Market Outlook

By Mark T Dodson, CFA

Zweig Breadth Thrusts when the Yield Curve is Inverted

Market Risk Index fell to 60.4% on another significant improvement in the Monetary Composite, more than offsetting an increase in the Valuation Composite Risk Score. The Fed's reaction to the failure of Silicon Valley Bank has created monetary conditions that look like easing from the perspective of our Monetary Composite. Market Psychology also improved slightly but has been unable to move out of the worst 20% of readings.

If you follow any stock market technicians, you know that the stock market experienced what is known as a Zweig Breadth Thrust within the last week, which equates to a market environment where stocks go from highly oversold to highly overbought over a short period. We track it as it has an impressive track record, often signaling more upside to come, with the last such thrust occurring after the infamous Powell Pivot in early 2019. Historically, the stock market has advanced an average of 21% over the next 12 months after such signals going back to 1970. There was one glaring failure – a breadth thrust in September 1973 which also occurred when the yield curve was inverted as it is today.

Table - Stock Market Returns after Zweig Breadth Thrusts

	1M	3M	6M	1Y
Average	2.9	3.9	13.0	21.0
Max	10.9	19.5	39.0	51.7
Min	-9.4	-24.9	-10.3	-32.1
Pct Pos	85%	69%	85%	96%

S&P 500 price returns since 1970

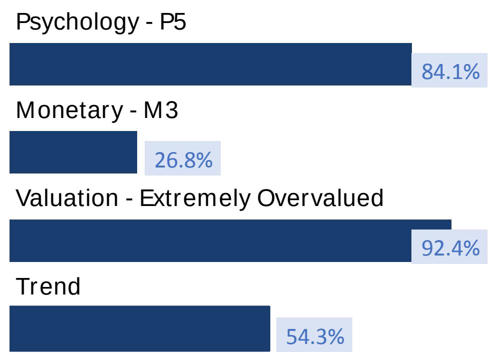
Seeing a Zweig Breath Thrust when the yield curve is inverted is atypical. Of the 33 Zweig Breath Thrusts (using NYSE Volume) since 1960, the present breath thrust signal is only the third to occur when the yield curve was inverted – the other two were in 1973 (noted above) and 1980. In 1980, the stock market rallied approximately 35% for another six months before the bull market peaked before the next bear market, which ultimately led to the start of the secular bull market in 1982.

Market Risk Index

Rec Allocation 25% Underweight

60.4%

Category Percentiles



Largest Psychology Influences

Leveraged Investments	Negative
Consumer Confidence	Negative
Surveys	Positive
Flow of Funds	Negative

