Market Outlook

By Mark T Dodson, CFA

Stimulus by Wealth Effect

Market Risk Index climbed back above 75% into the zone that denotes markets with high drawdown risk. Psychology and Valuations were largely unchanged. Instead, a worsening of Monetary Conditions drove MRI higher.

We've noted for several months that investor behavior, pinned on the hopes of lower rates, appeared to be pushing our Monetary Composite into bullish readings for the stock market, despite the third most prolonged and severe yield curve inversion in 100 years.

An increase in risk score on our Monetary Composite coming this week, after the market's reaction to another disappointing inflation release, illustrates the nature of the liquidity present in markets and the economy. It's driven more by enthusiastic sentiment and a sharp drop in risk aversion among households than any notion of a Fed pumping liquidity into the economy. It's been stimulus by wealth effect. The speculative era that Covid-stimulus and persistent deficit spending brought to bear has had staying power, and along with it, inflation.

Psychology stayed mired in the worst two percent of euphoric readings since 1970, but there was a notable drop in enthusiasm when we look at daily dollar volume in levered versus inverse ETFs. However, positioning, in terms of assets and the willingness to carry leverage, is still euphoric and near record highs. One week of higher volatility hasn't shaken investors' over-bullish convictions.

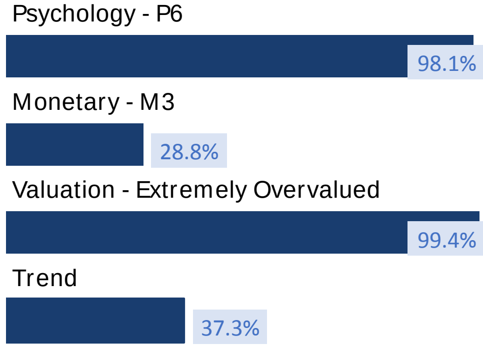
Meanwhile, corporate insiders have been persistent sellers over the last three months. They haven't sold this steadily into stock market strength since May 2021. Over the last decade, when selling was this severe, the average stock tended to begin to underperform cap-weighted indices, and the market narrowed. This implies worsening technicals. Thus far, technicals have been one of the most constructive things this stock market has had going for it.

Market Risk Index

Rec Allocation 25% Underweight

75.3%

Category Percentiles



Largest Psychology Influences

Leveraged Investments	Negative
Surveys	Negative
Consumer Confidence	Negative
Option Activity	Negative

Largest Monetary Influences

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

Valuation

7-10 Year Equity Return Forecast	0.1%
10Yr US Treasury Yield	4.6%

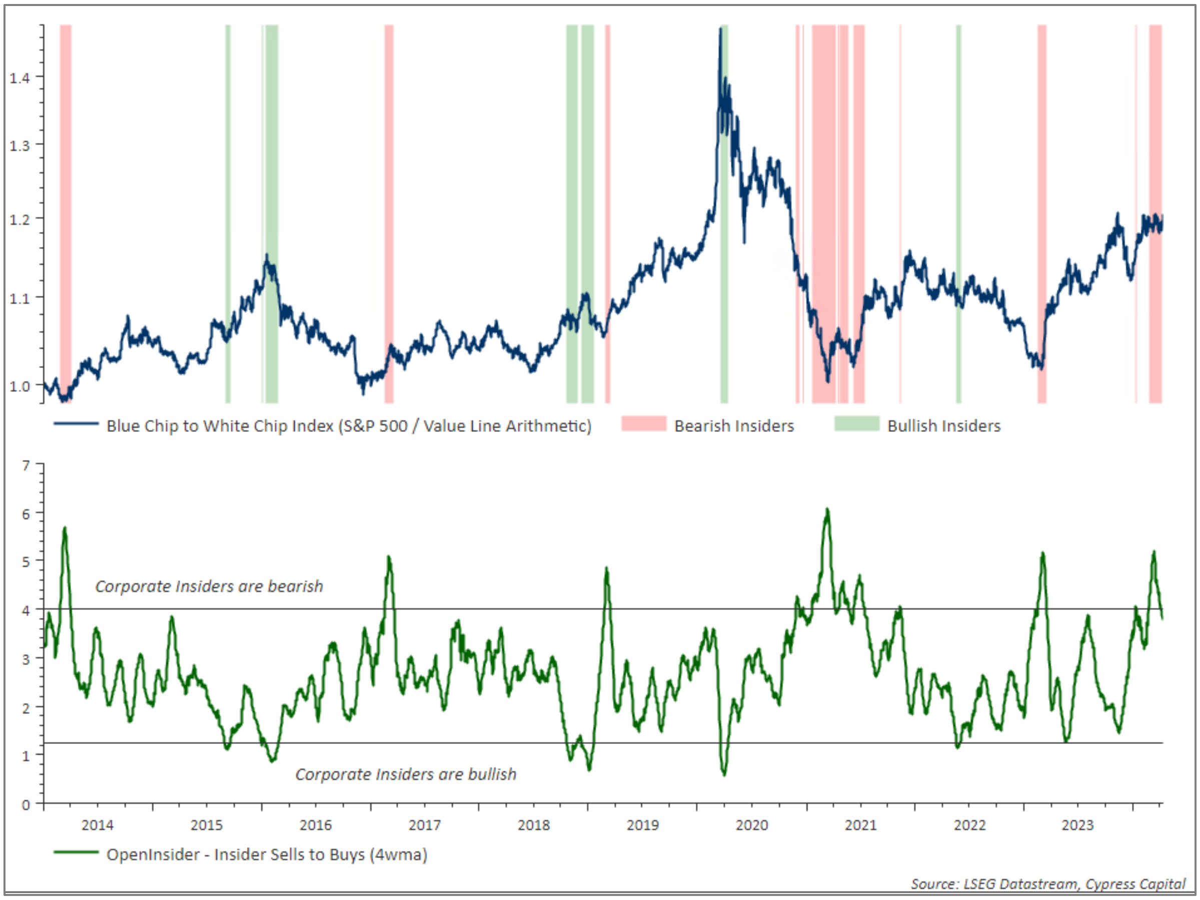
Market Trends

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

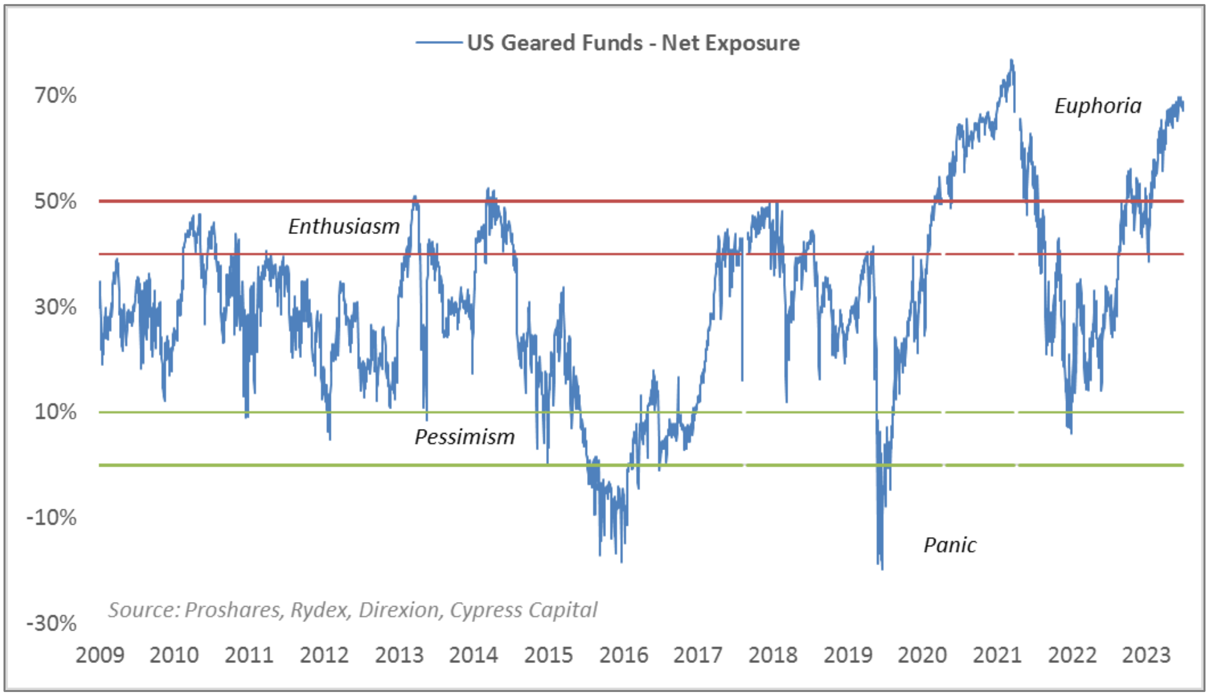
Market Risk Index scales from 0 to 100%. Higher readings correspond with higher risk markets based on our model & opinion. Scores below 25% are bullish. Scores between 25-75% are neutral, and scores above 75% are markets vulnerable to major drawdowns.

