A Market Note: Psychology of the Risk Cycle

Alright, this one's going to be a bit of a brain dump. Stick with me as I try to untangle and connect some threads that have been rattling around in my head lately.

Let's start with a question: does it actually matter for markets which political party is in power in the U.S.?

The answer? Yes.

But also… not really. Let me explain.

Back in 2003, a paper titled *"The Presidential Puzzle: Political Cycles and the Stock Market"* was published in the *Journal of Finance*. It explored whether U.S. presidential cycles had any meaningful relationship with equity market performance (shoutout to Operator @Karan and the Rational Reminder pod for pointing this out).

The findings? Pretty striking.

The authors discovered that stock market excess returns were significantly higher under Democratic presidencies compared to Republican ones—9% versus 16% for value- and equal-weighted portfolios, respectively. They noted that this difference wasn't explained by business-cycle variables or concentrated around election dates. In other words, it's not about timing or policy shifts—it's a genuine anomaly. They called it "a puzzle" because, theoretically, markets are supposed to be efficient. Political leadership shouldn't systematically affect returns.

Interesting, right? Democrats outperform Republicans in terms of market returns. But hold up—I've got some issues with this paper (we'll get there). First, let's dig into why this so-called puzzle exists.

Fast forward to 2020, and another paper—this time from the *Journal of Political Economy*—titled *"Political Cycles and Stock Returns"* offers a compelling explanation. Pastor and Veronesi, the authors, confirmed that markets perform better under Democratic administrations (+10.7% annual excess return) than Republican ones (-0.2%). That's an eye-popping 11% annual gap.

Table 2
Average Stock Market Returns in the Presidents' Early Years in Office

This table reports average excess stock market returns under Democratic presidents, Republican presidents, and the Democrat-Republican difference over the full sample period of January 1927 to December 2015. The results are computed over subsets of presidents' terms corresponding to their first one, two, or three years in office. Full-term results are identical to those reported in the first row of Table 1.

	Democrat	Republican	Difference
Year 1 in office	21.75	-15.13	36.88
	(2.03)	(-1.94)	(2.70)
Years 1 and 2 in office	11.47	-4.08	15.55
	(1.73)	(-0.66)	(1.56)
Years 1, 2, and 3 in office	15.00	2.57	12.43
	(3.11)	(0.56)	(1.67)
Full term	10.69	-0.21	10.90
	(4.17)	(-0.07)	(2.73)

Now, if you're thinking, "Wait a minute… shouldn't the 'party of business' be better for business?"—you're not alone. But before anyone starts using this as ammo for partisan superiority debates, let's unpack what's really going on here.

The truth is we've got causation backward. Presidential parties don't drive market returns; rather, initial market and economic conditions drive voter behavior—and ultimately, party selection. It's correlation, not causation.

Pastor and Veronesi argue that *time-varying risk aversion* is the key mechanism behind this phenomenon. When risk aversion is high (think fear-driven environments), voters lean Democratic; when risk aversion is low (optimism abounds), they lean Republican.

Here's the kicker: Democrats tend to take office during periods of high-risk aversion when stock prices are beaten down. As risk aversion declines and confidence returns, stock prices naturally rise—making Democrats look like market saviors.

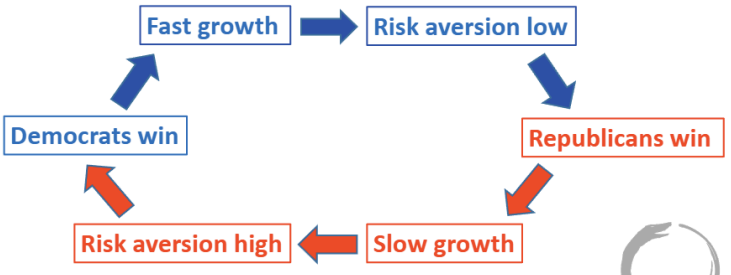


Figure 1. Political cycles. This figure describes the formation of political cycles in the model.

In simpler terms: voters elect Republicans when they're feeling bullish and ready to take risks (leveraging up). This often leads to excesses that eventually unwind, triggering forced liquidations and economic downturns. In contrast, Democrats typically come into power during these bearish troughs (when everyone wants more government support) and all the weak hands have been flushed out—leaving only one direction for markets to go: up.

My one gripe with both studies? The sample size is small—just 23 presidential terms during their periods of analysis. And if you strip out large outliers like FDR's post-Depression rebound, the Democrat advantage shrinks (though it doesn't disappear entirely). Still, the logic holds water.

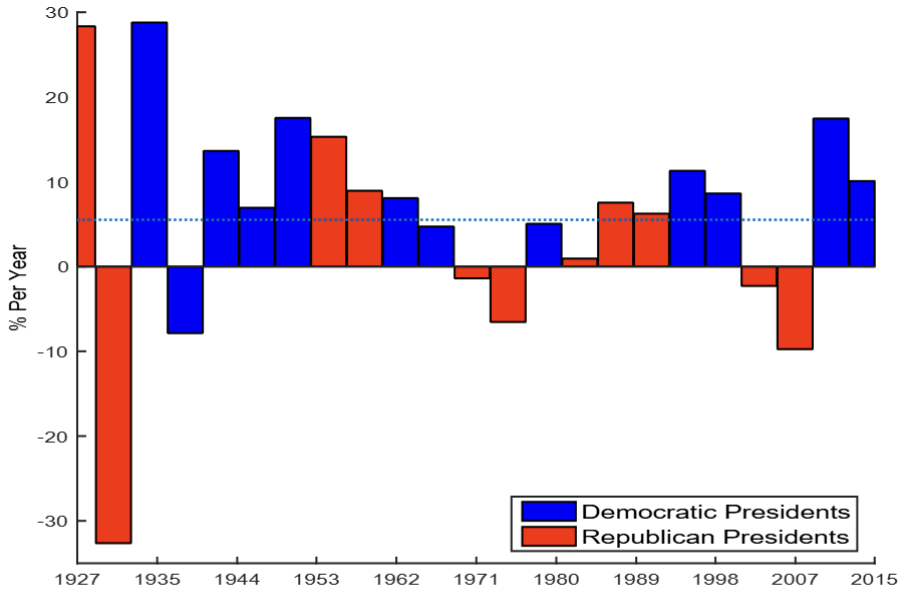


Figure 2. Average market returns under Democrat vs Republican presidents. This figure plots average U.S. excess stock market returns under each of the 23 administrations between 1927 and 2015, from President Coolidge through President Obama. We plot log returns on the value-weighted market index in excess of log returns on the three-month Treasury bill. Presidents are assumed to be in office until the end of the month during which they leave office. The horizontal dotted line plots the unconditional mean return.

