Market Outlook

By Mark T Dodson, CFA

A World Looking for Inflation Hedges

Drawdown risk present in equity markets climbed this week as MRI moved up to 80.9%. The Monetary composite continued its fall trend of reversing the steady improvements it had made over the summer. The inflation category hasn't budged from its maximum negative score, as inflation pressures have broadened. Instead, what we see in the Monetary composite is the quantitative embodiment of a slow and steady procession of come to Jesus moments, as people begin to doubt the transitory inflation narrative.

Conditioned by the experience of Japan as well as our own post-GFC secular stagnation story, many of us doubted that a surge of inflation of this magnitude was even possible. However, history has shown us that World Wars, and the fiscal spending that goes along with them, are massive inflation creators. Covid rained down some World War stimulus, but in the place of guns and tanks, we built an army of Teslas and Amazon drivers armed with cardboard boxes.

Even if doubts about the nature of inflation are beginning to creep in, the stock market and current enthusiasm for speculation have done a fine job of shaking them off. Our short-term sentiment composite spiked back into enthusiasm territory after the briefest flirtation with a pessimism reading two weeks ago. That same AAII poll which was excellent from a timing perspective in its signal of pessimism has already reversed back to above-average bullish responses as well.

This is par for the course in 2021 – speculators buying the dip before most long-term stock market followers would even consider it a dip. Another hallmark on these minor dips has been abnormally large negative short-term breadth readings immediately followed by abnormally large breadth positive breadth readings as speculators rush back in to buy.

The new high in the market pushed the Valuation composite into the highest 99.9% of readings. The month of October has our valuation composite working on extending its record of consecutive monthly negative return forecasts after beating the previous record set in 2000 earlier this year. It suggests that stocks are an uncharacteristically poor inflation hedge at this moment in time.

The inflation spike and absence of yield have created a perverse feedback loop of yield-seeking as investors search for anything that might shield them from inflation. Some have no doubt sought protection or feel more complacent in equities – traditionally considered a good inflation hedge. That's an argument that hinges on history, while a significant determinant of the ability of a financial asset to hedge against inflation is its valuation. Treasuries are historically considered a poor inflation hedge, or so the rule of thumb goes, but a Treasury bond priced to yield 14% would be an excellent inflation hedge in an environment of 5% inflation. Valuation creates the opportunity for returns, and the higher expected return is the source of the hedge. Finding a financial asset to serve as an inflation hedge is less about looking at 100 years of historical returns and more a matter of searching for assets priced to return more than the rate of inflation.

Market Risk Index

Rec Allocation 25% Underweight

80.9%

Category Percentiles

Psychology - P6: 95.8%

Monetary - M4: 53.7%

Valuation - Extremely Overvalued: 99.9%

Trend: 0.0%

Largest Psychology Influences	
Levered Investments	Negative
Volatility	Negative
Option Activity	Negative
Consumer Confidence	Negative

Largest Monetary Influences	
Inflation	Negative
Velocity	Positive
Exchange Rates	Positive

Valuation	
7-10 Year Rtn Forecast	-0.1%
10Yr Treas Yield (on 10/20)	1.6%

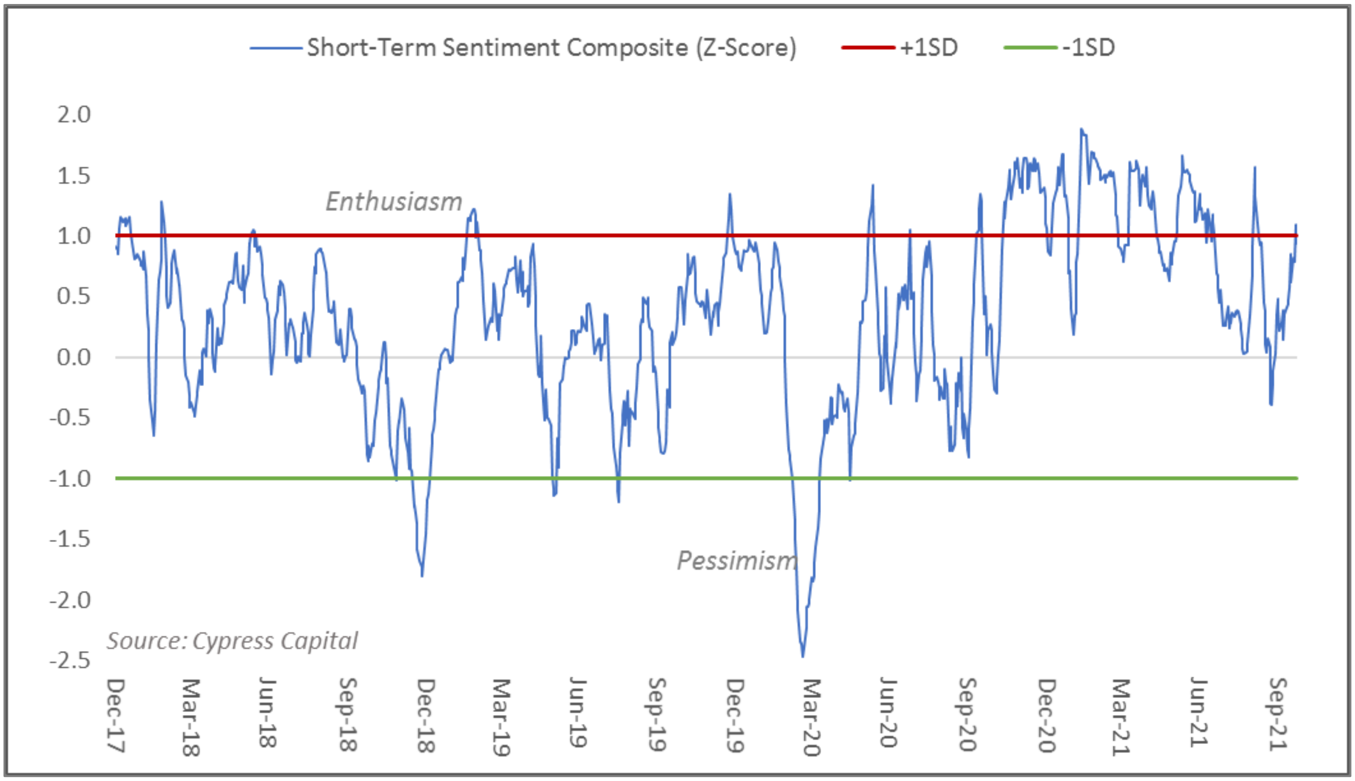
Market Trends	
US Equities	Bullish Investment
Intl Equities	Bullish Investment
REITs	Bullish Investment
Broad Commodities	Bullish Investment

