Market Outlook

By Mark T Dodson, CFA

Investing TIPS

The Market Risk Index decreased a smidgeon to 72.2%, leaving few developments to report on this week within the model. Psychology remains in the worst decile of readings. However, we started to see a shift in some of the more euphoric elements of the composite on the market volatility this week. Small-cap stocks' record underperformance at this stage of a bull market appears as an anomaly to pundits, but it is stock market behavior consistent with the peak euphoria readings that we saw from the Psychology composite in July.

The Monetary Composite continues to hover around the best third of readings, but the recession signals coming from the yield curve and the indications of tight money coming from a higher rate of change on interest rates keep Monetary conditions from signaling the formation of a new credit cycle.

Valuations are in the worst 5% of readings – where the message is that investors are over-allocated to equities at prices that are too high relative to fundamentals. Now, cash offers a better return than stocks. But, the high yield coupled with the attractiveness of not worrying about losing your money has yet to shake the average investor from over a decade of Fed-policy-driven habits to disregard price when considering the purchase of risky financial assets.

While not an allocation change per se, we used the weakness in fixed-income markets to initiate a starting position in longer-duration TIPS inside asset allocation portfolios this week. Real yields have climbed well above 2%, the highest levels since those initial weeks of panic after the failure of Lehman Brothers in 2008. To put a 2% real return into perspective, Robert Shiller's seminal work on the history of the US real estate market found that the real return on home values over a century in the United States averaged 1%. Achieving a 2% passive real return on a government security isn't too shabby.

TIPS yields have been higher, particularly in the late 90s, when TIPs were less liquid, and vehicles had not become a standard part of investor asset allocations. Still, should the yields climb higher, we will welcome that development to lock in attractive yields that are inflation-hedged in an environment where we aren't confident that inflation has been defeated. Also, TIPs aren't pricing much in terms

Market Risk Index

Rec Allocation 25% Underweight

72.2%

Category Percentiles

Psychology - P6	90.7%
Monetary - M3	34.9%
Valuation - Extremely Overvalued	95.3%
Trend	22.6%

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	2.0%
10Yr US Treasury Yield	4.6%

Market Trends

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

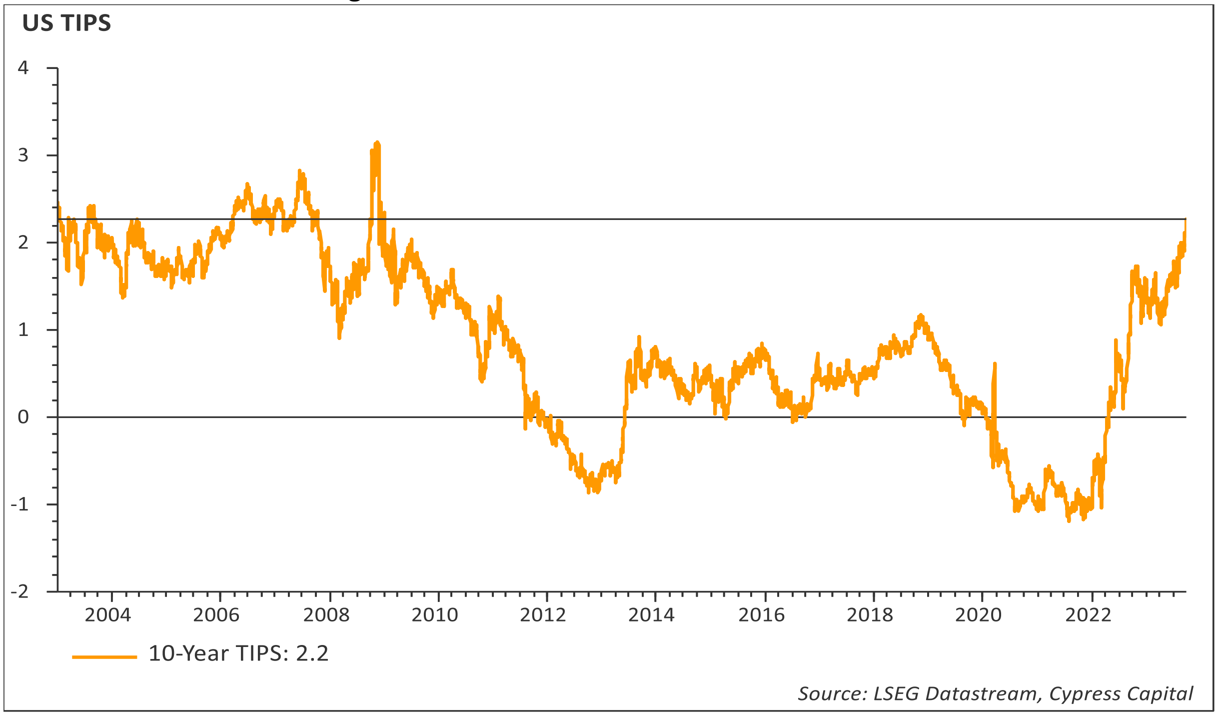
Market Risk Index scales from 0 to 100%. Higher readings correspond with higher risk markets. Scores below 25% are bullish. Scores between 25-75% are neutral, and scores above 75% are markets vulnerable to major drawdowns.

of a break-even rate on the inflation rate, around 2.25%, which could be optimistic, given continued headlines of striking workers and growing government deficits.

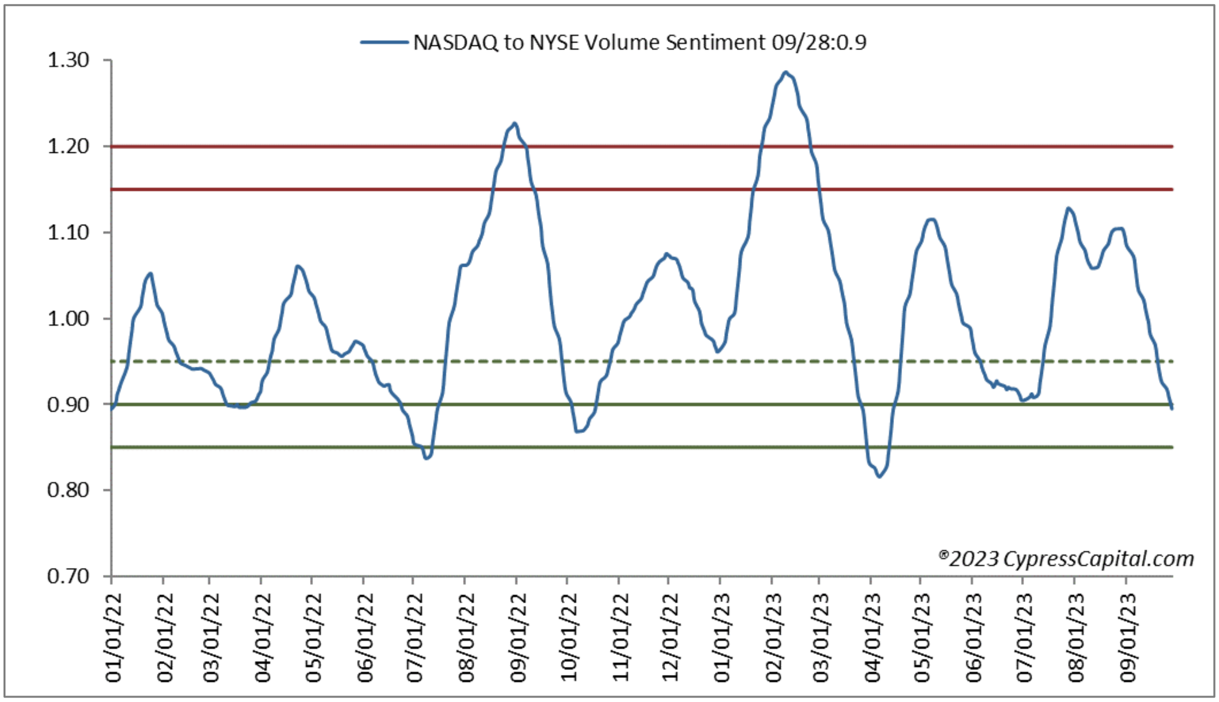
We anticipate that the next 12 months will provide us with opportunities to add more duration to our fixed-income positions and increase equity exposure to take advantage of lower stock prices, as the full force of the Fed's tightening campaign begins to bear down on the economy and financial markets.

