Increased fears over the rising number of coronavirus cases in the U.S. and the impact on global growth continued to negatively affect the U.S. and world markets. March was the worst month for U.S. stocks since 1987 with the S&P 500 Index down over -12%. The first quarter of 2020 was the worst first quarter on record, with a loss of almost -20% for the S&P 500. At the stock market's March low point, the S&P 500 had fallen 37% from its February high.[1] Stocks were able to stabilize somewhat in the last few weeks of the month on news of the U.S. Federal Reserve (Fed) lowering the federal funds target rate to near zero [2] and providing massive liquidity to the markets. Congress also finalized passage of a $2.2 trillion fiscal stimulus package to help the economy.[3]

A rush to the safety of U.S. Treasury securities resulted in interest rates falling to their lowest levels in modern history. The 10-year U.S. Treasury Note fell to an all-time low of 0.54% on March 9, 2020, (trading even lower—below 0.40%—intraday) and ended the month with a yield of 0.70%.[4] Credit spreads soared to their highest levels since the financial crisis of 2008-2009 but then narrowed somewhat in response to the injections of liquidity by the Fed and the passage of the congressional stimulus bill. In addition, it was anticipated that Congress was preparing another fiscal stimulus package to help the economy.

The investment team moved the portfolio to the maximum defensive position in the last few weeks of February and maintained this defensive position into March. Both the intermediate- and long-term models of volume and breadth turned harshly negative causing our risk management process to call for a maximum defensive posture. This was the first time that the team had taken a maximum defensive position since the severe stock market decline of late 2018.

The investment team began to see some bullish signs at the end of the month, however. First, valuations declined to their best level in over six years. Second, investor bearish sentiment reached a nine-year high and exceeded the bearishness seen at the stock market lows of 2016 and 2018. Third, several of the team's measures of market momentum reached their most oversold levels in many years. Fourth, these oversold levels were accompanied by some positive volume and breadth momentum divergences: measures of money flow showed an easing of selling pressure as the prices sank to new lows. Lastly, the Fed promised to do "whatever it takes" to provide almost unlimited liquidity to the markets. For these reasons, the team took some opportunistic long positions in the large cap and technology sectors toward the end of March.

In order to raise exposure further, the investment team will need to see its volume and breadth momentum measures strengthen and turn positive. The team is now watching a variety of thrust indicators that measure the strength of a market rally in terms of volume and breadth. A strong and broad-based recovery from the lows would be a positive sign. On the other hand, these are treacherous markets and a resumption of the decline from current levels would likely move our volume and breadth indicators back into negative territory causing the team to once again move to a maximum defensive posture.

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

1. **Valuation:** Valuations declined to their lowest level in over six years during March. The S&P 500 median price-earnings (P/E) ratio fell to 18.8x, well below its 15-year high of 26.8x reached in January 2018.[5] As the economy slows to a virtual halt in the coming month, earnings will decline significantly causing P/E ratios to rise from current levels. This is a normal occurrence in a business and stock market cycle as the stock market begins to discount the decline in earnings. The investment team expects that the ultimate low in the stock market may roughly coincide with this upward spike in P/E ratios, whenever it occurs. Likewise, we believe the ensuing recovery rally from the lows will likely occur as analysts begin to get a handle on when earnings will recover. The stock market is a leading indicator that discounts changes in earnings at inflection points.

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2. **Monetary factors and credit conditions:** Interest rates declined to modern all-time lows in March as the Fed lowered the federal funds target rate to near zero. As mentioned previously, the 10-year U.S. Treasury Note yield reached an all-time low of 0.54% in early March and ended the month at 0.70%, down from 1.10% at the beginning of the month.[4] While low and declining interest rates are generally positive for equities, credit spreads widened significantly in March. Credit spreads have now risen to their widest level since the financial crisis of 2008-2009.[5] Credit spreads are an important measure of economic risk, and the widening of spreads is negative. On the other hand, credit spreads began to narrow somewhat in the last few weeks of March in response to the Fed's massive injections of liquidity through the new quantitative easing program and the $2.2 trillion fiscal stimulus package. A further narrowing of spreads from these levels would be a positive indicator.

3. **Sentiment:** Investor pessimism rose significantly during March, which is positive from a contrary point of view. Pessimistic investor sentiment reached levels not seen since the 2011 stock market bottom nine years ago and exceeded the levels reached at the 2016 and 2018 stock market lows.[5] Investor pessimism has only been higher at the 2002-2003 and 2008-2009 major stock market lows. Coupled with the market's oversold condition, we see this as a positive development.

4. **Momentum:** With severe weakness in the markets during February and March, the team's measures of volume and breadth both declined sharply into negative territory. However, the steep market decline created oversold levels, which rival those reached at or near other stock market bottoms. For instance, the percentage of stocks above their 10- and 30-week moving averages fell to their lowest levels since the 2008-2009 lows and, before that, the 1987 low.[6] The other times these measures reached such extremes were at the market lows of 2011, 2016 and 2018.

   While these types of oversold extremes often occur at or near market bottoms, sometimes there are multiple tests of the low, or new lows, prior to the final low point. That is why the team's investment process requires an upside confirmation of a change of trend before significantly raising exposure. We will be measuring the upward thrust of volume and breadth on any rally from oversold levels. In addition, one key indicator of an intermediate- to long-term change in trend is upside versus downside volume. Currently, downside volume is well above upside volume. Statistically, since 1981, when downside volume has been above upside volume, the S&P 500 has recorded an average -2.53% annual return.[5] A move of this model into positive territory is one of the signals the team will be looking for to indicate a more durable change in trend.

[1] *Source: Bloomberg. March 31, 2020*
[2] *Source: U.S. Federal Reserve. March 16, 2020*
[3] *Source: Whitehouse.gov. March 27, 2020*
[4] *Source: U.S. Department of Treasury. March 31, 2020*
[5] *Source: Ned Davis Research. March 31, 2020*
[6] *Source: Ned Davis Research. March 27, 2020*

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