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.

The most probable cure for inflationary periods like this has been recessions and/or severe market corrections. Both of which create opportunities for obtaining good inflation hedges. The best move for investors is not to chase speculative assets in hopes that the price increases continue to outpace inflation. We're not saying put it under the mattress – only suggesting that it's not prudent to be an aggressive investor in the wackiest period in markets that we have ever seen.

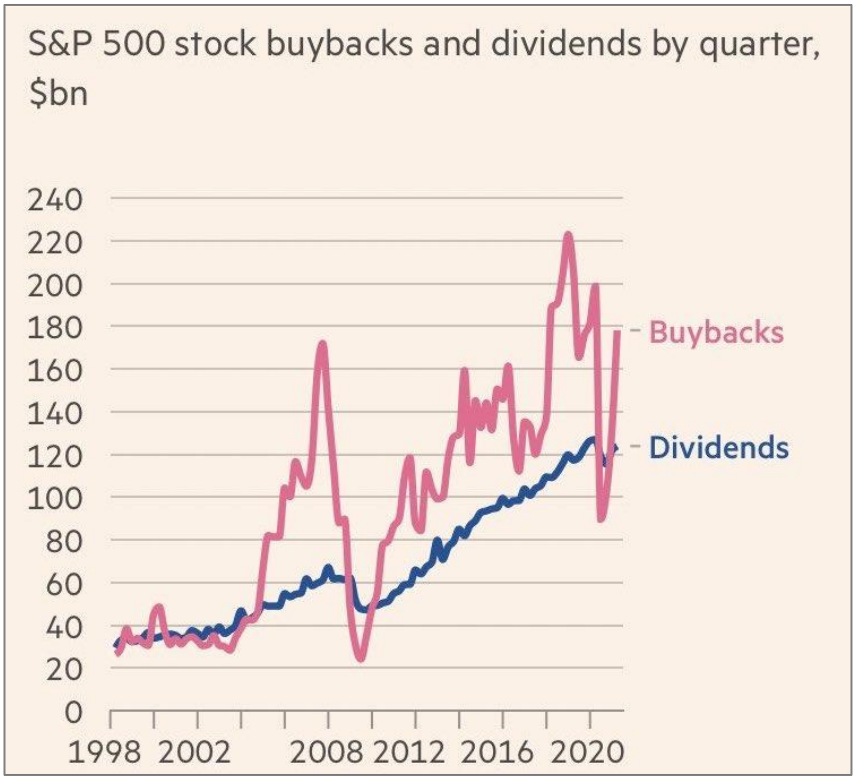
Charts of the Week

Short-Term Sentiment Composite shifts back to Enthusiasm



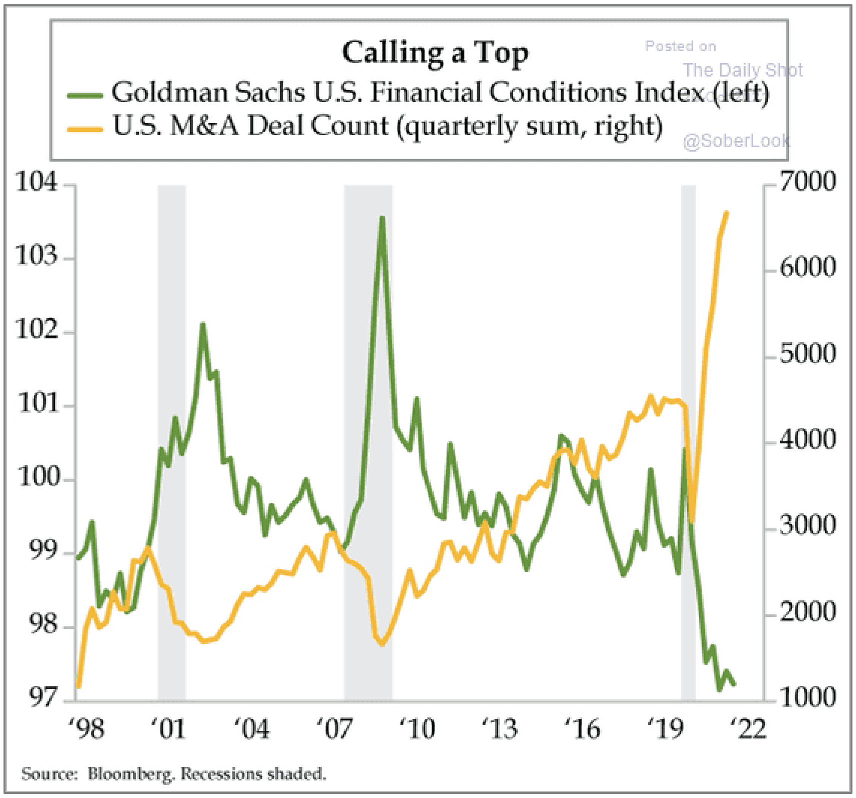
Corporate Sentiment I – Surging Buybacks

Buybacks act like a gauge of corporate sentiment. Be wary of big spikes, and back up the truck when they cut them below the level of dividends.



