BROADMARK

Market Update

November 1, 2021

Stock prices resumed their upward march in October following September's brief 6% pullback. Technology and growth stocks led the market higher with the NASDAQ-100 Index rising 7.94% and setting a new all-time high. The S&P 500 Index and Dow Jones Industrial Average (DJIA) also climbed to new all-time highs with the S&P 500 and DJIA up 7.01% and 5.93%, respectively. Small-cap stocks, as represented by the Russell 2000 Index, lagged large-cap stocks but were still up 4.25% for the month.[1]

Economic statistics showed less strength than the stock market, however. Gross domestic product grew at a pace of only 2% in the third quarter, a sharp slowdown from the 6.7% increase in the first quarter of 2021.[1] Global energy prices surged with oil hitting multiyear highs. Investors also worried about just how transitory the rise in consumer prices would prove to be. U.S. Federal Reserve (Fed) Chair Jerome Powell acknowledged that the effects of the economy's reopening and bottlenecks have been larger and longer-lasting than anticipated. Another concern was evidence of a slowing of China's economy due to stringent coronavirus controls and tight curbs on technology companies and property developers. China's economy increased 4.9% in the third quarter, markedly slower than the 7.9% increase in the previous quarter.[1] Investors began to wonder if the world may be facing stagflation-like risks in which rising prices are accompanied by sluggish economic growth.

Interest rates rose modestly during the month and the yield on the 10-year U.S. Treasury Note increased from 1.52% to 1.55%.[2] With the current high level of elevated absolute equity valuations, further rises in interest rates would be negative for equity valuations. The recent rise in interest rates has pushed one of the investment team's rate-of-change indicators into slightly negative territory. Also, investor sentiment swung from pessimism to optimism during the October market rally, which is negative from a contrary point of view.

The investment team kept market exposure steady in October and maintained its positions in large cap stocks and technology stocks. The team would raise market exposure further if the market can get through an anticipated Fed tapering announcement with interest rates remaining relatively stable, credit spreads staying narrow, investor sentiment not getting overly optimistic, and momentum being positive. The team would lower market exposure if interest rates were to rise, credit spreads widened, or if the team's volume and breadth momentum models turned more negative.

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

Valuation: The S&P 500 price-earnings ratio declined to 28.3x from its high of 33.9x in March 2021. As noted in last month's commentary, however, equities remain in overvaluation territory and the team would like to see this ratio decline toward its 57.7-year median of 17.3x.[3]

Monetary factors and credit conditions: Interest rates edged up in October. The 10-year U.S. Treasury Note closed October with a yield of 1.55%, up from 1.52% at the beginning of the month. Despite this modest increase in rates, the team's 26-week rate-of-change indicator for the 3-year U.S. Treasury Note ticked up into modestly negative territory. Further interest rate rises could push this indicator deeper into negative territory whereas a decline in rates could bring the indicator back toward a more neutral reading.[4]

So far, however, we have not seen these interest rate rises precipitate any widening of credit spreads. Credit spreads have in fact narrowed in the last several months.[4]

Sentiment: Investor sentiment turned far more optimistic (negative from a contrary point of view) in October as the stock market resumed its advance led by a surge in technology and growth stocks. The Ned Davis Research Daily Trading Sentiment Composite climbed into negative territory during the month.[4] Investor sentiment, which had been a positive factor as the market corrected in September, has now become a headwind for the market.

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Momentum: Despite the S&P 500, DJIA and NASDAQ-100 hitting new all-time highs in October, only a little more than half of all stocks have been able to stay above their 10- and 40-week moving averages. The percentage of stocks above their 10-week moving averages is 55.4% and the percentage above their 40-week moving averages is 55.8%.[4] This is a meaningful negative divergence as the major market averages have climbed to new highs. This divergence could be positively resolved by a broadening of market strength. However, continued negative divergences are often a precursor of a deeper market correction.

[1] *Source: Bloomberg. November 1, 2021*
[2] *Source: U.S. Department of Treasury. October 31, 2021*
[3] *Source: Ned Davis Research. October 31, 2021*
[4] *Source: Ned Davis Research. October 29, 2021*

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