



Market Outlook

By Mark T Dodson, CFA

Record Divergence in Futures Sentiment

Market Risk Index closed out the quarter at 74%, just below the line that qualifies the market environment as neutral. Monetary Conditions continued their steady improvement and are now scoring near the best quartile of readings. Much of the monetary improvement was offset by a deterioration in Valuations this week.

The inverted yield curve is the only indication across our Monetary Composite that anything might be amiss with markets and the economy. The other seven categories score positive, with bullish implications for markets.

While the yield curve is no longer making front-page headlines, we are not ready to toss it in the trash bin. The longer the duration and depth of the inversion, the more pause it should give investors on leaning too far into aggressive risk-taking behavior. It receives the biggest weight in our Monetary Composite for good reason, and it's not on an island unto itself. It perfectly aligns with the message from our asset allocation model's two other counter-cyclical components (Psychology and Valuation).

Animal spirits are running red hot in our Psychology Composite, and Valuations are only 1/10th of a percent away from scoring in the worst 1% of over-valued markets. Our bottom-up forecast for equity returns has fallen to 0.25%. Valuations are stretched, and the dividend yield on stocks hasn't been this far below Treasury Bill yields since 2000.

Within Psychology, Margin debt growth has climbed to 18% year over year, but it's not a red flag for markets until it surpasses 30%. However, with high interest rates this high, that's not where the action has been for levered investors. It's in leveraged funds and derivatives. In US Equity Futures, the spread between smart money and dumb money climbed to a new record. Asset Managers have never been this confident and long, and Dealers haven't been this apprehensive and hedged since the start of the 2022 bear market.

If you are a pure momentum trader or trend follower who uses Technicals to guide your decisions, there's not much cause for bull market concern, as both the Trading Data and Volatility categories of our Psychology Composite are signaling full steam ahead. It's when you factor in the weight of all the evidence that the market looks top-heavy and laden with drawdown risk.

Market Risk Index

Rec Allocation 25% Underweight

74.0%

Category Percentiles

Psychology - P6



Monetary - M3



Valuation - Extremely Overvalued



Trend



Largest Psychology Influences

Leveraged Investments	Negative
Surveys	Negative
Option Activity	Negative
Fund Flows	Negative

Largest Monetary Influences

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

Valuation

7-10 Year Equity Return Forecast	0.3%
10Yr US Treasury Yield	4.2%

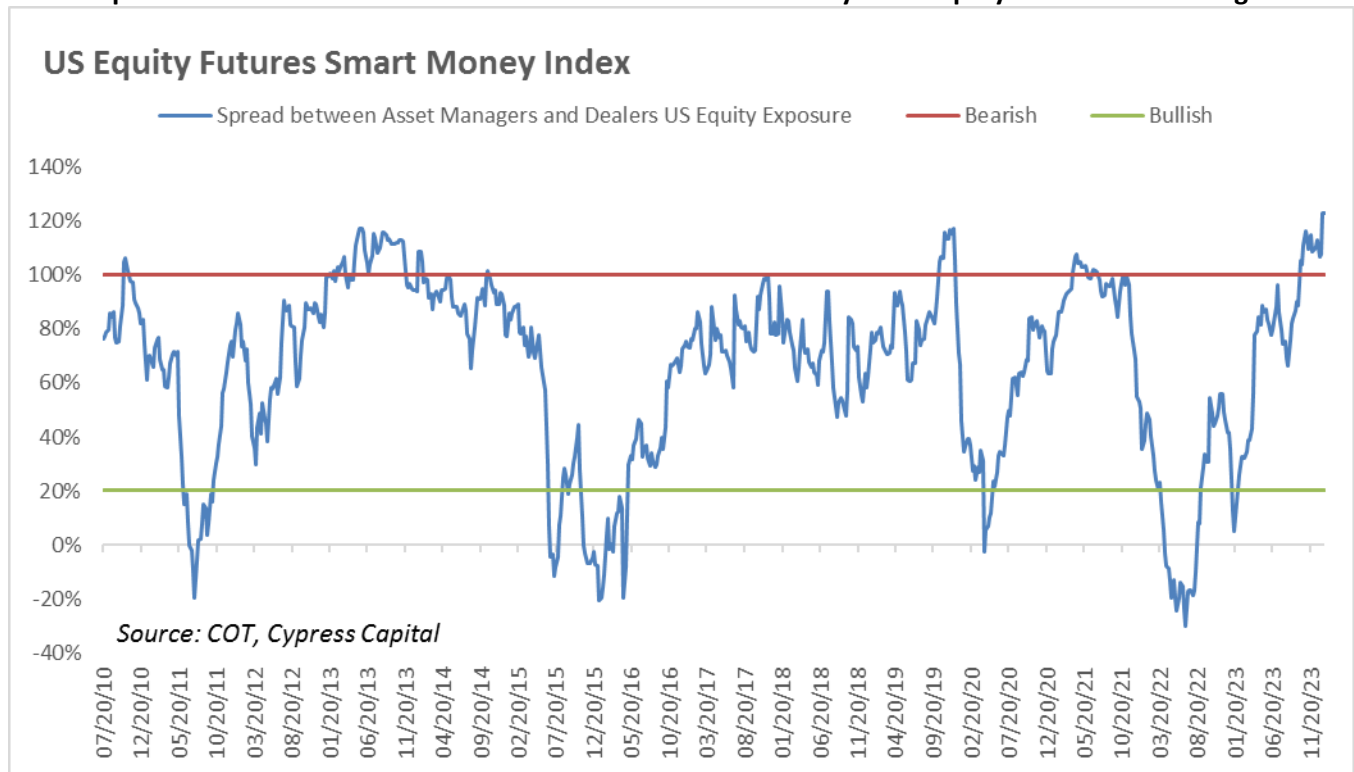
Market Trends

US Equities	Bullish Investment
Intl Equities	Bullish Investment
REITs	Neutral 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.

