BROADMARK

Market Update

March 1, 2018

The long-awaited return of volatility finally arrived in full force during February along with a stock market correction. The major market averages dropped -10% in the first few weeks of February—the largest decline in over a year. The recent rapid rise in interest rates precipitated a repricing of stocks versus fixed-income instruments to the detriment of stocks.

One of the primary buttresses of equity prices in recent years has been low interest rates. In the last three years, between 40% and 60% of all stocks in the S&P 500 Index had dividend yields above the 10-year U.S. Treasury Note. As interest rates climbed in February, yields on fixed-income securities became more attractive as compared with equities and the capital markets repriced this relationship accordingly. The percentage of S&P 500 stocks with dividend yields above the 10-year Treasury yield fell to 25% in February—its lowest level in four years. Further interest rate rises coupled with the high current equity valuations would make equities less competitive with fixed-income securities.

Investor sentiment climbed to its most optimistic levels for this cycle in January, then declined during the February sell-off. Currently investor sentiment is still in neutral territory, but it is improving. Increased investor pessimism would be expected in order to for this indicator to recycle and attain a bullish reading.

Valuation measures remain elevated, with the median price-earnings (P/E) multiple on the S&P 500 still at its highest level in 15 years.

Our rate of change models of interest rates are now moving into negative territory as interest rates rise. On the positive side, however, credit spreads remain narrow, which indicates that business conditions remain favorable. In addition, although the yield curve has flattened, an economic recession or bear market is not usually indicated until it actually inverts.

We lowered the beta of the portfolio in January due to concerns over valuation, sentiment and rising interest rates. We lowered overall market exposure to a more defensive posture in early February. As investor sentiment began to recycle and momentum improved, we increased exposure mid-month in response to increased bearish sentiment readings and decreased downside momentum. On March 1, we lowered exposure again as momentum reversed to negative.

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

1. **Valuation:** Valuation remains elevated by any measure. The median P/E ratio on the S&P 500 reached 26.8—its highest level in almost 15 years. While the market sell-off has brought down equity valuations, the percentage of S&P 500 stocks that have dividend yields above the 10-year U.S. Treasury Note has now declined to 25%—its lowest level in four years. Further interest rate rises would make equities less competitive with the fixed-income sector.
2. **Monetary factors and credit conditions:** Short-term interest rates have climbed to their highest levels since 2008. The 10-year U.S. Treasury Note rose toward 3.00%—its highest level since the spring of 2014. This movement has caused our rate of change models to become more negative. From a longer-term perspective, it is not until the yield curve inverts that the market has historically discounted economic problems.

The spread between the long-term U.S. Treasury bond and the three-month Treasury bill is still positive by about 100 basis points. In addition, credit spreads remain very narrow. Prior to most bear markets and recessions, credit spreads begin to rise, which has not happened yet.

3. **Sentiment:** Investor sentiment got far more bullish—negative from a contrary point of view—in January, but then quickly reversed in February as the market fell, improving slightly at the end of the month. We would expect investor sentiment to recycle and get more negative prior to a more sustained market up move.

4. **Momentum:** Our models of price and volume momentum turned harshly negative in early February. In addition, the interest rate-sensitive utilities and real estate investment trust sectors have been weak since late 2017. If other interest rate-sensitive and economically important sectors, like the homebuilders, begin to diverge from the major averages, that would indicate caution and suggest a more meaningful decline. Potential positive divergences in coming weeks include a lessening of volume on down days and the broad market being able to hold steady on any test of the recent market lows. On the other hand, if the market declines on heavier volume and the broad market is weak, it would indicate further potential weakness ahead.