Charts of the Week

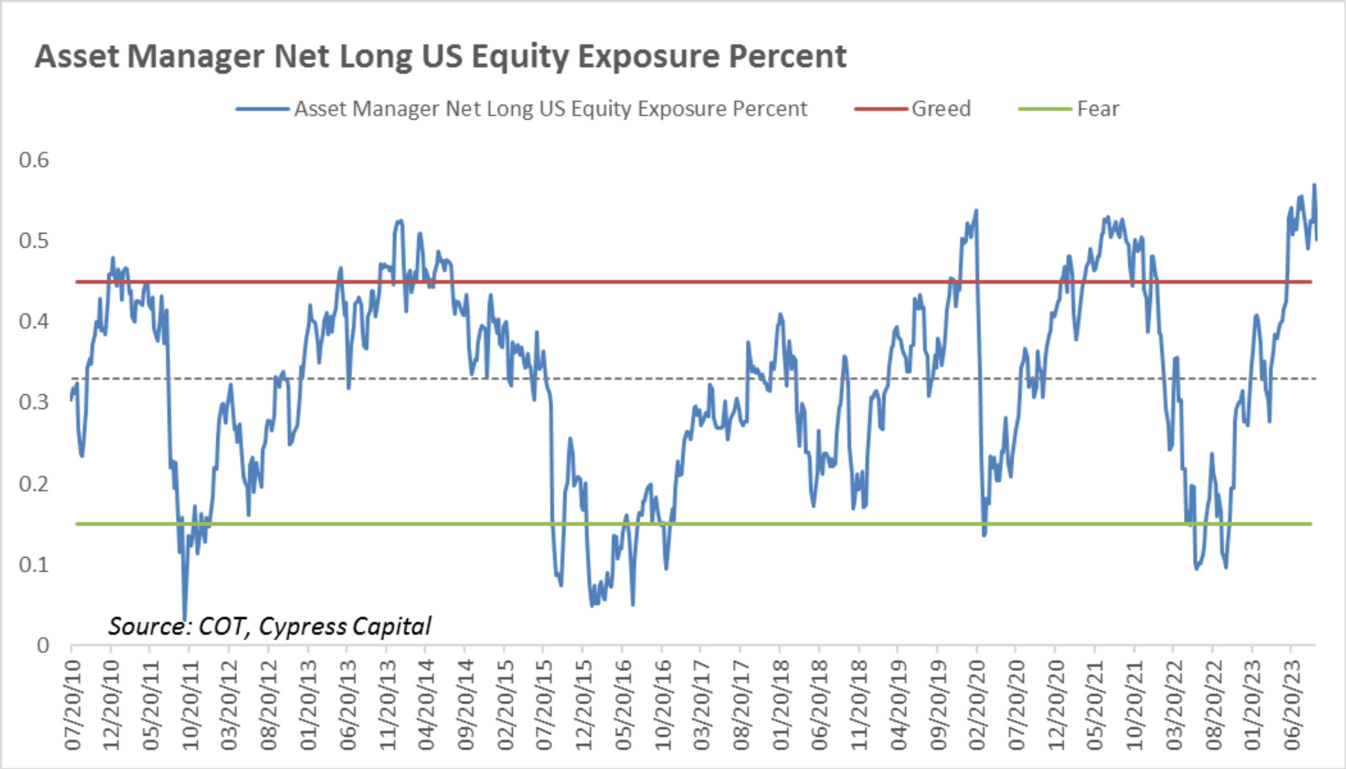
Yields on 10Yr TIPs hit the highest level since the failure of Lehman brothers.



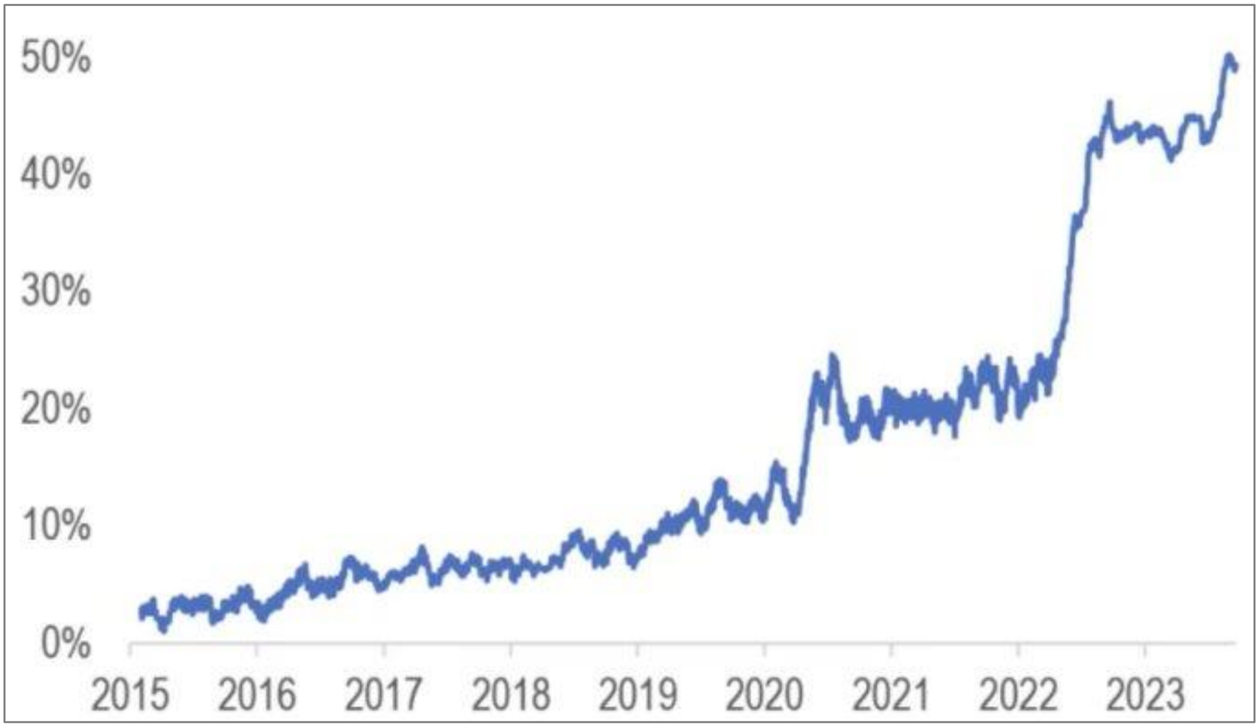
NASDAQ to NYSE Volume is shifting back toward fear.



