Market Outlook

By Mark T Dodson, CFA

It's Okay to be a Pig.

Market Risk Index climbed to 77.6%, with Psychology and Valuations climbing simultaneously into the worst 2% of readings since 1970.

Psychology worsened, but we're seeing a lower high in euphoria on individual indicators. Instead, more categories are signaling greed simultaneously – euphoria is more pervasive. Surveys were one such category, not breaching the January highs but worsening to become one of the largest detractors of the composite.

Valuations also deteriorated, with our return expectations for stocks falling further and the value offered by Treasury bonds relative to stocks climbing higher and closer to challenging the gulf we saw during the dot-com era when investors all but shunned Treasury bonds for Internet stocks.

Meanwhile, Monetary Conditions, sans the yield curve's warning, are generally favorable for markets. Juxtaposed with such polar opposite extremes coming from Investor Psychology and Valuations, our Asset Allocation Model offers us no other conclusion than policymakers are doing their best to maintain a permanently high plateau in both confidence and valuations. You don't have to believe our quantitative to work to see it. The government is running recession-level deficits in a full-employment environment. If interest expense on the Federal debt can serve as proxy for maintaining confidence as one of the nation's top priorities, it's on the cusp of overtaking national defense spending.

The only other period in US stock market history that came close to maintaining a permanently high plateau in valuations was the 60s – a time referred to as the Go-Go Years. The parallels are there. Like this market, which has cycled from FAANG to the Magnificent Seven, that era cycled from theme to theme to maintain elevated valuations – from putting "tronics" in the name of your company to its ultimate culmination with the Nifty-Fifty stocks in the early 70s. New investment products were also lauded – from the advent of the mutual fund to the hedge fund – it's not hard to draw the line to an analog to SPACs or Crypto from there.

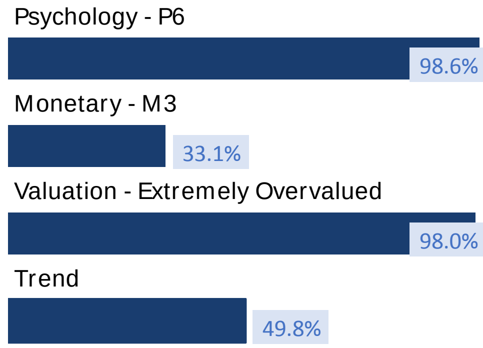
Sixties-era investors became further emboldened when valuations not challenged since the 1929 stock market peak were initially followed only by mild bear markets – not too different from today's comparisons to the dot-com era and recent interventions by

Market Risk Index

Rec Allocation 25% Underweight

77.6%

Category Percentiles



Largest Psychology Influences

Leveraged Investments	Negative
Surveys	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	0.9%
10Yr US Treasury Yield	4.3%

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.

government officials at the slightest hint of a drawdown. As time passes without incident, belief in the permanently high plateau grows – to the benefit of momentum and growth investors.

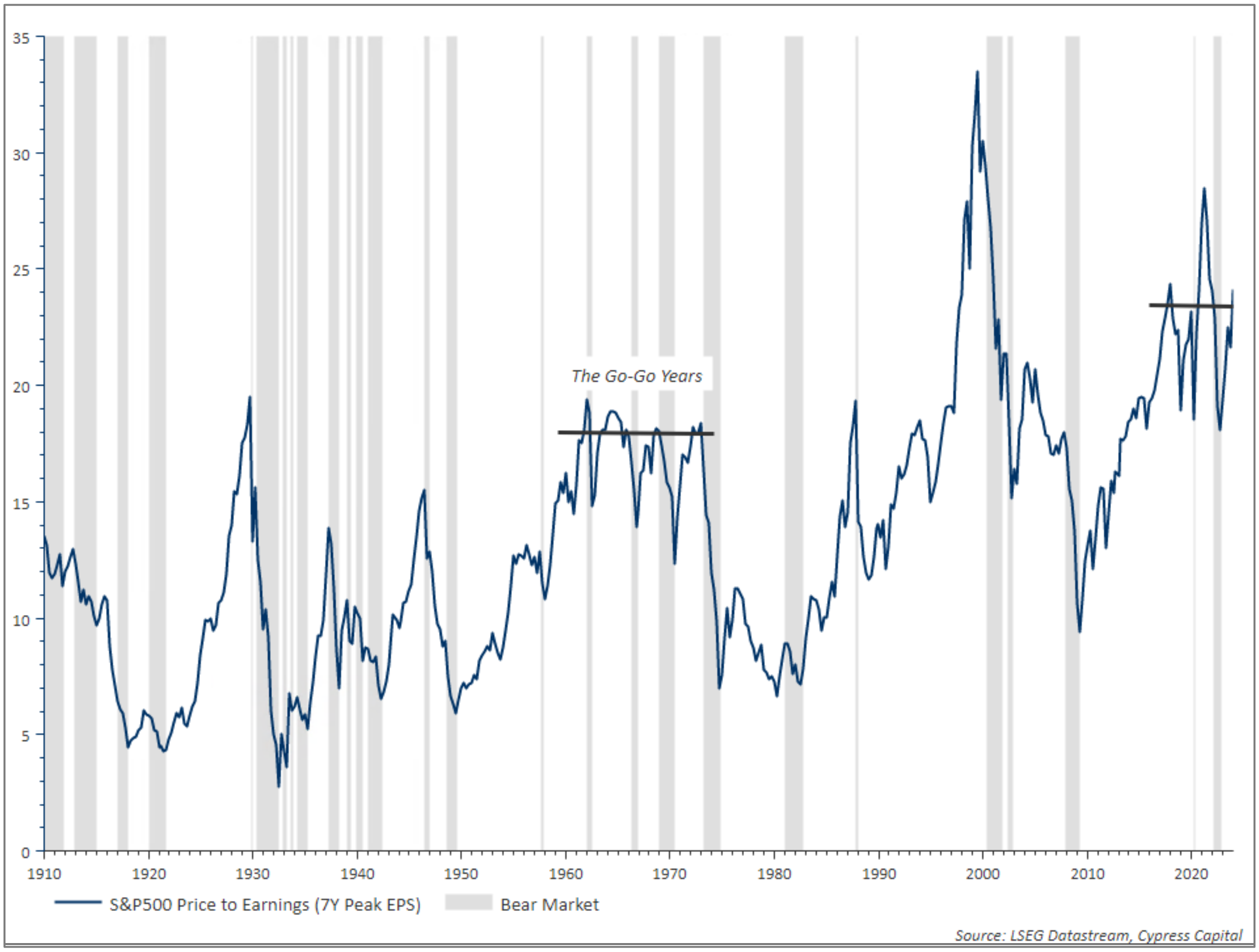
Policymakers need to protect the permanently high plateau by maintaining the confidence of consumers and investors at above-average levels, and they can often do that for longer than investors who are too rational and stubborn can remain solvent. Ultimately, the iron laws of valuation and economics set the world back on the straight and narrow.

Demise for the Go-Go years came in the form of inflation. Investors had grown complacent about the prospect of inflation after a generation of not worrying about it, and they subsequently ignored the dwindling premium above inflation that equity valuations implied. The lesson sunk in all at once, as the premium that investors required to own financial assets to compensate them for inflation increased sharply, and in short order. Avoiding lost decades is about not being over-exposed to risky financial assets over short windows of time when investors take off the rose-colored glasses.

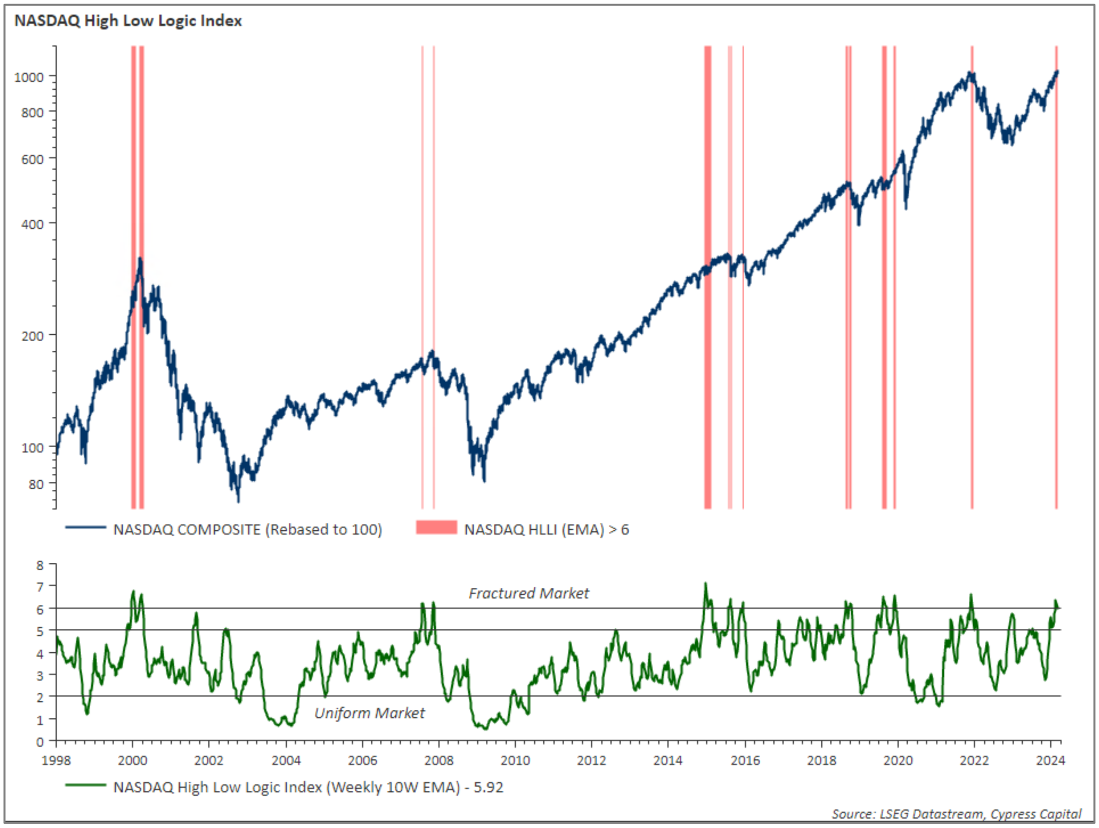
We don't advocate that investors bury their heads in the sand and avoid investing in financial markets altogether – we are advocates of maintaining a balance between extremes in your approach, even in frothy markets. The promise of technological innovations and new financial instruments is worthwhile and to be lauded. Still, investors in financial markets should never forget the lesson that financial market history has taught us over and over – pigs get fat, and hogs get slaughtered.

