Market Outlook

By Mark T Dodson, CFA

Is it time to bail on the yield curve?

Gains in our Monetary Composite offset a move by the Psychology Composite into the worst 3% of readings. Market Risk Index fell slightly to 73.5%.

Euphoric readings from the Psychology Composite have become pervasive with no categories giving readings that imply bullish outcomes. The two best categories are neutral. Still, the overall score is not as high as in July. The high watermark for the euphoria readings was 2021, which broke the previous dot-com era euphoria readings.

It's become commonplace in the last few years to try to navigate an overvalued market with euphoric investor sentiment. There's a reason that "the market can stay irrational longer than you remain solvent" is a longstanding stock market adage. When you decide to become a disciplined investor who requires a margin of safety when risking investment capital, you also understand that it implies you will not get to drink all the punch at the punch bowl.

Our Monetary Composite is designed to help with the frustration of being an investor that keeps valuation at the heart of the process. At this point, it has become difficult to ignore that the only thing in our Monetary Composite keeping it from encouraging a full embrace of this bull market is the yield curve. The yield curve is an indicator that has always proved prescient – but it has such long and varying lead times that most investors (and all investment strategists) lose their patience with it.

The new stock market highs added to our frustration with the yield curve, which has been inverted longer than any time in 40 years. We put our frustration to the test, asking if new stock market highs should be the reason to abandon the yield curve as a relic of the past. We looked back at all the times the stock market made new 10-year highs while the yield curve was inverted.

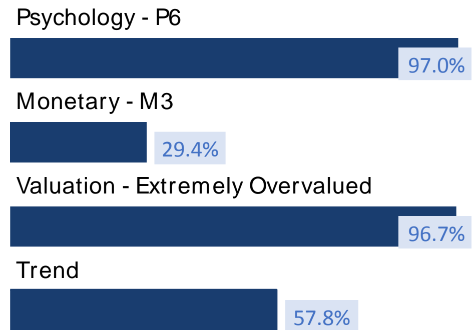
It turns out the opposite is true – waiting for new highs when the yield curve is inverted improves the timing of an indicator known for its inconsistent lead times. It's happened four other times since 1950, and a bear market or recession was forthcoming within four months on average – with the longest lead time being 12 months. Maybe the yield curve is failing, but the recent action in the stock market doesn't give us enough evidence to remove it from the toolkit.

Market Risk Index

Rec Allocation 25% Underweight

73.5%

Category Percentiles



Largest Psychology Influences	
Leveraged Investments	Negative
Bank Sentiment	Negative
Option Activity	Negative
Consumer Confidence	Negative

Largest Monetary Influences	
Interest Rate Spreads (Yield Curve)	Negative
Lending & Leverage	Positive
Inflation	Positive

Valuation	
7-10 Year Equity Return Forecast	1.4%
10Yr US Treasury Yield	4.1%

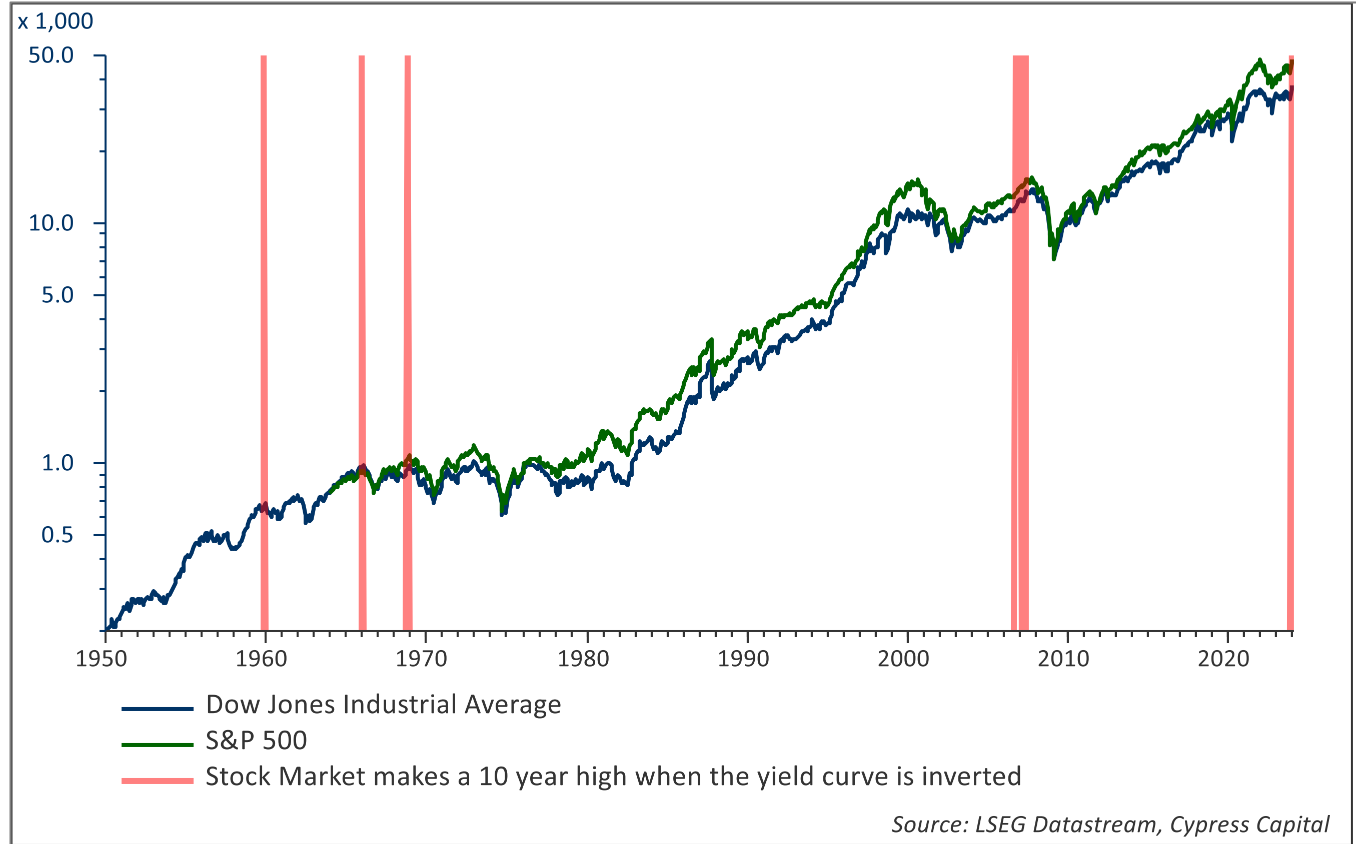
Market Trends	
US Equities	Bullish Investment
Intl Equities	Bullish Investment
REITs	Bullish Trade
Broad Commodities	Bearish Trade

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.

