Market Outlook

By Mark T Dodson, CFA

Three Fed Cuts in the Bush are Worth One in the Hand.

Market Risk Index fell below 75% to 74.3%. That's a move into the neutral zone for MRI, and it came on additional improvement in Monetary Conditions.

It's a fragile neutral reading for MRI because of some significant discord among the factors that make up the Market Risk Index. Investor psychology and Valuations are clearly suggesting bubble behavior in markets, but Monetary conditions (except for the yield curve) look a lot like an economy coming out of recession with a Federal Reserve trying to encourage investors to throw caution to the wind.

It is difficult to discern the Federal Reserve's continued expectations for three-rate cuts this year in light of both animal spirits running hot and the unwillingness for inflation pressures to subside (they stopped declining last June). Either the Fed is privy to some economic or geopolitical information that we are not, they have an unspoken mandate to maintain a permanently higher plateau in valuations, or God forbid, they are engaging in some electioneering. At best, this Federal Reserve Board has a significant case of groupthink.

On the Psychology front, Asset Managers' exposure to US Equities using futures set another new all-time high, and smart-money derivatives investors went as short as they were on the eve of the 2022 bear market. Individual investor exposure to leveraged ETFs also set a new cycle high and continues to make strides toward taking out the all-time high achieved during the COVID bubble. Investors Intelligence Survey net bullishness is also back to the levels from 2021.

Still, Technicals leave little expectation that a stock market peak is imminent, possibly part of the reason for such excess enthusiasm among professional investors. The only exception is the NASDAQ High Low Logic Index, which has made its second breach above 6% for the second time this year. That indicator has an enviable track record, but it's the only major red flag on the Technicals or the stock market breadth front.

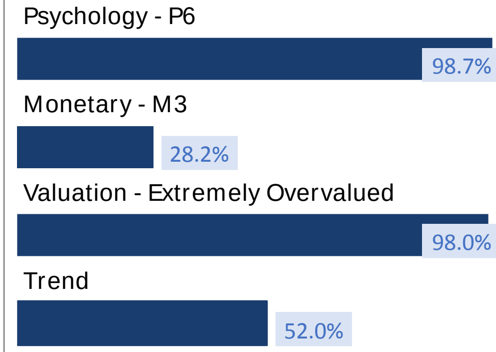
While Valuations and Psychology have done a reasonable job of highlighting the point where markets have reached their maximum

Market Risk Index

Rec Allocation 25% Underweight

74.3%

Category Percentiles



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	0.8%
10Yr US Treasury Yield	4.2%

Market Trends

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

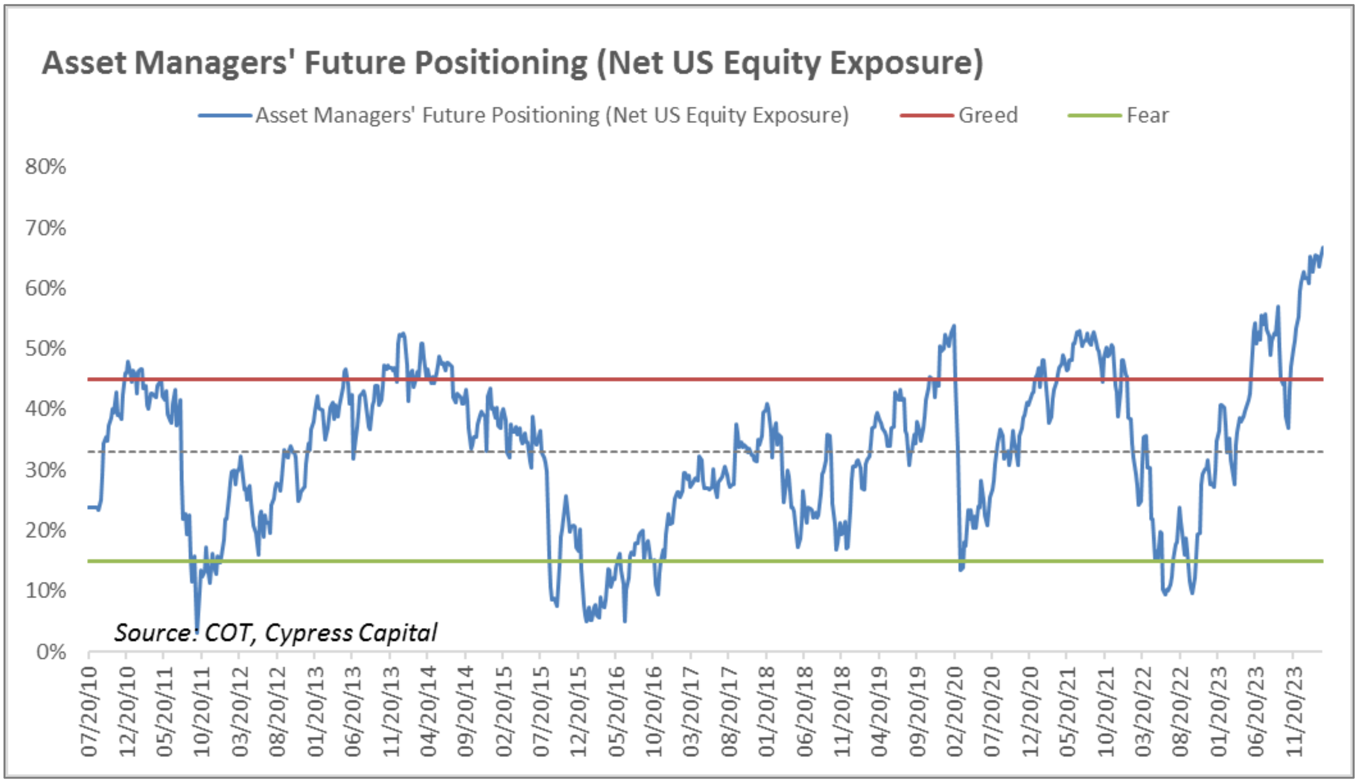
Market Risk Index scales from 0 to 100%. Higher readings correspond with higher risk markets based on our model & opinion. Scores below 25% are bullish. Scores between 25-75% are neutral, and scores above 75% are markets vulnerable to major drawdowns.

risk of drawdown, their warnings of excess have been elevated for much of the COVID-stimulus era. Drawdowns have been muted given the severity of overvaluation and extremes we have seen in sentiment, leaving contrarians and intelligent investors with a value bias frustrated about missed gains. Investors who have turned a blind eye to the margin of safety present in equity markets have been rewarded repeatedly.

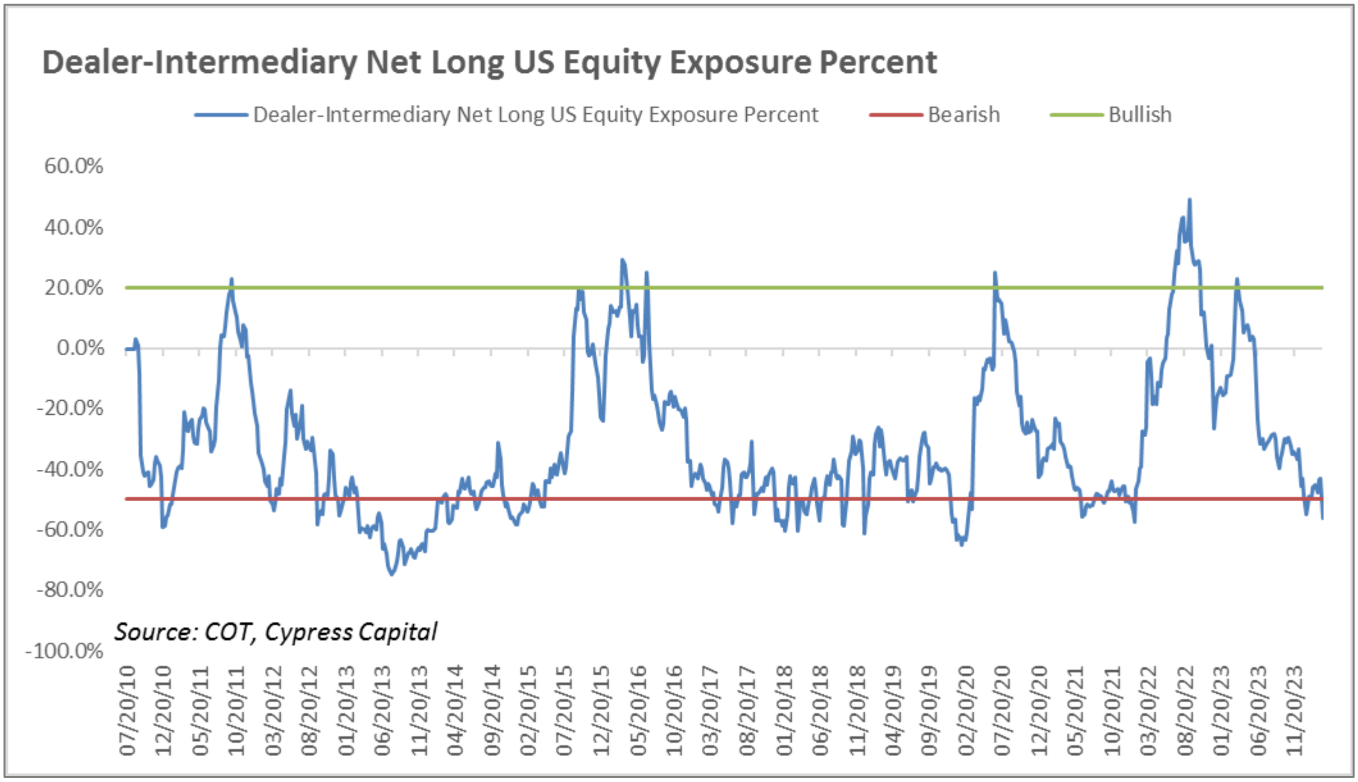
Instead, our Monetary Composite has proven much timelier and more valuable in the current environment, as investors have become hyper-focused on Federal Reserve policy. Typically, sentiment and valuations would correlate with Fed policy, but both monetary and fiscal policy are doing their own thing – pushing the limits of what most of us would think are the boundaries of prudent governance. The lack of repercussions for excessive speculation further emboldens investors, who are back to speculative extremes now with only the hopes of coming rate cuts. For 2024's stock market, three Fed cuts in the bush are worth one in the hand.

