BROADMARK

Market Update

July 1, 2021

The S&P 500 Index rose 2.33% in June, recording its fifth consecutive monthly gain and reaching another all-time high.[1] For the first half of 2021, the S&P 500 was up 15.24%.[1] Investors shrugged off fears of inflation with the growth and tech sectors rotating back to their former leadership positions. The NASDAQ-100 Index hit an all-time high during the month with a gain of 6.40%; the index is up 13.34% year-to-date.[1] The renewed interest in the growth and tech sectors came at the expense of cyclical stocks. The Dow Jones Industrial Average eked out a gain of 0.02% for June, although year-to-date the index is still up 13.79%.[1] Representing small cap stocks, the Russell 2000 Index has beaten the other indices since the beginning of the year with a year-to-date gain of 17.53% and a 1.94% gain in June.

After the June mid-month meeting of the U.S. Federal Reserve (Fed), investors were encouraged that the Fed made no move to slow its rate of bond purchases, nor did the Fed give any hint as to when it might do so. The bond market's reaction reflected the Fed's statements that the current spike in inflation would prove transitory. Interest rates declined after the Fed meeting and remained lower into the end of the month. The yield on the 10-year U.S. Treasury Note fell to 1.45% from 1.62% at the beginning of June.[2]

The continued stability of interest rates provided support for the historically elevated absolute equity valuations. However, investor sentiment deteriorated in June as investors showed increased optimism (negative from a contrary point of view) with the rebound in high-profile growth stocks. Margin debt climbed to a new all-time high and the Conference Board's Consumer Confidence Index rose to its highest level since February 2020,[3] reflecting renewed investor optimism, which is negative from a contrary point of view.

While Fed policy remains accommodative and credit spreads continue to be narrow, the Fed signaled a faster-than-expected pace of policy tightening at their June meeting. The central bank's dot plot, which the Fed uses to indicate its outlook for the path of interest rates, suggests two interest rate hikes by the end of 2023 as opposed to no hike until 2024, which was signaled back in March. The investment team will be closely watching its interest rate rate-of-change indicators and credit spreads for any change in the favorable monetary policy and credit environment, particularly prior to the Fed's meeting in Jackson Hole later this summer.

Due to the reemergence of relative strength in the tech and growth sectors, the team eliminated exposure to energy, financials, materials and gold miners during the month and replaced these areas with exposure to the large cap tech sector. At month's end, the portfolio was invested in large cap stocks with exposure to the technology sector.
The team would lower market exposure if interest rates were once again to rise significantly or if the team's volume and breadth momentum models turn negative. The team would raise market exposure if investor sentiment becomes more pessimistic (positive from a contrary point of view), interest rates and credit spreads remain stable, and the team's volume and breadth models continue to be positive.

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. If profits continue to meet or exceed expectations in the first half of 2021, we could be witnessing a cyclical peak in this ratio.[4] A peak in the P/E ratio coming a year or more after the stock market bottom is entirely consistent with stock market history.

Monetary factors and credit conditions: Interest rates declined in June. The 10-year U.S. Treasury Note closed the month with a 1.45% yield, down from the 1.62% yield at the beginning of the month. The team's 26-week rate of change for the Moody's Corporate Baa Bond Index yield remained elevated and in borderline negative territory,[5] but a continued stabilization or decline in interest rates would alleviate this condition. On the other hand, a rise in rates would likely push this indicator deeper into negative territory.

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The maxim "Don't fight the Fed" has been a good guide since the start of the bull market over a year ago. And despite the Fed's more hawkish comments at their June 2021 meeting, interest rates have remained stable and credit spreads narrow. This could change rapidly, but for now the bond market is not fighting the Fed.

Sentiment: Investor sentiment deteriorated in late June. Investors became more optimistic as the growth and tech sectors once again rallied back with new highs in the S&P 500 and the NASDAQ-100. The Ned Davis Research Crowd Sentiment Poll remained elevated and in negative territory in June.[2]

Margin debt has reached a new record high and the 15-month rate of change of margin debt has risen into the excessive speculation zone.† This measure is now at its highest level since the 2008-09 financial crisis.

Momentum: "Don't fight the tape" has been the watchword for momentum. The rotational aspect of the market's rise brought tech and growth stocks to the forefront in June. Currently, the team's volume and breadth models are in positive territory and the divergences we have seen are largely the result of the market's rotating leadership. Nonetheless, we would point out that while the S&P 500 hit a new all-time high during the month, only 50.6% of all stocks were above their 10 week moving averages.†† This type of divergence, if it persists, usually indicates some type of stock market correction.

[1] *Source: Bloomberg. July 1, 2021*
[2] *Source: U.S. Department of Treasury. June 30, 2021*
[3] *Source: Ned Davis Research and Conference Board. July 1, 2021*
[4] *Source: Ned Davis Research. June 30, 2021*
[5] *Source: Ned Davis Research. June 25, 2021*
[6] *Source: Ned Davis Research. June 29, 2021*
† *Source: Ned Davis Research. May 31, 2021*
†† *Source: Ned Davis Research. July 2, 2021*