Cypress CAPITAL

Market Outlook

By Mark T Dodson, CFA

Third longest yield curve inversion since 1920.

Market Risk Index improved to 76.5% on a boost in Monetary Conditions. Psychology worsened again and is a rounding error away from being scored in the top 1% of euphoric environments since 1970. As a reminder, MRI is, first and foremost, a measure of the level of drawdown risk present in markets. We use it to tactically guide us (in a range) around our static, neutral allocation to risk assets. Market timing is a concern, but it's secondary. It's secondary because it's nearly impossible to get right, and we want to avoid ever putting ourselves in a position of not achieving our goals as a result of attempting to make some market call, whether that failure comes in the form of being either underexposed or overexposed to financial assets.

Monetary Conditions were buoyed by the Interest Rates category, which has seen steady improvement from the moment markets decided the Fed had pivoted – also the point where risk aversion among investors began a persistent, almost linear descent. The category is bullish – but not as bullish as it was at the same point in the previous bull market.

Meanwhile, the severe yield curve inversion keeps Monetary conditions from moving into their maximum bullish zone. The now-forgotten (or dismissed) yield curve completed 17 consecutive months of inversion – this is the third longest-lasting yield curve inversion since 1920. November 1929 and March 1980 were longer at more than 20 months.

Valuations concur with the assessment of Psychology – to be expected. Our bottom-up forecast for large-cap equity returns fell to 0.4%. Financial Accounts of the United States (Z.1) were also released this week, and US Households' Equity Allocation (a more recent addition to the valuation composite) has climbed to a level that implies a zero percent return for equities.

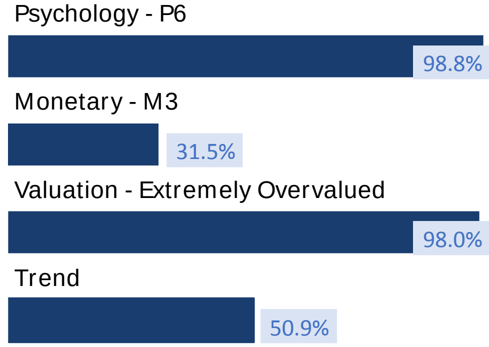
Admittedly, the yield curve, as well as Psychology and Valuations, have been easy to dismiss in the post-COVID environment, as aggressive speculation, leverage, and concentration have been rewarded in aggregate – you can make a strong case that politicians and central bankers have endorsed it.

Market Risk Index

Rec Allocation 25% Underweight

76.5%

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	4.1%

Market Trends

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

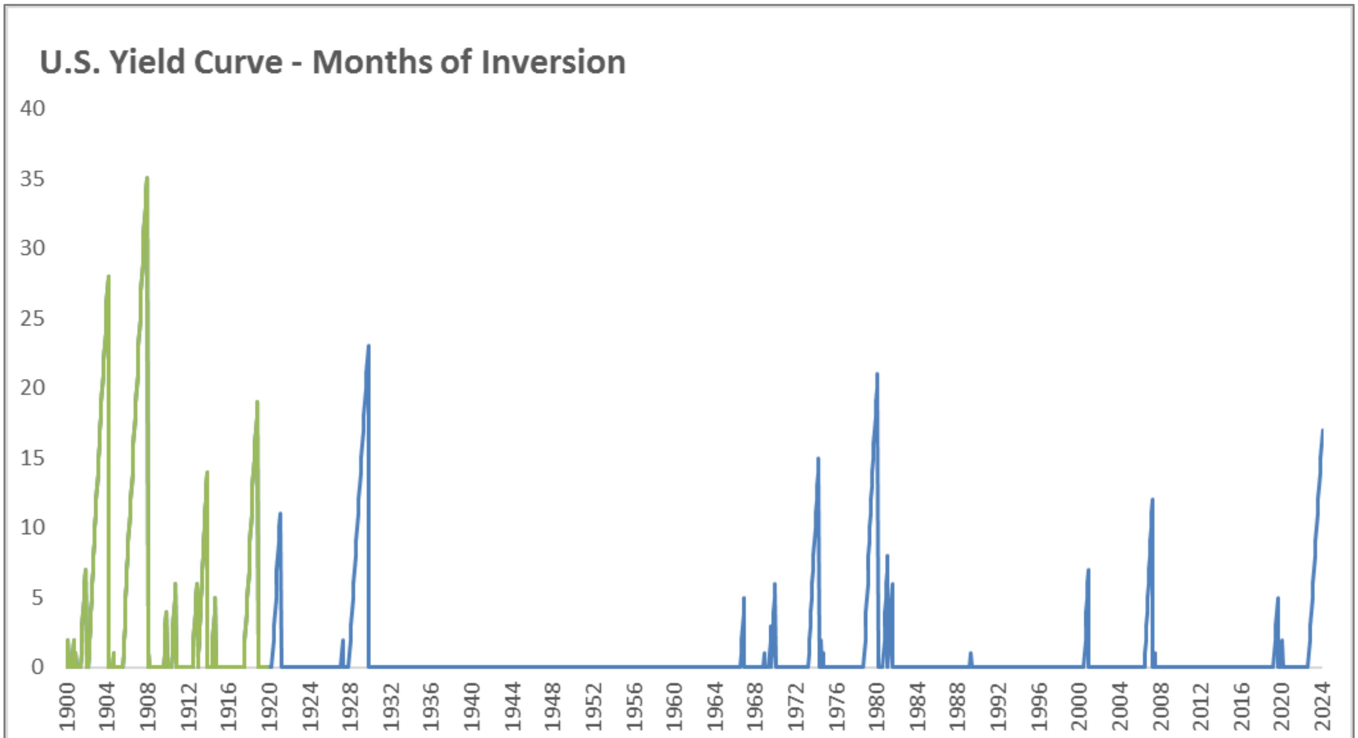
Market Risk Index scales from 0 to 100%. Higher readings correspond with higher risk markets based on our model & opinion. Scores below 25% are bullish. Scores between 25-75% are neutral, and scores above 75% are markets vulnerable to major drawdowns.

Outside of the NASDAQ High Low Logic Index warning and the heavy concentration of cap-weighted indices in a handful of stocks, there is little causing market technicians concern about the current state of the bull market. However, with rampant over-enthusiasm and over-valuation, it may prove challenging for investors to lean too heavily on those short-term tools for an adequate warning of a sharp drawdown.

We still believe that the severity of a yield curve inversion, in both depth and duration, along with the state of valuations, reveal stock market environments embedded with substantial risk of drawdown and uncertainty. There's too much history to be flippant with the yield curve, particularly when its recurrent dismissal has been one of the hallmarks of its history.