Charts of the Week

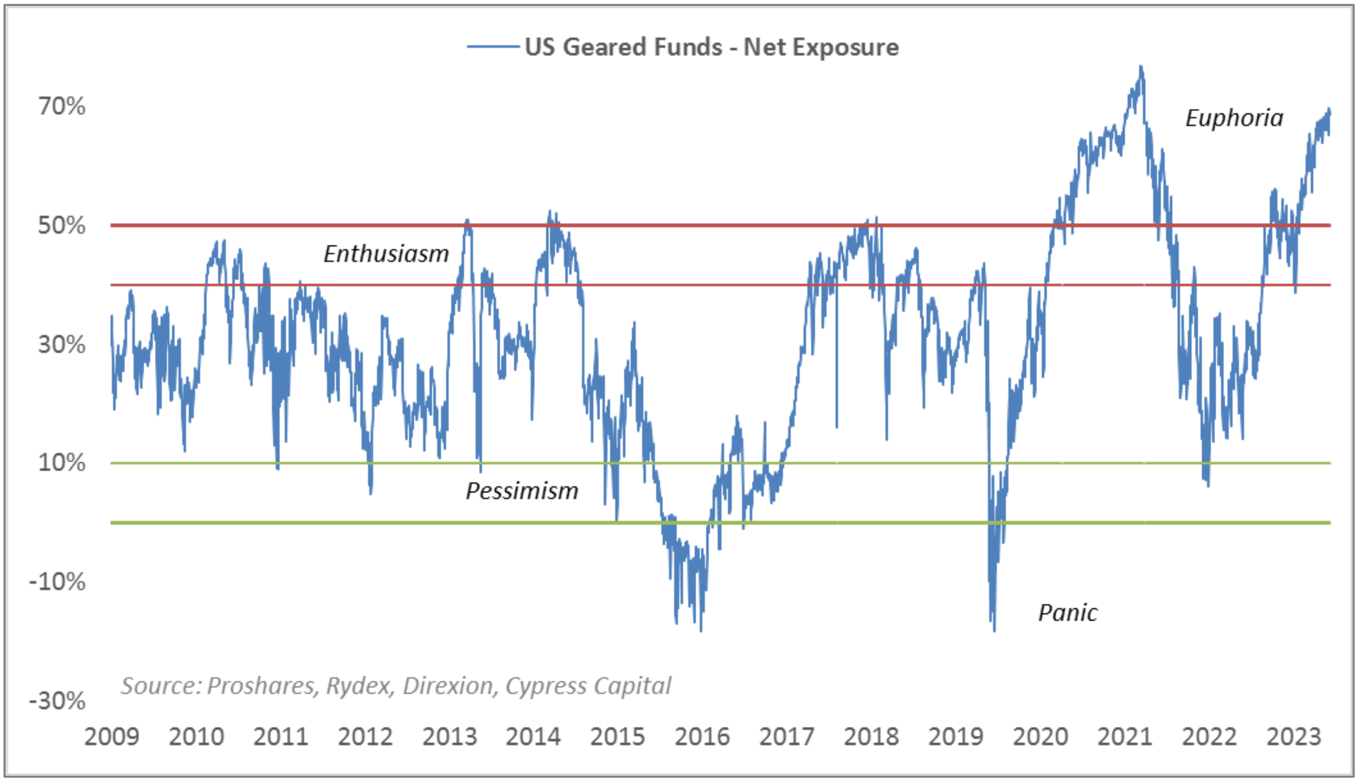
Asset Manager Derivatives Exposure (Dumb Mondy) to US Equities set a new all-time high.



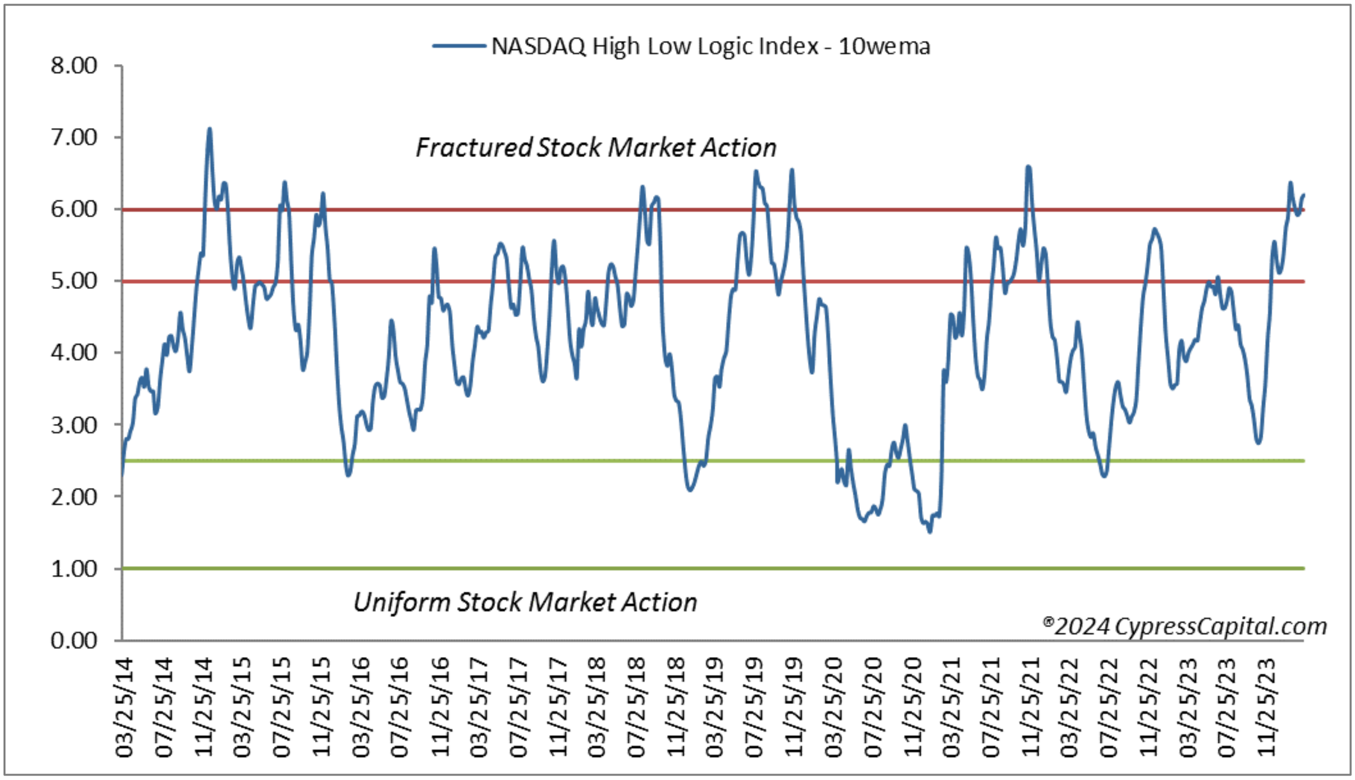
Dealers' (Smart Money) Futures Exposure is the shortest since the eve of the 2022 bear market.



Leveraged ETF Investors (Dumb Money) set another new cycle high. The 2021 record isn't far off.

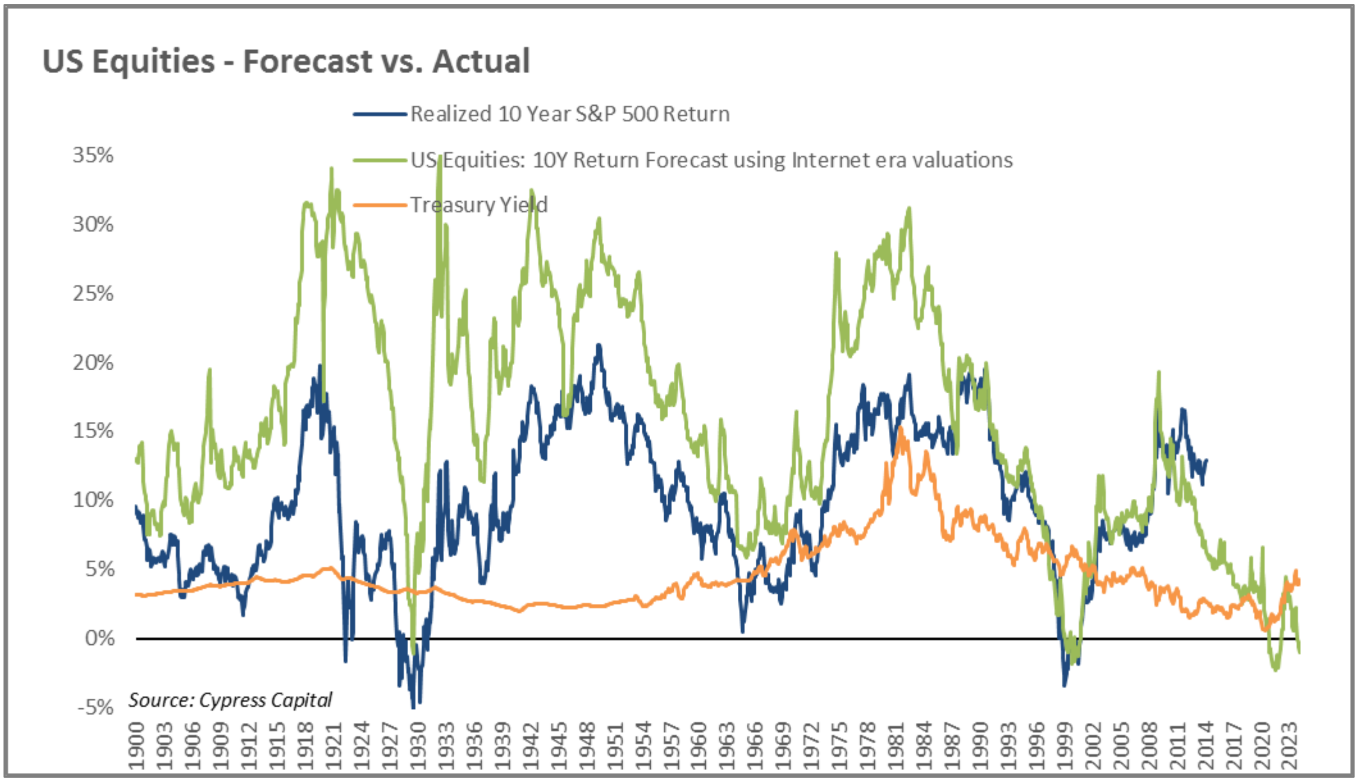


NASDAQ High Low Logic Index gives a fresh stock market warning.