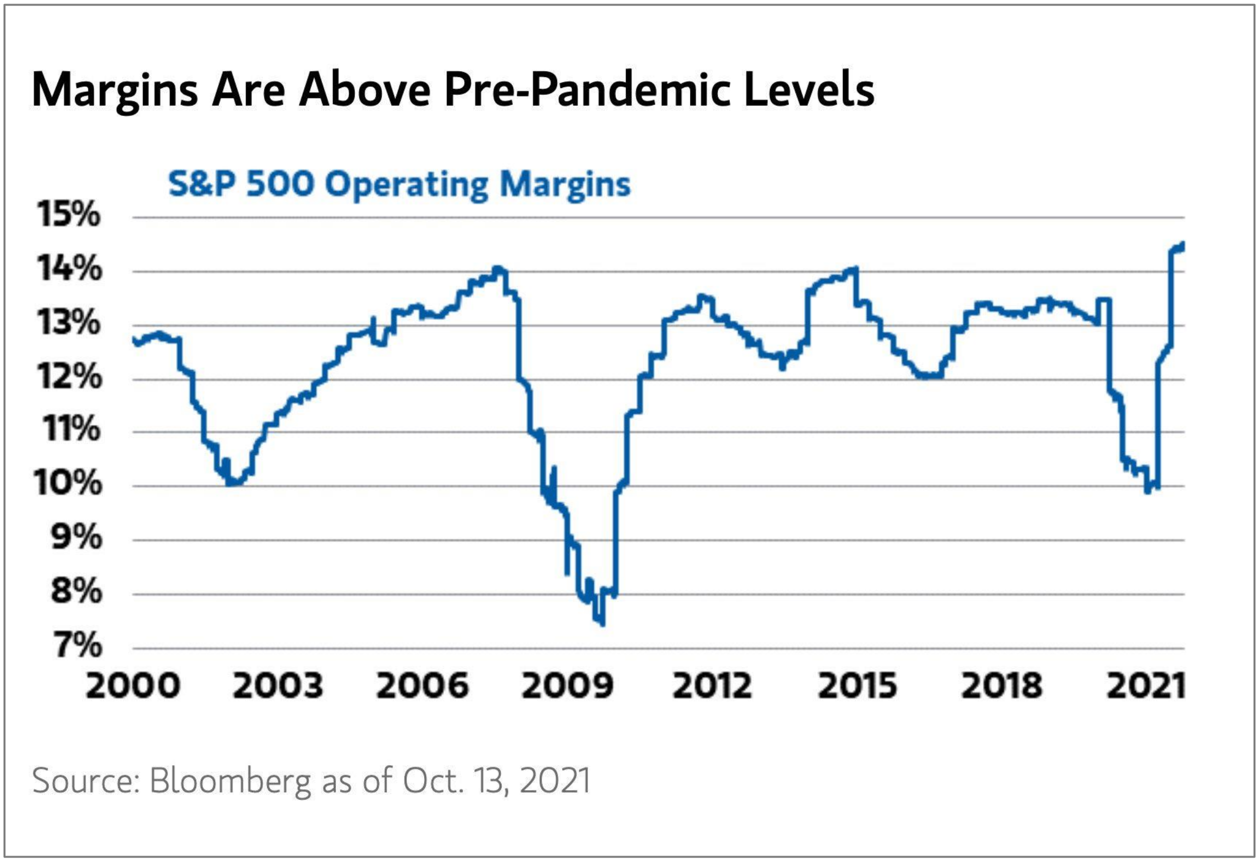
Source: Financial Times

Corporate Sentiment II – M&A Deal Count blows through the previous record.



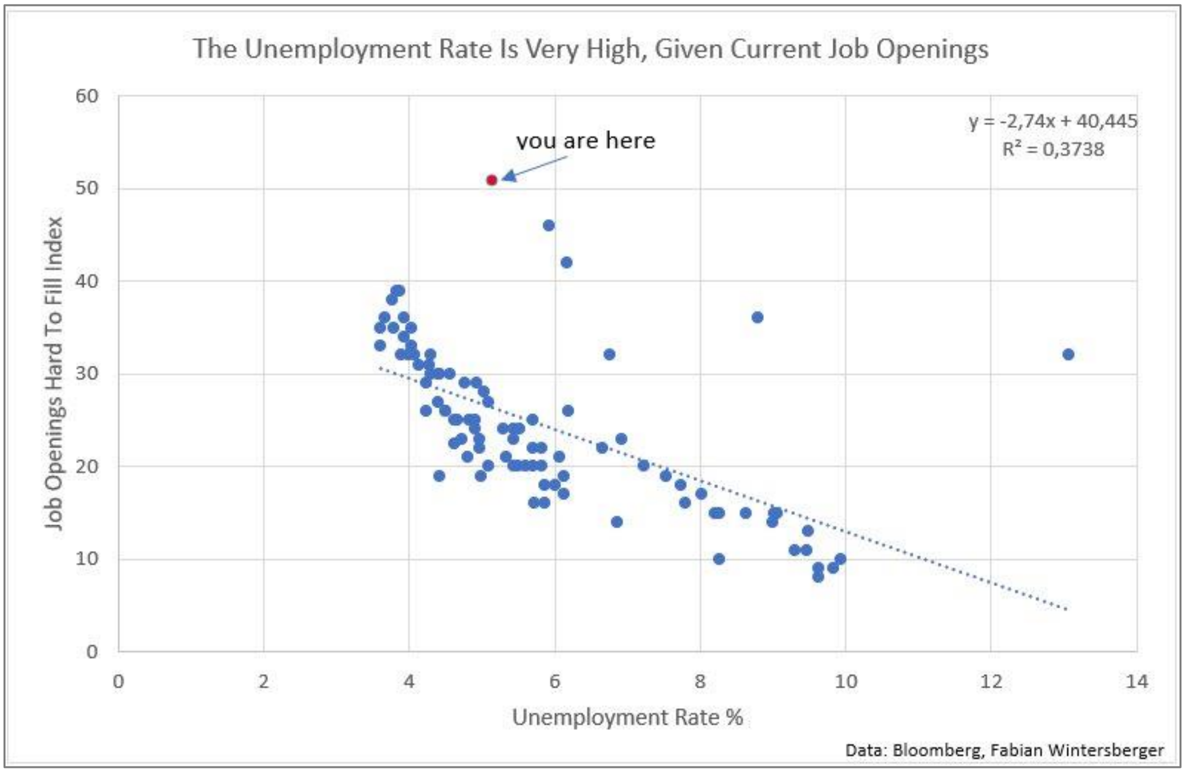
Source: Bloomberg. Recessions shaded.

