Market Outlook

By Mark T Dodson, CFA

Monetary Conditions Keep MRI In Check

Market Risk Index dropped slightly but remains above the 75th percentile. The psychology risk score increased again this week, but it was more than offset by an improvement in the Monetary composite. High volatility readings should be able to keep our psychology composite from moving into the worst 20% of readings, and the breakout that we saw a couple of weeks ago in a number of our technical indicators, like our overbought/oversold indicator, is still providing a boost to psychology.

That thrust in breadth came later and after a larger percentage move higher in markets than we have ever seen. The delayed thrust combined with current valuations make those riskier signals to chase, especially given how quickly markets retreated upon reaching those levels. Markets balked right as the percentage of S&P 500 stocks above their 200 day moving averages crossed the 50% threshold, and prices retreated immediately after the breadth thrust. This isn't how the market behaved in early 2019 after the 2018 correction and corresponding thrust. It kept pushing higher.

Bank Sentiment is pressing the psychology readings in the wrong direction and continues to weigh on the psychology composite. The lending standards at banks have climbed to levels reached early in each of the last three recessions. There's a good chance that the NBER will end up declaring that the recession ended sometime in May, but it's unlikely that bank standards are set to ease so soon.

On the monetary front, corporate and muni bond yields have settled in so much as a result of the Fed's actions that it's easing monetary conditions. Monetary base growth added points this week as well.

A rollover in the growth rate of monetary aggregates in M2 and MZM is showing up in the charts. That would normally provide a boost to our monetary composite, but it also coincides with yields that want to push higher. Should rates try to push higher and the Fed begin to engage in yield curve control, our monetary composite will have a difficult time signaling a robust credit cycle is on the horizon like it did in 2009. There's a lot of corporate debt overhang, so if the last cycle felt artificial, this one will be more so.

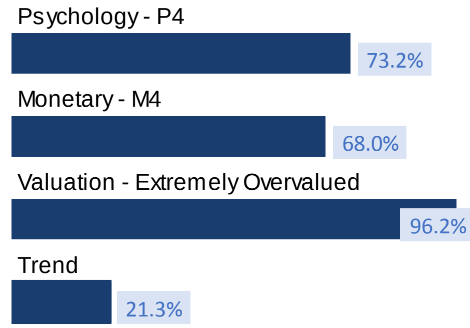
We were in favor of QE in 2008 and weren't concerned with inflation. This time around, we think inflation has potential to tick up more than most of the public expects. The recovery will be different than what we have grown accustomed to,

Market Risk Index

Elevated

76.5%

Category Percentiles



Largest Psychology Influences

Volatility	Positive
Technical Indicators	Positive
Option Activity	Negative
Leveraged Investments	Negative

Largest Monetary Influences

Interest Rates	Positive
Velocity	Negative
Yield Curve	Negative

Valuation

7-10 Year Rtn Forecast	2.0%
10Yr Treas Yield (on 06/18)	0.7%

Market Trends

US Equities	Bullish
Intl Equities	Neutral
REITs	Neutral
Broad Commodities	Neutral

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

and this bull market, technically defined, should prove to be more fragile and shorter than we are used to seeing.