Charts of the Week

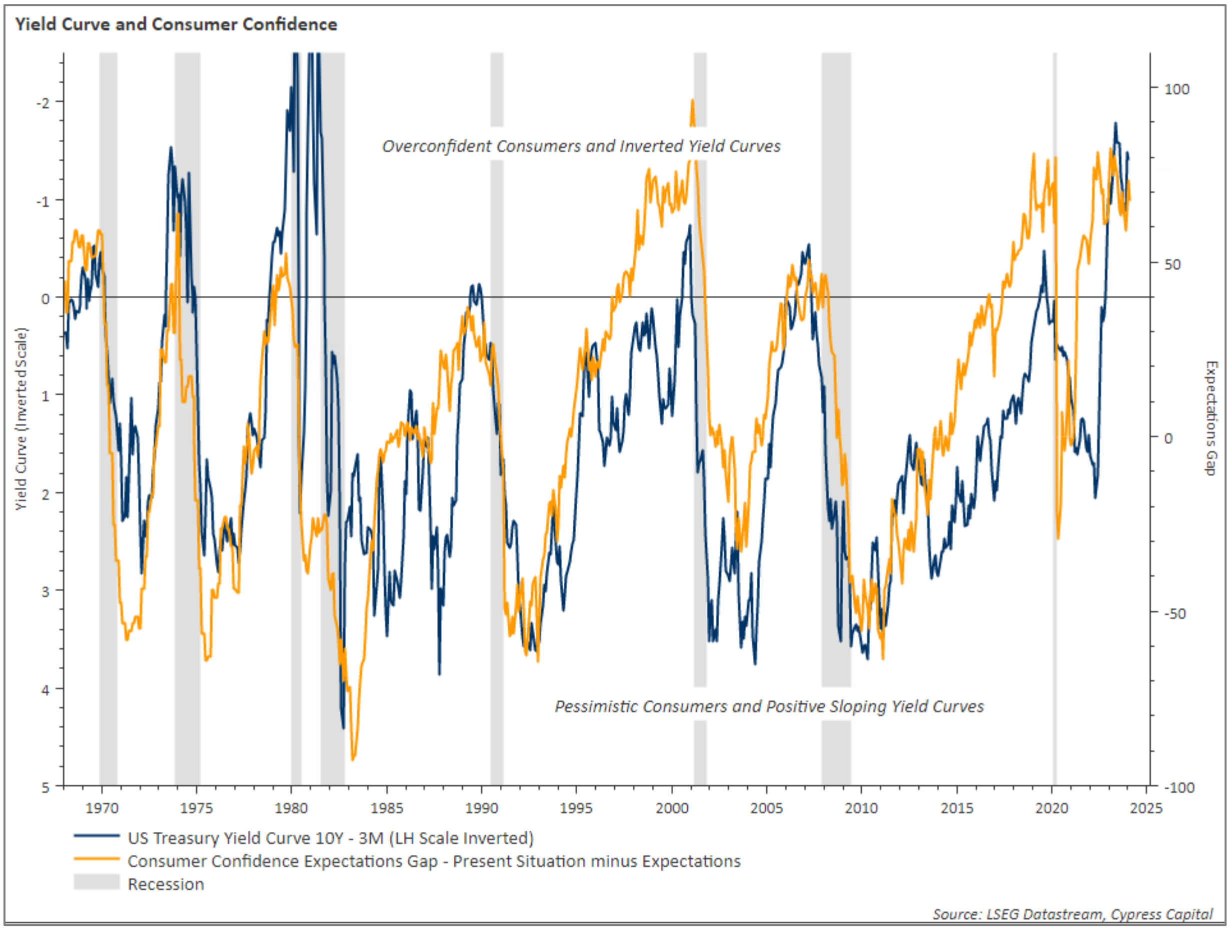
Third longest lasting yield curve inversion since 1920.
If we expand the yield curve to 1900, adjusting commercial paper yields to be a proxy for T-Bill yields, this is the sixth longest inversion since 1900. The most prolonged period of inversion preceded the panic of 1907, which led to the formation of the Federal Reserve.



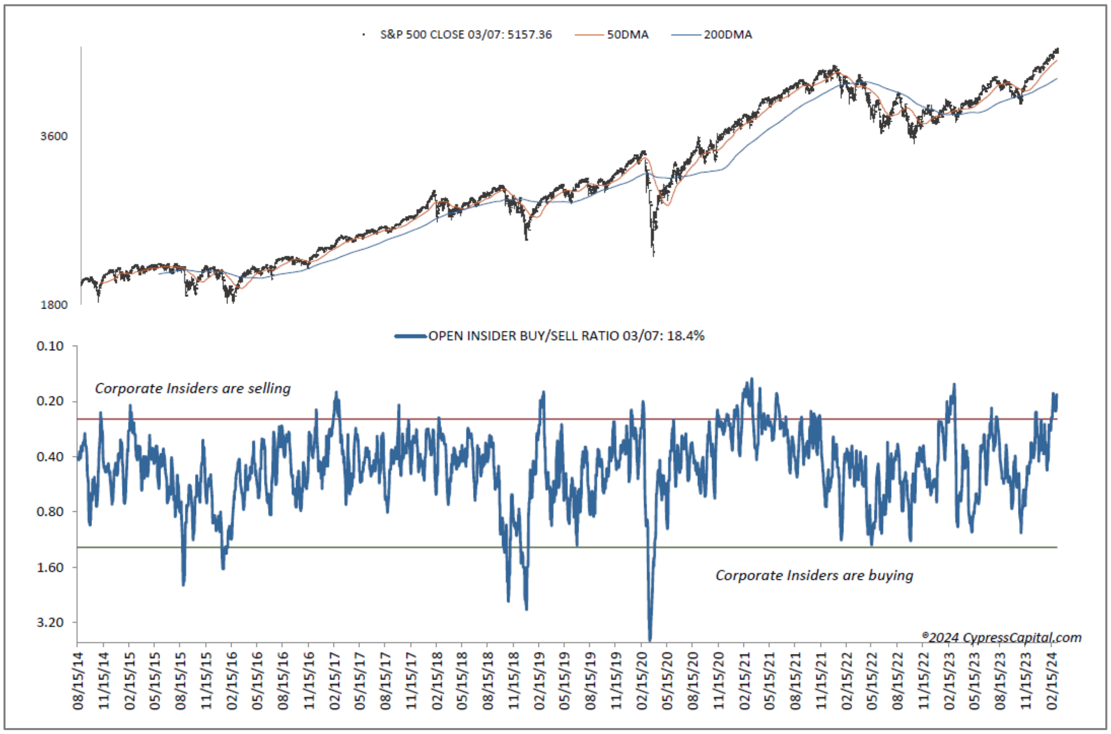
Source: Federal Reserve, Cypress Capital

Yield Curve as a measure of Economic Sentiment

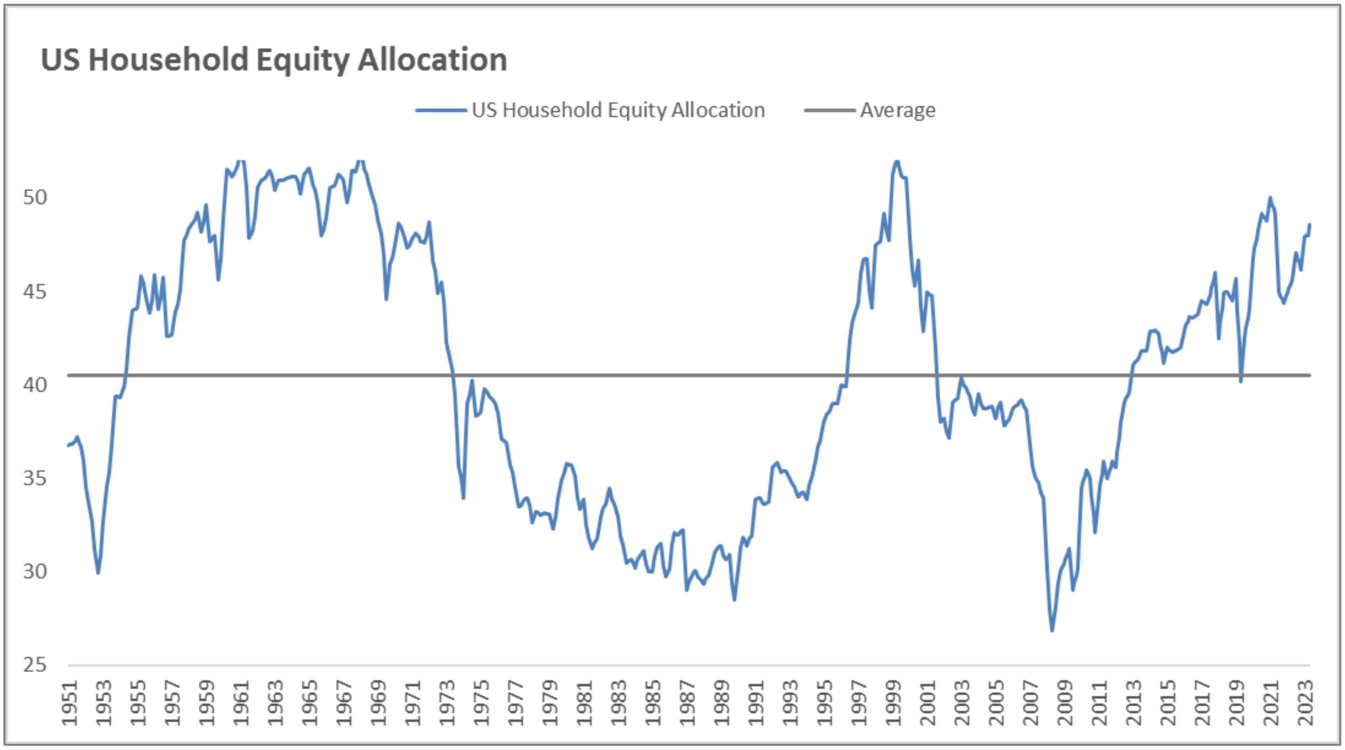
The slope of the Yield Curve correlates with Consumer Confidence in the Economy.