So what can we take away from all this?

1. This single conditional data point suggests market performance over the next four years will not match the prior four. Historically, the first year of Republican terms tends to deliver the worst equity returns.
2. The risk cycle matters—a lot—for both markets and elections.

The Risk Cycle Explained

Since we've got some new Operators on board, I figured now's a good time to revisit the Risk Cycle (RC)—what it is and how it can help you stay on the right side of markets.

In my not-so-humble opinion, RC is *everything* when it comes to markets. It's one of the primary drivers of risk and return, yet ironically, it's something most people barely pay attention to.

At its core, RC captures the ebb and flow of investor confidence and liquidity (i.e., risk-taking) across different stages of the economic cycle. And here's the kicker: it doesn't just follow the economic cycle—it *drives* it in a reflexive loop.

What fuels this loop? A mix of central bank policies, macroeconomic conditions, and—most importantly—behavioral dynamics.

Now, let's pause for a quick reality check. There's this persistent myth out there that markets are efficient and deterministic. You know the story: if the Fed hikes rates, stocks will do X. If GDP hits Y, markets should trend Z.

Sounds neat, right? It's also dead wrong.

Markets are not some rational machine reacting to objective realities. They're messy, chaotic reflections of a massive crowd's ever-shifting beliefs. And this crowd? It's made up of people with wildly different worldviews, goals, fears, constraints, time horizons—you name it.

This crowd isn't immune to behavioral contagions either. FOMO (fear of missing out), TINA (there is no alternative), YOLO (you only live once), FUD (fear, uncertainty, doubt)… these emotional triggers drive everything from manias to panics.

And here's the truth: **markets don't just react to reality—they *create* it.**

Their aggregate beliefs shape narratives that emerge organically and spread like viruses—not because they're intrinsically true but because they resonate emotionally or socially. Just like a virus mutates to increase its reproduction rate (R_o), narratives evolve to amplify their emotional reach and impact.

This is why Andrew Lo nailed it in his book *Adaptive Markets* pointing out that markets are more like biology than physics—a constantly evolving ecosystem shaped by adaptation and survival instincts.

So why does this matter?

Because most traders and investors—macro types especially—spend way too much time drowning in an ocean of economic indicators as if they're deciphering some preordained future. Meanwhile, they ignore what truly matters:

- The tape
- Positioning & sentiment
- Capital cycles

- Liquidity
- And, of course, the Risk Cycle

The first approach gives you false confidence—it's complex but ultimately useless. The second keeps you humble and grounded, plus it's simple and repeatable.

Speaking of, do you know how Druckenmiller analyses the macro environment?

He looks at it through a three-lens framework. These are:

1. Valuations
2. Liquidity
3. Margins and Capacity Cycles

Here's Druck in his own words:

Valuations

> "First… we look at valuations. We use them to determine, really, the market's risk level, as opposed to its direction… Valuation is something you have to keep in mind in terms of the market's risk level… when catalysts come in and change the market's direction… the decline could be very major if you're coming from the kinds of overvaluation levels witnessed in '29 and the fourth quarter of last year (note: this was in the year following the '87 crash). So valuation is something we keep in the back of our minds."

Translation? Valuations don't tell you *when* markets will turn, but they do tell you how bad things could get when they do. High valuations are like dry tinder—just waiting for a spark to ignite a major decline.

Liquidity

> "The major thing we look at is liquidity, meaning as a combination of an economic overview. Contrary to what a lot of the financial press has stated, looking at the great bull markets of this century, the best environment for stocks is a very dull, slow economy that the Federal Reserve is trying to get going… Once an economy reaches a certain level of acceleration… the Fed is no longer with you… The Fed, instead of trying to get the economy moving, reverts to acting like the central bankers they are and starts worrying about inflation and things getting too hot. So it tries to cool things off… shrinking liquidity."

Liquidity is king. When central banks are pumping money into the system and trying to stoke growth, markets thrive. But when liquidity dries up—when central banks start tightening to combat inflation or overheating—things get dicey fast.

Margins and Capacity Cycles

> "Fat profit margins attract competition. Competition leads to increased investment. Increased investment leads to glut and contracting margins until capacity is taken offline. And then the cycle begins anew… When corporate America is operating at very high rates, it starts building capacity, which sucks out liquidity; it also lowers companies' margins two years out. And that's the opposite of when a bull market starts. All three of these things tend to shrink the overall money available for investing in stocks and stock prices go down…"

This one's simple: fat margins don't last forever. They attract competition, which leads to overbuilding and eventually a glut. Margins shrink, liquidity gets sucked out of markets, and stocks fall. It's a classic boom-bust dynamic.

Druckenmiller's framework overlaps heavily with what we track in the Risk Cycle (RC) model—especially when it comes to valuations and liquidity. RC helps us step back from all the noise and assess where we are in terms of cyclical fragility and trend duration.