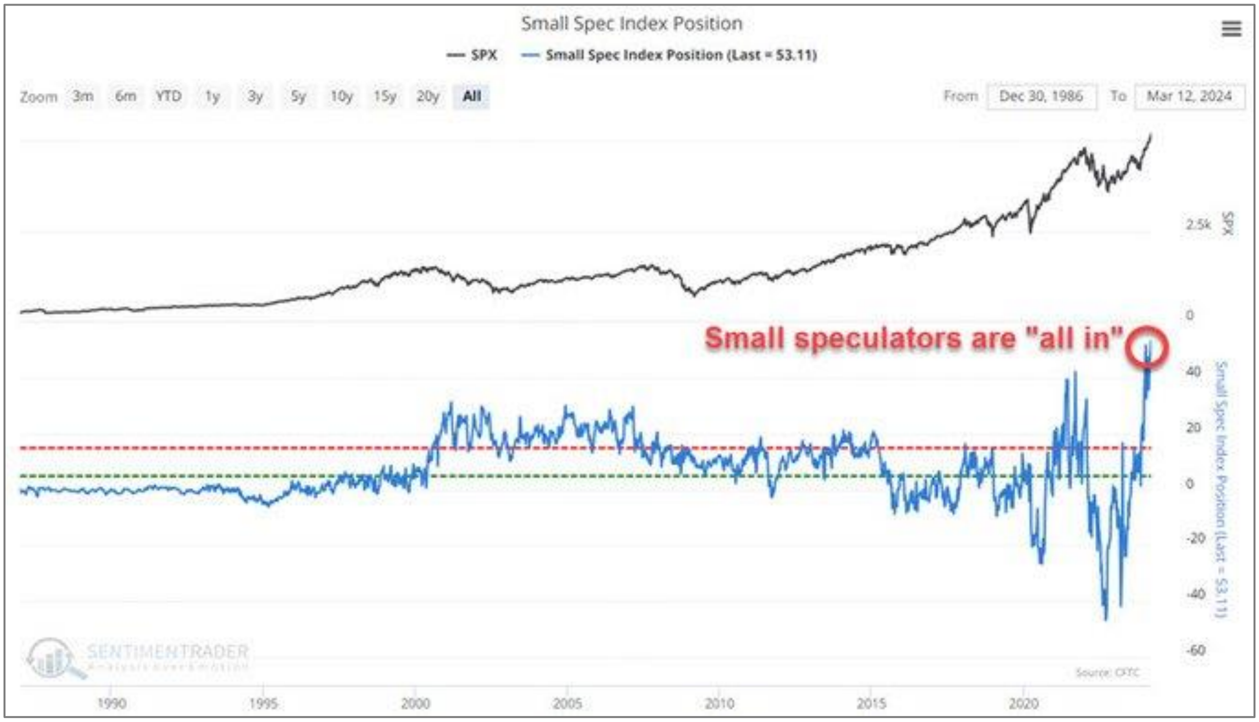


Is this a bubble? Valuations think so.

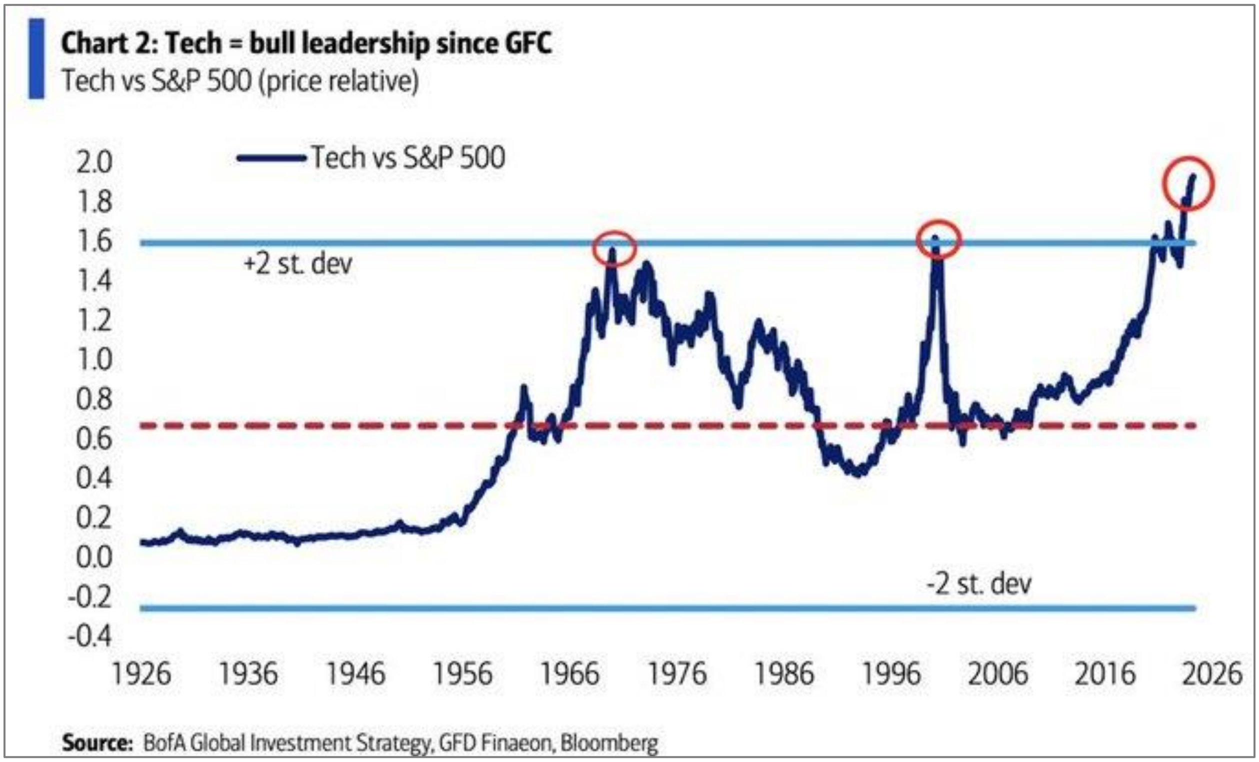
Using Internet-era valuations in the United States (higher than average) to forecast equity returns, stock market declines have been predicted only a few times - 1929, 2000, 2021, and today.



Small Speculators are record bullish on the stock market.

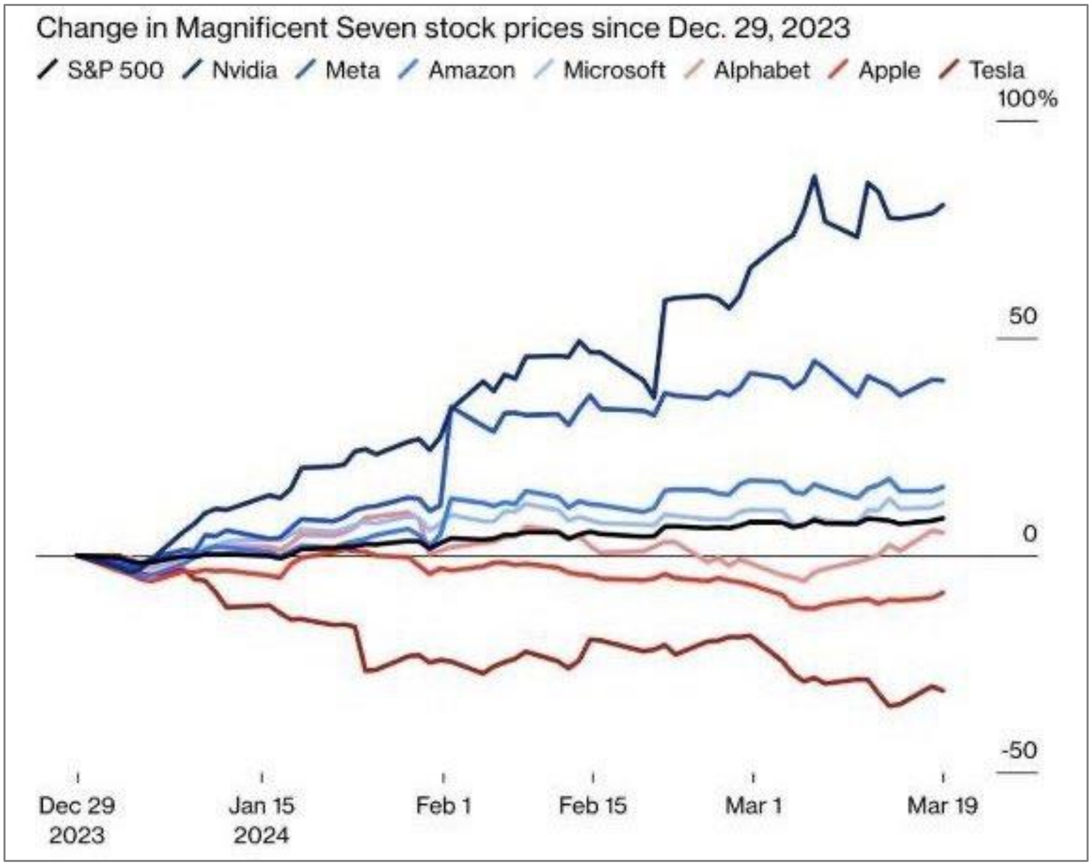


Relative outperformance of Tech Stocks is at 100-year highs.