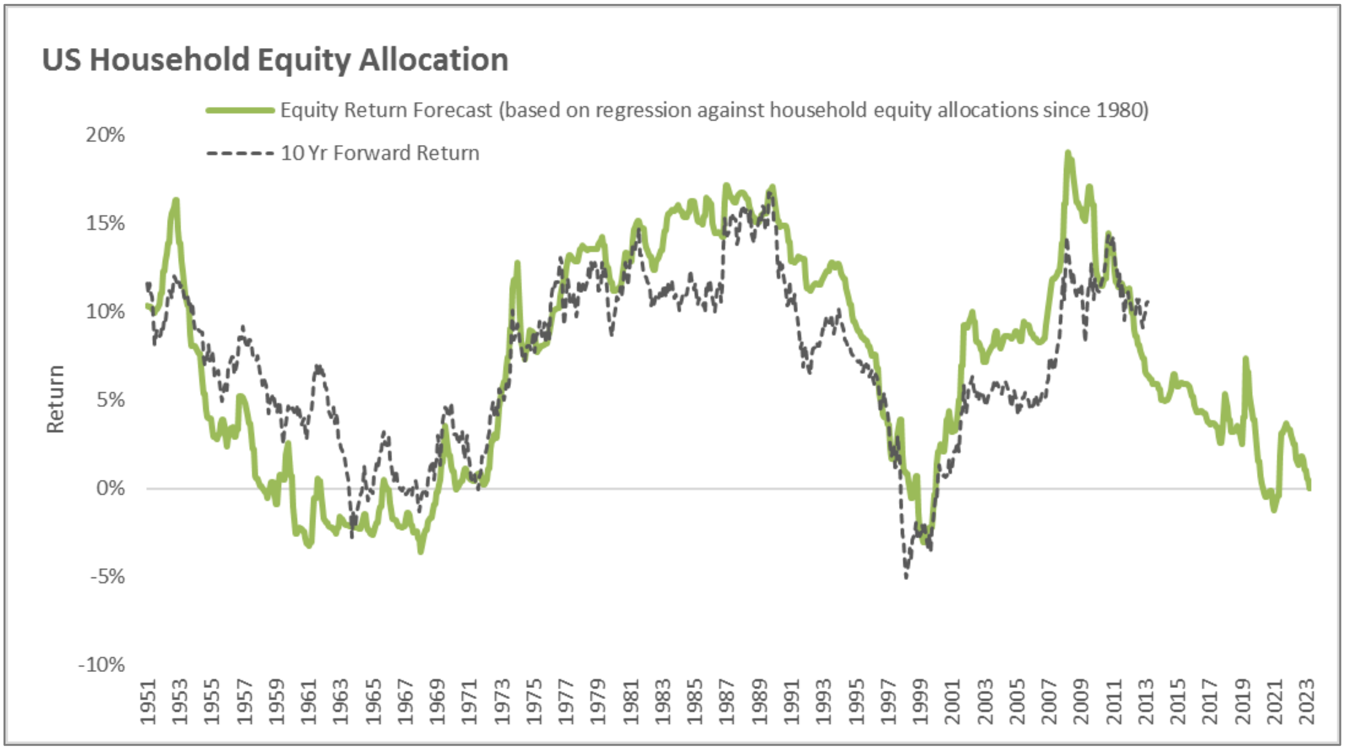
Corporate Insiders have been persistent sellers for the last two weeks.



Equity Allocations of US Households climbed into the highest quintile in Q4.

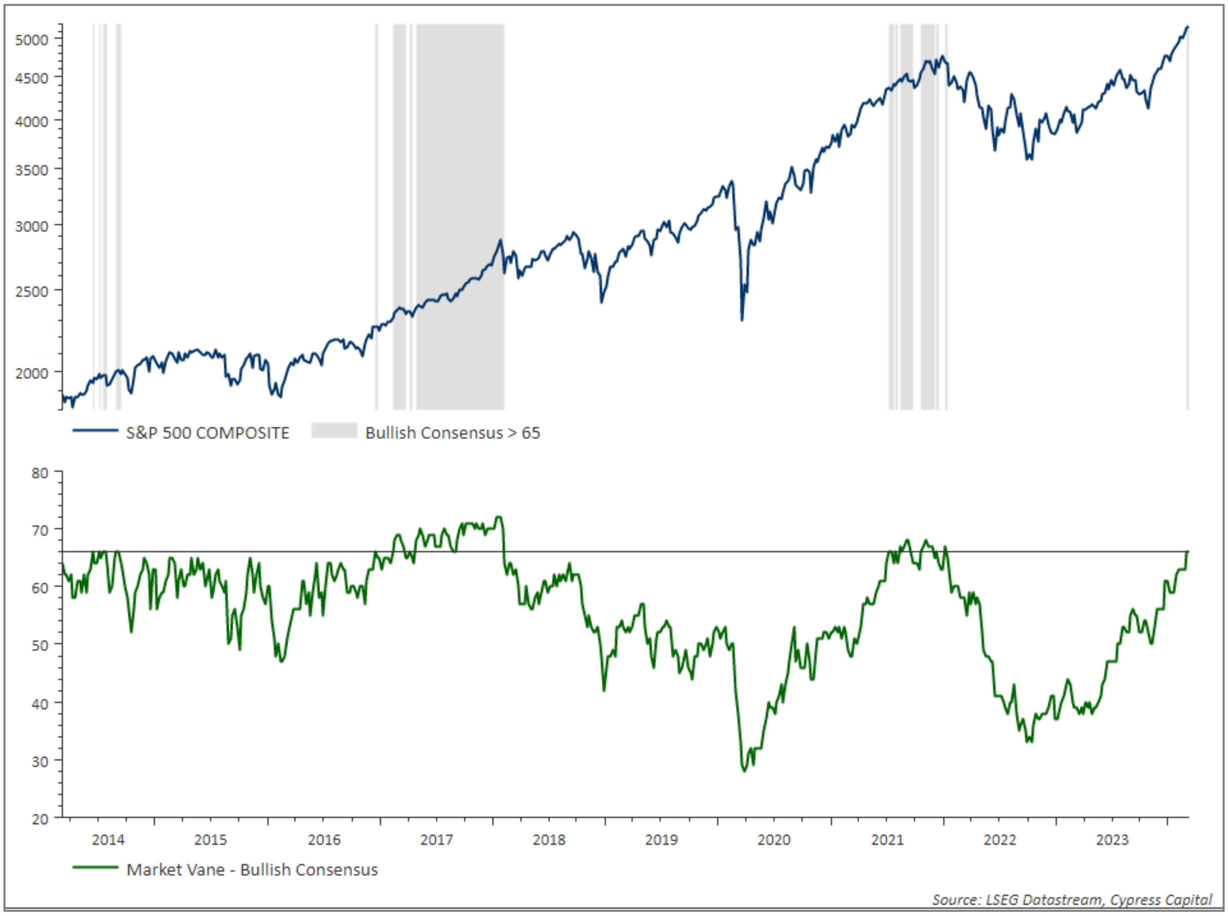


Households' Equity Allocation have climbed to levels that imply a Zero percent return for stocks.

