Market Outlook

By Mark T Dodson, CFA

We're all contrarians now.

The calendar flipped to November, and the stock market rallied on cue. Market Risk Index climbed alongside it to 65.6%. Psychology, Monetary, and Valuations all worsened, contributing to the increase in MRI.

The most notable development within Psychology is that Corporate Insider sentiment has gone bullish. When small-cap stocks took out the bear market lows last week, enough corporate insiders found their company stock compelling enough to start buying. They aren't buying like it's 2008 or March 2020, but they are buying. Small cap valuations are better than the median valuation. Still, we believe that by the time our Psychology and Monetary Composites are restored, small-cap valuations will likely present one of those back-the-truck-up kind of opportunities.

Monetarily, it appears safe to surmise that we have seen a peak in the surge of the Velocity of Money that originated during Covid. MZM growth has put in a clear trough as households have likely spent down the final remains of the free government largesse thrown at them in the name of Covid. The clear trough in the severity of the yield curve inversion is also confirmation. It's more than a coincidence that both indicators would see inflection points simultaneously. These are shifts that officially mark the start of the recession clock in our experience, where you cross the fuzzy threshold from leading to coincident indications of recession.

Speaking of coincident, the AtlantaNow GDP estimate for Q4 has dropped from 2.3 to 1.4% over the last week. Also this week, several months of jobs numbers were revised lower, and the unemployment rate rose to 3.9%. That's still an impressively low unemployment rate, but the rise from the Unemployment rate's trough is large enough to put us close to a recession warning from the Sahm Rule. The Sahm Rule has impeccable timing in marking the official start dates of previous recessions. We expect the drumbeat of recession stories to begin to beat louder as the soft-landing euphoria from July gives way to the realization that the most widely predicted recession may be unavoidable.

A contrarian would say that we can't have a recession if it's the most widely predicted in history, except it appears that we're all contrarians now. When you look at equity positioning, Households have largely dismissed the warnings from economists, including our favorite economist (the yield curve).

Market Risk Index

Rec Allocation 25% Underweight

65.6%

Category Percentiles

Psychology - P5

83.5%

Monetary - M3

33.2%

Valuation - Extremely Overvalued

95.3%

Trend

40.8%

Largest Psychology Influences

Leveraged Investments	Negative
Option Activity	Positive
Bank Sentiment	Negative
Volatility	Negative

Largest Monetary Influences

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

Valuation

7-10 Year Equity Return Forecast	1.9%
10Yr US Treasury Yield	4.7%

Market Trends

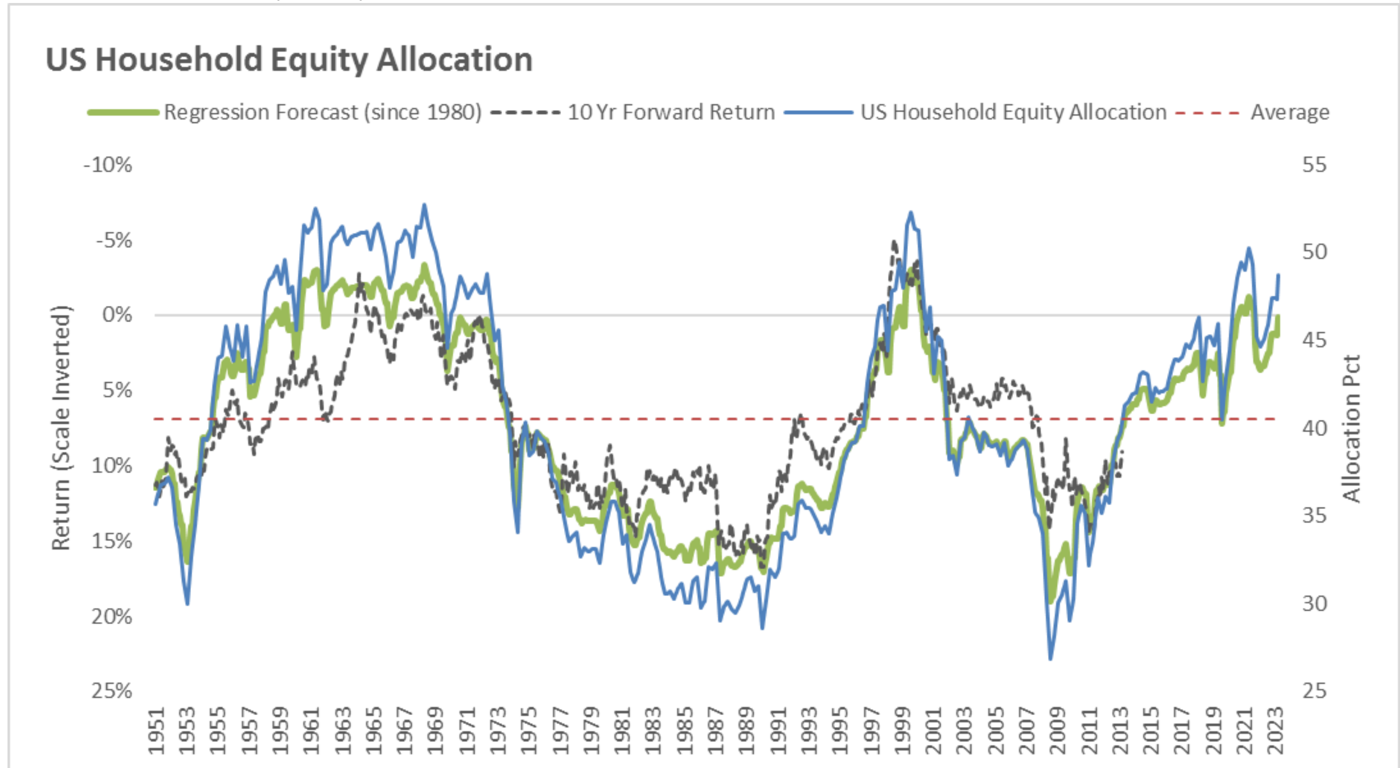
US Equities	Bullish Investment
Intl Equities	Bearish Trade
REITs	Bearish Trade
Broad Commodities	Bullish Trade