Corporate Operating Margins are near record levels.



Outlier – Job Openings versus Unemployment Rate

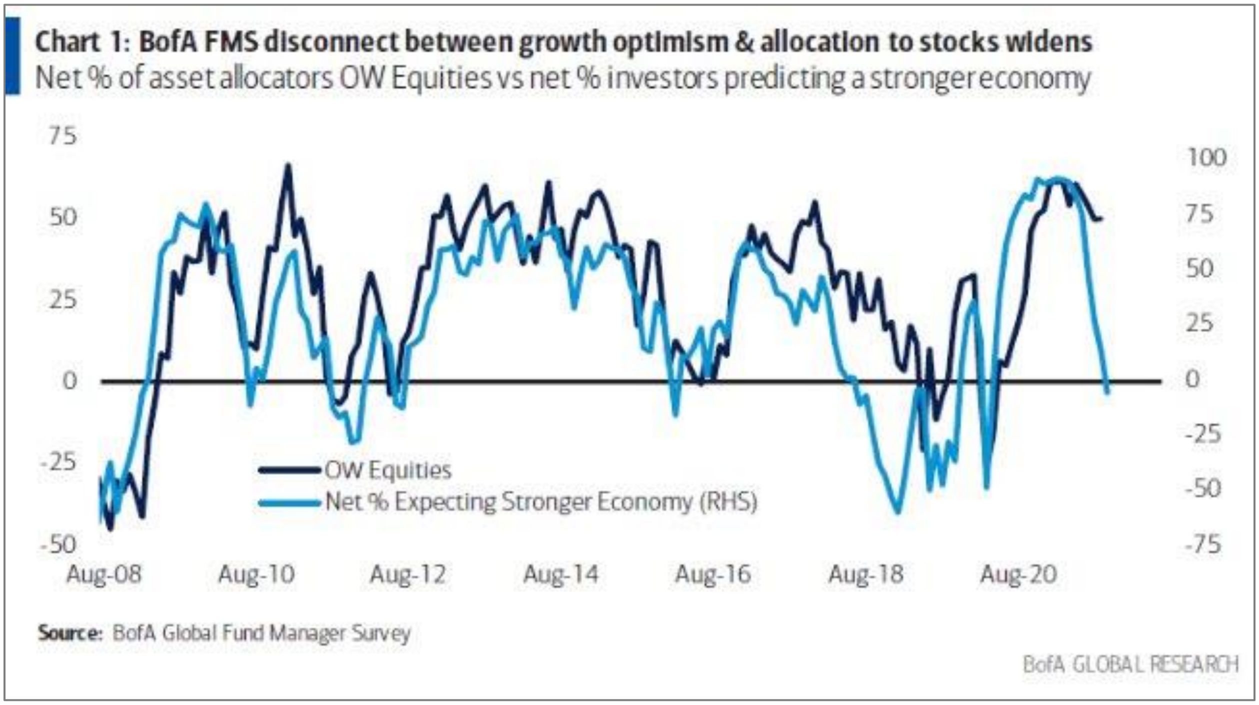
Two things fix this, higher wages (inflation) or sales slow enough to curb hiring (slower growth).