Charts of the Week

Small Cap Relative Performance versus Corporate Insider Activity
When Corporate Insiders are Heavy Sellers, Small Caps tend to underperform.

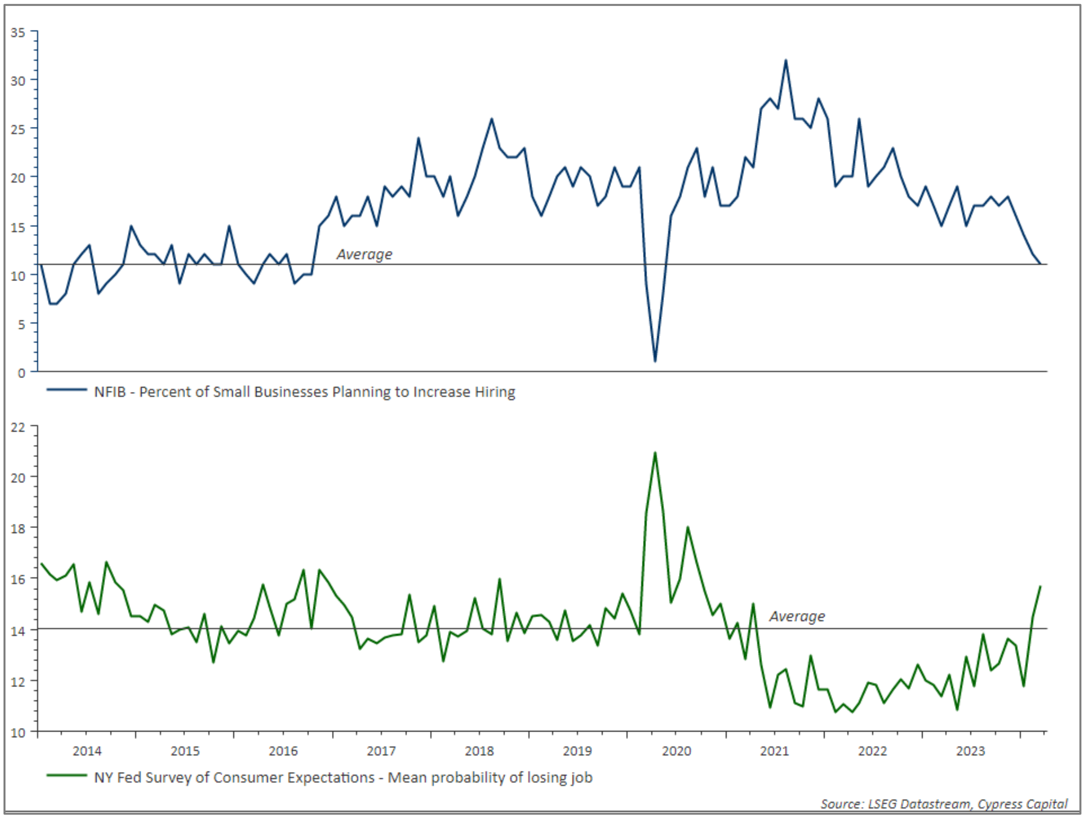


Dollar volume shifted away from Leveraged ETFs, but Net Exposure remains near 2021's euphoric highs.

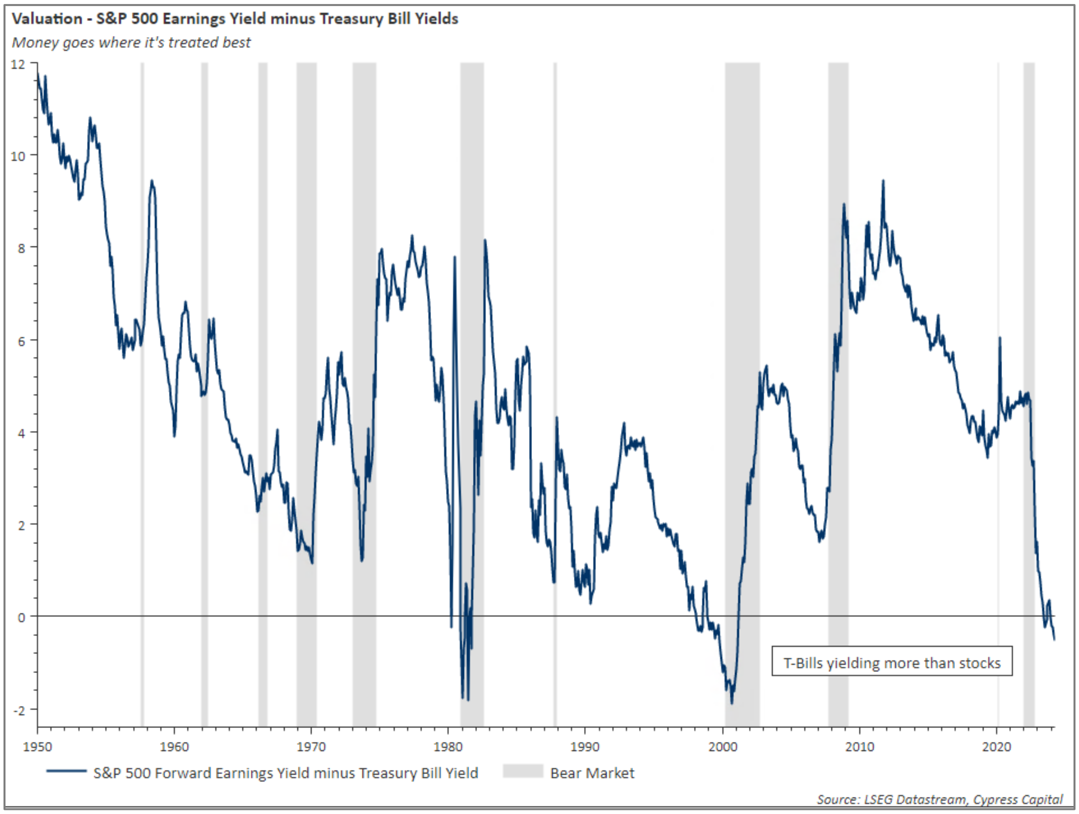


Employees are picking up messages from management.

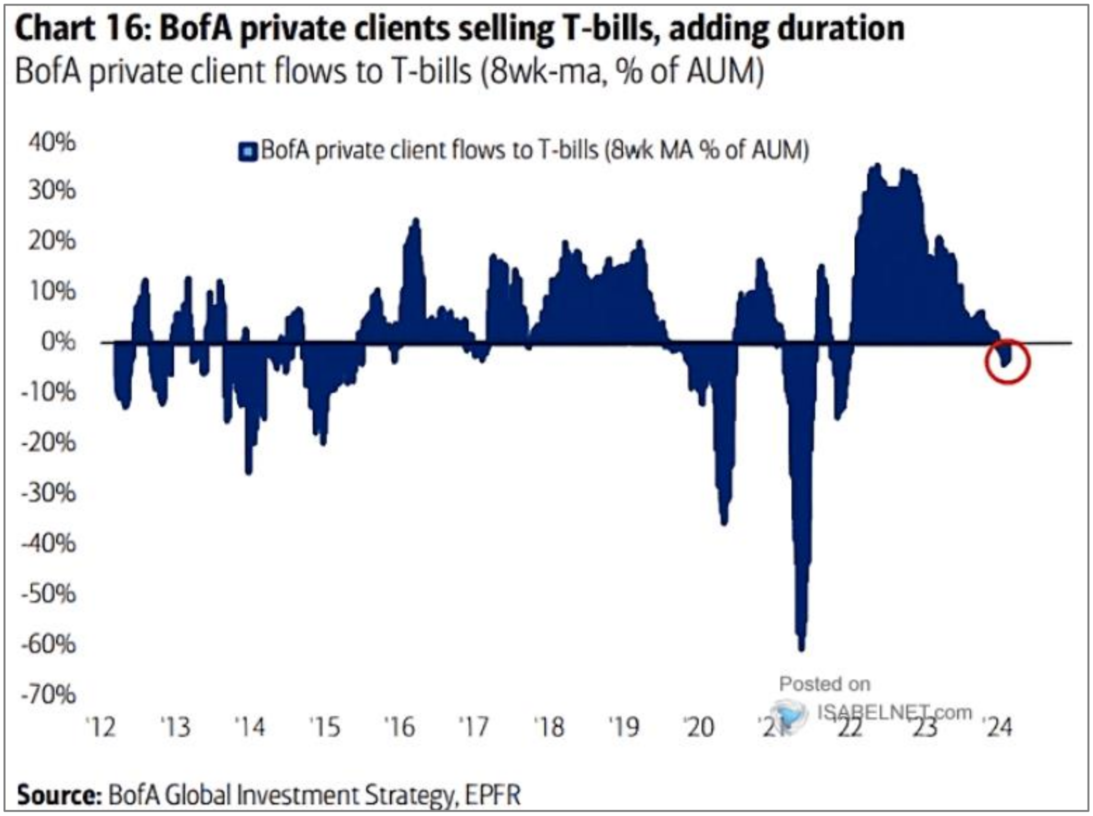
As the percentage of small businesses planning on increasing hiring falls to the lowest level since 2020, employees are beginning to feel vulnerable.