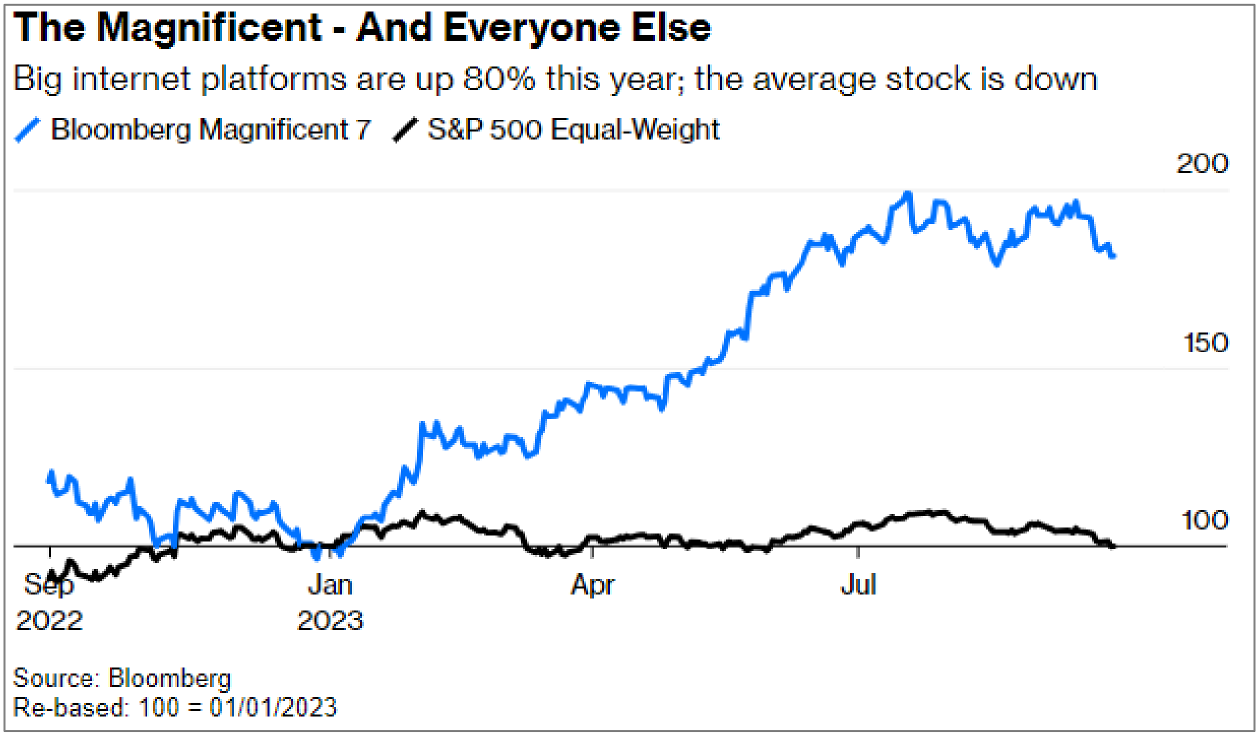
Asset Manager Futures Positioning in US stocks set a bullish record in September.



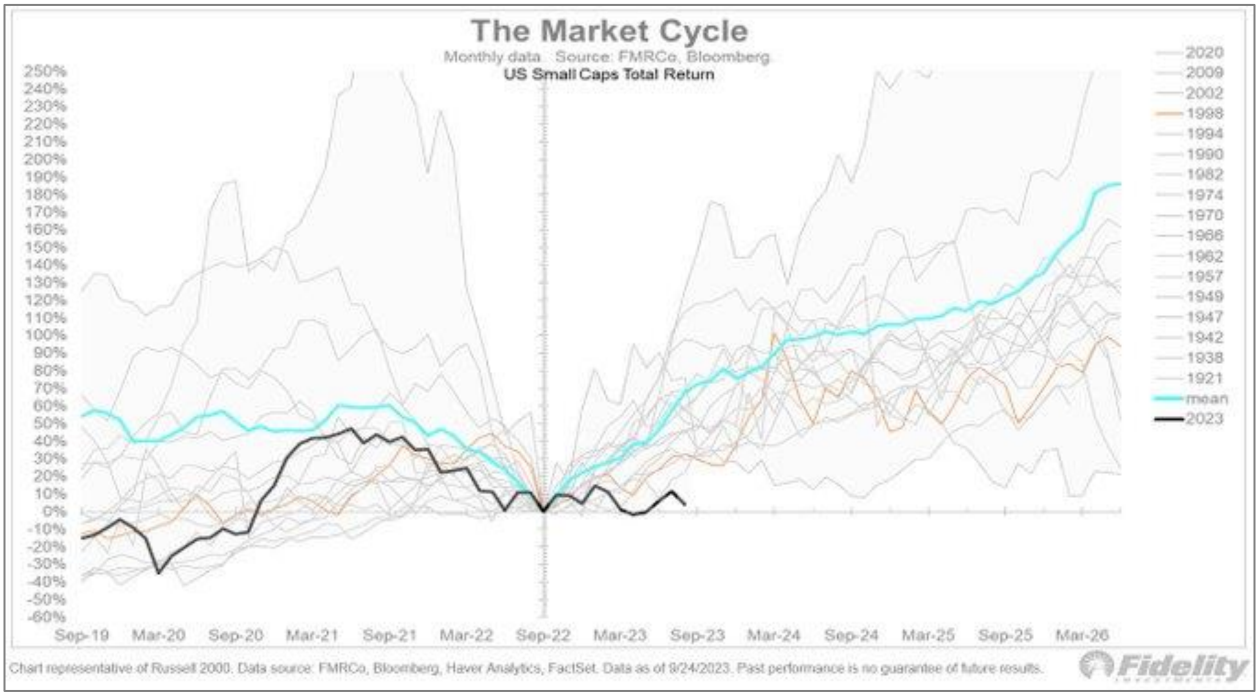
Zero-Days-To-Expiration trades surpassed 50% of total option volume.