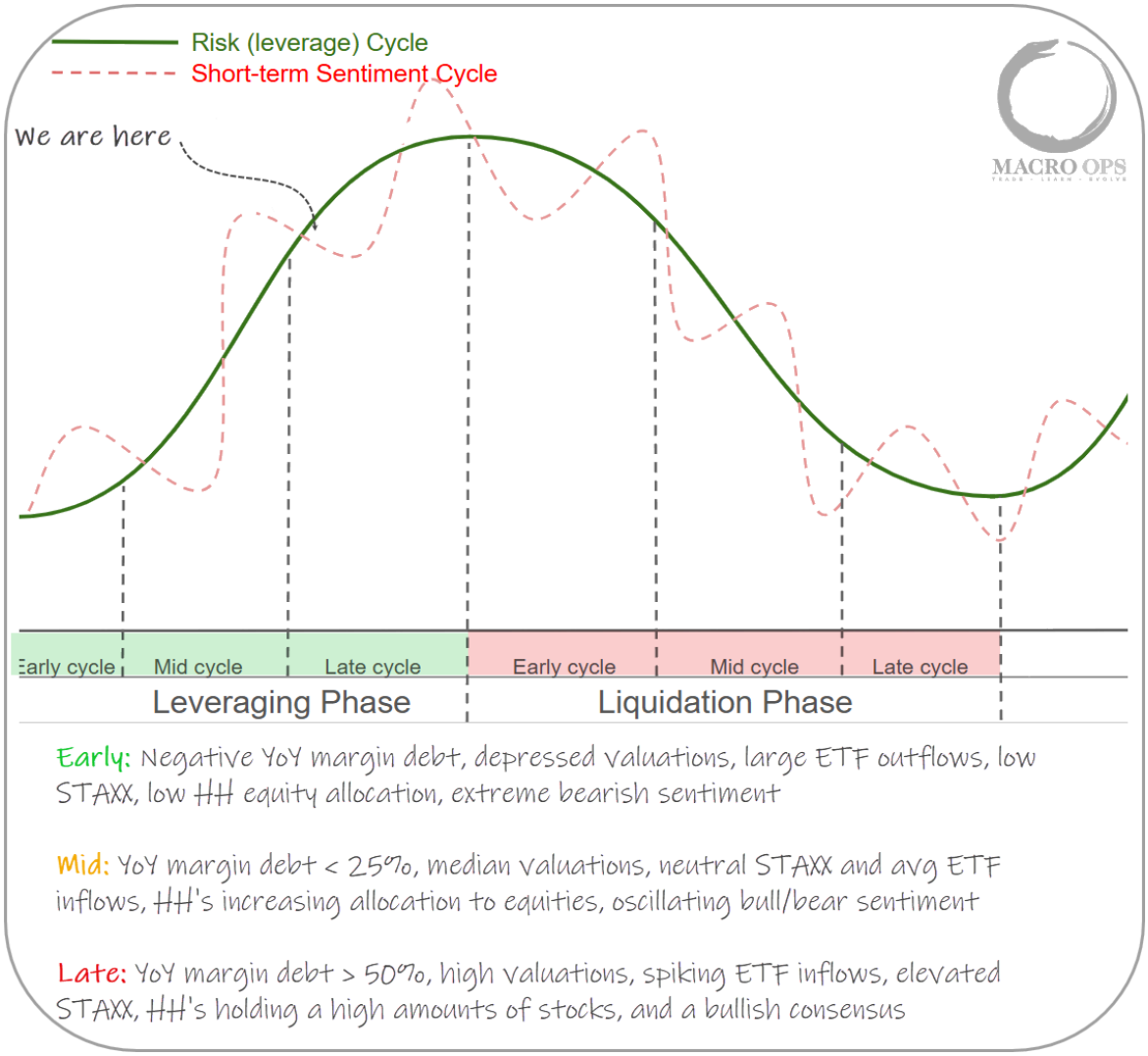
It's not a hard map but more like a set of guideposts for making +EV bets on where we're headed next.

RC works across growth, inflation, and markets—and right now, I'd argue we're in the early innings of late-cycle dynamics for growth and inflation. This cycle has been weird (thanks COVID fiscal policies), so there are still some mid-cycle characteristics hanging around.

In a future note we'll dive more into how to apply this framework to the current economic environment. But today, I want to show you how this plays out in markets.

Where We Are in the Risk Cycle

We're currently transitioning from mid- to late-cycle in terms of the leveraging phase—a critical point where things get interesting.