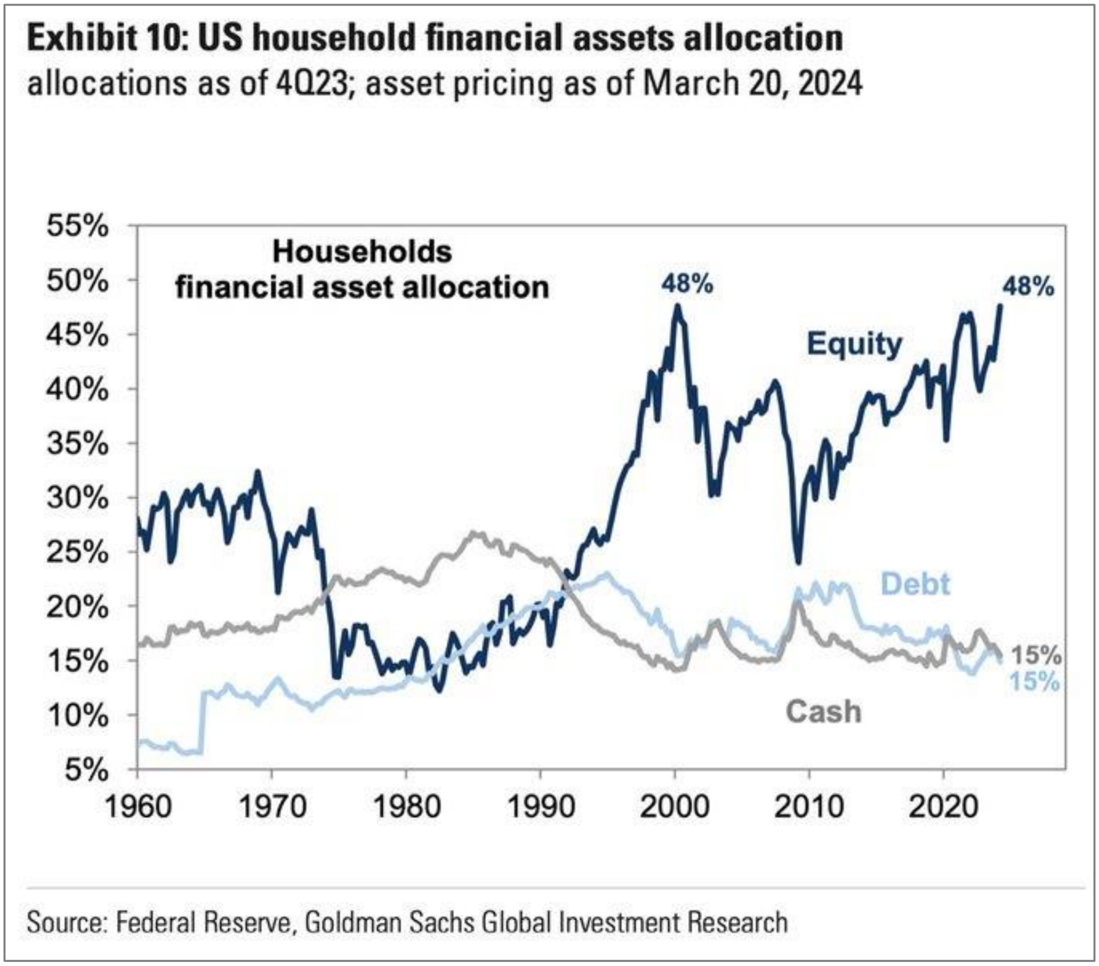


Tech insider selling hits the highest level in three years.

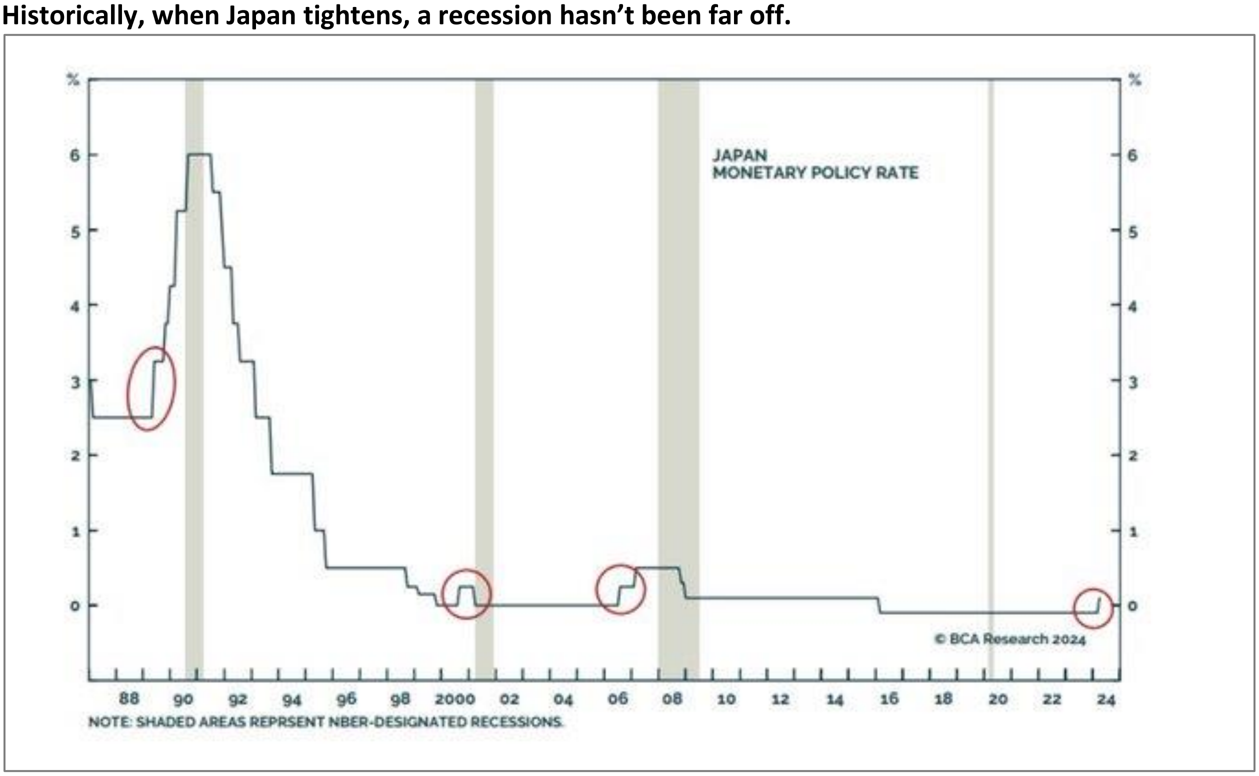
From the Magnificent Seven to the Fantastic Four.



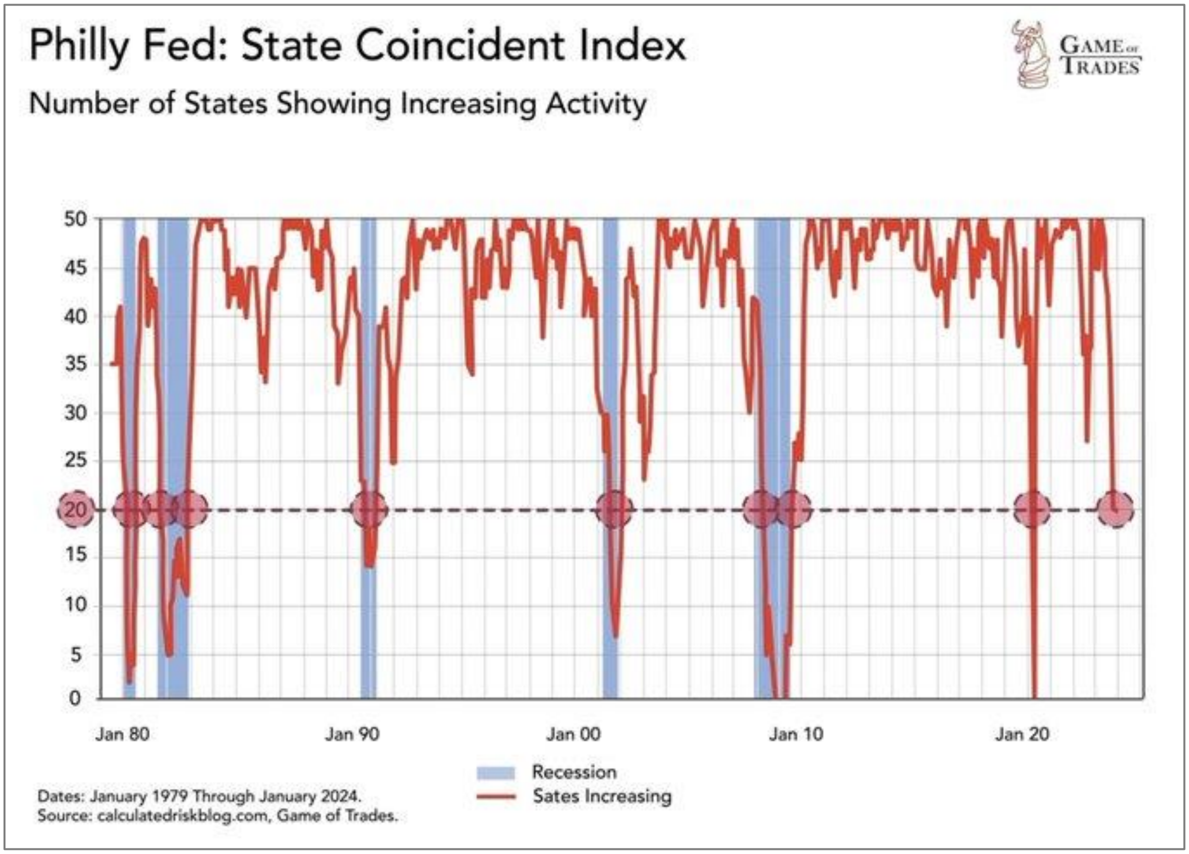
Household Equity Allocations have matched the 2000 peak.



