Strong economic statistics propelled stock prices to new all-time highs in May. At the same time, however, a surge in the prices of raw materials and a jump in consumer prices raised investor concerns about inflation. The Consumer Price Index rose at a 4.2% annual rate, higher than expected and the largest rise since 2009.[1] Nonetheless, U.S. Federal Reserve (Fed) officials pushed back against the idea that higher inflation would last long enough to put pressure on the U.S. economic rebound. Fed officials said that the price-growth momentum would prove "transitory."

Despite the new highs set by the S&P 500 Index and the Dow Jones Industrial Average (DJIA) early in the month, stock prices were volatile in May and the broad list of stocks lagged the averages. Large cap and cyclical stocks showed the strongest relative strength, with the DJIA leading the market with a gain of 2.21%.[1] The S&P 500 rose 0.70% for the month and the Russell 2000 Index was up 0.21%.[1] The NASDAQ-100, however, declined 1.17% for the month.[1] Also, despite the new highs in the DJIA and the S&P 500, only about 57% of all stocks were above their 10-week moving averages at the end of May.[2]

On the positive side, interest rates declined slightly during the month and the 10-year U.S. Treasury Note fell to 1.58% from 1.63% at the start of May.[3] The stable interest rate environment provided support for historically elevated equity valuations. Investor sentiment improved in May with the retail investor showing increased pessimism (positive from a contrary point of view) largely due to the drop in high-profile growth stocks.

On the monetary and credit front, Fed policy remained accommodative and credit spreads continued to be narrow. However, the investment team's monetary rate of change and liquidity indicators signaled the possibility of a further rise in interest rates. The team will be watching the Fed for any indication of a change in policy, possibly at the June Fed meeting or later in the summer at the annual Jackson Hole Economic Symposium. Currently, the Fed is purchasing $80 billion of Treasurys and $40 billion of mortgage-backed securities each month.[1] Fears that the Fed might taper this asset purchase program could serve as a trigger to a deeper market correction sometime in the future.

During May, the team decreased exposure modestly and diversified portfolio holdings into several sectors that have shown good recent relative strength: energy, financials, materials and gold miners. The team would raise market exposure if investor sentiment got more pessimistic (positive from a contrary point of view) and if the team's volume and breadth models improved. The team would become more defensive if interest rates once again begin to rise or if the team's volume and breadth momentum models show increased divergences and signs of deterioration.

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

*Valuation*: The S&P 500 median price-earnings (P/E) multiple has climbed above its 2002 peak and remains in overvalued territory. If profits continue to meet or exceed expectations for the first half of 2021, we could be witnessing a cyclical peak in this ratio.[4] A peak in the price-earnings ratio a year or more after a stock market bottom is entirely consistent with stock market history.

*Monetary factors and credit conditions*: Interest rates declined in May. The 10-year U.S. Treasury Note closed the month with a 1.58% yield, down from the 1.63% yield at the beginning of the month. However, the team's 26-week rate of change for the Moody's Corporate Baa Bond Index yield climbed back into negative territory[2] during May. Improvement in this model will require a continued easing of interest rates while a rise in interest rates from this point would likely turn the model more negative.

Another 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. This model turned down sharply in the last month, showing just how fast the economy has rebounded as compared with the money supply.[4]

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The team will be keeping a close eye on credit spreads in coming weeks since this money supply/industrial production model may be indicating decreased liquidity at a time of high economic growth — which could potentially have a negative effect on credit spreads.

*Sentiment*: Despite stock prices making new highs in May, the decline in the high-profile tech sector was a major reason for the improvement in investor sentiment during the month. The American Association of Individual Investors (AAII) poll represents individual retail investors who tend to increase their stock purchases as the market approaches more risky levels. This sentiment indicator rose to its most optimistic (negative) level reached in 2018 only a month ago but swiftly reversed course and improved in May.[2] An increase in pessimistic investor sentiment is a positive for the market.

*Momentum*: "Don't fight the tape" has been the watchword for momentum. However, the investment team's measures of upside versus downside volume and the market's breadth deteriorated somewhat in May, causing the team to diversify into the strongest relative strength sectors and decrease market exposure slightly. The investment team is also seeing a divergence with the DJIA and S&P 500 reaching new all-time highs while only about 57% of all stocks are above their 10-week moving averages.[2] While this divergence likely reflects the decline in the tech sector and market rotation, the deterioration in momentum was enough to cause some deterioration in the team's volume and breadth models.

[1] *Source: Bloomberg. May 28, 2021*
[2] *Source: Ned Davis Research. May 28, 2021*
[3] *Source: U.S. Department of Treasury. May 28, 2021*
[4] *Source: Ned Davis Research. May 31, 2021*