Market Outlook

By Mark T Dodson, CFA

Buybacks dwindle - right on cue.

Market Risk Index moved up to 71%. Psychology and Monetary Conditions deteriorated, and the Psychology Composite crossed back into the worst decile of readings. Valuations were unchanged.

Options markets are the sole bullish influence on markets within Psychology – the equity put/call ratio grew even more extreme this week and is giving readings on par with significant stock market declines. Such a high equity put/call reading (15dma) has never occurred with a VIX reading this low – a sign that options markets have run amok. Another sign is that the world's first zero-days-to-expiration options ETF started trading this week. However, leveraged investors are behaving more in line with current VIX readings. They grew bullish and have shown no signs of backing off euphoric positioning in derivatives, leveraged funds, and ETFs.

The deterioration in Monetary conditions came as the Inflation category got downgraded on stronger than expected Producer Price Inflation, but the category remains positive overall. The Interest Rates category also worsened on a spike in the rate of change on the 2Yr Treasury yield and Municipal bond yields, which, in this case, is picking up how much sentiment has shifted in bond markets since the regional bank scare earlier this year. Yields have climbed across the board since that time, but equities have so far dismissed it.

On the valuation front, we included a chart making the rounds this week that shows a notable retreat in corporate buybacks over the last quarter. If you are a regular reader, you already know why—the chart that we showed during the summer – our old buyback indicator. Yields on Corporate bonds have climbed above the earnings yields on stocks for the first time since the Quantitative Easing era began after Lehman's failure. The balance sheet arbitrage that CFOs have been doing for the last decade is no longer profitable. Tight Fed policy has also made cash more attractive than stocks for the first time since 2000 when comparing the earnings yields on stocks to Treasury-Bill yields. Money goes where it is treated best.

This week's bottom line is the same as it has been for several months. Investor Psychology and Valuations imply high drawdown risk due to too much investor enthusiasm, keeping us from embracing the bull. Monetary conditions are relatively bullish for

Market Risk Index

Rec Allocation 25% Underweight

71.0%

Category Percentiles

Category	Percentile
Psychology - P6	90.1%
Monetary - M3	33.9%
Valuation - Extremely Overvalued	95.6%
Trend	29.1%

Largest Psychology Influences

Leveraged Investments	Negative
Consumer Confidence	Negative
Bank Sentiment	Negative
Option Activity	Positive

Largest Monetary Influences

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

Valuation

7-10 Year Equity Return Forecast	1.7%
10Yr US Treasury Yield	4.3%

Market Trends

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

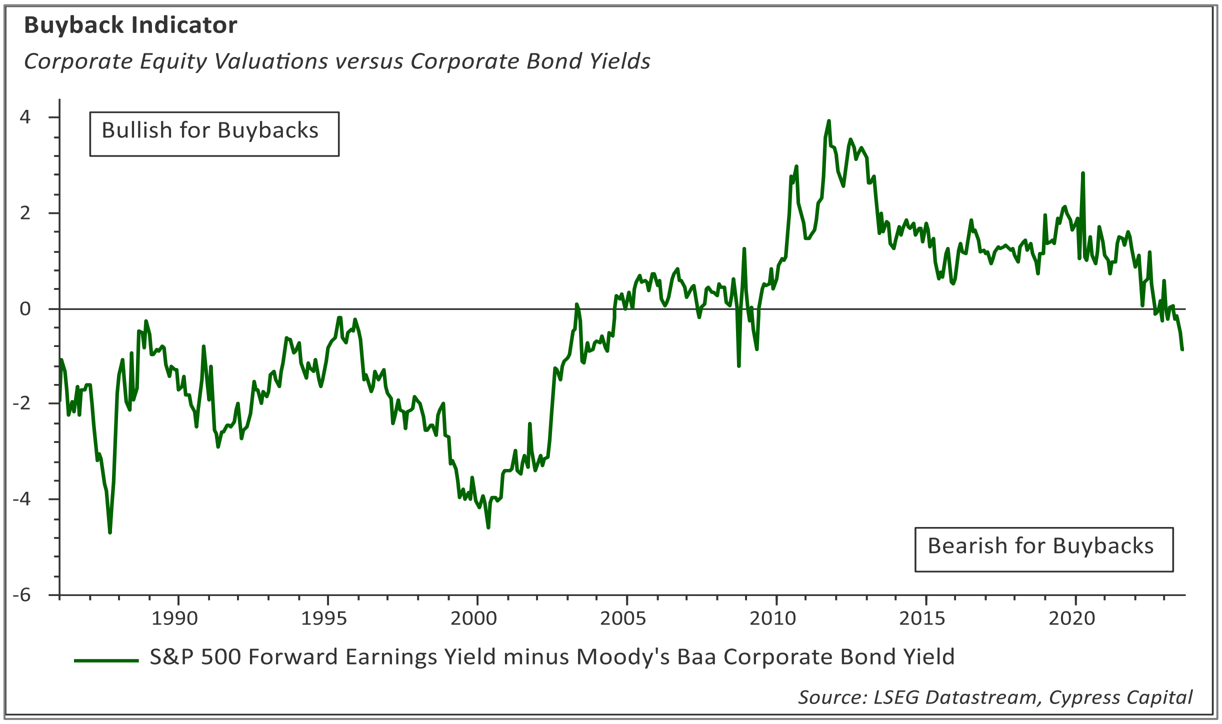
Market Risk Index scales from 0 to 100%. Higher readings correspond with higher risk markets. Scores below 25% are bullish. Scores between 25-75% are neutral, and scores above 75% are markets vulnerable to major drawdowns.

markets, not new credit cycle bullish, but bullish enough to support this ugly duckling of a bull market we are experiencing. And, the Trend has waffled in a range around neutral, with bull market participation primarily confined to the largest of large-cap stocks. The magnificent seven continue to outpace the stag-nificent rest, driving most gains in cap-weighted indices.

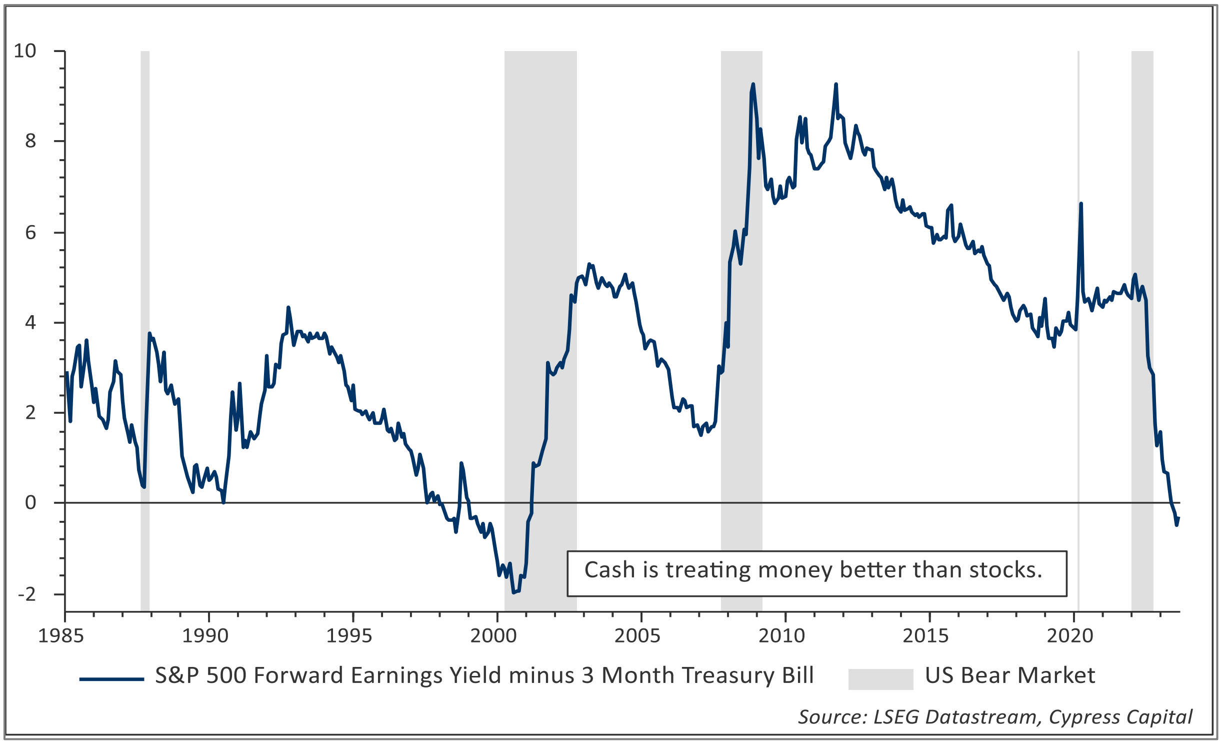
Charts of the Week

Buyback Indicator grows more bearish for buybacks and LBO activity.