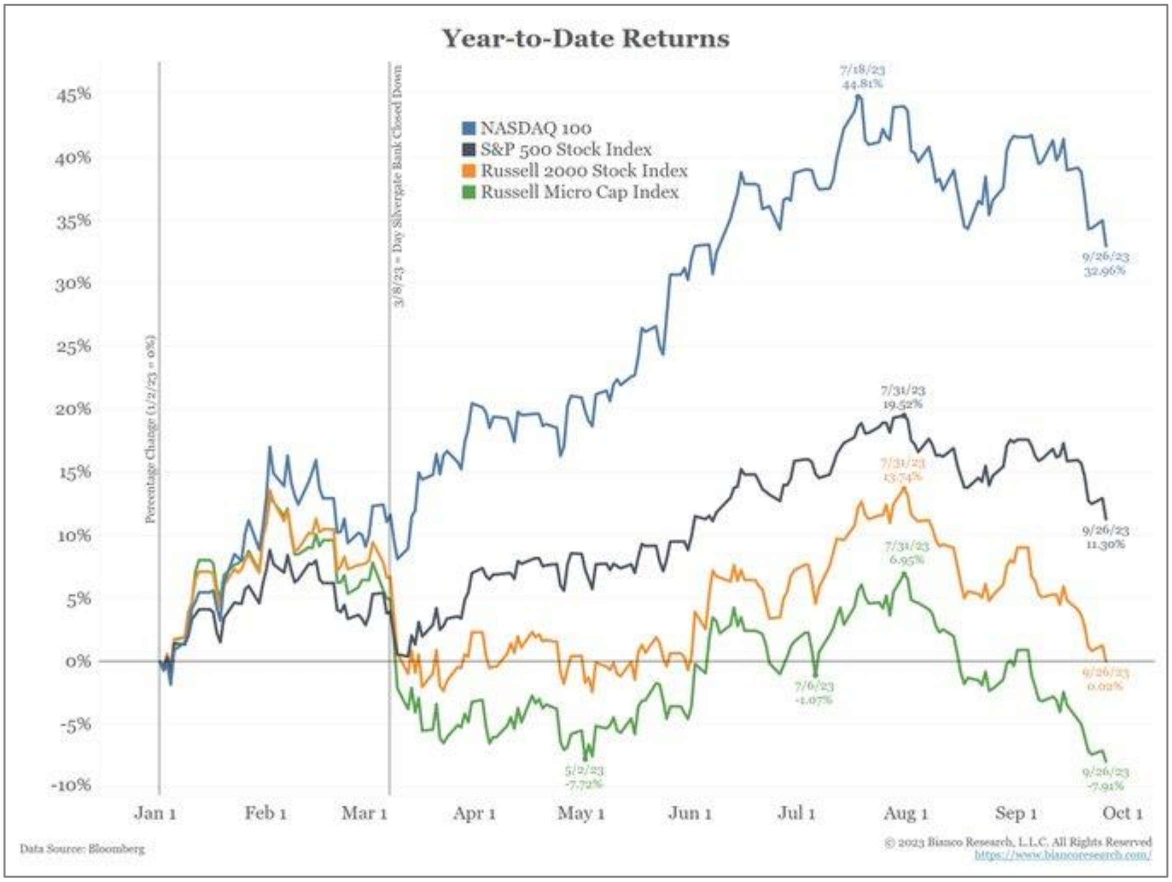
End of bull market behavior from a bull market that is less than a year old.



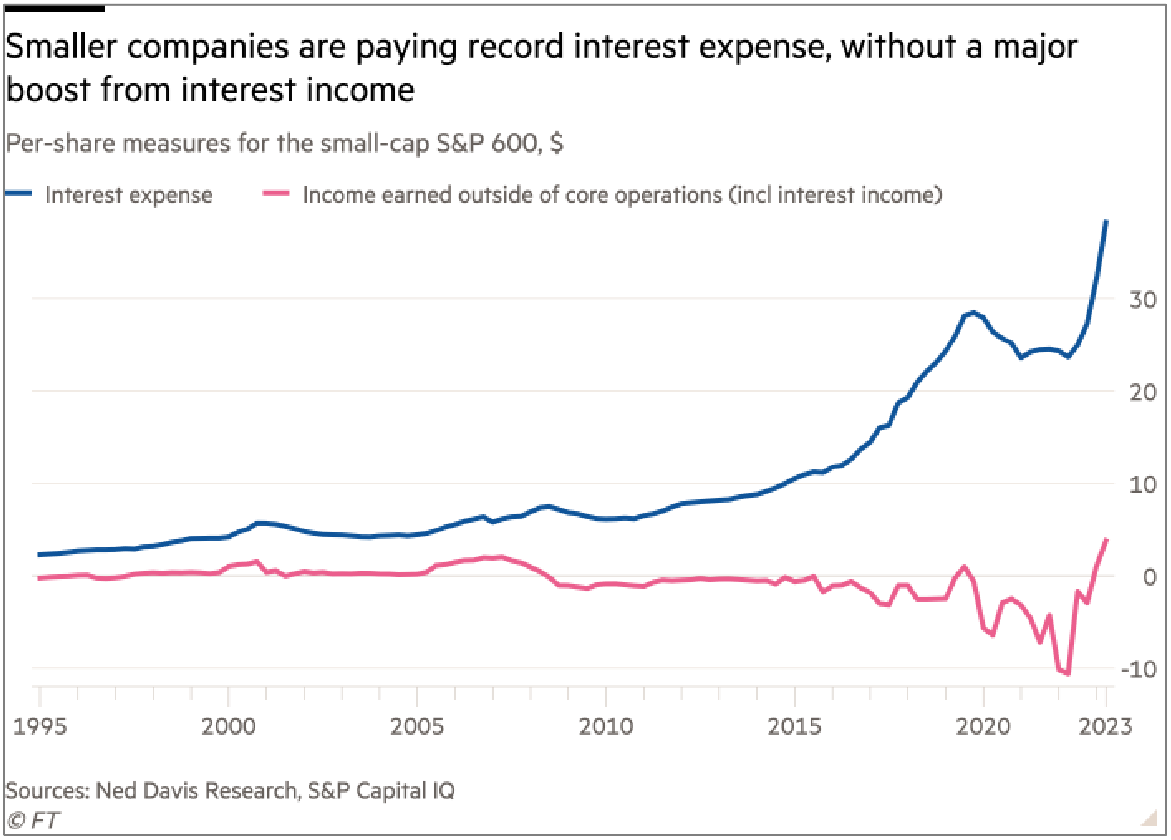
Worst ever bull market start for small cap stocks.



