Halloween arrived early this year for the U.S. stock market, with the broad market averages dropping nearly 10% in October before recovering in the last few days of the month.* Larger declines were recorded by the higher-beta sectors such as technology and small-cap stocks. International stock markets have been in their own bear markets for most of the year, and U.S. stocks finally played a bit of catch-up with the rest of the world.

The relative strength in the more defensive areas of the market—utilities, healthcare, consumer staples and telecoms—has indicated that institutional investors have gotten more defensive. Our models of upside and downside volume confirm this reallocation of assets among stocks, bonds and cash as interest rates have risen. This reallocation process is particularly important now because equity valuations remain high by historical standards and there is more talk among observers that peak earnings may have been reached for this economic cycle.

We began reducing the beta, or volatility, of the portfolio during September by eliminating our exposure to technology. In October, we further reduced market exposure and opportunistically established a net short exposure for a period of time during the month as the result of the deterioration in our momentum models. As the market reached an oversold position at the end of October, we moved back to net positive market exposure and ended the month with a net long position. The last time the strategy was net short was in late January/early February 2016—one of the worst Januarys on record for the stock market. Prior to that decline, our models also showed elevated equity valuations, a rise in interest rates, optimistic investor sentiment and negative momentum divergences.

Our models show that the market is oversold on a short-term basis and we expect some recovery in stock prices. Several of our longer-term models in our four-pillar process have deteriorated, so we remain cautious on the markets and continue to adopt a defensive posture. If investor sentiment remains fearful, interest rates remain stable, upside versus downside volume improves and the market successfully tests its lows, we would look to increase market exposure. A successful test of the recent lows would suggest at least a temporary bottom in stock prices. However, several of our longer-term market indicators are flashing more warning signs and we therefore remain defensive until we see more evidence of a stabilization in stock prices and improvement in our models. We are prepared to move to further reduce exposure and possibly move to the short side if our momentum models deteriorate further.

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 a positive in our models. The median price-earnings ratio now stands at 24.4, below its 15-year high of 26.8 reached in January 2018.** These valuations are still high by historical standards and, while on an improving trend, recent rises in interest rates present increased competition for funds from the fixed-income sector. In addition, there is a growing perception that we may have reached peak earnings for this economic cycle.

2. **Monetary factors and credit conditions**: After reaching their highest levels since 2011 in the first few days of the month, intermediate- and long-term interest rates stabilized in October. Short-term interest rates also pulled back from their recent highs, but still remain at their highest levels since the spring of 2008. A stabilization in interest rates at current levels would be a positive development

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in our models, particularly if investors perceived that the Federal Reserve might moderate or postpone future interest rate increases. Nonetheless, the trend in interest rates is still up and credit spreads have begun to widen, both of which are negative for stock prices.

3. **Sentiment:** Investor sentiment turned quickly negative in October as stocks prices tumbled. The NDR Crowd Sentiment Poll reached its most pessimistic level in two years, which is a positive development from a contrary point of view—our strategy is to become more bullish when everyone is fearful. 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 and represents an overhanging supply of funds in the market.

4. **Momentum:** While the Dow Jones Industrial Average and S&P 500 reached new all-time highs in the first few days of October, only about half of all stocks were above their 10- and 30-week moving averages, which is a negative divergence. With the sharp October sell-off, the percentage of stocks above their 10- and 30-week moving averages dropped below 20% by the end of the month—the lowest reading that we have seen in two years.**

   The severity of the market's October decline, accompanied by more pessimistic investor sentiment, has created a short-term oversold condition, which we expect the market to rally from. From a longer-term point of view, however, our measures of downside volume (supply) versus upside volume (demand) have deteriorated as a result of the October sell-off. The spread between upside volume and downside volume has fallen to its lowest level in almost three years. Historically, when the spread has fallen this far, it has usually signaled a poor environment for stocks until there is a reversal. Our momentum models also indicate that institutional investors have become more defensive as interest rates have risen. This shift has been reflected by a significant improvement in the relative strength of defensive sectors such as consumer staples, healthcare, utilities and communications.

**   Source: Bloomberg. November 1, 2018*
*** Source: Ned Davis Research. October 31, 2018*