BROADMARK

# Market Update

February 1, 2021

The S&P 500 Index climbed to all-time highs in the first few weeks of the new year but ended January with a loss of -1.01%.[6] The trends that emerged in the second half of 2020 continued into January: smaller-cap stocks outperformed larger-cap stocks, value stocks outperformed growth stocks and riskier stocks outperformed those that were less volatile. Indeed, market volatility surged in January as investors focused on the extraordinary run-up in shares of electronics retail company GameStop, which at one point was up 2,000% in less than a month.[1] Traders across the globe bet on where the flood of retail money would go next and concentrated on those stocks that had the highest short positions. These traders used online forums like Reddit's "WallStreetBets" to organize a concerted push at the expense of hedge funds that had established short positions in these stocks. This intense retail speculation also fueled a rise in silver futures on the first day of trading in February. Silver spiked 11% to more than $30 an ounce—its highest level since 2013.[1]

During January, investors also got their first look at the new Biden administration's policies. These initiatives included rejoining the Paris Agreement on climate change, killing the Keystone XL pipeline project (a proposed pipeline extension running from Canada to Nebraska), pushing for the adoption of green technology, increasing taxes for higher earners and corporations and proposing tougher Wall Street regulations. While the Biden administration made plans to distribute the COVID-19 vaccine, infection rates continued to surge during the month and far fewer vaccines were delivered than had been expected.

Equity valuations remained in historically high territory. The S&P 500 price-sales ratio soared to a record high. And while low interest rates have made stocks attractive when compared with bonds or holding cash, interest rates edged up slightly in January. The 10-year U.S. Treasury Note rose from 0.93% to 1.11% at month-end.[2] On the positive side, monetary policy and credit remained accommodative. Money supply has boomed over 60% in the last year and credit conditions remained positive with yield spreads continuing to narrow.[3] The Biden administration has indicated its support to add $1.9 trillion of new stimulus to the economy, although Republicans countered with an offer of $600 billion, causing uncertainty over when any new stimulus package would be agreed upon. Market internals were positive with the investment team's volume and breadth momentum models in positive territory.

The investment team lowered market exposure during January due to increased speculation and rising interest rates. The team also made some sector adjustments as a result of changes in sector relative strength. At the end of the month, the portfolio was diversified into large cap stocks, small cap stocks and emerging markets along with a small position in the semiconductor sector. The team would raise market exposure once investor sentiment becomes less speculative provided that the team's volume and breadth models remain positive. Conversely, the team would become more defensive if the team's rate of change models for interest rates were to rise or if the team's volume and breadth momentum models were to deteriorate.

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

<u>*Valuation*</u>: Equity valuations have now reached levels not seen since the 2000 dot-com bubble. The median price-earnings ratio for the S&P 500 is 31.9x, just below the record of 33.3x recorded in March 2002.[4] Another important valuation measure is the S&P 500 price-sales ratio, which shows what an investor must pay per dollar of sales for each unit of stock. This measure has soared to all-time highs.[4] The danger to already-elevated equity valuations from here would be if interest rates were to rise rapidly, causing a reassessment in the investment merits of stocks versus bonds.

<u>*Monetary factors and credit conditions*</u>: Interest rates edged up in January. The 10-year U.S. Treasury Note closed the month with a 1.11% yield, up from 0.93% at the beginning of the month.[1] While inflationary pressures have been benign in recent years, commodity prices have risen at their fastest annual rate since 2017.[3] A surge in commodity prices often precedes a rise in the Consumer Price Index and a subsequent rise in interest rates. A negative for the market would be if commodity prices were to continue to rise accompanied by an increase in our measures of the rate of change of interest rates.

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*Sentiment*: Investor sentiment reached highly optimistic levels (negative from a contrary point of view) as the major market averages rose to new highs in late 2020 and the first few weeks of 2021. However, in late January, investor sentiment showed some improvement as the general market reacted to the explosive gains in GameStop, AMC and other stocks with high short interest.[5] The investment team would like to see a lessening of investor optimism (positive from a contrary point of view) to recycle sentiment measures back into positive territory.

*Momentum*: Momentum continued to be strong. The team's measure of upside versus downside volume climbed to a new recovery high[5] and the market's breadth improved. Here too, as the market approaches overbought levels, some type of short-term correction would be normal. However, the longer-term volume and breadth momentum models remain positive.

1 *Source: Bloomberg. January 29, 2021*
2 *Source: U.S. Department of Treasury. January 29, 2021*
3 *Source: Ned Davis Research. January 29, 2021*
4 *Source: Ned Davis Research. December 31, 2020*
5 *Source: Ned Davis Research. February 2, 2021*
6 *Source: eVestment Alliance, LLC. February 9, 2021*