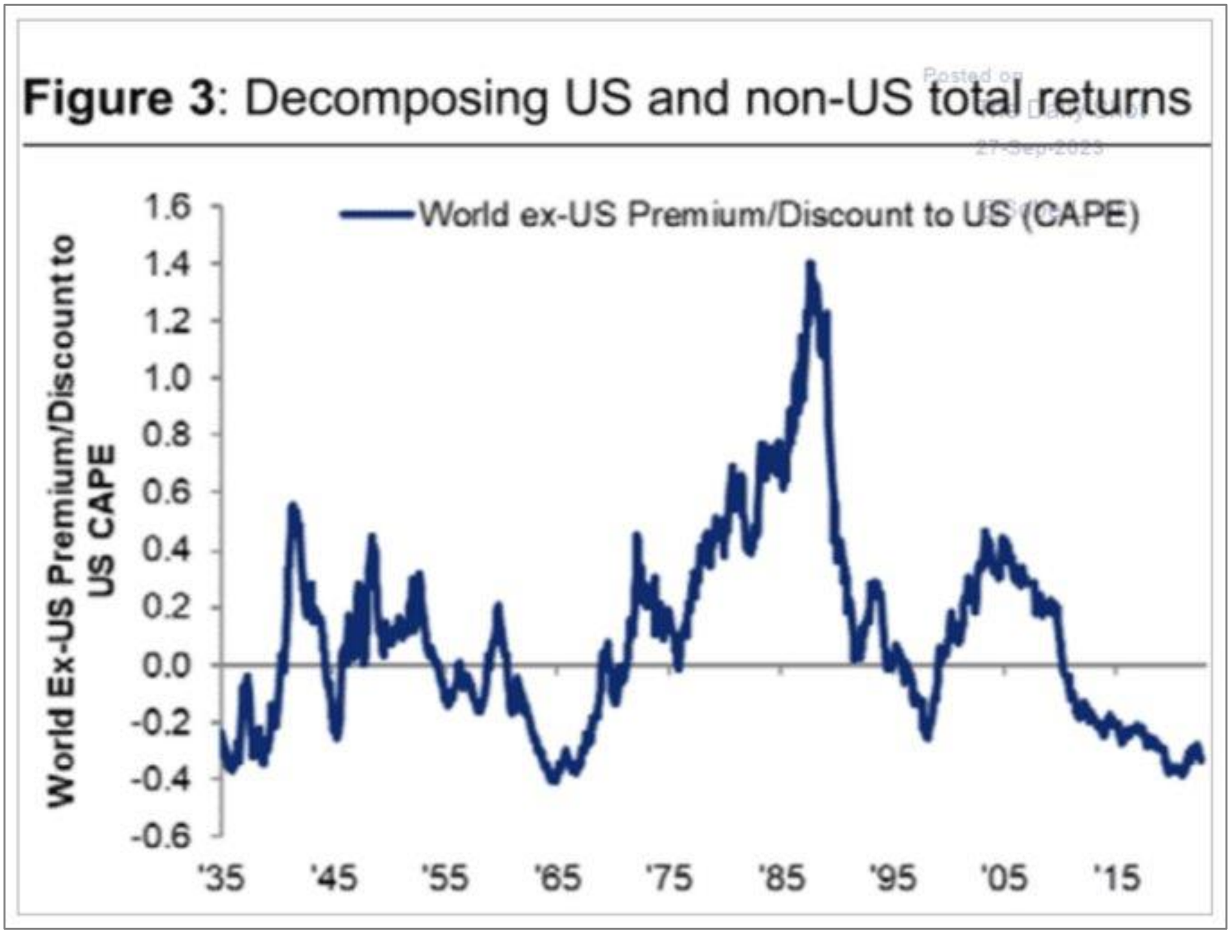
The smaller the market capitalization, the worse the year-to-date performance.



Higher interest rates have hit small cap stocks harder than big cap stocks.

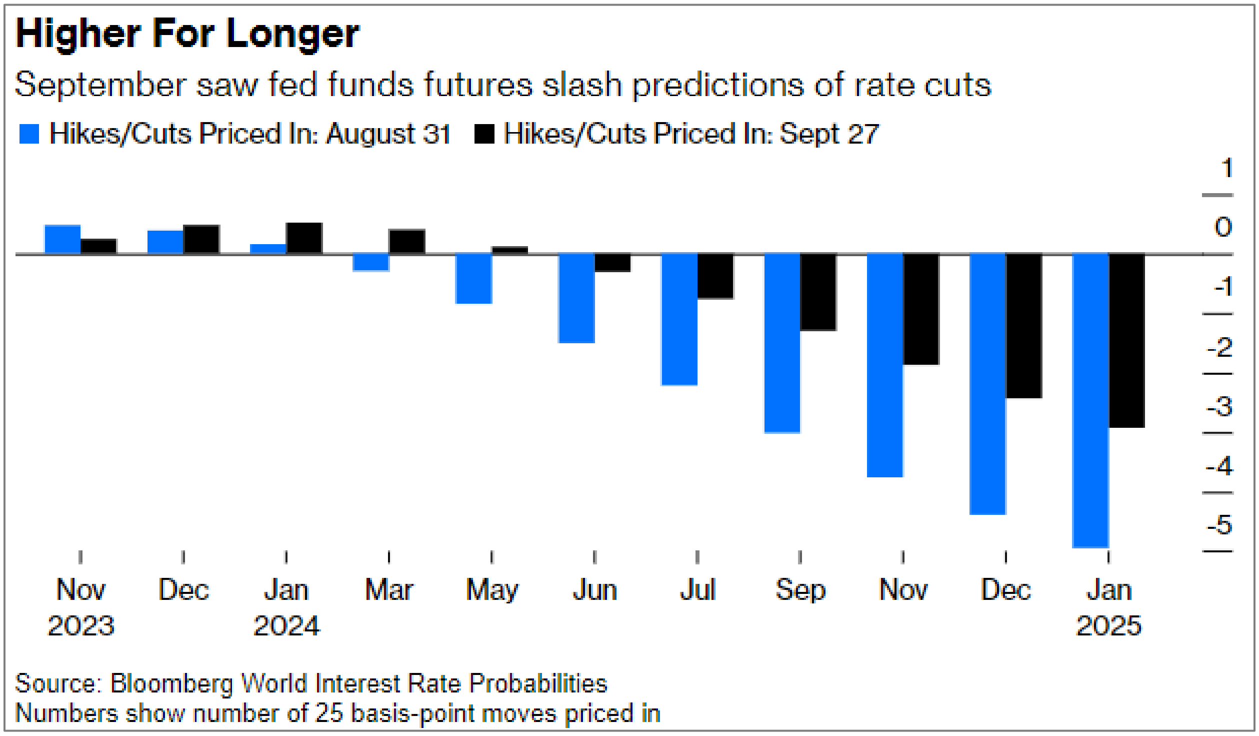


International relative valuations have only been this undervalued two other times in a century.

