Market Outlook

By Mark T Dodson, CFA

Yield Curve Inversion Birthday approaching

Three of the four factors that make up our asset allocation model deteriorated this week, driving the Market Risk Index up to 72.5%. Psychology worsened the most, and our Psychology Composite score has edged further into the worst decile of readings. We thought recent market weakness would have led to more improvement, but the fear needle hasn't budged outside of the extreme readings in the equity put/call ratio. Leveraged investors have been particularly stubborn, as measured by investors in leveraged funds and derivatives.

The headwinds for the Psychology Composite, even with a short-term improvement to the wall of worry, are our more long-leading indicators of sentiment - indicators highly correlated with the credit cycle. For example, Bank Sentiment and Consumer Confidence are unlikely to turn bullish within the Psychology Composite until the next Fed easing cycle is fully underway. The Fed made it clear this week that any expectations for rate cuts should be completely off your radar, that is, until some credit event occurs and gums up bond market machinations and leads to another moment of Powell panic. It's a hurdle other short-term investor sentiment indicators will face in signaling a fully rebuilt wall of worry.

Monetary Composite deterioration this week resulted from the Interest Rate category. The temporary, bullish respite in the spring of 2023 has disappeared. Yields are on the move, higher. After Powell's remarks this week, the 10-year Treasury yield broke out to new highs, bumping against the 4.5% level for the first time since 2007. The 30-year Treasury yield did the same for the first time since 2011.

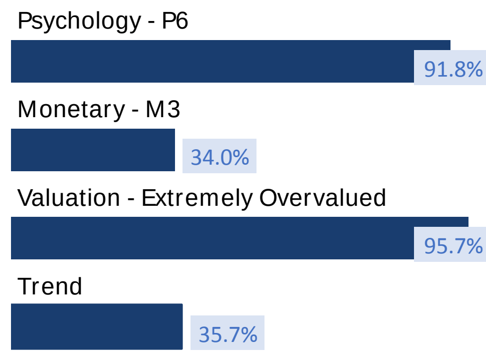
More than the recent increase in yields, however, it's a birthday that is more of a growing concern on our minds. The yield curve inversion will turn a year old next month. On its birthday, it will be one of the top four inversions, in terms of severity, since 1900. The average time between a yield curve inversion and the onset of recession since 1928 has been 14 months, which would be the start of 2024 in this case. We are just now entering the window where one would begin to entertain the notion of recession in your expectations if you are a student of the yield curve. That's an expected value – we remind you that the lead time on the 2006 inversion was a full 21 months before the onset of recession and 19 months before the bull market peaked.

Market Risk Index

Rec Allocation 25% Underweight

72.5%

Category Percentiles



Largest Psychology Influences

Leveraged Investments	Negative
Technical Indicators	Negative
Bank Sentiment	Negative
Flow of Funds	Negative