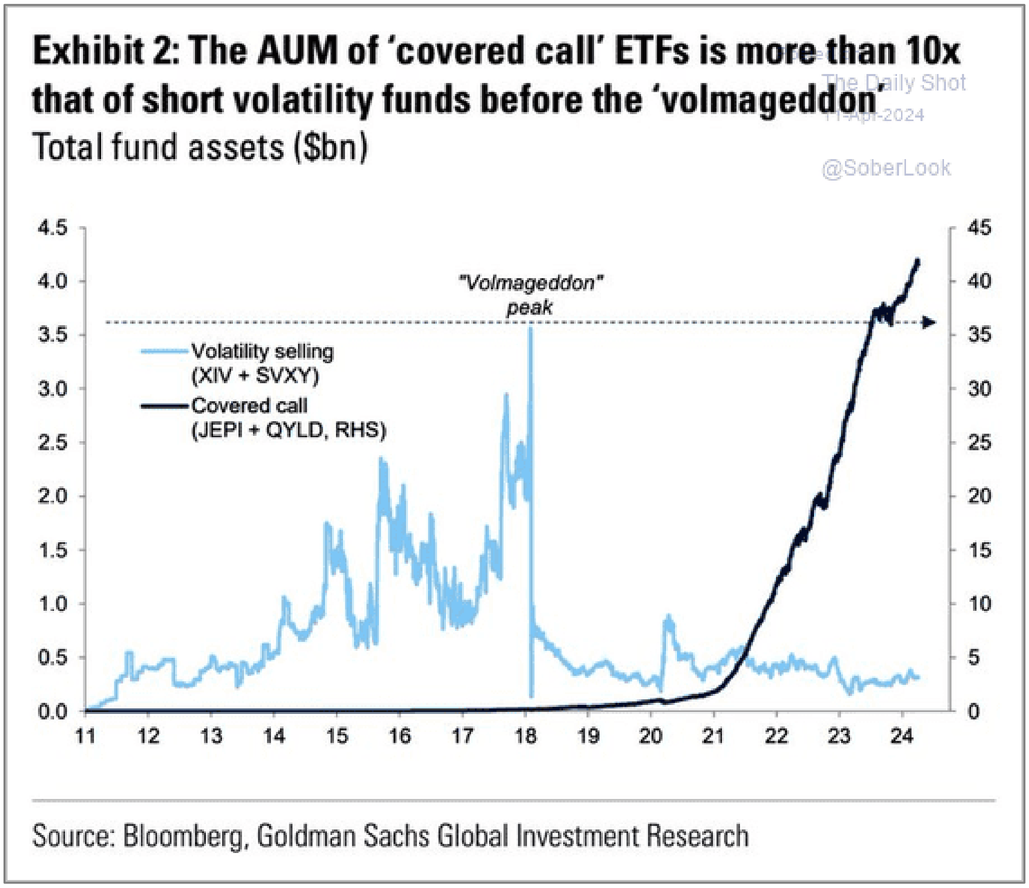
Valuation - This is only the 3rd time in at least 75 yrs that T-Bill yields are higher than Earnings Yields.



Relative valuations haven't swayed individual investors. They are net sellers of T-Bills.



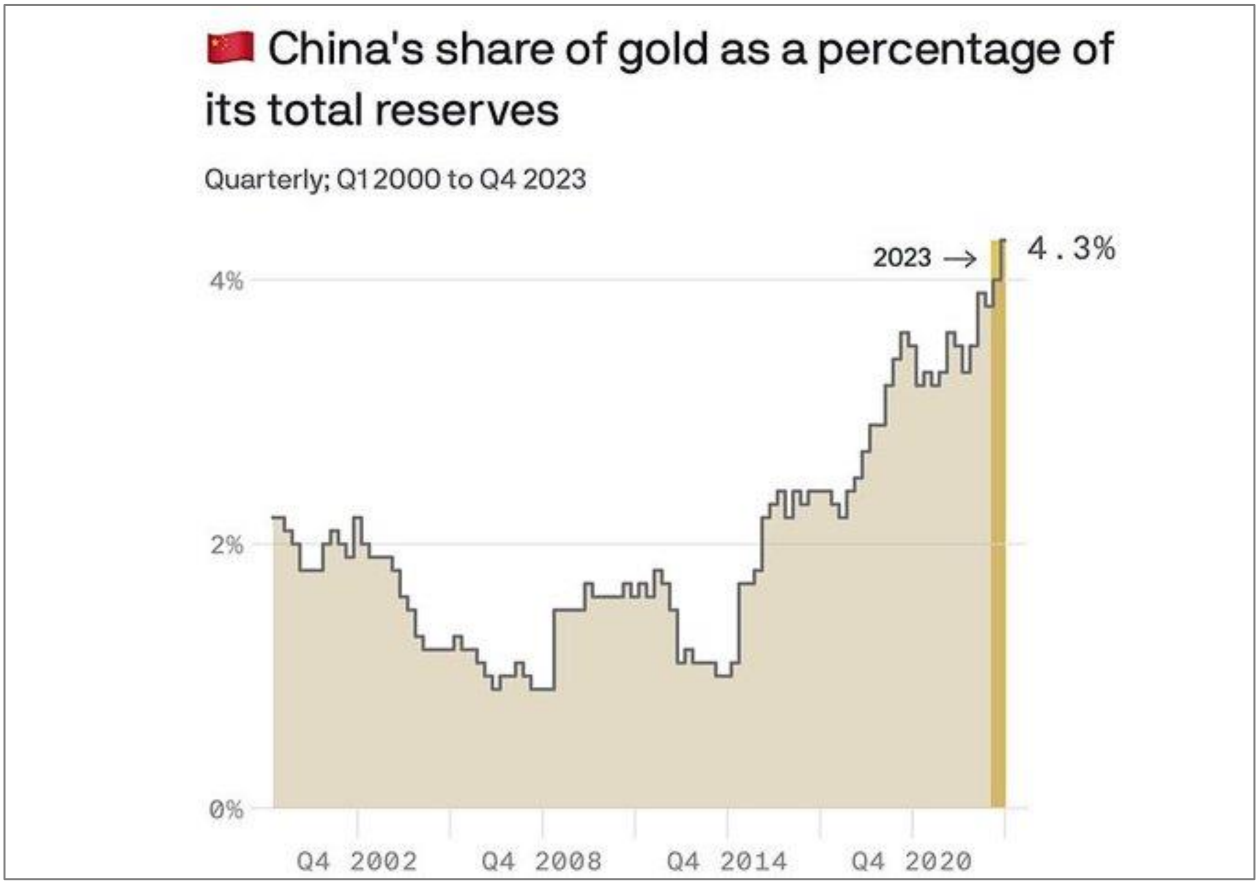
Instead, investors love Covered Call ETFs – they are more popular than the Short Vol ETFs were in 2018.



Gold shot to fresh new highs, but retail investors have showed no interest.

