BROADMARK

Market Update

October 1, 2022

In September, the U.S. Federal Reserve (Fed) raised the federal funds rate by 75 basis points (bps) for the third consecutive time[1] and Fed Chair Jerome Powell left no doubt as to the Fed's resolve to tighten monetary policy in its fight against inflation. The Fed also lowered its gross domestic product projections for the U.S. economy, stating that there is "more pain to come." Stocks tumbled after the interest rate hike and most major averages declined into the end of the month. For September, the S&P 500 Index fell -9.22%, the NASDAQ-100 Index lost -10.55% and the Russell 2000 Index was down -9.58%.[2] The first nine months of 2022 comprised the worst first nine-month period of any year since 2002 for the S&P 500 and the fourth worst period since 1926.[3]

Bond prices also fell as interest rates continued their upward march. The 10-year U.S. Treasury Note yield approached the 4% level before ending the month at 3.83%, up from 3.15% at the beginning of the month.[4] The yield on the 10-year U.S. Treasury reached its highest level in 15 years. Rising rates and the market's weakness strengthened the view of some market observers that earnings projections are still too high and that earnings estimates will need to be adjusted downward. The strength of the U.S. dollar since the beginning of the year could also be a significant headwind for the earnings of large multinational corporations.

Equity valuations have declined below their peak levels of a year ago, but equities remain overvalued, particularly in relation to the rise in interest rates. Investor sentiment became increasingly pessimistic as a result of the market's decline and investor sentiment reached its most pessimistic level of the year, suggesting at least a temporary recovery in stocks may be near. On the monetary policy and credit side, the Fed's hawkish stance remained a clear negative. "Don't fight the Fed" has been a useful guiding principle to follow so far this year. The investment team's volume and breadth momentum models continued in negative territory. We would note that the market has become deeply oversold and a market bounce to relieve this oversold condition could occur at any time.

The team maintained a maximum defensive posture during September. The team would increase exposure if the team's volume and breadth momentum models turned positive, particularly if a market recovery included several back-to-back days of positive upside thrust triggers. Also, the team would have to see interest rates stabilize and credit spreads narrow to buttress a more positive view. Conversely, the team would maintain its defensive posture if interest rates continued to climb, credit spreads widened or if the team's volume and breadth momentum models continued in negative territory.

Our assessment of the four pillars of our investment process is as follows:

Valuation: Equity valuations have declined since the beginning of the year but remain in overvalued territory, particularly in relation to the dramatic rise in interest rates. The recent rise in rates and hawkish Fed are negatives for equity valuations.

Monetary factors and credit conditions: Interest rates climbed to new highs for the year in September. The 10-year U.S. Treasury yield ended the month at 3.83%, up from 3.15% at the beginning of the month. This is the highest yield since 2007. The spread between the yields on the Bloomberg U.S. Corporate High-Yield Bond Index and the 10-year U.S. Treasury Note widened to 594 bps, above its 22.7 year mean of 506.2 bps and near this year's June high of 623 bps.[5] A widening of credit spreads is often a sign of credit disruptions and a precursor to economic weakness or a recession.

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Sentiment: Ned Davis Research's Crowd Sentiment Poll, a composite of a variety of sentiment indicators, touched a new low for the year on the market's most recent sell-off, marking the most pessimism since the pandemic low in 2020.[6] This is a positive factor from a contrary point of view and with so much bearishness this could indicate that the market may experience at least a short-term recovery.

Momentum: The team's volume and breadth momentum models continued to be in negative territory. Based upon the historical record since 1998, the S&P 500 has declined at an annual rate of -6.59% while downside volume is above upside volume as it is now.[5] However, we would note that stocks became deeply oversold at the end of the month with only 11.9% of all stocks trading above their 200-day moving averages.[5] This matched the June low and may be an indication of a possible market recovery to relieve the oversold condition.

[1] *Source: Federal Open Market Committee. September 21, 2022*
[2] *Source: Bloomberg. September 30, 2022*
[3] *Source: CFRA Research. September 26,2022*
[4] *Source: U.S. Federal Reserve. September 30, 2022*
[5] *Source: Ned Davis Research. September 29, 2022*
[6] *Source: Ned Davis Research. September 27, 2022*

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