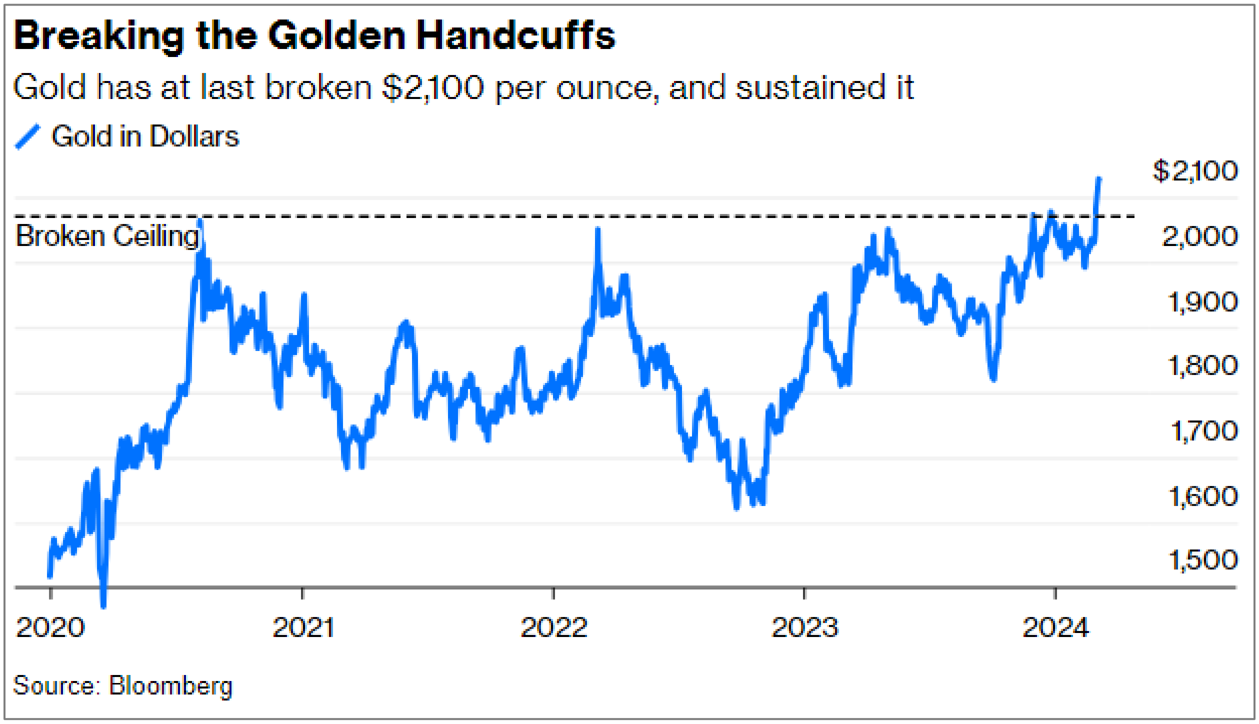


Another new cycle high for long positioning in Leveraged ETFs – 2021's peak is within sight.

Market Vane's Bullish Consensus climbed above 65% for the first time since January 2022.

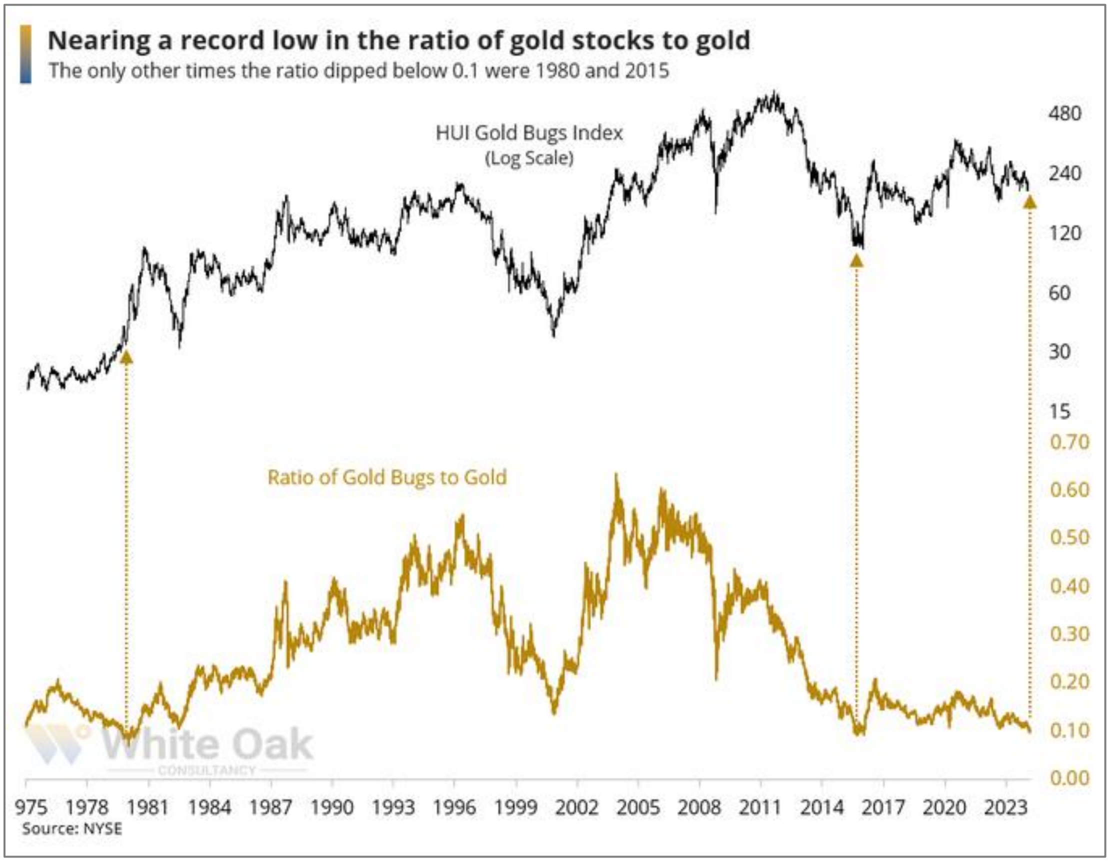


Gold is breaking out.



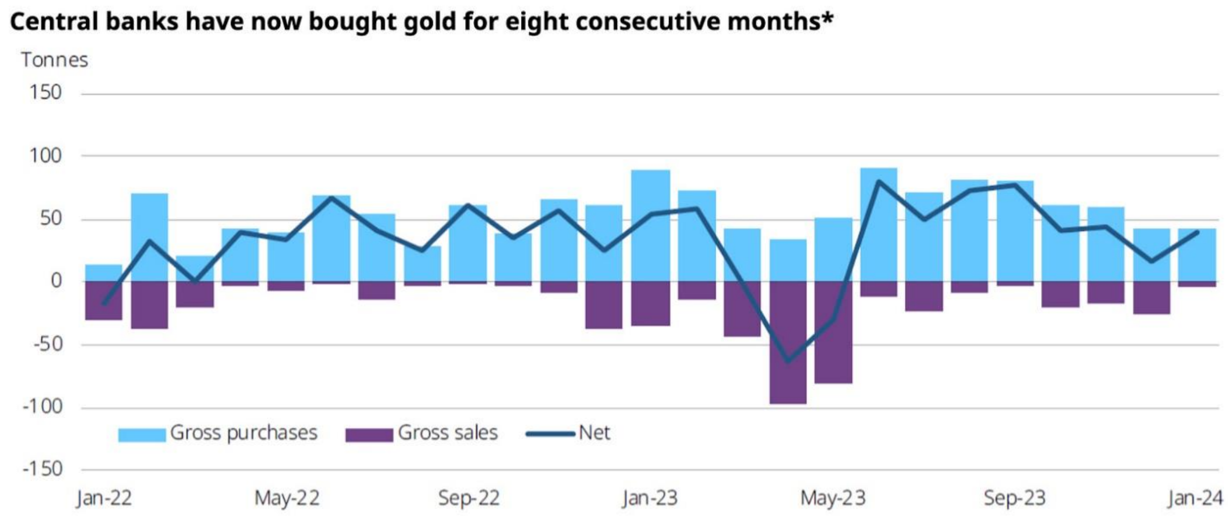
Gold-Miners are not.