Largest Monetary Influences

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

Valuation

7-10 Year Equity Return Forecast	1.8%
10Yr US Treasury Yield	4.4%

Market Trends

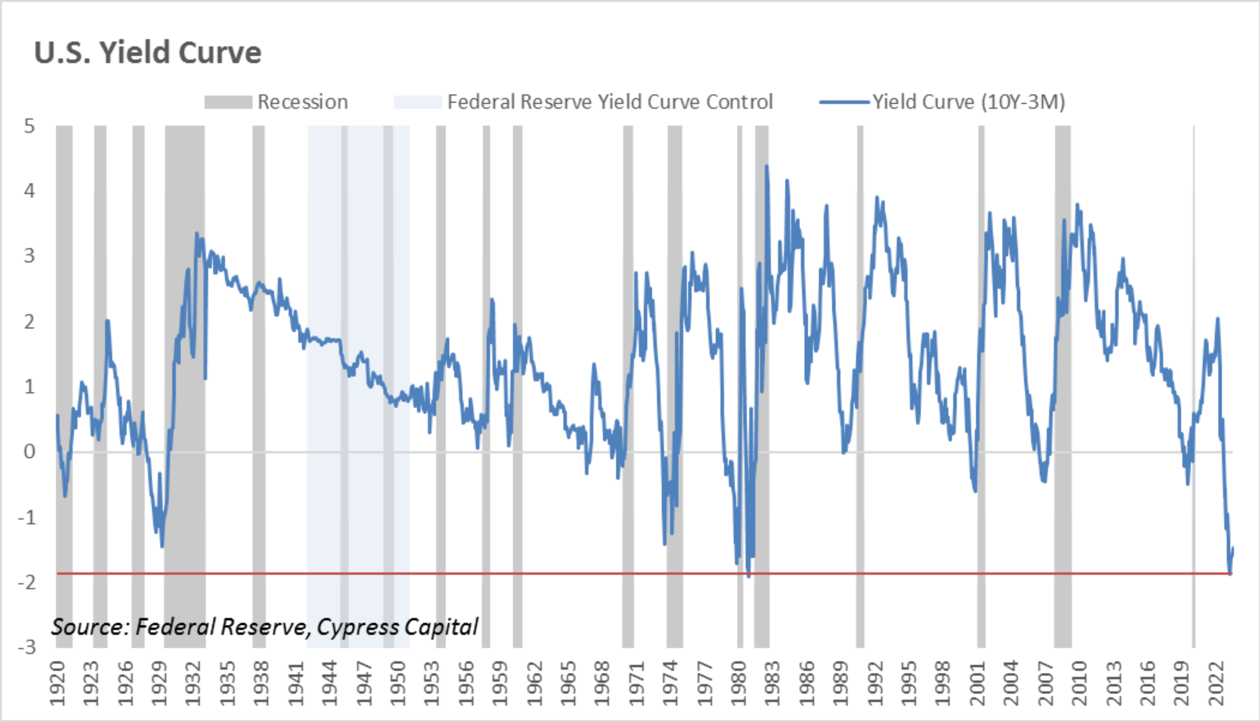
US Equities	Bullish Trade
Intl Equities	Neutral Trade
REITs	Neutral Trade
Broad Commodities	Bullish Trade

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.

The long lead time is the primary reason it's so easy to panic when the inversion occurs and equally as easy to dismiss it as a relic of a bygone era when nothing seems to happen a couple of months after it occurs. No wonder investment strategists go to great lengths to dismiss it, but investors interested in preserving their own capital, more than getting pats on the back, are more patient and forgiving with the timing of its signals.