Charts of the Week

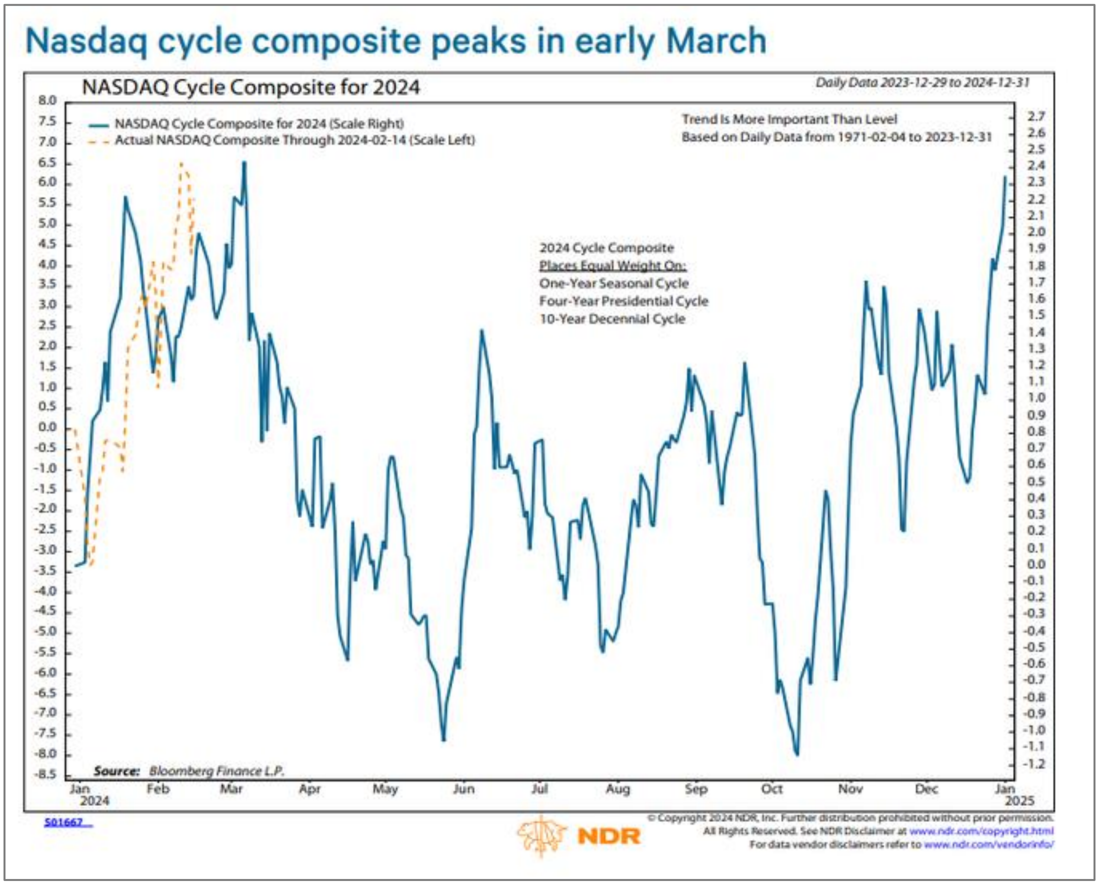
Stock market valuations and investor behavior trace a pattern similar to the mid-to late-60s.



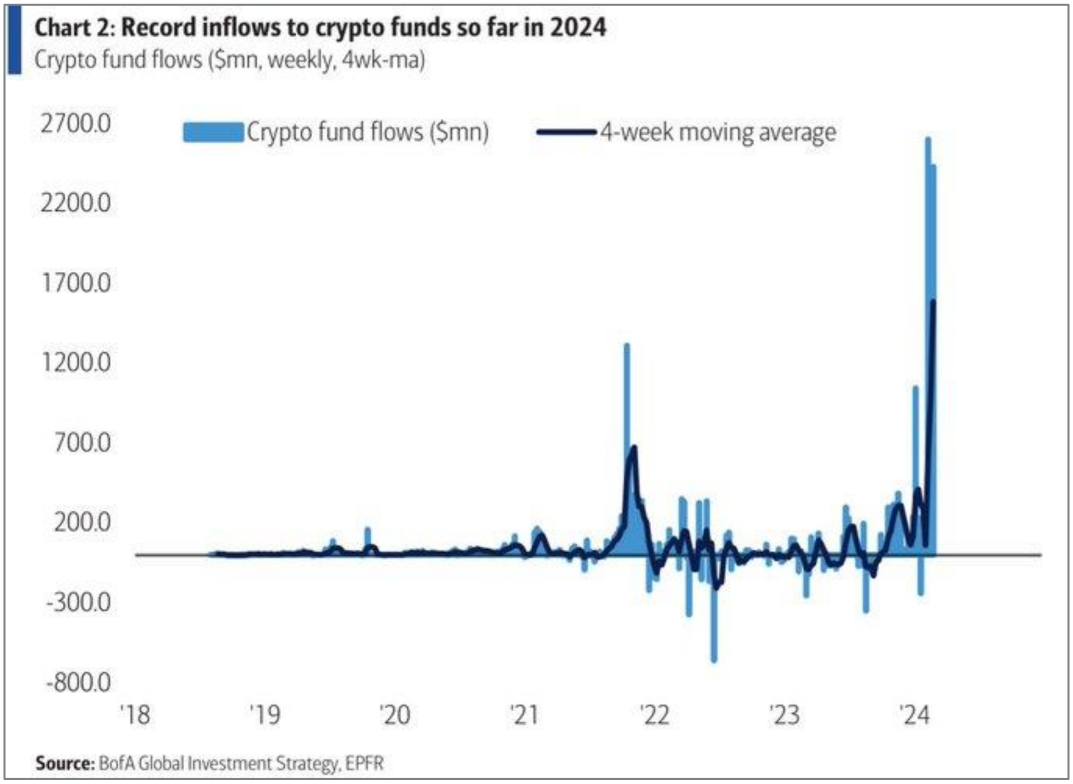
NASDAQ High Low Logic Index improved enough to bookend its recent warning.



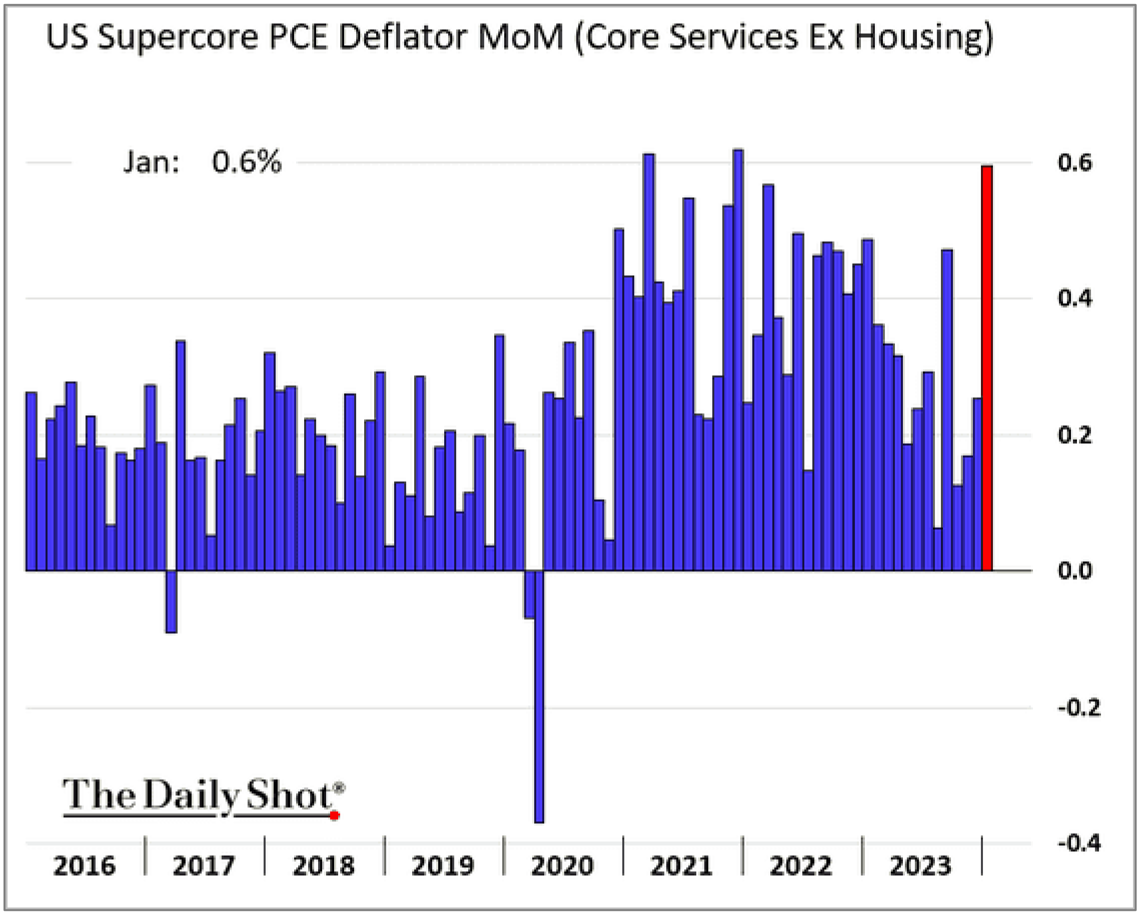
Composite of Seasonal Cycles for the NASDAQ peaks in March.



