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After steady gains during the first quarter of 2019, the stock market ran into significant headwinds in May. By the end of the month, the S&P 500 Index was down over 6% with all of the other major market indexes recording similar, or in some cases, larger declines.¹

Among the catalysts for the market setback were the failure of the U.S. and China to reach an agreement on trade, the imposition of further tariffs on Chinese goods and potential retaliation by China. In addition, threats of tariffs on Mexico late in the month accelerated the market's weakness. Another worry was the fear that the sharp decline in bond yields was signaling a weaker economy than many investors had expected. The 10-year U.S. Treasury Note declined to 2.14% by the end of the month — its lowest level in almost two years. This decline in turn had the effect of inverting the shorter end of the yield curve, which has often been a precursor of economic weakness.

Investor sentiment turned pessimistic (positive from a contrary point of view) as a result of the May market decline and reached its most pessimistic level of the year. Nonetheless, investor sentiment has only declined to neutral levels from a historical perspective. Further pessimistic sentiment may be necessary prior to getting sentiment measures back into bullish territory.

Momentum weakened in May. Our intermediate volume/breadth-based momentum model turned negative during the month, although our long-term measure of momentum remained positive as of the month's end. We reduced stock market exposure during May and at the end of the month we took a defensive position with low market exposure. If sentiment turns more pessimistic (positive from a contrary point of view) and our momentum measures of volume and breadth improve, we would then consider increasing market exposure. Until then, our models indicate the strategy remain in a defensive posture.

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

- 1. Valuation: The S&P 500 median price-earnings ratio now stands at 22.5, still below its 15-year high of 26.8 reached in January 2018.³ Given the low level of interest rates and the U.S. Federal Reserve's more dovish stance, valuations are more neutral than negative at this point.
- 2. Monetary factors and credit conditions: Interest rates fell substantially in May. The 10-year U.S. Treasury Note declined to 2.14% at the end of the month its lowest level in almost two years. Shorter-term interest rates, however, did not decline as much and as a result the shorter end of the yield curve began to flatten. For bonds with maturities below 10 years, the yield curve began to invert. For example, the yield on the 10-year U.S. Treasury Note has now fallen below the federal funds rate. This is the first time this has happened since the 2008-09 financial crisis. Statistically, when this spread has fallen to 0.2% or below, as it is now, the annual return on the S&P 500 has been -1.70% (while the spread remained at the 0.2% level or below).

We believe that the bond market is quite clearly signaling caution. If bonds are indeed telling us that business conditions are not as robust as most observers believe, this should begin to show up in a widening of credit spreads. Credit spreads have ticked up in recent weeks but still remain in historically neutral territory.⁵ It will be important to see if credit spreads widen further from here. Credit spreads are currently less than 50 basis points from their widest levels of the year. If credit spreads continue to widen, it might indicate further economic and stock market weakness.

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- **3. Sentiment:** The May market decline improved our sentiment measures. The NDR Crowd Sentiment Poll has now registered the most pessimism of the year. Nonetheless, this indicator is still in neutral territory from a historical point of view. ⁶ We may have to see a rise in investor bearishness before this indicator gives us a bullish reading.
- **4. Momentum:** Our intermediate-term volume/breadth-based momentum model turned negative during May. So far, our longer-term momentum model has remained positive, reflecting the good up volume and breadth that we saw during the early 2019 rally. This could change, however, if we see further stock market weakness.

One potential negative to the momentum picture is lagging broader market participation. Neither the Russell 2000 Index nor the Dow Jones Transportation Average reached new highs with the other major averages this year. Continued strength in large cap stocks with deterioration in the rest of the market would be a negative divergence.

One important momentum indicator we are currently watching is upside and downside volume. While our measure of upside volume versus downside volume is still positive at the moment, a negative development would be if downside volume rises above upside volume (Figure 4). Historically, when downside volume has risen above upside volume, the average annual return on the S&P 500 has been -4.96%. ⁵

¹ Source: Bloomberg. May 31, 2019

² Source: U.S. Department of Commerce. May 31, 2019

³ Source: Ned Davis Research. April 30, 2019

⁴ Source: Ned Davis Research. March 31, 2019

⁵ Source: Ned Davis Research. May 29, 2019

⁶ Source: Ned Davis Research. May 28, 2019

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