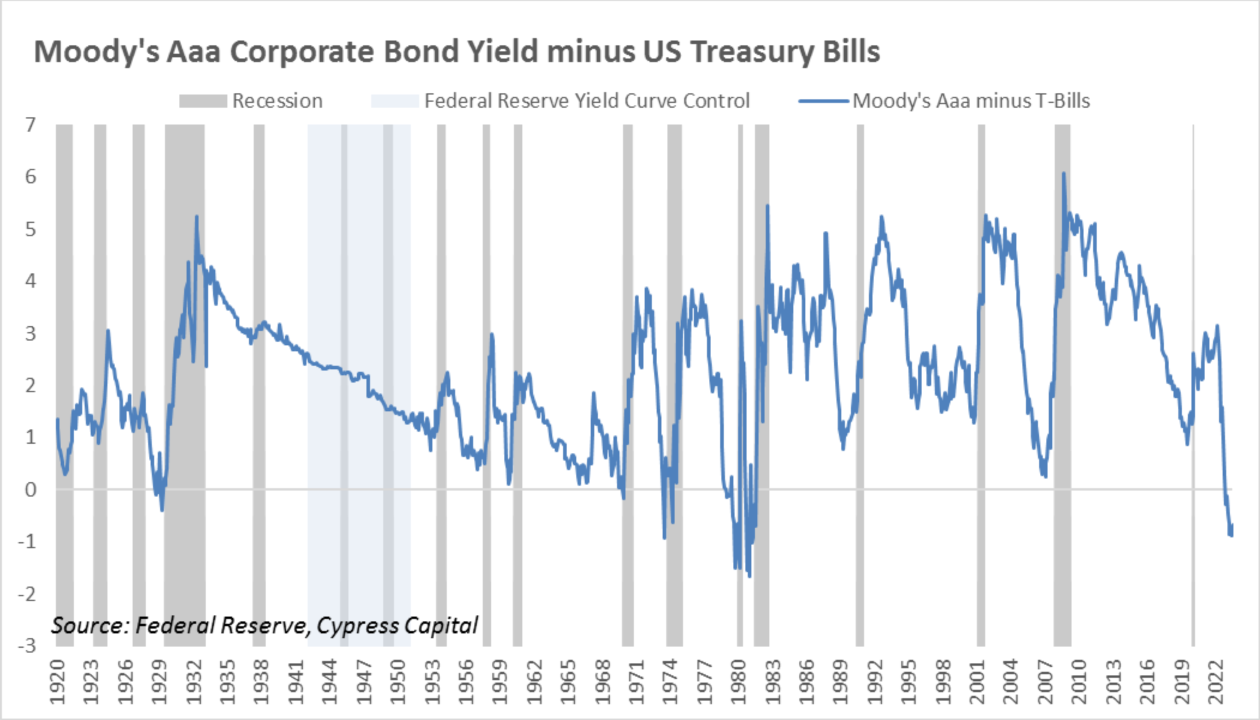
Charts of the Week

Yield Curve inversion enters its 12th month.



Corporate bonds yield less than Treasury Bills for only the sixth time in more than a century.

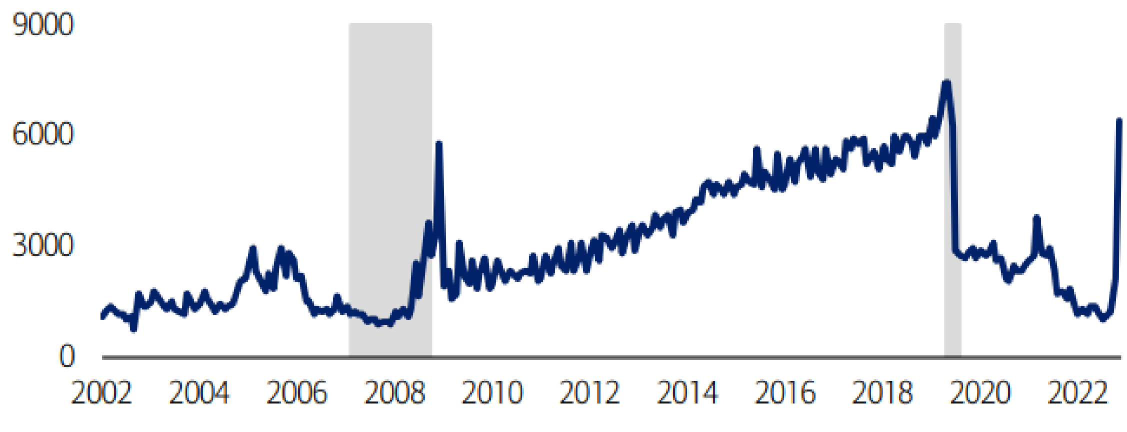
This event is rarer than a yield curve inversion, but its efficacy in forecasting coming financial market turmoil is renowned.



Student Loan Re-payments are surging.

Exhibit 1: Receipts corresponding to Department of Education (Millions $)

Receipts corresponding to the Department of Education (DoE) surged to $6.4bn in August, compared to $2.1bn in July and $1.2bn in June