Largest Monetary Influences

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

Valuation

7-10 Year Equity Return Forecast	2.9%
10Yr US Treasury Yield	3.4%

Market Trends

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

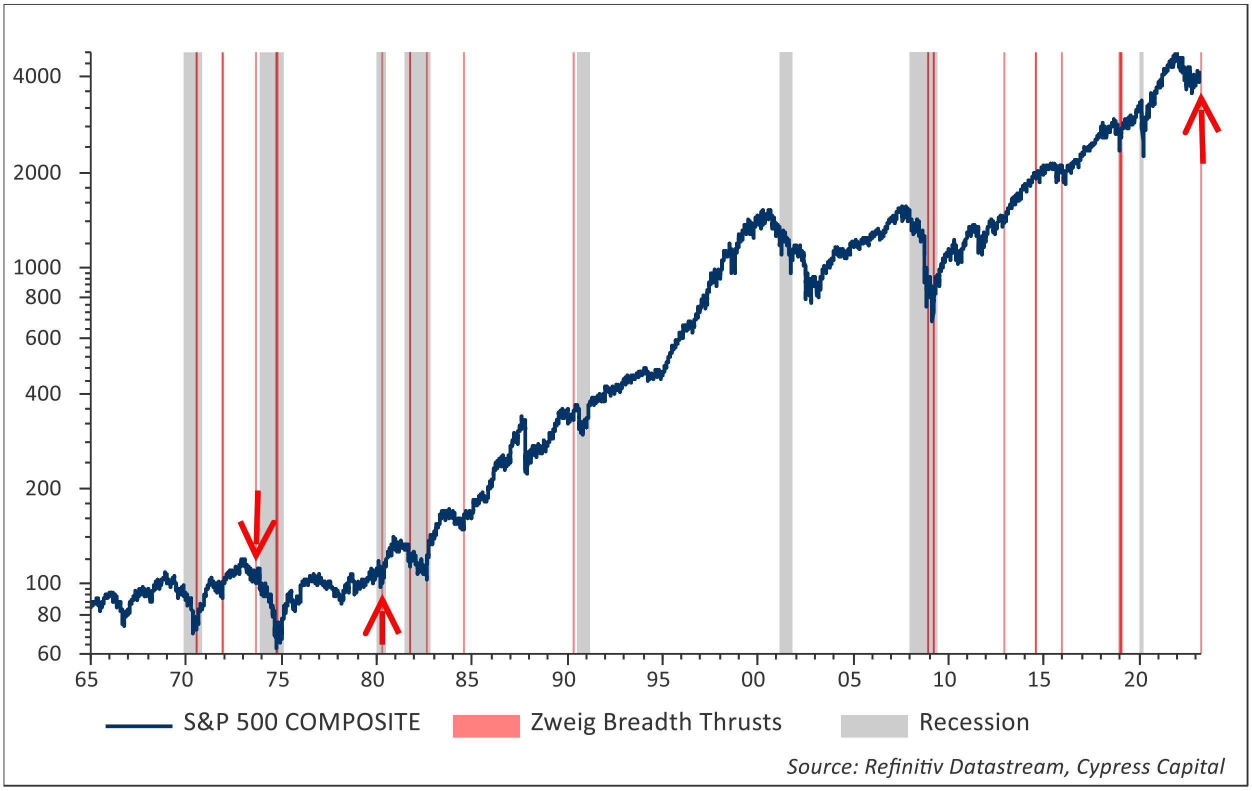
Market Risk Index scales from 0 to 100%. Higher readings correspond with higher risk markets. Scores below 25% are bullish. Scores between 25-75% are neutral, and scores above 75% are markets vulnerable to major drawdowns.

In 1973, the breadth thrust encouraged investors to embrace the only notable bear market rally within the 1973-74 bear market. Stocks rallied another 6% over the next 6-8 weeks before falling another 44% to the 1974 bear market lows.
With Monetary Conditions mimicking easing liquidity and positive technical news like the Zweig Breadth Thrust possibly encouraging Fear of Missing Out Investors to speculate more heavily, we are mentally prepared for an anxiety-inducing stock market rally that makes aggressively under-invested bears sweat.