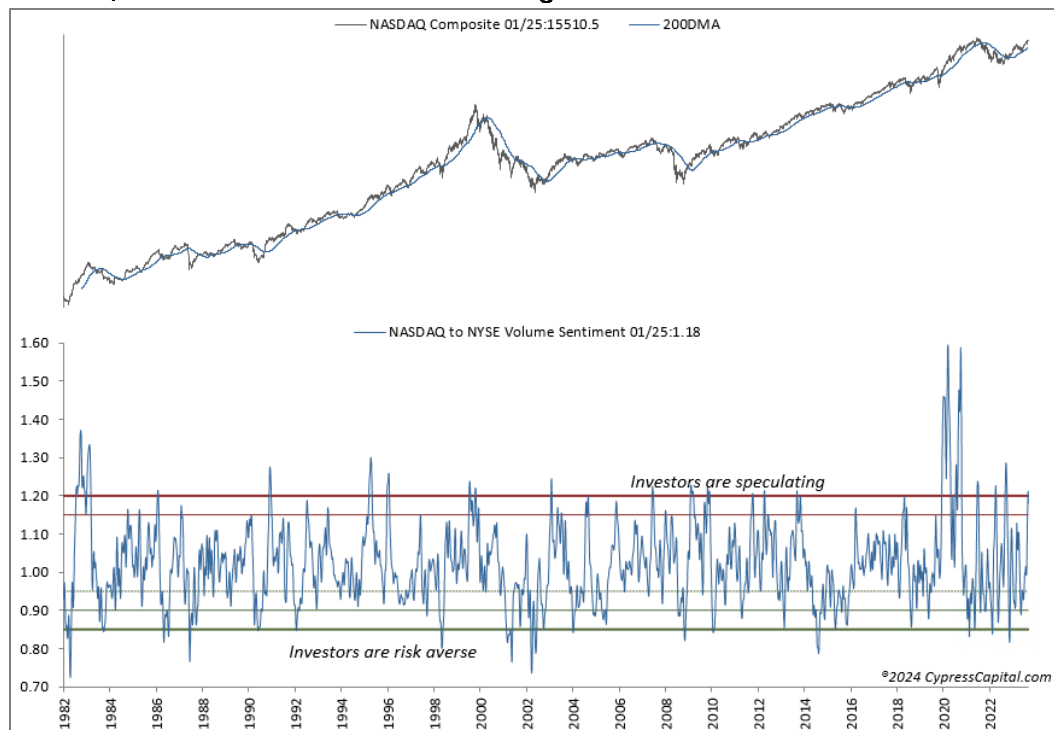
Charts of the Week

New stock market highs when the yield curve is inverted.

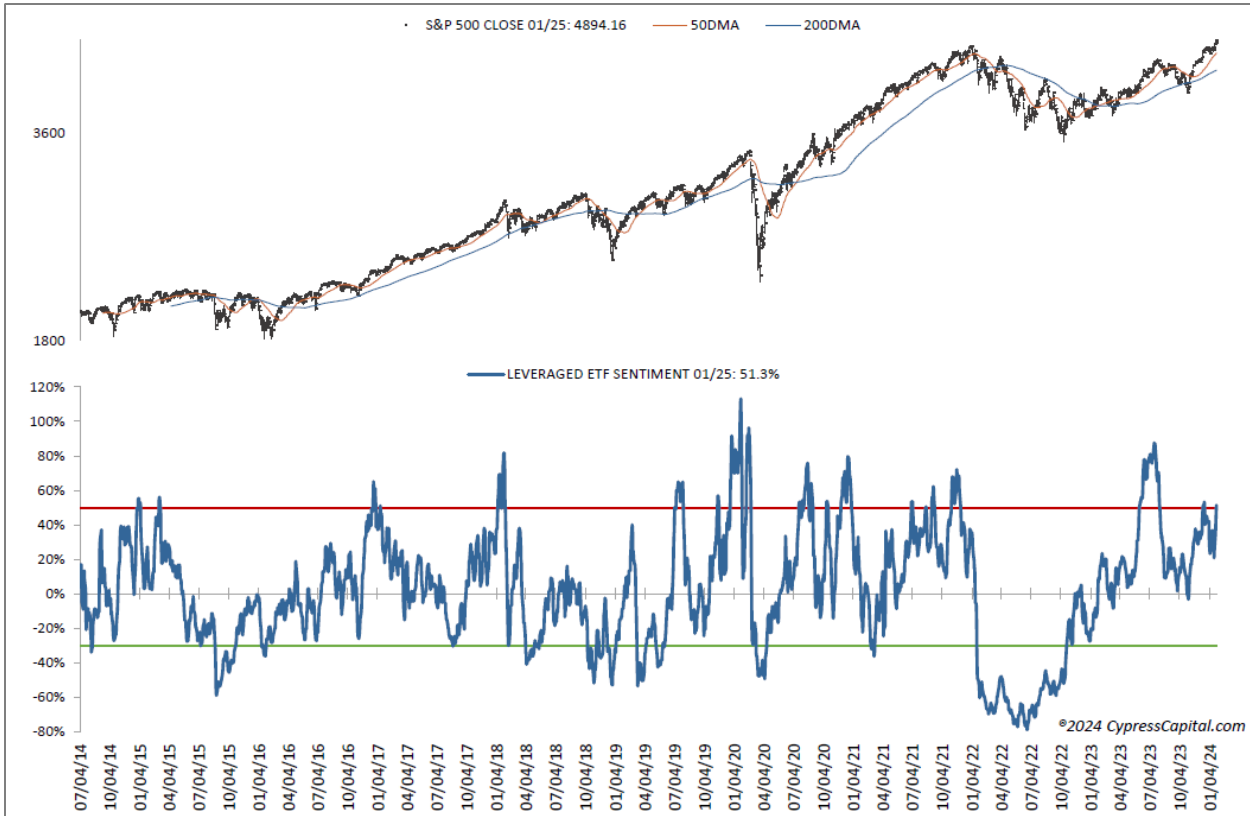
It's happened four other times since 1950, and in every case, either a bear market or a recession was months away.



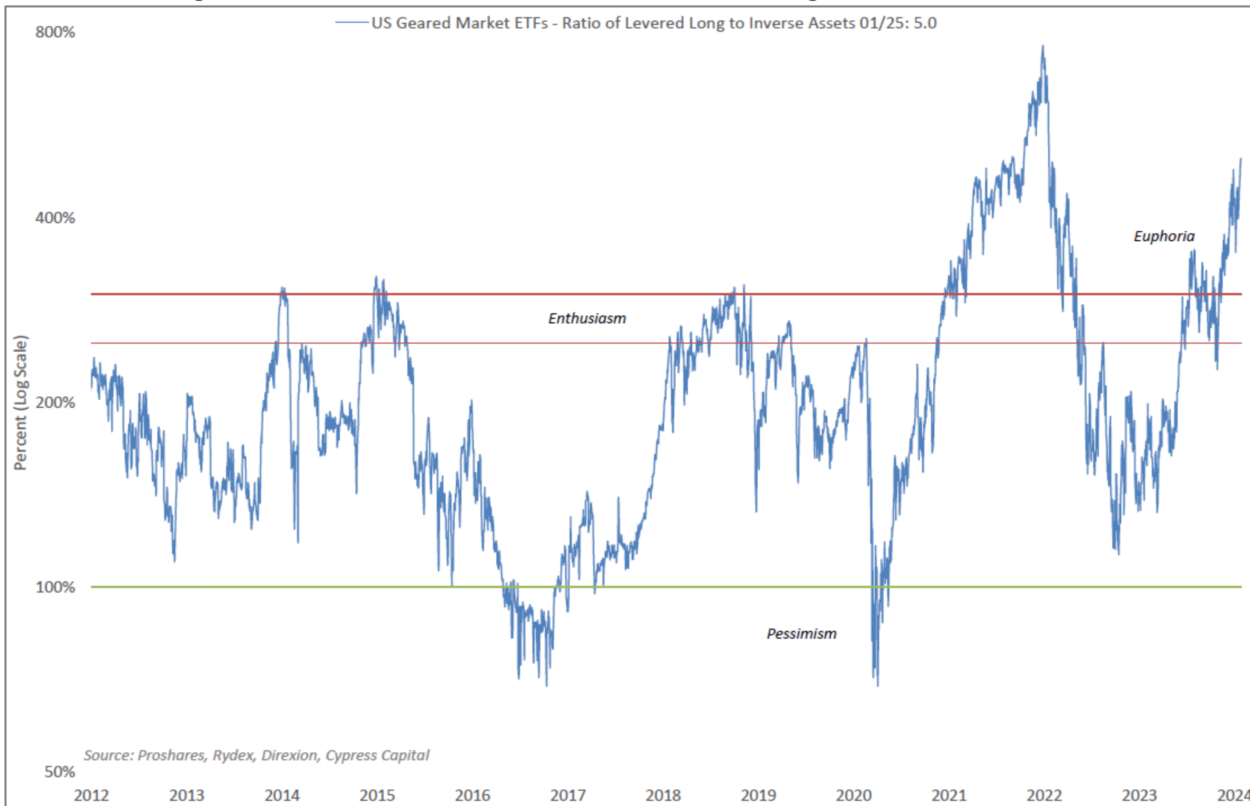
NASDAQ to NYSE Volume Indicator hits the greed line.