Charts of the Week

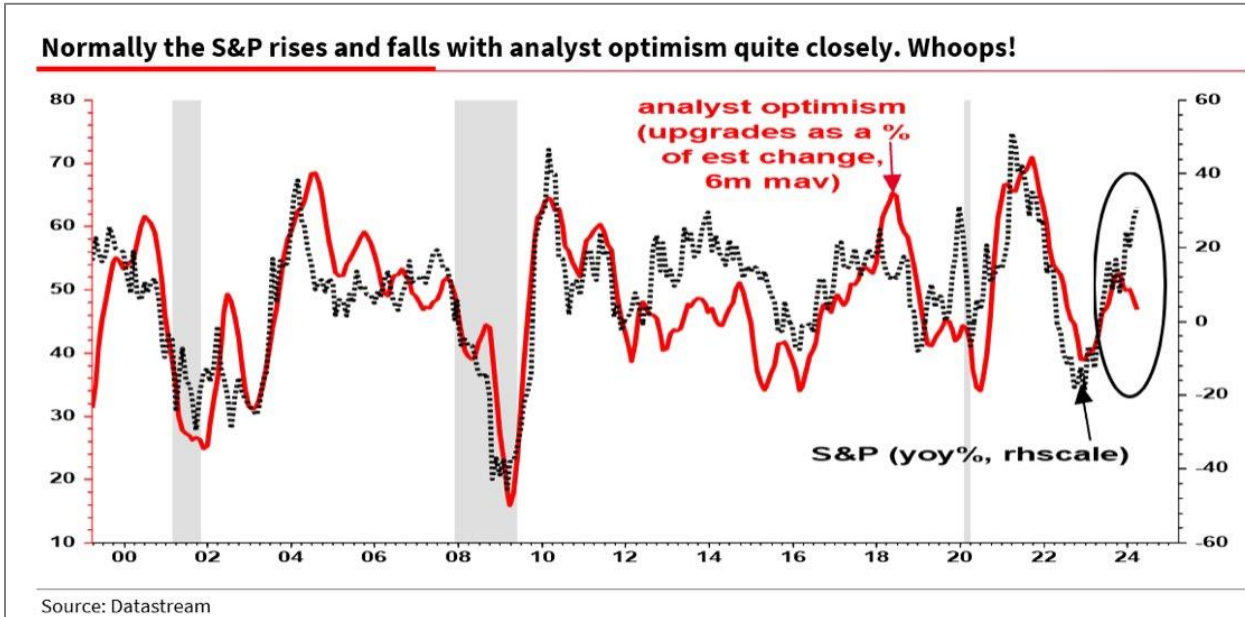
Record spread between the confidence of Dumb versus Smart Money in US Equity Futures Positioning



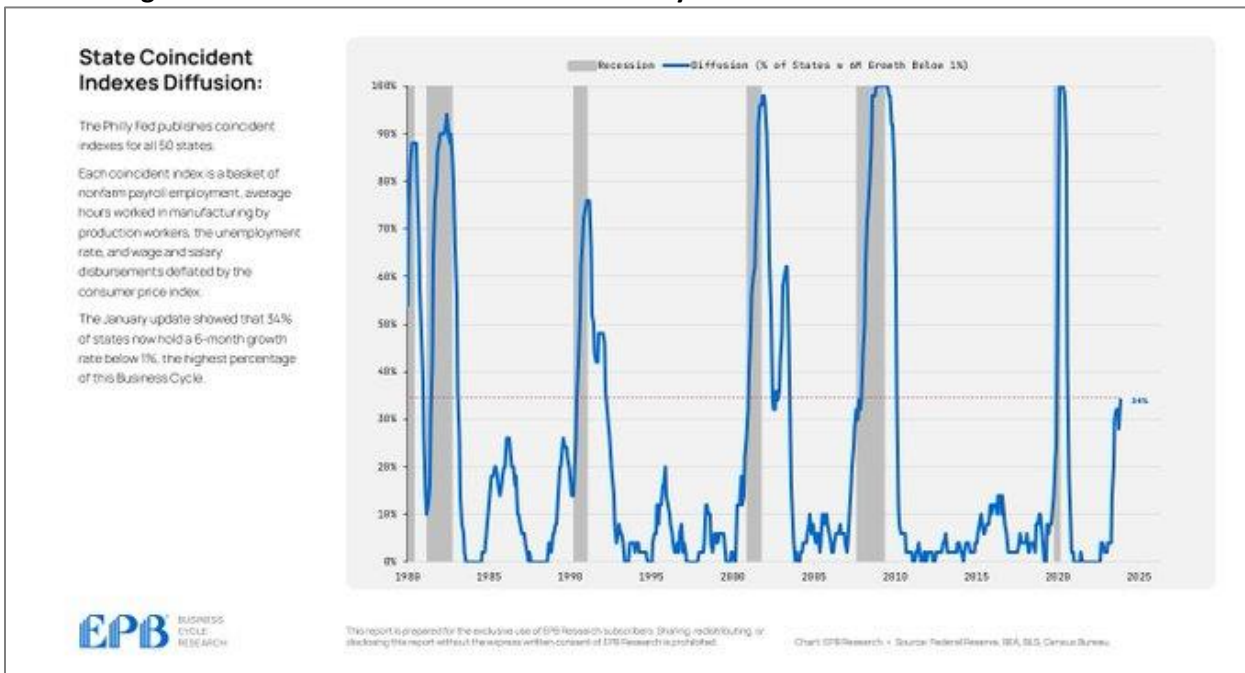
Asset Managers' speculative position in the S&P 500 is at record highs.



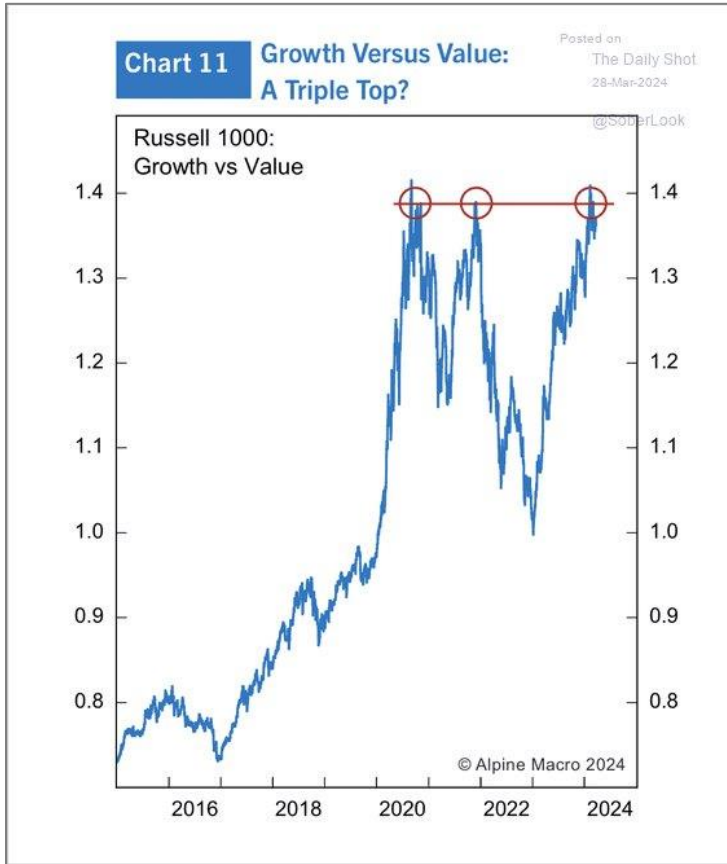
Analyst optimism on individual stocks is diverging from stock market performance.



Data coming in from individual states looks recessionary.