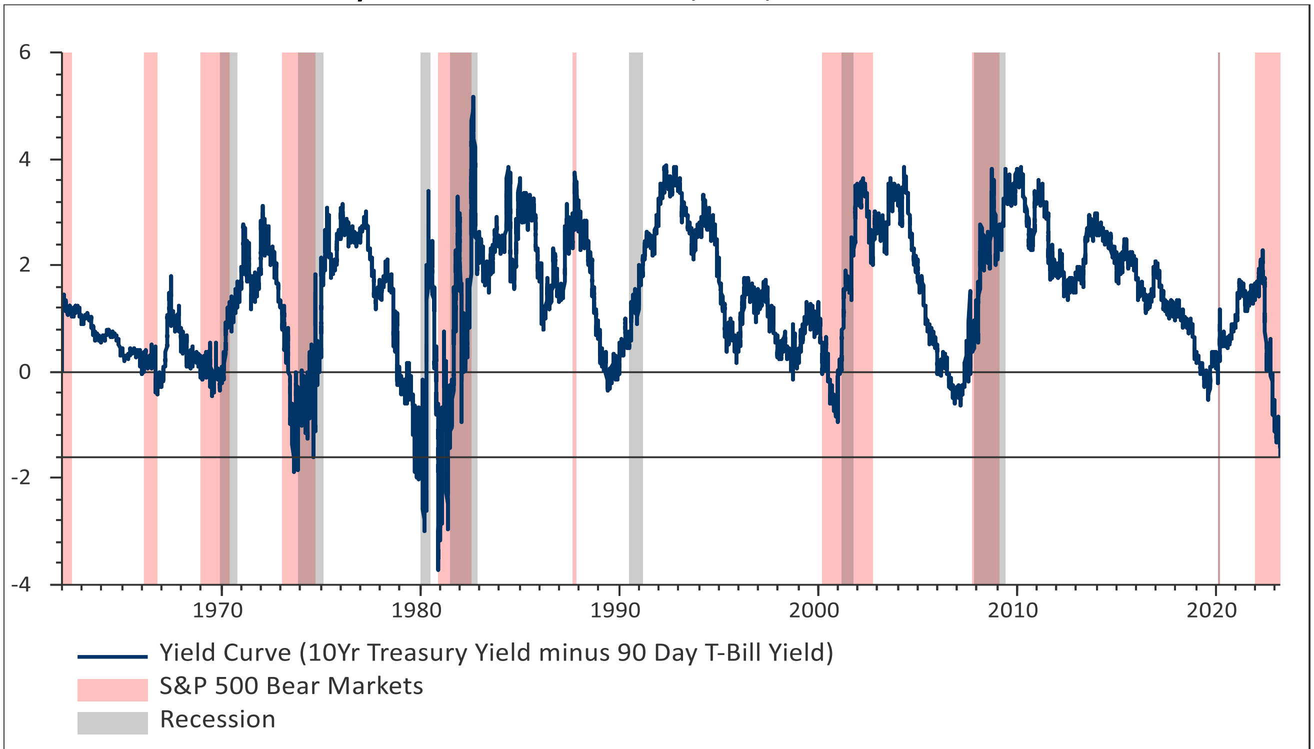
However, the weight of all the evidence doesn't remotely make us ready to embrace this market as a new bull, even if it eventually meets the definition technically. We still expect another leg down in the bear market. Markets are running out of new eras to form when it comes to financial market valuations and financial gravity, and the bill for central bankers' gross reliance on 15 years of quantitative easing appears to be coming due.

Charts of the Week

Zweig Breadth Thrusts and Inverted Yield Curves
The arrows highlight the only instances when a Zweig Breadth Thrust has occurred when the yield curve is inverted.