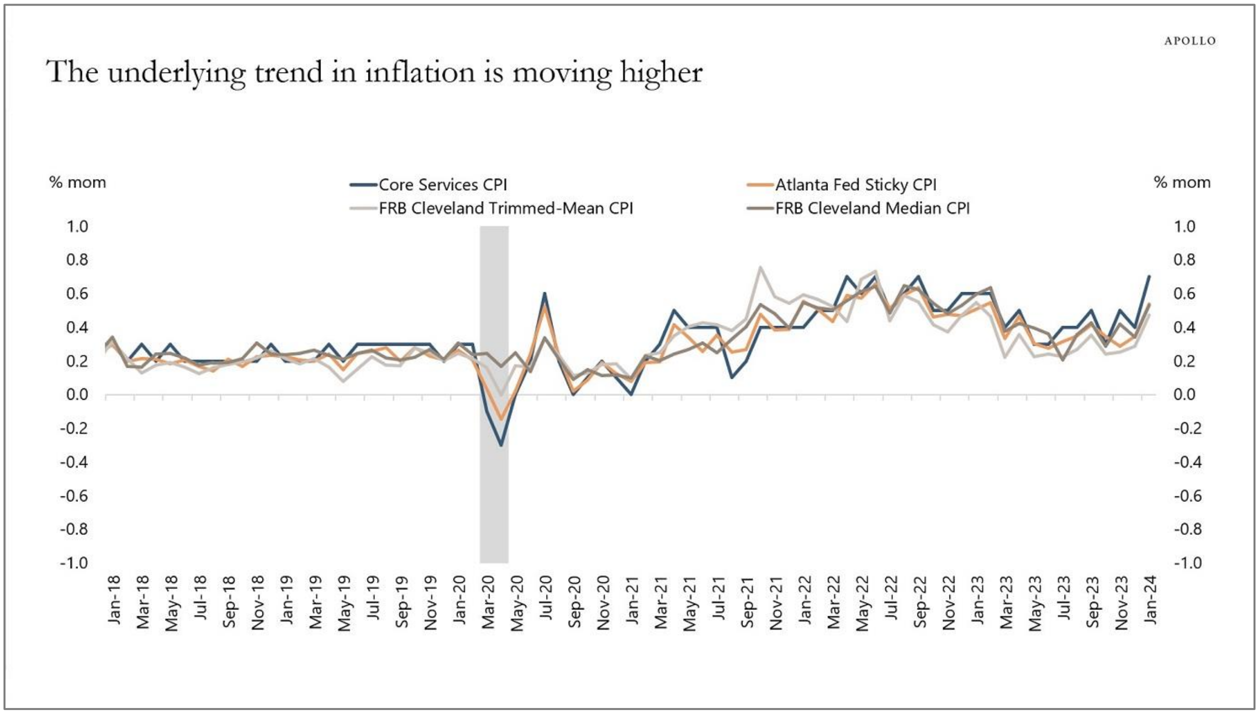
Record Crypto Fund Inflows



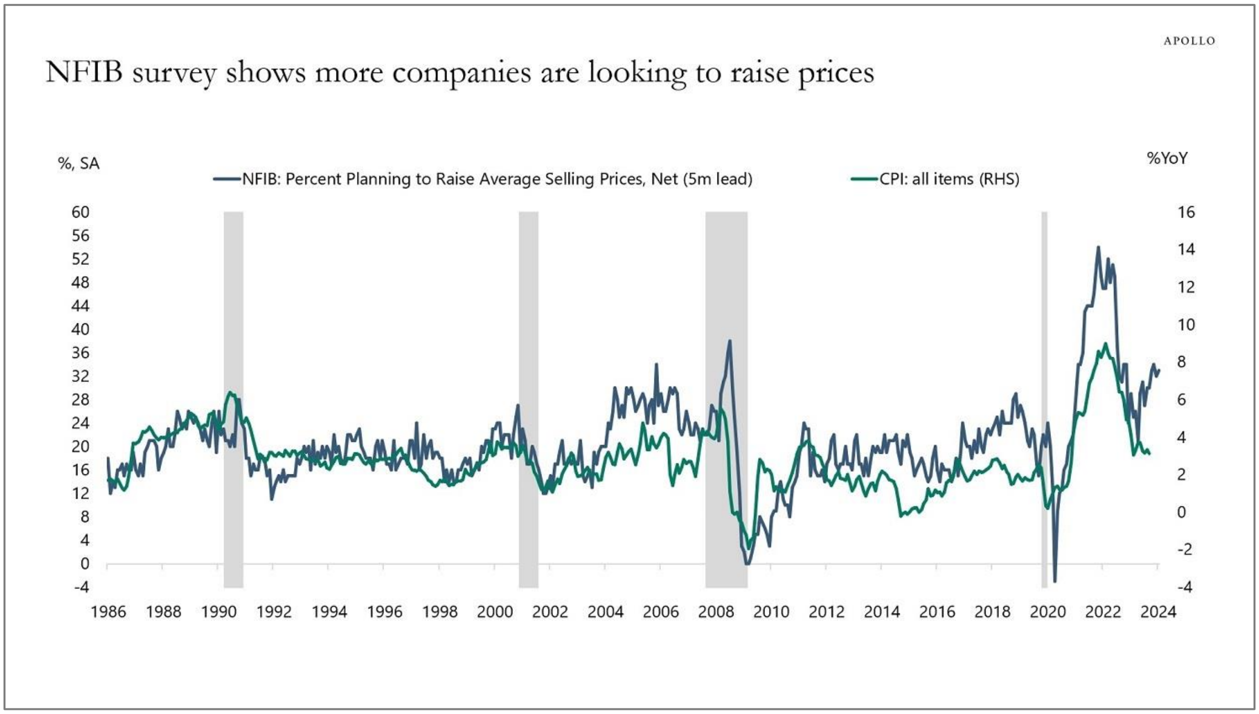
Supercore Inflation showed a substantial pickup in January.



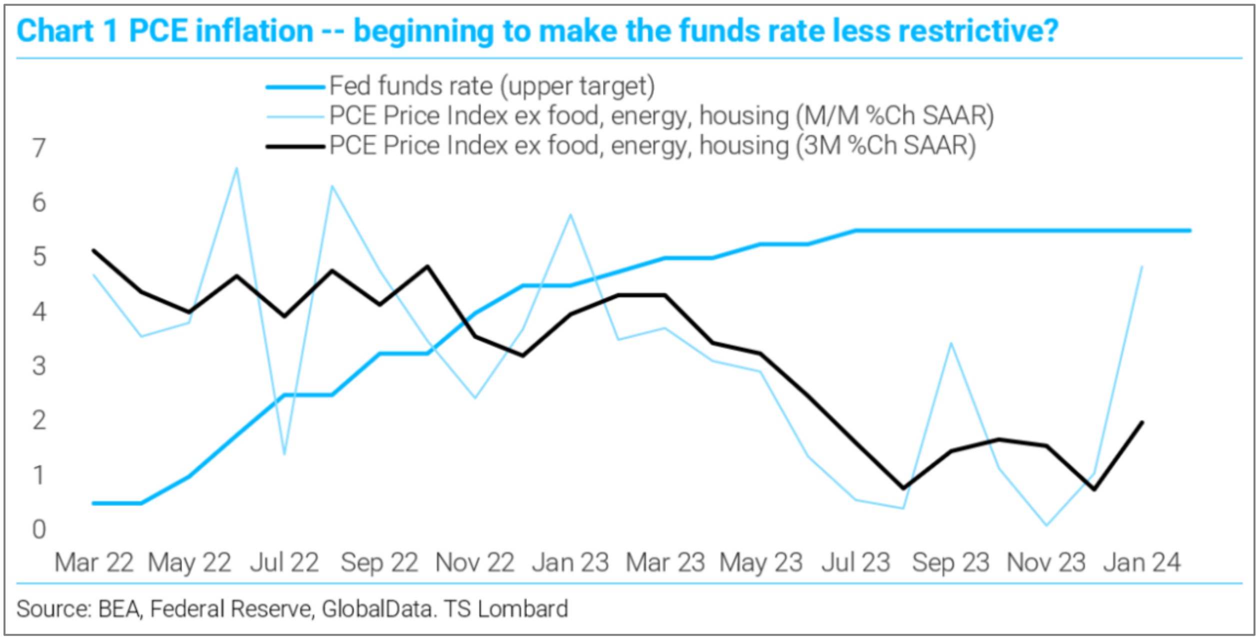
The underlying Inflation Trend is moving higher.



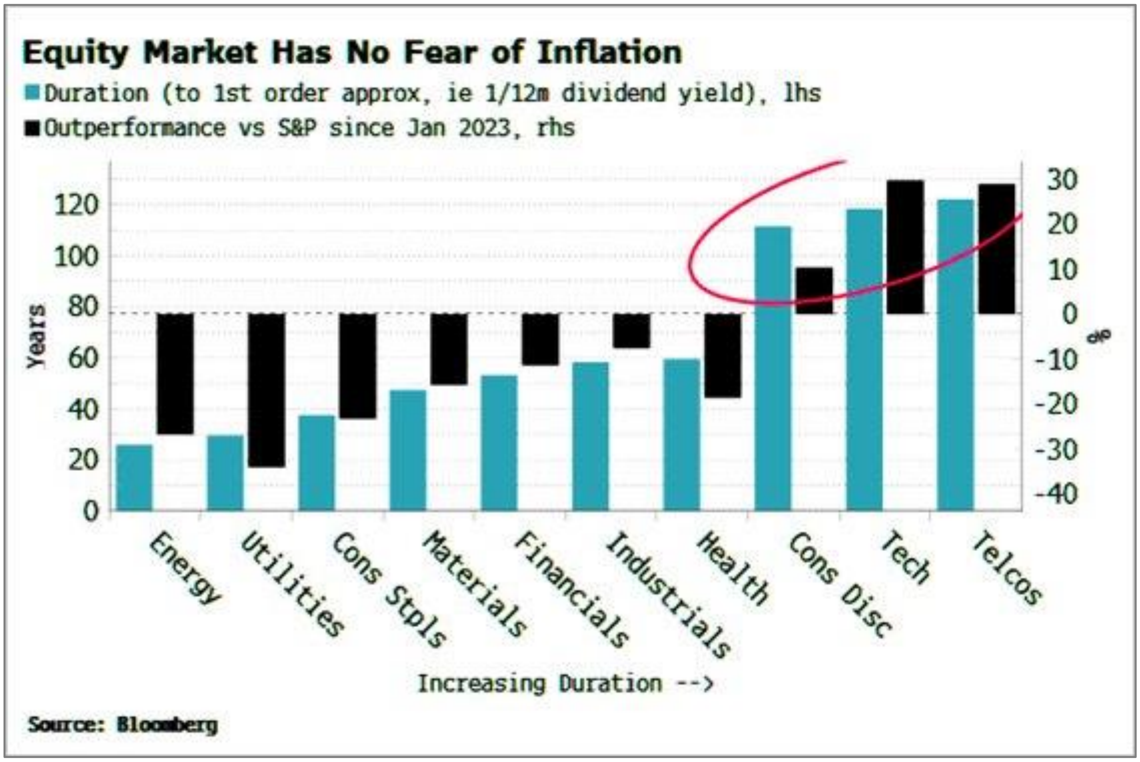
More companies are looking to raise prices.



