In July, stock prices continued to climb for the sixth consecutive month, with the S&P 500 Index rising to yet another all-time high. Market strength, however, became more focused on the major market indices as the broad list of stocks lagged these indices. For example, despite the new all-time highs in the S&P 500, Dow Jones Industrial Average and the NASDAQ-100 Index, only about 42% of all stocks ended the month above their 10-week moving averages.[1] Also, the Russell 2000 Index, which represents small cap stocks, declined -3.61% during the month and remains below the highs reached in March.[1] This divergence between the large cap indices and the broad list of stocks is a warning sign and often occurs prior to market corrections, although the timing of any market correction is always uncertain.

At its July meeting, the U.S. Federal Reserve (Fed) maintained its accommodative monetary policy. But the Fed signaled that it would begin to dial back its emergency support for the economy at some point in the near future. The Fed said that any tapering would be done deliberatively and with plenty of warning. The 10-year U.S. Treasury Note had traded as low as 1.15% earlier in the month before closing July at 1.24%, its lowest yield since February.[2] The decline in yields reflected both the Fed's accommodative policy as well as investor fears that the surge in global coronavirus cases and the spread of the Delta variant would disrupt supply chains and adversely affect global economic activity. Investors also worried that we may be seeing the peak in earnings comparisons followed by less favorable comparisons in coming months.

The investment team lowered market exposure modestly in July due to the increased divergences that weakened the team's breadth models. At month-end, the investment team increased its cash balance as a defensive measure but retained exposure to large cap stocks as well as the technology and consumer staples sectors.

The team would lower market exposure further if interest rates were to rise once again or if the team's volume and breadth momentum models turned more negative, exacerbating the divergences between the major market averages and the broad list of stocks. The team would raise market exposure if investor sentiment remained pessimistic, if interest rates and credit spreads remained stable and if the team's volume and breadth models improved.

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

Valuation: The S&P 500 median price-earnings (P/E) ratio has climbed above its 2002 peak and remains in overvalued territory. Another indicator of overvaluation is the real generally accepted accounting principles (GAAP) earnings yield on the S&P 500. The four-week moving average of this yield recently dropped to its lowest level since the series began in 1967.[3] Historically, when the real earnings yield has been this low, the average return on the S&P 500 has been -10.9%.

Monetary factors and credit conditions: Interest rates declined in July to their lowest levels since February. The 10-year U.S. Treasury Note closed the month with a 1.24% yield, down from 1.45% at the beginning of the month. As we have noted previously, the maxim "Don't fight the Fed" has been a good guide since the start of the bull market over a year ago, and the monetary and credit environment continues to be a positive for the financial markets.

Nonetheless, at their July meeting, Fed officials debated when and how to slow the bond buying program, which is expected to be a first step toward a more normal policy environment. A decision is not imminent, but Fed officials used their July policy statement to signal that tapering is coming. One monetary indicator that is flashing a warning signal is the team's model of the rate of money supply growth as compared with industrial production. When money supply grows faster than the economy, it indicates excess liquidity, which is positive for the financial markets. When industrial production is growing faster than the growth of money supply, there is less liquidity in the system, which could lead to possible credit problems. The model turned down sharply over the last month, showing just how fast the economy has rebounded as compared with the money supply.[4]

Continued next page
Disclosure next page

The team will be keeping a close eye on Fed announcements and actions in coming weeks. Credit spreads will be an important indicator to watch since the team's money supply/industrial production model may be signaling decreased liquidity at a time of increased economic growth.

Any rise in illiquidity would likely show up in a widening of credit spreads. While credit spreads showed a slight widening in July, they remain historically narrow at current levels.

Sentiment: Investor sentiment improved during July. The increase in market volatility caused investors, at least on a short-term basis, to become more pessimistic than they have been since the beginning of the year. The Ned Davis Research Daily Trading Sentiment Composite reached its highest level of pessimism (positive from a contrary point of view) in two years.[5] This is a positive development.

On a longer-term basis, however, investors hold a historically low level of cash relative to their stock holdings. The percentage of money market cash relative to stocks is now lower than the market peaks of 2000 and 2007.[6] The low point in cash reserves was reached in 2008 at 9.06% and now stands at 9.70%.

Investors' wariness of the market is positive, likely reflecting both the increased volatility and narrowing of market leadership. On the other hand, some longer-term sentiment indicators, such as the low levels of cash and high margin debt, indicate increased market risk.

Momentum: "Don't fight the tape" has been the watchword for momentum. But the team has seen increased divergences in the market, which have often led to market corrections in the past. For example, while the S&P 500 hit a new all-time high last month, only 42.1% of all S&P 500 stocks are above their 10-week moving averages.[3] This type of divergence, if it persists, usually indicates the possibility of some type of stock market correction.

[1] *Source: Bloomberg. July 30, 2021*
[2] *Source: U.S. Department of Treasury. July 30, 2021*
[3] *Source: Ned Davis Research. July 30, 2021*
[4] *Source: Ned Davis Research. June 30, 2021*
[5] *Source: Ned Davis Research. July 29, 2021*
[6] *Source: Ned Davis Research. July 31, 2021*