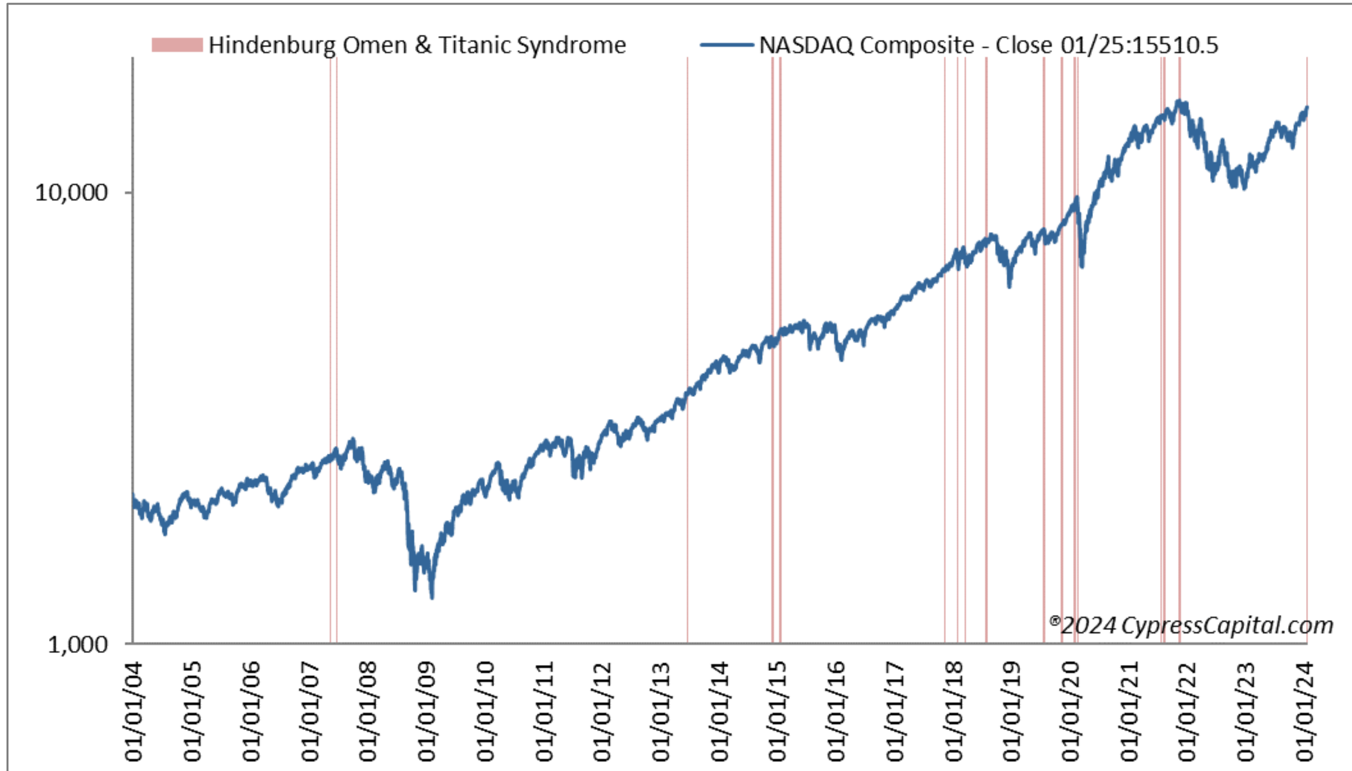
Daily dollar volume in Leveraged ETFs signals euphoria.



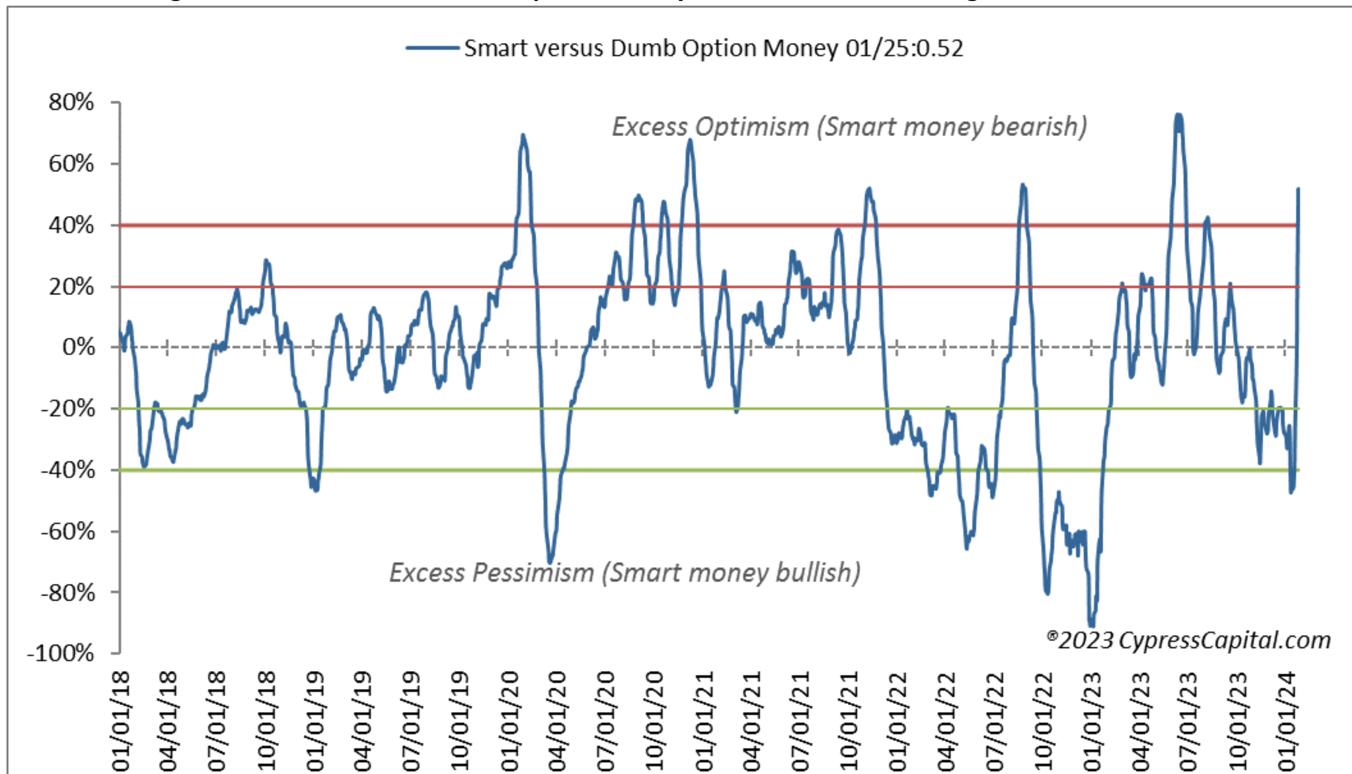
Ratio of Leveraged to inverse ETF assets sets a new bull market high.



