Russia's invasion of Ukraine and the world's response dominated the news in February. The Russian ruble fell over 25%, the Russian central bank hiked its lending rate from 9.5% to 20.0% and the Russian stock market planned to be closed for at least several days.[1] Energy and commodity prices surged with crude oil rising above $100 a barrel, the highest price since 2014, and the price of wheat jumping 20%.[2] Global stock markets plunged on news of the Ukraine invasion but began to stabilize in the last week of February. At month-end, the S&P 500 Index was down -3.00%.[2] The NASDAQ-100 Index was hardest hit, losing -4.54%, and the Dow Jones Industrial Average declined -3.29%.[2] Small cap stocks were a bright spot, however. The Russell 2000 Index managed to gain 1.07% during February.[2]

The jump in energy prices exacerbated investors' concerns over inflation. The Personal Consumption Expenditures Price Index, which is closely watched by the U.S. Federal Reserve (Fed), rose 6.1% over the past year — the fastest pace of increase since 1982.[3] Consumer prices for January showed prices jumping 7.5% year-over-year, exceeding most forecasts.3 Economists and market analysts projected that the Fed would begin raising interest rates at its March meeting and continue to hike rates throughout the rest of the year. Another worry was that the expected deceleration in earnings comparisons and profits might quicken due to geopolitical events and disruptions. Interest rates rose early in February with the 10-year U.S. Treasury Note climbing to its highest level in two and a half years at 2.05%.[4] However, the Russian invasion caused a flight to quality and the yield on the 10-year U.S. Treasury Note receded to close the month at 1.83%, up modestly from 1.81% at the beginning of the month.[4]

Equity valuations have been elevated for quite some time on an absolute basis but have been declining due to good earnings comparisons. Valuations adjusted for inflation as measured by the Consumer Price Index remained high, however. Investor sentiment was the bright spot in the team's work during February since bearish sentiment increased significantly as stock prices fell. Investor sentiment at the end of February was as pessimistic as it has been at several other previous market bottoms, which is a positive development. Nonetheless, the team's rate-of-change models for interest rates — for both Treasurys and corporates — remained in negative territory. Long- and intermediate-term volume and breadth momentum models remained negative while the team's short-term momentum model improved at the end of the month.

The team decreased market exposure to a maximum defensive position in late January due to the deterioration in its volume and breadth momentum models. Rising interest rates and the deterioration in the rate-of-change indicators also contributed to the more defensive posture. As investor sentiment grew more bearish (positive from a contrary point of view) and the team's short-term momentum model improved, market exposure was raised modestly toward the end of February. The team would raise market exposure further if momentum improved, interest rates declined, credit spreads remained narrow and investor sentiment remained pessimistic. The team would lower exposure if interest rates rose, credit spreads widened or the team's short-, intermediate- and long-term volume and breadth momentum models again turned negative.

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

Valuation: Equities remained in overvalued territory in February. While price-earnings (P/E) multiples declined from their peak in early 2021, the team's measure of valuations adjusted for inflation remained high.[5] Continued inflationary pressures and a rise in interest rates would be negative for this valuation measure.

Continued next page
Disclosure next page

Monetary factors and credit conditions: Interest rates rose to over 2% in early February but settled back late in the month as the Russian invasion of Ukraine unfolded and investors moved to more defensive investment vehicles. The 10-year U.S. Treasury Note closed February with a 1.83% yield, up only slightly from 1.81% at the beginning of the month. However, the team's 26-week rate of change for 3-year U.S. Treasury Notes remained in negative territory. The rate-of-change data for corporate bond yields also climbed into negative territory.[6] Further rises in interest rates would be negative for the team's rate-of-change models. However, declines in interest rates from current levels might suggest that the peak upward rates of change had been reached, which would be a positive development.

Credit spreads widened slightly during the month but remained narrow. The team will be watching credit spreads closely as the Fed moves to hike interest rates since a widening of spreads would be indicative of a deterioration in credit conditions.

Sentiment: Investor sentiment improved significantly in February as stock prices declined. Ned Davis Research's measure of daily sentiment showed the most bearishness since the pandemic low in early 2020, landing in the range of several previous market low points. This is a positive development from a contrary point of view.[5]

Momentum: The team's intermediate- and long-term volume and breadth momentum models were both negative in February but the short-term momentum model turned up at the end of the month. The team's models indicated an oversold condition suggesting that a market rally from the recent lows is possible. The team will be watching any rally for signs of upside thrust, which would indicate a possible market low point. If these thrust measures do not trigger and momentum falters, there is the possibility of another test of the market lows.

[1] *Source: The New York Times. February 28, 2022*
[2] *Source: Bloombergy. March 1, 2022*
[3] *Source: Bloomberg. February 28, 2022*
[4] *Source: U.S. Department of Treasury. February 28, 2022*
[5] *Source: Ned Davis Research. February 28, 2022*
[6] *Source: Ned Davis Research. February 25, 2022*

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