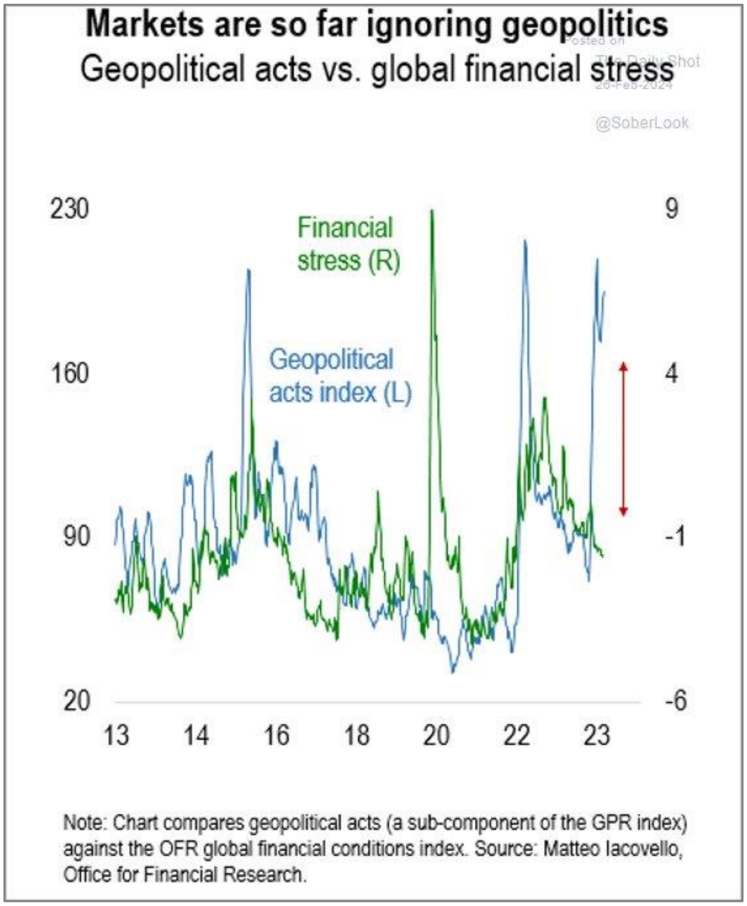
Inflation upturn is making the current Fed Funds rate look less restrictive.



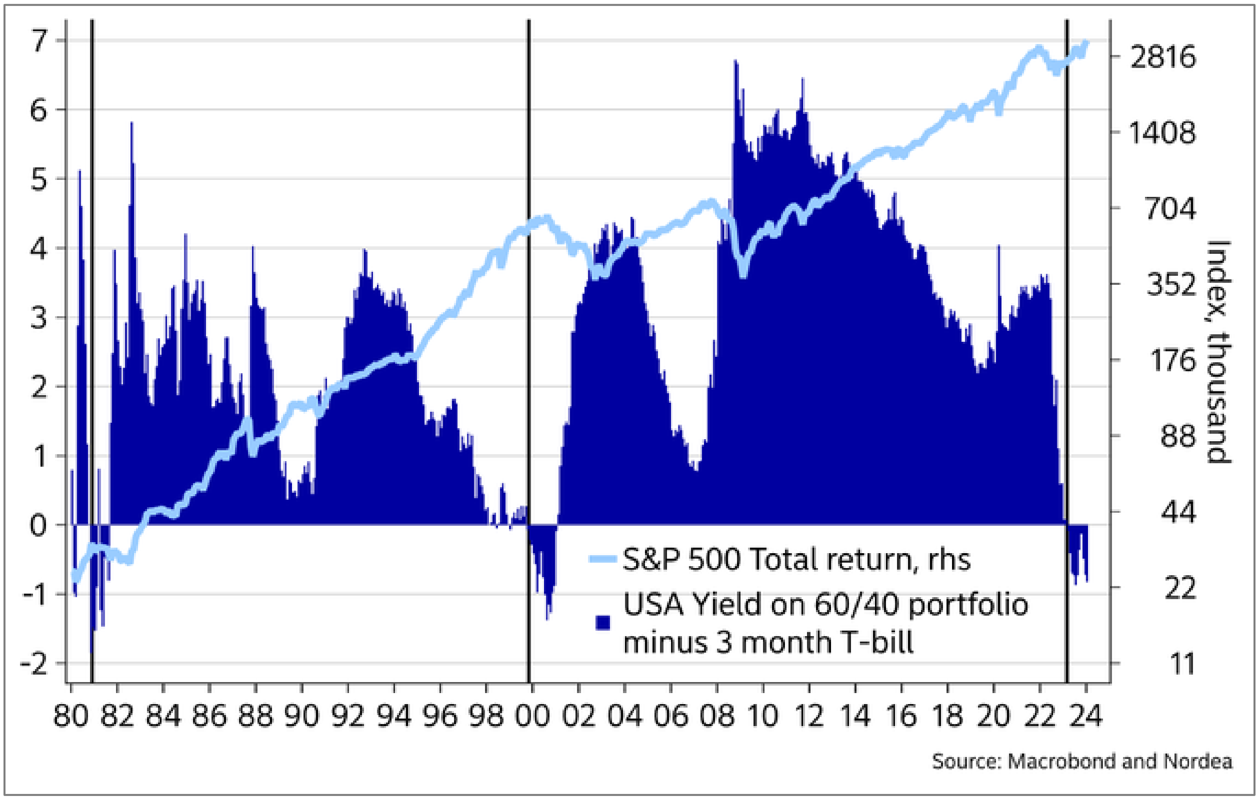
Equity Markets are complacent to Inflation risks.



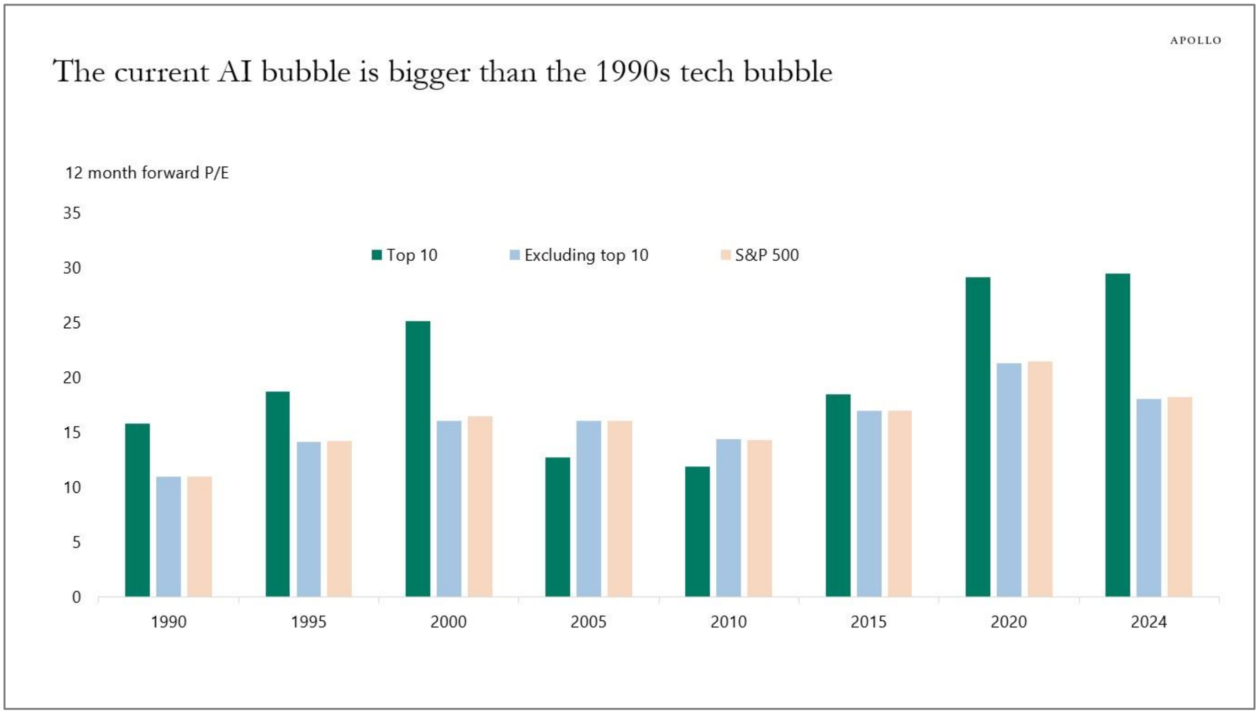
Markets are also complacent to geopolitical risks.



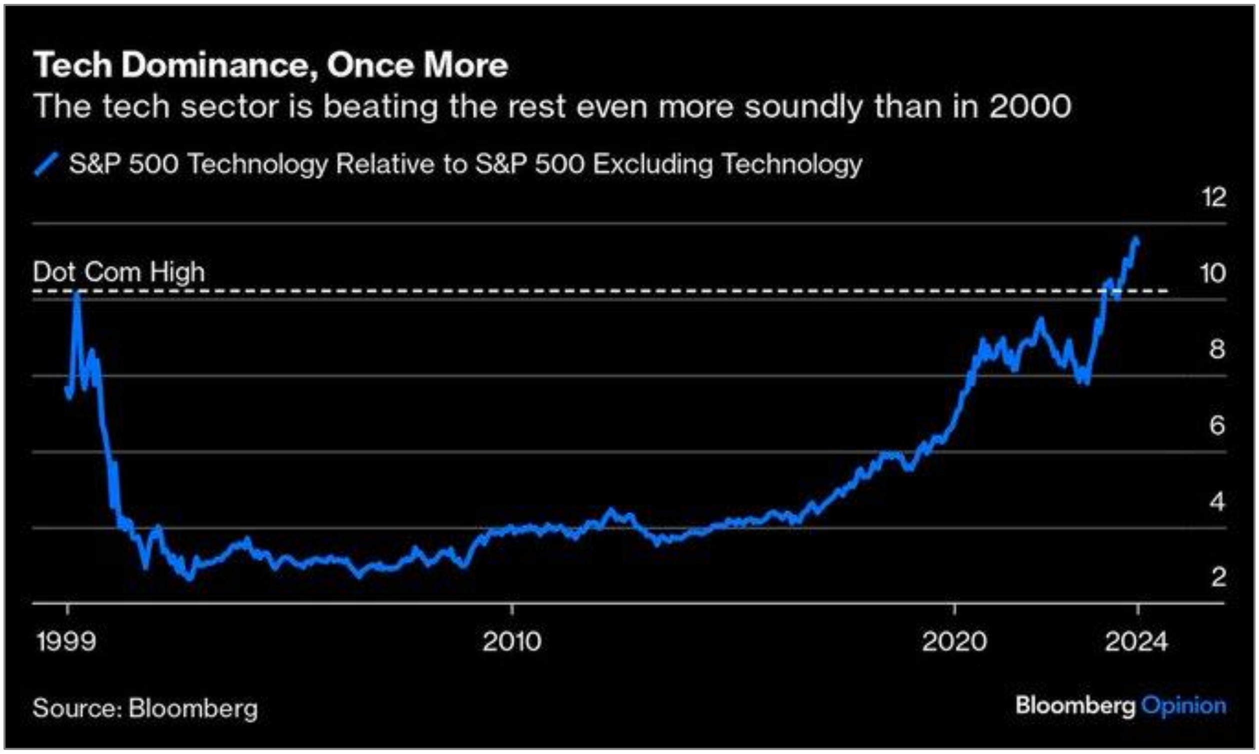
The yield on a traditional 60/40 portfolio have fallen below T-Bill yields for only the 3rd time in 45 yrs.



