Most investors will be happy to put 2022 behind them. The stock market notched its 14th bear market since World War II and fourth worst year since 1945, behind 2008 (-38.5%), 1974 (-29.7%) and 2002 (-23.4%).[1] The S&P 500 Index was down -18.13% for the year and -5.78% in December.[2] Tech stocks were especially hard hit in 2022 with the NASDAQ-100 Index falling -32.38% for the year and -9.01% in December.[2] Small-cap stocks were also weak with the Russell 2000 Index down -20.46% for the year and -6.49% in December.[2] Of the major market averages, the Dow Jones Industrial Average (DJIA) held up best with a loss of only -6.86% for the year and -4.09% in December.[2] One of the major factors contributing to the stock market's 2022 weakness was the Federal Reserve's (Fed's) continued tight monetary policy and rising interest rates. The 10-year U.S. Treasury Note yield more than doubled during the year, beginning the year with a 1.63% yield and ending at 3.88%.[3] The 3-month U.S. Treasury Bill yield soared from 0.08% at the beginning of 2022 to 4.42% at the end of the year.[3]

Stocks began the final quarter of 2022 on a positive note with the S&P 500 gaining over 14% from the mid-October low to the end-of-November high.[2] In fact, for the last quarter of 2022, the S&P 500, the Russell 2000 and the DJIA all posted positive returns, while the NASDAQ-100 showed a minor loss. The fourth quarter rally was due to many factors — among them an extreme in investor pessimism, an oversold condition in the market, some stabilization in long-term interest rates and anticipation that the Fed might be less hawkish at its December meeting. Those hopes were dashed, however, by Fed Chair Jerome Powell's comments following the December meeting. While the Fed raised the federal funds rate by only 50 basis points (bps), which was less than the previous rate hikes of 75 bps, Powell indicated that interest rates would rise higher in 2023 than previously expected as inflation has proved more stubborn than the Fed had hoped. This put an end to the rally and ushered in the year-end weakness.

Equity valuations have improved in the last year but are still high when adjusted for inflation. In addition, inflation fears have begun to shift to fears over earnings and the economy as 2023 begins. A tightening Fed into a slowing economy and continued high inflation is not a healthy environment for stocks. On the monetary front, while yields at the long end of the yield curve declined, short-term interest rates rose at the same time longer-term rates declined for the second consecutive month. The 3-month/10-year U.S. Treasury yield curve is now the most negative since the 2008–2009 financial crisis. Historically, while timing is always uncertain, this inversion has often been a leading indicator of a future recession. In addition, since 1962, the market has shown a negative return during the periods when the 3-month/10-year U.S. Treasury yield curve was inverted.[4] As of the end of the year, the team's volume and breadth momentum models were negative across the board with short-term momentum also having turned negative.

The team was positioned defensively during December and maintained a defensive exposure throughout the year. Market exposure would be raised if interest rates fell, investor sentiment grew more pessimistic, and the team's volume and breadth momentum models turned positive. The team would maintain its maximum defensive positioning if interest rates remain high and the team's volume and breadth momentum models remain negative.

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

Valuation: Price-earnings ratios adjusted for inflation (defined as the year-to-year change in the Consumer Price Index) have declined from their lofty levels of a year ago, but they are still in overvalued territory. It looks like this readjustment process has further to go before equities become more fairly valued.[5]

Continued next page
Disclosure next page

Monetary factors and credit conditions: The yield curve comparing the 3-month U.S. Treasury Bill yield with the 10-year U.S. Treasury yield experienced its greatest inversion since the 2008–2009 financial crisis. December was also the second consecutive month that short-term yields rose while longer-term yields declined. This inversion has occurred less than 12% of the time since 1962. Historical statistics show that during the time these inversions persisted, the S&P 500 declined at an annual rate of -1.99%.[4]

Sentiment: Investor sentiment got more pessimistic in December (positive from a contrary point of view) as the market declined. Again, we note that investor sentiment is a condition and not a trigger until it reaches an extreme. Nonetheless, the return of investor pessimism is a positive sign, and the team will be watching for an extreme reading on this indicator.[6]

Momentum: The team's breadth momentum model, which measures the breadth of Standard & Poor's industry groups, improved in November but declined into negative territory in December.[5] The team's volume momentum model, which compares upside volume with downside volume, remained negative.[5] The stock market's December decline also turned short-term momentum negative.

[1] *Source: CFRA Research. January 2, 2023*
[2] *Source: Bloomberg. January 1, 2023*
[3] *Source: U.S. Department of Treasury. December 31,2022*
[4] *Source: Ned Davis Research. December 30, 2022*
[5] *Source: Ned Davis Research. December 31, 2022*
[6] *Source: Ned Davis Research. December 27, 2022*

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