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

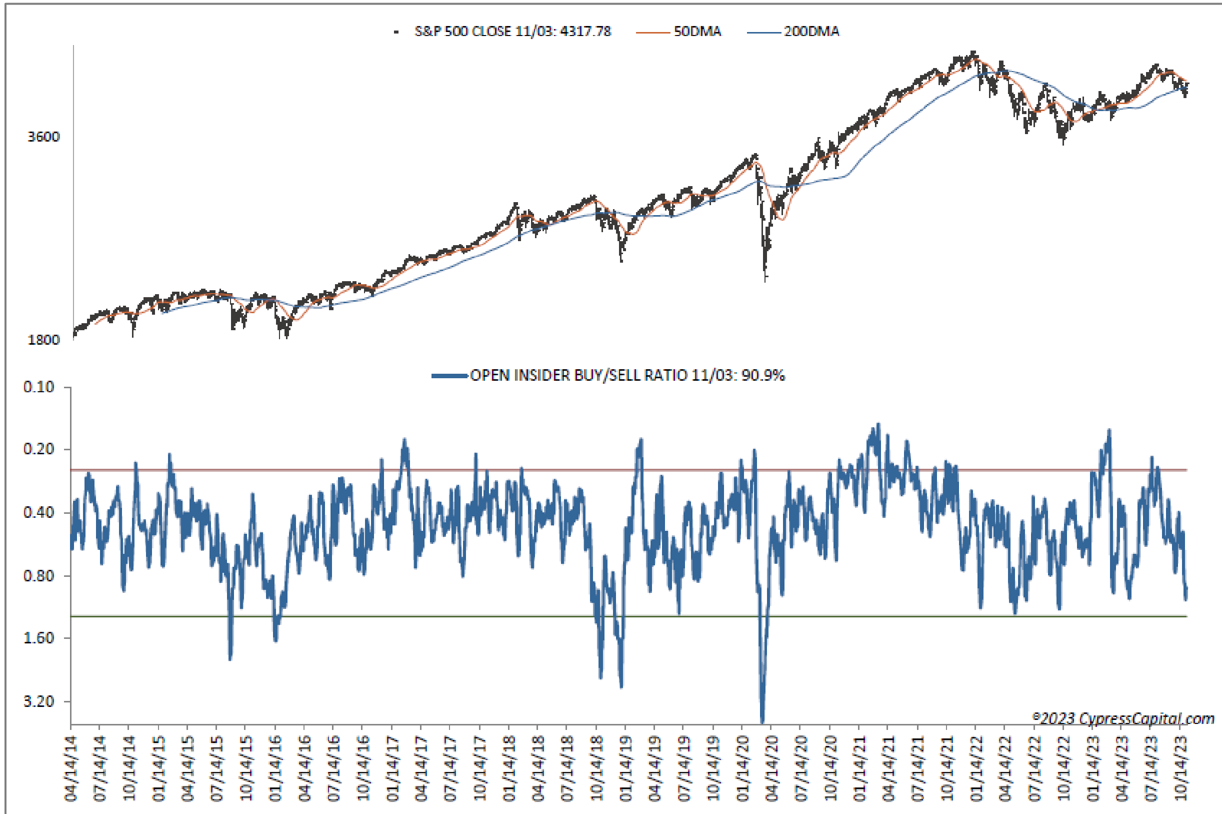
Household equity allocations are positioned for a roaring bull, not a recession. Even a cushy 5.5% yield on Treasury Bills hasn't been enough to sway them. The over-arching lesson that most investors learned over the last decade is not to fear recession as much as to fear not having considerable exposure to equities before the Fed's next deluge of liquidity gets dumped on markets.

Charts of the Week

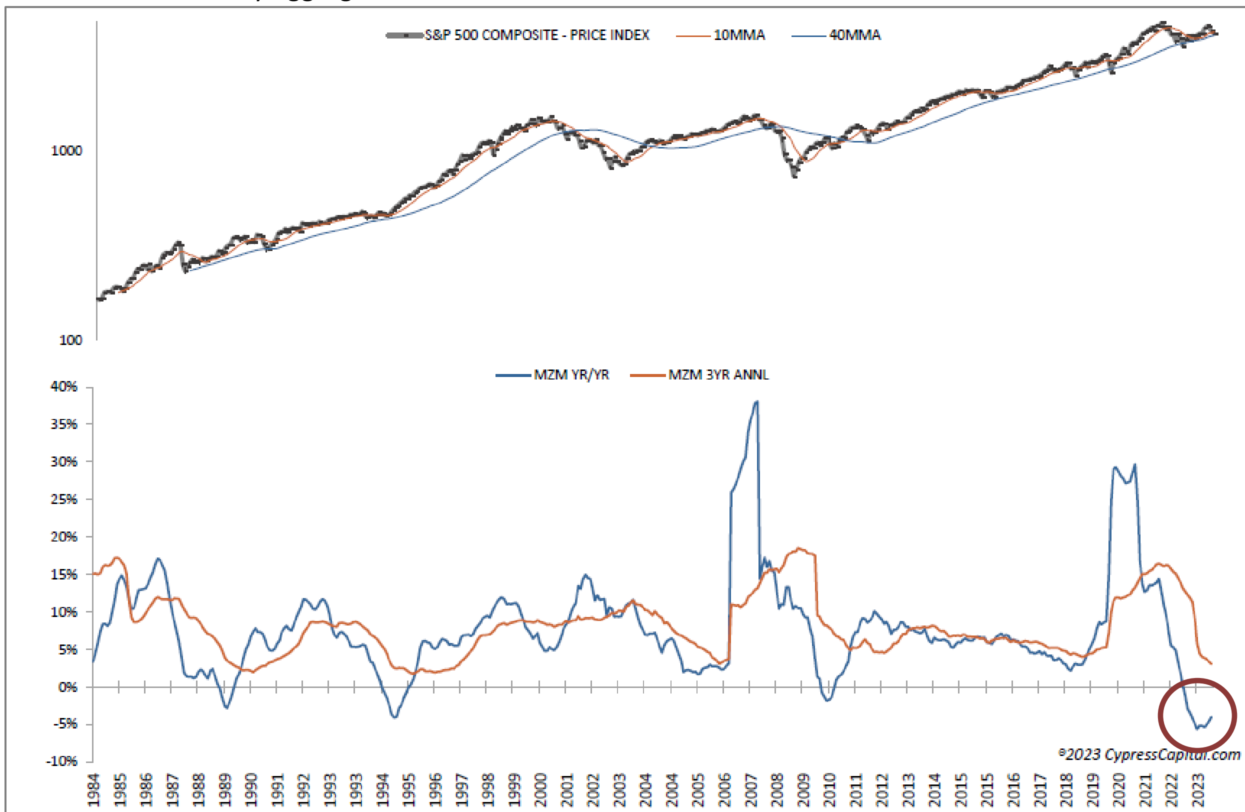
Average Equity Allocations are just shy of the previous bull market peak.
The return forecast implied by current household allocations has fallen back to 0%.