Source: US Treasury, Haver Analytics

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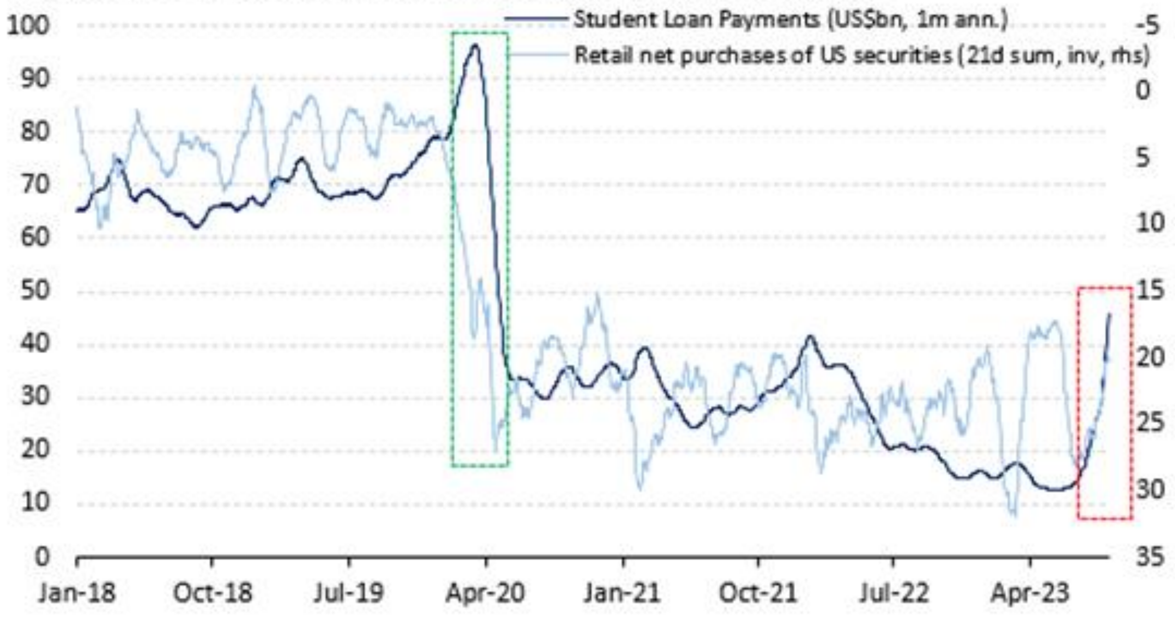
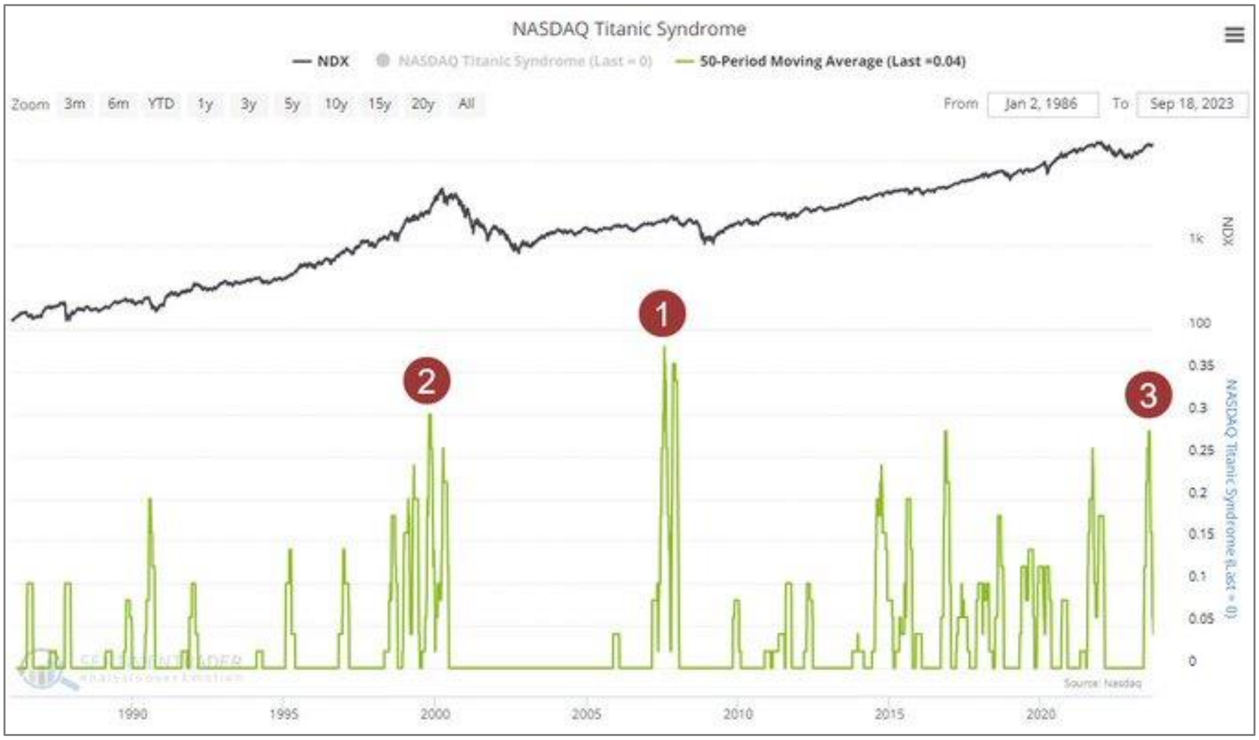
Say What? Student loan payments are inversely correlated with retail stock market speculation.