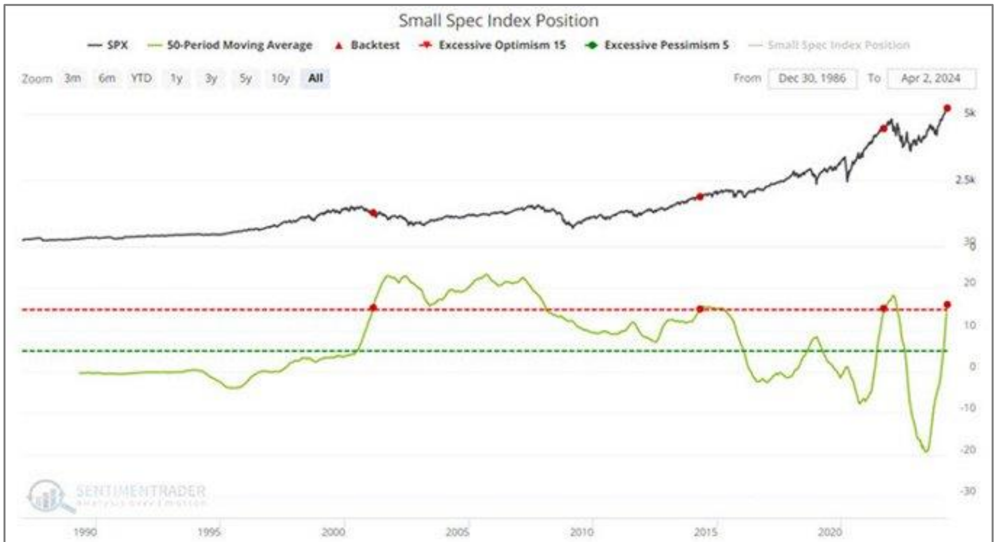
Source: @super_macro

While retail has been selling gold, China has been stockpiling it.



Complacency in options markets – fears of a bear market fall to 2007 levels.

Highest excessive optimism among Small Speculators since 2021.



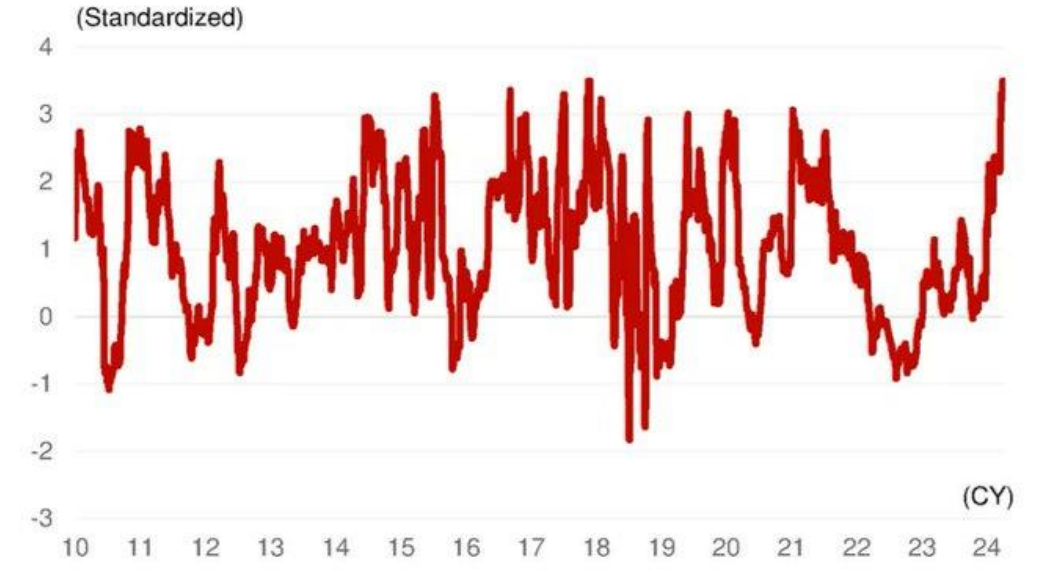
SPX	1 Week Later (%)	2 Weeks Later (%)	1 Month Later (%)	2 Months Later (%)	3 Months Later (%)	6 Months Later (%)	1 Year Later (%)
Average Returns	-1.40%	-0.99%	-3.65%	0.82%	2.93%	-2.63%	-4.05%
Median Returns	-1.64%	-1.97%	-2.08%	3.81%	5.48%	-4.06%	-11.49%
Win Rate	0%	33%	33%	67%	67%	33%	33%

Trade Date	1 Week Later (%)	2 Weeks Later (%)	1 Month Later (%)	2 Months Later (%)	3 Months Later (%)	6 Months Later (%)	1 Year Later (%)
2001-02-20	-1.64%	-1.97%	-10.66%	-6.81%	-2.31%	-9.51%	-13.26%
2014-04-29	-0.56%	1.02%	1.79%	3.81%	5.60%	5.68%	12.59%
2021-09-14	-2.00%	-2.04%	-2.08%	5.45%	5.48%	-4.06%	-11.49%
2024-04-02							

Macro Funds exposure to US equities is near all-time highs.

Fig. 11: Macro hedge funds' exposure to US equities

Long exposure to US equities near the historical high



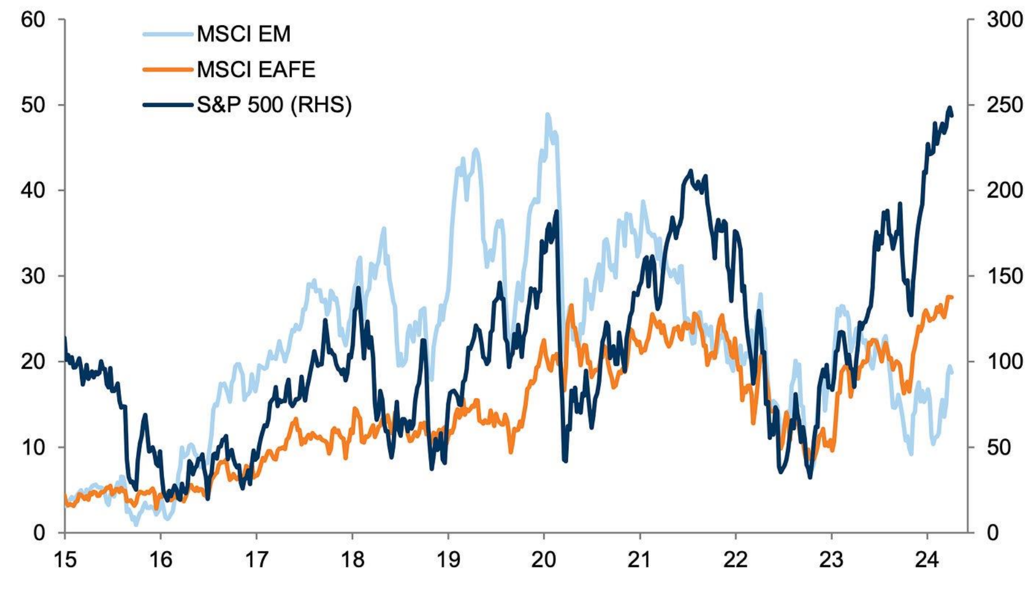
Note: CTAs have been excluded from the macro hedge funds that are included here. Gross exposure to US equities estimated as the regression coefficient (beta)—standardized to one standard deviation—for the S&P 500 in a multiple regression model in which macro hedge funds' performance over the preceding two months is regressed against the performance of two variables over the same period: the S&P 500 and the ICE US Treasury 7-10 Year Bond Index. Sample period is 4 January 2010 through 4 April 2024.

Source: Nomura, based on Bloomberg data

Asset Manager's positioning in S&P 500 and EAFE is hitting highs.