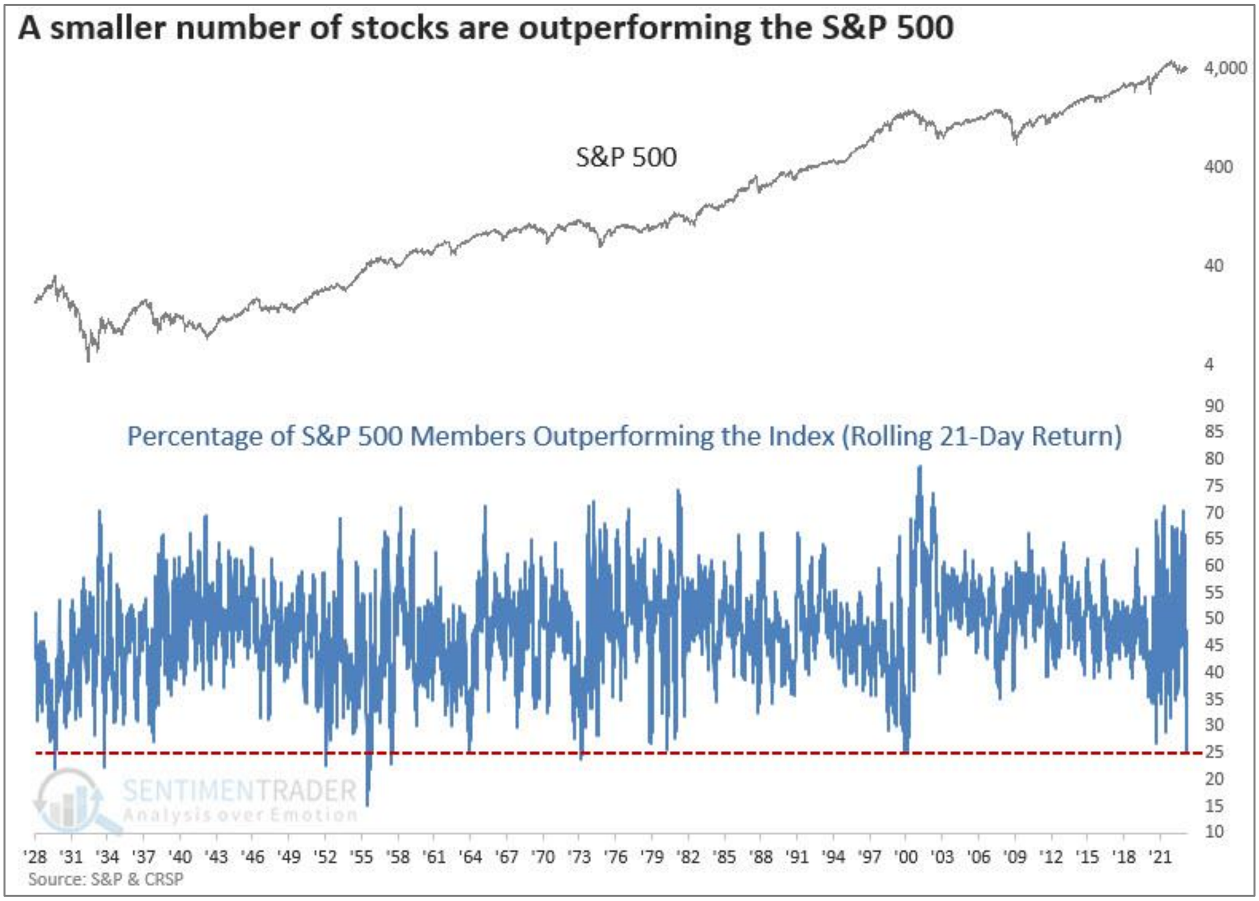


Yield Curve Inversion has only been this extreme in 1973, 1980, and 1981.