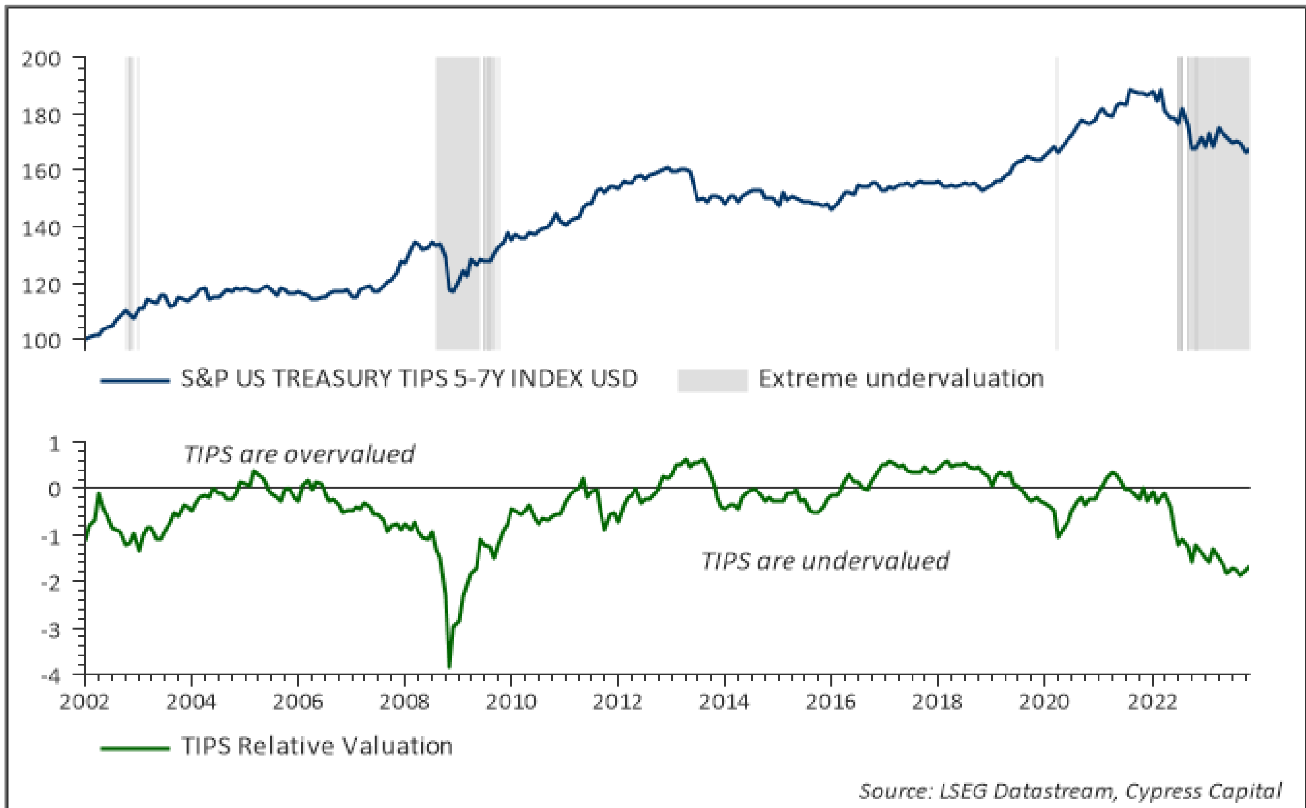
When the Russell 2000 took out its bear market lows, Corporate Insiders started to buy the dip.



MZM is showing a clear sign of an inflection point in the demand for money.
The Fed stopped publishing official MZM figures, but we still calculate the aggregate internally. It's long been our favorite monetary aggregate.

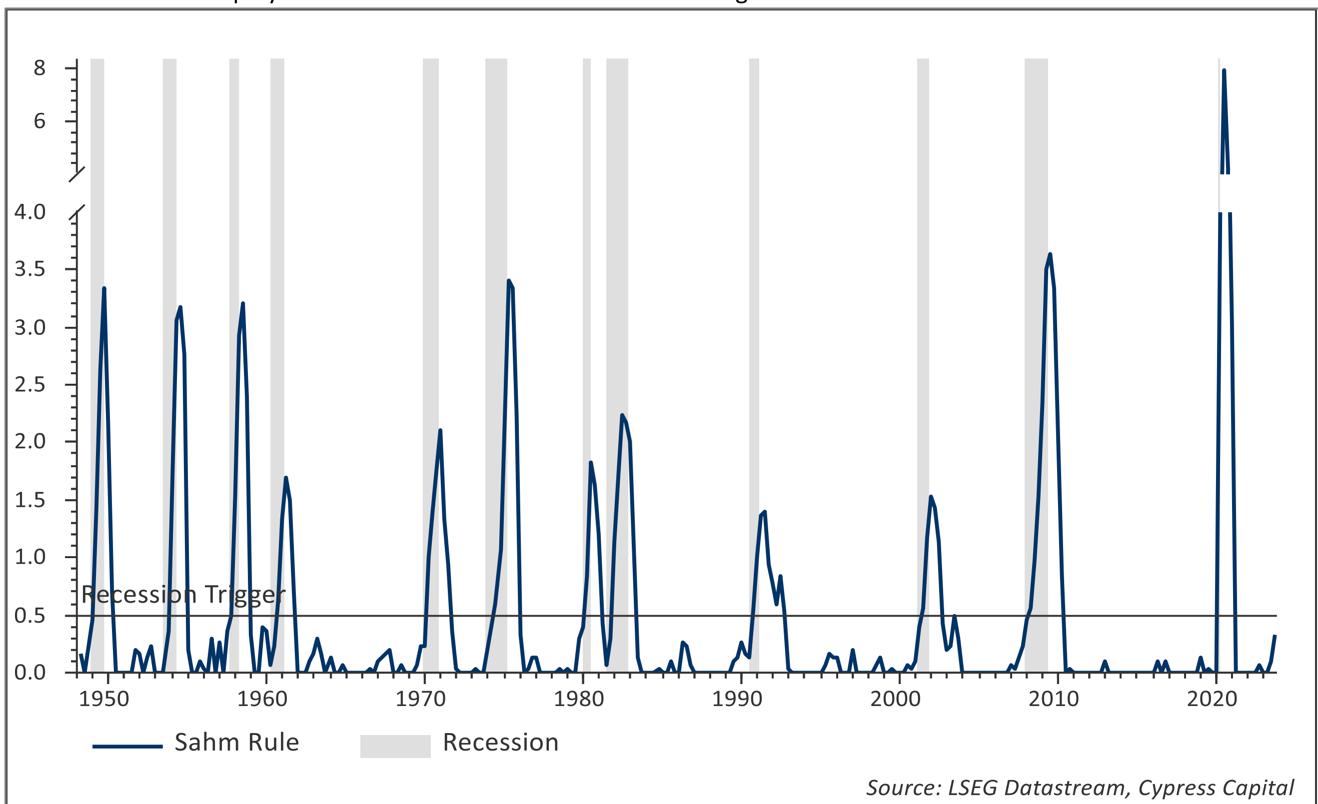


Relative Valuations on TIPS haven't been this attractive since the 2008 credit crunch.