Payments to Dept. of Education vs. retail inflows into US markets



Source: US Treasury, Vanda

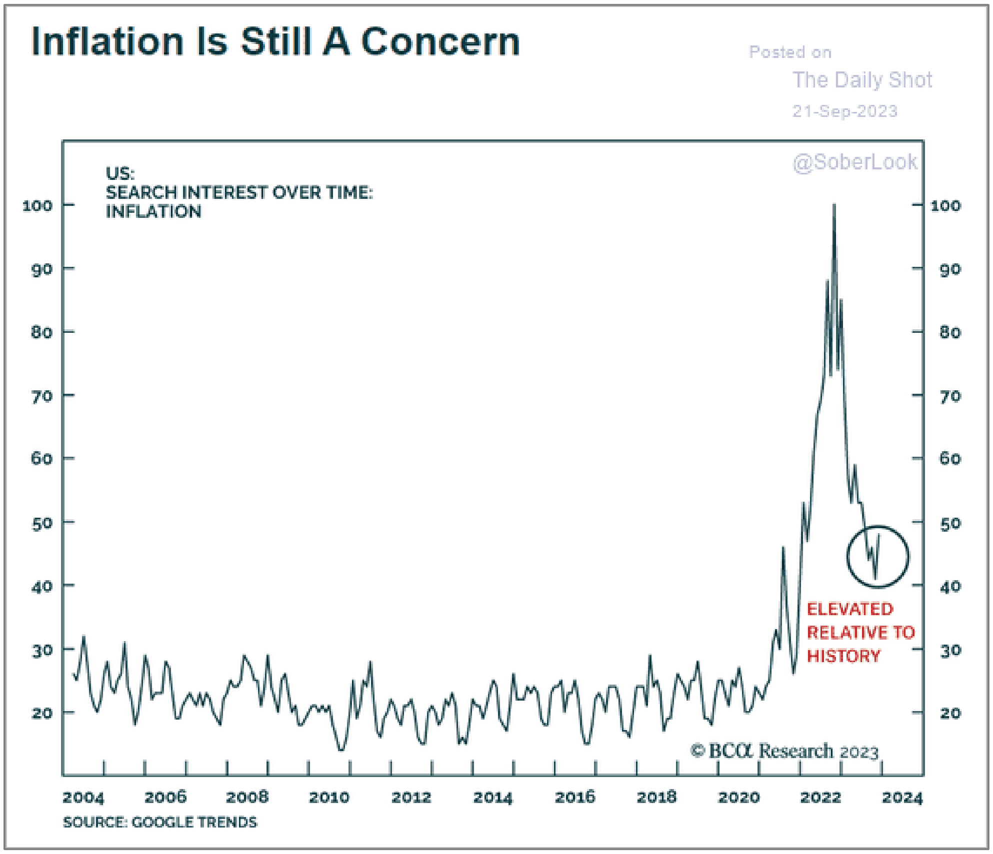
Breadth warning - stock market bifurcation within the NASDAQ is on the rise.
Highest cluster of days with Titanic Syndrome since 2007.