A Triple Top in Growth Versus Value

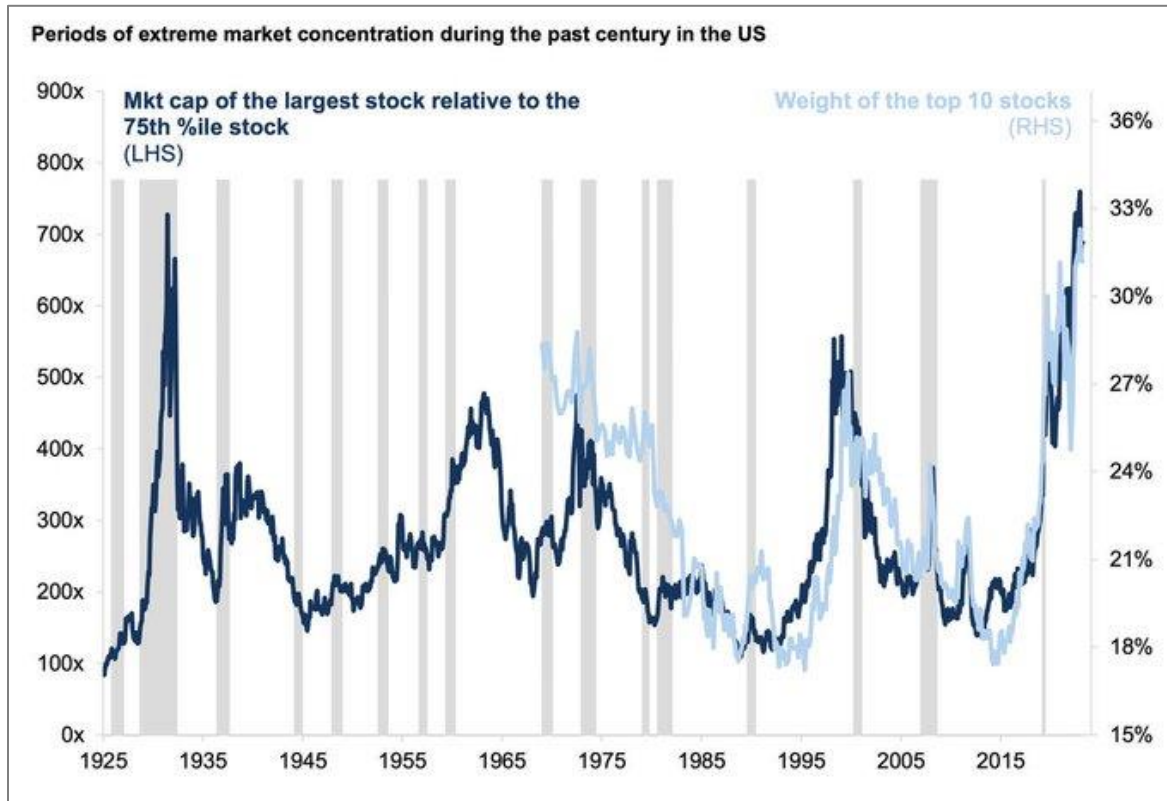


Has High Beta Momentum ever been this extended?



Source: Bernstein Advisors

Historic Level of Stock Market Concentration



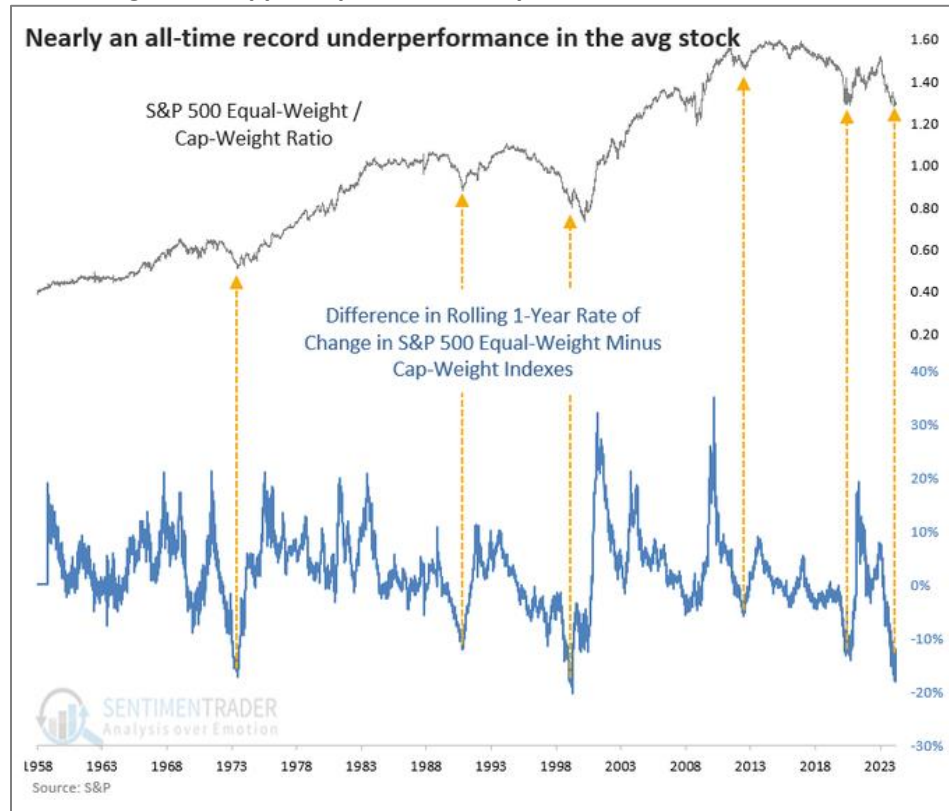
Magnificent Seven are 30% of S&P 500's market cap.

Chart 6: Magnificent 7 back to >30% of S&P 500 market cap
 "Magnificent Seven" market cap as % of S&P 500



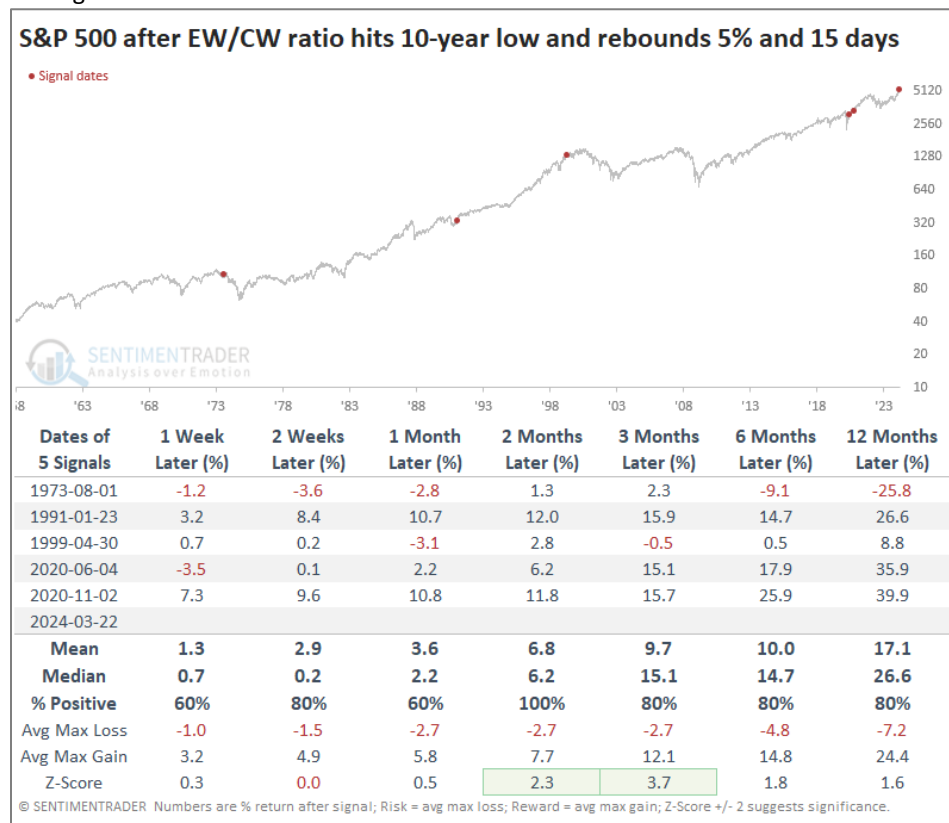
Source: BofA Global Investment Strategy, Bloomberg
 Magnificent Seven = Apple, Amazon, Google, Meta, Microsoft, Nvidia, Tesla

The average stock appears primed for outperformance.