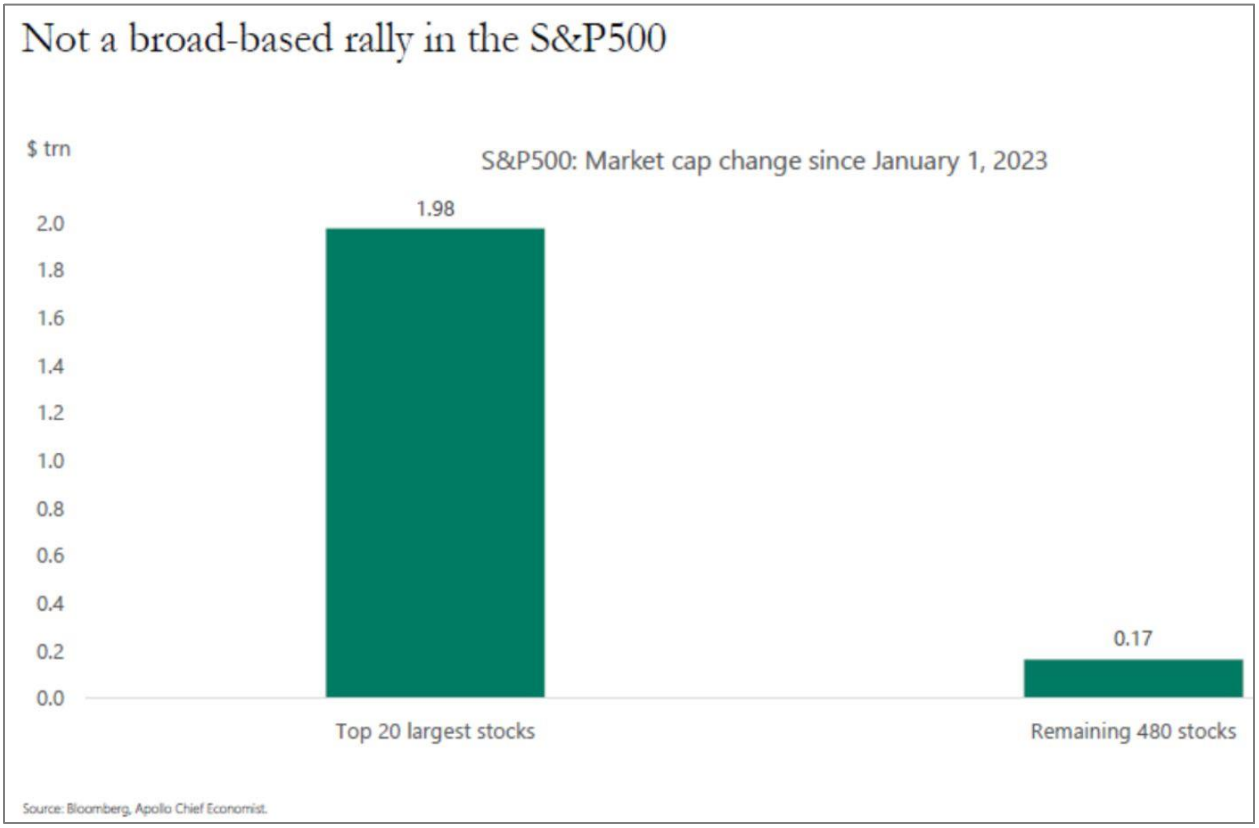


Source: Refinitiv Datastream, Cypress Capital

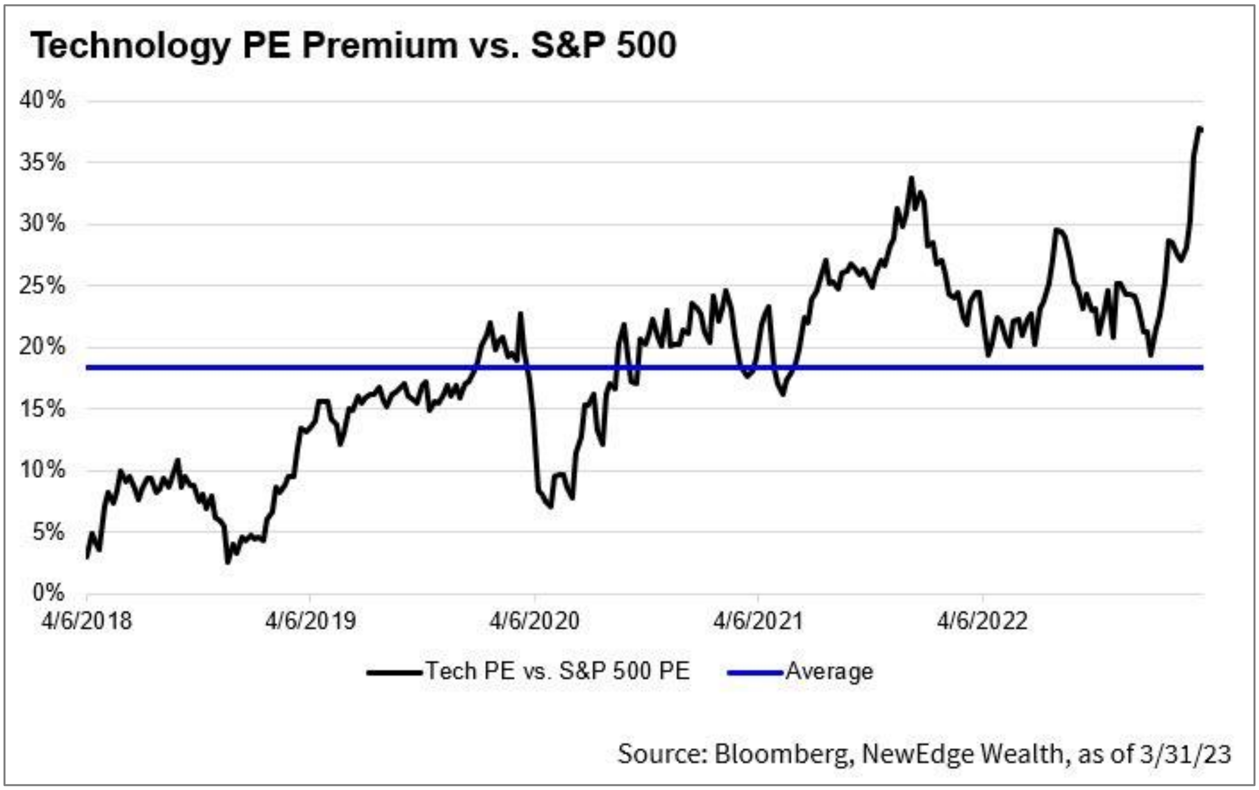
Despite a Zweig Breadth Thrust signal, the stock market's advance off the March lows appears narrow.



