While inflation fears dominated the news in early November, news of a new strain of coronavirus, dubbed the Omicron variant by the World Health Organization, overshadowed global markets at the end of the month. As the Omicron variant spread rapidly in southern Africa, the U.S., European Union and the U.K. halted air travel from some areas in Africa while Singapore announced a similar move. The surge in coronavirus infections was particularly severe in Europe. Austria entered a nationwide lockdown as a record spike in infections threatened to overwhelm the country's health care system. As Germany's health care crisis worsened, the government set up restrictions for holiday gatherings. Meanwhile, Hungary recorded its highest number of cases. In the U.S., infections were on the rise again, particularly in the Midwest, according to the latest data from the Centers for Disease Control and Prevention.[1]

Inflation was still an area of concern during the month. The Consumer Price Index (CPI) soared 6.2% in October as compared to last year, accelerating from September's 5.4% year-over-year reading.[2] The Biden administration released 50 million barrels of oil from the Strategic Petroleum Reserve to relieve upward pressure on gasoline prices.[3] The reappointment of Federal Reserve (Fed) Chair Jerome Powell was well-received by the markets but investors wondered whether this new mandate would give him greater flexibility in setting policy, which could lead to possible future interest rate hikes. In congressional testimony at the end of November, Fed Chair Powell said that it was time to retire the term "transitory," suggesting that the Fed was ready to further taper its asset purchases. Stock and bond prices both declined following his testimony.

While the S&P 500 Index and the NASDAQ-100 Index reached all-time highs earlier in the month, stock prices declined into month-end. Growth stocks held up best with the NASDAQ-100 gaining 1.88% for the month.[1] The S&P 500 closed the month with a loss of -0.70%.[1] The general market's performance was weaker with the Dow Jones Industrial Average (DJIA) declining -3.50% and the Russell 2000 Index declining -4.19%.[1] The 10-year U.S. Treasury Note yield, which had reached as high as 1.68% in early November, ended the month at 1.43% versus 1.58% at the beginning of the month.[4]

With the current elevated level of equity valuations, we believe the markets remain vulnerable to a correction at any time. Stable interest rates and narrow credit spreads have provided a positive monetary and credit backdrop for stock prices, but if the Fed moves toward less accommodation as Fed Chair Powell's recent comments have suggested, the backdrop could change quickly. Investor sentiment swung toward greater pessimism at the end of November, which is positive from a contrary point of view. However, the investment team remains concerned about the narrowing of market leadership, which has created negative divergences. The team's volume and breadth momentum models deteriorated but both were still positive as of the end of November.

The team increased market exposure slightly during November. The team eliminated its position in small cap stocks and added to its allocation to large cap stocks and technology due to superior relative strength. Market exposure would be raised further if interest rates remain stable, credit spreads continue to narrow, investor sentiment grows more pessimistic and momentum remains positive. The team would lower market exposure if interest rates rise, credit spreads widen or if the team's volume and breadth momentum models turn more negative.

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

<u>*Valuation*</u>: Equities remained in overvalued territory although good earnings reports brought price-earnings (P/E) multiples lower since their early 2021 peak. The median P/E ratio was 27.1x at the end of November, well above its 57.8-year median of 17.3x. When P/E ratios were adjusted for inflation (the year-to-year change in the CPI), stocks were still in overvalued territory.[5]

Continued next page
Disclosure next page

Monetary factors and credit conditions: Interest rates declined in November but stabilized after Fed Chair Powell's statement that it was time to retire the term "transitory." Rates had risen earlier in the month after the reappointment of Fed Chair Powell but later fell back due to the spread of the Omicron coronavirus variant. The 10-year U.S. Treasury Note closed the month with a 1.43% yield, down from 1.58% at the beginning of the month. The team's 26-week rate of change for 3-year U.S. Treasury Notes rose into modestly negative territory [5] but the rate-of-change data for corporate bond yields did not confirm the negative readings on Treasurys. Nonetheless, further increases in interest rates would be negative for the team's rate-of-change models.

While credit spreads ticked up slightly at the end of November, they were still in neutral territory. In our analysis, further widening of spreads would be negative so the team will be watching this indicator closely.[4]

Sentiment: Investor sentiment was optimistic (negative from a contrary point of view) in early November but fell back into neutral territory as stock prices declined later in the month.[4]

Momentum: The stock market's advance has been marked by a narrowing of leadership. Despite the S&P 500, DJIA and NASDAQ-100 hitting new all-time highs in early November, less than half of all stocks have been able to stay above their 10- and 40-week moving averages. At the end of the month, the percentage of stocks above their 10-week moving averages was 38.2% and the percentage above their 40-week moving averages was 48.4%.[5] This is a meaningful negative divergence as the major averages have climbed to new highs. This divergence could be positively resolved by a broadening of participation by small cap stocks and the rest of the market. However, continued negative divergences would be negative for our momentum models. The team's breadth and volume measures declined with stock prices at the end of the month but remained in positive territory.

1 *Source: Bloomberg. November 30, 2021*
2 *Source: U.S. Bureau of Labor Statistics. November 10, 2021*
3 *Source: Bloomberg. November 26, 2021*
4 *Source: U.S. Department of Treasury. November 30, 2021*
5 *Source: Ned Davis Research. November 26, 2021*