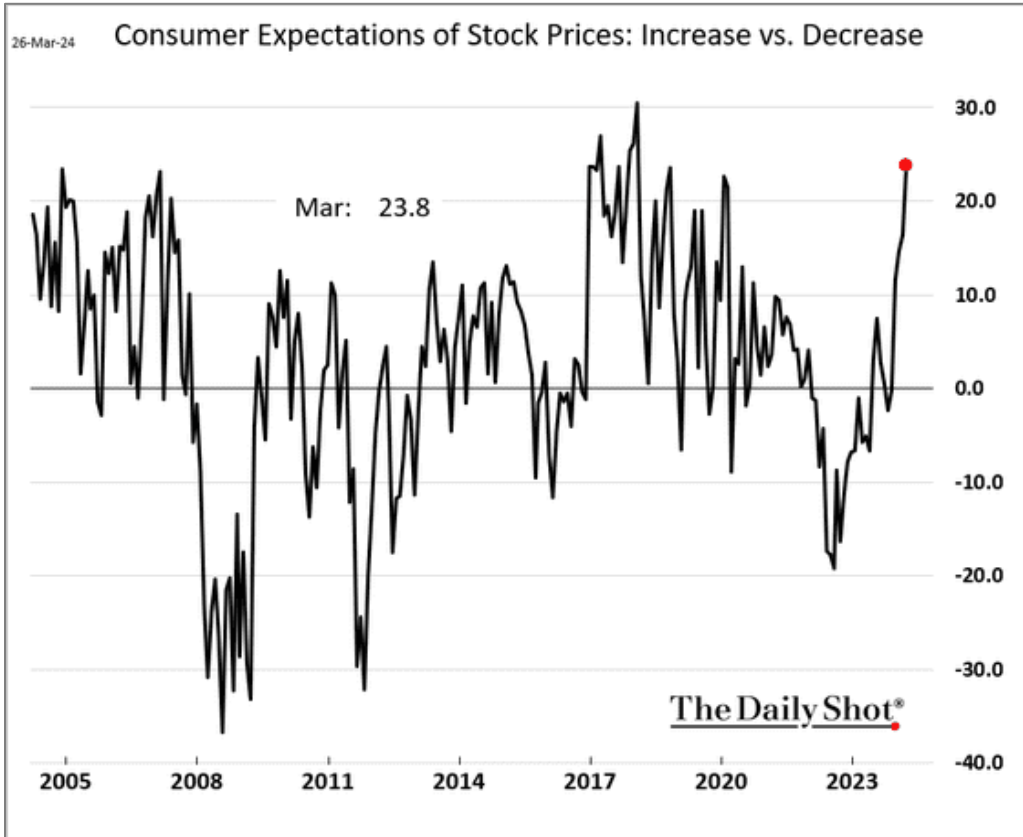


Is a broadening out of a highly narrow market bullish?

The table's numbers are solid. However, two of the four general frames were near major bear market peaks, and the other two signaled robust bull market moves for the broad market.



Consumers have become bullish on stock prices.

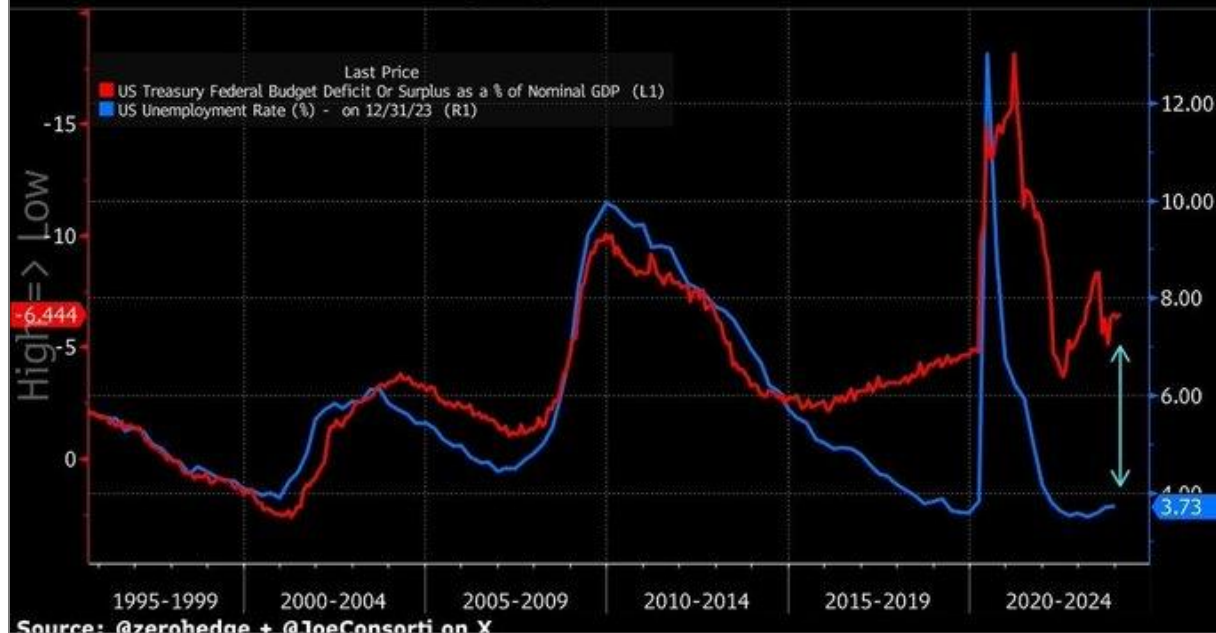


Tech Insiders are selling stock at the fastest pace in three years.



