The stock market continued its slide during the first few weeks of May due to fears of both rising inflation and the potential for a global economic decline. In the final week of the month, however, the S&P 500 Index was able to end its eight-week losing streak — the longest since 1932 — by recording its best week of performance since November 2020. As a result, most major market averages were able to close the month nearly unchanged from the start of the month. The S&P 500 was up 0.18% for May, but year to date, the index was still down -12.76%.[1] Technology stocks also made a strong comeback at the end of the month, but it was not enough to turn the index positive. The NASDAQ-100 Index ended the month with a loss of -1.53% and was down -22.27% year to date.[1] The Russell 2000 Index was up 0.14% for the month and was lower by -16.58% for the year as of the end of May.[1] Defensive issues and large cap cyclical stocks continued to show a bit more relative strength. The Dow Jones Industrial Average was up 0.33% for the month and was down -8.43% year to date.[1]

Equity valuations continued to decline from their peak levels over a year ago due to better earnings comparisons and lower stock prices. While this is an improvement, equities remained in overvalued territory and were still high when adjusted for inflation. Also, the percentage of stocks with a dividend yield higher than the 10-year U.S. Treasury Note fell to 21.67%, its lowest level in several years and down from 78% just over a year ago.[2] Bond returns are thus far more competitive with stocks than they have been in recent years. On the monetary and credit front, the investment team's rate-of-change models for interest rates — for both Treasurys and corporates — remained in negative territory, and the U.S. Federal Reserve (Fed) is expected to raise rates in coming months. Despite these headwinds, interest rates eased off their highs in May. The yield of the 10-year U.S. Treasury Note, which had climbed as high as 3.12% early in the month, fell to 2.85%, which was lower than the 2.99% yield at the beginning of the month.[3] Another positive from a contrary point of view was that investor sentiment turned increasingly pessimistic with the fall in stock prices.

The investment team retained its defensive portfolio position during May, as the team's momentum models continued to register negative readings. The team retained a modest allocation to conservative large cap stocks but maintained a zero net exposure to the market in an effort to weather future market volatility. The team would raise market exposure if volume and breadth momentum improved, particularly if upside thrust readings were indicated by the team's volume and breadth models. The team would also raise exposure if interest rates stabilized, credit spreads remained narrow and investor sentiment remained pessimistic. The team would maintain its maximum defensive position and would consider initiating short sales if interest rates continued their rise, credit spreads widened or if the team's short-, intermediate- and long-term volume and breadth momentum models deteriorated.

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

Valuation: Equity valuations have continued to improve but remain in overvalued territory. The median price-earnings (P/E) multiple on the S&P 500 has declined from its high of 33.9x in early 2021 to 23.6x as of the end of May 2022.[1] But valuations were still above the 58.3-year median P/E ratio of 17.4x.[1] The team's measure of valuations adjusted for inflation also remained high. This measure could decline if inflation abates but a rise in interest rates would be negative for this valuation measure.

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In March of 2021, the percentage of S&P 500 stocks with dividend yields greater than the 10-year U.S. Treasury Note climbed to an unprecedented high of 78%.[1] Since then, interest rates have risen and this measure has plummeted. One year later, only 21.67% of S&P 500 stocks have a dividend yield greater than the 10-year U.S. Treasury yield.[1] Whereas in the past many investors have used the acronym "TINA" (There Is No Alternative) to describe the attractiveness of stocks over bonds, fixed-income yields have now become far more competitive as compared with equities. In the last decade, stocks have often reached a temporary low point when this percentage has fallen into the low 20s or below, as it did in late 2018 and where it was at the end of the month.[1]

It is important to note, however, that due to the Fed's quantitative easing (QE) program begun in 2008, which added liquidity to the financial system, the Fed is now reversing course and draining funds from the system. This is a significant difference. Thus, a better comparison might be the pre-QE period of 1976 to 2008, when this ratio was in the 5%-20% range,[1] far lower than it has been in the last decade. By this measure, we believe bond yields may become even more attractive as compared with equities in the future, reversing the TINA comparison to the detriment of equity investors.

Monetary factors and credit conditions: Interest rates eased off their previous highs during May and the 10-year U.S. Treasury Note closed the month with a 2.85% yield, down from 2.99% at the beginning of the month. Continued stabilization and/or decline in interest rates might suggest that the peak upward rates of change had been reached, which would be a positive development. Nonetheless, we do not yet have evidence of that as the team's rate-of-change models remain negative.

The spread between Treasurys and high-yield corporate bonds rose to their 22.4-year median of 506 basis points during the month but settled back to close the month at 424 basis points.[1] The team will be watching credit spreads closely as the Fed moves to hike interest rates, as a widening of spreads would be indicative of a deterioration in credit conditions. But as of the end of May credit spreads remained in neutral territory.

Sentiment: Ned Davis Research's Crowd Sentiment Poll, a composite of a variety of sentiment indicators, has recently shown the most pessimism since the pandemic low two years ago. From a contrary point of view, this is a positive development. This indicator is now nearing levels reached during 2018 and several other market low points over the last decade. The team will be watching this indicator closely, as maximum pessimism is usually associated with market low points.[1]

Momentum: The team's intermediate volume and breadth momentum models remained in negative territory during May, as downside volume (supply) has exceeded upside volume (demand) since February. Since 1998, during those periods when supply has exceeded demand, the market has experienced a -5.25% annualized return while this condition persisted.[1] A rise in upside volume above downside volume would be a positive development, particularly if the team's upside thrust models of volume and breadth were to indicate a potential reversal in trend. Until then, the team believes the saying "Don't fight the tape" remains wise advice during these volatile markets.

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[1] *Source: Bloomberg. May 31, 2022*

[2] *Source: Ned Davis Research. May 31, 2022*

[3] *Source: U.S. Department of Treasury. May 31, 2022*