BROADMARK

Market Update

January 1, 2019

In December, the Dow Jones Industrial Average (DJIA) recorded its largest monthly decline since 1989 and experienced its worst December since 1931. The major market averages ended the year with losses between 4%–6% after being down around 10% during the year. 2018 was the first down year for the stock market since 2008. Small-cap stocks closed the year with losses of over 10% and international and emerging market stocks closed out 2018 with losses of over 15%.*

The shutdown of the U.S. government, the resignation of Secretary of Defense Jim Mattis, continuing interest rate hikes by the U.S. Federal Reserve (Fed) and fear over a trade war with China all weighed on the market. As expected, the Fed raised the federal funds rate in December to a target rate of 2.00%–2.25%, the ninth increase since December 2015.** While the increase was expected, the markets were disappointed that Fed Chair Jerome Powell did not say explicitly that the Fed would consider postponing future interest rate hikes in 2019 if economic conditions were to weaken.

Several of our models improved as the market moved downward. Investor sentiment turned pessimistic quickly, which is a positive sign from a contrary point of view. Toward the end of the year, our sentiment models showed the most pessimism in almost three years. Interest rates also continued to ease and valuation measures improved. In addition, inflation has moderated recently, which could help to stabilize interest rates. However, a major negative in our models was the increase in downside volume versus upside volume toward the end of the year. Both our intermediate- and long-term volume/breadth momentum models turned down. Accordingly, we took a maximum defensive position seeking to protect client assets from the severe stock market decline.

As we look ahead to 2019, a number of our longer-term models, such as long-term volume/breadth momentum, the low level of mutual fund cash and the widening of credit spreads, indicate that the market may still be vulnerable to further stock market weakness in 2019. We therefore remain in a defensive position, ready to opportunistically initiate short positions on rallies until our models turn positive.

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

1. **Valuation:** Rising earnings have brought valuations lower in recent months, which is positive. The median price-earnings ratio now stands at 20.2, well below its 15-year high of 26.8 reached in January 2018.*** There is a growing perception that the market has reached peak earnings for this economic cycle and lower valuations reflect this lower assessment.

2. **Monetary factors and credit conditions**: Intermediate- to long-term interest rates declined in December, despite the hike in the federal funds rate. However, one of the most important developments in the last few months has been a widening of credit spreads. The spread between the yield on the Bloomberg Barclays U.S. Corporate High Yield Bond Index and 10-year U.S. Treasury Note widened to its highest level in almost two years. This spread is an important indicator to watch, as widening credit spreads have historically been a precursor of future economic weakness. Inflation does not seem to be accelerating, which may indicate a weakening of economic activity. The annual rate of change of the Consumer Price Index has turned down in the last month and the Ned Davis Inflation Timing Model has actually fallen into positive territory, indicating little inflationary pressure.*** Lower inflation expectations could influence the trajectory of interest rate hikes by the Fed next year.

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3. **Sentiment:** Investor sentiment turned negative quickly in December as stock prices declined. The NDR Crowd Sentiment Poll reached its most pessimistic level since the February 2016 stock market bottom, which is a positive development from a contrary point of view.*** From a longer-term perspective, however, mutual fund cash as a percentage of total assets (adjusted for interest rates) has now fallen to its lowest level since the market top of 2007. This low level of cash indicates that mutual funds are nearly fully invested by historical measures. Further liquidation in the coming year may need to occur in order to see a normalization of these low cash levels.

4. **Momentum:** The severe December market decline pushed the percentage of stocks above their 10- and 30-week moving averages to the most oversold levels in two years.*** The severity of the market's December decline, accompanied by lower valuations and very pessimistic investor sentiment, has created a short-term oversold condition from which the market should rally to relieve the oversold condition, in our opinion. However, if our longer-term models continue to be negative, we would seek to take advantage of rallies to initiate short positions until our longer-term models improve.

** Source: Bloomberg. December 31, 2018*
*** Source: U.S. Department of Treasury. December 31, 2018*
****Source: Ned Davis Research. December 31, 2018*