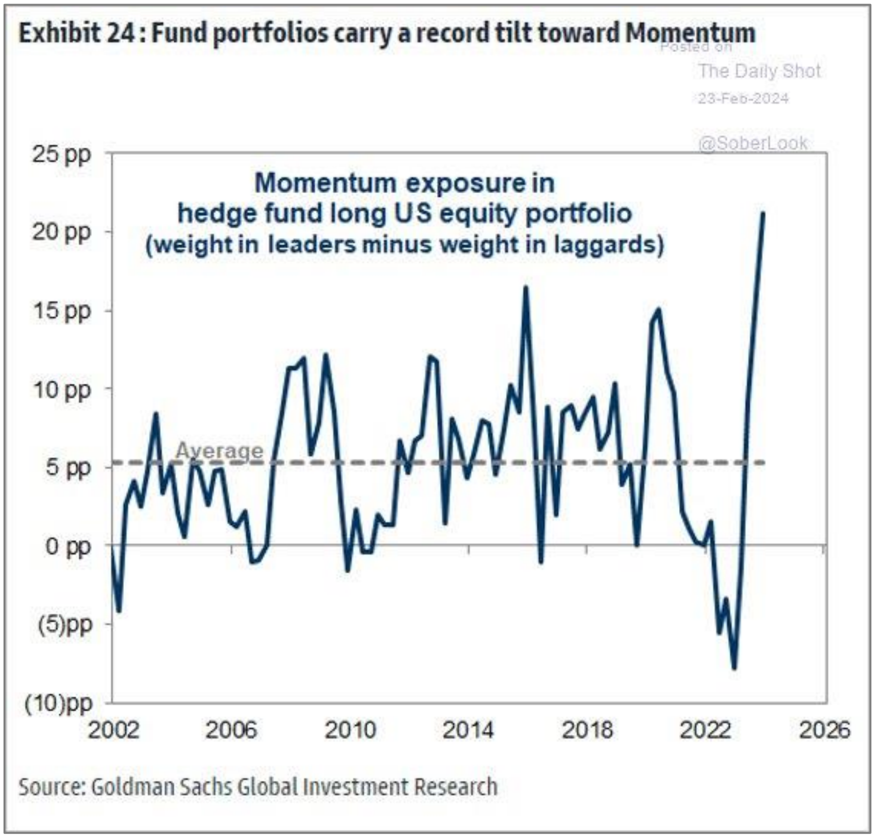
AI Bubble is already larger than the Dot-Com and the Covid-Stimulus bubbles.



Tech sector's outperformance is more extreme today than in 2000 by this measure.

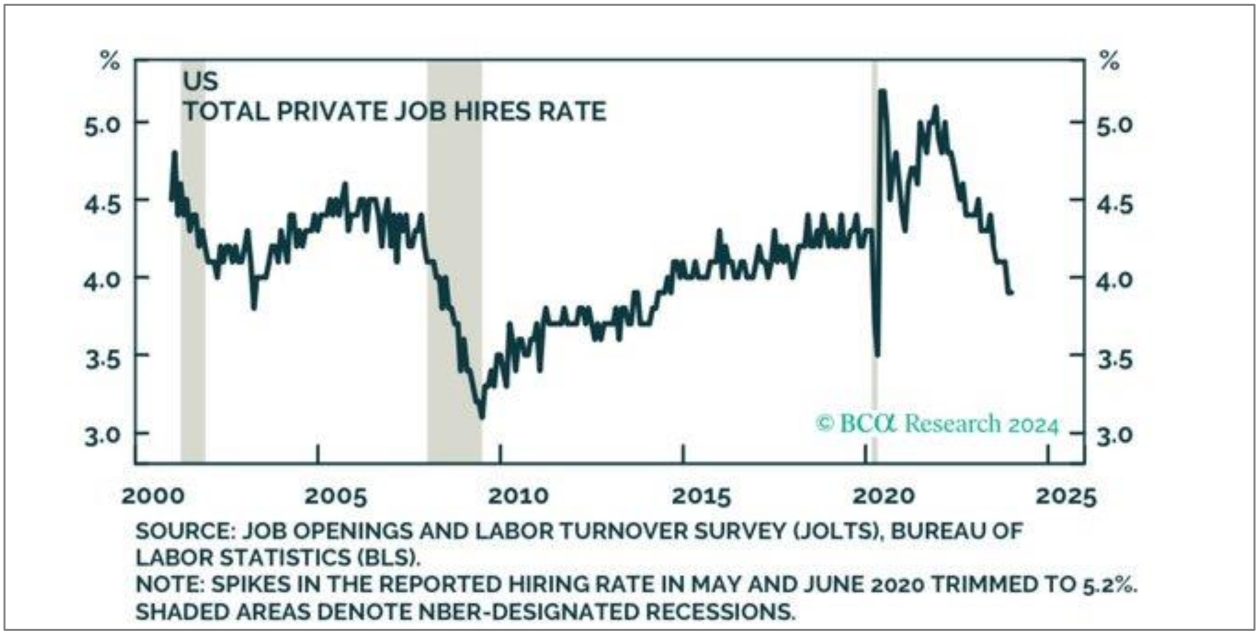


Hedge Funds have gone record long Momentum Stocks.

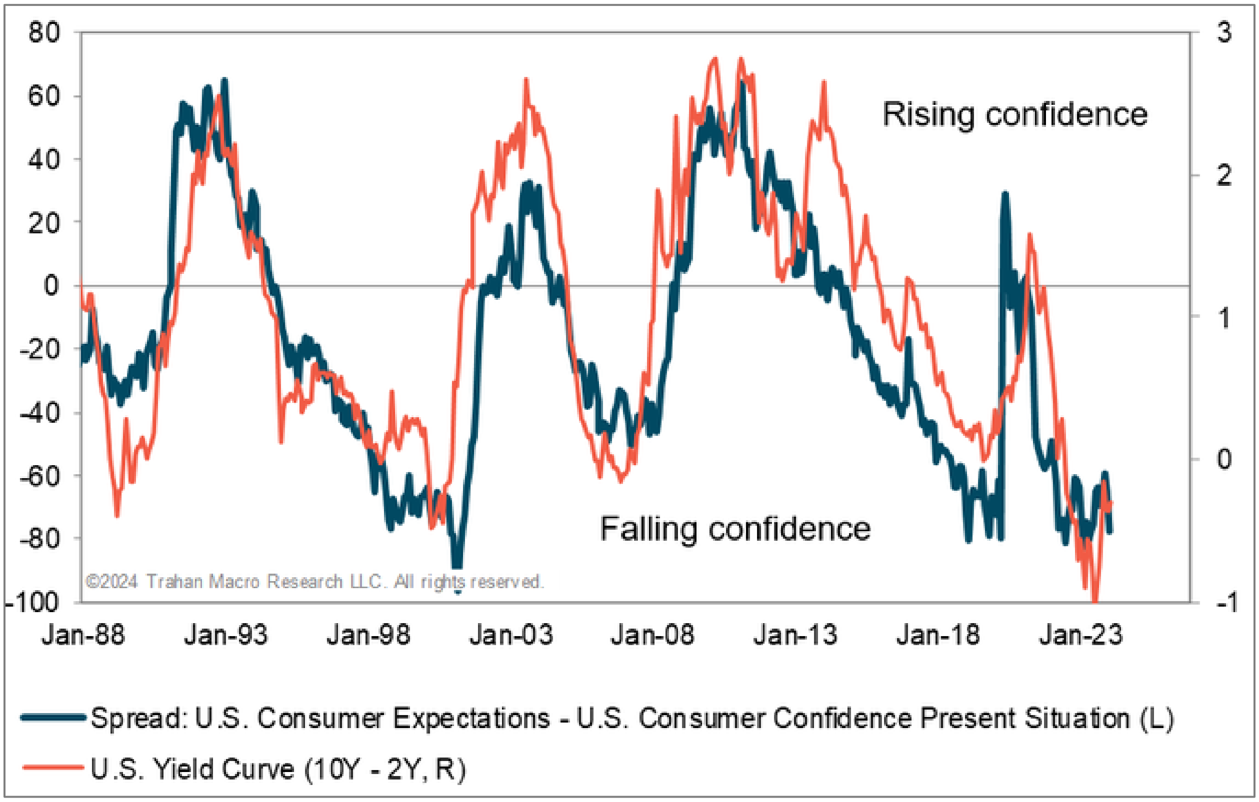


Foreign Investors have a heavy allocation to US stocks.

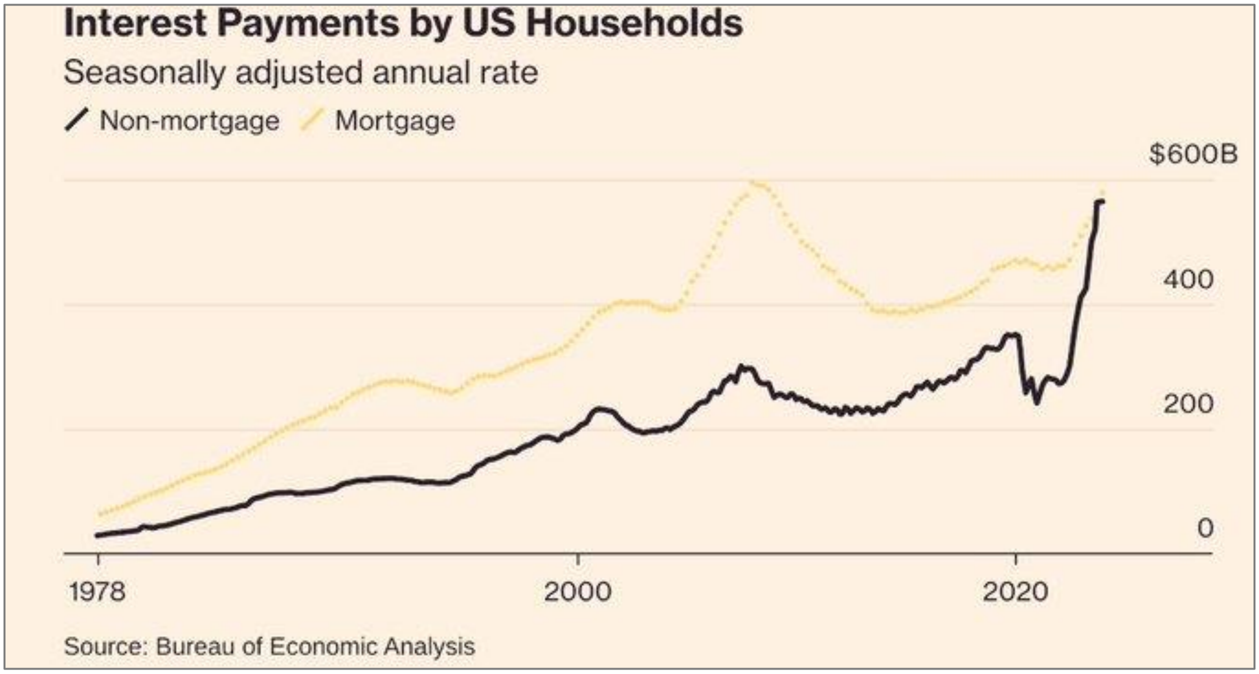
The strong, no-landing economy is seeing some unusual declines in Job Hiring.