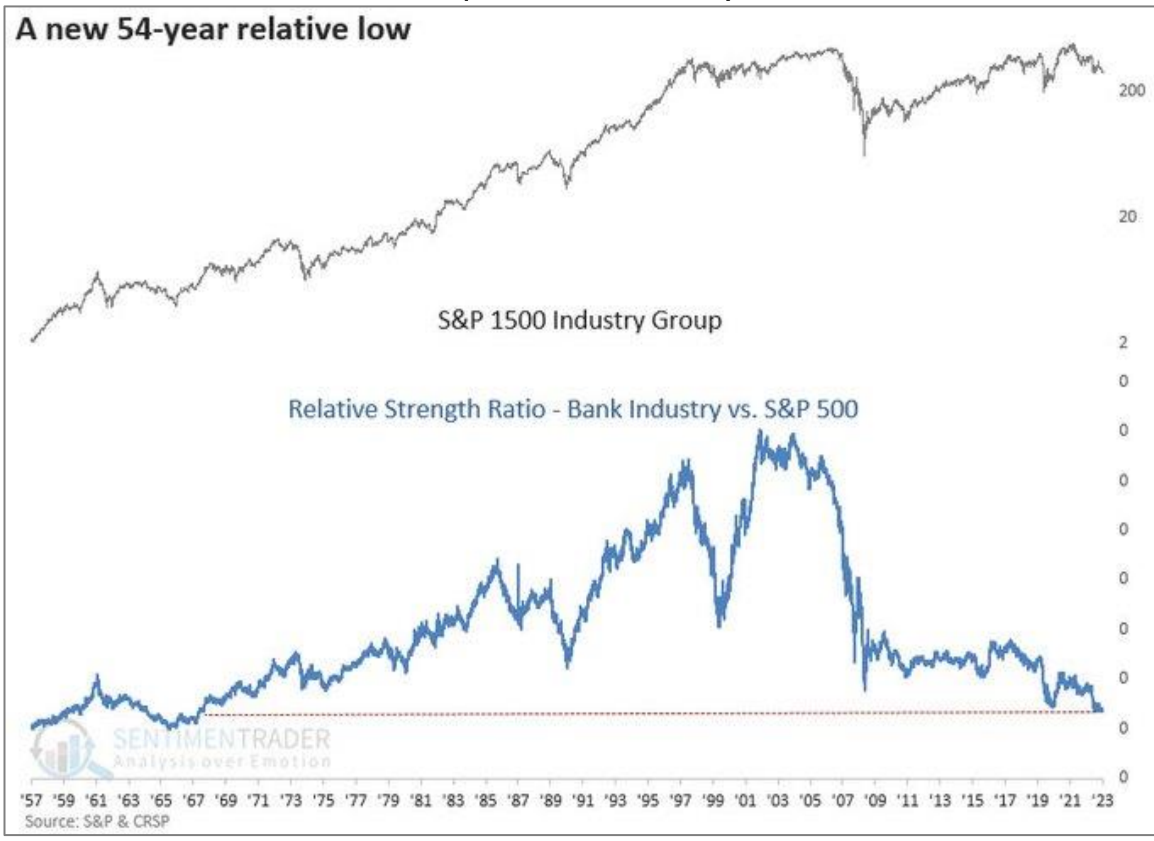
Sahm Rule is approaching a recession trigger.

The Sahm Rule is a coincident indicator of recession and has marked the start of every recession. It highlights the kind of increase in the Unemployment rate that is difficult for the NBER to ignore.

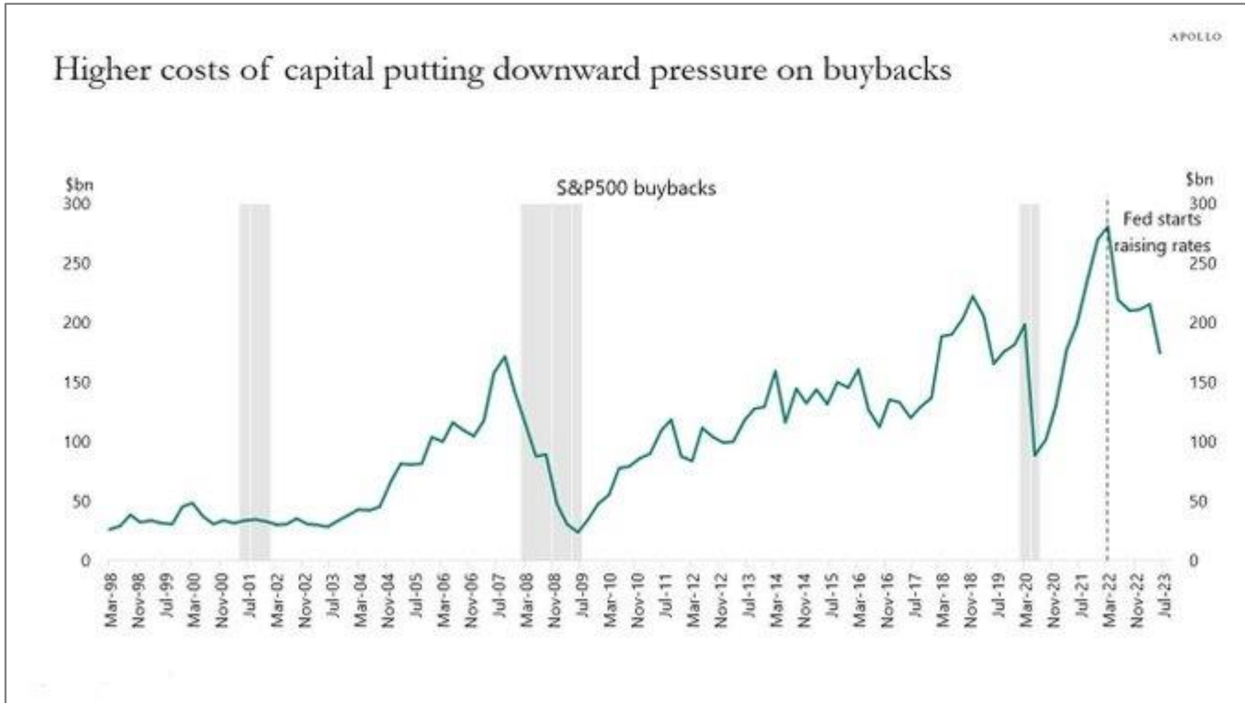


Relative Outperformance of Tech is at 100-year highs.