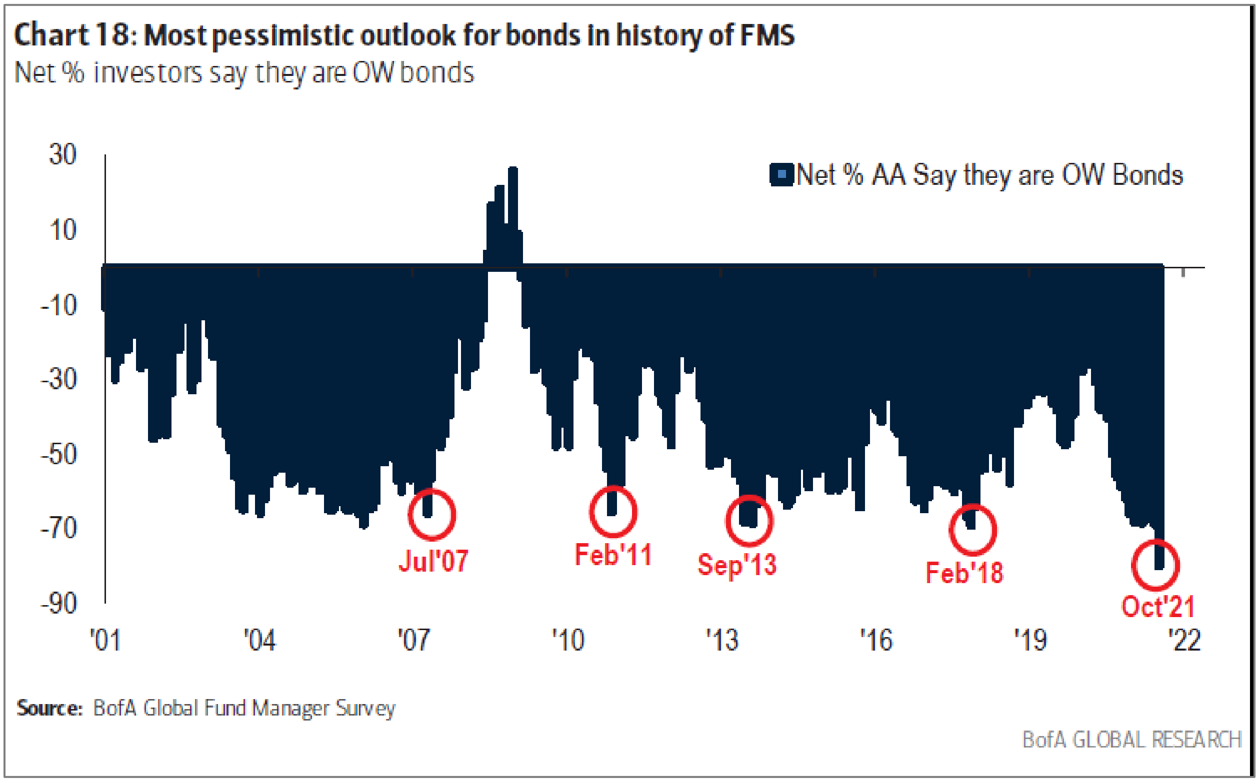
Record Jobs Hard to Fill also implies a much higher Fed Funds Rate.

Fed Funds futures imply two rate hikes in 2022 with more than 90% probability.

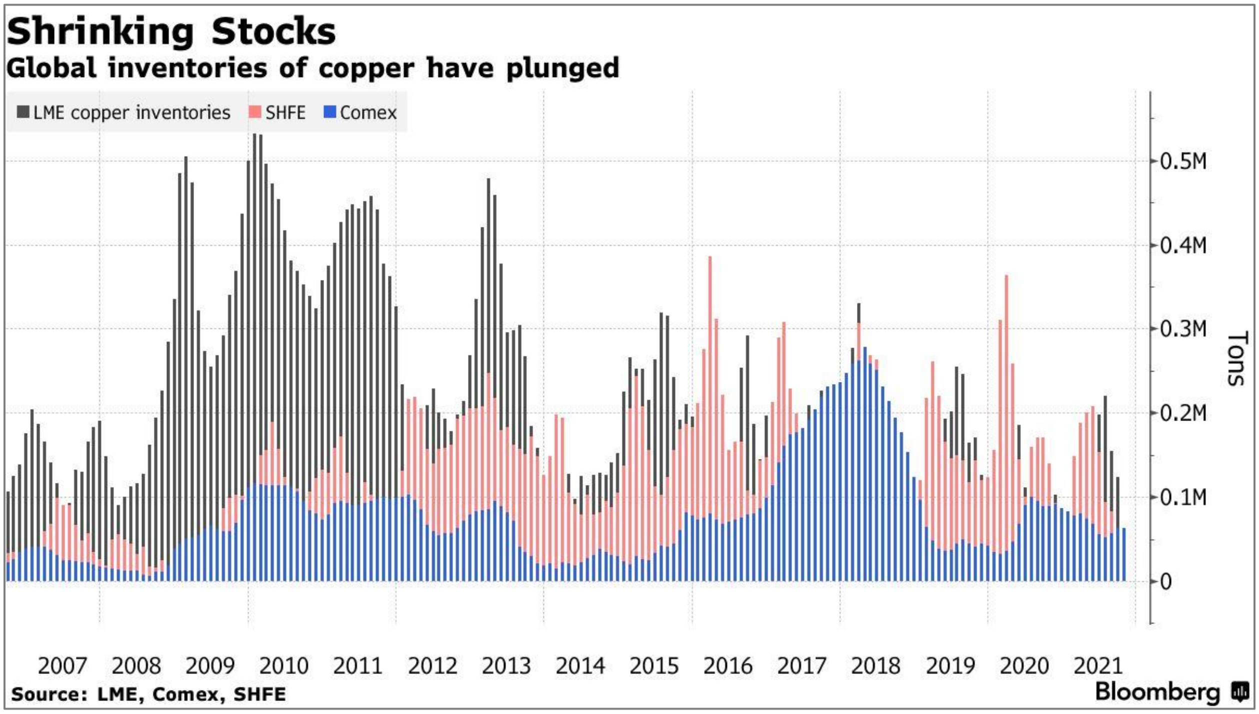
Fund Managers disconnect between Growth expectations and Equity Allocations.



