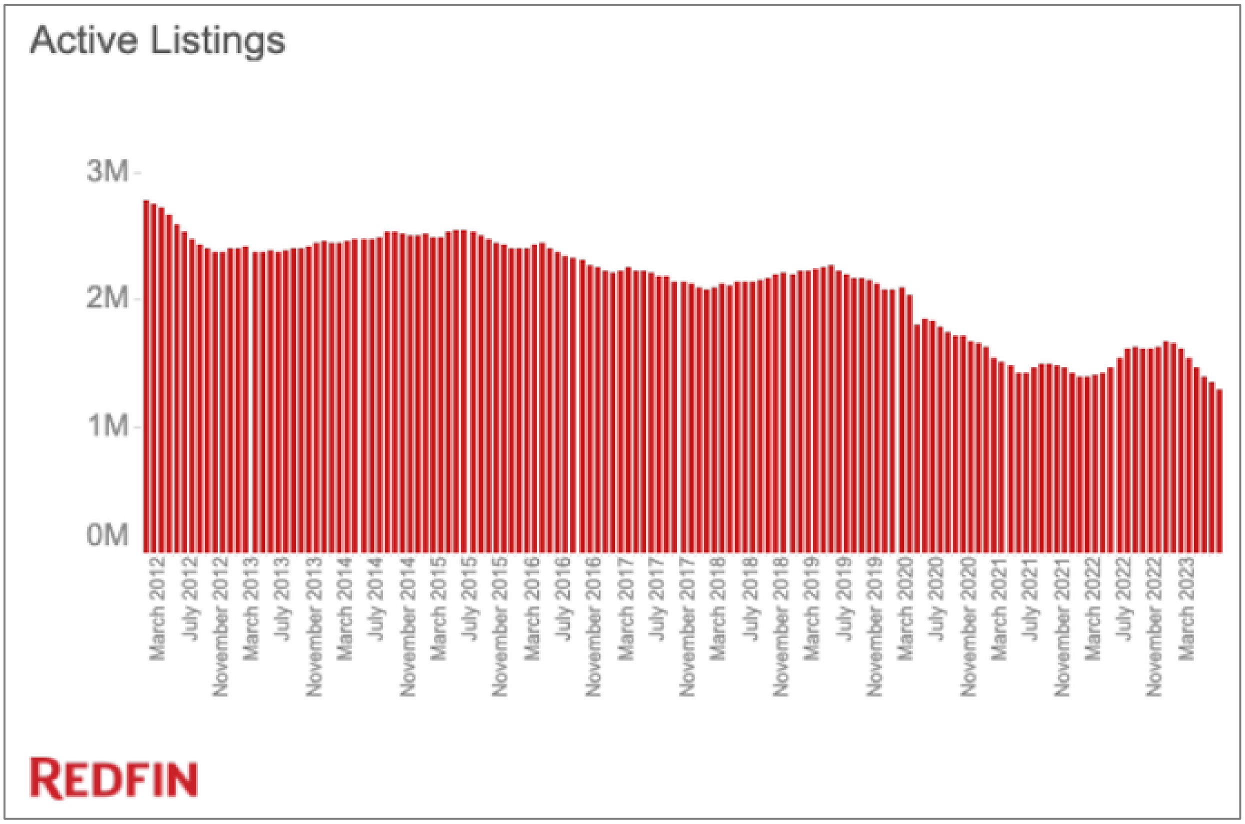
Days lost to labor on strike has been surging.



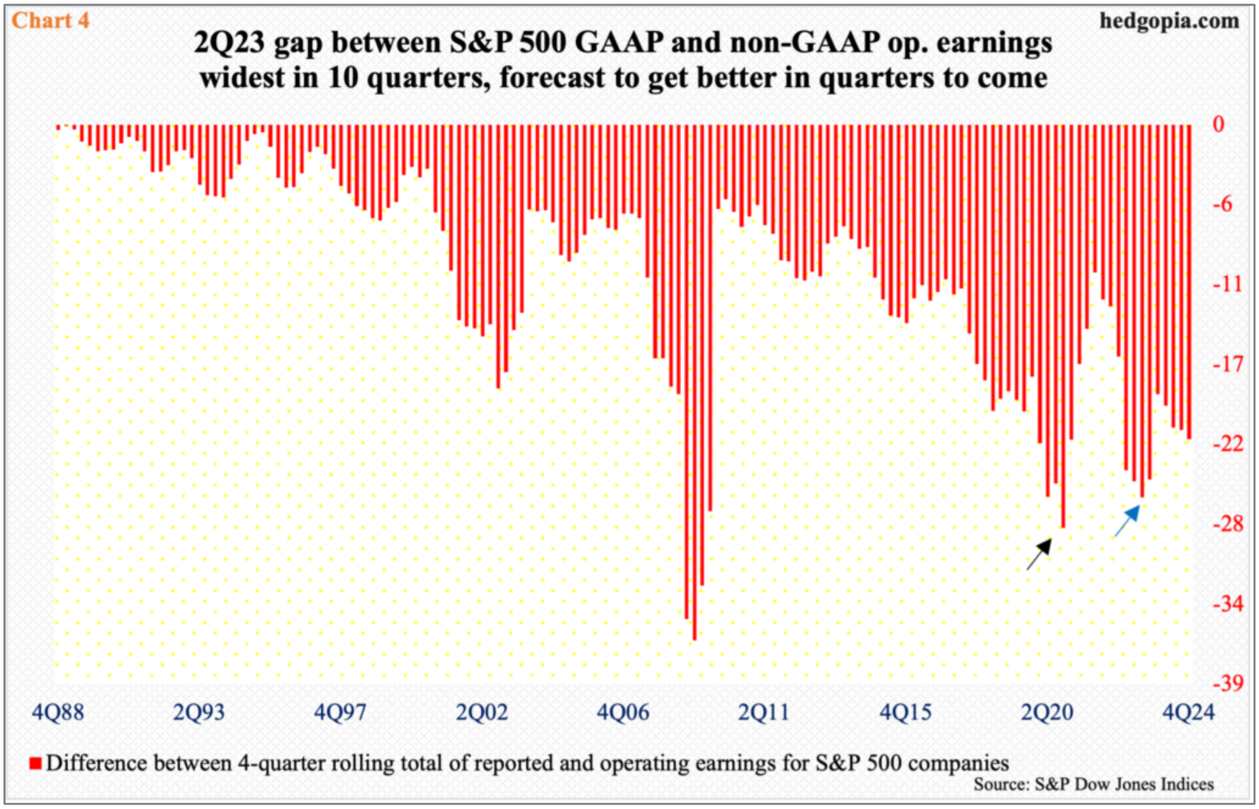
ISM Manufacturing has never spent this many months under 50 without recession.