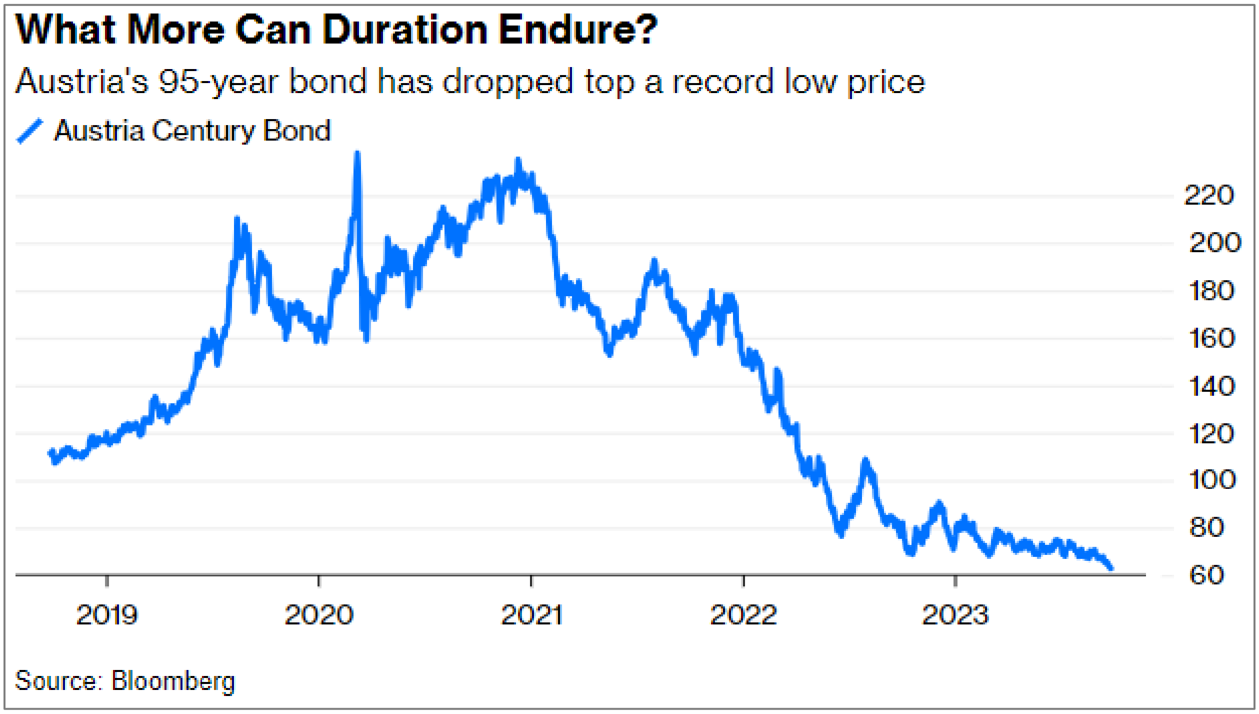


Magnificent-7 stocks are worth more than China, France, Japan and the UK stock markets combined.

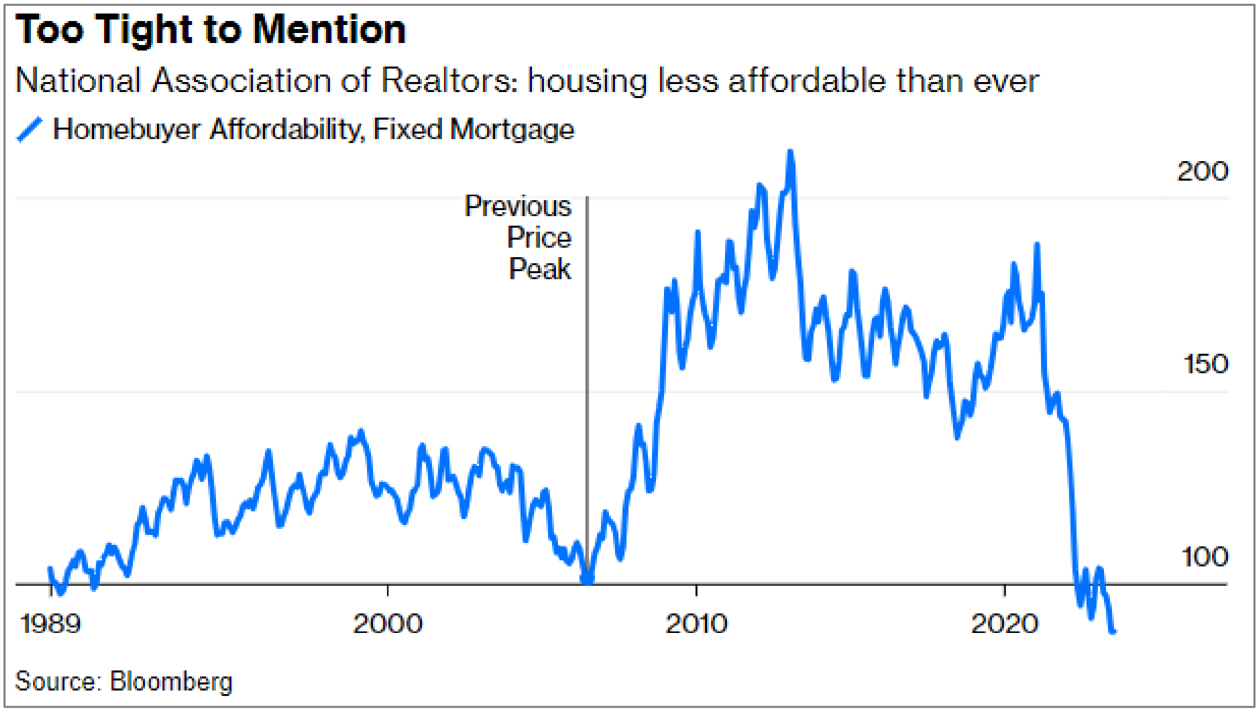
In a matter of weeks, markets rapidly lowered their expectations for future rate cuts.



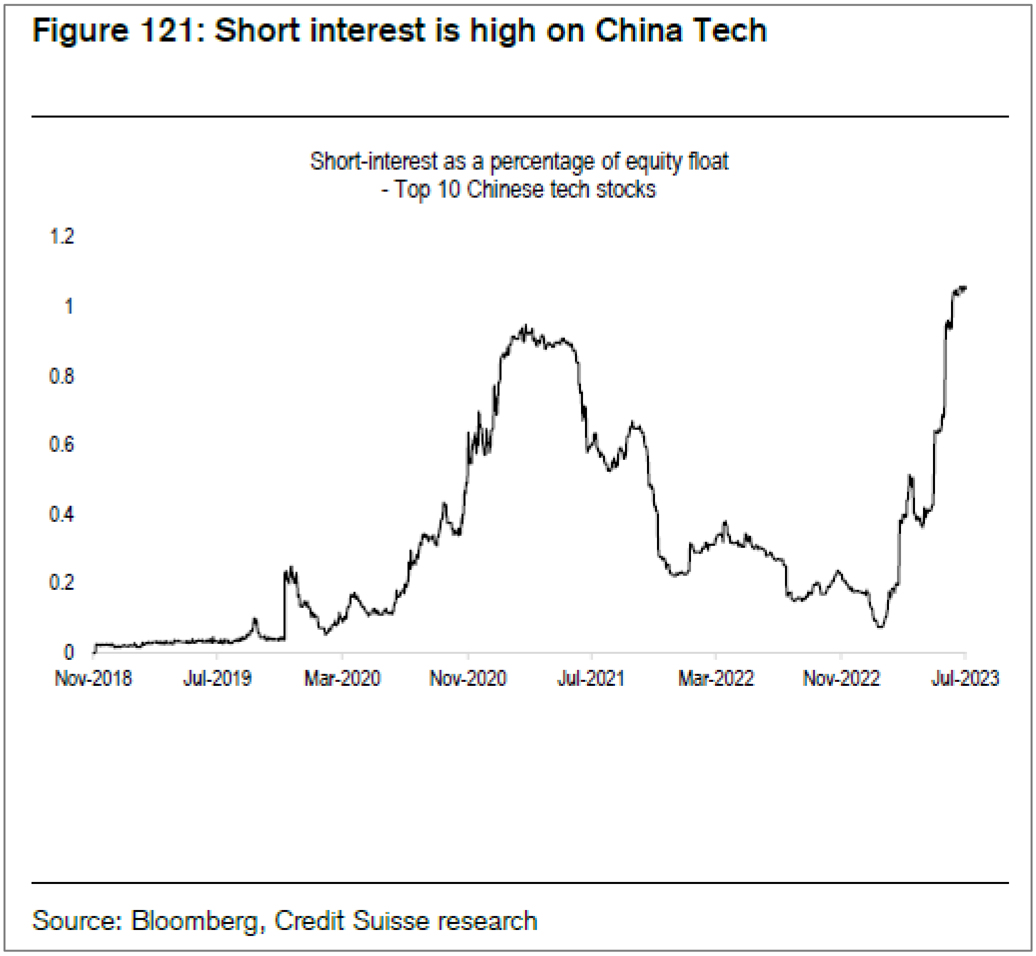
Chasing yield in Austria's Century Bond was a costly mistake.