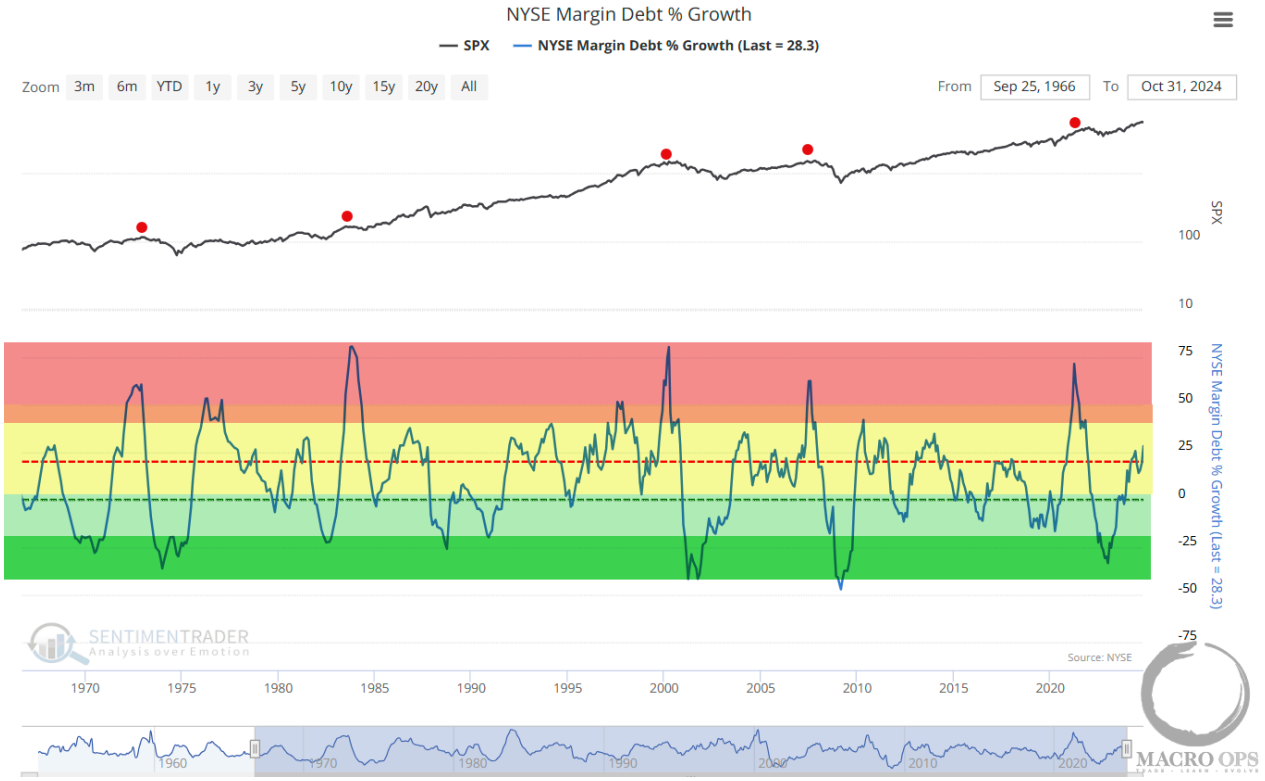


Let's walk through each key data point:

1. NYSE Margin Debt YoY Growth

Cyclical market tops occur when margin debt spikes above 50% YoY growth (red-shaded line).

Right now? We're at 35% YoY growth and climbing—not critical but worth watching closely.



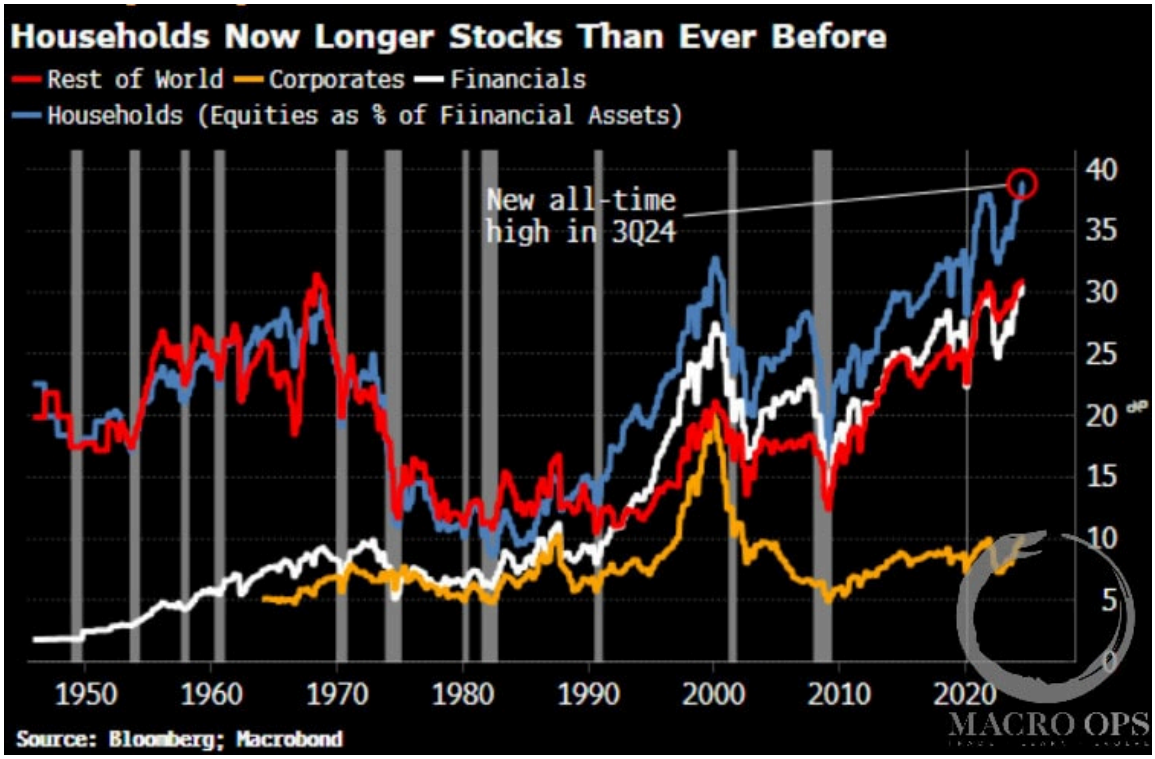
High leverage creates fragility—it sets up markets for their "over-the-skis" moment. Historically, margin debt can go from 35% to 50%+ in as little as three months or as long as a few years. The path depends on sentiment swings along the way.

For FOMO-driven margin spikes (think +50%) to happen, we need a viral narrative with high R_0 potential. Maybe Trump's returning to power could spark something like that—but we'll have to wait and see if anything gains traction.

Until margin debt hits at least +40% YoY (orange zone), there's no need for panic about major corrections (-20% or worse). For now, focus on adding risk smartly during pullbacks.