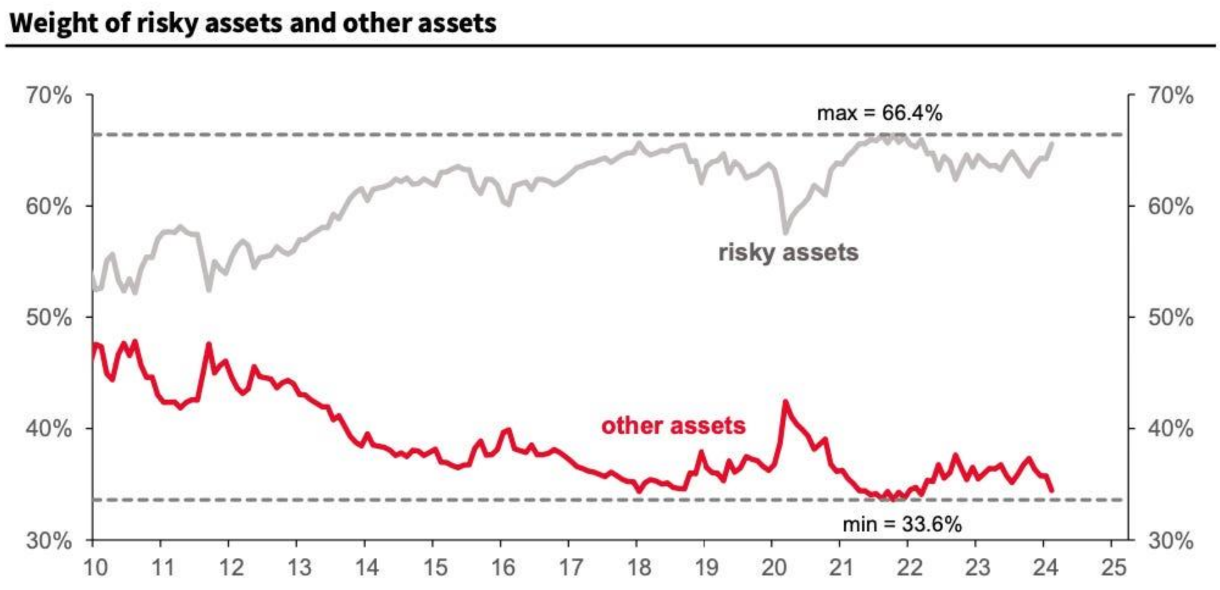
Exhibit 49: Equity future asset managers' positions

Asset manager net positioning in $bn



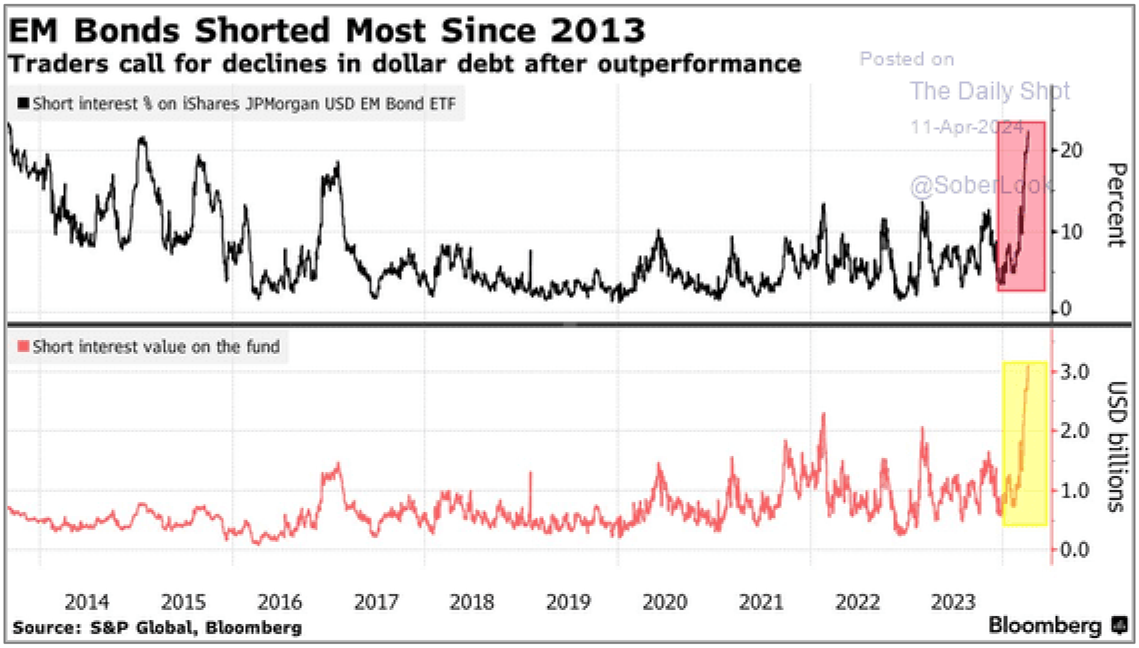
Source: CFTC, Haver, Goldman Sachs Global Investment Research

Mutual Funds are near their max exposure to risky assets.

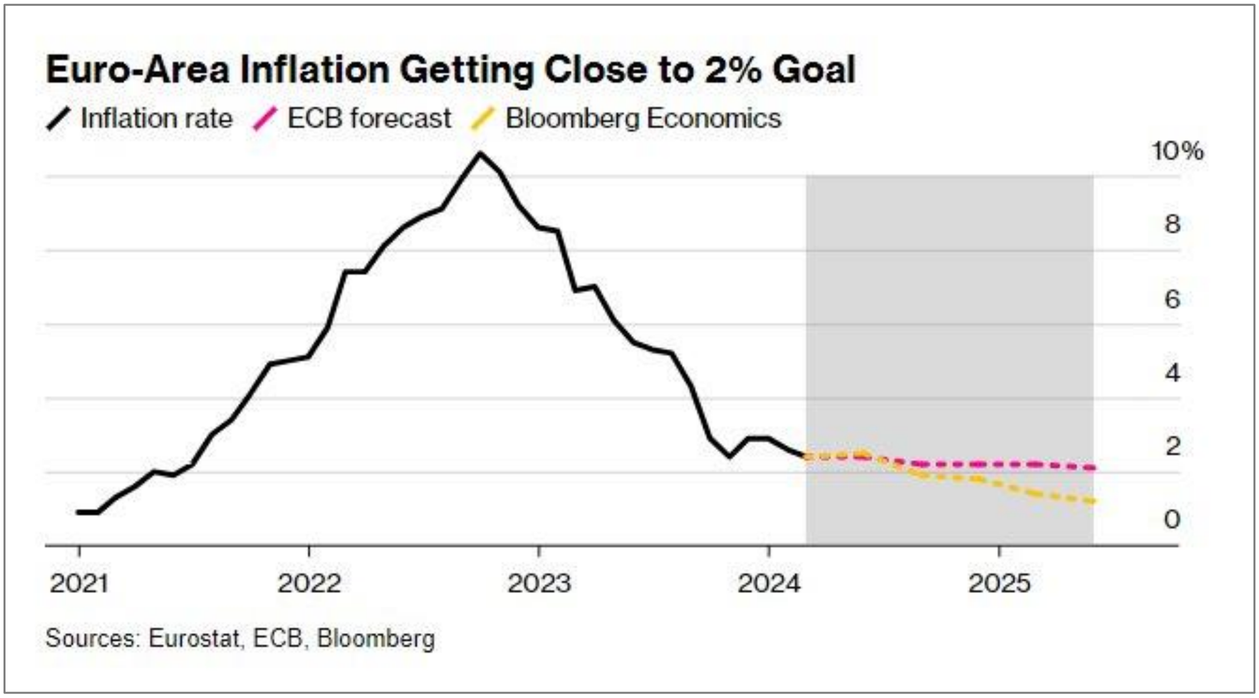


Weight of riskiest assets (equity+credit) and other assets (bonds+money markets), AuM as a % of all EPFR funds Combined data for mutual funds and ETFs, monthly statistics to 29/02/2024.