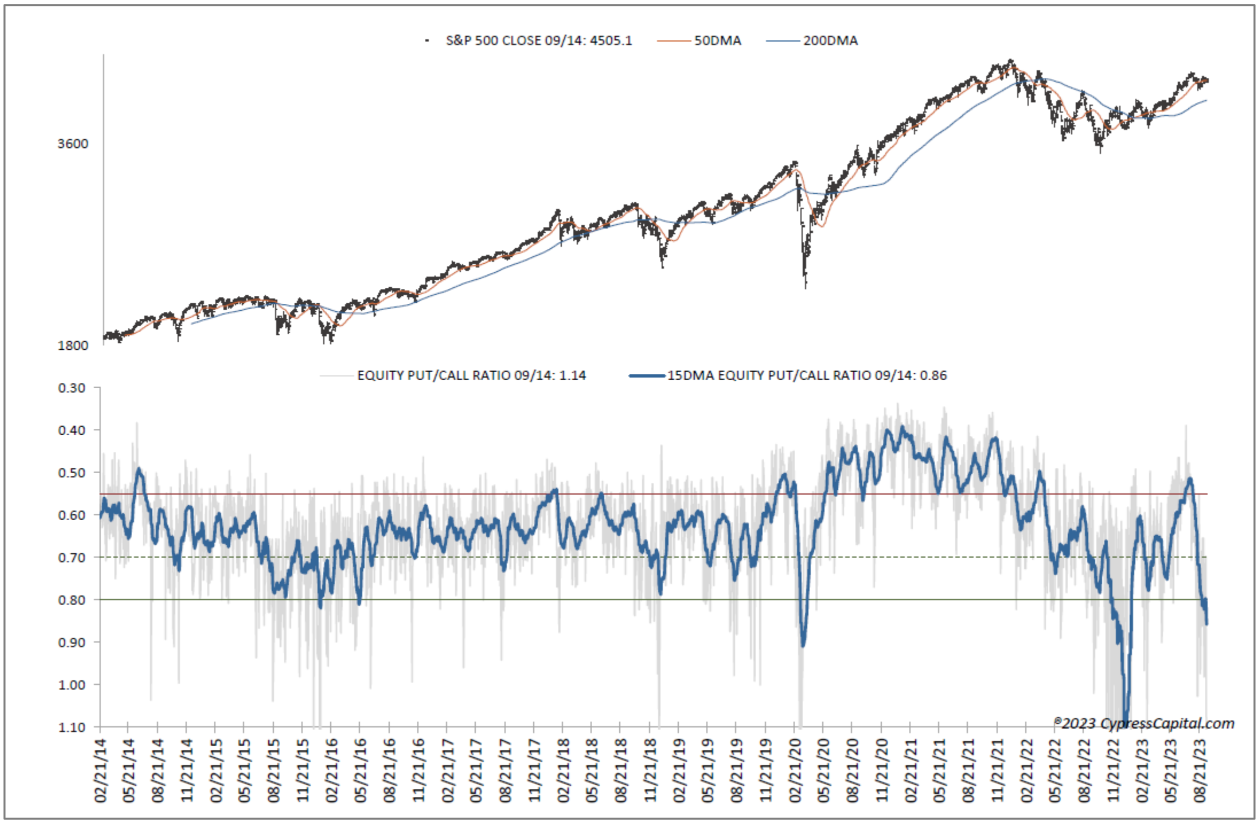
The cost of issuing corporate debt has climbed too far above the cost of issuing equity.



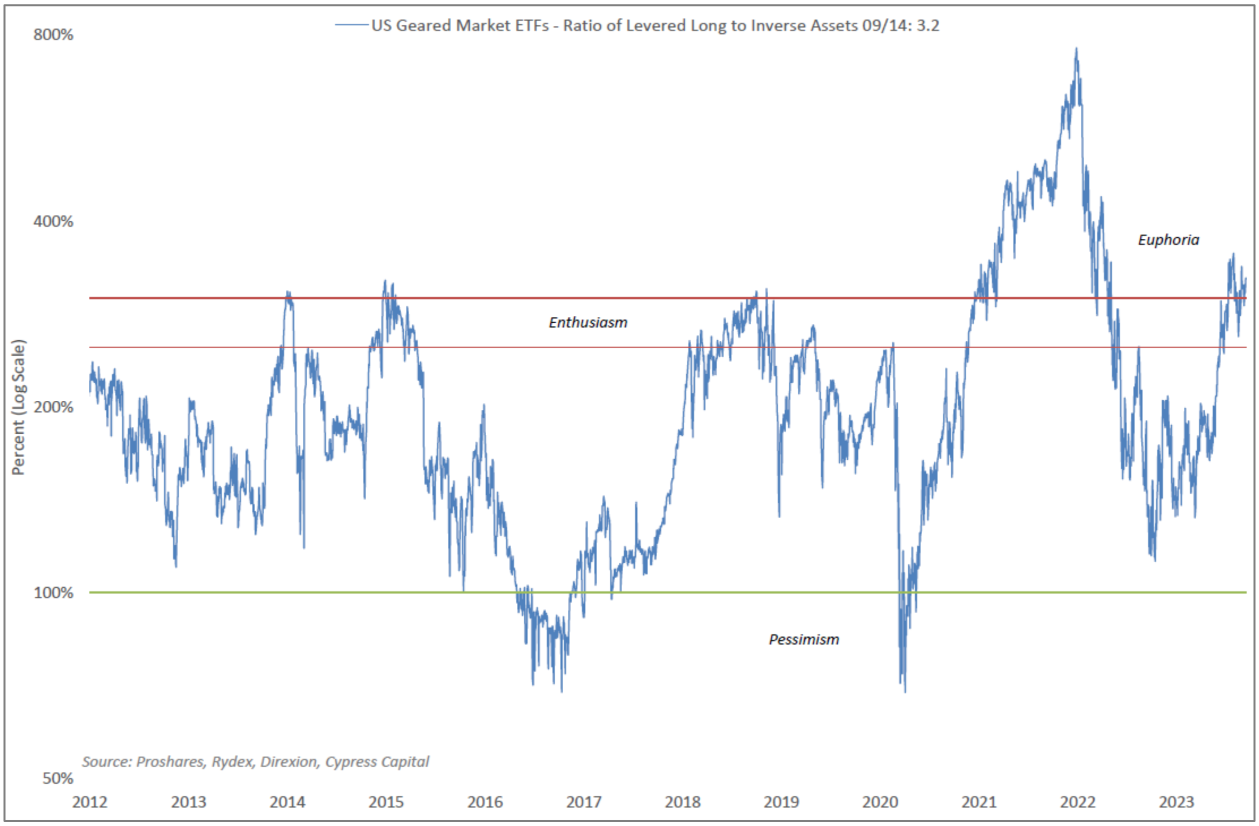
Relative Valuations - Money is being treated better by cash than stocks.



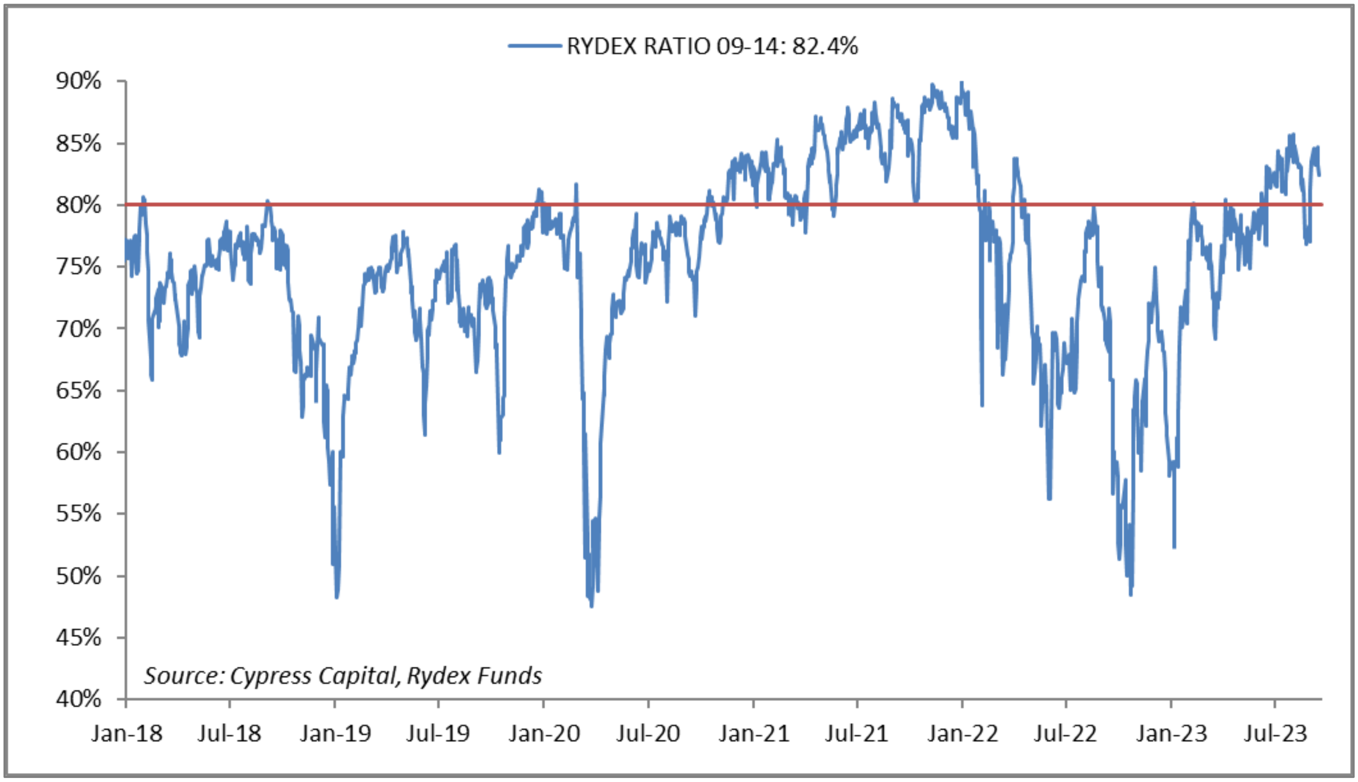
Equity Put/Call Ratio continues to surge into the fear zone.
We have never seen such a surge with VIX readings so low.