2. Household Equity Holdings

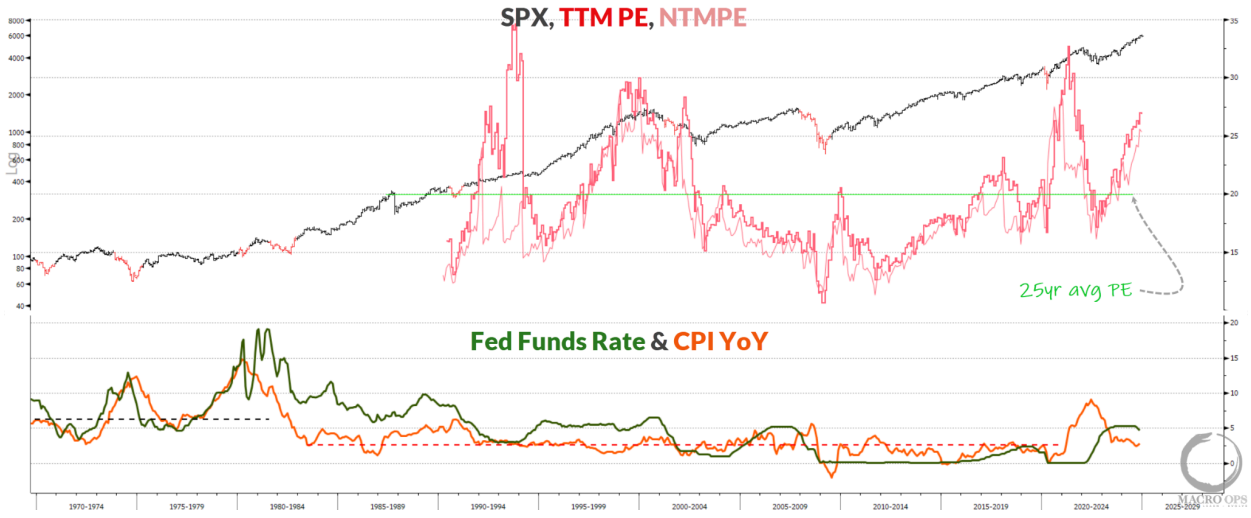
Americans are holding a record-high proportion of their financial assets in stocks compared to other asset classes—a clear sign we're closer to the end than the middle of this secular bull market.



When this tide turns—and it will—it'll be seismic. A recession will likely trigger this shift, flipping all those structural feedback loops (USD strength, suppressed commodities) on their heads. But that's not something for us to be concerned with right now.

3. Valuations

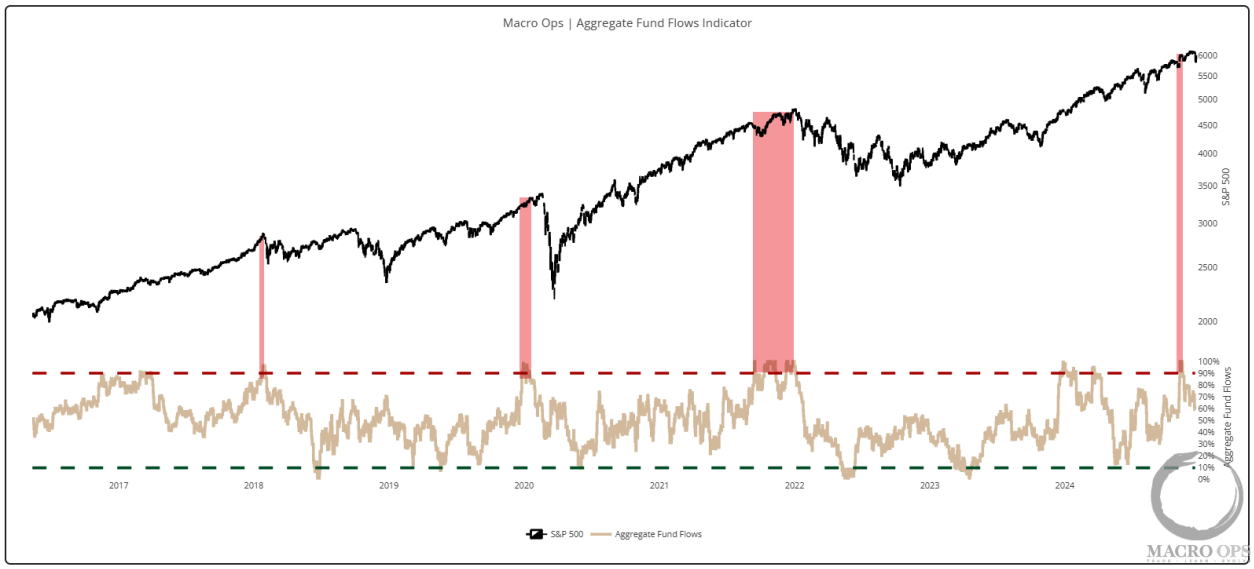
Yes, valuations are high—but they can go higher…



Valuations aren't timing tools—they're conditional data points that help gauge risk levels when combined with catalysts like margin debt or credit spreads widening. They tell us how far the fall can be *once* the rug gets pulled.

4. Aggregate U.S. Fund Flows

The HUD chart below shows fund flows on a three-year percentile basis.

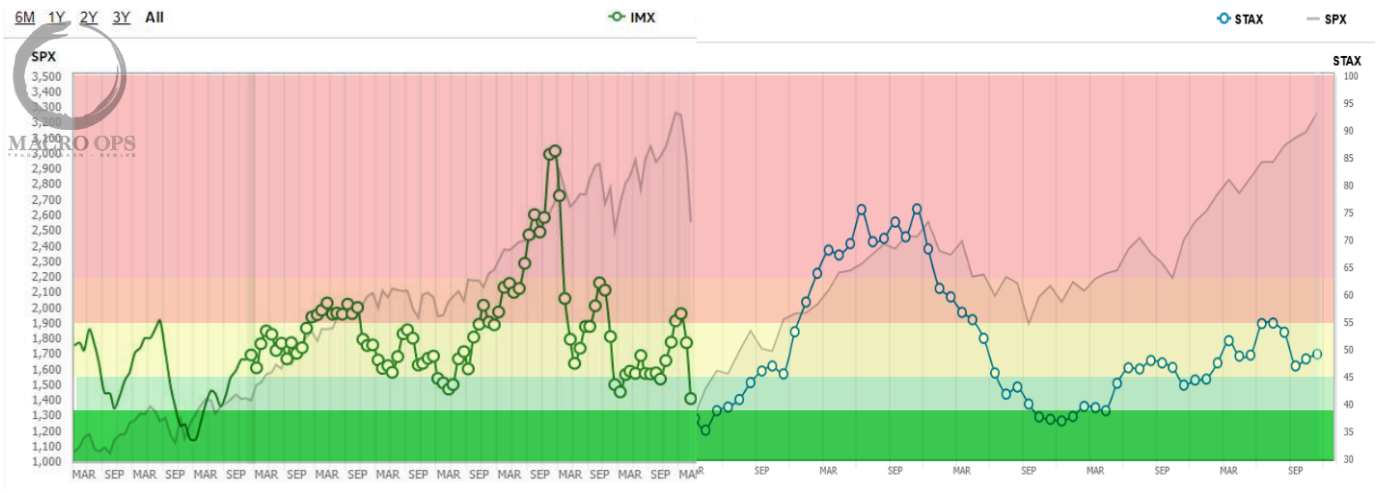


When fund flows max out at 100%, it often signals fragility—but context matters here. For example, surging flows after corrections can signal bullish momentum rather than instability.