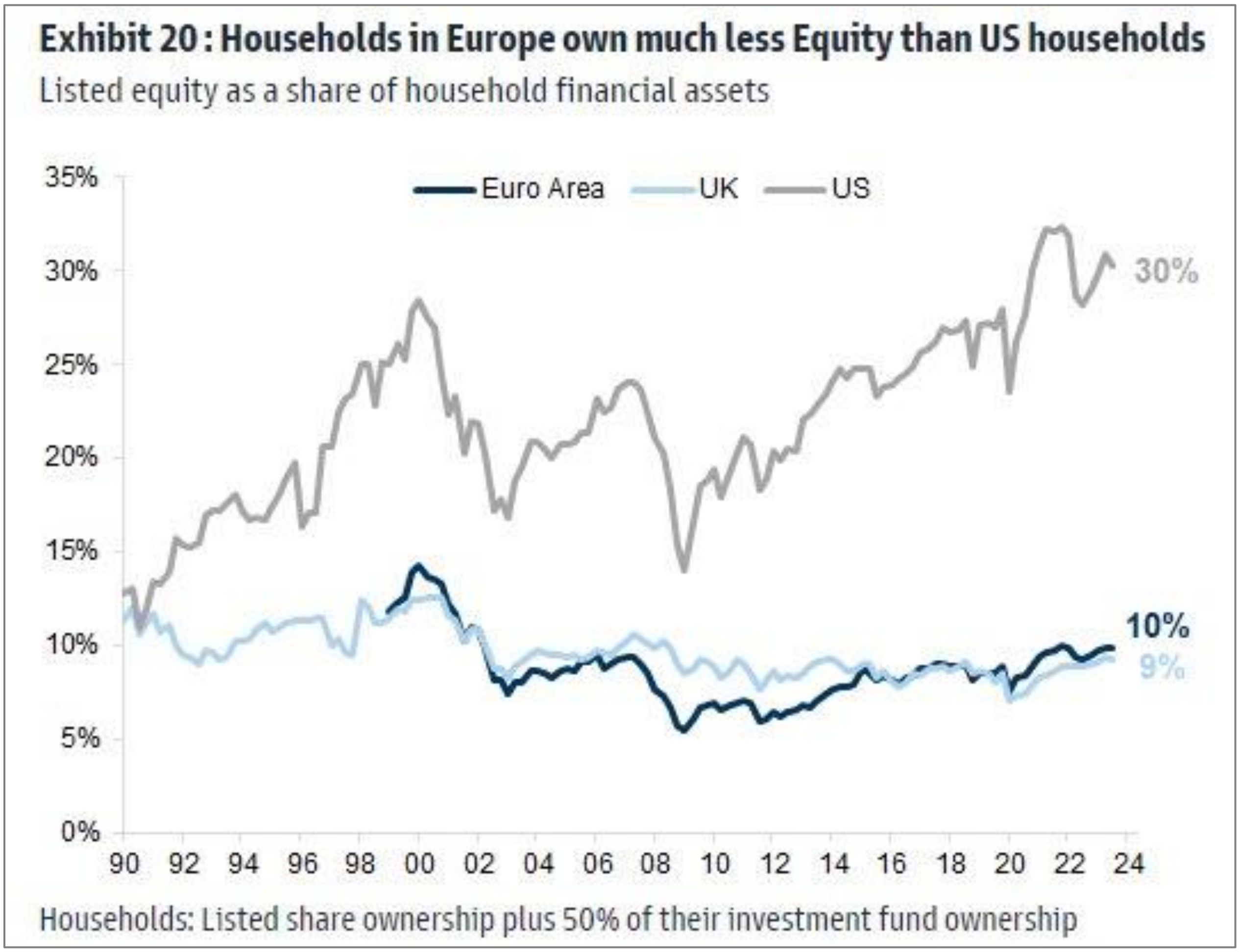
Investors making a big bet that something is going to break in emerging markets.



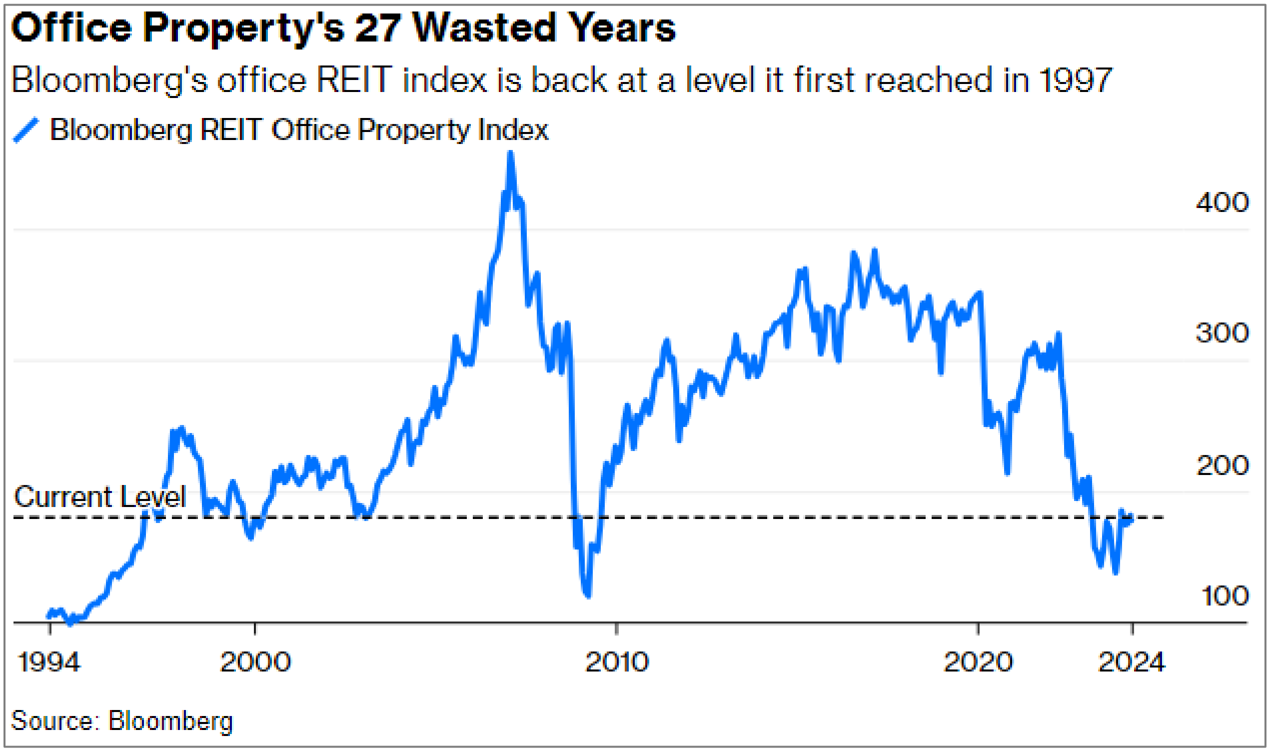
Unlike the United States, Euro-Area Inflation is getting close to 2% Goal.



Is it because FOMO and the resulting wealth effect are more of a United States phenomenon?
Households in the United States have heavy equity exposure.

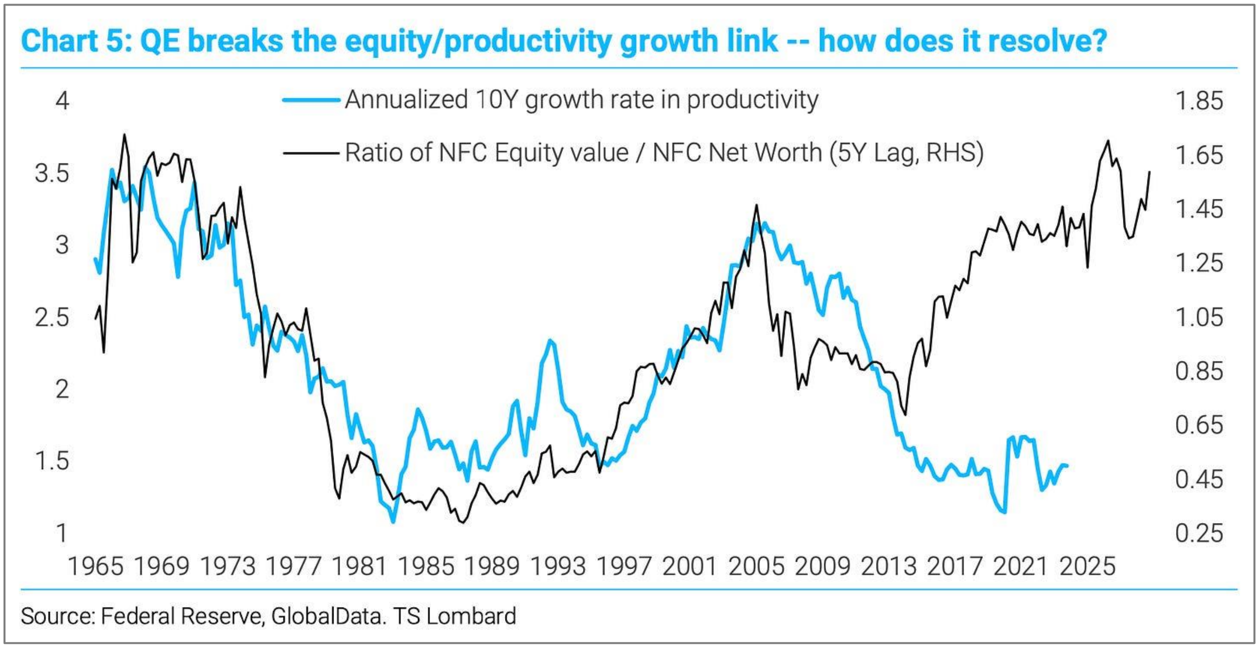


Office REITs are trading at 1997 levels.