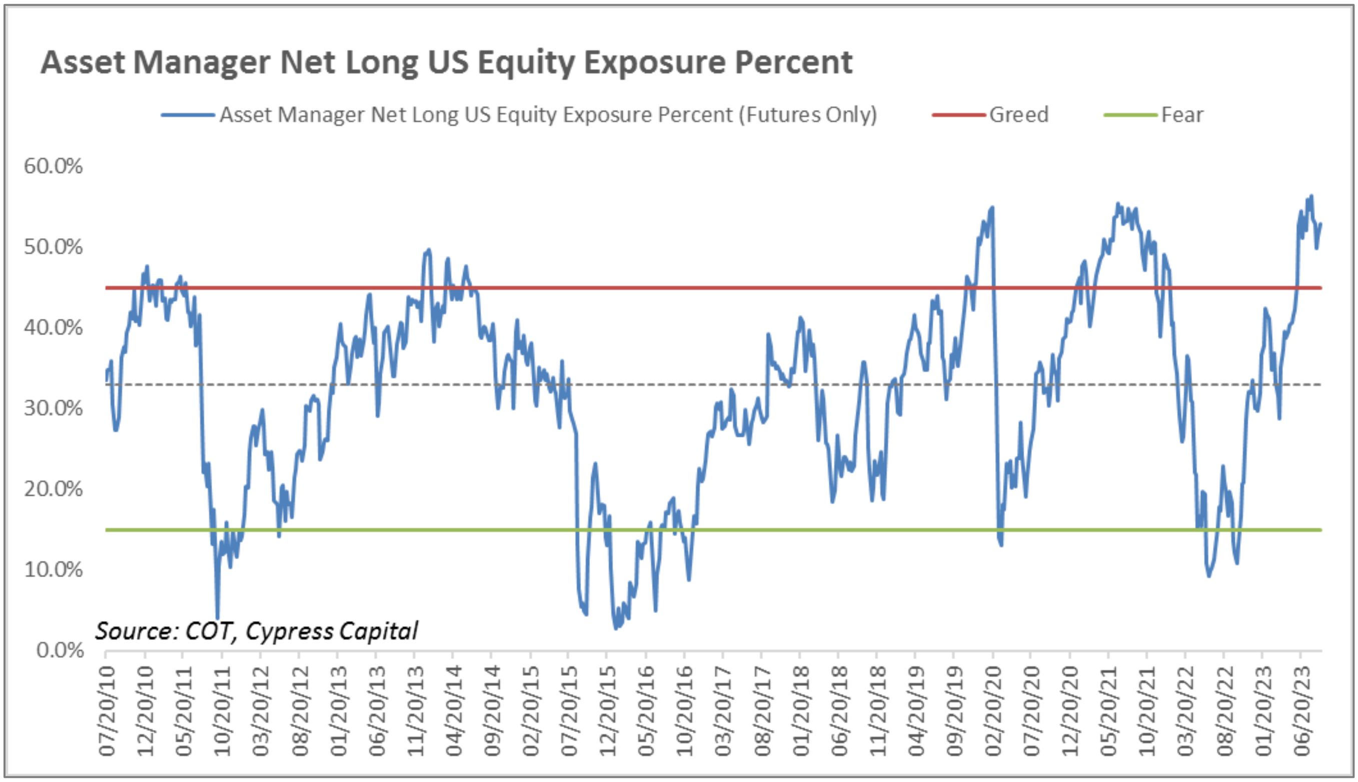
Leveraged ETF investors have had diamond hands – this pullback hasn't affected their greed.



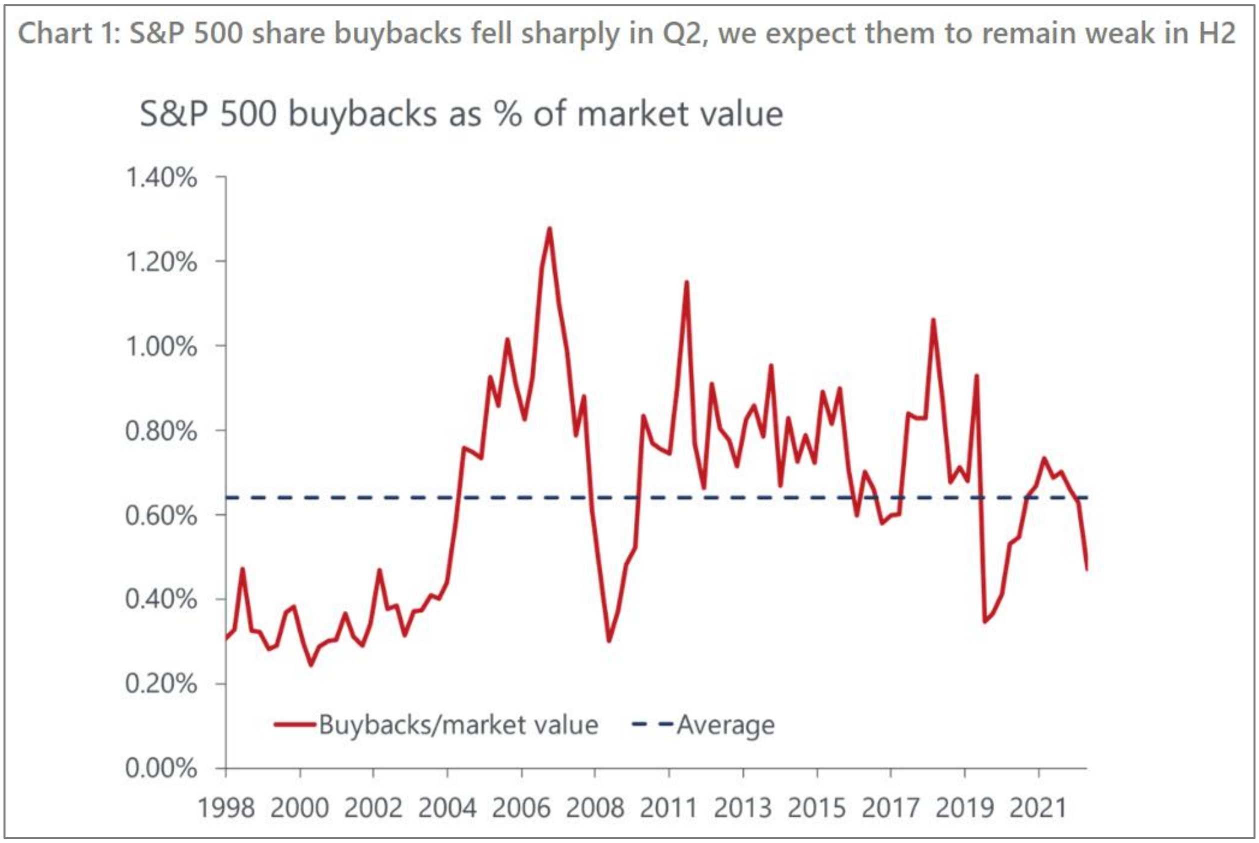
Rydex Ratio (leveraged fund investors) has barely retreated from its euphoric July peak.



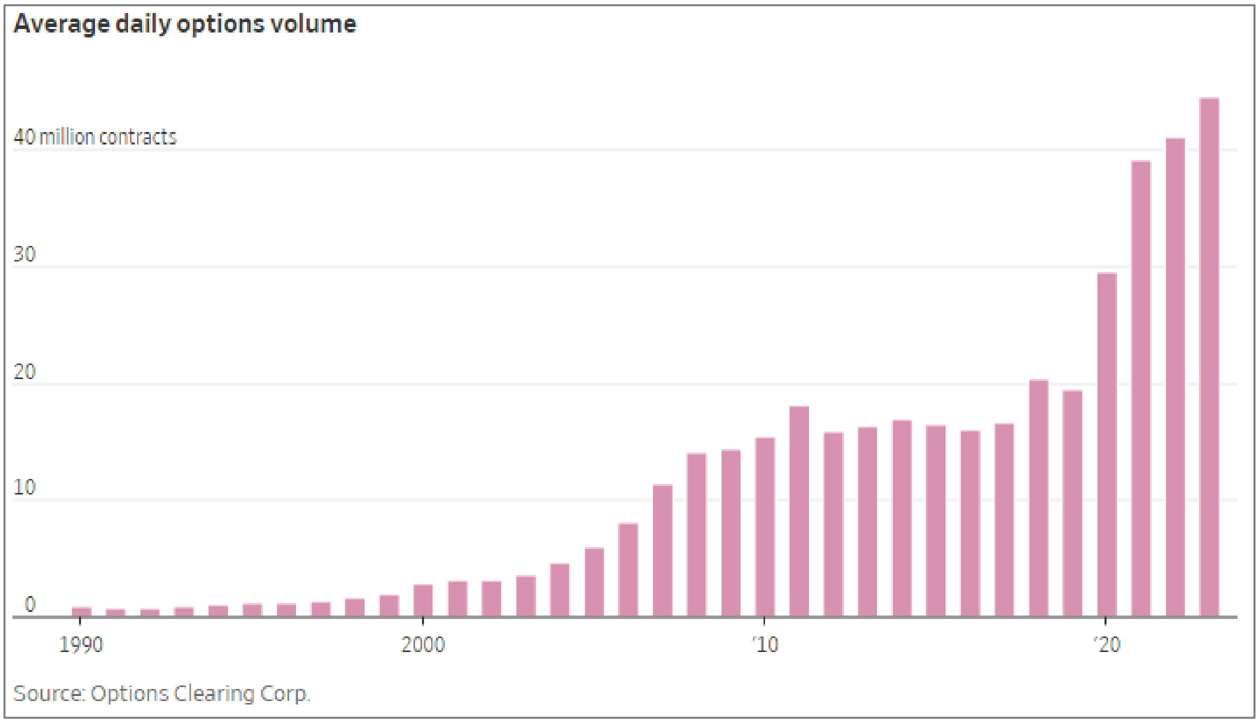
Asset Managers' net long exposure using futures is close to all-time highs.