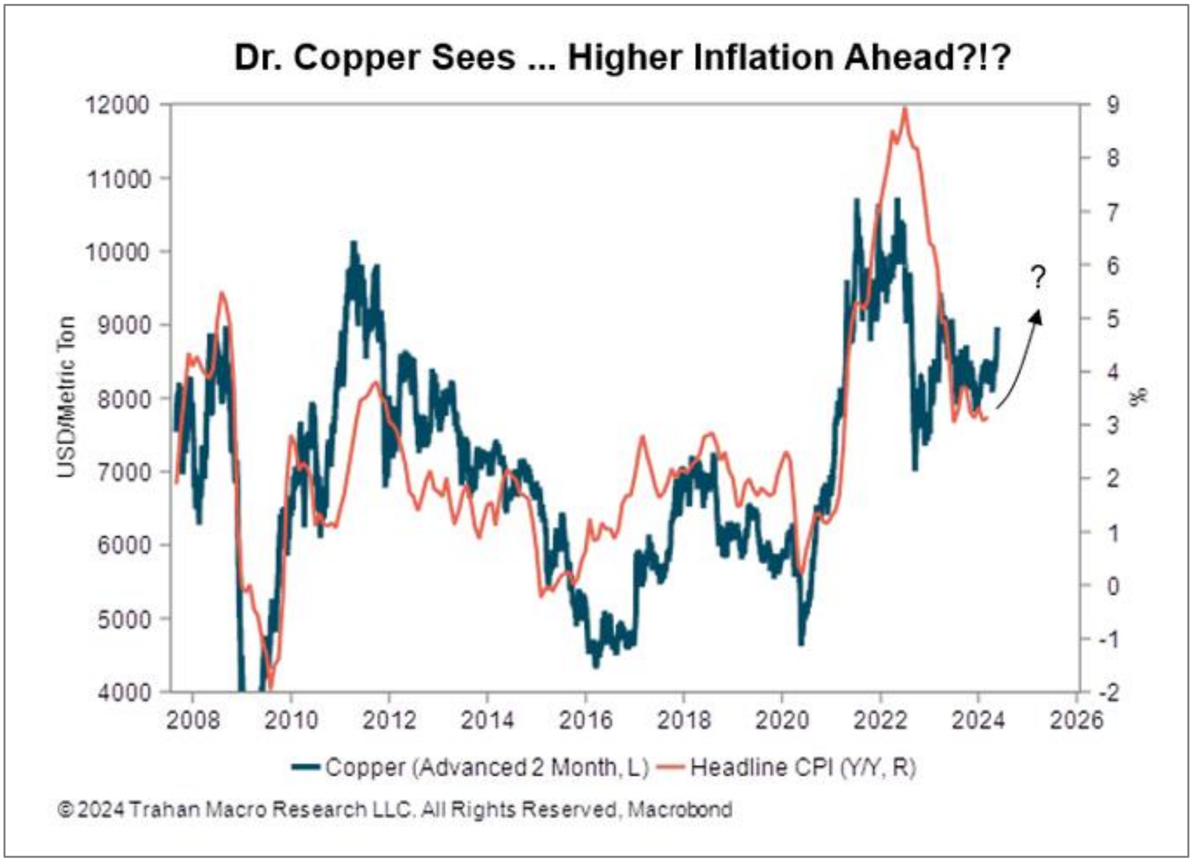
Historically, when Japan tightens, a recession hasn't been far off.



The number of states with declining activity looks like a recession warning.

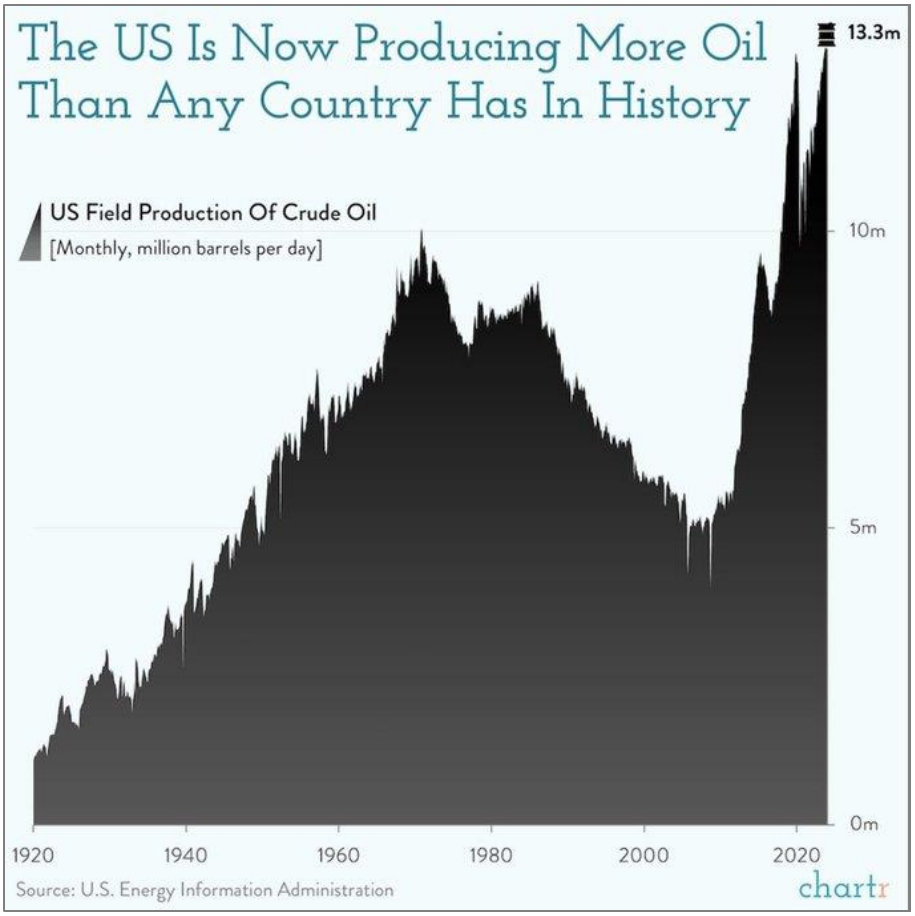


Dr. Copper signaling higher inflation.

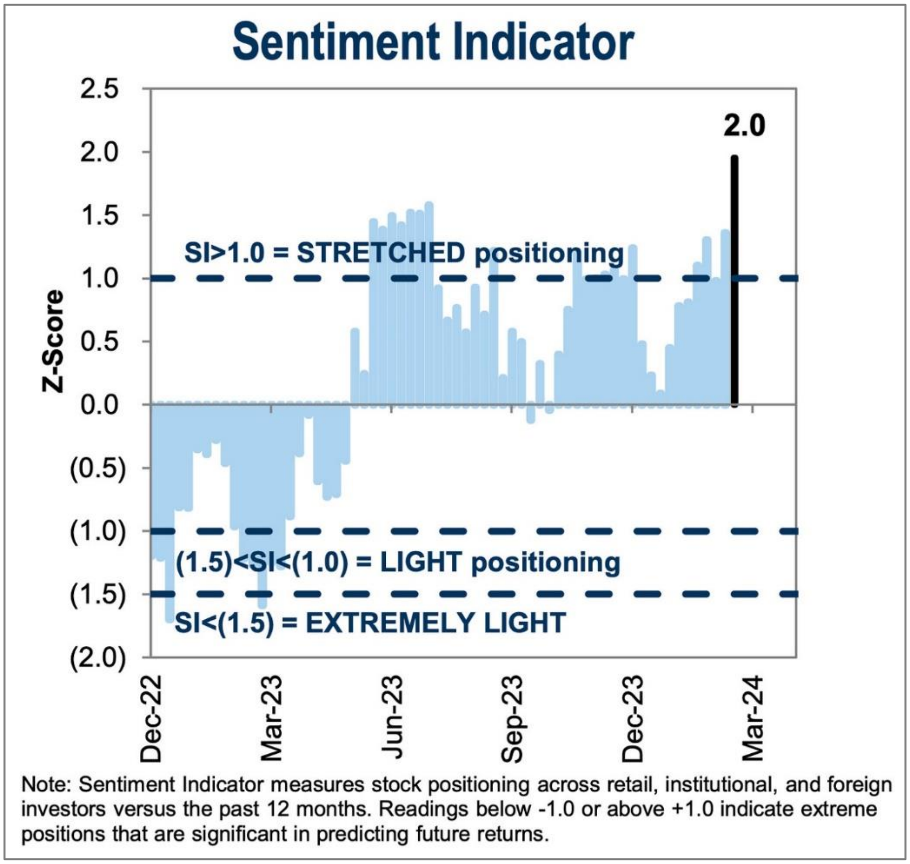


Record Stock Market Concentration

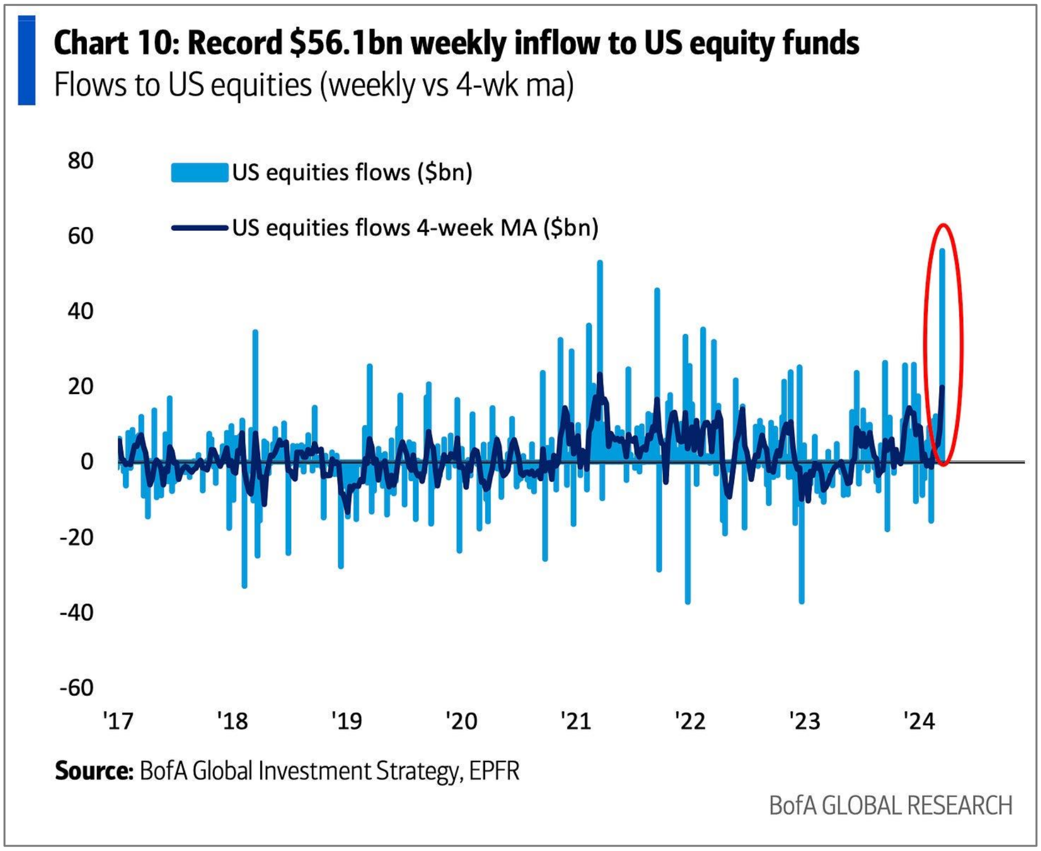
Only in America - the United States is the World's Largest Oil Producer.
This is a prediction we wouldn't have believed 20 years ago.