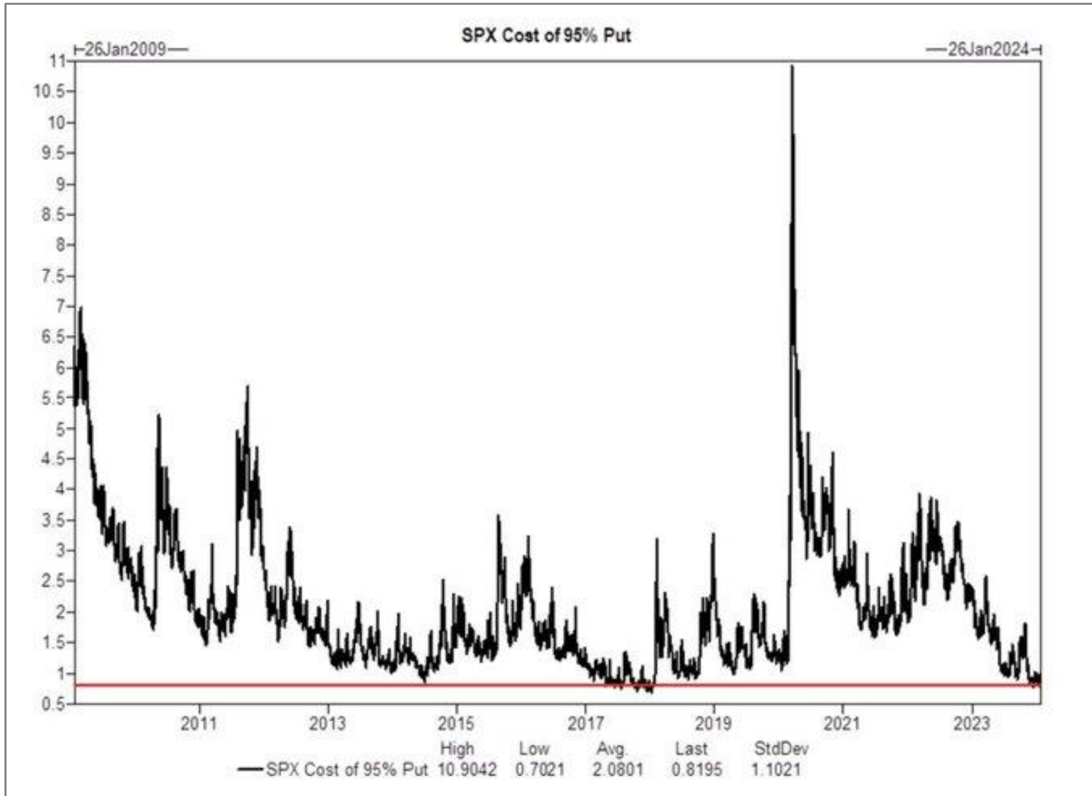
NASDAQ Composite signaled its first combined Hindenburg Omen & Titanic Syndrome



Massive Swing in our Smart versus Dumb Option Money indicator from fear to greed.



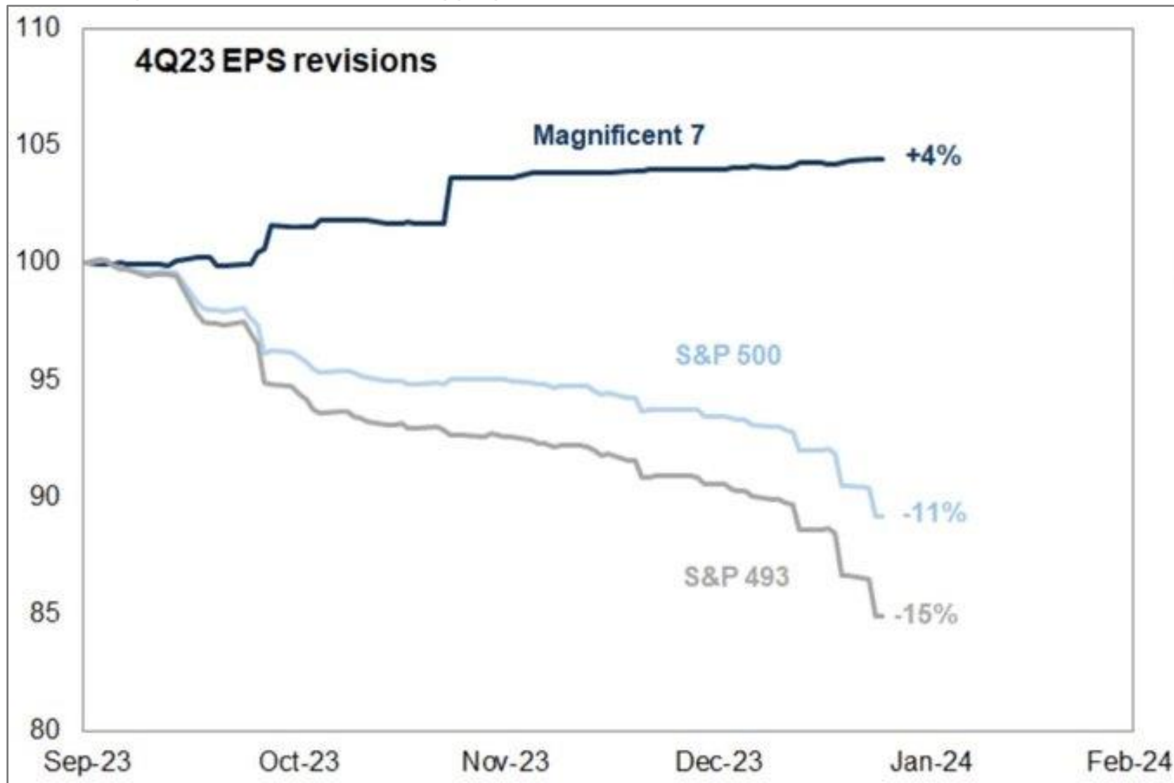
Complacency in markets– the cost to hedge the market has fallen to one of the lowest levels ever.