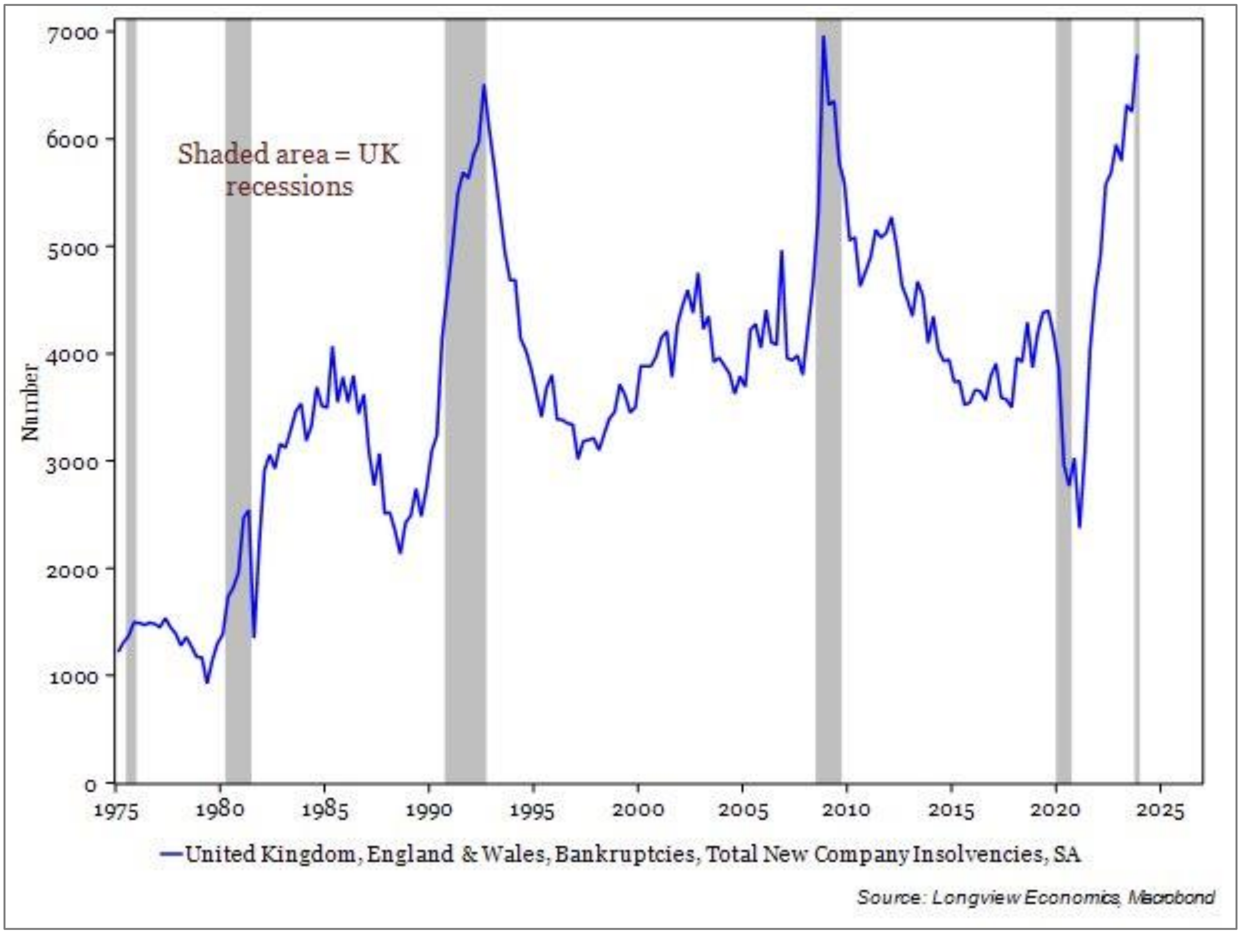
The Yield Curve has a high correlation with consumer confidence in the economy.



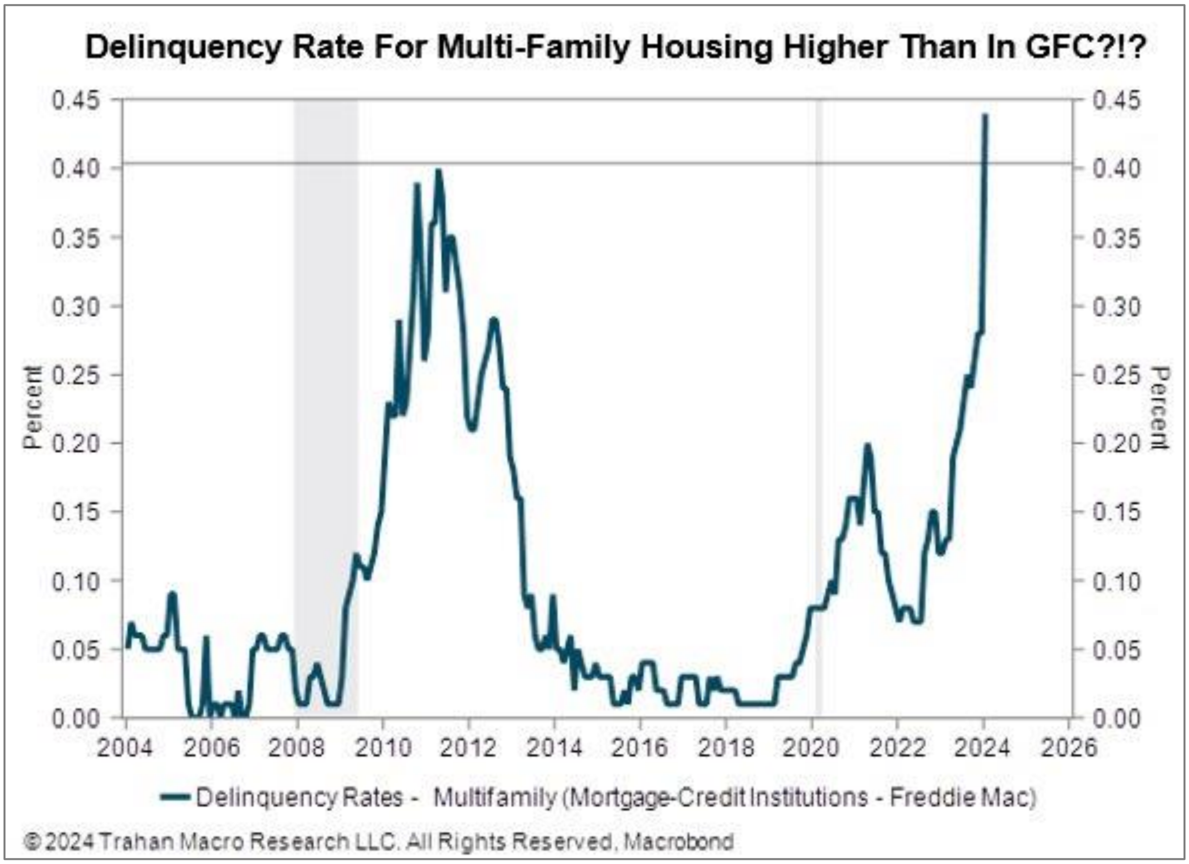
Surge in Non-mortgage Interest Payments by US Households



Bankruptcies in the UK are close to surpassing 2008 levels.

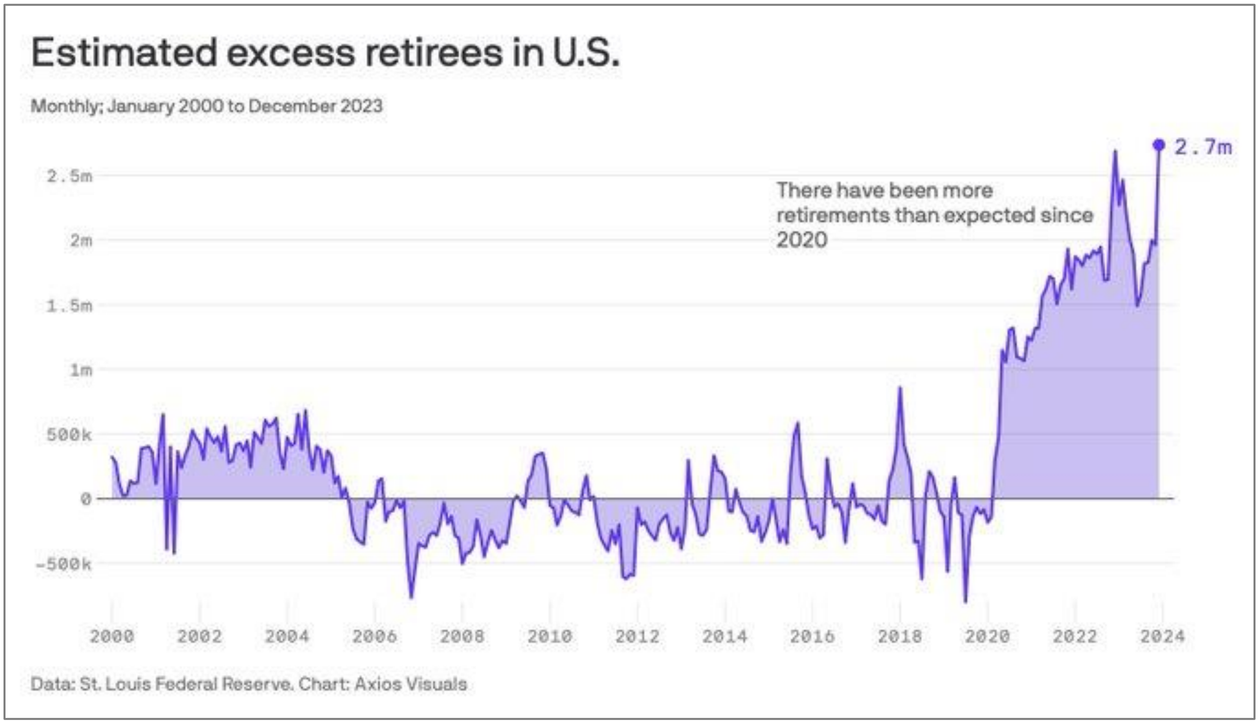


Multi-family Housing Deliquency rate is setting a record.
Although, that looks to be a very small number...