Right now? The data suggests we're primed for a parabolic run higher into Q1 2025—but watch out for volatility going into Q2.

5. Schwab Trading Activity Index (STAX)

STAX tracks retail sentiment based on trading activity from Schwab's 37 million accounts—it's actual positioning data versus survey fluff like AAII sentiment reports.



As you can see in the chart above, the current reading is 49—neutral territory—compared to its 2021 high of 75 and the all-time high of 87 back in 2018.

This aligns with what we're seeing in other data points, like year-over-year margin trends and BofA's Bull & Bear Indicator. Together, these suggest that the larger risk cycle still has some room to run.

Timing the Late-Late Cycle: A Path-Dependent Game

How long until we officially cross into *late*-late cycle? That depends on two factors:

1. **A viral narrative driving leveraged positioning**—the kind of story that captures the market's imagination and pushes sentiment and risk-taking into overdrive.
2. **The path the market takes as these narratives evolve**—how competing stories fight for dominance and shape investor behavior.

This could happen in as little as three months—or take as long as 18 months or more. It's all path-dependent, meaning the sequence of events and how they unfold will dictate the timeline.

But here's the good news: we *don't* need to predict exactly when the leveraging cycle will turn critical. Trying to pinpoint that is a fool's errand. Instead, we focus on our tried-and-true guideposts:

- Look for YoY margin debt growth to rise well above 40%.
- Watch for Schwab's Trading Activity Index (STAX) to climb above 55.

When those signals flash, you'll know it's time to buckle up.

The Risk Cycle: A Foundational Framework

The Risk Cycle (RC) isn't about crystal ball predictions—it's about simplifying complexity and enhancing our systematic process of analysis. Along with other key frameworks we use—like the Trifecta Lens, Trend Fragility, and Market Regimes—RC gives us practical tools to navigate uncertainty.

The goal isn't to predict the exact future (that's impossible). Instead, these frameworks provide clear, actionable guideposts that tell us where we are in the cycle. This allows us to assess probabilistic paths with greater confidence and make smarter decisions about where we might be headed next.

The RC is one of the foundational pillars of this process—a compass for navigating markets when the map gets blurry.

Send 'Em Higher…

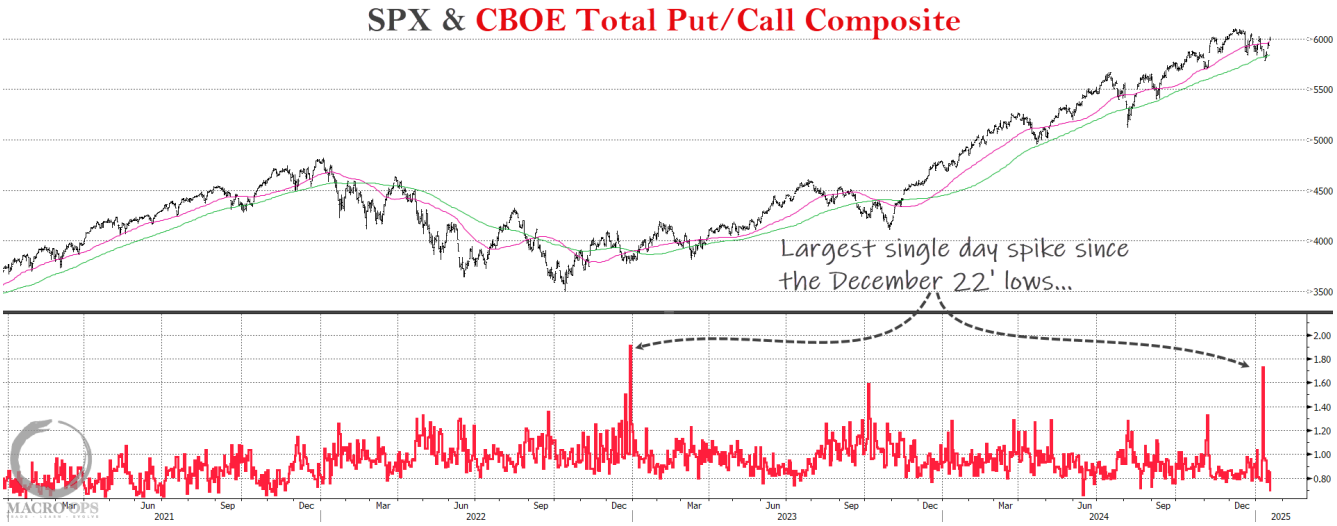
Sometimes the market corrects in price, sometimes in time, and always in sentiment.

Over the past month, we've seen the market chop sideways to slightly down—nothing like the sharper correction that positioning and technical indicators hinted at heading into December. Instead, what we got was a correction in **time** and **sentiment** with minimal downside action. And that's a good sign.

Why? It suggests there's a strong, patient bid coming in on every little dip—classic signs of broader accumulation.