Source: GS, Barchart

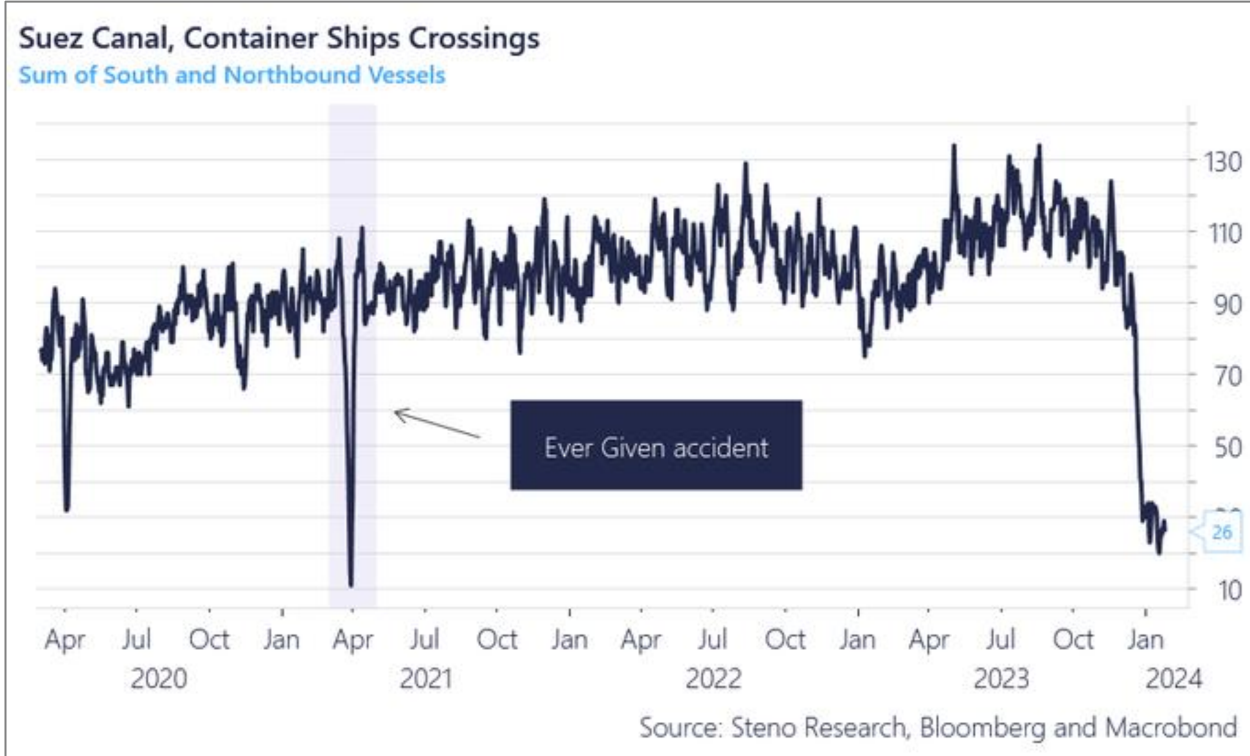
Ratio of NYSE 52 week highs and lows signals a warning.

Not so Magnificent S&P 493 are dragging down Q4 EPS revisions.

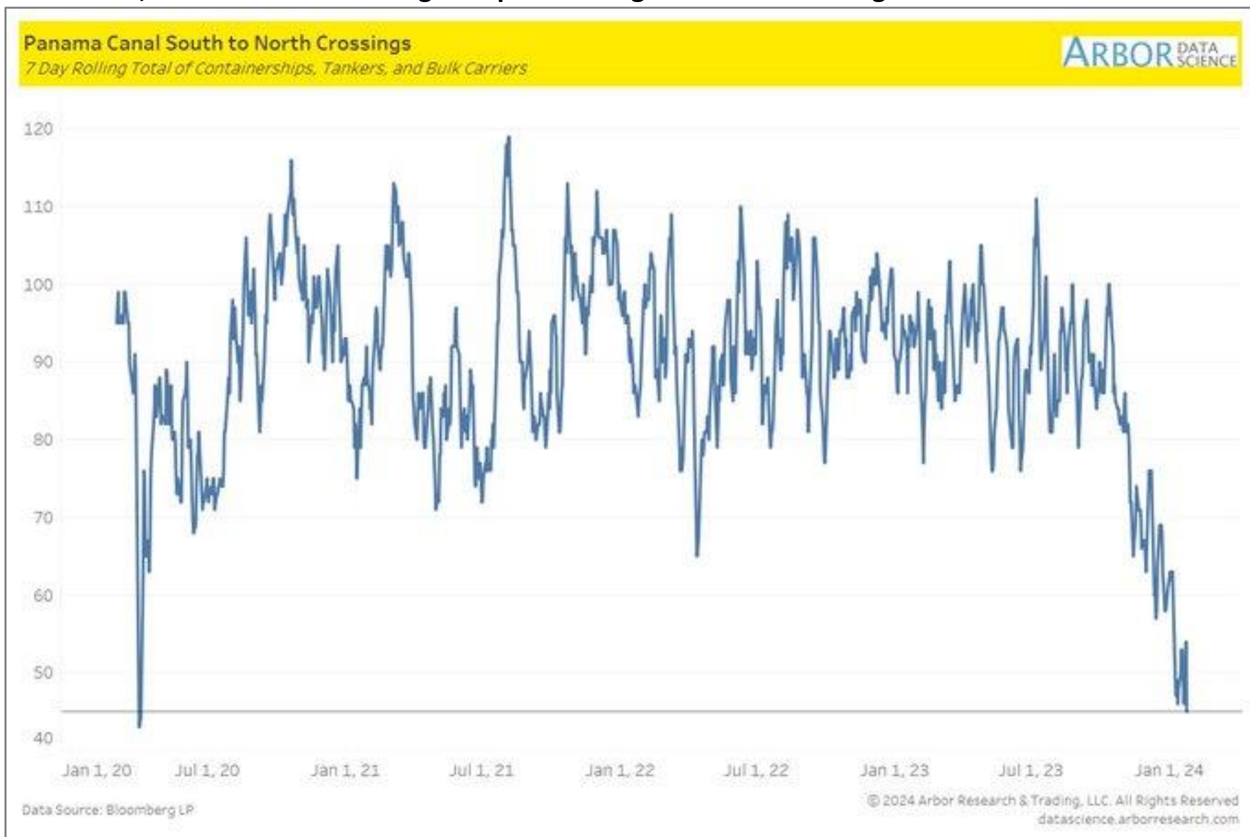


The growing gulf between Tech's share of earnings and Tech's share of the index.

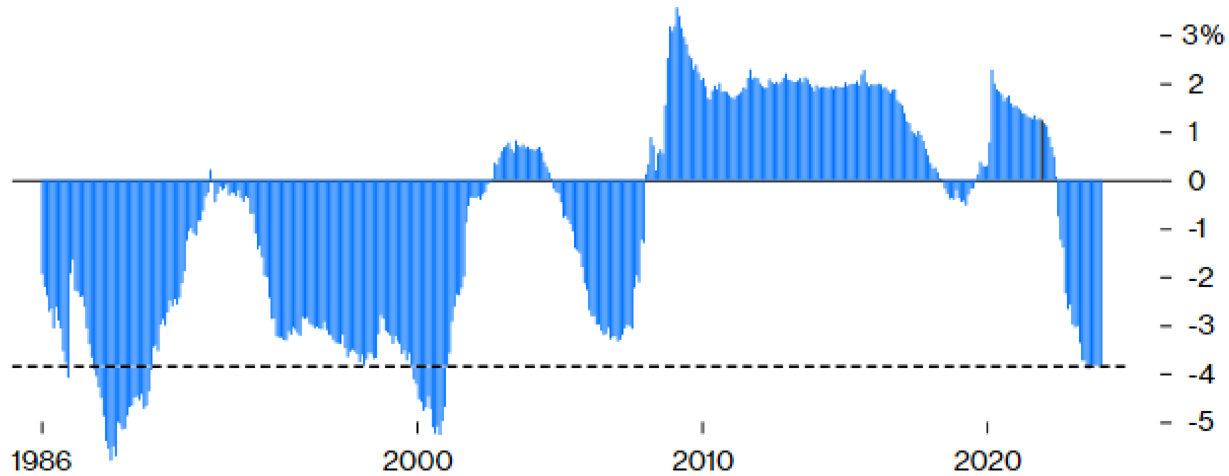
Goods price inflation incoming?
Ship crossings through the Suez have plummeted as a result of Houthi rebel attacks.