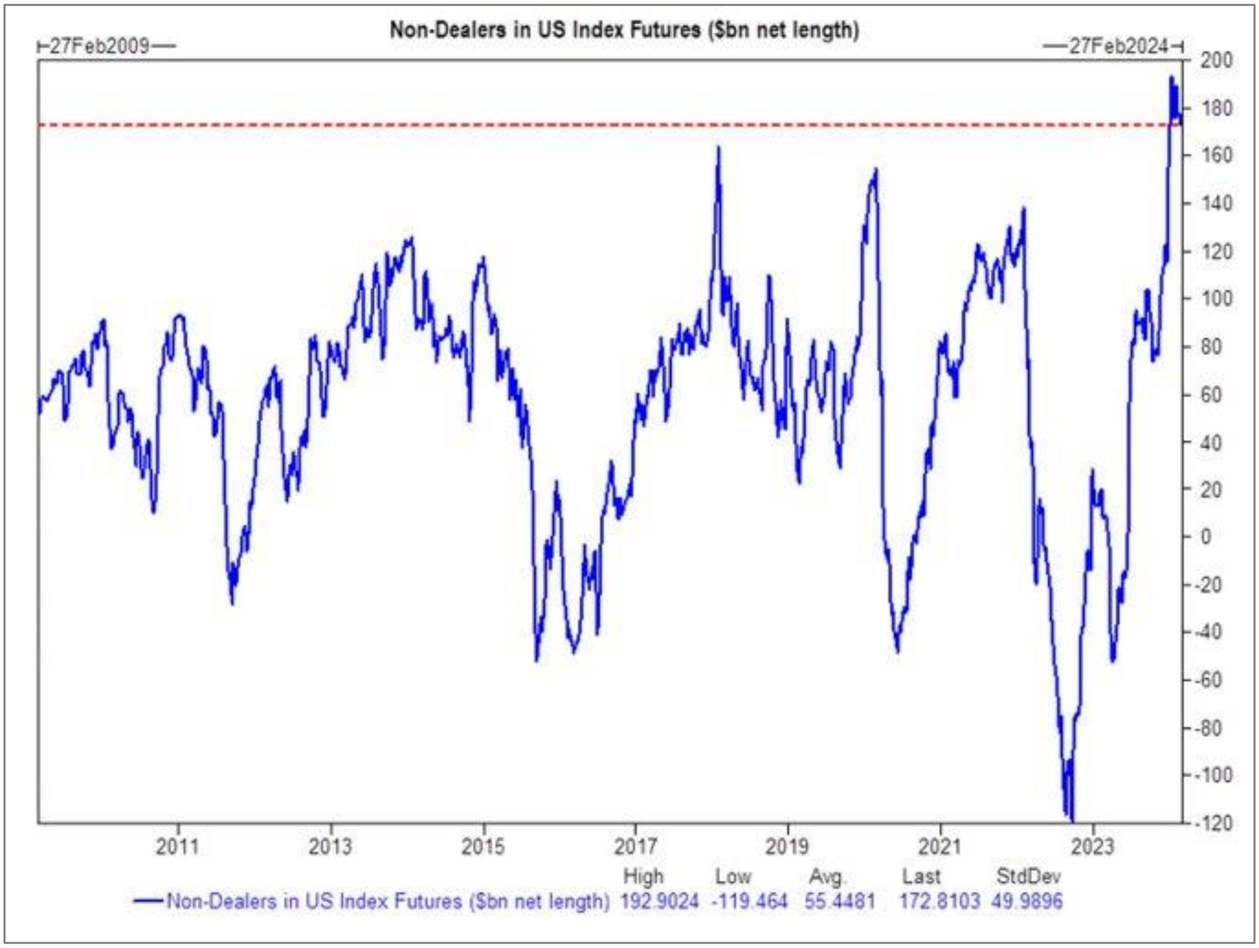


Forward PEs in China are in single digits.

AI-led stock market boom has driven excess retirements to a new record.

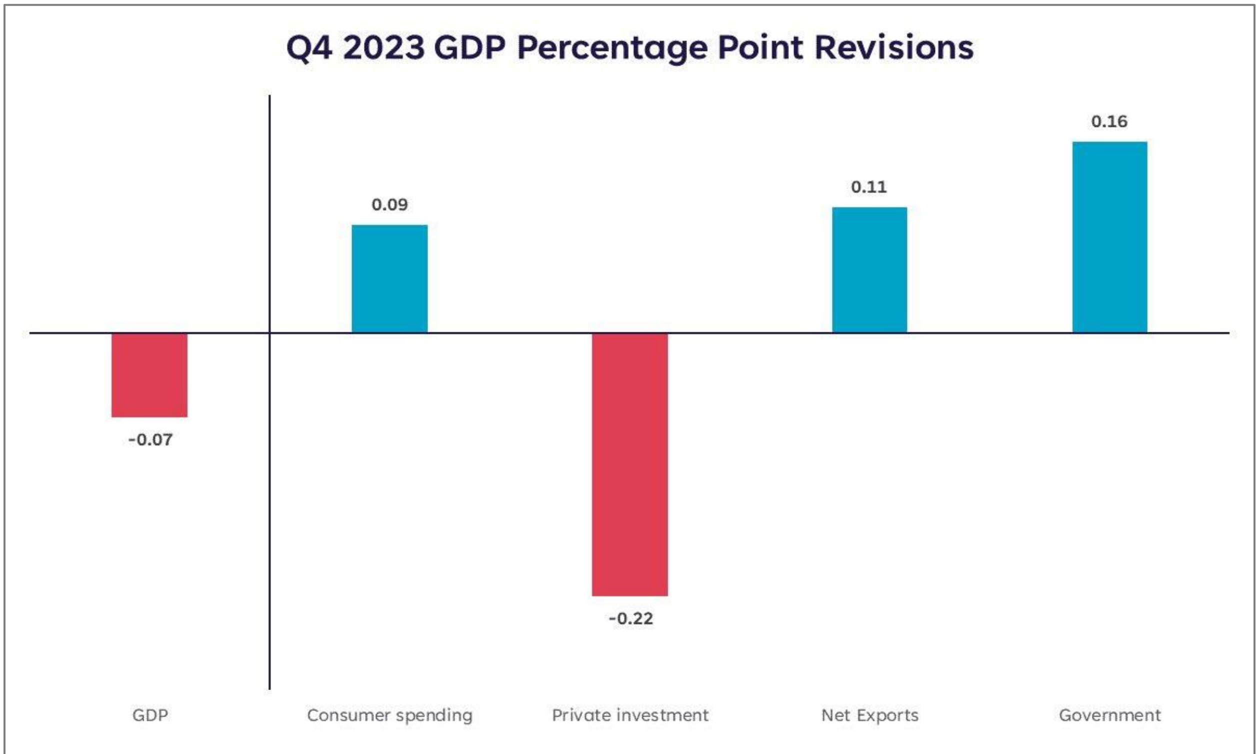


Non-dealers are record long US Index futures.



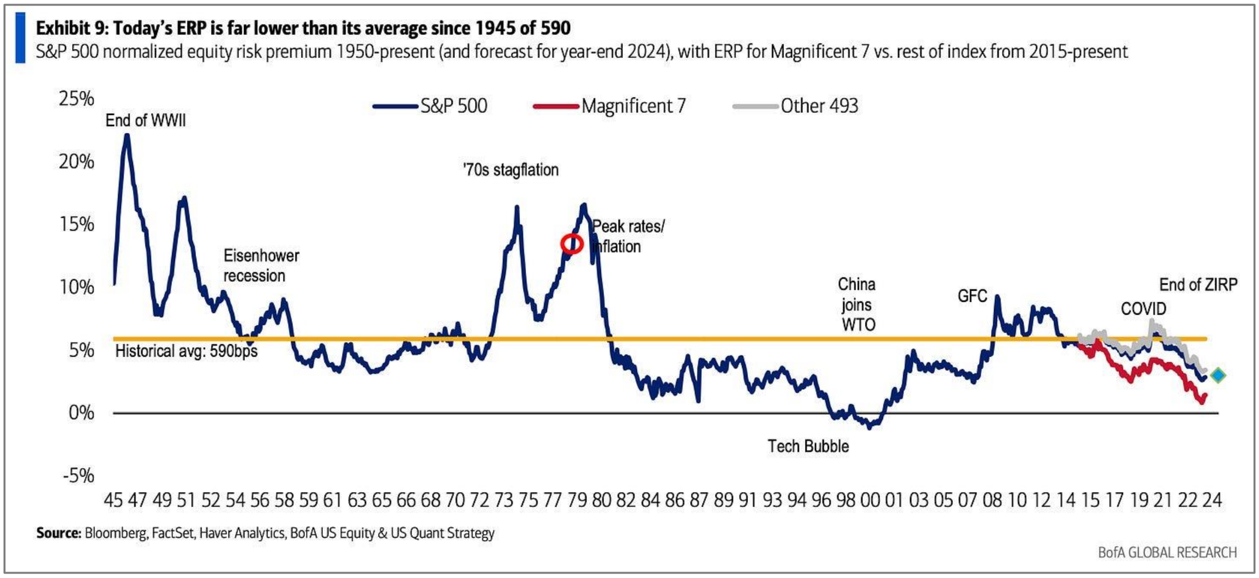
Europe on sale - US relative to Europe equity valuations have matched the dot-com era peak.

Government spending has been the hero for GDP revisions.