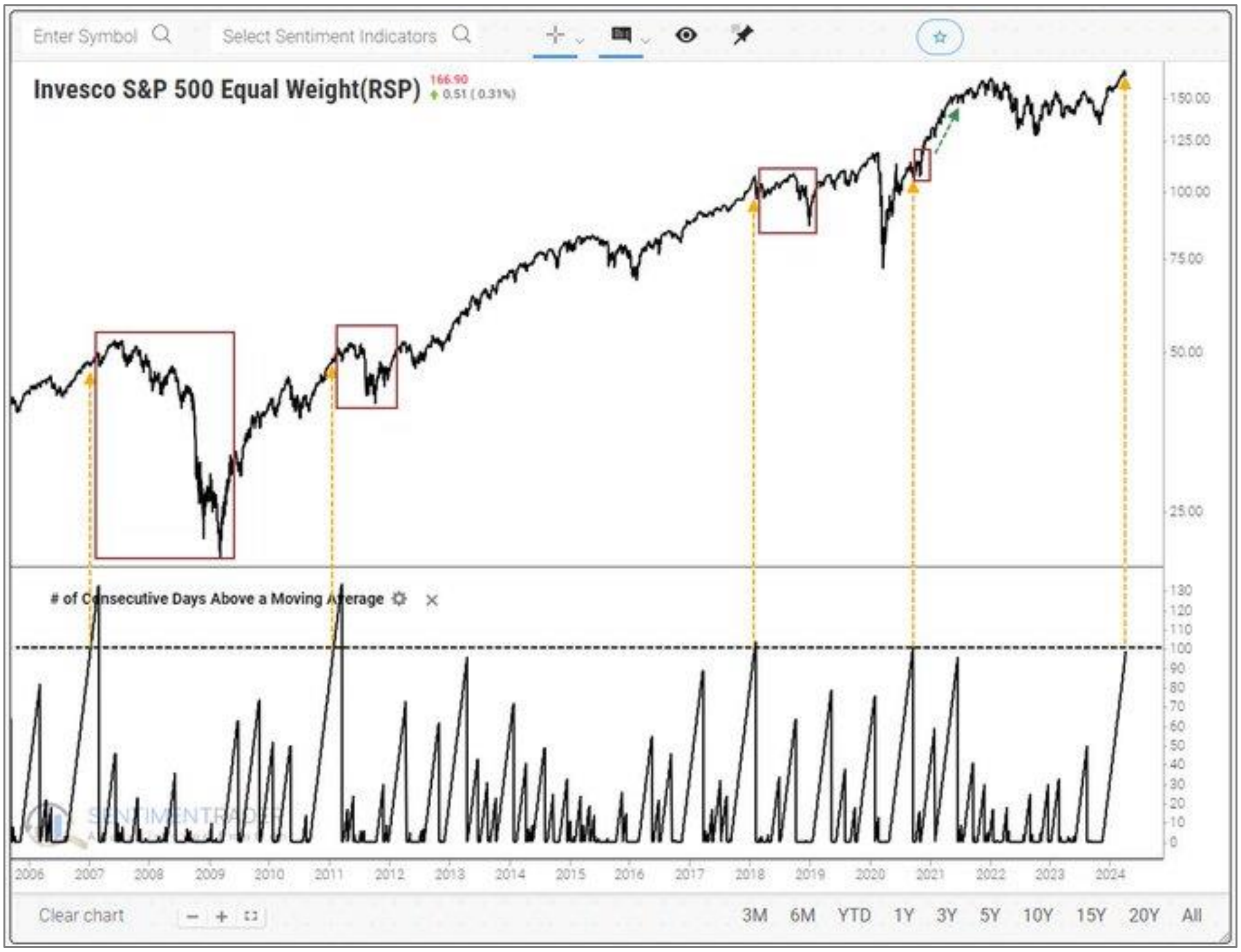


Growing gap between labor market conditions and US employment.

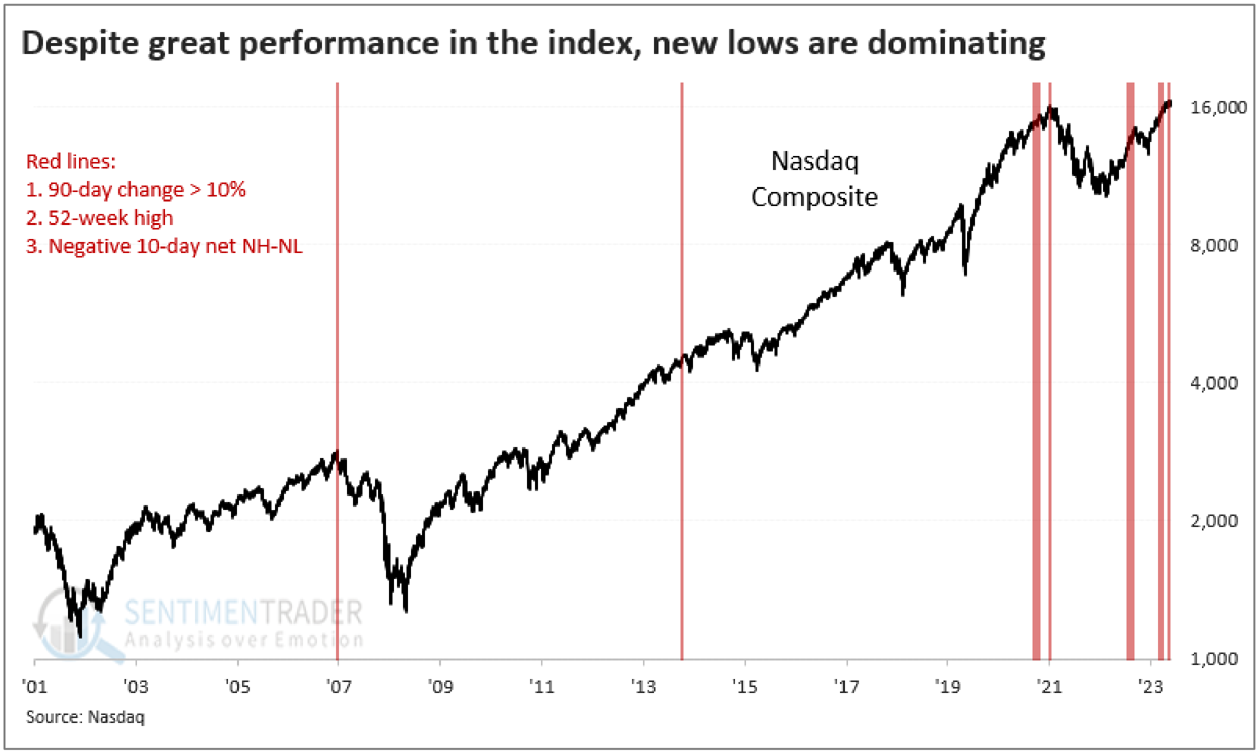
This chart seems to imply that Quantitative Easing has made us lazier.