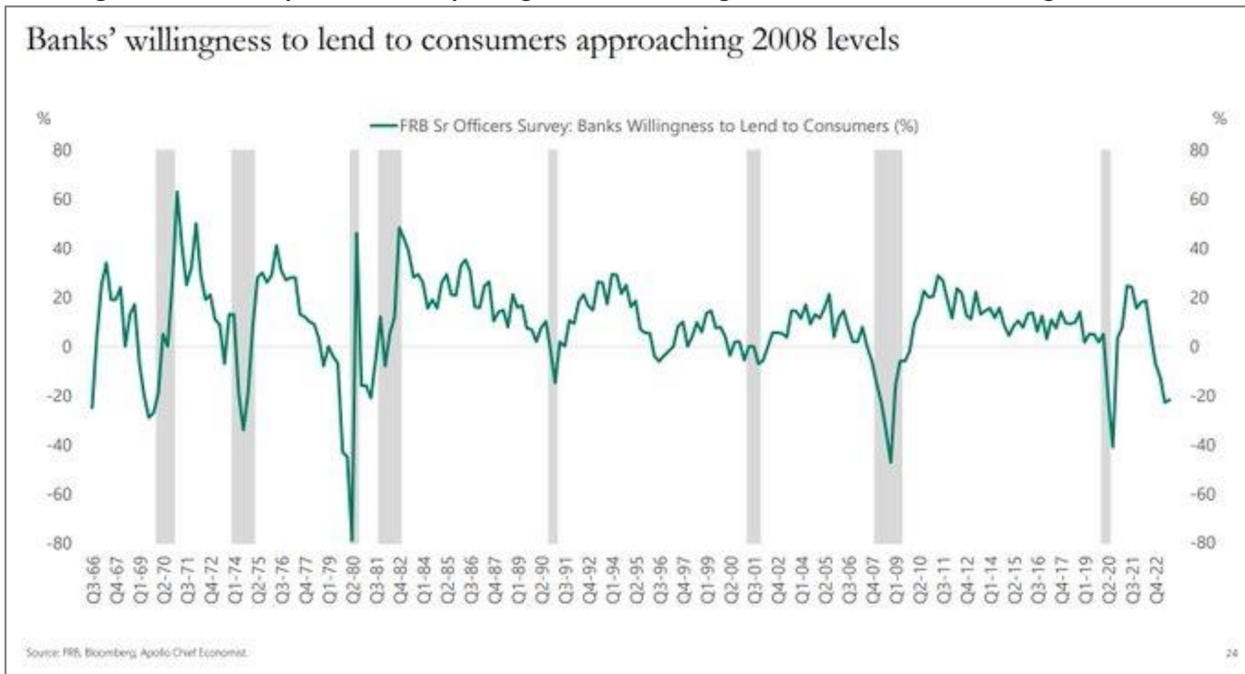
Meanwhile, Bank stock relative underperformance is at 50-year lows.



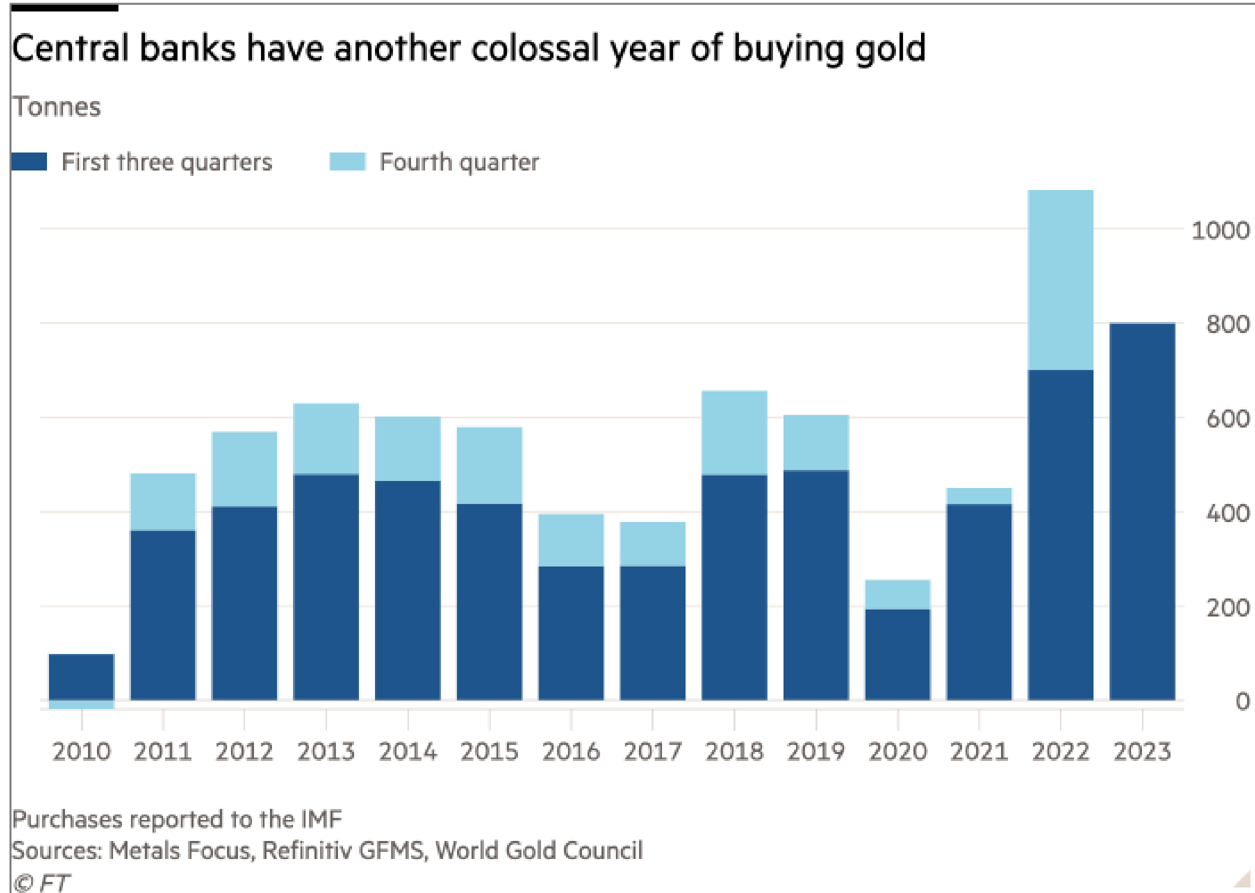
Buybacks are softening.