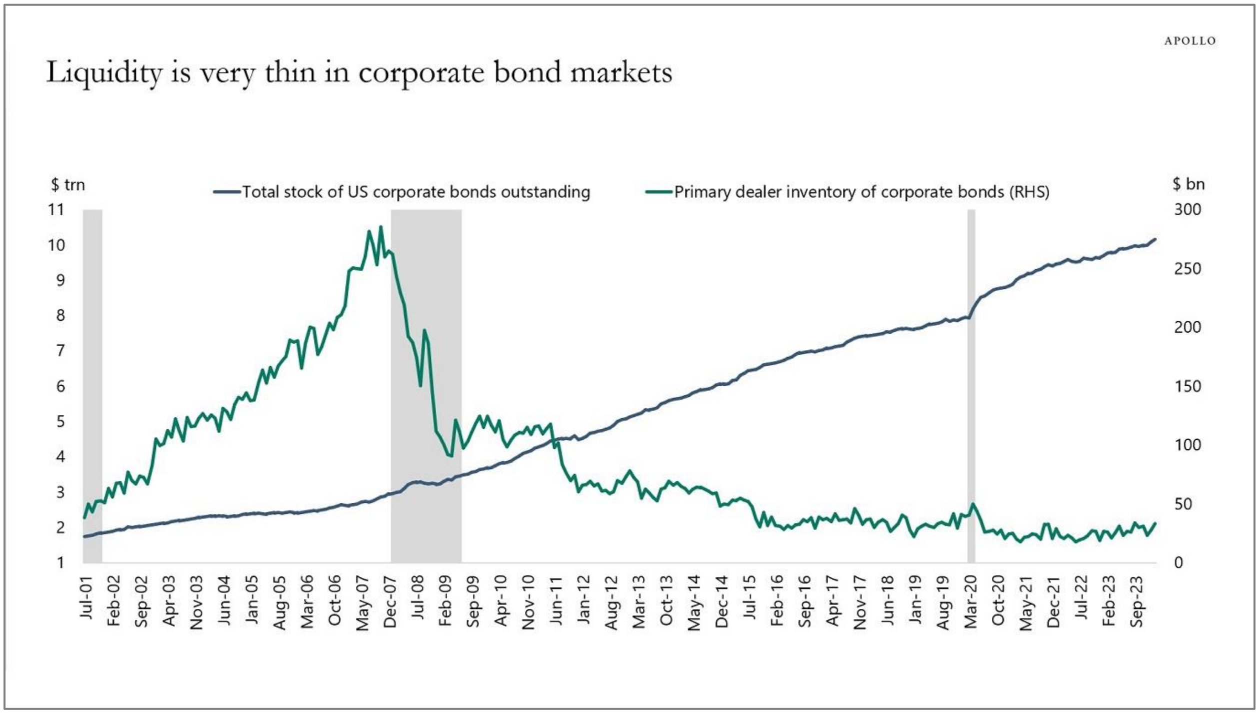
Goldman Sachs Sentiment Indicator hits the highest level since 2021.



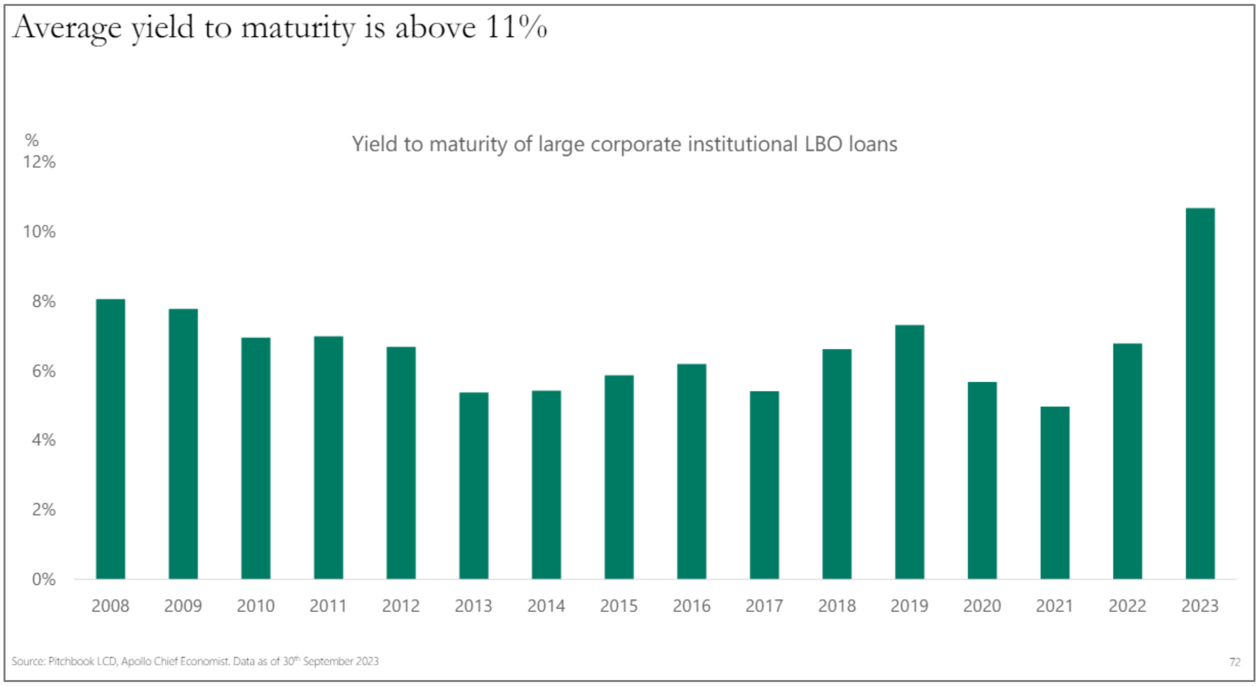
Record inflows to US Equity Funds.



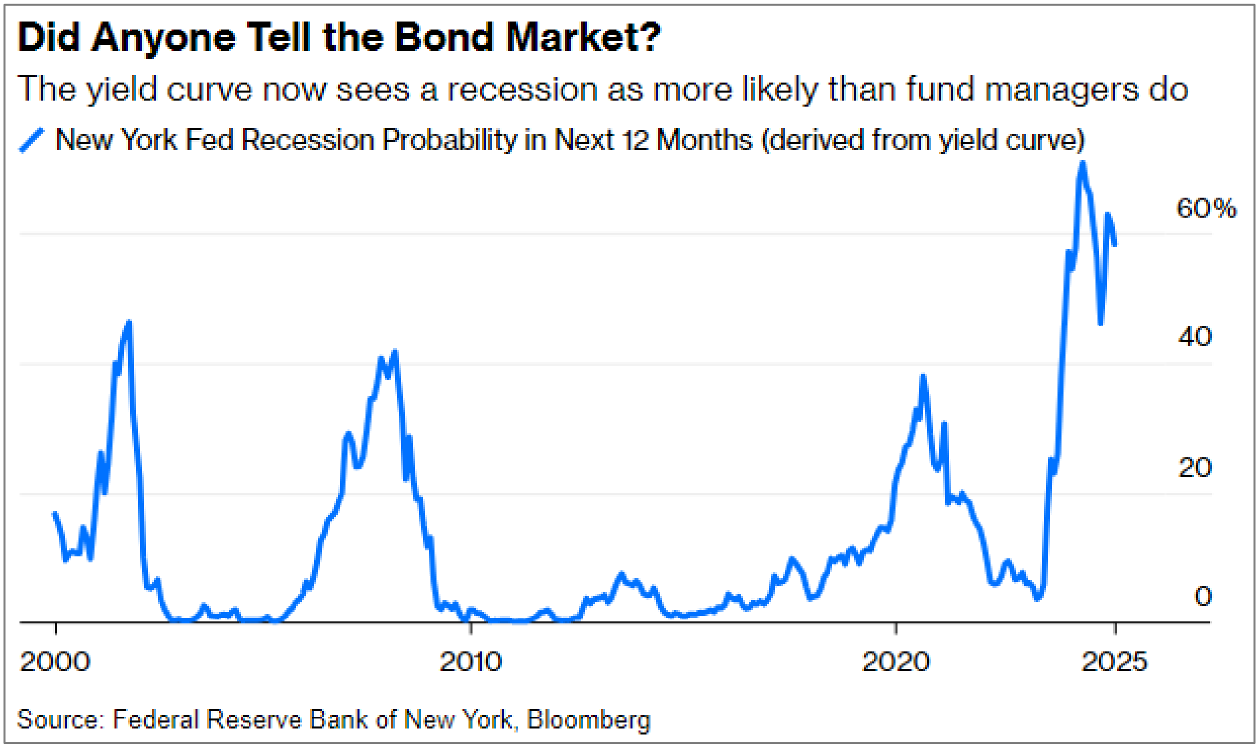
Corporate Bond Market Liquidity is very thin.