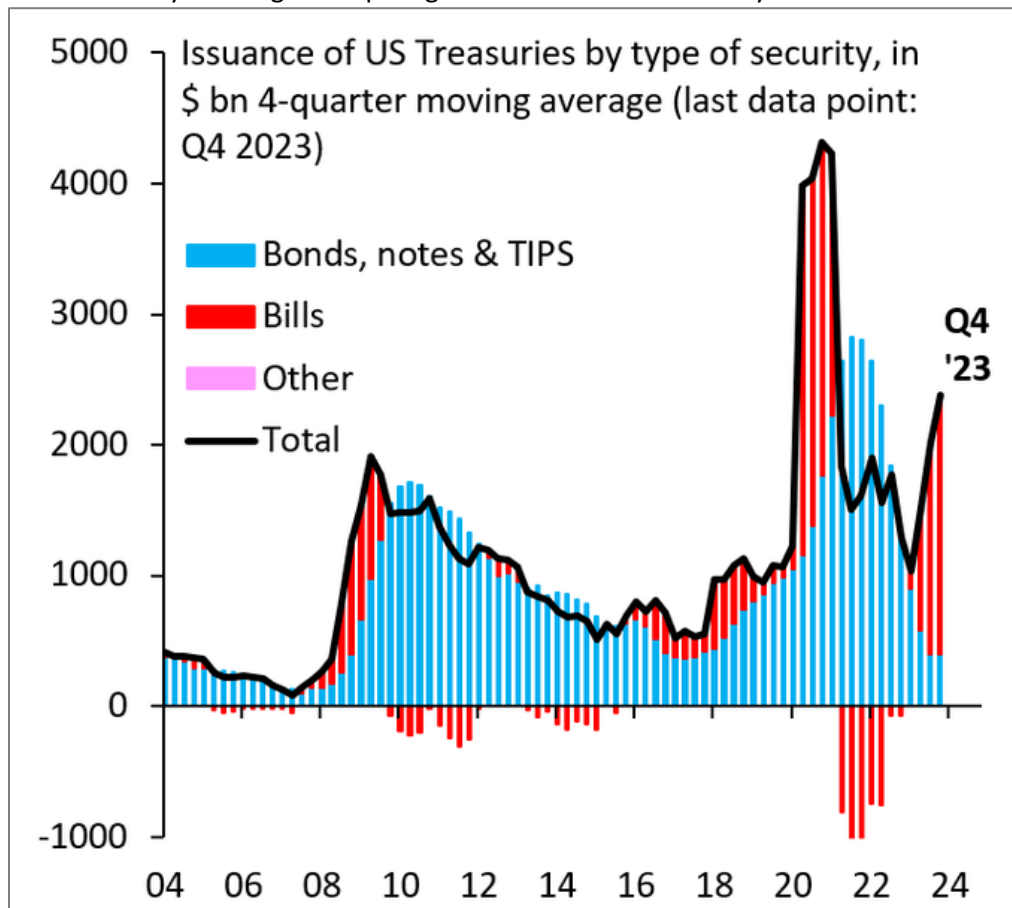
The US is running a Federal deficit consistent with an 8% unemployment rate.

Federal Deficit at 6.5% of GDP implies an 8% Unemployment Rate

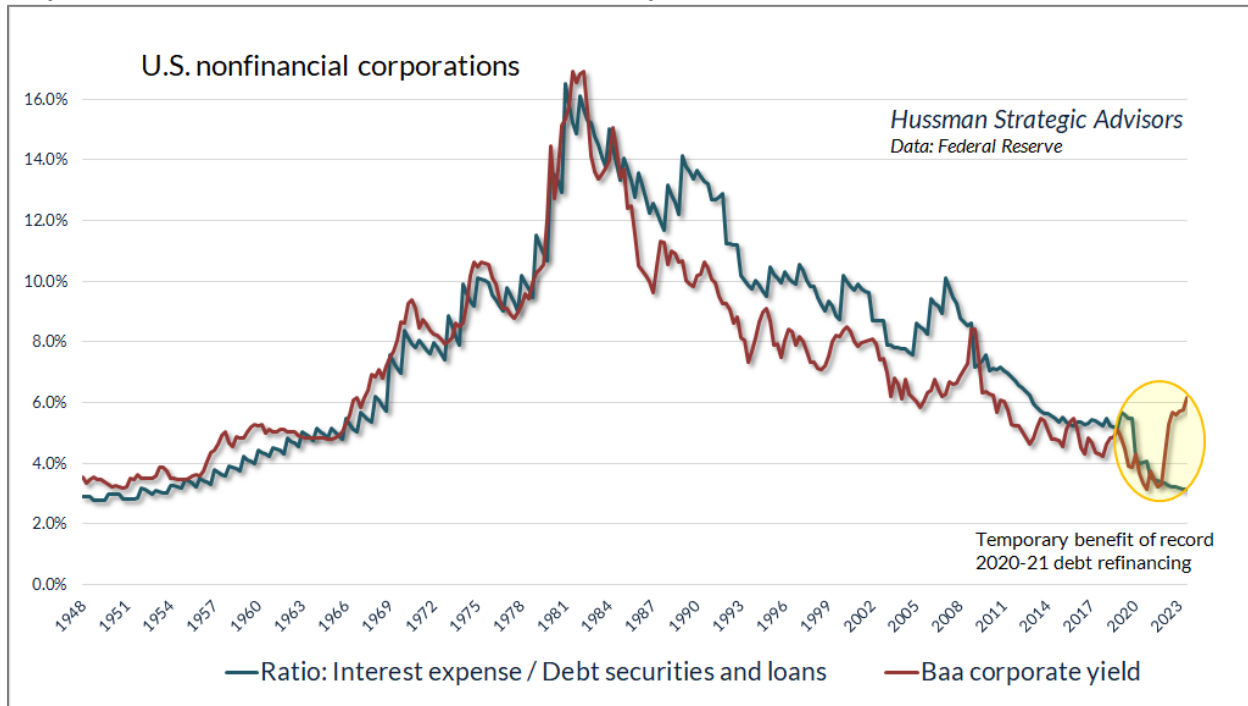


The Treasury is funding the deficit with Treasury Bills.

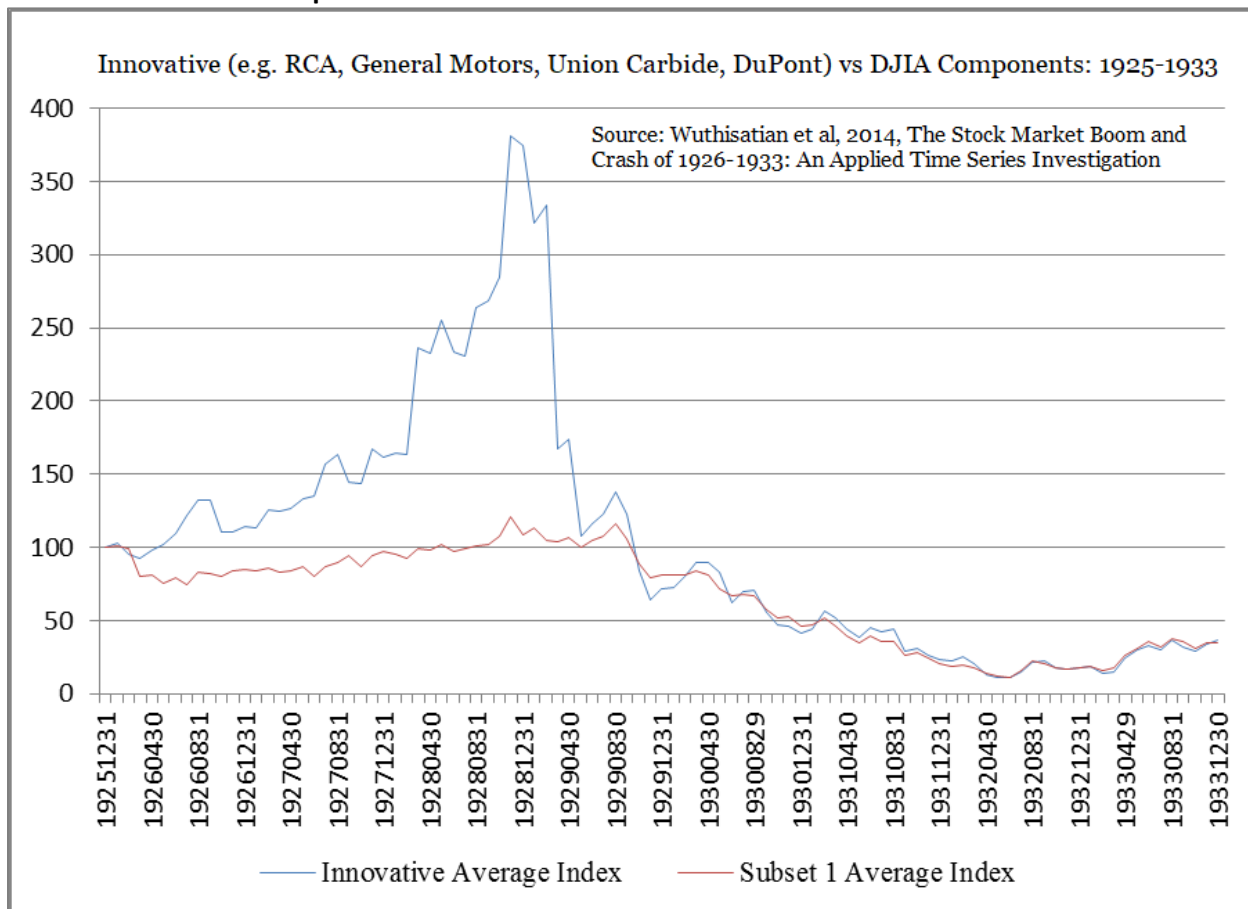
Is the Treasury working to keep long rates lower in an election year?



