BROADMARK

Market Update

May 1, 2018

A series of news events buffeted the stock market during April. Investors began to assess the impact of the Trump administration's proposed tariffs, particularly those on Chinese imports. Tensions with Russia increased over the poisoning of a Russian official turned British spy and his daughter in Britain. Tensions further increased with reports of the use of chemical weapons in Syria by the Assad regime and the retaliation by the U.S. On the positive side, the historic meeting between North and South Korea to bring an end to the Korean War and news that North Korea is willing to denuclearize resulted in a welcome reduction of global tensions. Further, corporate earnings reports were stellar with 80% of companies that reported first quarter earnings during April beating their estimates—the highest since 1999.

These factors caused wide daily market swings during the month and kept volatility high. So far, most major market averages were able to successfully test their February lows and end the month above these lows. Further testing wouldn't surprise us. Each test has been on lessening net negative volume and breadth, which is a positive.

As a result of our investor sentiment and momentum models improving during the month, we added some small-cap stock exposure to the portfolio and then rotated to technology as our models indicated changing relative strength trends. We continued to hold our core position in large-cap stocks. We would likely raise market exposure further if we see increased investor pessimism, continued stable interest rates and improved momentum. However, if sentiment swings back to more optimistic, interest rates rise and momentum deteriorates, we would likely take a more defensive posture.

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

1. **Valuation:** Valuation remains elevated, but the first quarter market correction has brought valuations somewhat lower, which is positive in our models. The median price-earnings ratio has now declined to 24.8 from its 15-year high of 26.8, reached in January 2018.

2. **Monetary factors and credit conditions**: Interest rates continued to creep higher and the 10-year U.S. Treasury Note reached 3.00% in April—its highest level since the spring of 2014. Rates backed off later in the month and stabilized just below 3.00% by the end of April. The market is grappling with rising earnings being offset by multiple contractions due to rising interest rates.

   A stabilization of interest rates at current levels would be a positive development for equities and would improve our rate of change indicators. A current positive factor is that credit spreads remain low. We would expect credit spreads to widen before more severe market weakness.

3. **Sentiment:** As the market successfully tested its February lows during April, investor sentiment reached its most bearish level (positive, from a contrary point of view) in over a year. This positive development was a factor in our decision to add small-cap stock exposure to the portfolio and then rotate into the technology sector.

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4. **Momentum:** The successful test of the February lows during April improved the near-term market outlook, which will continue provided that the market is able to hold above its February lows. One of the signs of a more important market top historically has been a divergence between the major market averages and the broad list of stocks. The percentage of stocks above their 10- and 30-week moving averages fell to their lowest levels in two years during the first quarter 2018 market setback. This drop sets up a potential negative divergence in coming months if the major market averages climb to new highs without participation by the broad market.

   We will be watching this indicator closely in the coming months. The percentage of stocks above their moving averages rising strongly along with the major market averages from here would be a positive sign. On the other hand, if the major averages rise to higher levels unaccompanied by the broad market, it would create negative divergences and could be an indication of more significant market weakness later in the year.