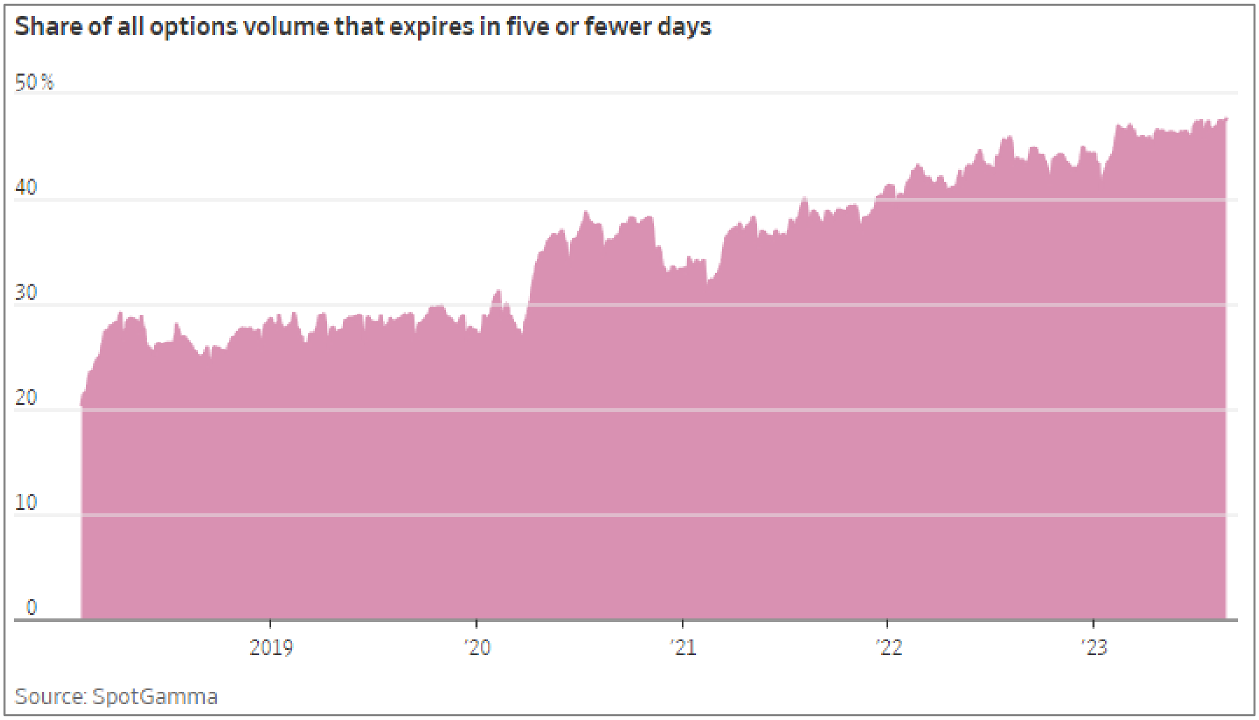
Buybacks fell sharply in Q2.
It's the first drop outside of a bear market in the QE era.



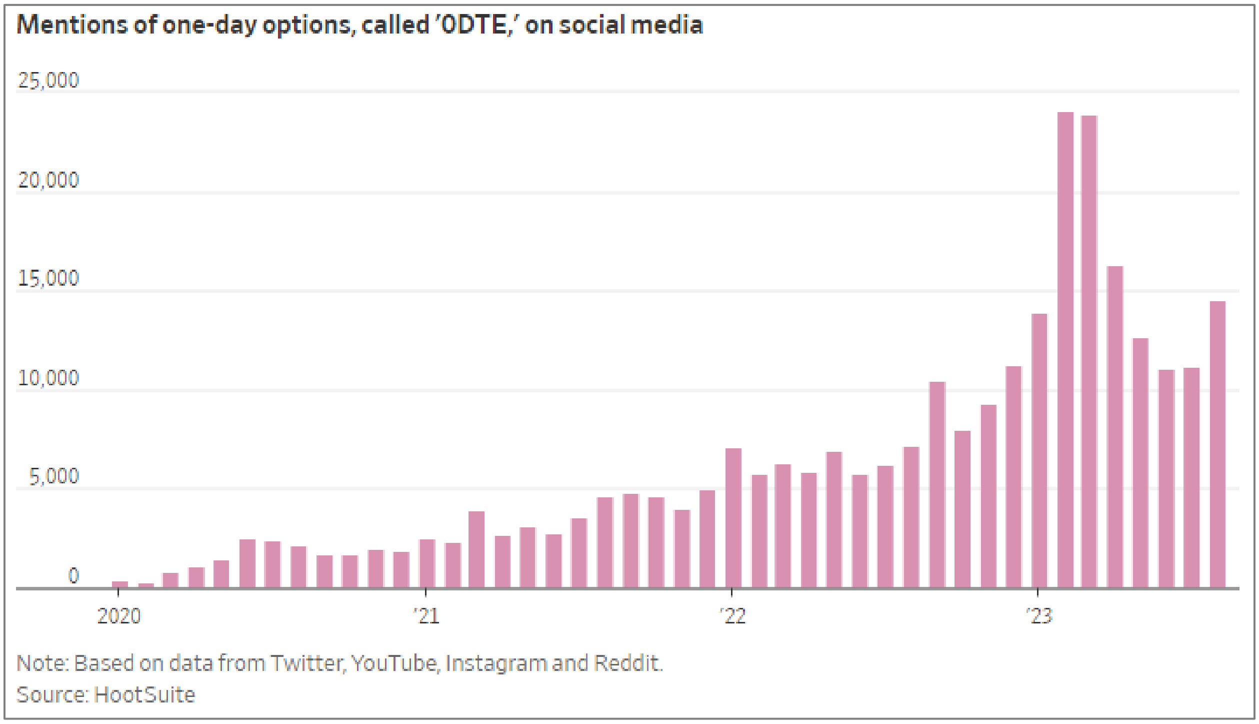
Average daily options volume is setting records.



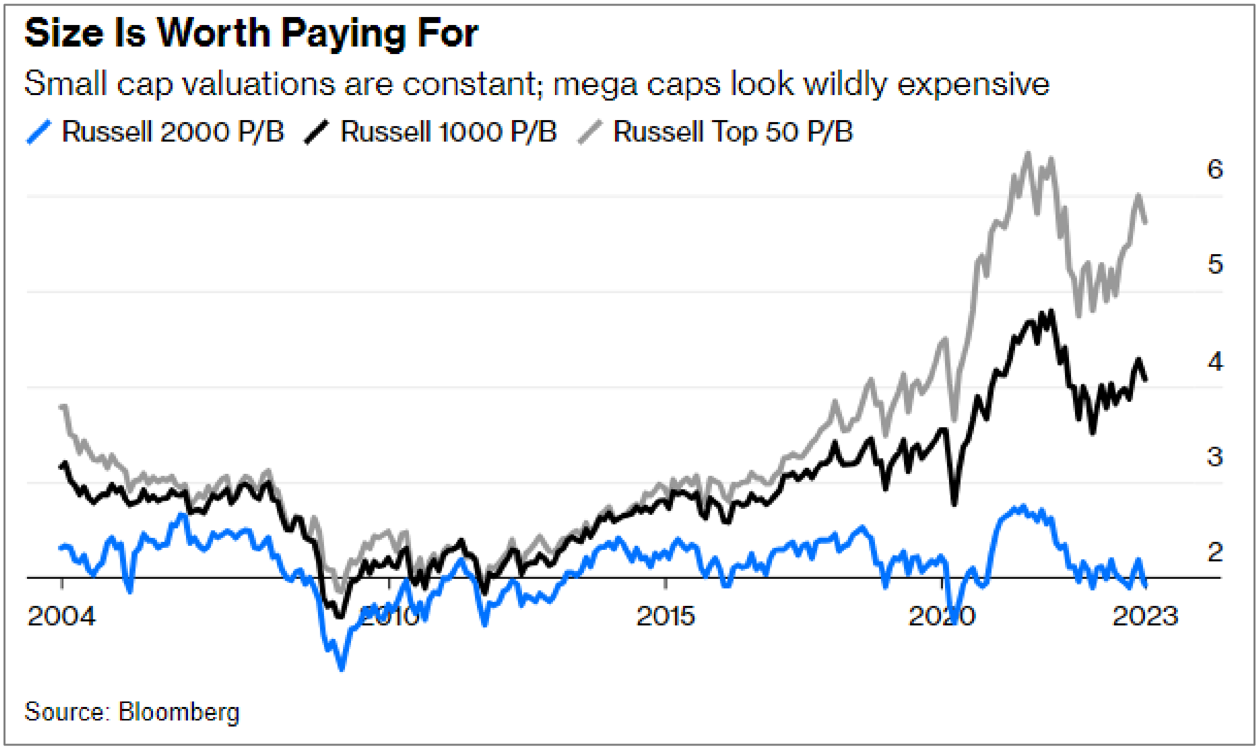
...As is the share of options volume that expires in less than a week.