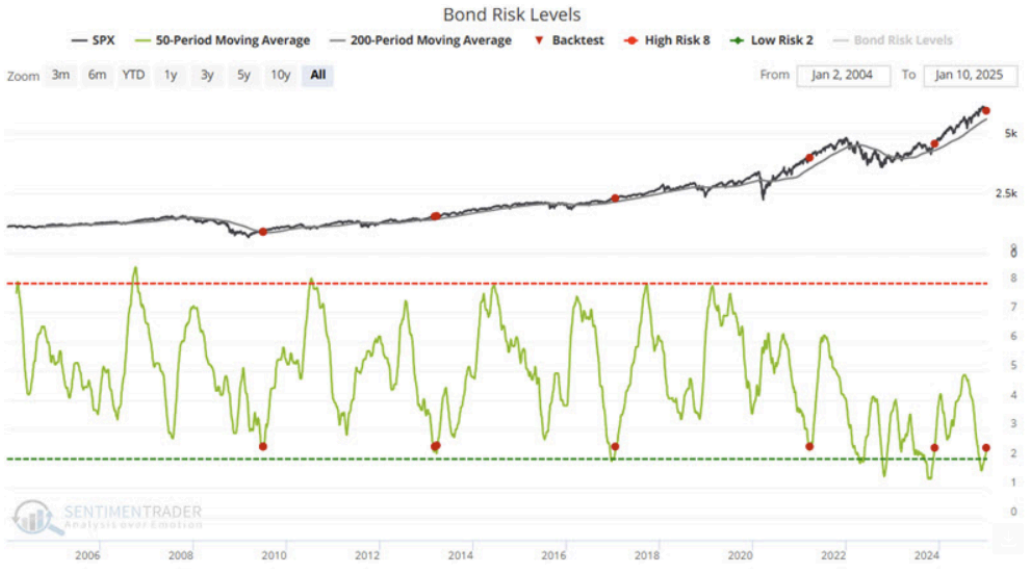
Even better, short-term sentiment and positioning indicators have reset back to neutral territory, which gives the market room to run. Let's break it down:

- **Trend Fragility:** Dropped to a neutral 67% after peaking at 100% in early November.
- **CBOE Total Put/Call Composite:** Saw its largest single-day spike on Jan 10 since the Dec 2022 lows (see chart below).



- **BofA Bull & Bear Indicator:** Firmly neutral at 3.8.
- **MO Trifecta Lens Model:** Down to 27% (major buy signals trigger below 10%).
- **MO Internals Aggregator:** Climbed to 15% (major buy signals trigger at 20%).
- **MO Nervous & Numb Indicator:** Flashed a major buy signal in late December (valid for 3m+).

- **SPX % of Members > 50dma:** Fell below 20% last week—sub-20% readings mark bottoms.
- **And let's not forget bonds:**
- Bond sentiment is completely nuked.
  - Rolling 3-month net TLT fund flows are at record lows.
  - TLT short interest is at an all-time high.
  - SentimenTrader's "Bond Risk" indicator shows very low risk, this historically leads to strong forward SPX returns (see chart).



Dates of 8 Signals	1 Week Later (%)	2 Weeks Later (%)	1 Month Later (%)	2 Months Later (%)	3 Months Later (%)	6 Months Later (%)	12 Months Later (%)
Mean	-0.1	2.1	5.0	7.1	8.6	14.2	19.5
Median	0.3	1.6	5.1	6.2	7.7	12.1	18.3
% Positive	63%	86%	100%	100%	100%	100%	100%
Avg Max Loss	-1.2	-1.2	-1.3	-1.3	-1.3	-1.3	-1.3
Avg Max Gain	0.8	2.3	5.2	8.3	10.6	15.5	26.6
Z-Score	-0.3	2.2	3.1	4.5	3.5	3.7	4.5

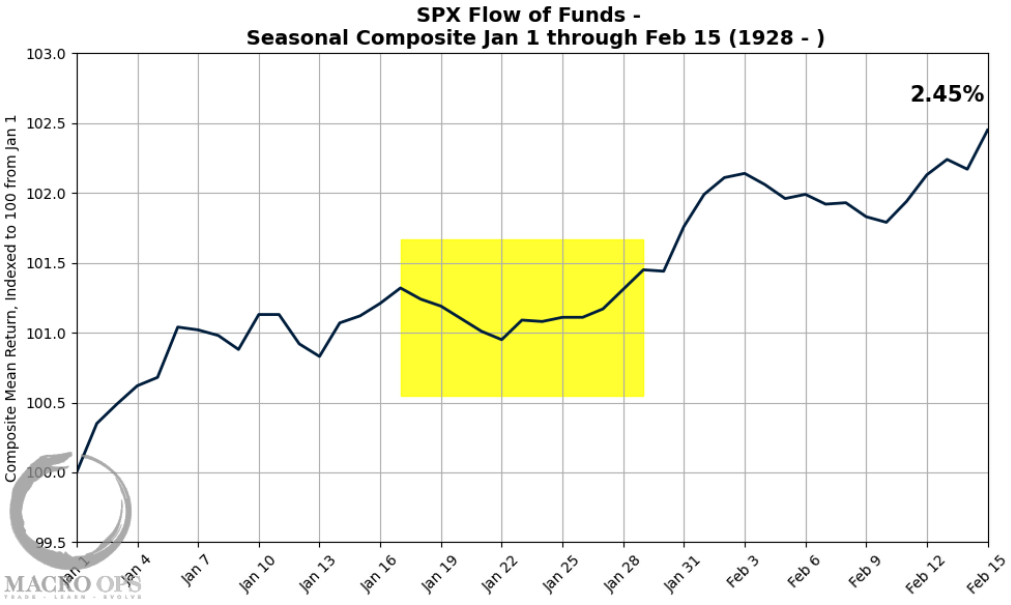
© SENTIMENTRADER Numbers are % return after signal; Risk = avg max loss; Reward = avg max gain; Z-Score +/- 2 suggests significance.

Recent updates from GS's Tactical Flow of Funds team add more fuel to the bullish pyre:

1. Largest macro ETF shorting since 2021 at GS Prime Brokerage.
2. Elevated systematic short positioning in global fixed income.
3. Decline in leverage across professional and systematic investors.
4. Largest weekly inflow into money market funds since March 2020.
5. Peak corporate blackout period right now—but the corporate repurchase window opens on Jan 24, with 45% of S&P market cap returning to buybacks.