Meanwhile, Panama Canal crossings are plummeting as a result of drought.

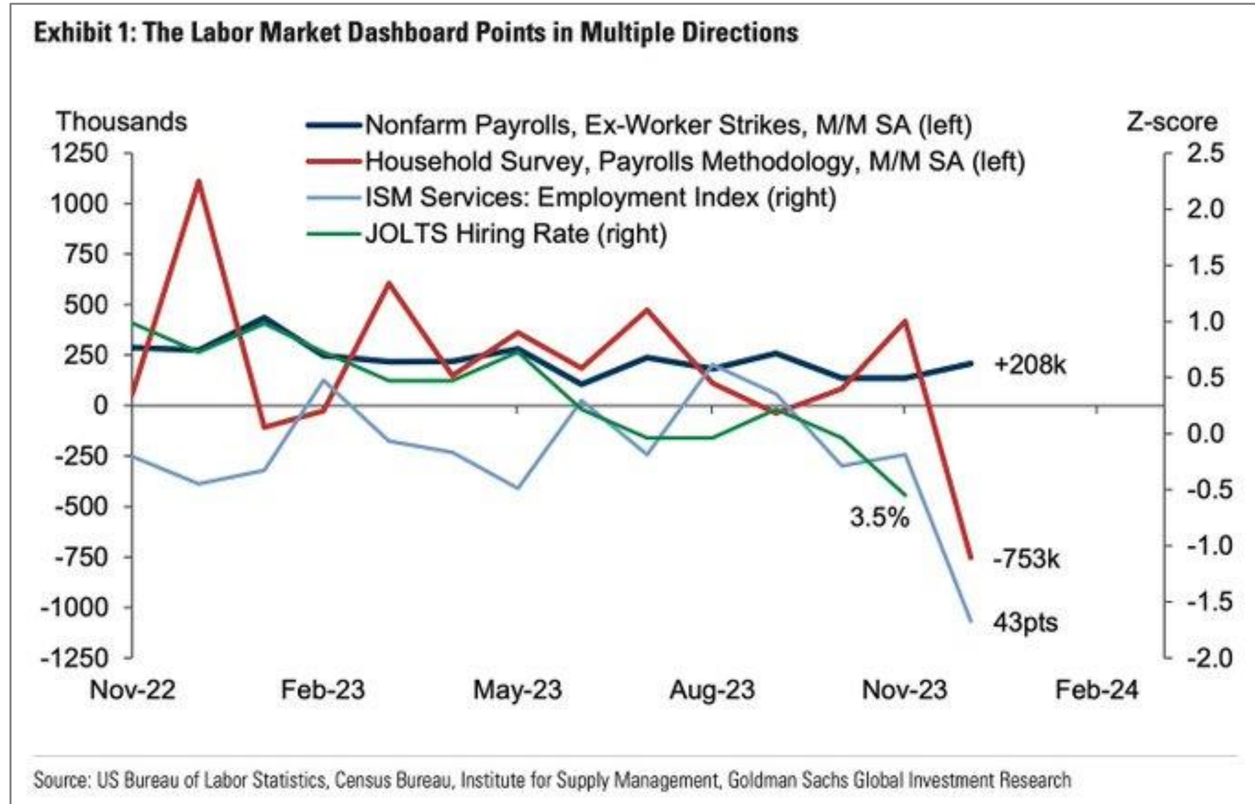


Spread between Treasury Bills and S&P 500 dividend yield is the widest since 2000.

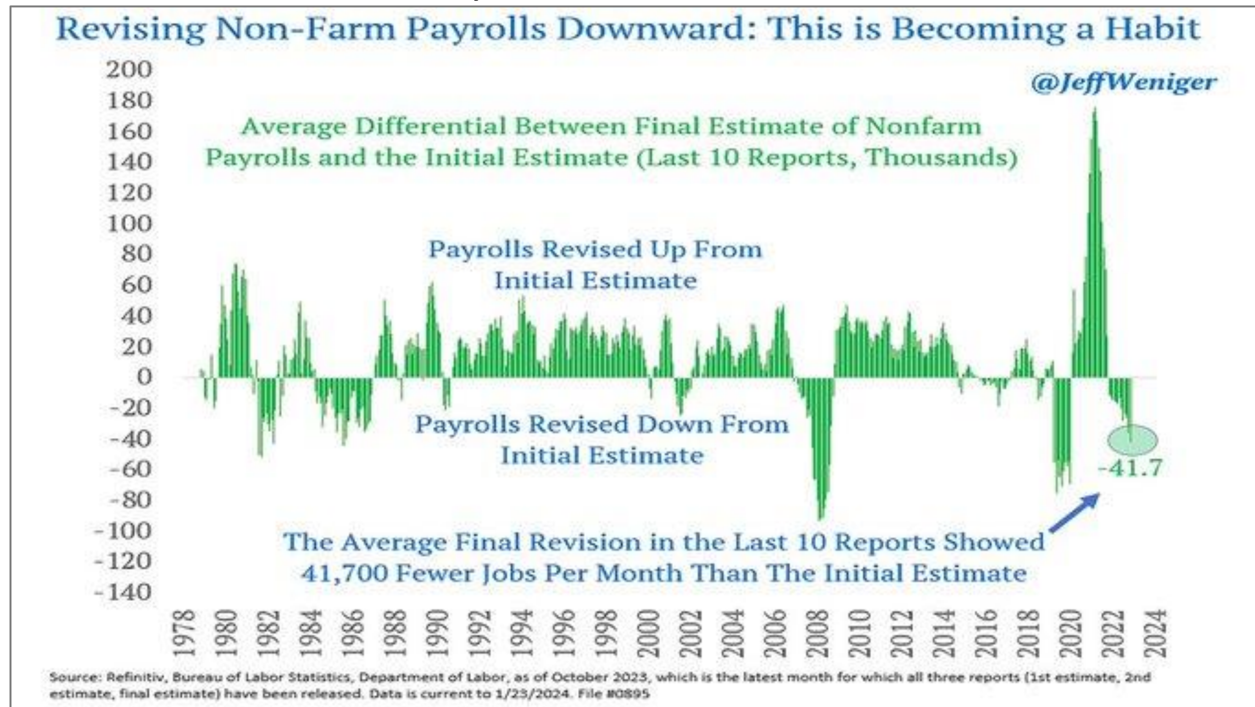


Corporate Bond spreads are at the tightest level in two years.