Consequently, for bottom fishers, gold stocks look attractive relative to gold.



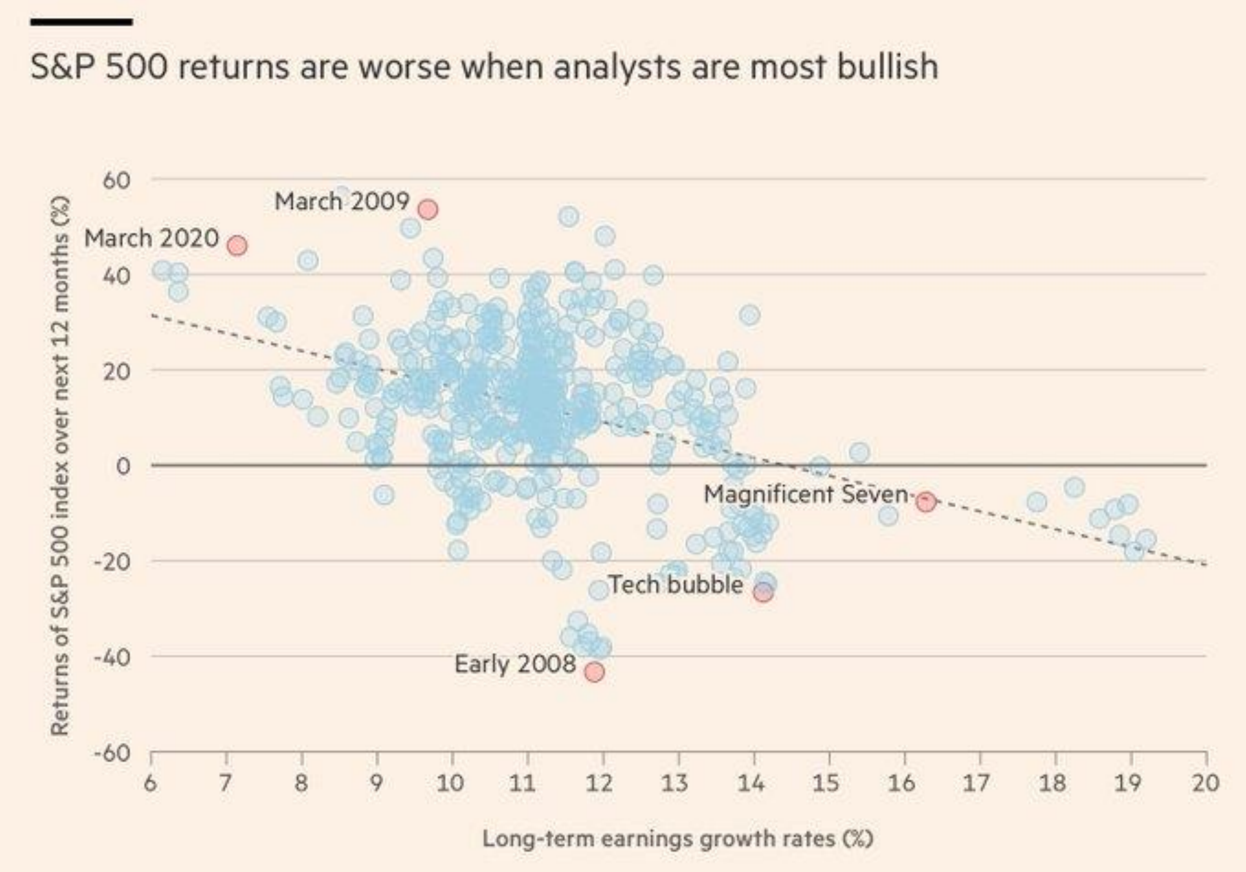
Gold has been climbing despite outflows to Gold ETFs.

Retail investors may be selling gold, but Central banks have been consistent buyers.

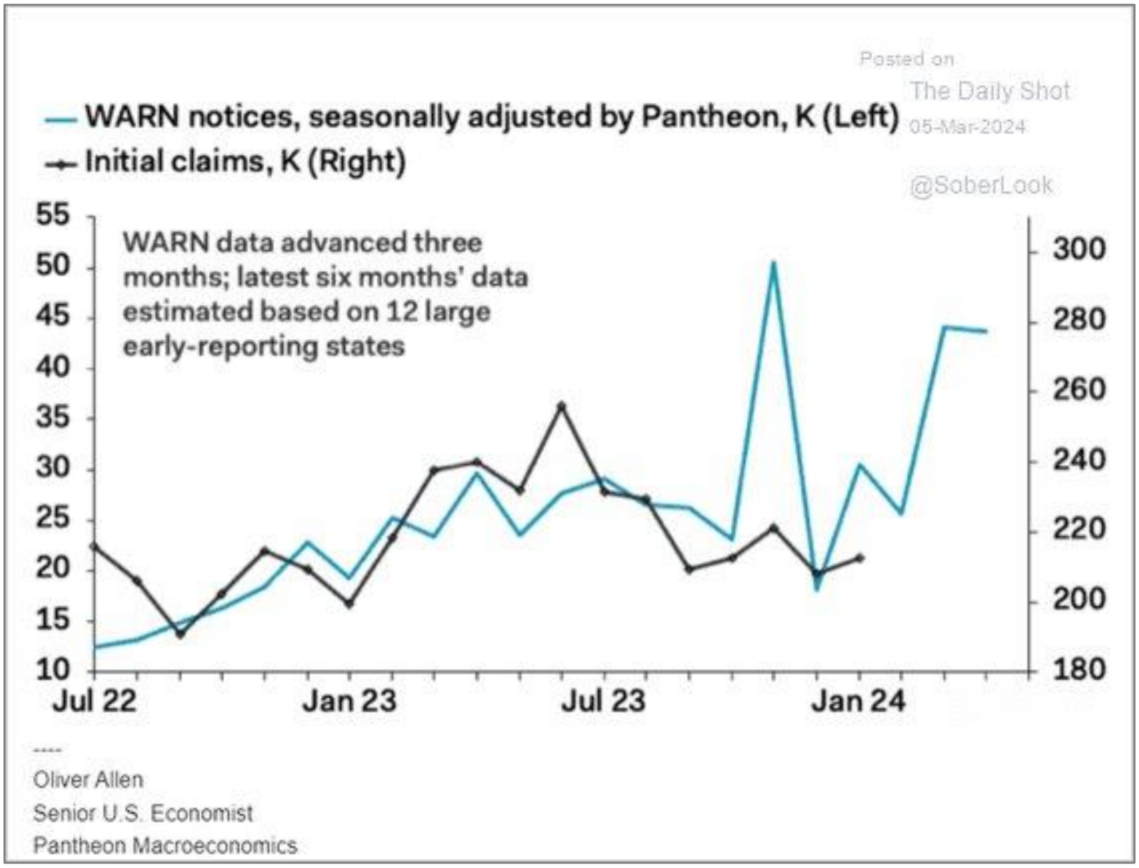


*Data to 31 January 2024 where available.
Source: IMF IFS, respective central banks, World Gold Council