Cash Use ($ billion)	2020	2021	2022	2023	2024E	2025E
Capital Expenditures	$667	$739	$892	$958	**$1,063**	**$1,148**
Share Buybacks	538	919	950	824	**931**	**1,070**
Dividends	520	548	598	621	**664**	**711**
R&D	401	453	516	584	**642**	**700**
Cash Acquisitions	224	349	288	318	**271**	**325**
Total Cash Use	**$2,351**	**$3,007**	**$3,244**	**$3,304**	**$3,571**	**$3,954**

Oh, and don't forget: positive SPX seasonality kicks in around Jan 22nd.



The Playbook

This tells us one thing: we want to be long and adding risk as long as two conditions hold:

1. The market stays above last week's lows.
2. Bonds stay above last week's lows.

Trump's inauguration this week could serve as a catalyst to drive a ramp up higher in risk assets.

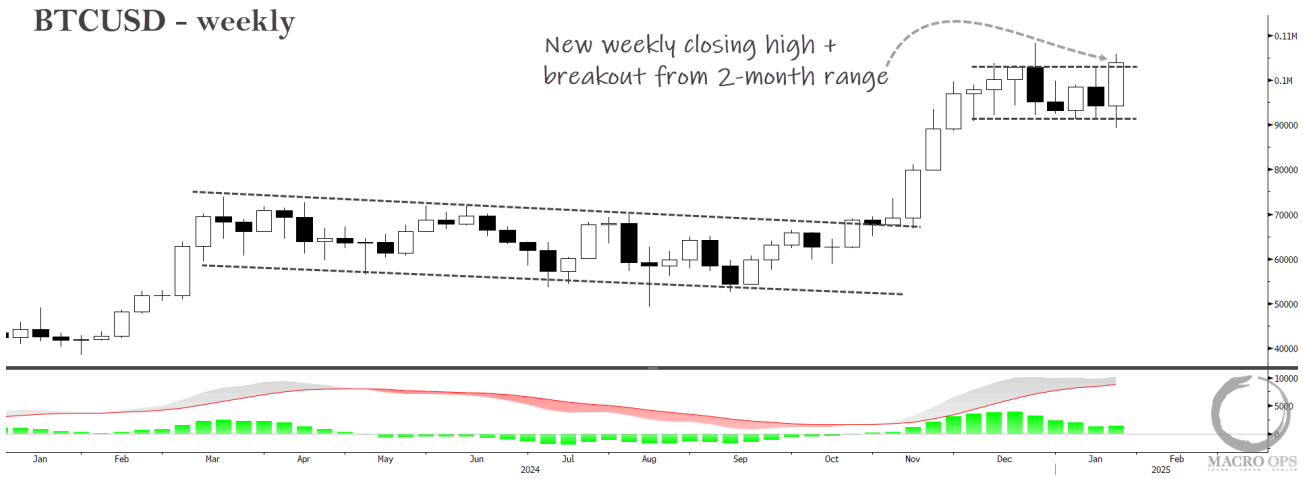
We're already seeing a big shift in bullish sentiment among small business surveys, and overall investor sentiment remains surprisingly neutral-to-bearish given that the market is just shy of all-time highs.

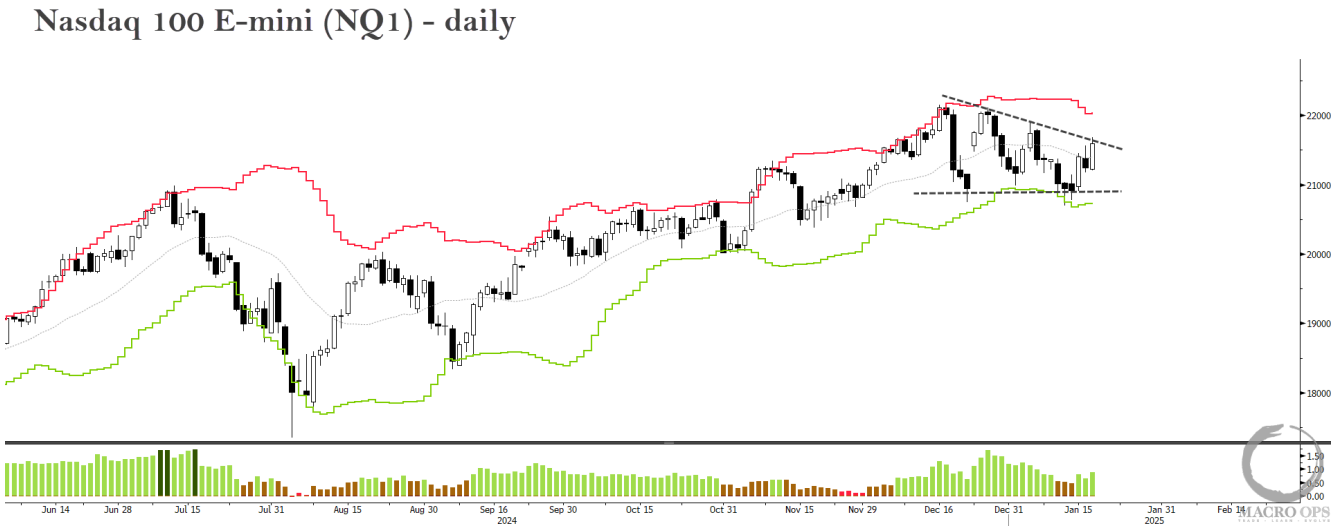
The weight of the evidence points to a gearing up of U.S. investor sentiment and positioning — conditions that are ripe for upside acceleration.

To play this, we're going to stick with what's been working: BTCUSD, QQQs, USD, growth/tech names, etc.

Here's what we're focusing on:

- **BTCUSD:** Reentered our long last week and will look to add on follow-through confirmation from the tape.
- **QQQs:** Putting on a starter position Monday with a stop below the recent wedge.
- **CAD Futures Short** (Long USDCAD): Adding sell stops tomorrow at the open to increase our size if triggered.





That's it for now.

This week we'll be pushing out trade updates as well as our annual portfolio review. Also, don't miss Chris's *Sunday Setup* tomorrow—it's always worth your time.

Stay frosty and keep buying…

Your Macro Operator,

Alex