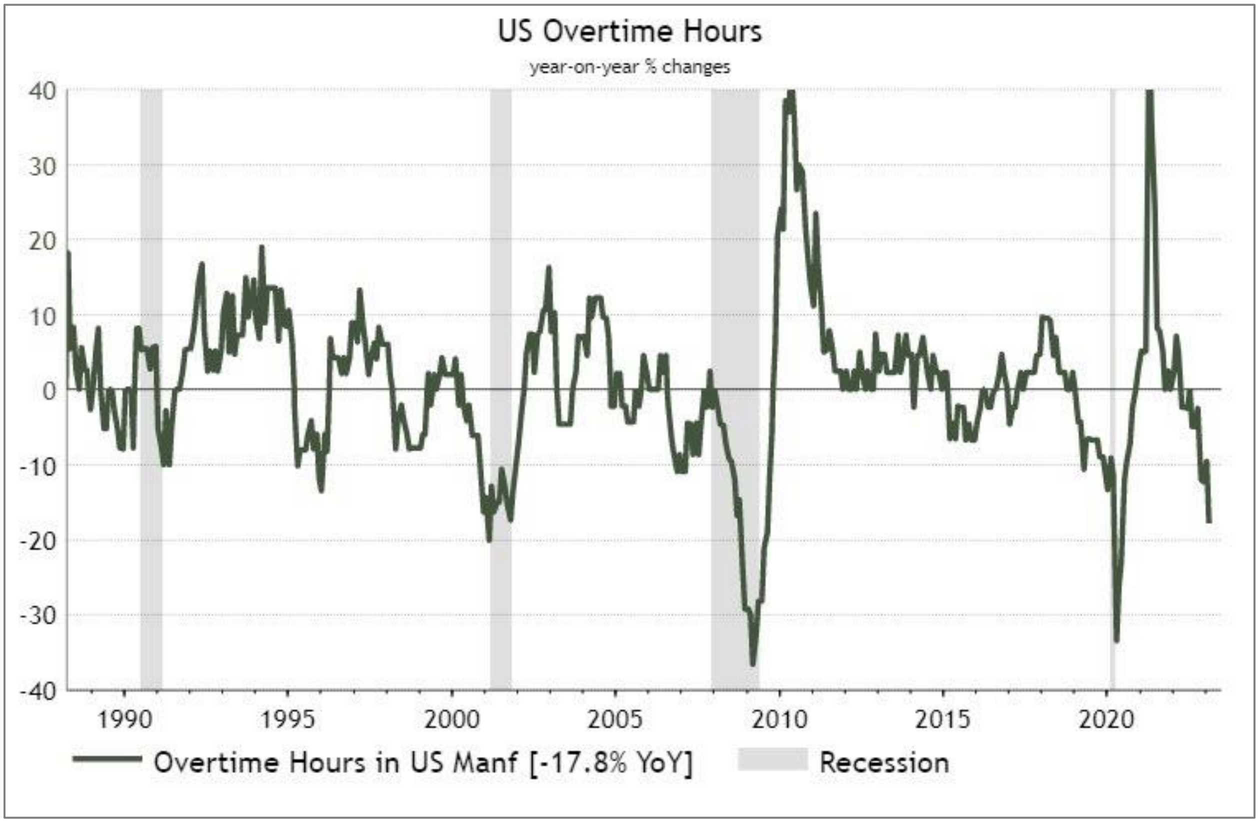
A handful of stocks have been responsible for the stock market's positive return in 2023.