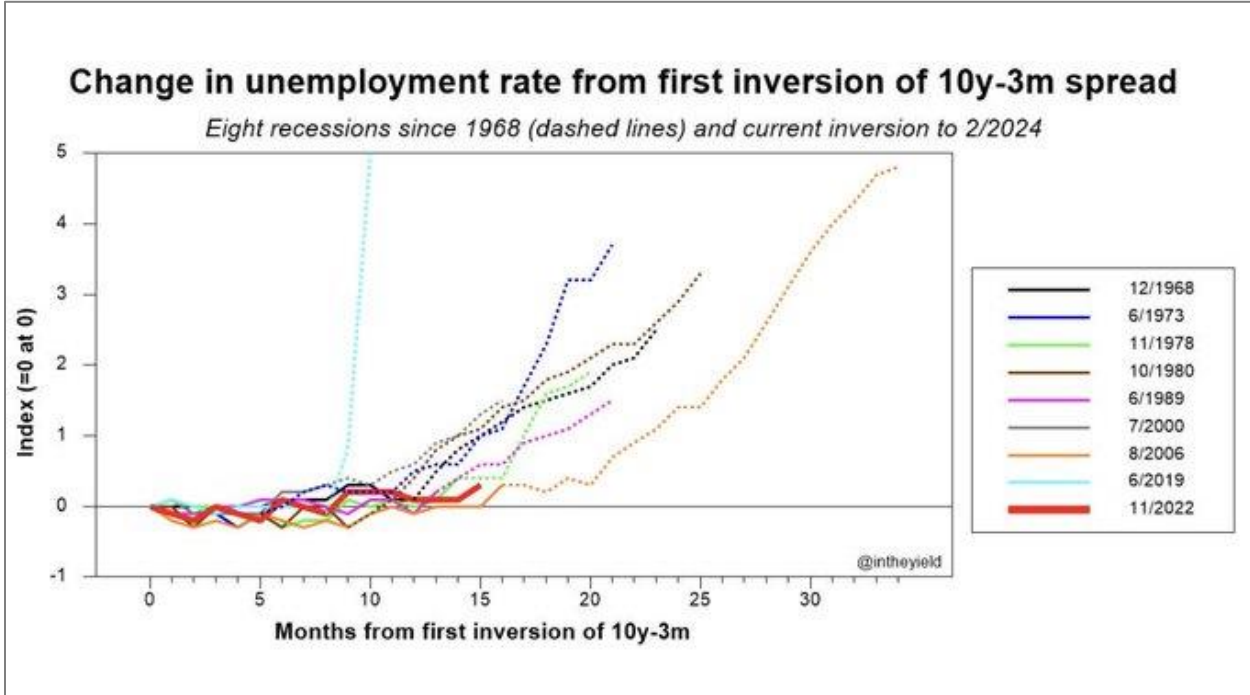
Corporate Income Statements have avoided the sharp rise in interest rates.



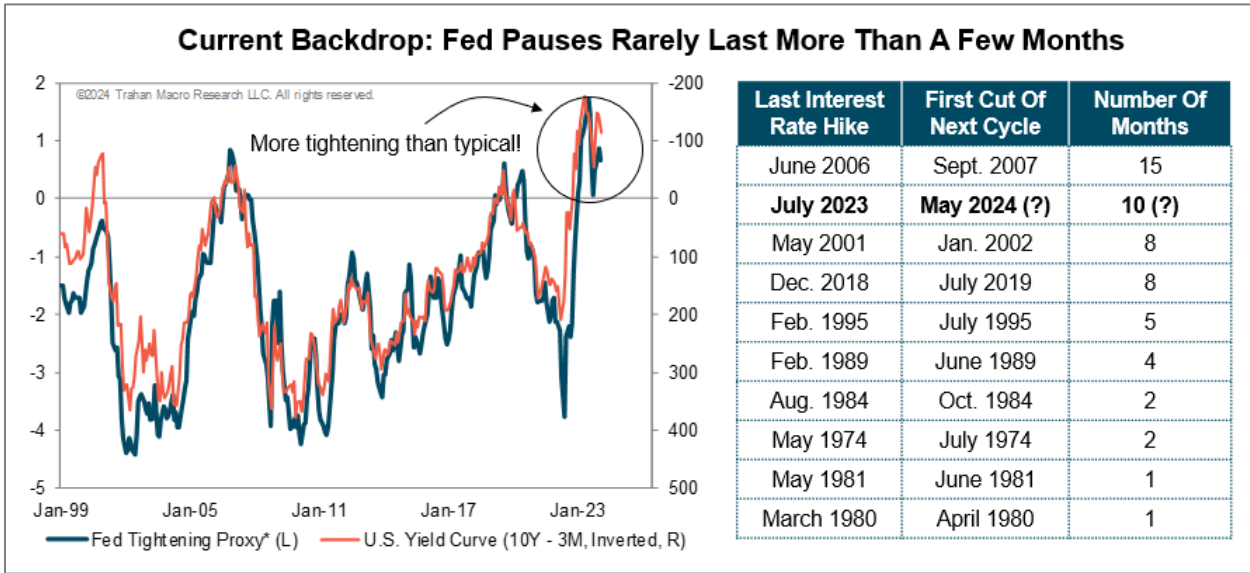
The most innovative companies in the 1920s crashed before the broader market did.



The long lead times of the yield curve.