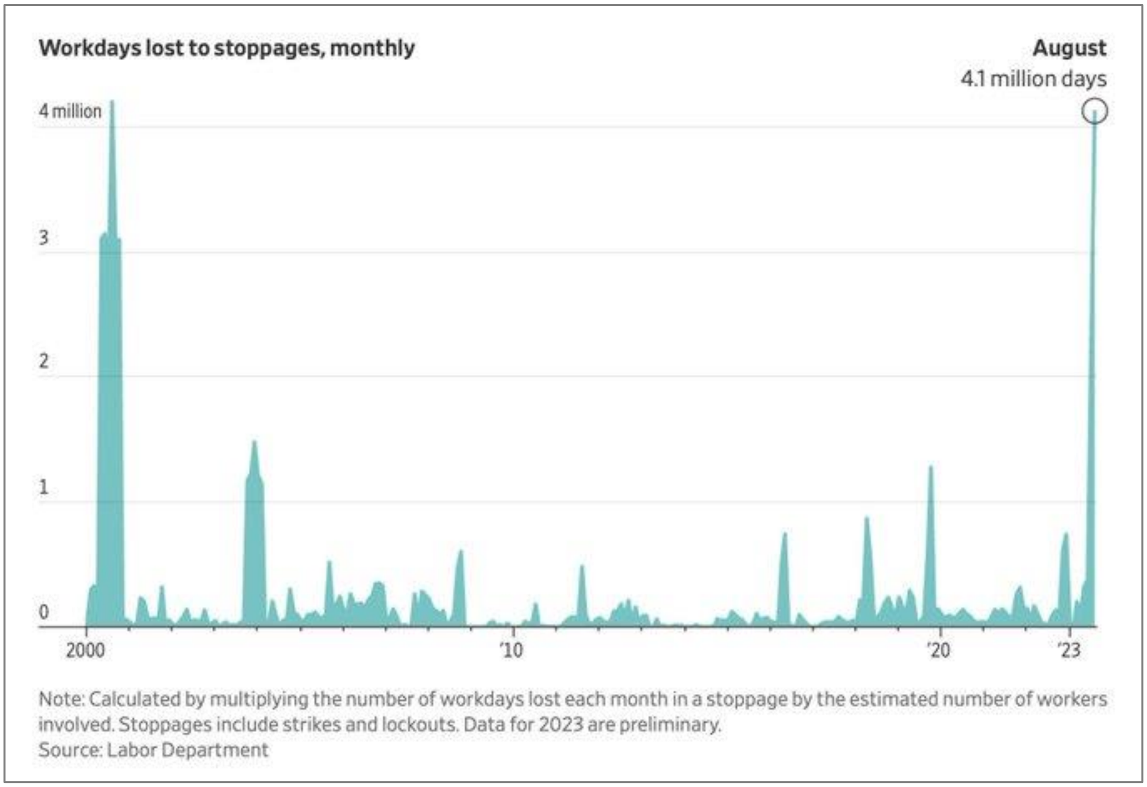
Covid-Bubble Hangover – 95% of NFTs are now worthless.

Inflation concerns have not retreated.

"The real point, though, is the worst thing we can do is to fail to restore price stability, because the record is clear on that. If you don't restore price stability, inflation comes back. People hate inflation. Hate it." - Jay Powell