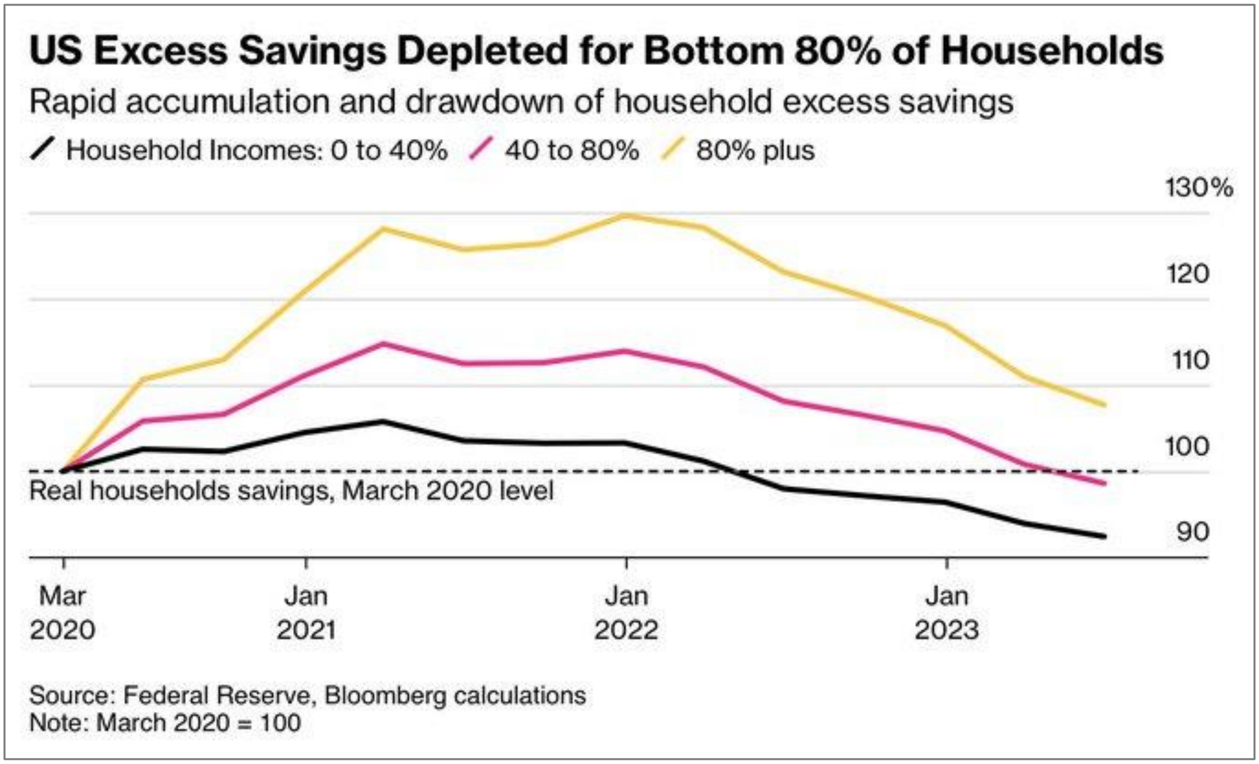
Owning a home has never been so unaffordable.



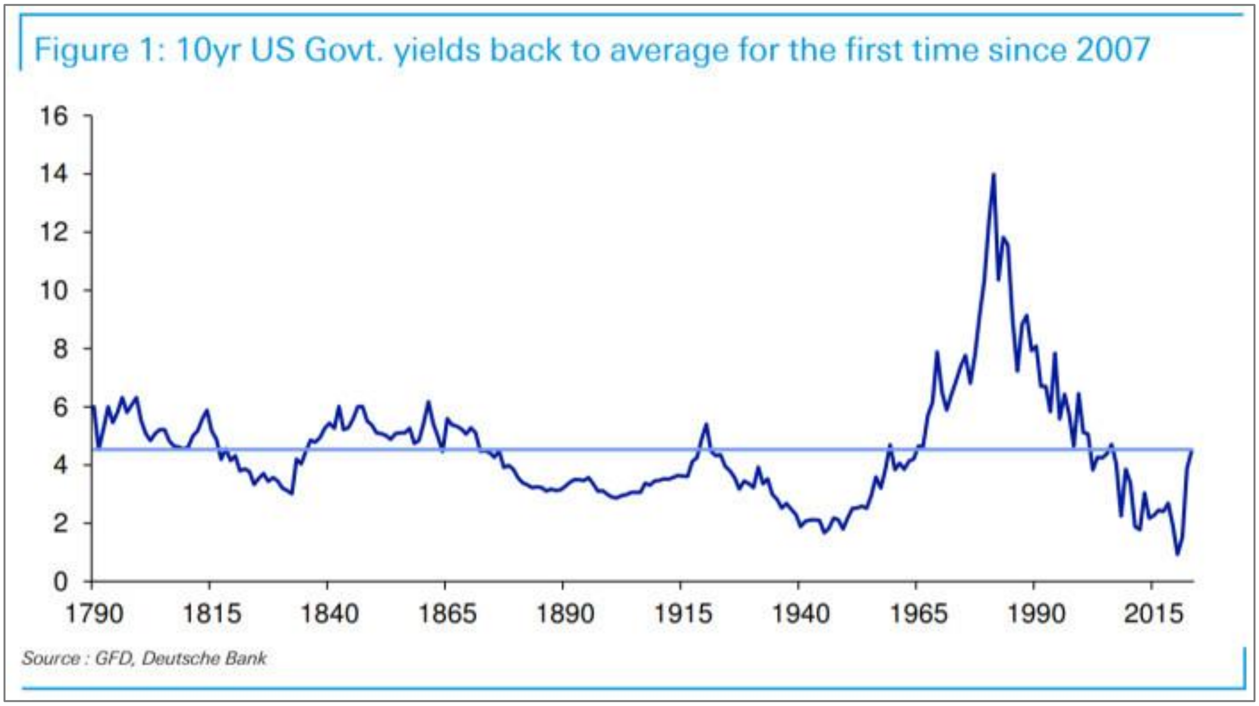
Short Interest on Chinese Tech Stocks has rocketed higher.