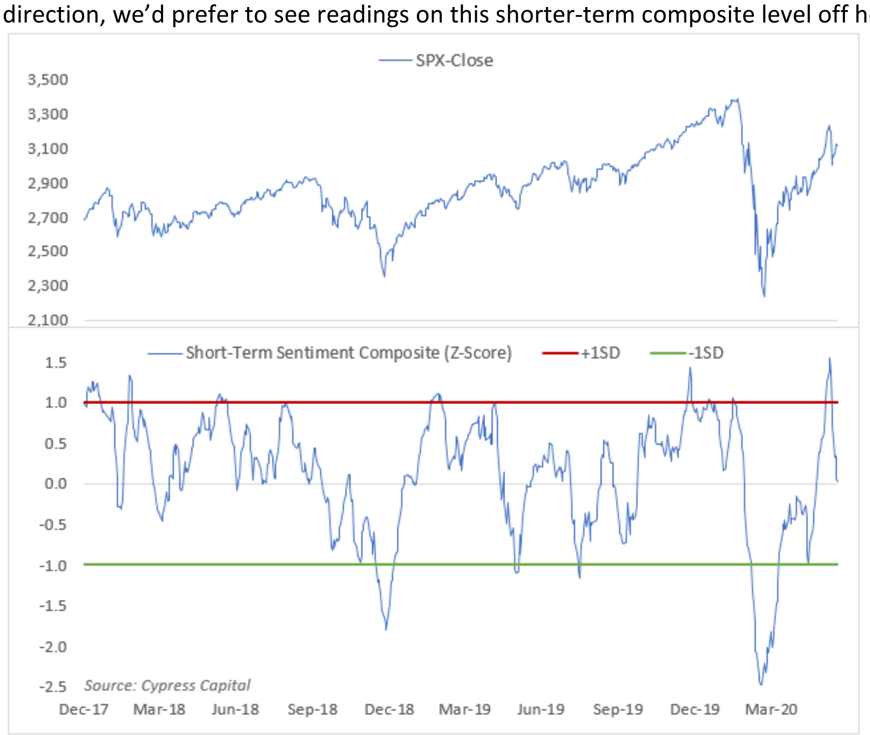
Our valuation composite and return expectations for US equities are a rounding error distance away from where they were at the beginning of the year, and that was when unemployment was below 4%, without a pandemic. US equity valuations don't make sense given a backdrop holding this much uncertainty, as uncertainty is supposed to be the playground for stock market bargains. Even the small cap rally has put a dent in how attractive those stocks are. Don't fight the Fed was a mantra designed to encourage you to get into stocks when they were cheap and unloved – not as fuel for FOMO to buy stocks at lofty valuations and high yield debt while bankruptcies and credit downgrades are rising. The default rate on junk has even climbed above the yield – not sure that has ever happened before

It's a risky environment to get caught up in the fear of missing out. For investors who remember the opportunity that 2008-09 presented and feel regret for not pouncing on it, thinking the March 2020 selloff was an analog to that – it wasn't. This binary, all or none, bottom and top-picking mindset that represents financial market writing and media is a stumbling block. There is an alternative. It's called patience.

We're patient and comfortable hovering somewhere between all in and all out. We've gotten good breadth that you want to see after a bear market, and we've got the Fed put – so much so that the Fed is coming across as panicky on any market volatility. We're also seeing more faith in the Fed put than ever and also contending with the worst valuations since 2000, with pockets of euphoria in markets that bear a resemblance to that 2000 environment, but with little reason to be euphoric. It makes for a poor environment to play another game of greater fool theory. There is nothing wrong with holding steady, like a good blackjack player, waiting for the card count to get high before betting big. We loathe losing money and have no interest in being lauded for taking a bad bet that happens to have a good outcome. Balance out the risk of drawdown AND regret to make better decisions. Can you tell that I'm preaching to myself?

