Stocks gained ground in October prior to the widely expected one-quarter point cut in the federal funds rate by the U.S. Federal Reserve (Fed) at the end of the month.[1] Positive developments included the generally positive earnings reports and the fact that equity valuations, while elevated on an absolute basis, are still reasonable when adjusted for the low level of interest rates. In fact, the percentage of stocks in the S&P 500 Index that have a higher yield than the 10-Year U.S. Treasury Note has now risen to 62.5%, the highest level in two years and one of the highest readings on record. With interest rates so low, the scales currently seem to be tipped in favor of equities. In addition, credit spreads remained narrow and momentum improved during the month.[2]

In view of this more positive environment, we raised market exposure. We increased our exposure to large cap stocks due to their good relative strength, and we retained our position in the technology sector. In order to raise exposure further, we would need to see evidence that the broad market is participating in the market advance. Better relative strength in the small- and mid-cap sectors and better market breadth would be a big positive. On the other hand, if investor sentiment were to get too bullish (negative from a contrary point of view) and we were to continue to see lagging broader market participation, we would move to a more defensive posture.

We believe current events and news reports will likely buffet the market between now and year-end. The House of Representatives is moving forward on impeachment while trade talks between the U.S. and China are still uncertain. Developments on the news front could affect the market—both positively and negatively—along with the usual year-end crosscurrents. We are comfortable with our current market exposure but remain flexible to adjust market exposure in light of new developments..

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

1. **Valuation:** The S&P 500 median price-earnings ratio has risen slightly to 22.5x in recent months but remains below its 15-year high of 26.8x reached in January 2018.[3] Given the historically low level of interest rates and the Fed's more dovish stance, valuations now appear to be more reasonable when adjusted for interest rates. In fact, 62.5% of all S&P 500 stocks now have a higher yield than the 10-year U.S. Treasury Note, which is among the highest readings on record.[2]

2. **Monetary factors and credit conditions**: Interest rates remained stable in October. The 10-year U.S. Treasury Note yield rose to 1.85% prior to the Fed's announcement but then settled back to end the month at 1.69% — up only slightly from the yield level at the beginning of the month.[4] Current low interest rates and the Fed's interest rate cut at the end of October provided a bullish monetary background for stocks.

   Our indicator of the 26-week rate of change of the Moody's Baa bond yield reached bullish territory in October. This type of rapid decline in rates also occurred at the stock market bottoms of 2009 and 2016 and reflects the current positive monetary background. [5]

   High yield corporate spreads are an important factor to watch in coming months. Signs of any disruptions in the economy will likely show up in wider spreads between high yield corporate bonds and U.S. Treasurys. From a long-term point of view, a rise in credit spreads, coupled with the current inversion of the yield curve, would be a warning sign of future possible economic and stock market weakness. To date, however, credit spreads remain neutral and actually narrowed during October. [6]

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3. **Sentiment:** In October, the market's move to new highs produced more bullishness among investors (negative from a contrary point of view). This rise in bullishness is a negative development and could potentially signal a near-term market correction. However, while negative, investor sentiment has not yet risen to the optimistic levels reached earlier in the year. [6]

4. **Momentum:** Both our intermediate- and long-term measures of breadth and volume remain positive. For momentum to remain positive, we will need to see more strength in the broad list of stocks, which have not accompanied the major market averages to new all-time highs. For example, while the S&P 500 reached a new all-time high during October, only about 60% of all stocks are above their 10- and 30-week moving averages. [5] A rise in this percentage to the 65%–70% level would be a positive development. If the broad list of stocks does not participate, it would be a negative for the market.

[1] *Source: Bloomberg. October 29, 2019*
[2] *Source: Ned Davis Research. September 30, 2019*
[3] *Source: Ned Davis Research. July 31, 2019*
[4] *Source: U.S. Department of Treasury. October 31, 2019*
[5] *Source: Ned Davis Research. October 25, 2019*
[6] *Source: Ned Davis Research. October 29, 2019*