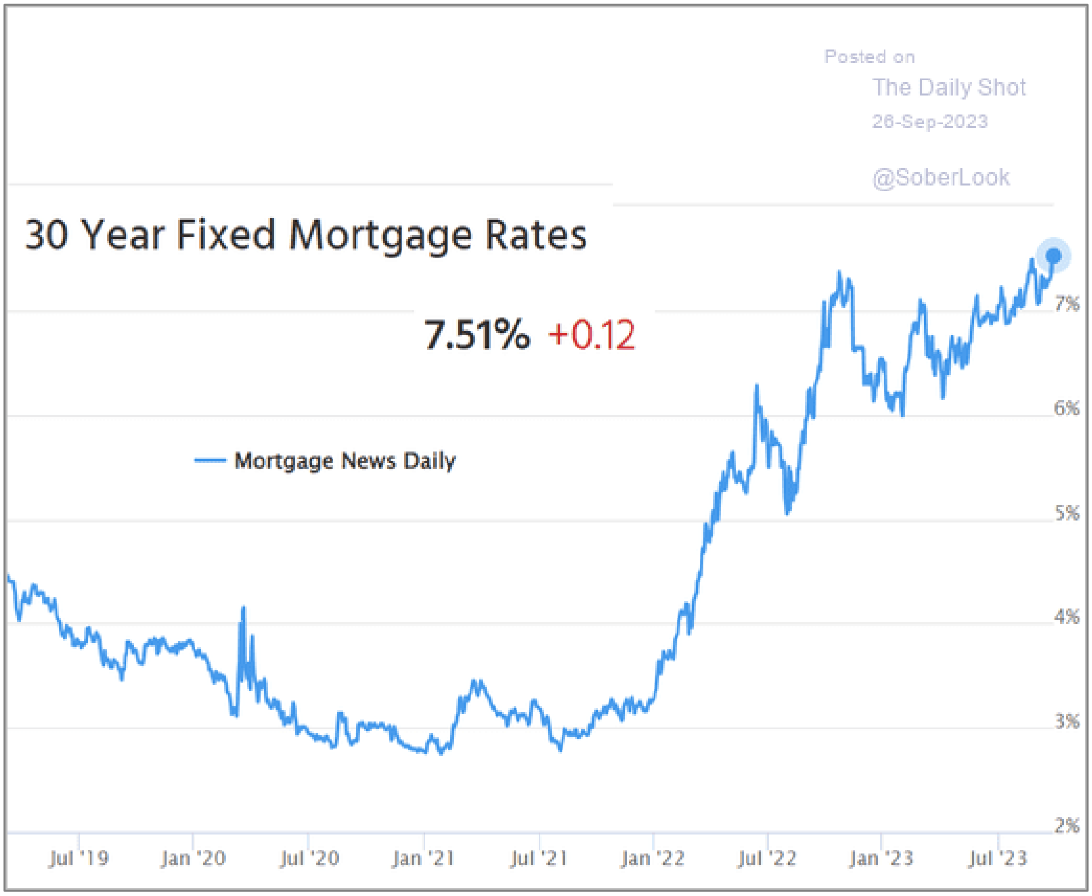
80 Percent of Households have spent all their excess savings (Covid stimulus).



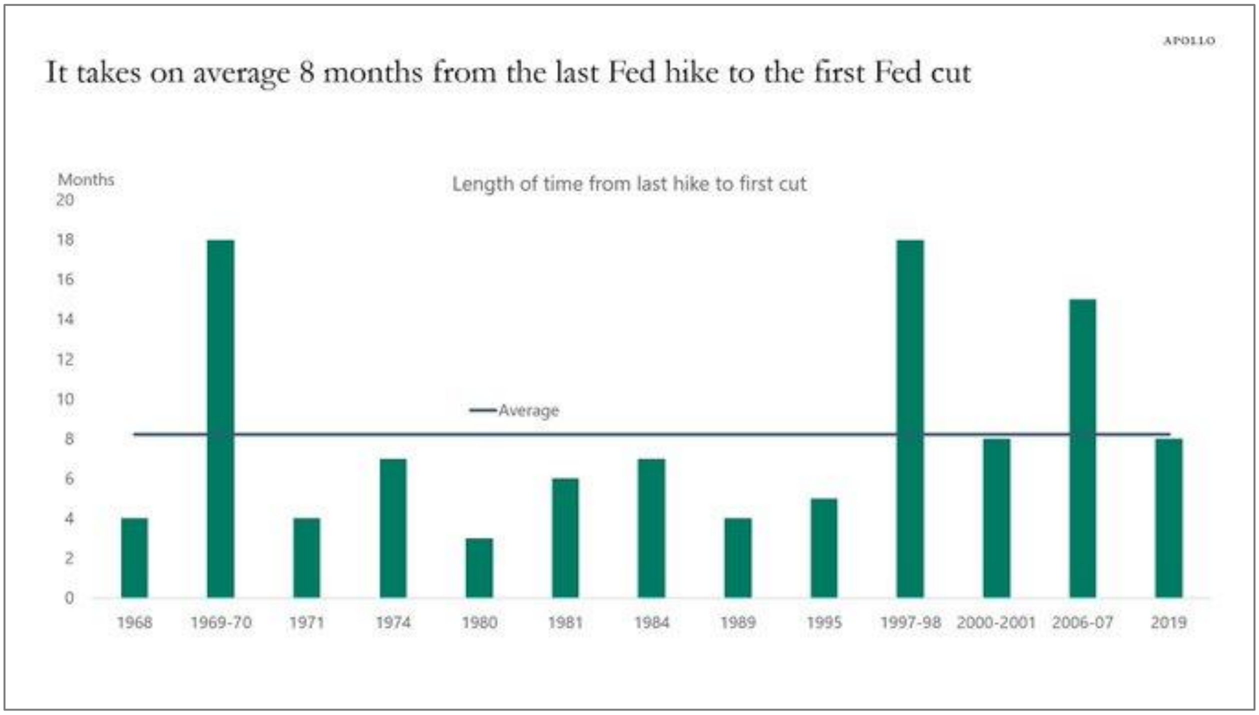
After 16 years, 10-year US Treasury Yields revert to the mean.



Mortgage Rates climb to 7.5%.



Eight months – that's the average time between the last Fed rate hike to the first Fed cut.



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.