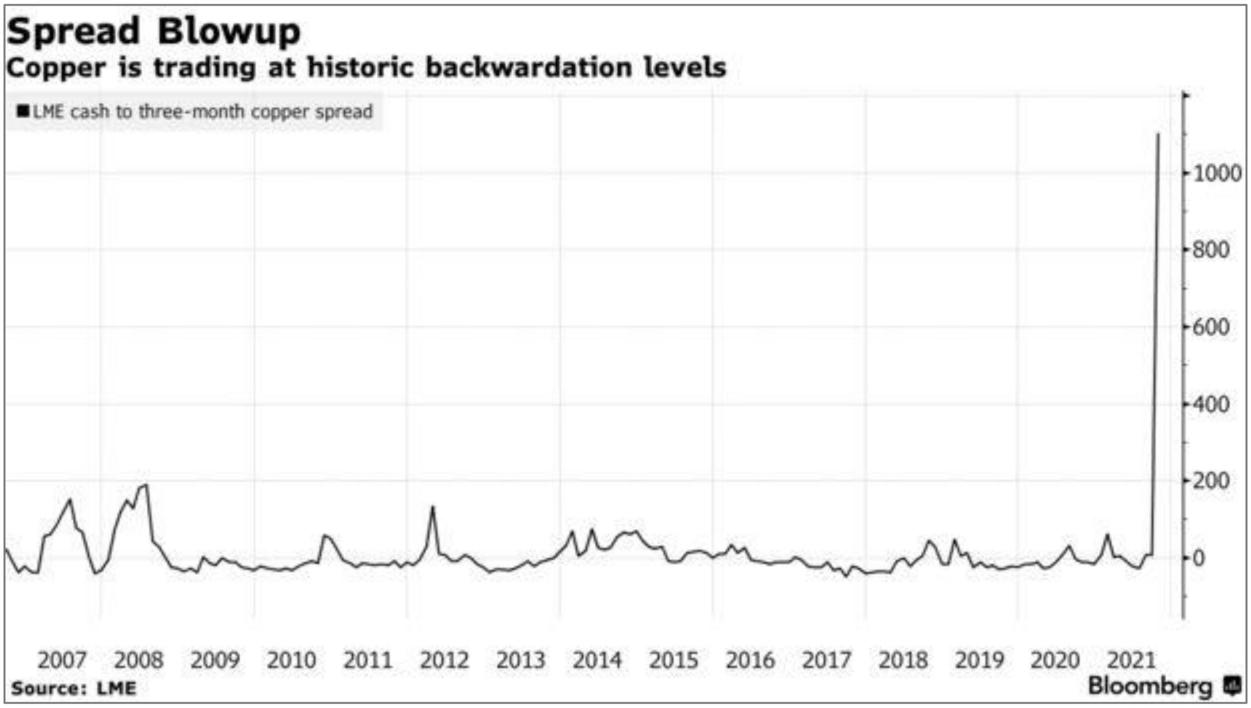
Fund Managers also loathe bonds.



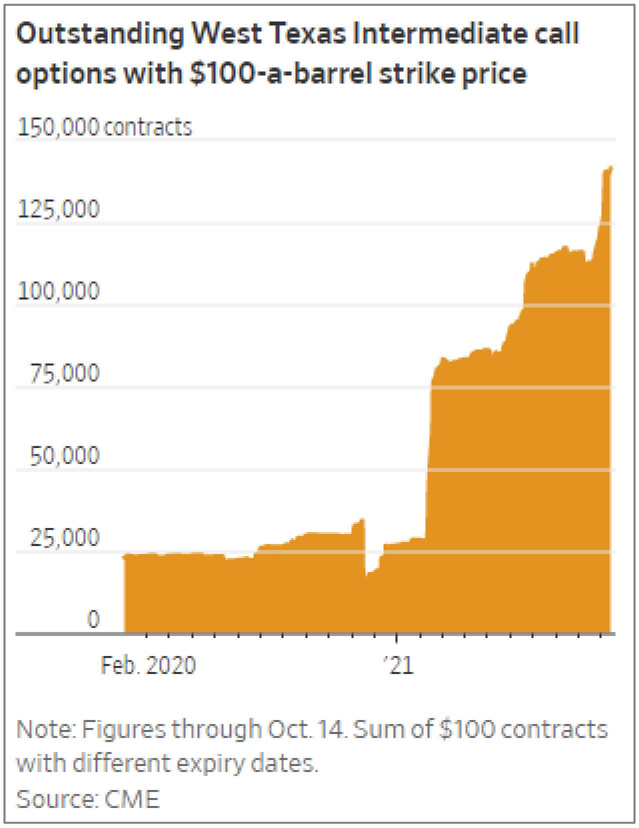
Copper inventories have plunged.



...Causing copper to trade at historic backwardation.



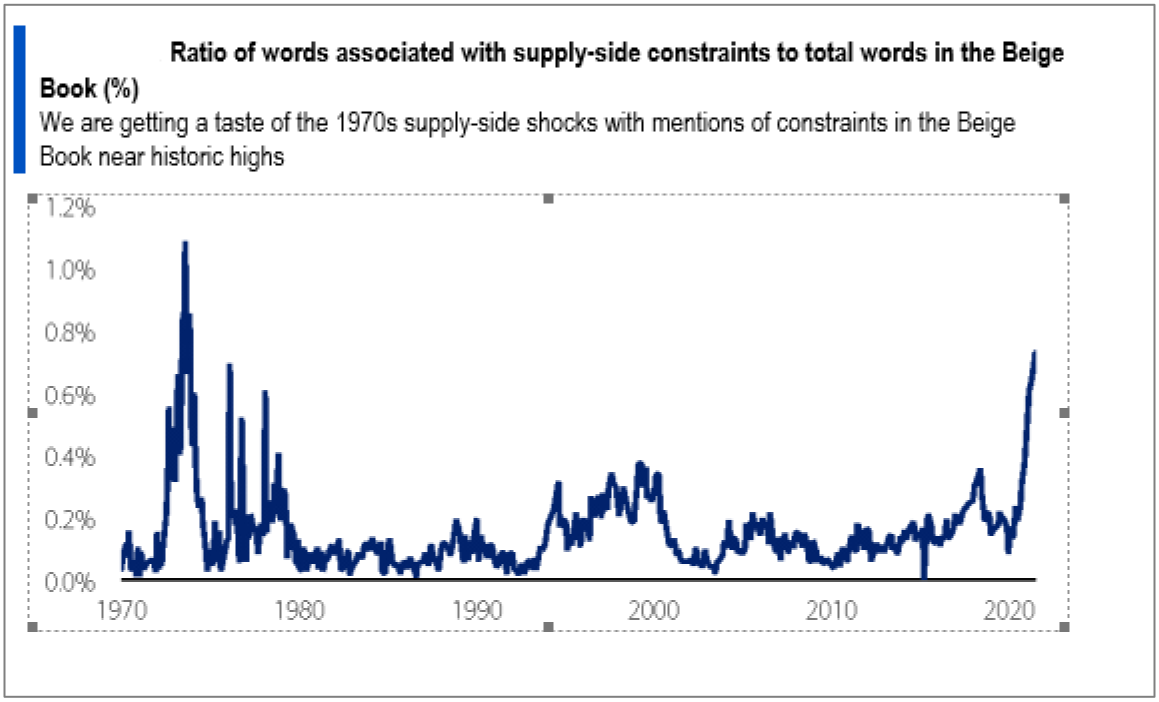
Surge in the number of call options in Oil with a $100 strike price.