It is tough to find examples of banks pulling back on lending with a recession occurring.

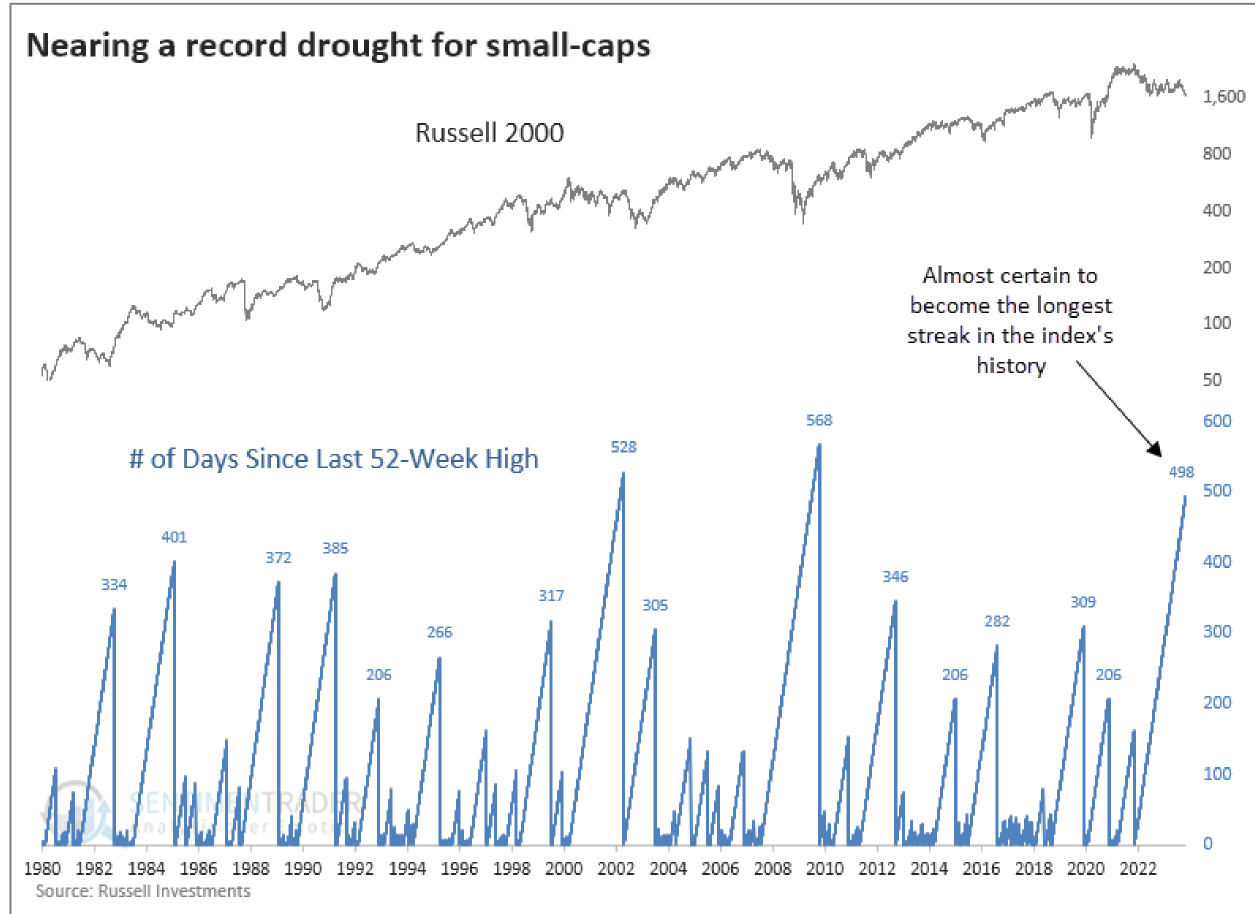


Central banks continue to stock up on gold.



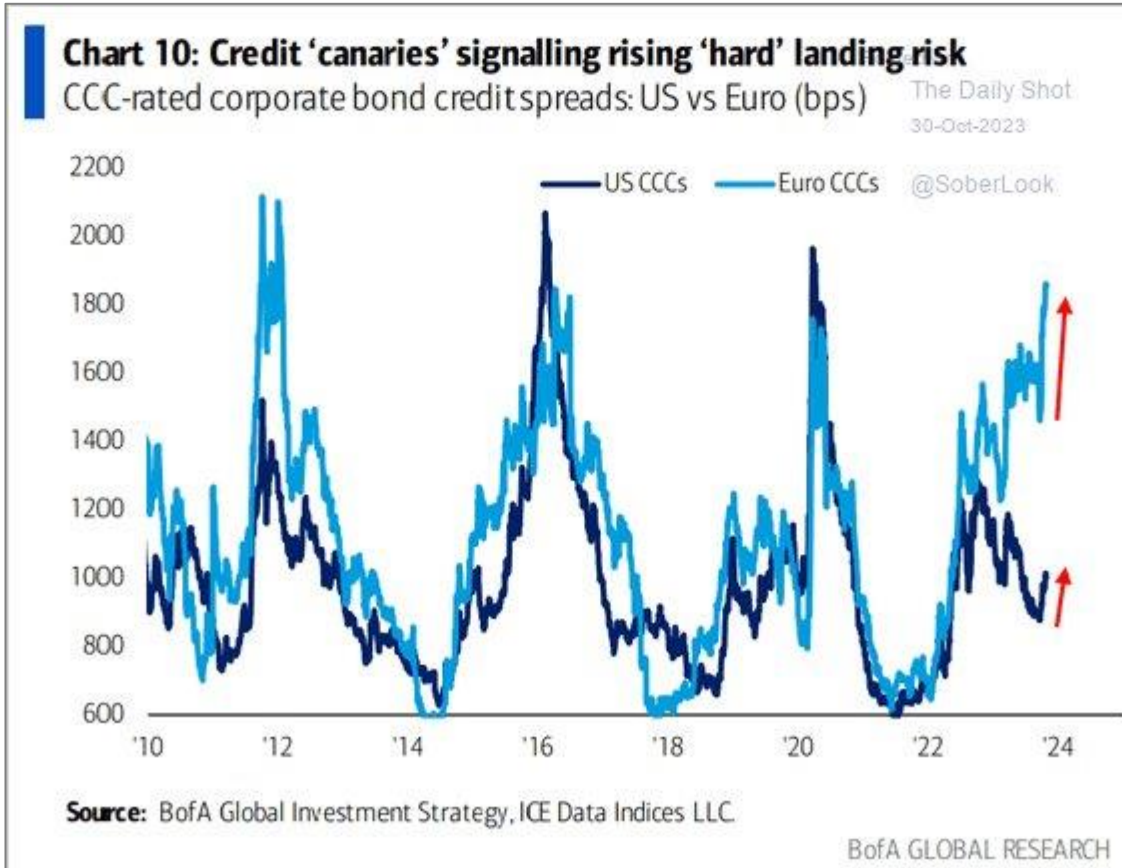
Spreads widening on Commercial Property backed securities.