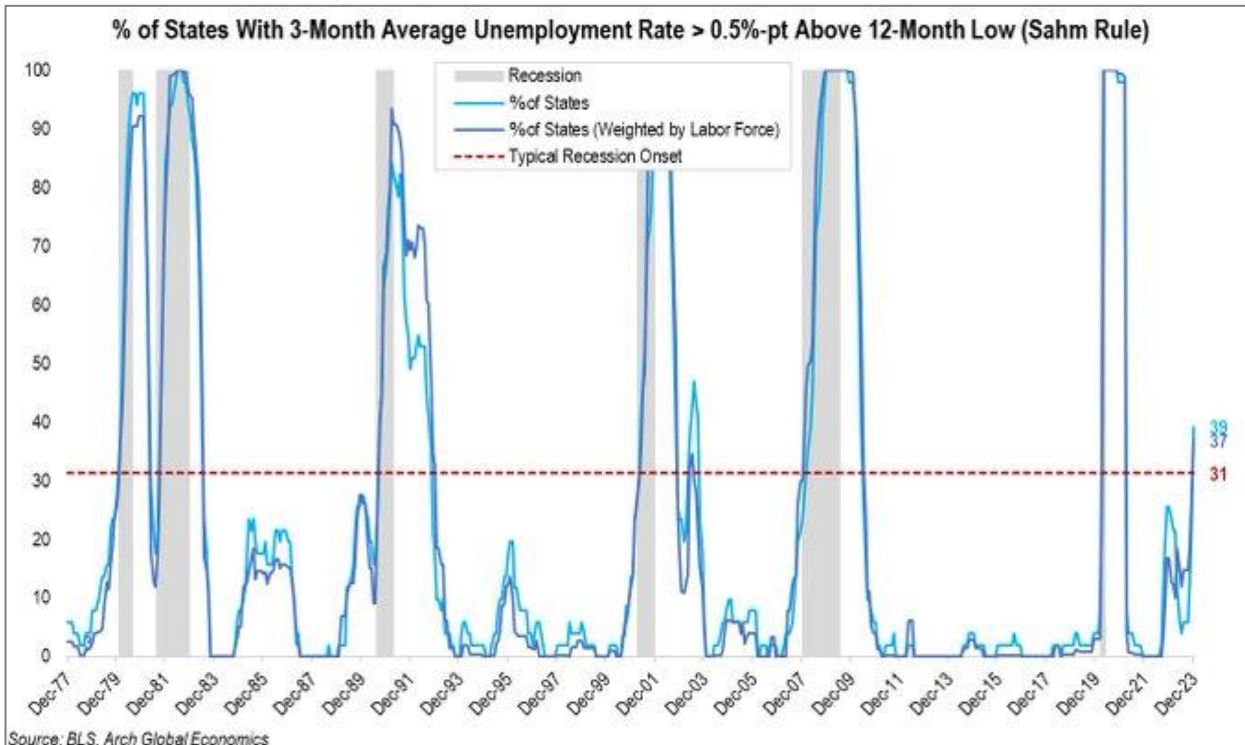
Nonfarm Payrolls data is at odds with other labor market indicators.



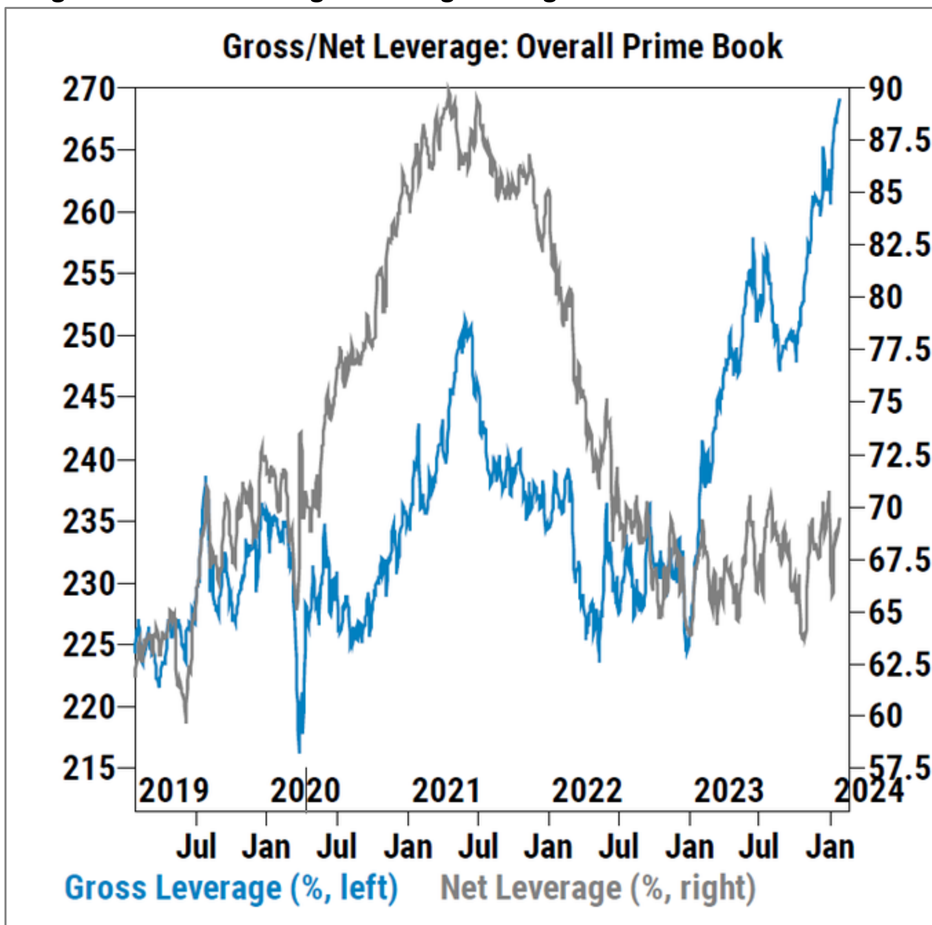
But, the recent trend for Non-Farm Payrolls data is to revise it lower.



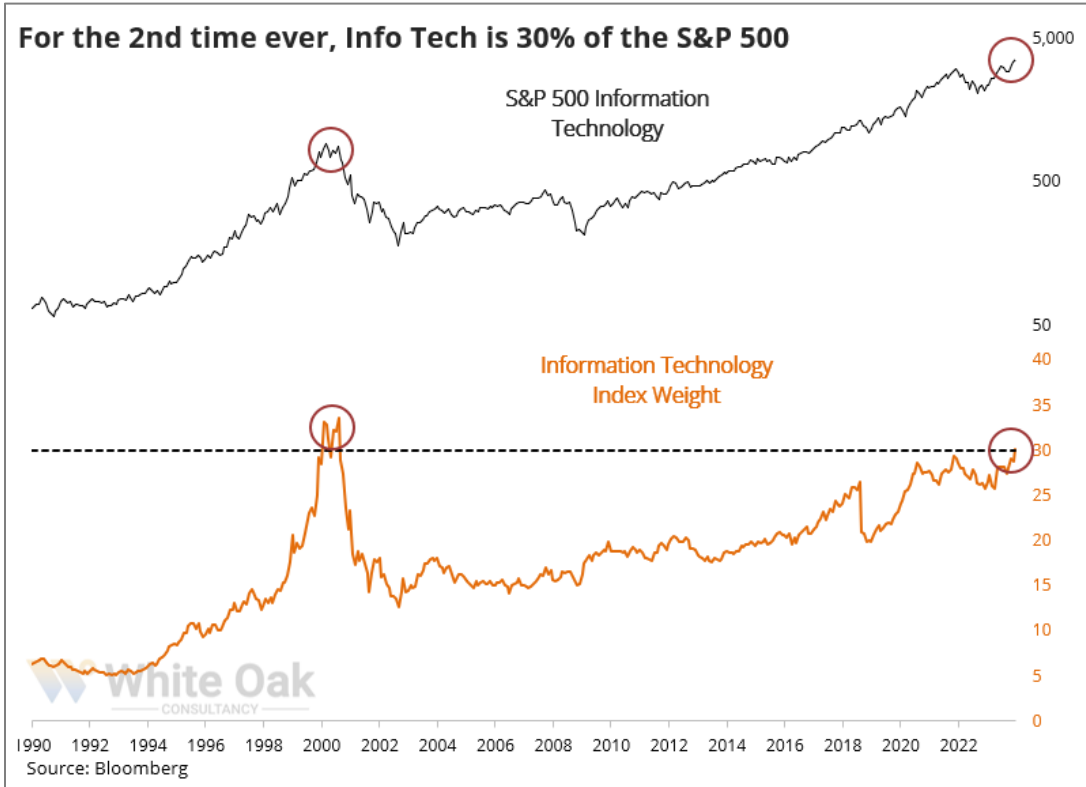
Percent of States with rising unemployment looks recessionary.