Source: WSJ

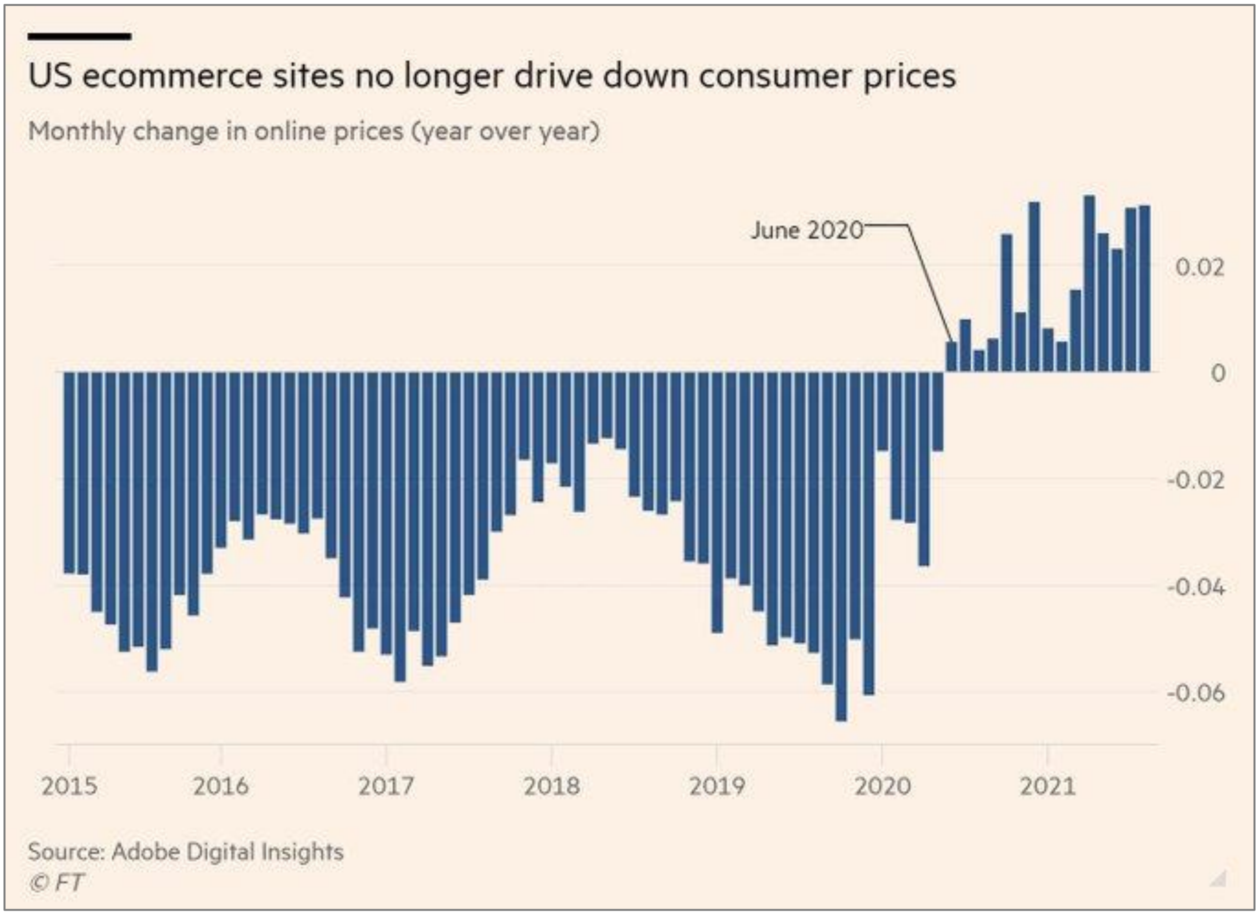
The bond market's inflation expectations hit 20-year highs.

Mention of supply-side constraints in the Beige Book looks like the 1970s.