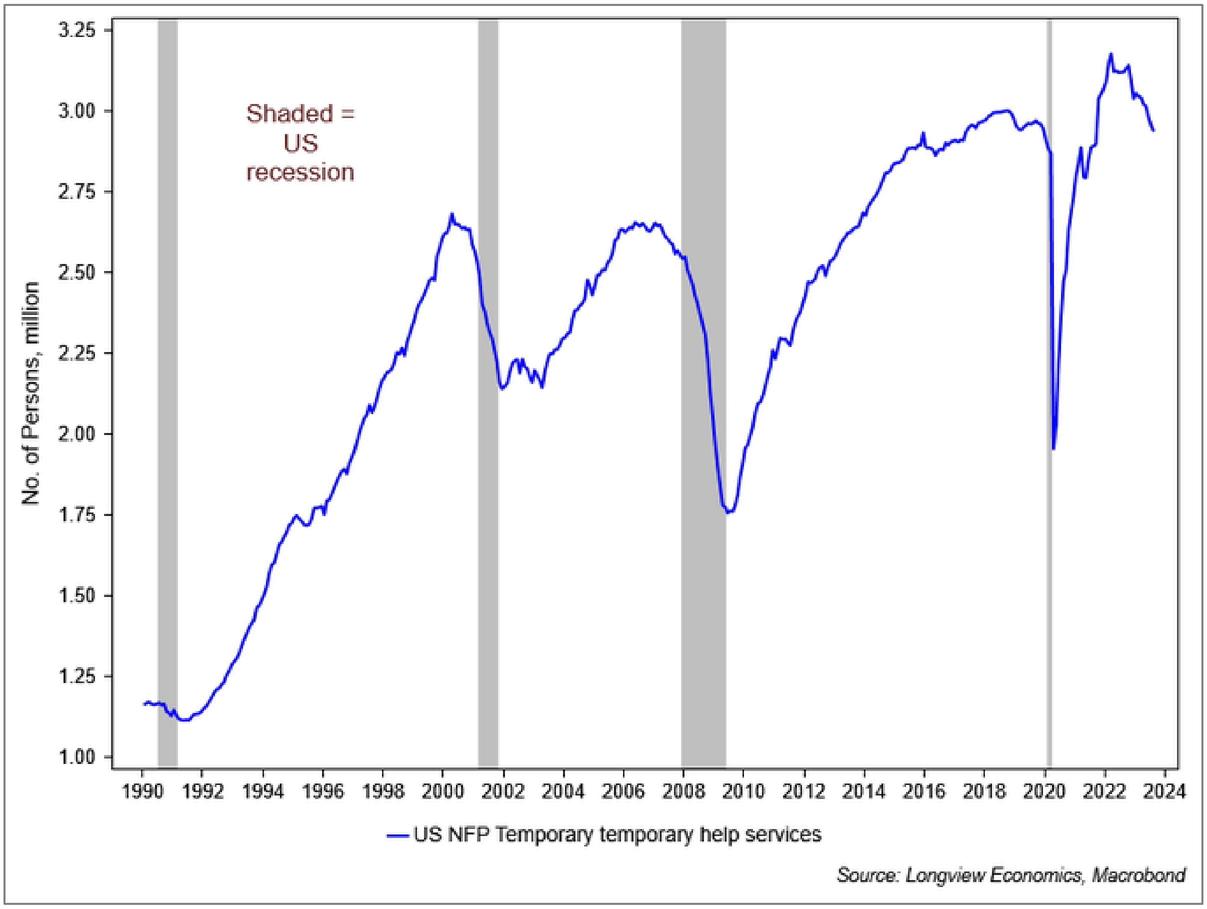
Active Listings of Homes for Sale fell to the lowest since Redfin has tracked the data.



Gap between GAAP and non-GAAP earnings looks recessionary.



Rollover in Temporary Help looks recessionary.



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.