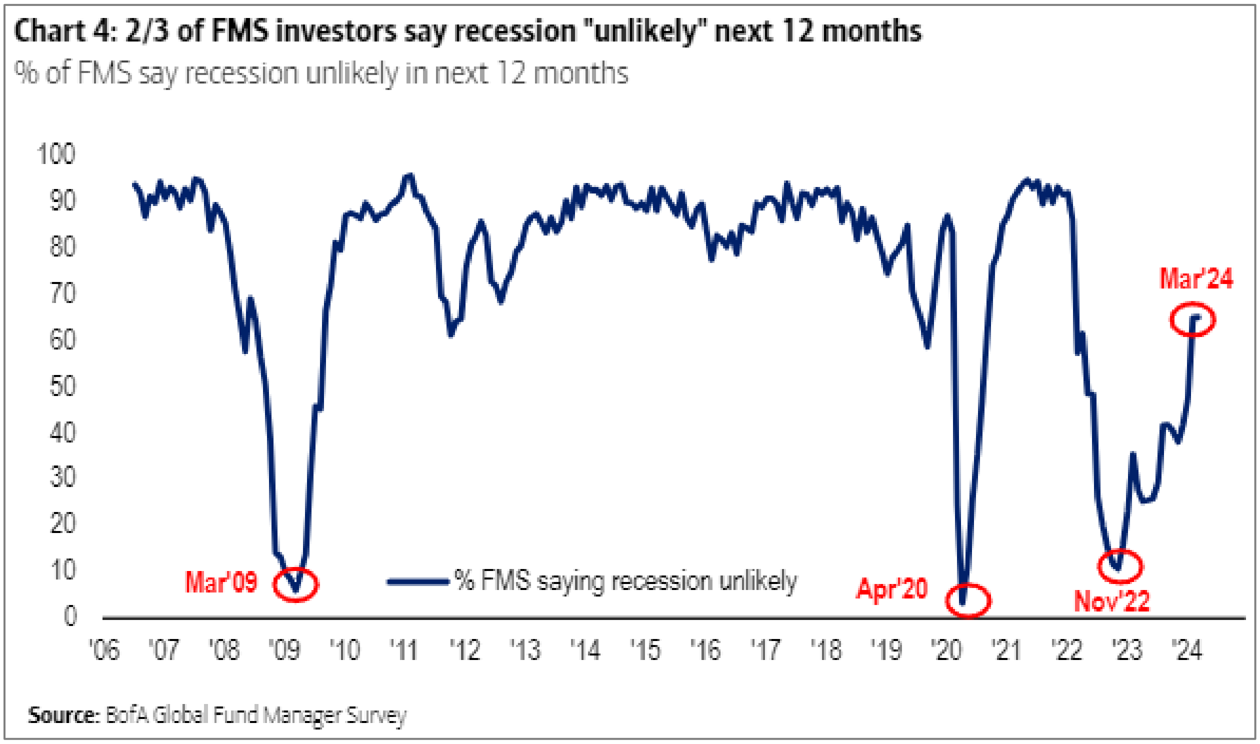
Cost of Capital for private equity is at 16-year highs.



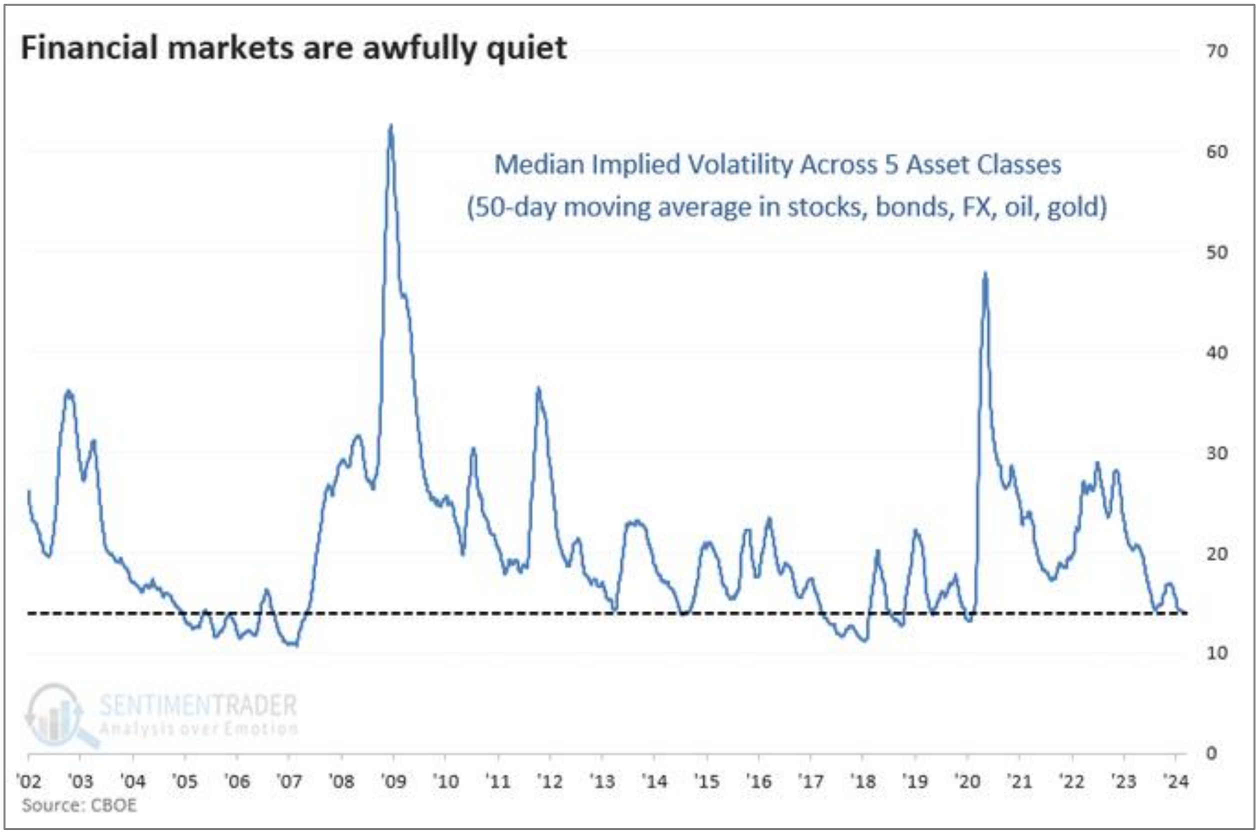
Yield Curve has been sounding the recession alarm bells for a long time.



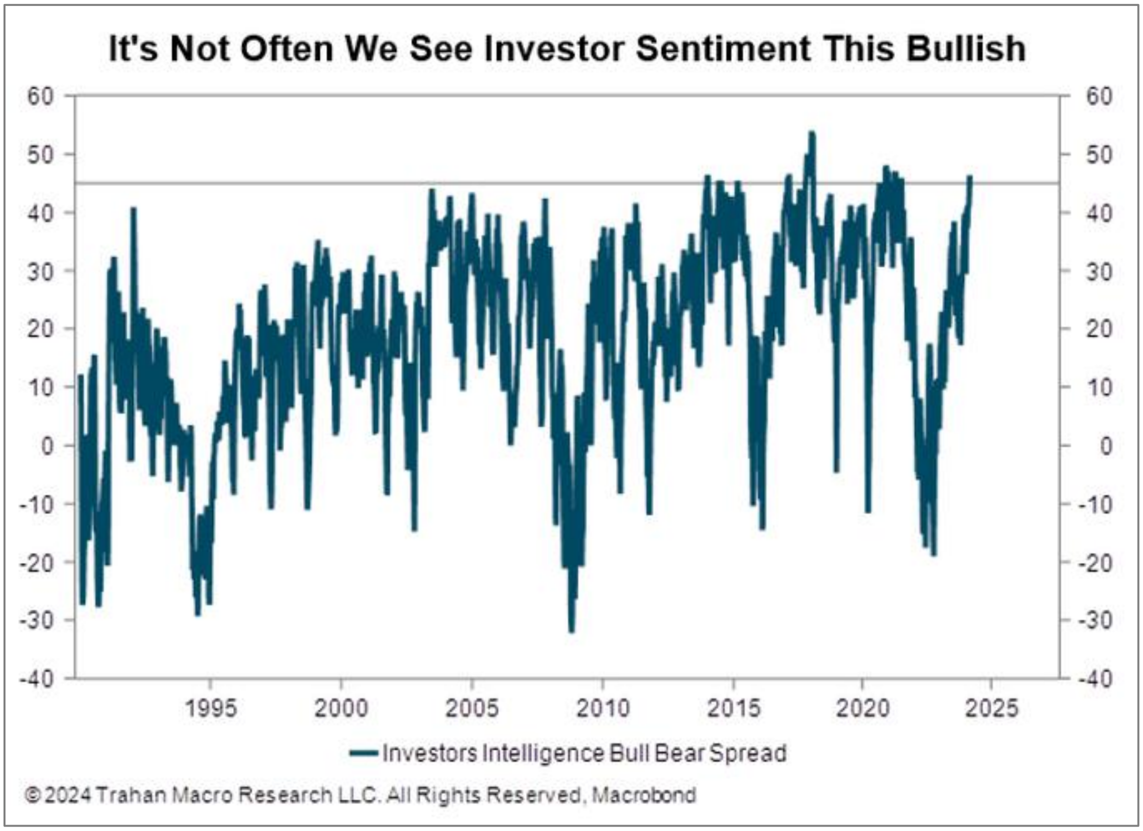
But, in the last month, most investors stopped believing it.



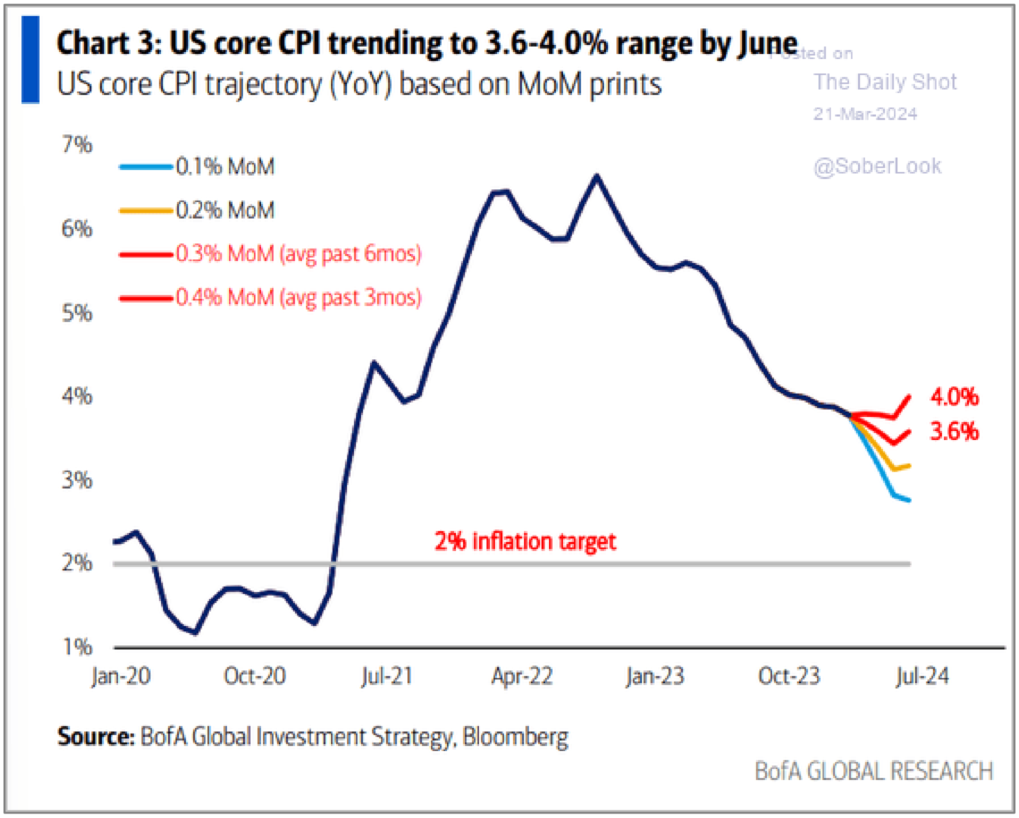
Financial markets haven't been this calm collectively since early 2020.