Hedge Fund Gross Leverage is setting new highs.

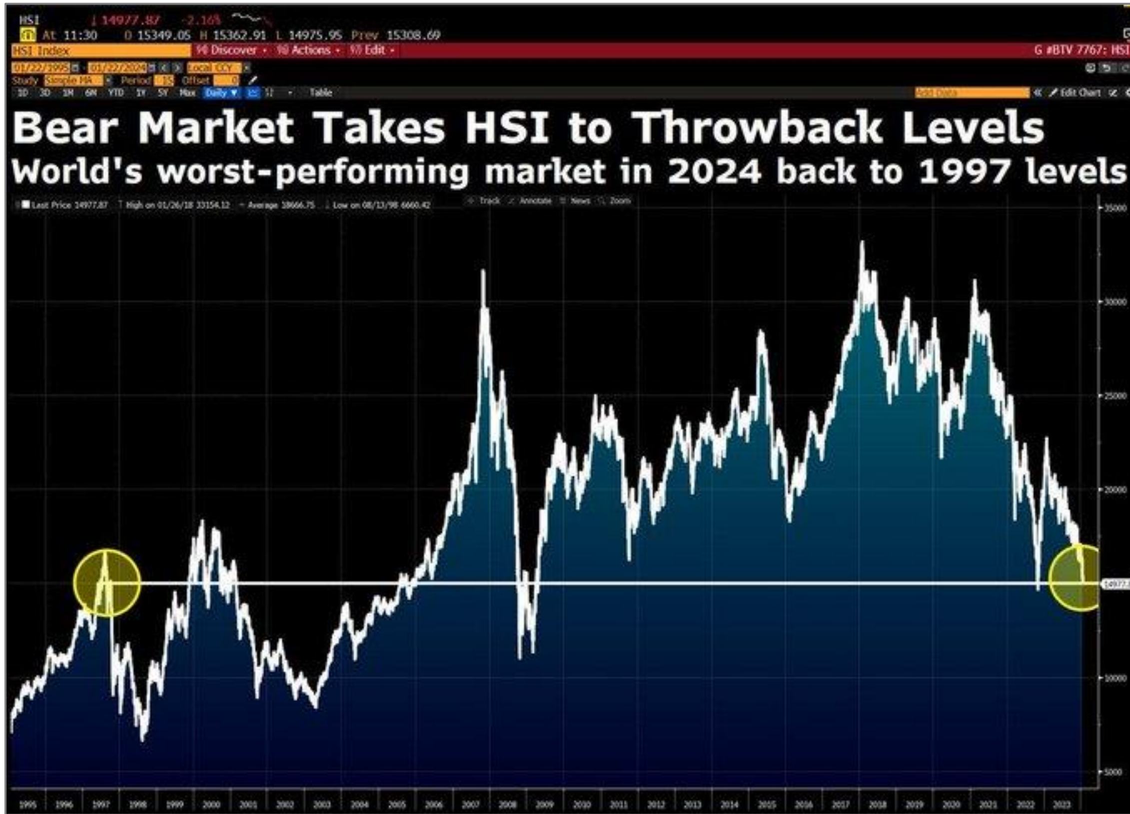


Tech's share of the S&P 500 climbs above 30% for the first time since 2000.

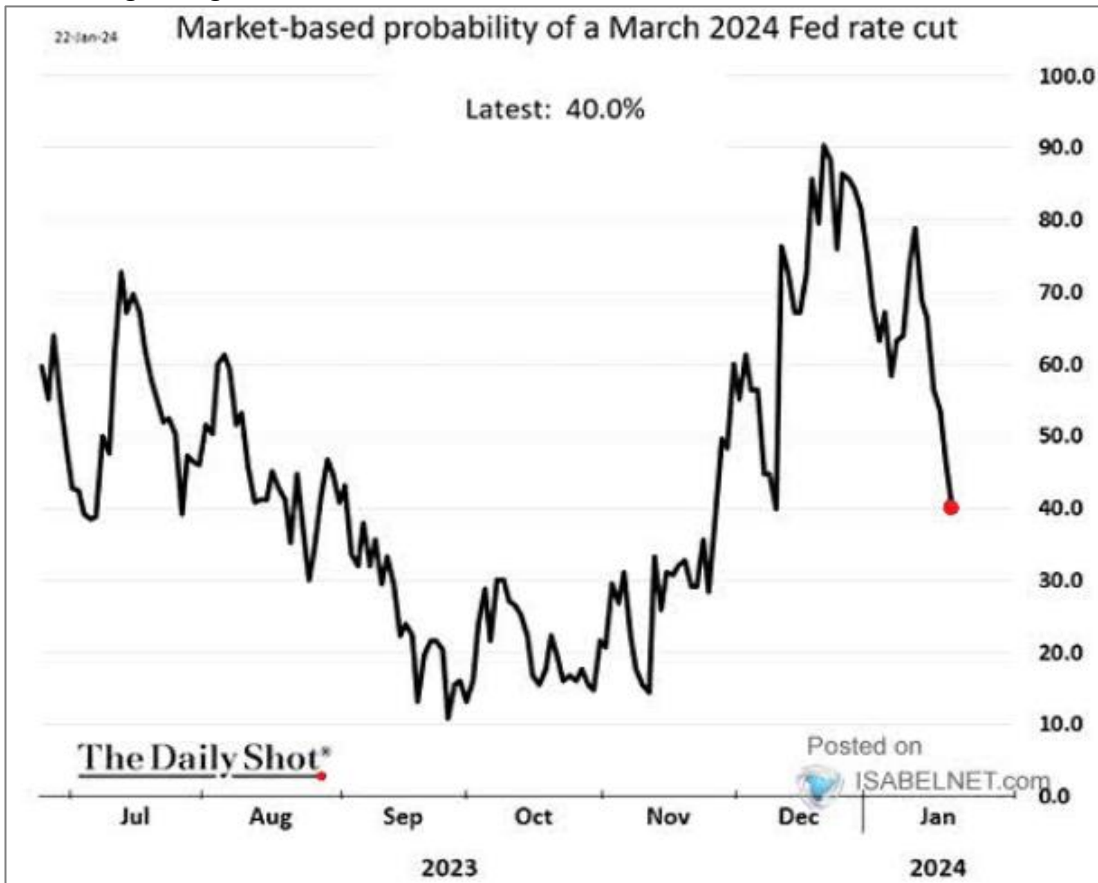


The stock market hasn't been this concentrated in over a century.

Hong Kong's bear market has taken it back to 1997 levels.



Market is growing less confident of a March rate cut.



Spread between Consumer Confidence and Consumer Sentiment Index still looks late cycle.

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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