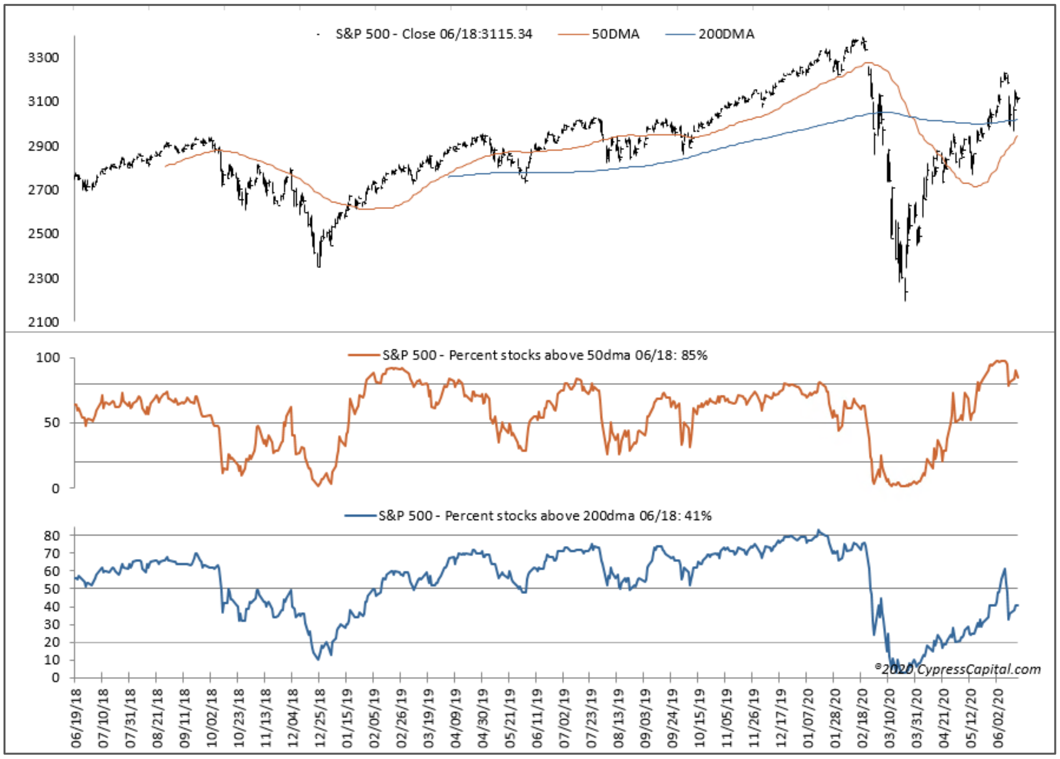
Short-Term Sentiment Composite

This is the same composite of short-term indicators that we had coined "Buy the Dip" back in March. This basket of indicators hit new highs for 2020 on June 9th and is reversing. For a bull market to have legs and moving in the right direction, we'd prefer to see readings on this shorter-term composite level off here.



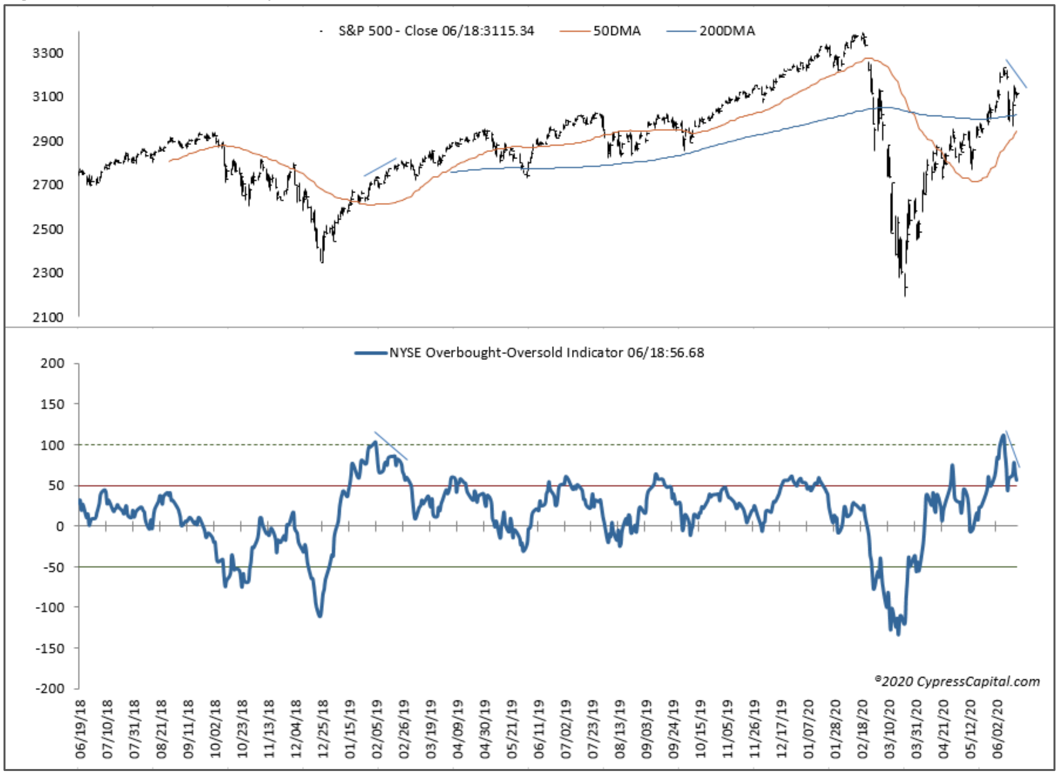
Percentage of S&P 500 Stocks Above 200DMA

All things equal, bulls prefer to see a market push right on through as the percentage of stocks above their 200dmas crossed above the 50% threshold, not roll over.



Overbought/Oversold Indicator

In a typical trending environment, this indicator is useful in making short-term mean reversion bets. When the indicator gets really overbought after a substantial selloff, it's a bullish sign, even more so when supported by valuations. What's unusual in this case is how quickly the market gapped down after breaching that level. It's a market giving more mixed signals than it did in early 2019.



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. Portfolio built upon Cypress Capital's own metrics that measure dividend quality and safety. The portfolio is divided 75/25 into payers and growers. Payers are stocks with above average yields and 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 with 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 in an effort 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. 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.