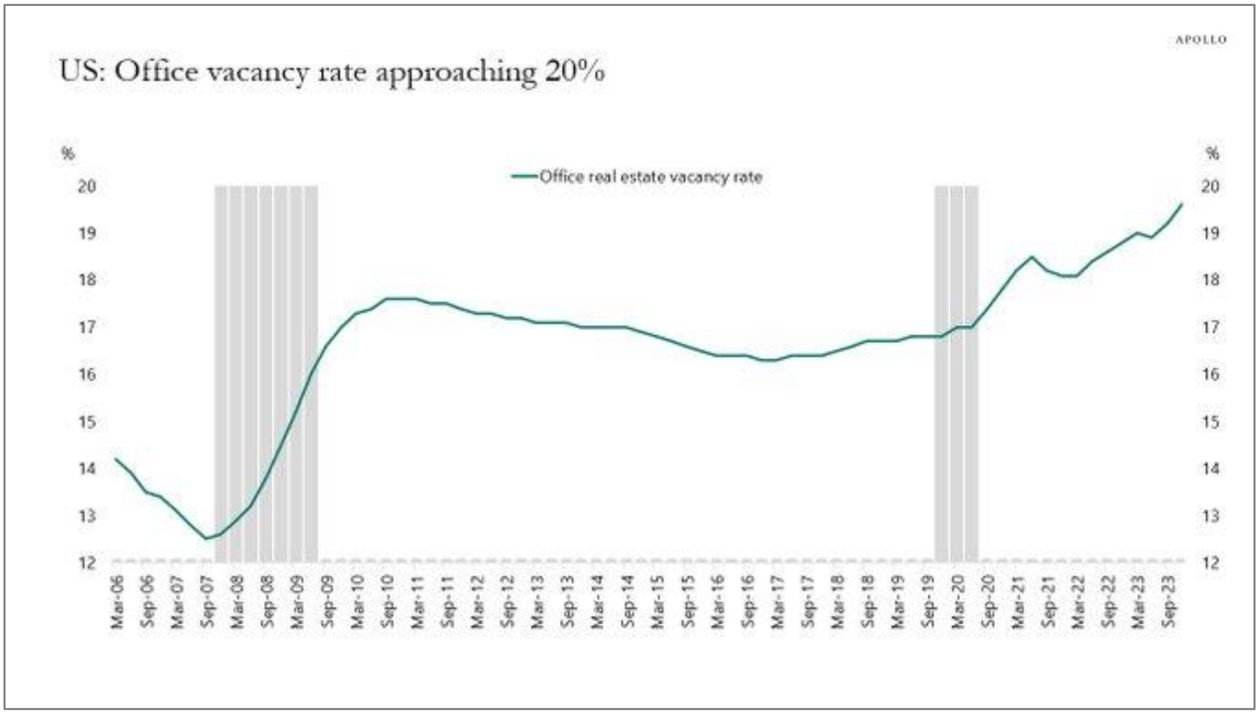
The smart money has been to fade Wall Street Analysts at extremes.



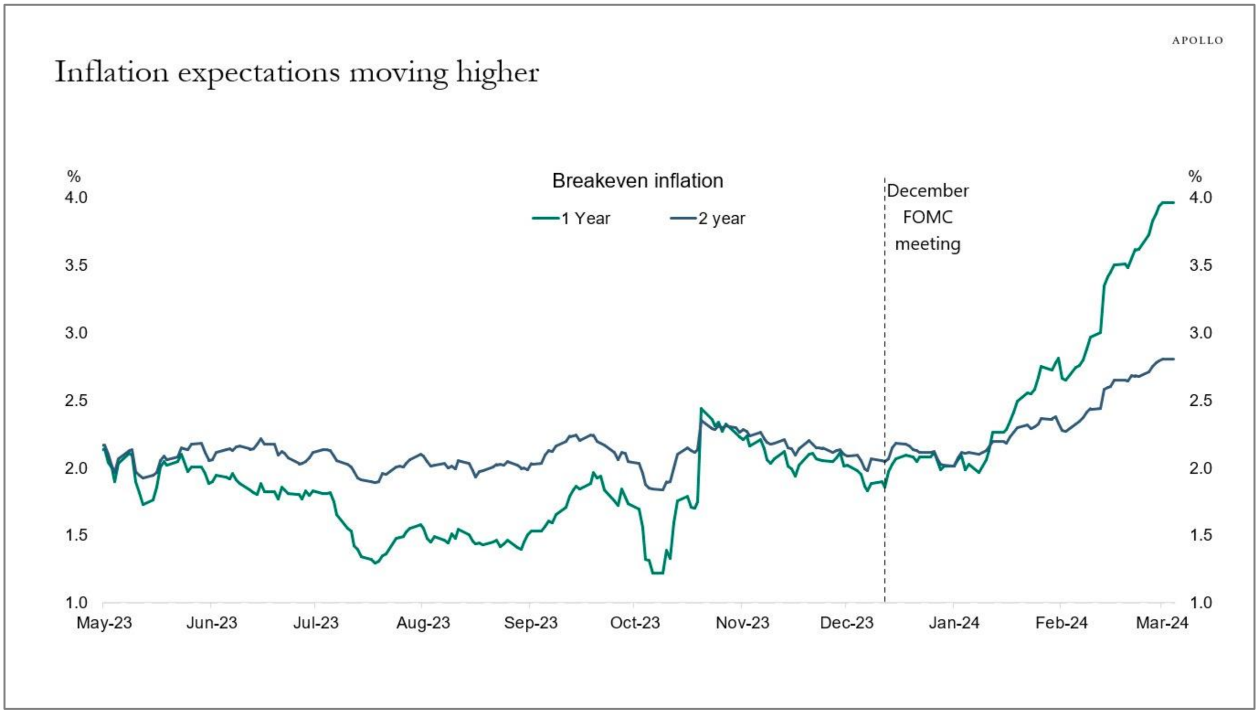
WARN notices continue to signal higher initial claims, but claims keep pleasantly surprising markets.



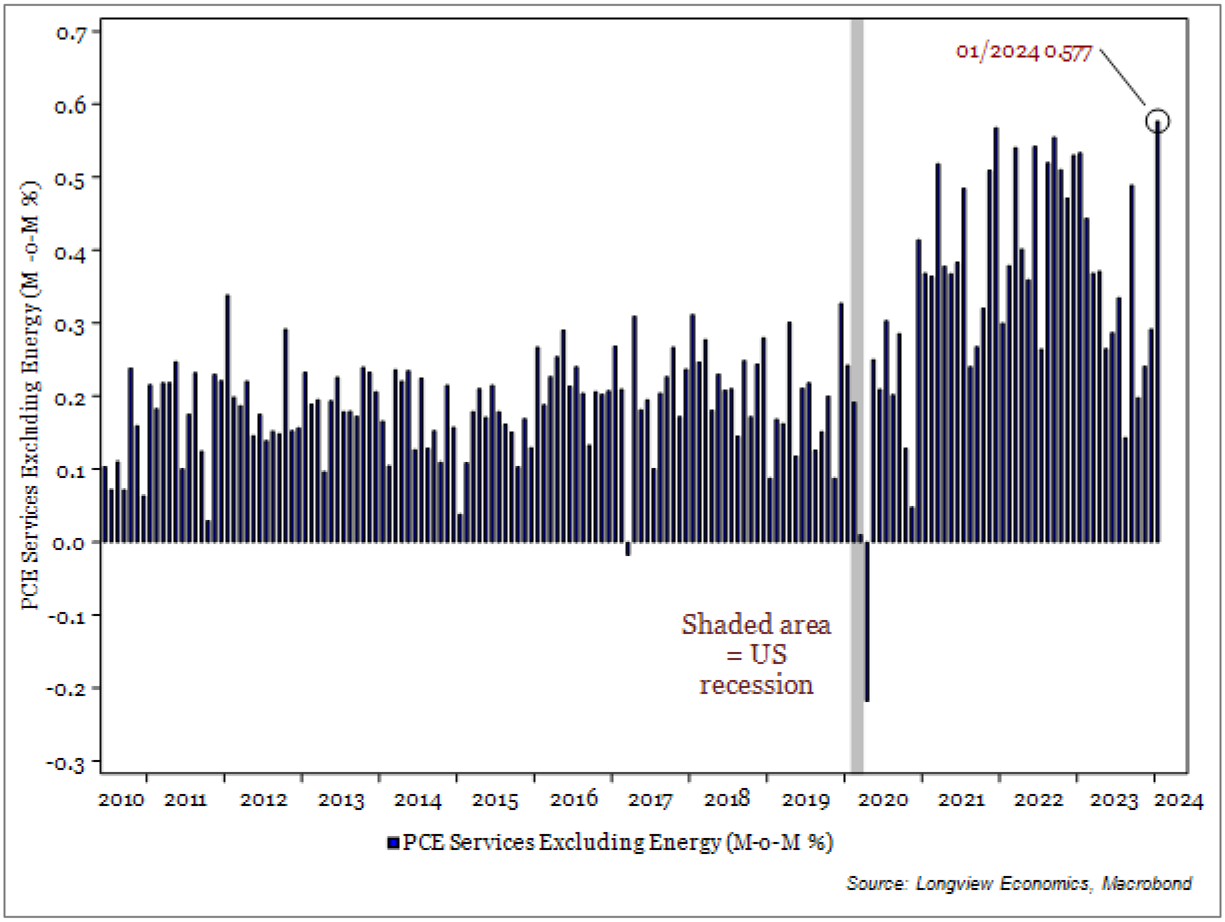
Office vacancy rate in the US is approaching 20%.