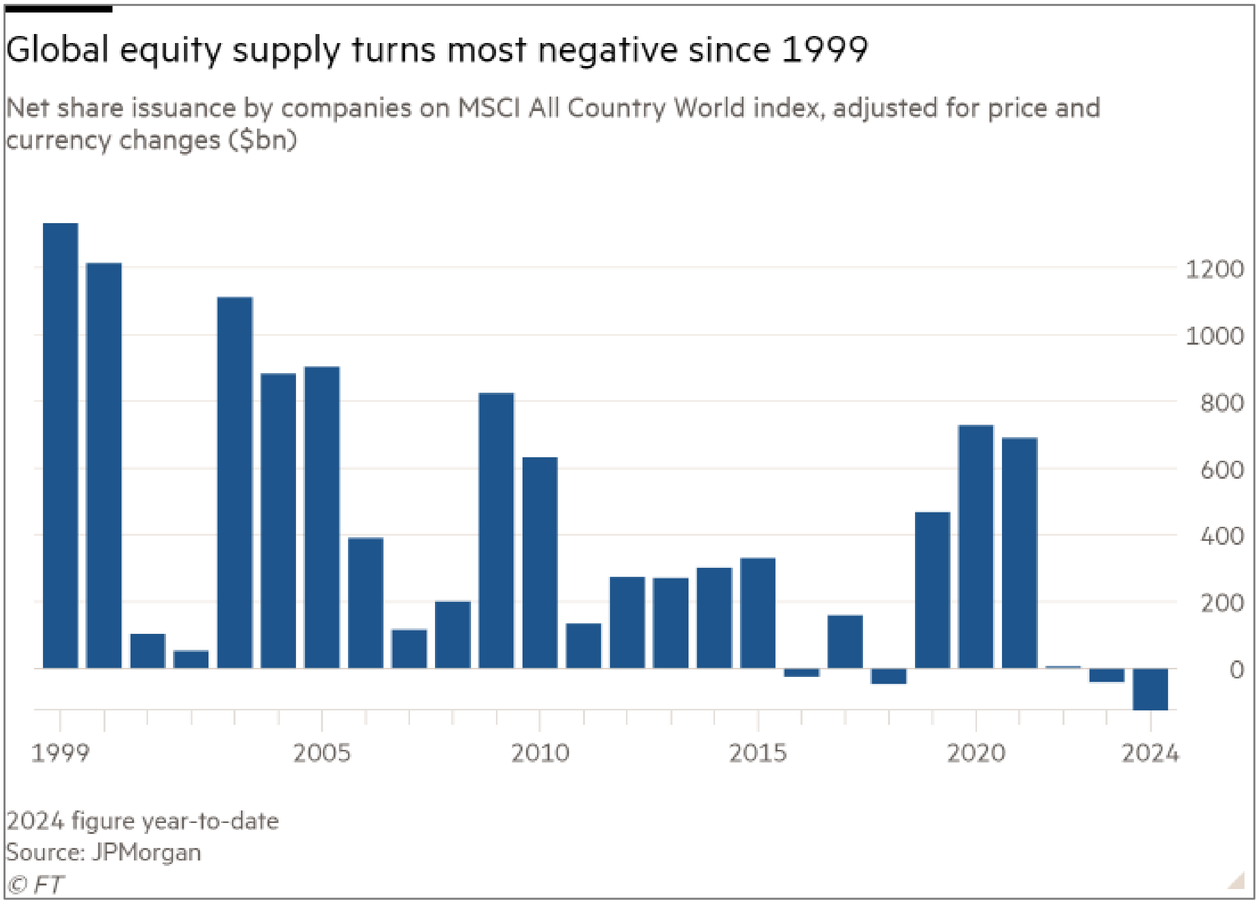
S&P 500 Equal-Weight Index makes it 100 days above it's 50-day moving average.
That was bullish one out of the last four times previously.



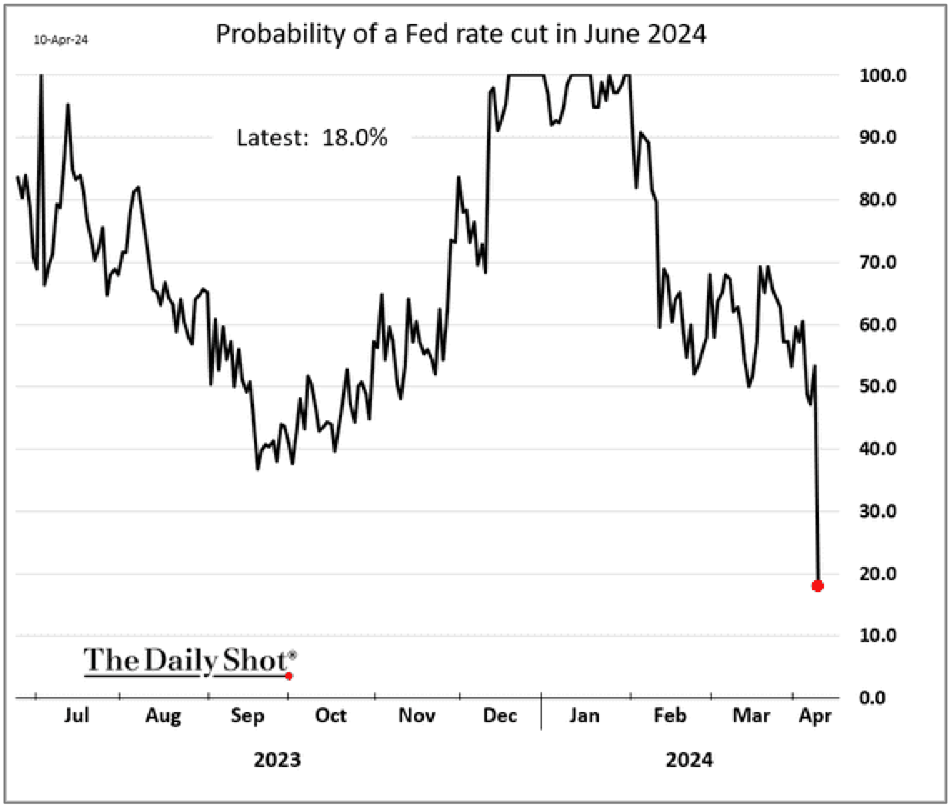
New lows are dominating the NASDAQ as the index makes new highs.



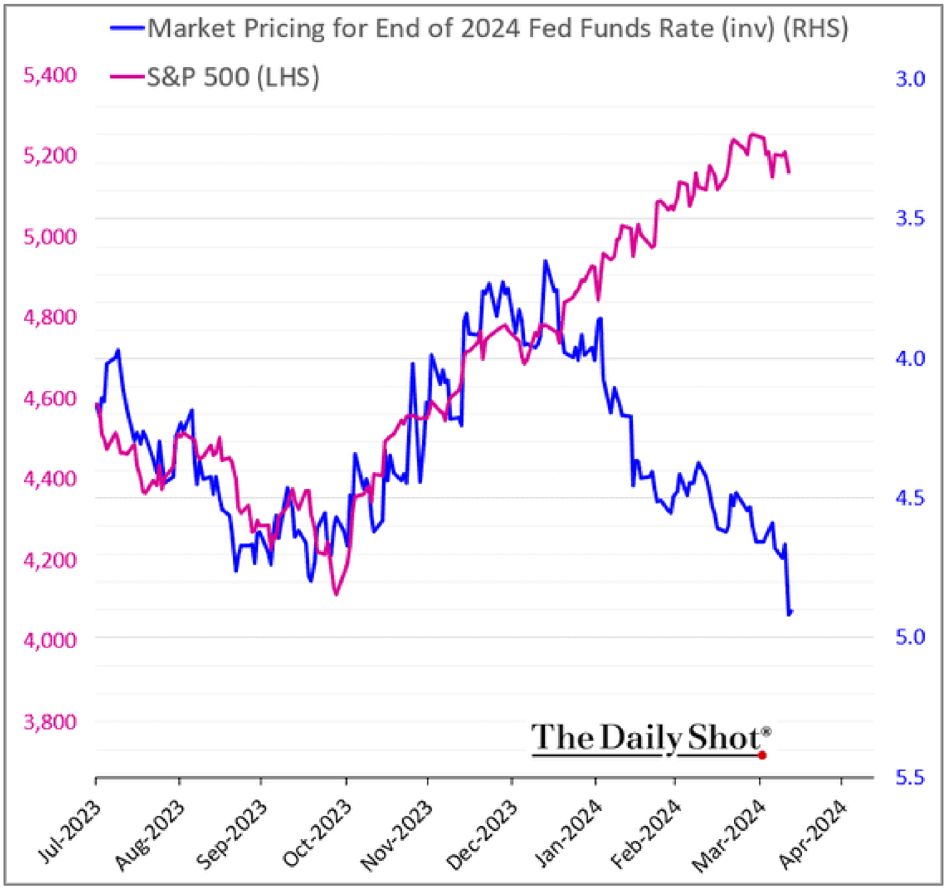
Global buybacks drive equity share issuance negative as corporations try to spend excess cash.



Investors lose hope of a June rate cut after this week's inflation print.



But, the stock market has either stopped caring or stopped believing the bond market.



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.