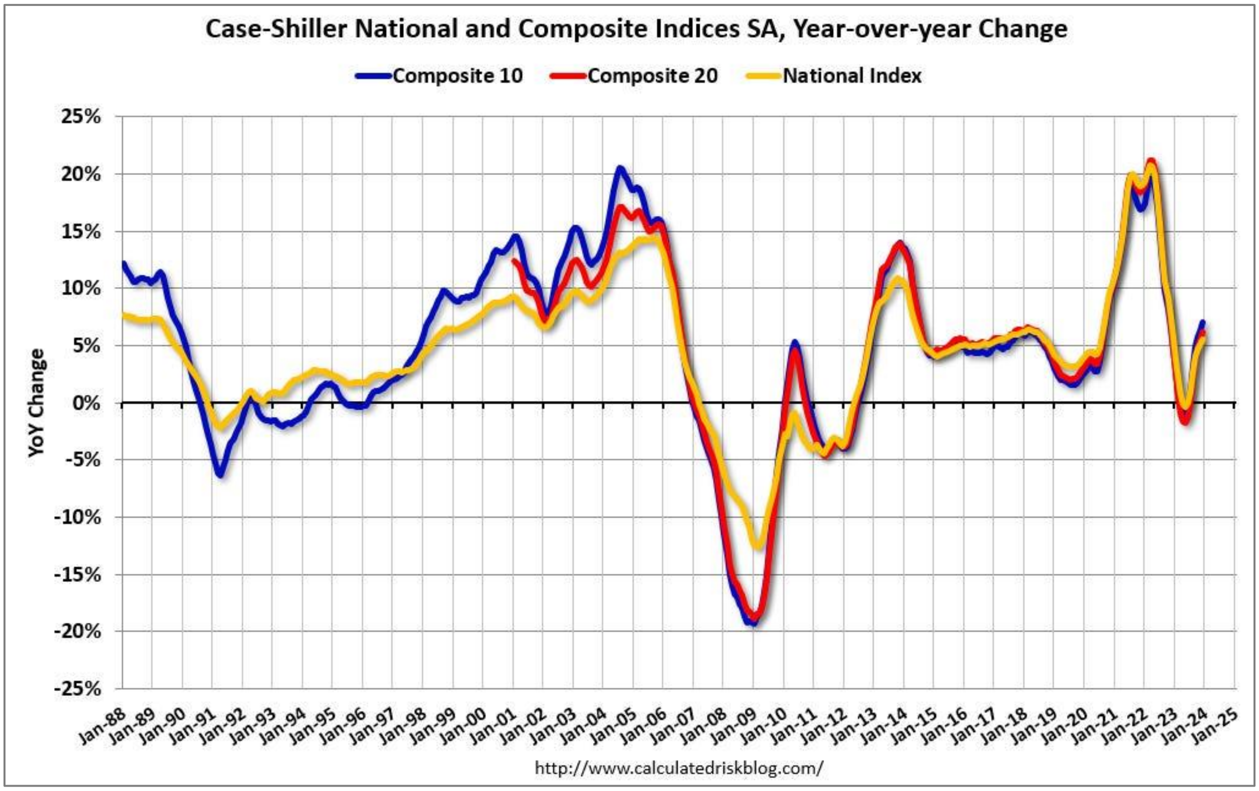


Source: SoFi, BEA, Bloomberg

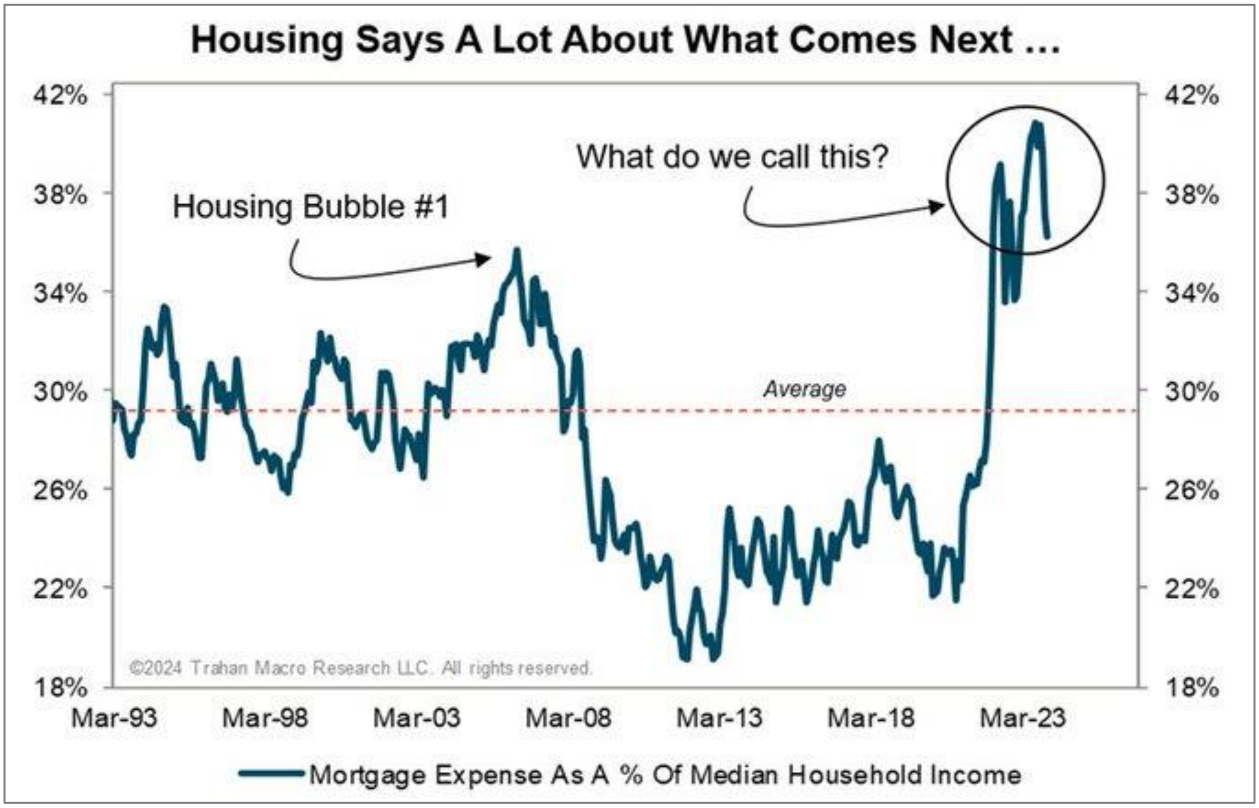
Equity Risk Premiums are well below the post-WWII average.



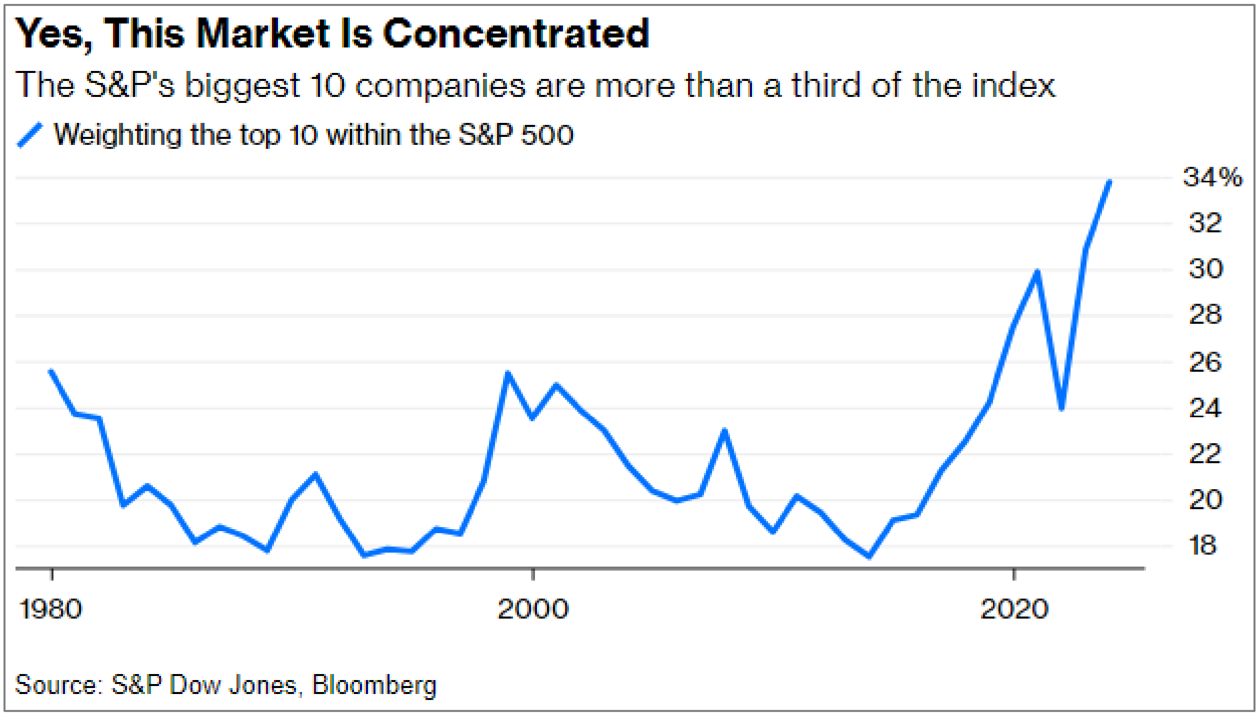
Home Prices are on the rise again.



Mortgage payments aren't far from record highs.

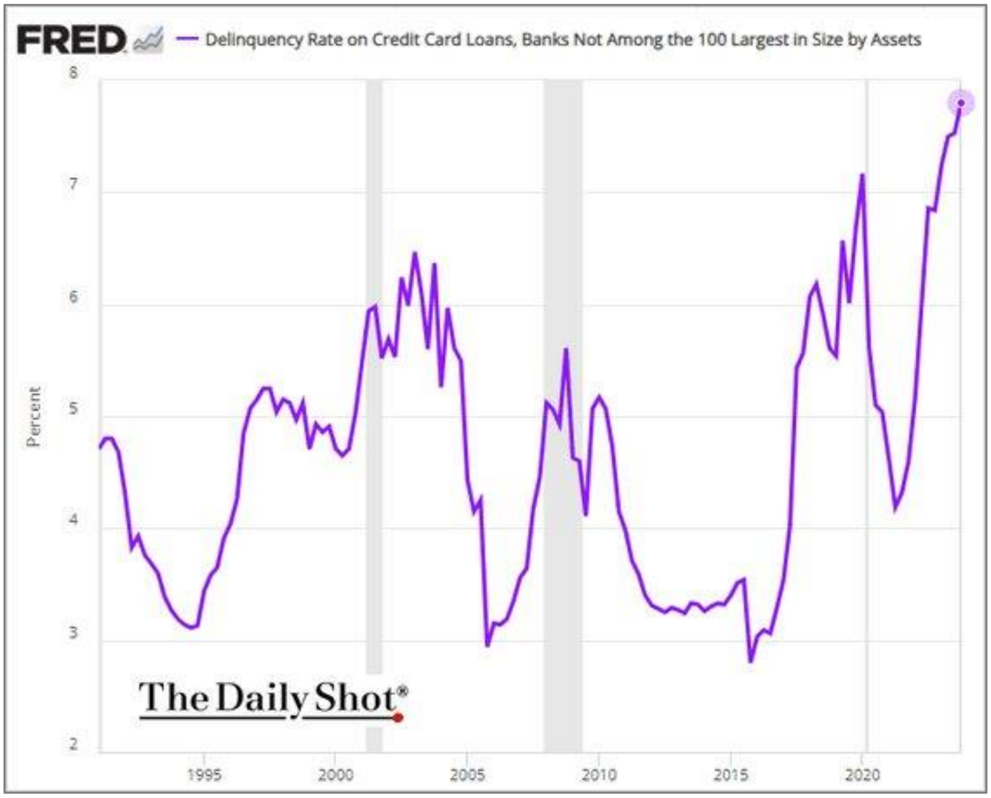


The top 10 stocks comprise over a third of the S&P 500 index.



Complacency in US Corporate Spreads is similar to 2021.

Smaller banks are seeing record-high credit card delinquencies.



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.