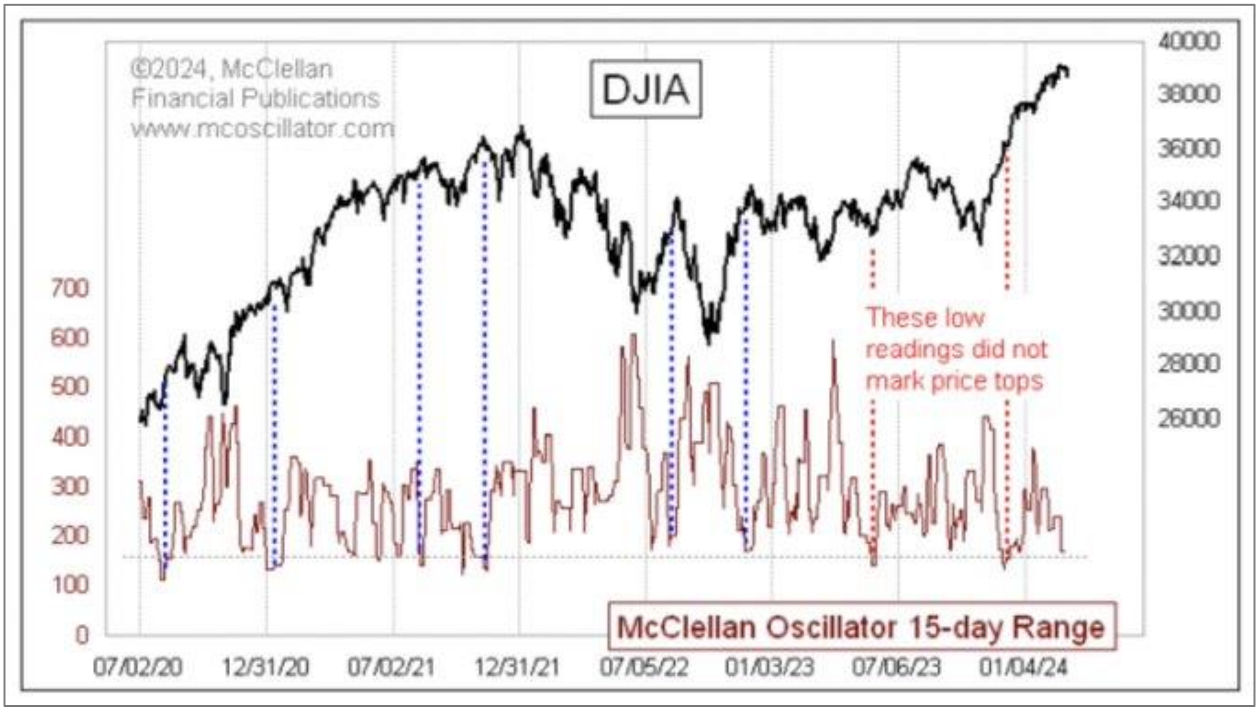
Inflation expectations started moving higher after the pivot.



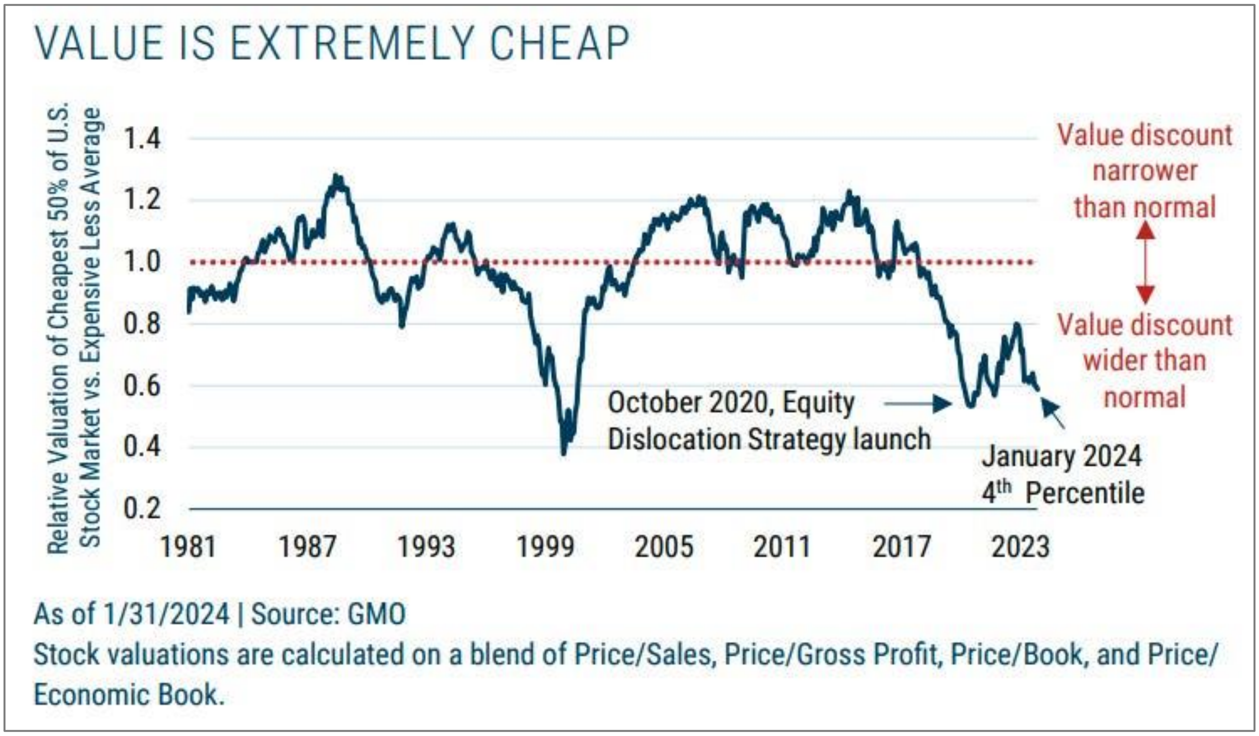
PCE Services inflation (excl Energy) saw a record one-month increase in January.



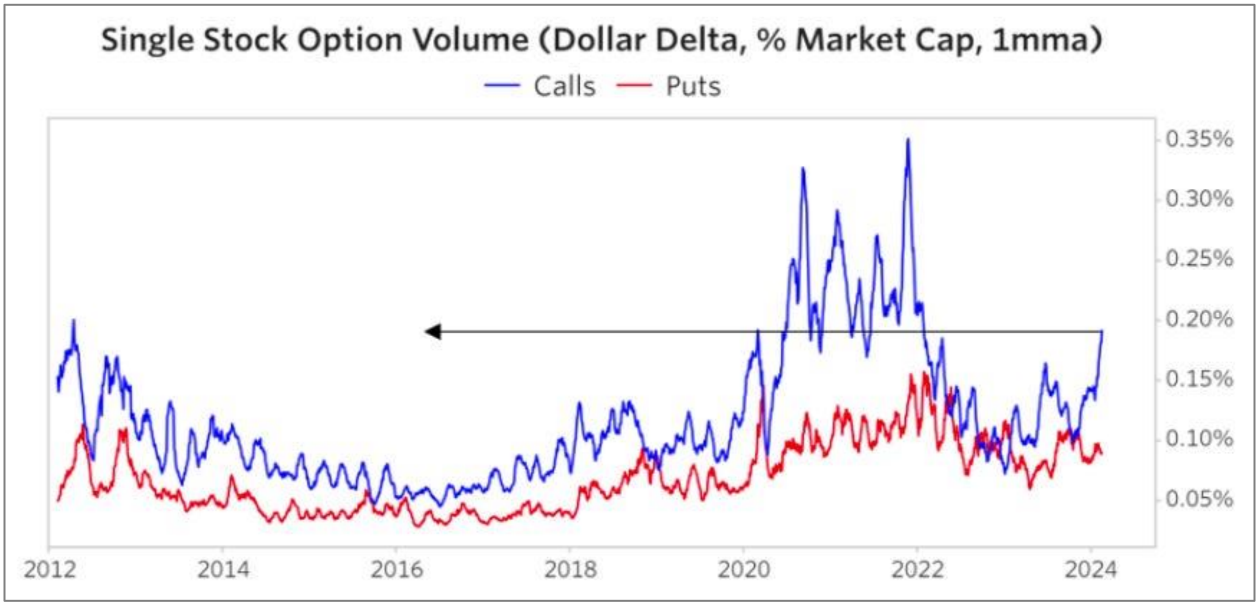
Low volatility in the McClellan Oscillator often signals short-term pauses in markets.



