BROADMARK

# Market Update

December 1, 2022

Stocks gained ground in November continuing their recovery from the October lows. The more defensive Dow Jones Industrial Average edged out the other major market averages, posting a gain of 6.04% for the month.[1] The NASDAQ-100 Index, however, was not far behind with a gain of 5.62% while the S&P 500 Index was up 5.59%.[1] Small cap stocks lagged large cap stocks, but the Russell 2000 Index still gained 2.31%.[1]

A favorable report on consumer prices, a weaker-than-expected Producer Price Index reading, and stronger-than-anticipated retail sales showed that the economy is holding up well despite tightening by the Federal Reserve (Fed). Interest rates declined during the month and the 10-year U.S. Treasury Note yield fell to 3.68% from 4.07% at the beginning of the month.[2] A good part of this decline was due to Fed Chair Jerome Powell signaling that the central bank is likely to slow the pace of interest rate increases next month. Nonetheless, he stressed that borrowing costs will need to keep rising and remain restrictive for some time to beat inflation. While these comments were generally in line with expectations, the confirmation that a calmer pace of hikes is imminent sparked the rally in global stocks toward the end of the month and pushed the U.S. dollar to a three-month low. Some stock market bulls also pointed to favorable seasonal trends. Historically, the S&P 500 has risen in nearly three out of every four times between Thanksgiving and year-end.[3]

Equity valuations are still high when adjusted for inflation. But with expectations of inflation beginning to moderate, valuations may become more attractive. While yields at the long end of the yield curve declined, short-term interest rates rose during the month. This resulted in an inversion of the Three-month U.S. Treasury Bill/10-year U.S. Treasury Note yield curve. This is the first time that this yield curve has inverted since the 2020 pandemic. Historically, this type of inversion has often been a leading indicator of a future recession. However, the timing is always uncertain and has ranged from coincident to a lead time of several years. We also note that prior to the onset of a recession, credit spreads often widen. Currently, credit spreads are still in line with their long-term average and have not widened significantly. Investor sentiment remained generally pessimistic during the month, which is a positive from a contrarian perspective. However, we would point out that investor sentiment is a condition, not a trigger, in our work. Pessimistic sentiment can continue for a long period until reaching an extreme. The team's breadth momentum model swung into positive territory during the month but has yet to be confirmed by the team's volume and money flow models.

The team increased market exposure modestly during November. At month-end, the team held positions in the health care, consumer staples and utilities sectors as well as large cap stocks. Market exposure would be raised further if interest rates continued to fall, credit spreads narrowed, investor sentiment grew more pessimistic and the team's volume-momentum models confirmed the improvement in breadth. The team would lower market exposure if interest rates rose, credit spreads widened or if the team's volume and breadth momentum models deteriorated.

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

*Valuation*: Price-earnings ratios adjusted for inflation (defined as the year-to-year change in the Consumer Price Index) are still in overvalued territory. While the recent decline in rates has brought valuations lower than a year ago, it still looks like this readjustment process has further to go before equities become more fairly valued.[4]

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*Monetary factors and credit conditions*: The yield curve comparing the three-month U.S. Treasury Bill yield with the 10-year U.S. Treasury yield inverted in November for the first time since the 2020 pandemic. Recessions have often followed these inversions, but the lead time can range from coincident to several years.[4]

Historically, credit spreads often widen when credit becomes tight or unavailable, warning us of dislocations and potential problems in the economy. While credit spreads have widened above their long-term average several times this year, spreads currently remain right around the long-term average. A widening of spreads, particularly coupled with an inverted yield curve, would be negative. The team will be watching this indicator closely as we move into the new year.[4]

*Sentiment*: Investor sentiment reached an extreme pessimistic level in October (positive from a contrary point of view) and rose back toward neutral in November. Nonetheless, sentiment is still pessimistic, which could support potential short-term market strength, particularly coupled with the favorable seasonal year-end trends.  We would note that investor sentiment is a condition, not a trigger, and investor sentiment can remain pessimistic for an extended period of time until a final extreme is reached.[5]

*Momentum*: The team's breadth momentum model, which measures the breadth of Standard & Poor's industry groups, turned positive in November.[6] However, the team's volume-momentum model, which compares upside volume with downside volume, has remained negative all year.[4] The volume-momentum model turning positive would be a confirming indicator to the upside but a continued divergence and/or nonconfirmation would potentially indicate a return to more defensive portfolio positioning.

[1] *Source: Bloomberg. December 1, 2022*
[2] *Source: U.S. Treasury Department. December 1, 2022*
[3] *Source: CFRA Research. December 1,2022*
[4] *Source: Ned Davis Research. November 30, 2022*
[5] *Source: Ned Davis Research. November 29, 2022*
[6] *Source: Ned Davis Research. November 25, 2022*

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