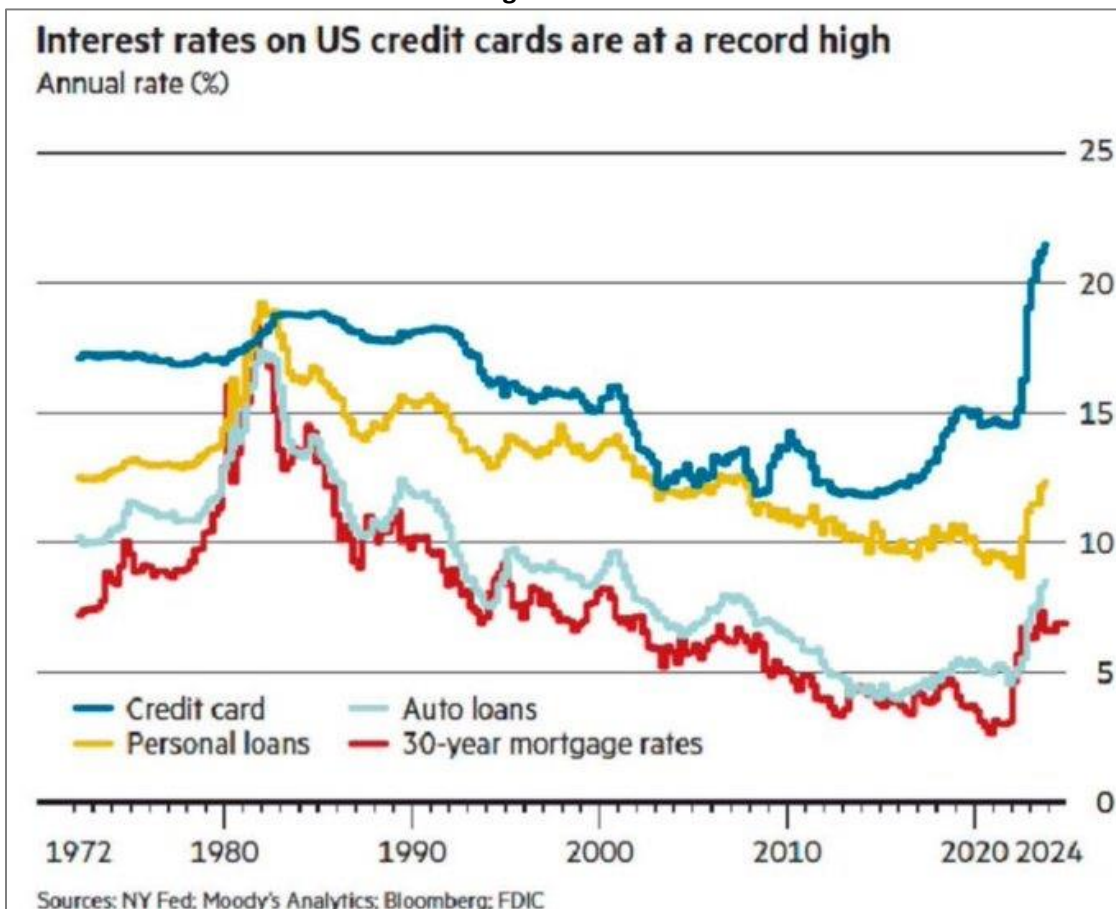
The length of this Fed pause is the second longest in 50 years.



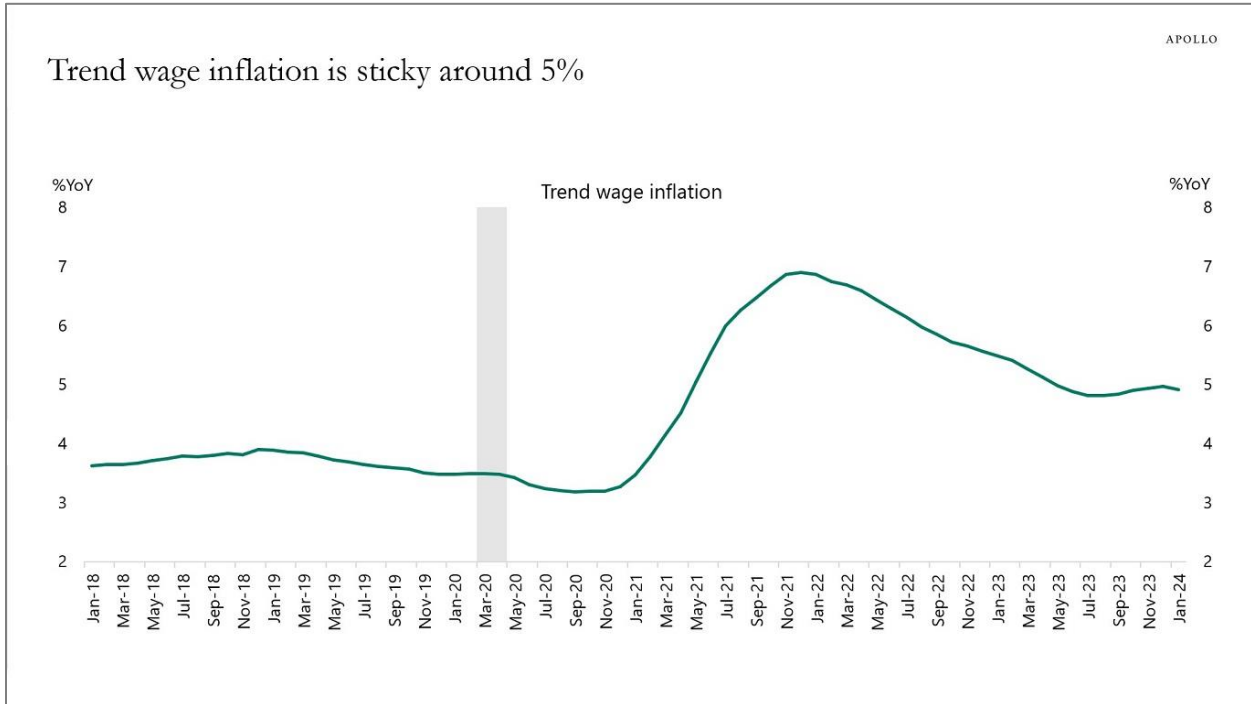
Valuations in Europe aren't too far above the historical average.



Credit Card interest rates are at record highs.