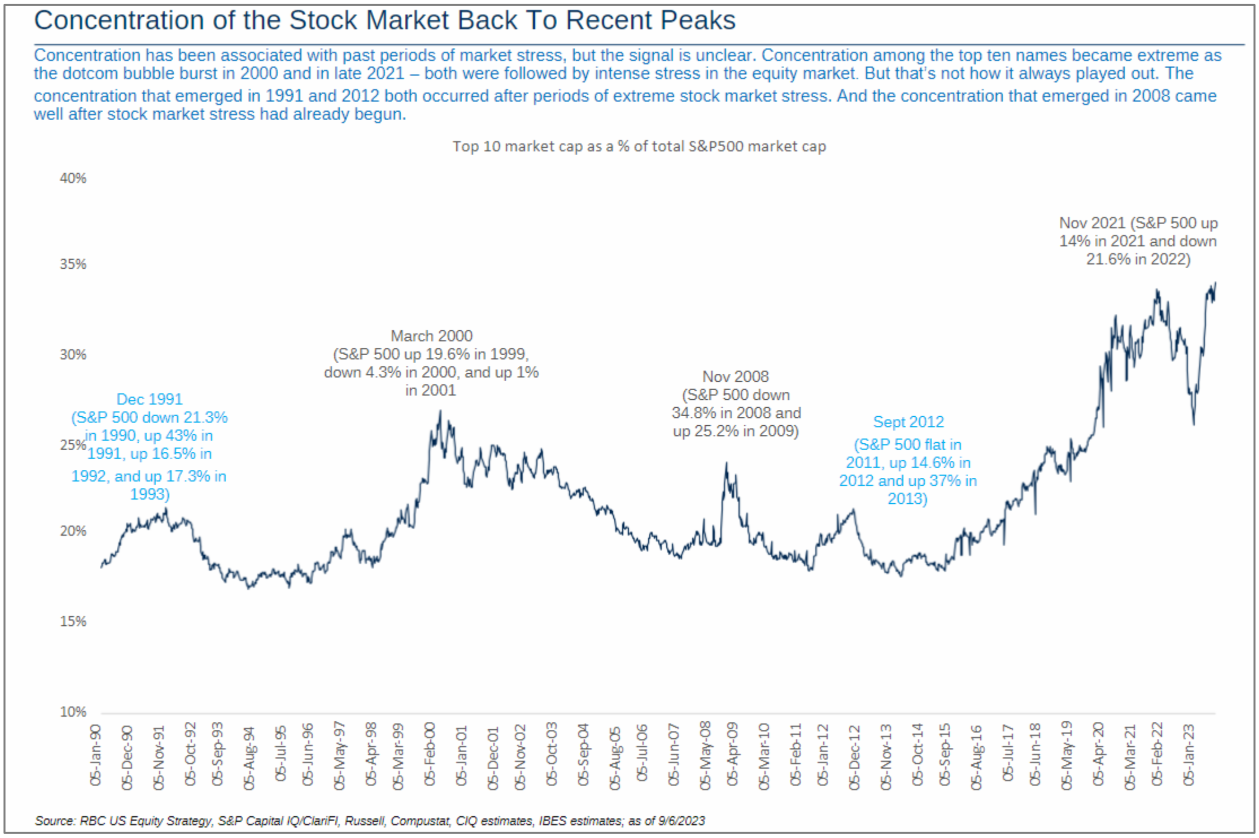
2023 is the year of the Zero Days to Expiration option.



The bigger the stock, the more expensive it is.

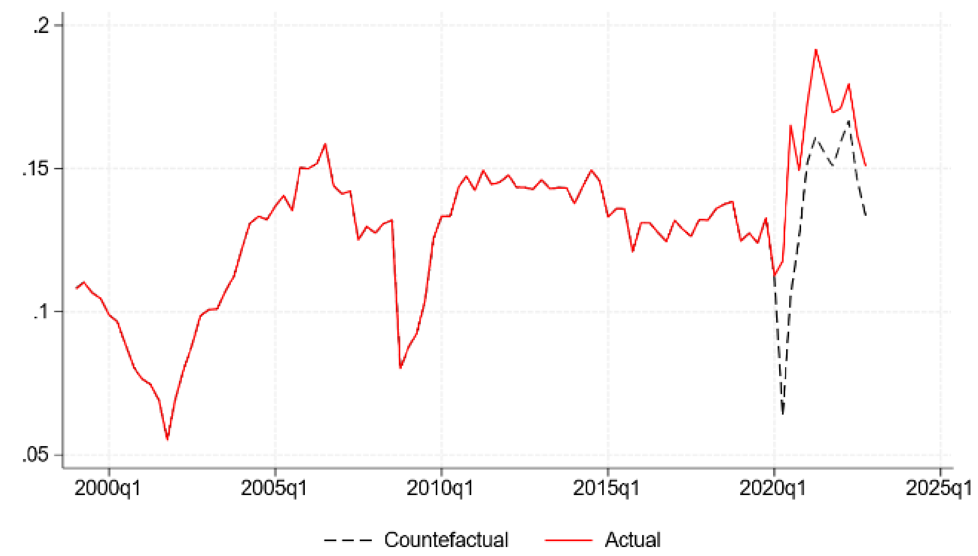


Stock Market Concentration is setting records this year.



Quantifying how much government stimulus (fiscal and monetary) has impacted profit margins.
The dotted black line represents profit margins sans the politicians and central bankers.

Figure 3. Adjusted Profit Margins

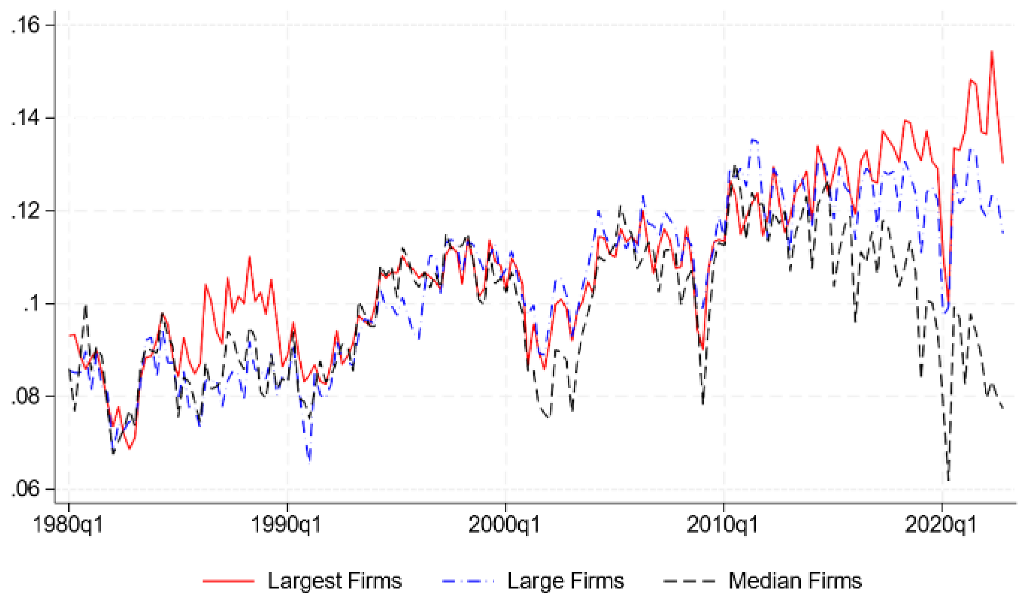


Note: This figure reports the aggregate non-financial corporate profit margins (red line) together with the adjusted profit margins under the assumption of constant (i.e., 2019q4 value) government and net interest components (dashed black line) for the period 2020q1-2022q4. To facilitate the comparison, we restrict the sample to the period 1999q1-2022q4.

Source: U.S. Bureau of Economic Analysis and author's calculations.

If government stimulus helped corporations post-Covid, it appears to be the big boys that benefited.

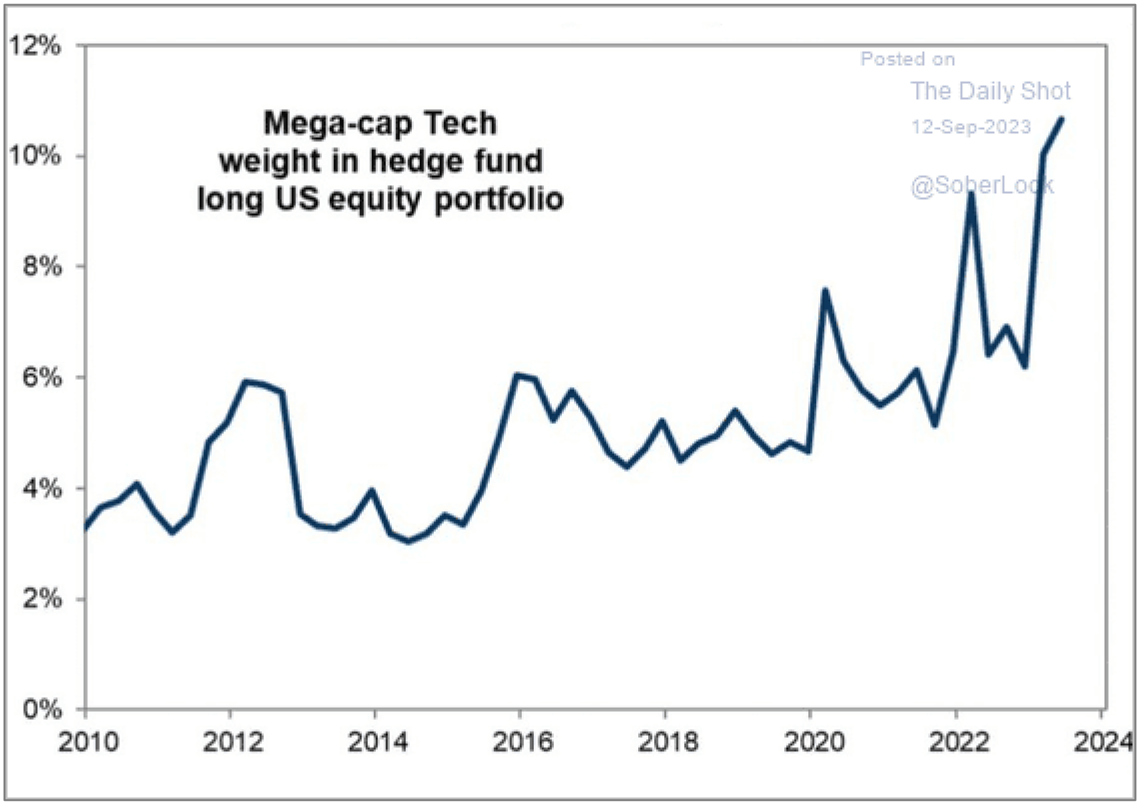
Figure 5. U.S. Nonfinancial Publicly Traded Companies Profit Margins