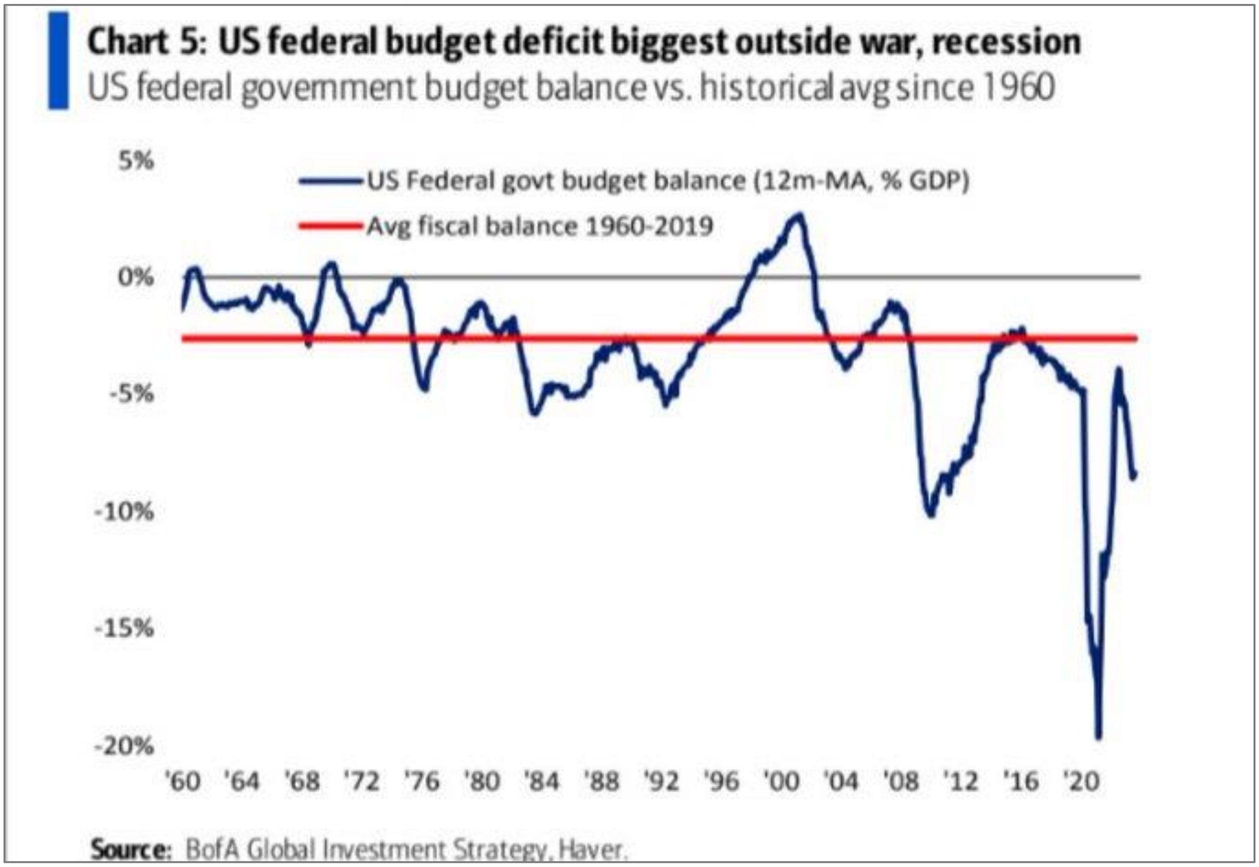


Going on strike hasn't been this popular in over 20 years.

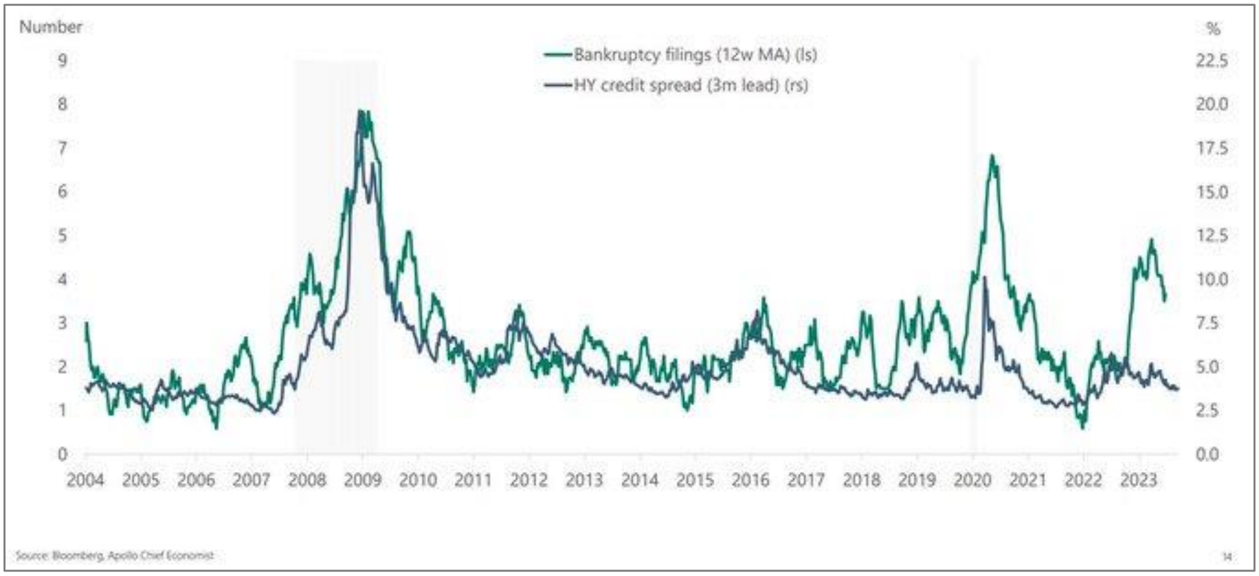


China's answer to bad news on economic growth is to stop publishing stats about their economy.