Russell 2000 number of days without a new high will likely surpass the 2008 bear market.

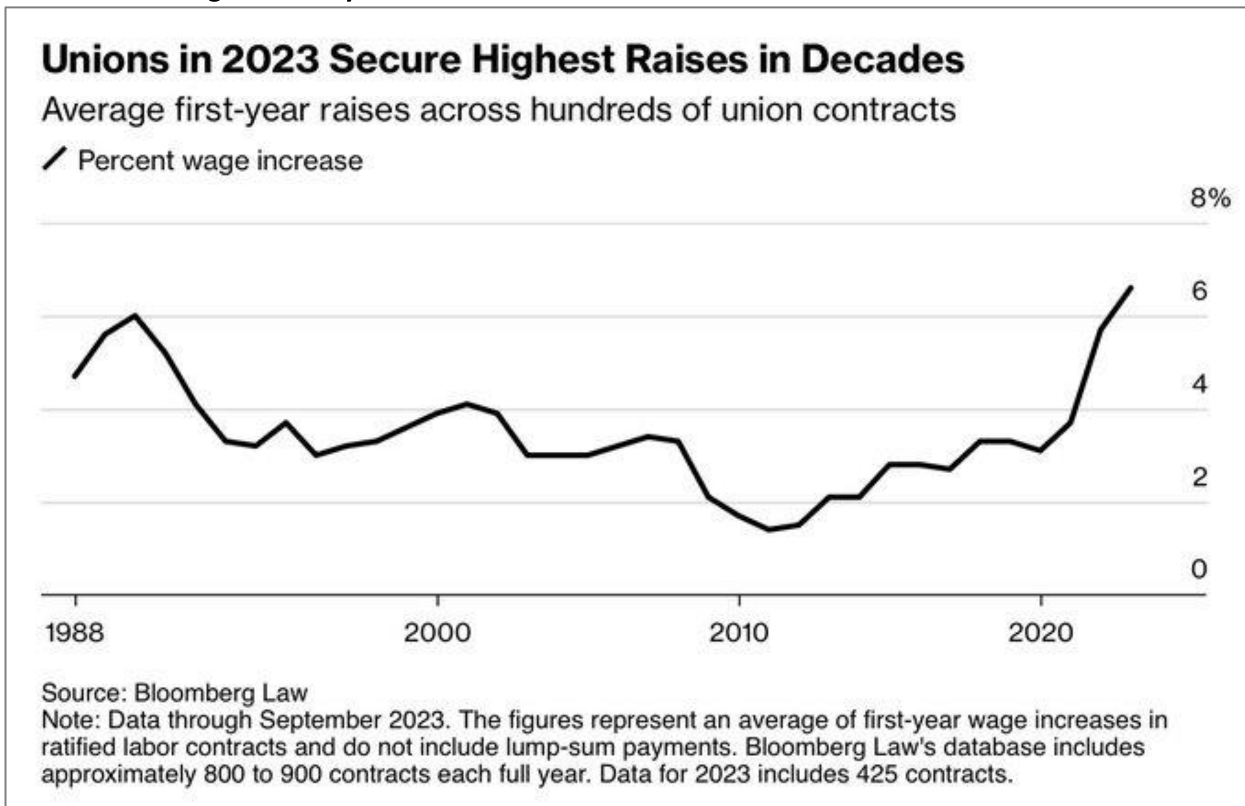


The cost of capital is becoming a frequent topic on earnings calls.

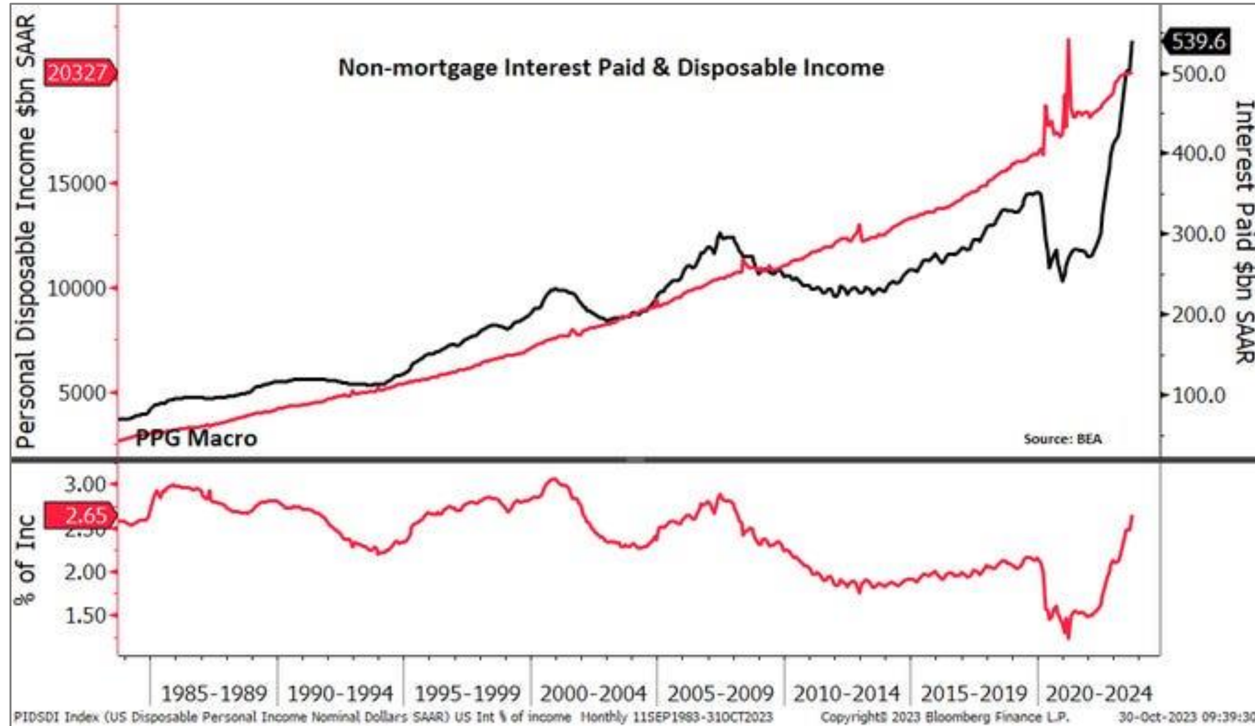
Growing Gap between credit spreads in Europe and the US.



