BROADMARK

Market Update

March 1, 2019

In February, stock prices posted more modest gains compared to the strong gains recorded in January. Small cap stocks continued to lead the way, rising over 5% for the month, while a majority of the other major market indices rose between 3% and 5%. Most of the major market averages have been able to recover a good portion of their fourth quarter 2018 declines and are now up 10% or more so far in 2019.*

Our momentum models continued to strengthen during February and several major market averages rose above longer-term moving averages. Many commodity trading advisors (CTAs) and trend-following strategies use these moving averages as signals. It's possible some of the market's upward momentum has been due to these investors increasing exposure as the signals were triggered.

Investor sentiment has now shifted to increased optimism due to the strong market rally. In addition, the market has gotten somewhat overbought after the almost uninterrupted rise since the beginning of the year. On a near-term basis, therefore, we believe a correction of 2% to 4% could happen at any time.

Nonetheless, the most important driver of the intermediate-term to longer-term trend of stock prices is, and has always been, the Federal Reserve (Fed) and credit conditions. Currently, interest rates remain stable and credit spreads have narrowed. Thus, at the moment, we see no serious near-term problems in our models. Of course, conditions can change quickly. A complete failure on the trade front, for example, could change these conditions.

We increased our market exposure during January and again in February. During February, we increased our position in small cap stocks and diversified the portfolio into large cap stocks and the technology sector.

The improvement in the four pillars of our process—particularly the Fed's more dovish stance, the narrowing of credit spreads and the improvement in both our intermediate- and long-term momentum indicators—is a healthy sign and suggests that any declines from current price levels will be corrections rather than a resumption of the weakness that we saw in late 2018.

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 S&P 500 Index median price-earnings ratio now stands at 21.1, well below its 15-year high of 26.8 reached in January 2018. In addition, almost 40% of all S&P 500 stocks still have a higher dividend yield than that of the 10-year U.S. Treasury. In the competition between stocks and bonds for funding, stocks have become more fairly valued in relation to the low level of interest rates.**

2. **Monetary factors and credit conditions**: Interest rates eased further in February. Credit spreads also continued to narrow. These are very good signs and largely a result of Fed Chair Jerome Powell's more dovish statements. A continued narrowing of credit spreads and stable interest rates would be a positive development for the longer-term market outlook.

   It is difficult to see a significant rise in interest rates or widening credit spreads without some evidence that inflation is returning. Yet, the Consumer Price Index (CPI) has slowed in recent months and the year-over-year change as of January 31, 2019, is only 1.9%, still below the Fed's 2% target. In addition, the NDR Inflation Timing Model does not indicate an increase in inflation at this time.**

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3. **Sentiment:** At the end of 2018, 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, and marked the most recent bottom in stock prices. As the market rallied in February, bullish sentiment increased and has now risen to levels that may indicate a market pullback. Nonetheless, investor sentiment is still below the worrisome levels reached in 2018.

   Another positive development is that insider buying (corporate executives buying their own company stock on the open market) has now risen to its highest level in three years. Some of this buying by corporate executives mirrors the recent increase in corporate buybacks. The last time insider buying reached these levels was at the early 2016 stock market bottom.

4. **Momentum:** The severe December 2018 market decline pushed the percentage of stocks above their 10- and 30-week moving averages to the most oversold levels in two years. This type of extreme oversold position has often marked short-term market low points. The market's subsequent rally off those lows turned our intermediate- and long-term volume/breadth momentum models positive. We are impressed by the strength of the broad market. Our model of 5-week total weekly New York Stock Exchange (NYSE) advances versus declines has reached its strongest reading since the early 2016 low, indicating strong market upward thrust on the most recent advance.***

* *Source: Bloomberg. February 28, 2019*
** *Source: Ned Davis Research. January 31, 2019*
*** *Source: Ned Davis Research. February 22, 2019*