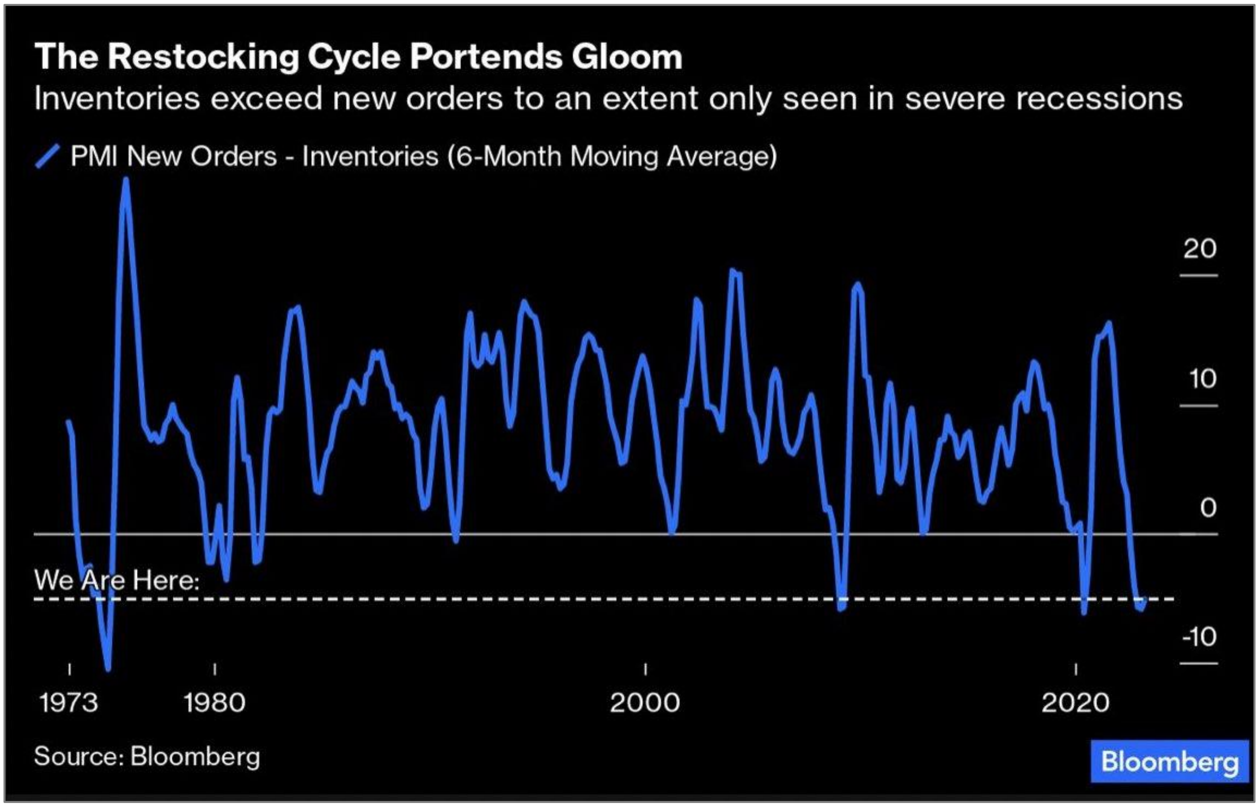
Recent rally in Tech shares has driven relative valuations of Tech shares to new highs.



Declines in US Overtime Hours look recessionary.