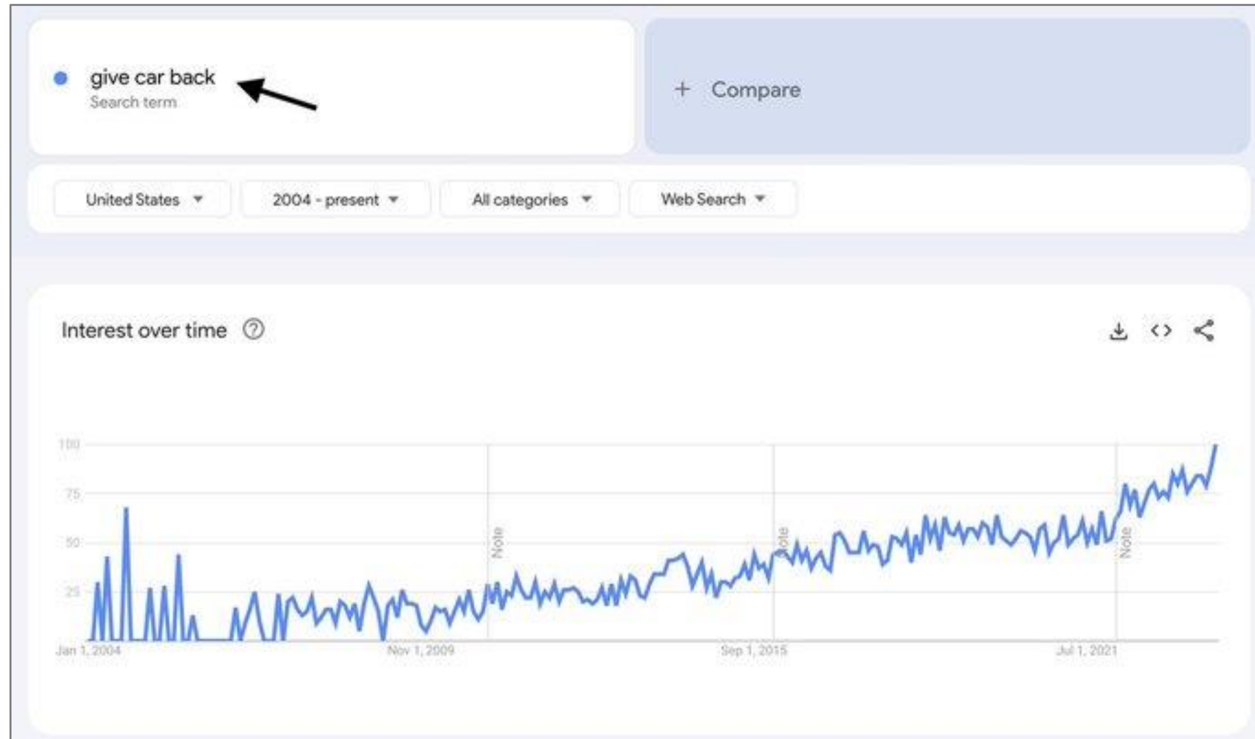
Unions are having a banner year.



Non-mortgage interest payments rise to the highest level in the post Lehman QE era.

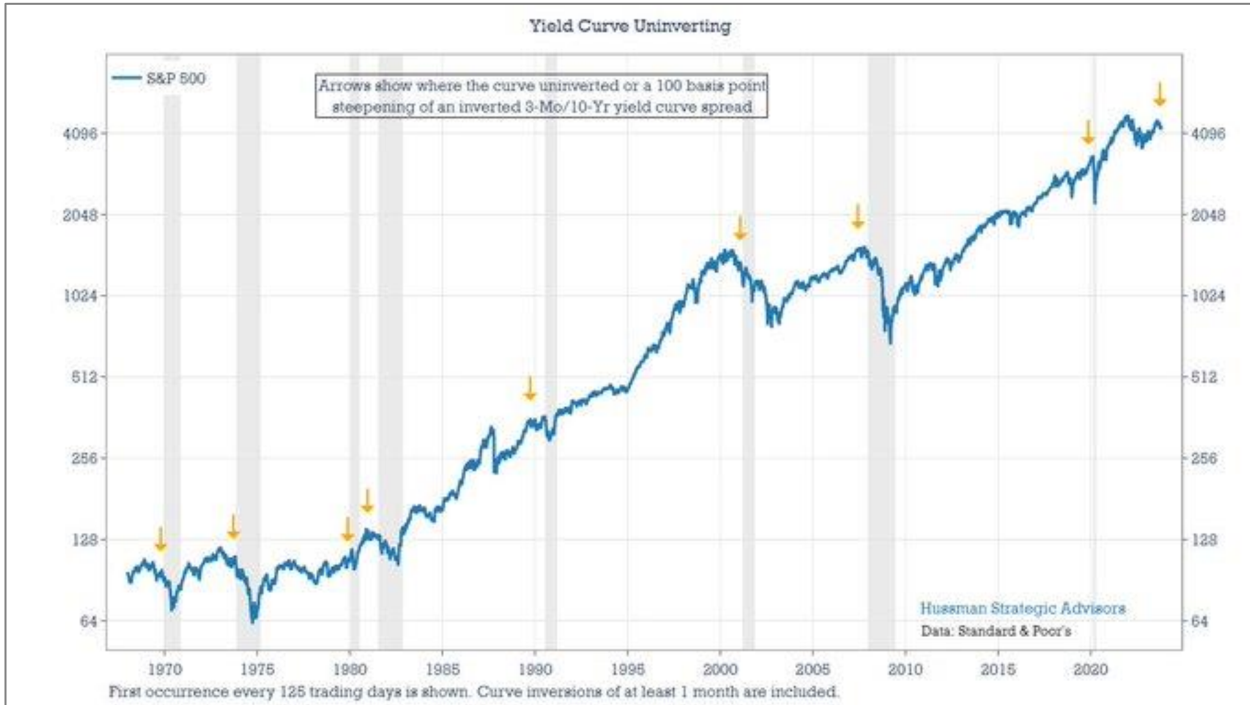


Consequently, search interest in how to give your car back is surging.



Source: CarDealershipGuy

The point where the yield curve 'un-inverts' is often the time it impacts markets.



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.

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