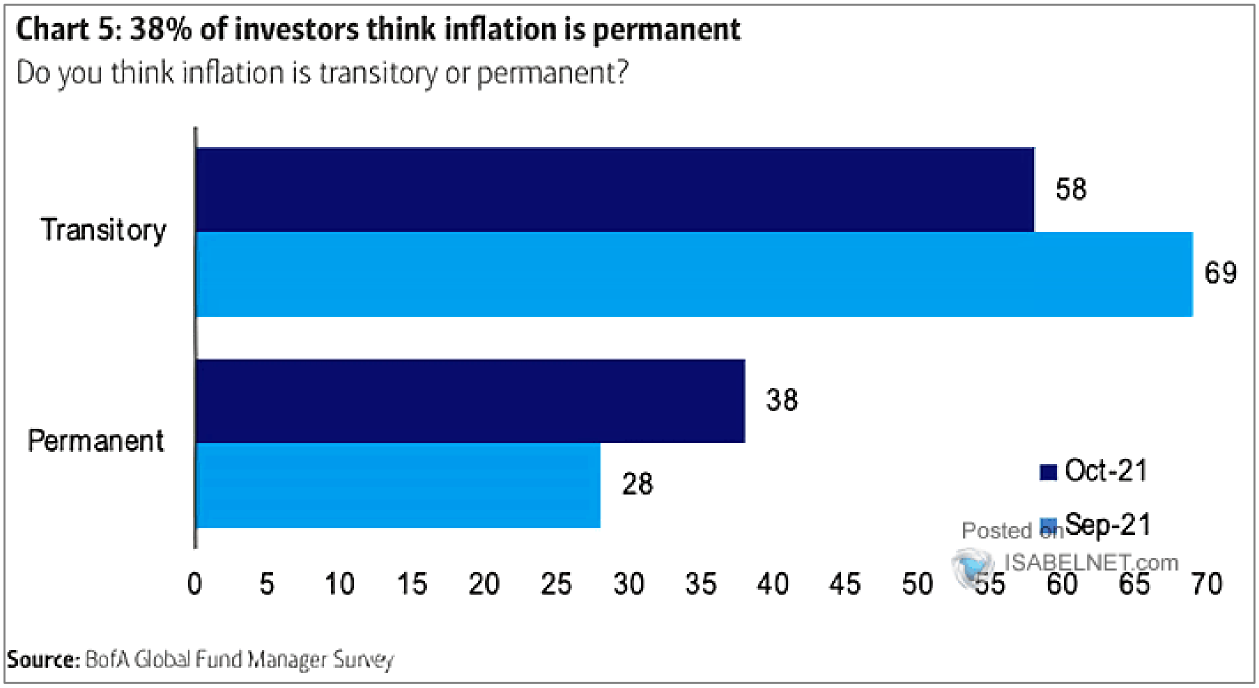


Source: BofA, RBA

E-commerce is no longer a disinflationary force.

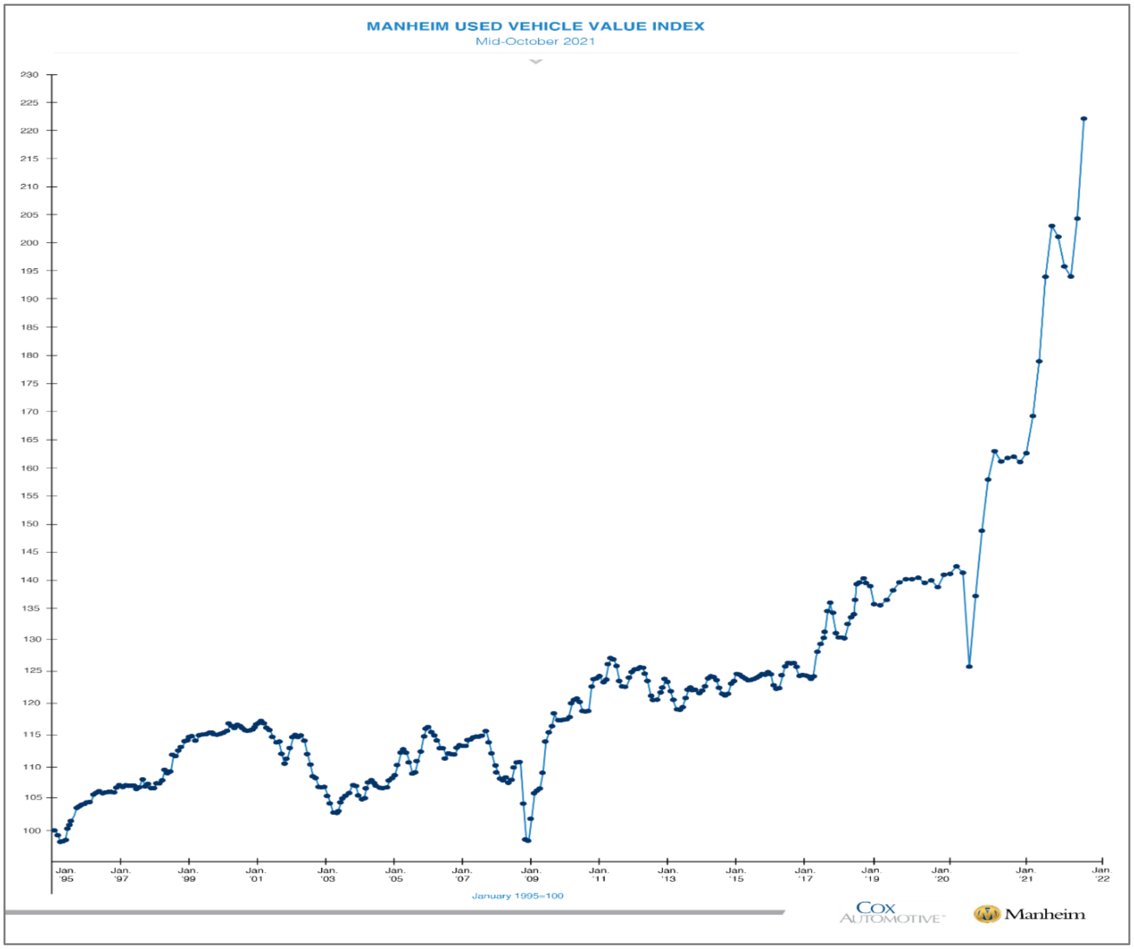


Transitory is still in the lead, but her poll numbers are fading.



German PPI inflation set a record.

Used Car values set another record.



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.

for more information.