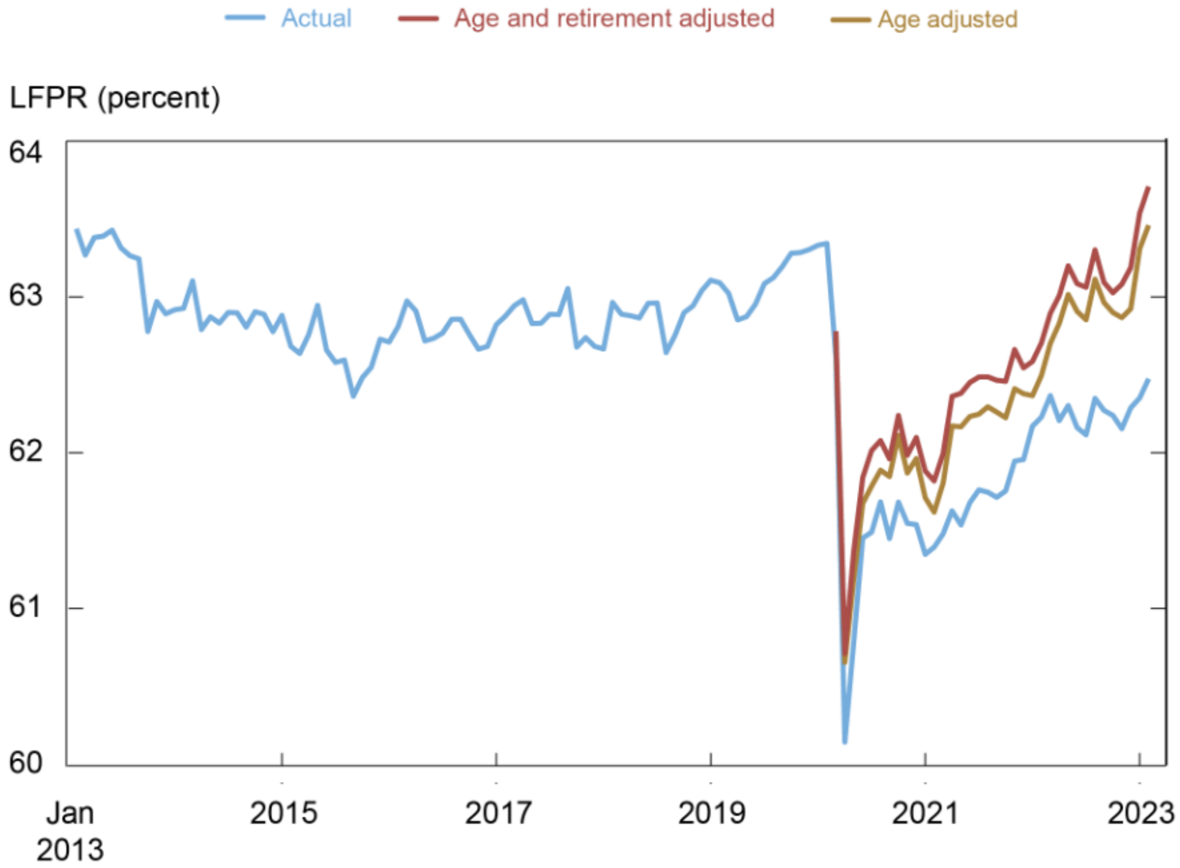
Inventories versus New Orders also appears recessionary.



Explaining the Labor Shortage

It turns out that Covid, combined with the historic Covid stimulus, encouraged so many baby boomers to retire that it explains most of the persistent decline in the labor force participation rate.

Participation Rate Is Higher after Adjusting for Aging and Excess Retirements



Sources: Current Population Survey; authors' calculations.

Notes: The blue line shows the headline labor force participation rate (LFPR) reported by the Bureau of Labor Statistics. The gold line is the counterfactual LFPR holding fixed the population age structure in February 2020. The red line further adds the surplus of retired workers in the recent period compared to 2018-19, at the fixed age structure of February 2020.

Source: NY Federal Reserve

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.