

During the first quarter, the stock market achieved its biggest quarterly gain in nearly a decade, buoyed by lower interest rates and the expectation that the U.S. Federal Reserve would hold interest rates at current levels. The month of March, however, was more of a mixed bag. While the S&P 500 Index and NASDAQ Composite Index rose by 2%–3%, the Dow Jones Industrial Average and the Russell 2000 Index failed to make much headway.*

The spread between short-term interest rates and the 7-year to 10-year end of the Treasury yield curve turned negative in March. We would note that while an inversion of the yield curve has often indicated a future slowing of economic growth and subsequent stock market decline, the timing can be uncertain and has often been well ahead of any resulting stock market weakness. For example, the yield curve inverted in the summer of 2006 and yet U.S. stock prices climbed almost 30% before the peak in 2007—which was over a year later. In addition, the yield curve inverted in 1996 and briefly in 1998 without a subsequent recession.** A widening of credit spreads can also be a sign of future economic weakness, but so far credit spreads have not widened significantly. We will be watching these monetary indicators closely in coming months.

Our daily stock market momentum models turned weaker during the month. In addition, investor sentiment rose to levels that often accompany some market consolidation. As a result, we decreased our market exposure on the rally as a defensive measure.

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

1. **Valuation:** Valuations have crept up as the market rallied earlier in the year. The S&P 500 median price-earnings ratio now stands at 22.2, higher than its low point in the fourth quarter of 2018 but still below its 15-year high of 26.8 reached in January 2018.*** When adjusted for the recent decline in interest rates, valuations now appear to be more reasonable.
2. **Monetary factors and credit conditions:** Interest rates declined sharply in March to their lowest levels in over a year. The 10-year U.S. Treasury Note fell to 2.41% from its October 2018 high of 3.25%.****

The 10-year to 2-year Treasury spread turned negative during the month. However, we note that there is often a lead time that could be anywhere from months to a few years between an inversion in the yield curve and stock market weakness. In addition, the 13-week to 30-year spread remains positive.*** Therefore, while an increased inversion of the yield curve is a long-term negative factor in our work, we always weigh it in conjunction with the other pillars of our investment process.

Credit spreads have not widened significantly. Future economic weakness and a subsequent adjustment in stocks will likely be signaled by rising credit spreads and we have not seen that happen yet. Nonetheless, we will be watching credit spreads closely in coming months.

3. **Sentiment:** Bullish investor sentiment has increased since the beginning of the year (which is a negative development from a contrary point of view) and has now risen to levels that often indicate elevated downside risk. However, we have not seen bullish sentiment rise to levels that would call for a steeper market decline.

4. Momentum: Our short-term momentum models turned negative during March. However, our longer-term volume and breadth momentum measures continue to be positive.

So far, our momentum models have shown solid up volume and breadth on the early 2019 rally. Coupled with declining interest rates and lower valuations, this is a favorable backdrop for the stock market. If momentum begins to deteriorate alongside rising investor optimism, it would signal elevated risk.

* Source: Bloomberg. March 29, 2019

** Source: Ned Davis Research. March 29, 2019

*** Source: Ned Davis Research. March 31, 2019

****Source: U.S. Department of Treasury. March 29, 2019

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