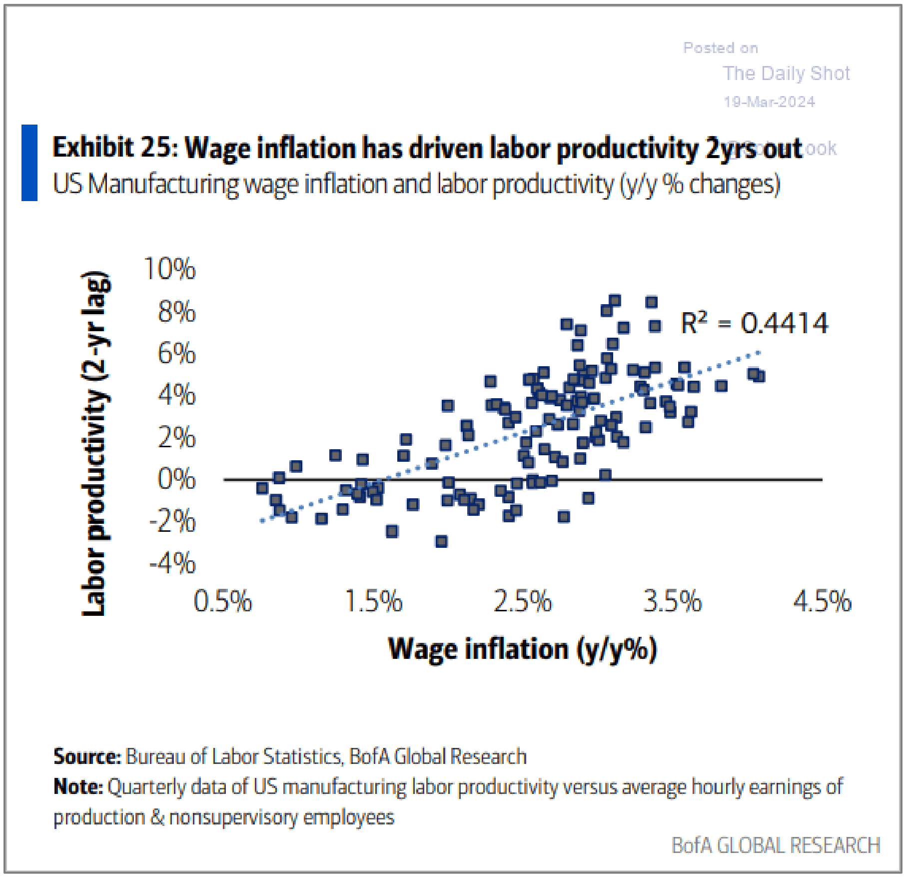
We don't often see Investor Sentiment this Bullish.



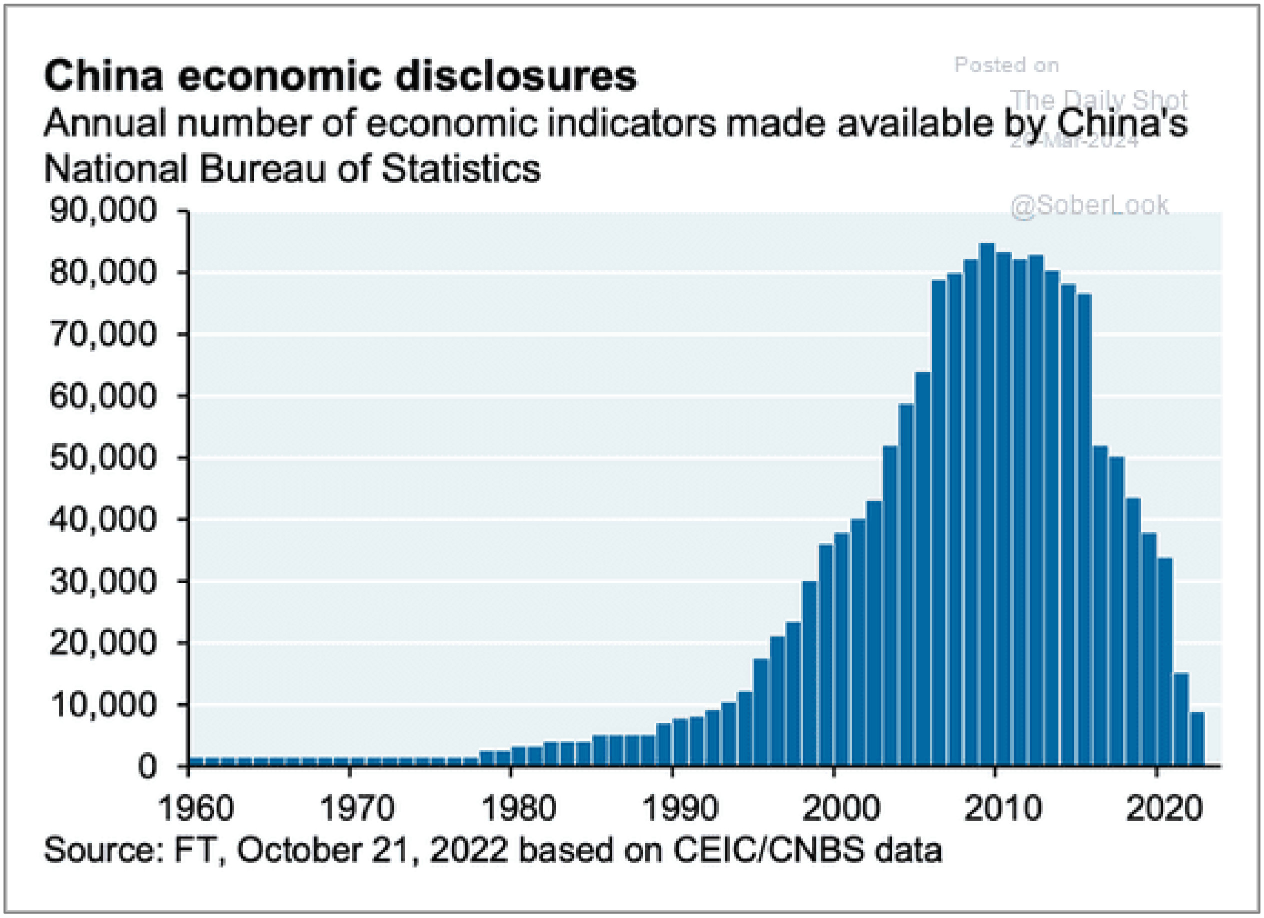
Core CPI is trend toward a level that is well above the Fed's stated target.



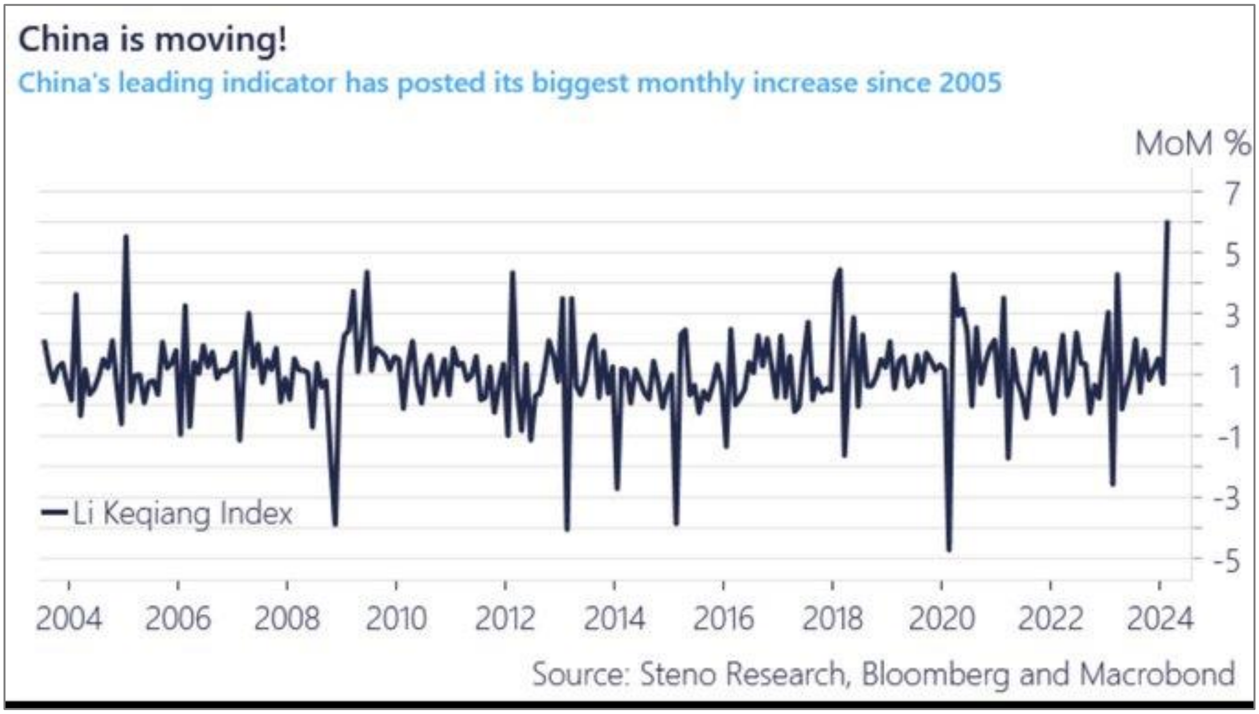
Higher wage inflation leads to future productivity increases.



It looks like when China stops liking the numbers, they stop publishing the numbers.



China didn't mind publishing this one – largest leading indicator increase since 2005.



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.