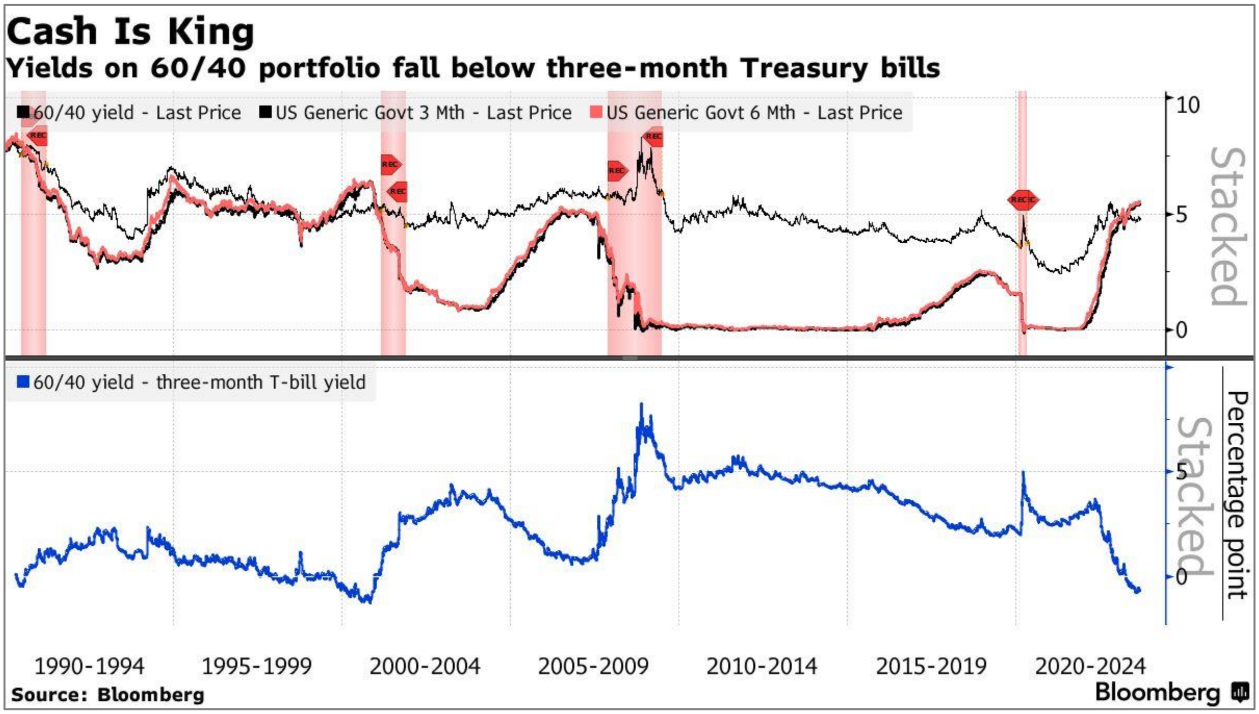
Note: This figure depicts the profit margins for the largest firms (top 20% of the size distribution, solid red line), large firms (fourth quintile of the size distribution, dashed-dot blue line), and medium firms (third quintile of the size distribution, dashed black line) for the period 1980q1-2022q4.

Source: Standard & Poors Global Market Intelligence: Compustat Unrestated Quarterly Data, (June 2023)

Hedge Funds have piled into Mega-cap Tech stocks.



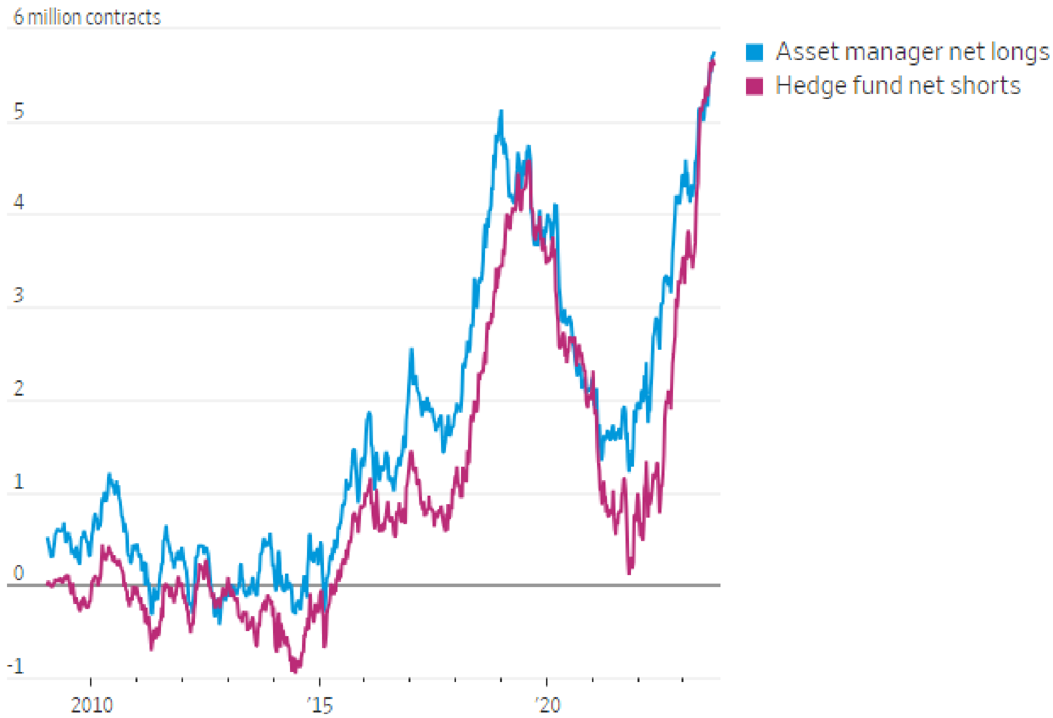
Yield on 60/40 Portfolio has fallen below Treasury Bill yields.



The Basis Trade is back, baby!

Unwinding this trade during Covid was thought to exaggerate stock market declines in early 2020.

Treasury futures positions



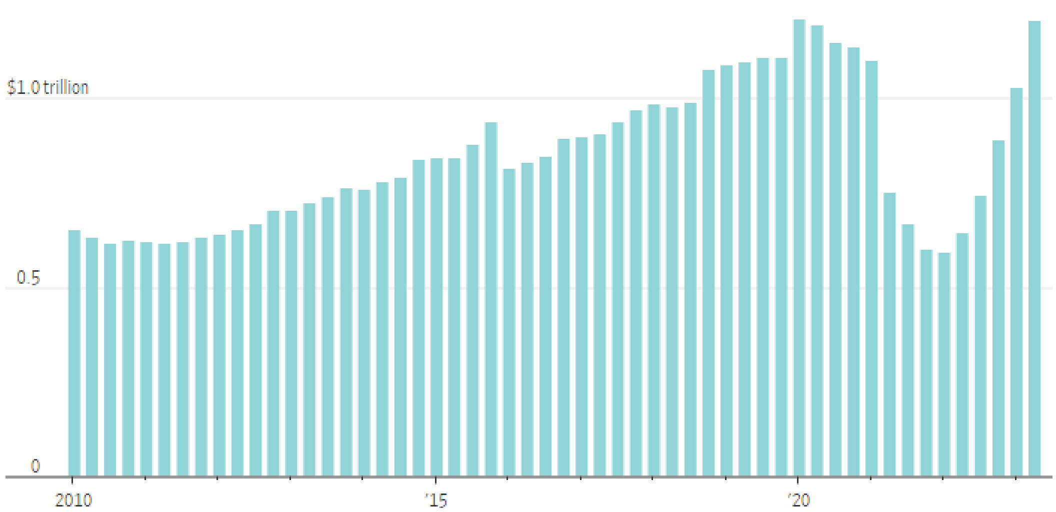
Note: As of Sept. 1
Source: CFTC, FactSet

Banks are relying on Brokered Deposits in record amounts.

Banks Load Up on $1.2 Trillion in Risky 'Hot' Deposits

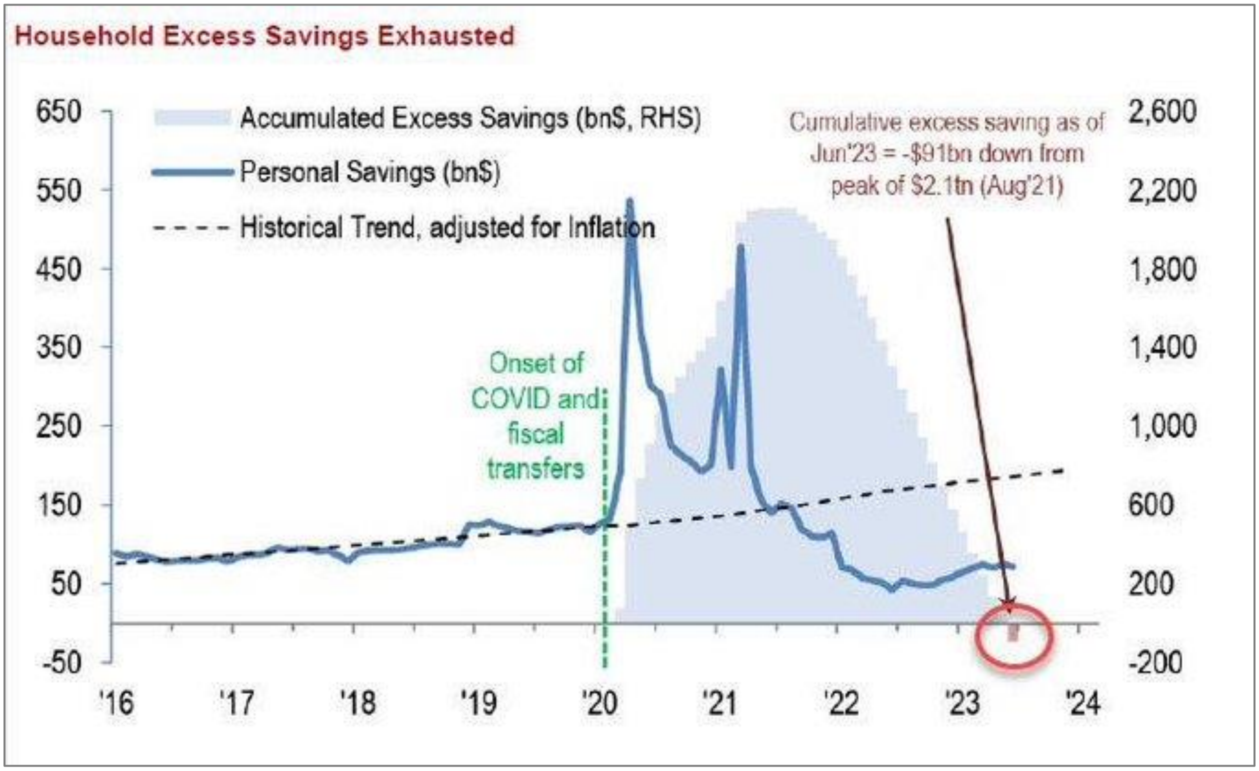
Brokered deposits rose 86% from a year earlier, and regulators are growing concerned

