

In the first few days of August, the major market averages dropped about 6%<sup>1</sup> due to disappointment surrounding U.S. Federal Reserve (Fed) Chair Jerome Powell's comments that July's one-quarter point cut in the federal funds rate may not be the beginning of more interest rate cuts. Volatility increased over uncertainty regarding a host of issues: speculation over how much the Fed may cut rates at the end of September, a seemingly on-and-off trade war with China, slowing earnings growth and an inverted yield curve. The markets also rose and fell as reports emerged from the G-7 summit held in Biarritz, France. By the end of August, while still in negative territory, most market averages were able to make up some lost ground, although small cap stocks continued to lag with the Russell 2000 Index still down about 6%.<sup>1</sup>

Equity valuations, when adjusted for the low level of interest rates, appear to be reasonable at current levels. Short-term sentiment improved as the market declined in early August and reached positive readings. Interest rates plummeted to historic lows, which is positive for stocks in the trade-off between equities and fixed income. From a longer-term perspective, however, the yield curve remains inverted and credit spreads have widened, although credit spreads are still in neutral territory by historic standards.

Our intermediate-term momentum model turned negative in early August, as did our measures of market breadth. But by the end of the month, our short-term momentum models had improved. We went to a maximum defensive position mid-month but increased portfolio exposure at the end of August.

If investor sentiment gets more bearish (bullish from a contrary point of view) and momentum continues to improve, there is a chance that the market might make another attempt at its July 2019 highs. However, if sentiment once again gets optimistic, momentum wanes and we continue to see lagging broader market participation, we will take a relatively defensive portfolio posture.

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

- 1. Valuation:** In August, the S&P 500 median price-earnings ratio rose a bit to 21.6 but remains below its 15-year high of 26.8 reached in January 2018.<sup>2</sup> Given the historically low level of interest rates and the Fed's more dovish stance, valuations now appear to be reasonable when adjusted for interest rates.
- 2. Monetary factors and credit conditions:** Interest rates declined to historic low levels in August. The 10-year U.S. Treasury Note dropped from 2.02% at the beginning of the month to 1.50% at the end of the month, nearing its lowest yield ever reached in 2012.<sup>3</sup> The yield on the 30-year U.S. Treasury Bond was 1.96% at the end of August<sup>3</sup>—trading at its lowest yield in modern U.S. market history.

From a long-term perspective, we continue to be concerned that sections of the yield curve have inverted. The yield on the 10-year U.S. Treasury has fallen below the federal funds rate in the last few months<sup>4</sup> and the 30-year U.S. Treasury's yield dipped below the 1-week Treasury Bill during the month as well. The lead time to possible stock market and economic weakness from a yield curve inversion, however, has historically been anywhere from months to several years.

- 3. Sentiment:** Weakness and volatility in the major market indexes produced increased pessimistic investor sentiment, which is positive from a contrary point of view. Our short-term sentiment dropped into positive territory, indicating the possibility of a rally from current levels<sup>5</sup>, although our longer-term sentiment readings are still in neutral territory.
- 4. Momentum:** Our intermediate-term momentum model turned negative in early August and our measures of market breadth went negative as well. However, our short-term model improved at the end of the month. The short-term model often leads the intermediate- and longer-term models and the market did in fact recover toward the end of the month.

We are closely watching trends in money flows.<sup>5</sup> If upside volume continues to rise relative to downside volume and market breadth improves, we believe that the market could make an attempt at the July 2019 highs. However, if the downside volume rises and market breadth deteriorates, we would once again become more defensive.

<sup>1</sup> Source: Bloomberg. August 31, 2019

<sup>2</sup> Source: Ned Davis Research. July 31, 2019

<sup>3</sup> Source: U.S. Department of Treasury. August 30, 2019

<sup>4</sup> Source: Ned Davis Research. July 31, 2019

<sup>5</sup> Source: Ned Davis Research. August 27, 2019

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