Value's Relative Cheapness has been persistent in the COVID-stimulus era.



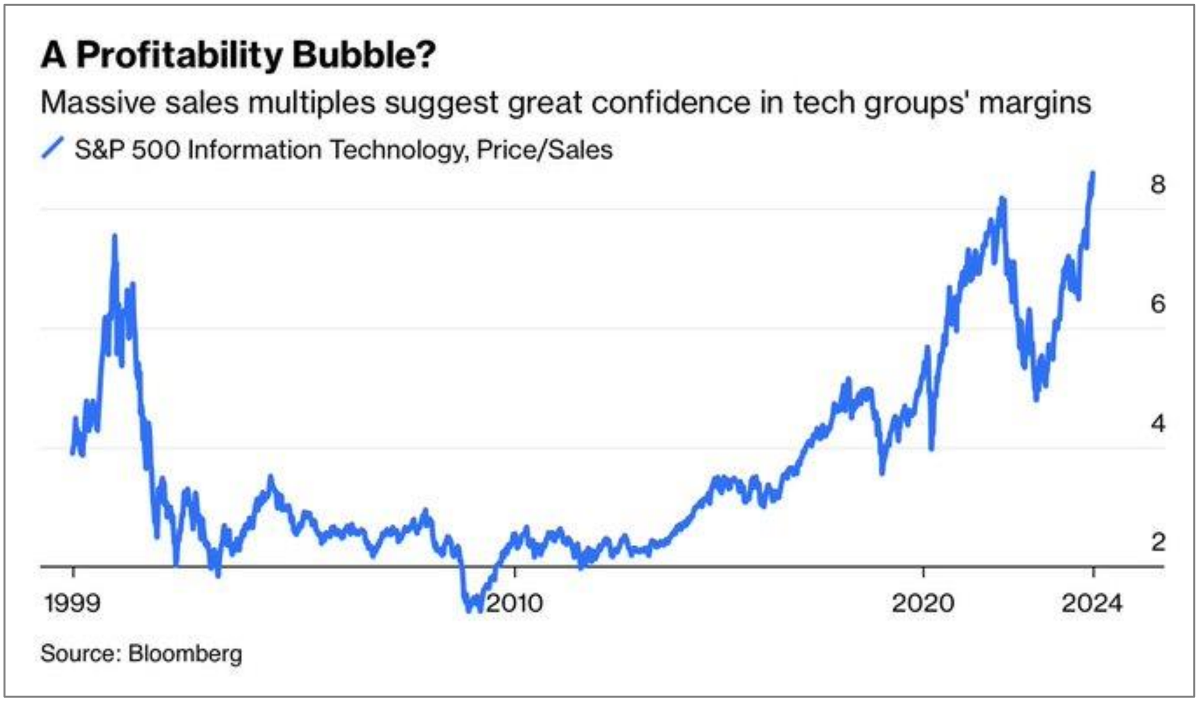
Single Stock Call Option Volume returns to the speculative levels from 2021.



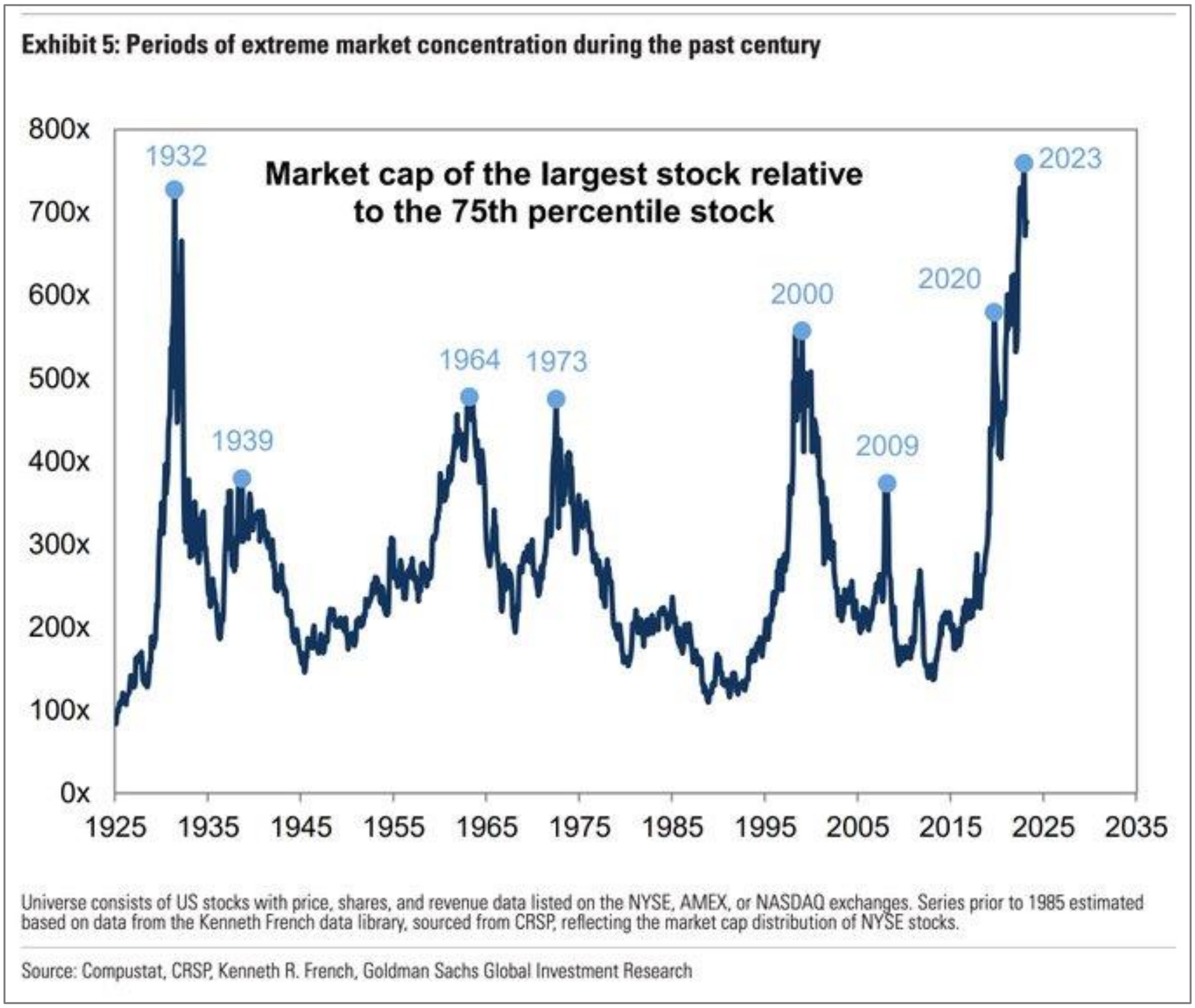
Source: John Authers, Bloomberg

Semiconductor relative performance broke the dot-com era high.

Price to Sales on Tech surpassed the Dot-Com and COVID-stimulus bubbles.



The most concentrated stock market in a century.



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.