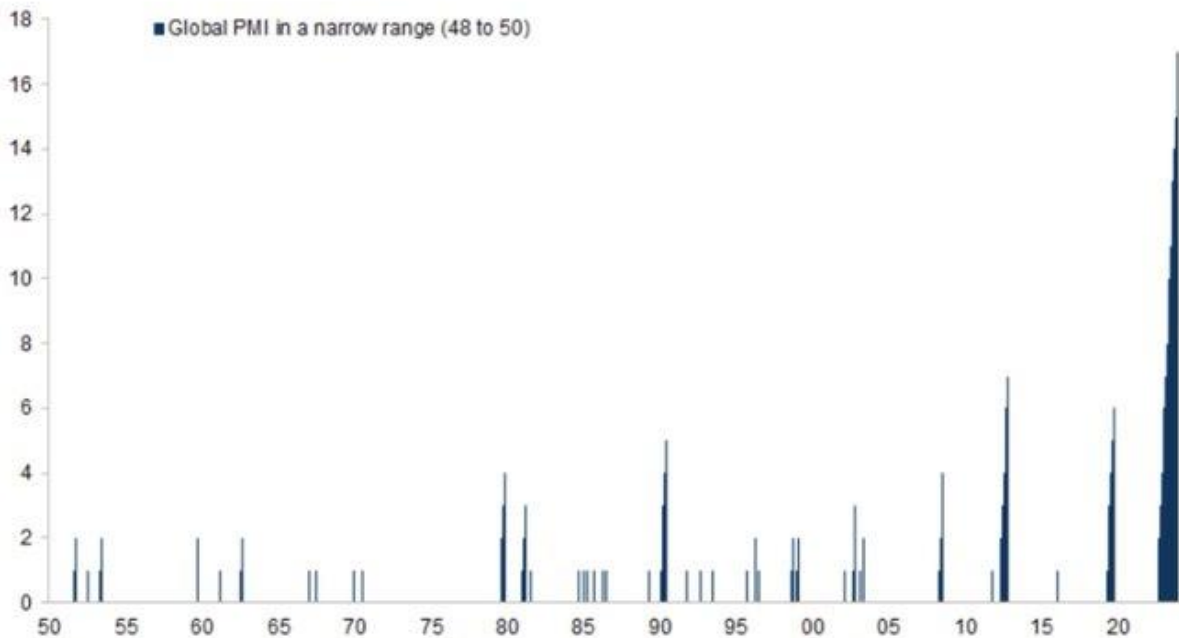
Wage inflation has become sticky at 5%.



Global PMIs have never been flat for this long.

Exhibit 1: It is unusual for Global PMIs to be stuck in a flat range for such a long time

Number of consecutive months with global manuf. PMIs between 48 and 50. The series is backfilled with ISM Manuf. before 1998

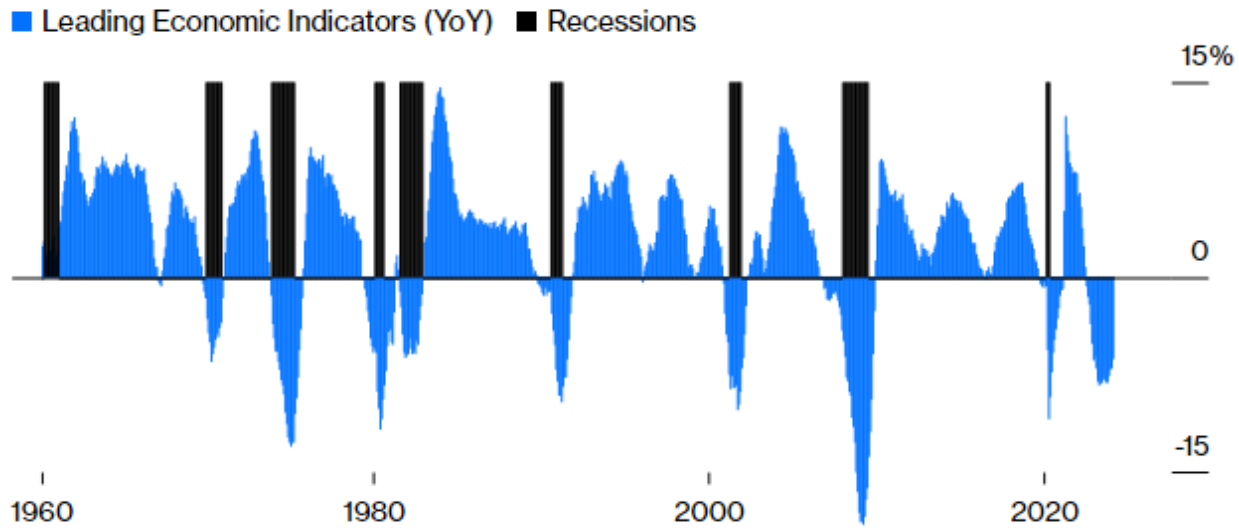


Source: Haver Analytics, Bloomberg, Goldman Sachs Global Investment Research

Is the Conference Board going to revamp Leading Economic Indicators?

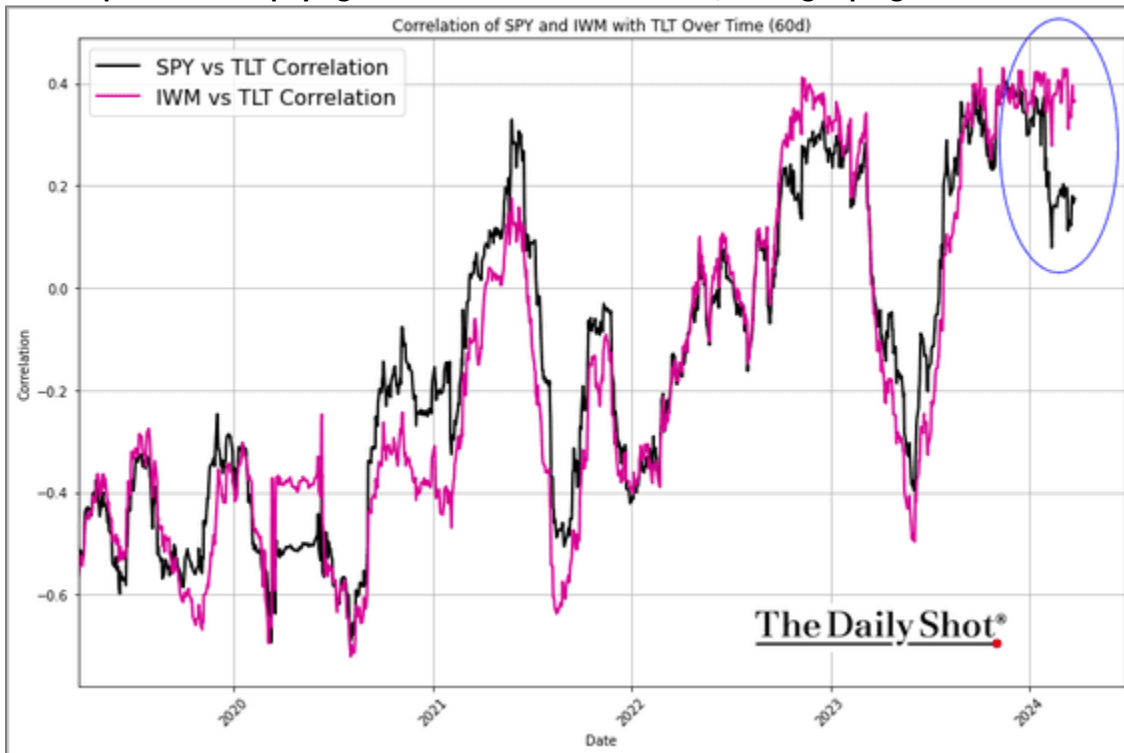
Misleading Economic Indicators?

LEI has never trended downwards for this long without a recession



Source: Bloomberg

Small caps have been paying attention to the bond market, but big caps ignore it.



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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