Total brokered deposits across banks

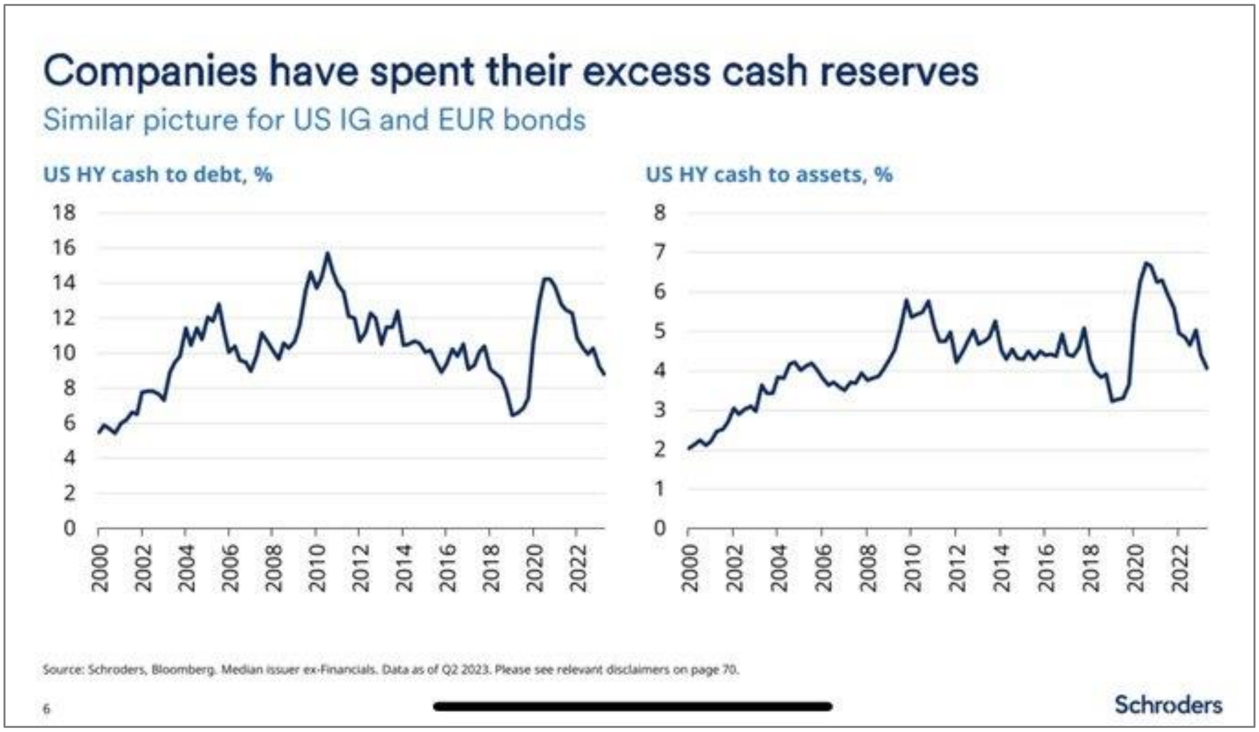


Note: Changes to FDIC rules in 2021 resulted in fewer deposits that would have previously been considered 'brokered' being reported as such.
Source: Federal Deposit Insurance Corp.

Households have finally spent their excess savings from the Covid government checks.

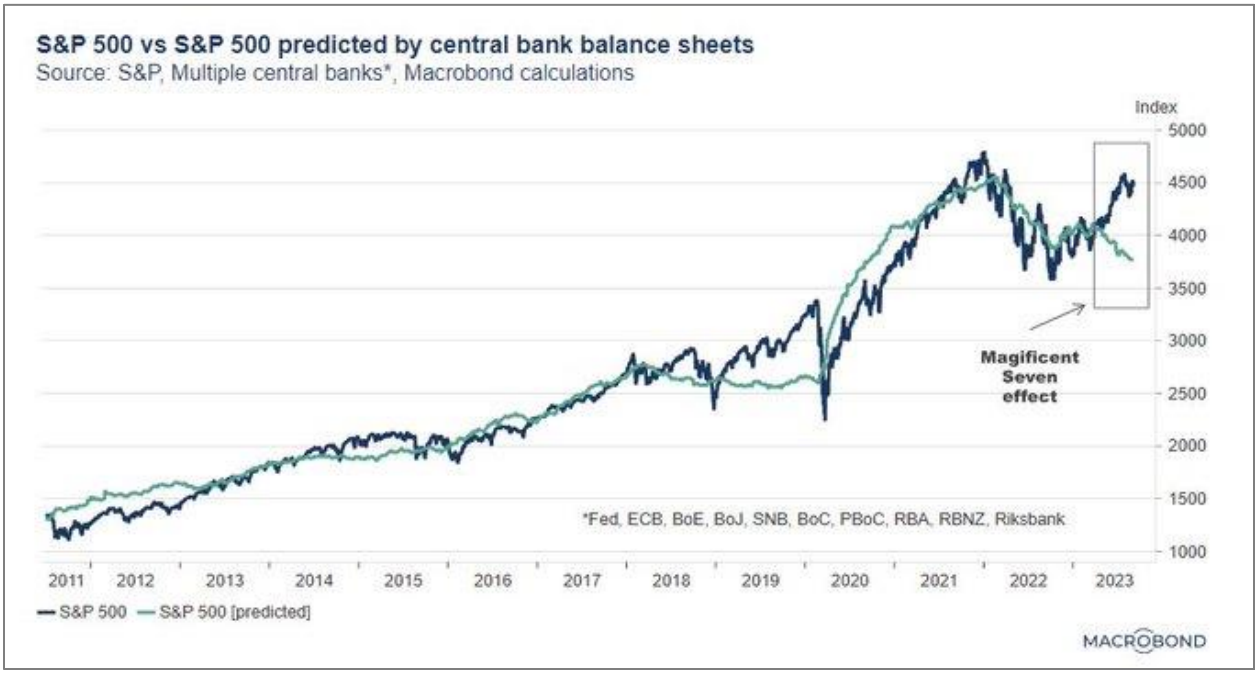


Similarly, corporations have finally depleted their Covid-stimulus excess cash.

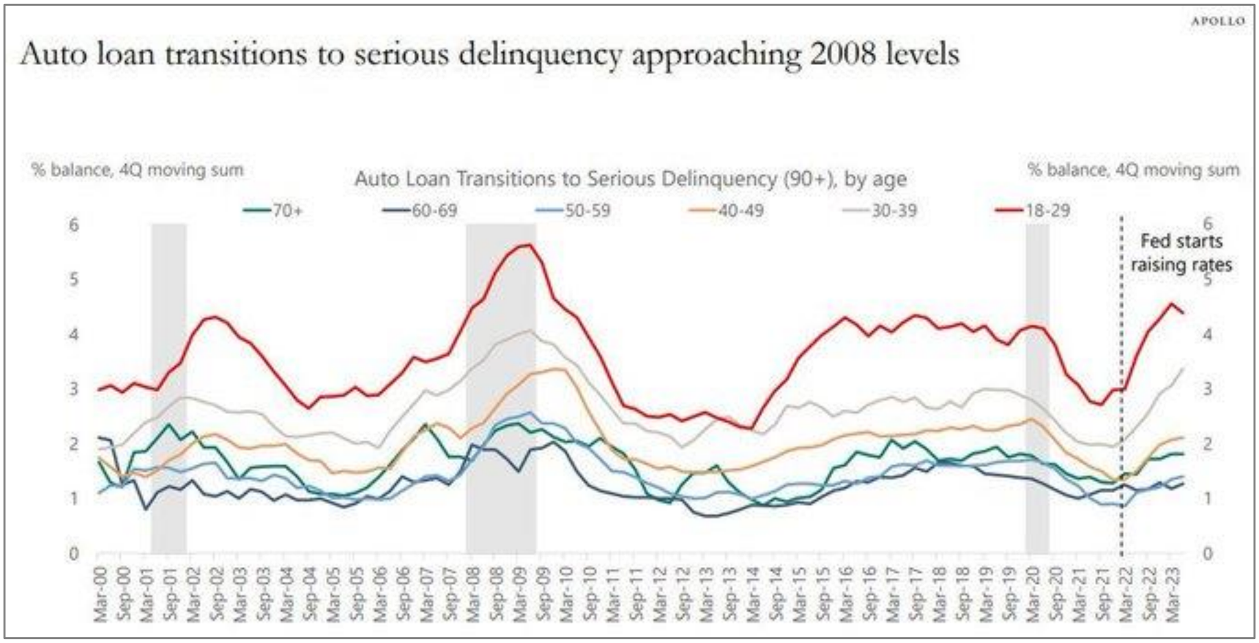


More Benny Button Jr. stock market evidence - Late cycle valuations with early cycle Macro conditions.