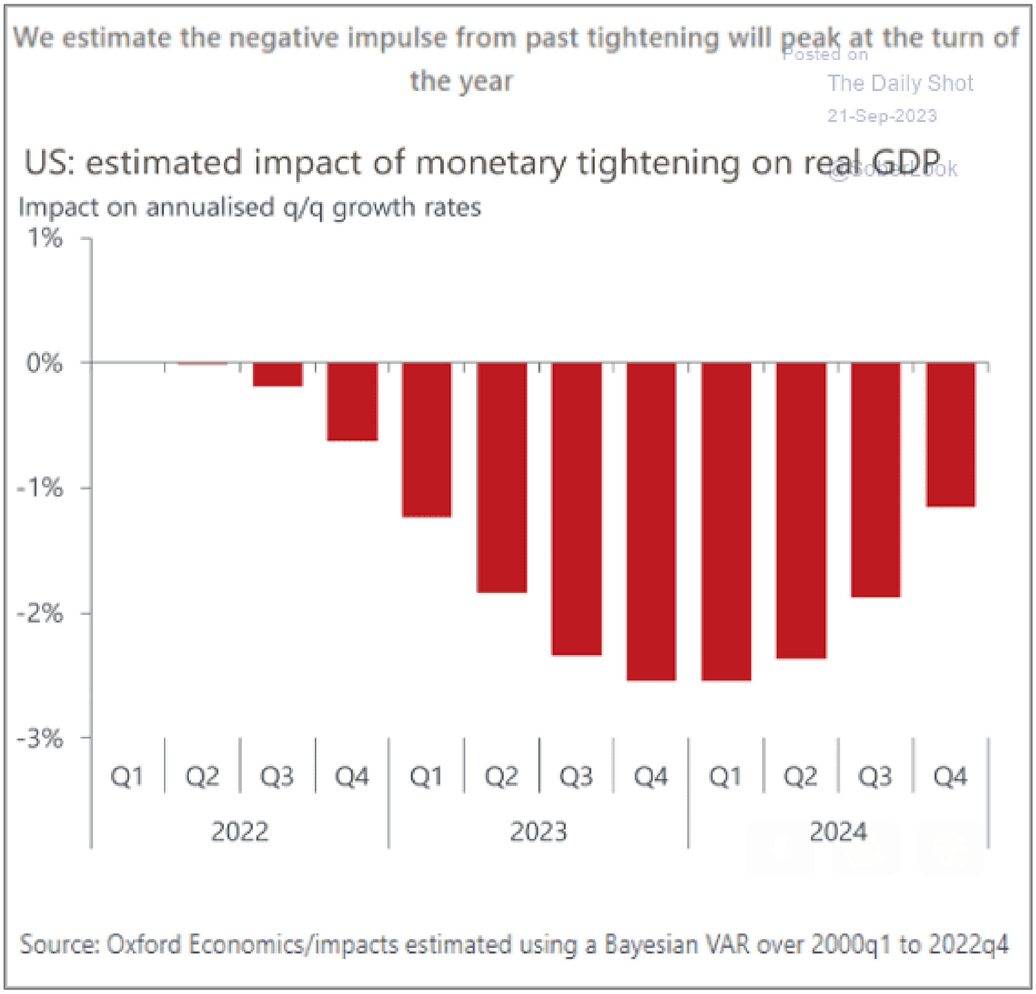
Largest Federal Deficit outside of war or recession.



Widest divergence between bankruptcy filings and investor appetite for High Yield ever.



Monetary Tightening is just now expected to impact economic growth.



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.