BROADMARK

Market Update

December 1, 2017

Stocks ran into some modest headwinds in the first two weeks of November with the major market averages experiencing a quick correction of less than 2%. At mid-month, however, investors began to anticipate congressional progress on tax reform. The perception that both corporate and individual tax cuts could boost gross domestic product and consumer spending in 2018-2019 spurred a powerful stock market rally that carried most major averages to new highs by the end of the month.

As noted in our last commentary, the market continues to rotate leadership. Small-cap, mid-cap, transportation and financial stocks all surged to new highs at the same time that technology and international stocks took a breather from their recent leadership. This rotation is healthy, from a technical point of view.

Sentiment measures continued to reflect increasingly bullish sentiment, which is negative from a contrary point of view. Valuation measures also remain high, with the median price-earnings (P/E) multiple on the S&P 500 Index at its highest level in almost 15 years.

On the positive side, however, credit spreads remain narrow, although they have ticked up a bit in recent weeks. Despite an anticipated Federal Reserve interest rate increase in December, interest rates remain stable. In addition, despite the optimistic sentiment readings (negative from a contrary point of view), recent data shows that flows into equity mutual funds (including ETFs) are only just beginning to rise into positive territory. These inflows are likely to increase prior to an important market top.

We hold a portfolio that is well diversified among sectors so as to participate in the rotational nature of the market's advance.

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

1. **Valuation:** Valuation remains elevated by any measure. The median P/E ratio on the S&P 500 reached 25.2, its highest level in almost 15 years. On the other hand, 34.4% of all S&P 500 stocks still have a dividend yield above the 10-year U.S. Treasury Note, which continues to be a powerful motivation for equity investment. This percentage has declined from 39% in the last month, and higher rates would change this metric in a negative way for U.S. stocks.

2. **Monetary factors and credit conditions:** The yield curve continues to flatten. So far in 2017, the 3-month Treasury note is up 79 basis points (bps) whereas the 30-year Treasury note is actually down 17 bps. The 2-year U.S. Treasury note, in fact, has now risen to its highest level since 2008. We will be closely watching the effect that the continuing reduction in the balance sheet, coupled with a potential rate hike in December, may have on interest rates. If interest rates do not rise further from here, the yield curve stays positive, and credit spreads remain narrow, it would be very healthy for the market and indicate that declines from current levels may be buying opportunities. On the other hand, if interest rates rise, the yield curve flattens, and credit spreads widen, it could be the first sign of more significant market weakness ahead.

3. **Sentiment:** Investor sentiment got far more bullish—negative from a contrary point of view—in November as the major market averages rallied to new highs. However, as veteran stock market observer Mark Hulbert has commented, bullish sentiment is "a mile wide and an inch deep." Currently, every time the market pulls back, investors still get nervous, which usually does not happen at important market tops. One potential sign of more persistent optimism on the part of the public would be increased flows into equity mutual funds (including ETFs). While flows have increased recently, we would anticipate that these flows into equity mutual funds and ETFs will continue to rise prior to a more significant market top.

4. **Momentum:** Momentum continues strong with most market averages and the NYSE advance-decline line hitting new highs during the month. The rotational nature of the advance is positive, from a technical point of view. We note, however, that our models of upside and downside volume continue to show some divergence from the general market. While upside volume (demand) is still above downside volume (supply), downside volume has been rising and upside volume declining since the beginning of the year—an indication that institutional investors are becoming more cautious.