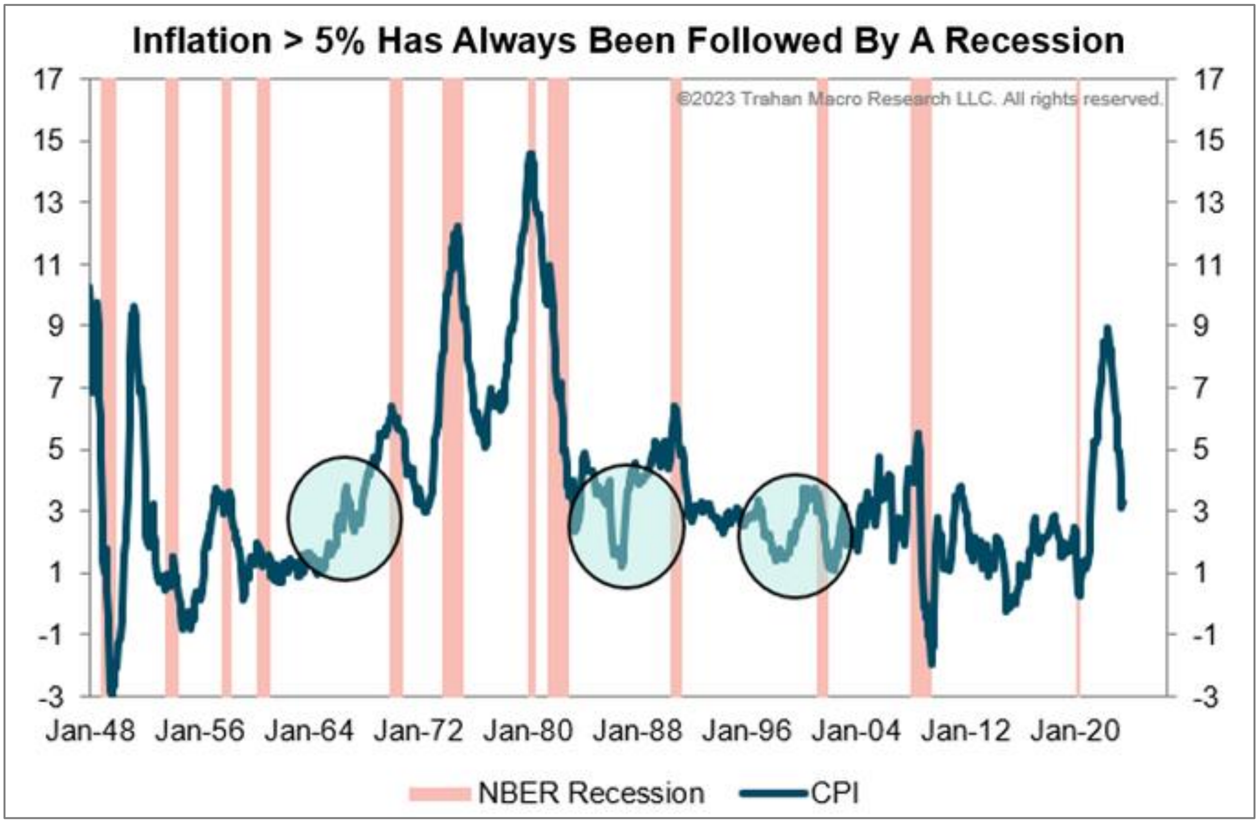
Stocks are breaking away from the Fed Balance sheet like in 2019.



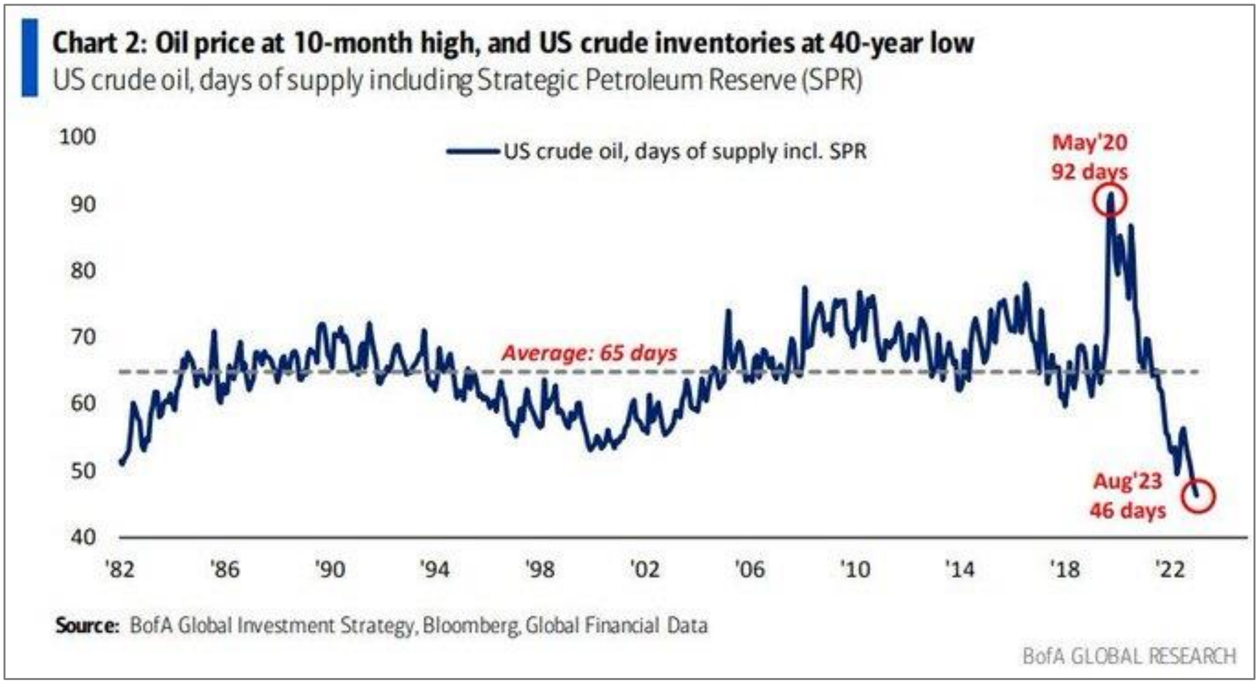
Auto loan delinquencies haven't surged like this since 2008.



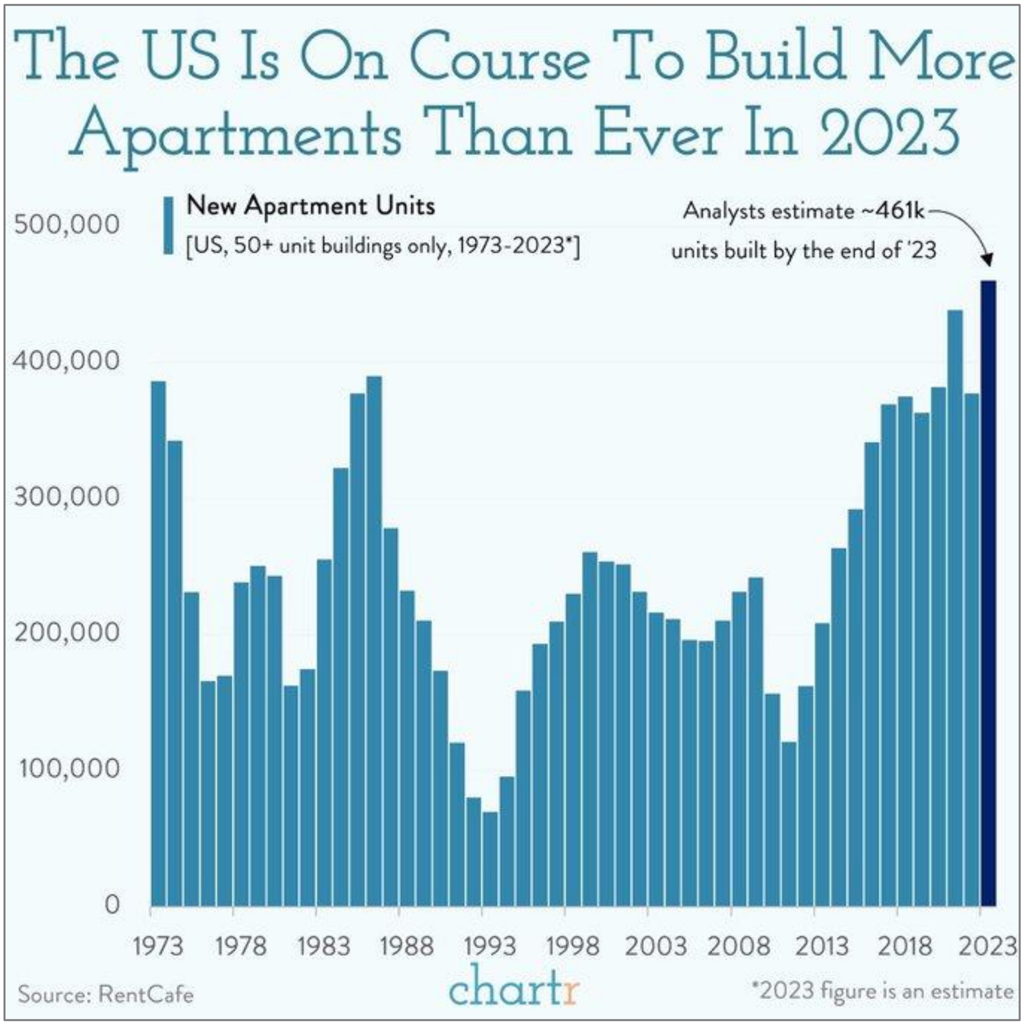
If we avoid recession, it will be the first ever after an inflation surge to greater than 5%.



US crude oil inventories are at a 40-year low.



The US is building more apartments than ever in 2023.



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.