BROADMARK

Market Update

December 1, 2018

The major market averages rallied in early November, but tumbled again midmonth, testing their 2018 lows. Higher-beta sectors, such as technology and small-cap stocks, were weaker than the broader market averages. Stocks recovered in the last few weeks of the month, with the S&P 500 Index and Dow Jones Industrials Average (DJIA) ending the month with small gains. The Nasdaq-100 Index and Russell 2000 Index both ended the month slightly negative. During the last week of November, U.S. Federal Reserve (Fed) Chair Jerome Powell said that the benchmark interest rate was “just below the neutral rate” after previously having said that it was “a long way” from neutral. The markets perceived this statement as reflecting more flexibility on the part of the Fed regarding future interest rate hikes and sparked the market’s rally in the last week of the month.

As the market declined into mid-November, our models turned more positive. Investor sentiment improved significantly with our sentiment models showing the most pessimism (positive from a contrary point of view) in two years. Interest rates continued to ease and valuation measures improved. We also saw some positive divergences in the market itself as the market successfully tested its 2018 lows with an improvement in upside versus downside volume.

As our models improved, we increased our market exposure during November. In addition, we replaced our exposure to the defensive DJIA with the higher-beta Russell 2000, increasing the beta of the portfolio. If interest rates remain stable, investors remain cautious and our momentum models remain positive, we will maintain or increase our market exposure in order to take advantage of market strength. However, a number of our longer-term models, such as the low level of mutual fund cash and the widening of credit spreads, indicate that we are still in the late stages of the economic cycle. We therefore remain ready to become more defensive in the portfolio if we see a deterioration in our models from their current levels.

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 median price-earnings ratio now stands at 22.8, below its 15-year high of 26.8 reached in January 2018.* There is a growing perception that we may have reached peak earnings for this economic cycle and the lower valuations reflect this lower assessment.

2. **Monetary factors and credit conditions**: Interest rates declined in November. However, one of the most important developments during the month was that despite the decline in rates, credit spreads widened. The spread between the yield on the Bloomberg Barclays U.S. Corporate High Yield Bond Index and 10-year U.S. Treasury Note widened to its highest level in over a year. ** This spread is an important indicator to watch, as widening credit spreads are often a precursor of future economic weakness.

3. **Sentiment:** Investor sentiment turned quickly negative in November as stock prices declined. The NDR Crowd Sentiment Poll reached its most pessimistic level in two years, which is a positive development from a contrary point of view. From a longer-term perspective, however, mutual fund cash as a percentage of total assets (adjusted for interest rates) has now fallen to its lowest level since the market top of 2007 and, prior to that, the market top of 2000. This low level of mutual fund cash indicates that mutual funds are nearly fully invested by historical measures.

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4. **Momentum:** The November decline pushed the percentage of stocks above their 10- and 30-week moving averages to the most oversold levels in two years. ** The severity of the market's November decline, accompanied by lower valuations and pessimistic investor sentiment, has created a short-term oversold condition, which contributed to our decision to raise our market exposure and increase the beta of the portfolio.

** Source: Ned Davis Research. October 31, 2018*
*** Source: Ned Davis Research. November 30, 2018*