Economic data in October showed that the U.S. economy gained ground in the third quarter accompanied by rising prices and wages. Real gross domestic product (GDP) increased at an annual rate of 2.6% in the third quarter.[1] The Personal Consumption Expenditures Price Index—the preferred measure of inflation for the U.S. Federal Reserve (Fed)—climbed 6.2% during the year through September.[1] Inflation in Europe surged even more as consumer prices in the 19 countries that use the euro as their currency rose at a record annual rate of 10.7% in October.[2] Interest rates continued to rise with the 10-year U.S. Treasury Note yield climbing to 4.23% during the month, its highest level in 14 years.[3] The 10-year U.S. Treasury ended the month at 4.10%, up from 3.67% at the beginning of the month.[3]

As earnings season began, some major earnings disappointments were reported by several of the largest technology and social media companies. Amazon's earnings were below market expectations and the company's market value fell below $1 trillion.[1] Microsoft posted its weakest quarterly sales growth in five years, while sales at Alphabet fell below estimates.[1] Despite these disappointments, however, stocks were resilient: the NASDAQ-100 Index gained 4.01% for the month.[1] The real strength in the stock market during October, however, was concentrated in large cap industrial stocks. The Dow Jones Industrial Average (DJIA) posted a gain of 14.07%, its best October gain ever and its best monthly gain since January 1976.4 In fact, the DJIA outperformed the NASDAQ-100 by over 10%, its best showing relative to the NASDAQ-100 since 2002.[1] Small cap stocks were also strong with the Russell 2000 Index up 11.01% for the month.[1] The S&P 500 Index posted a solid gain of 8.10% in October.[1]

Equity valuations have declined below their peak levels of a year ago but remain overvalued, particularly in relation to the continuing rise in interest rates. Investor sentiment was a bright spot with bearish sentiment reaching its most pessimistic level of the year, a positive development from a contrary point of view. The investment team's volume and breadth momentum models began to improve as the industrial and small cap sectors of the market strengthened. In addition, several of the team's upside momentum thrust models were triggered. This improvement in momentum, coupled with the deeply oversold condition of the market and the extreme level of negative investor sentiment, bolstered the possibility that at least a temporary recovery in stocks may have begun, particularly during the last few months of the year, which has historically been a favorable seasonal period for stocks.

With this improved market momentum, the team raised market exposure for the first time since it moved to a maximum defensive position in early September. The team added exposure to the large cap industrial sector and small cap stocks as these areas showed the strongest relative strength. The team would add further to exposure if the team's longer-term volume and breadth momentum models turned positive. The team would move back to its defensive posture if interest rates continued to climb, 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: Equity valuations have declined over the last year but remain in overvalued territory, particularly in relation to the dramatic rise in interest rates. The S&P 500 operating earnings price-earnings ratio, adjusted for the year-to-year change in the Consumer Price Index, still shows that equities are overvalued relative to inflation.[4]

Continued next page
Disclosure next page

Monetary factors and credit conditions: In October, interest rates climbed to new highs for the year. The 10-year U.S. Treasury Note yield ended the month at 4.10%, up from 3.67% at the beginning of the month. The team's 3-year U.S. Treasury Note yield rate-of-change model has shown some improvement from its rapid rise this year but remains elevated.[5] A declining rate of change would be positive for the monetary picture. Credit spreads also narrowed during October, falling to 497.0 basis points (bps), below their 22.8-year mean of 506.4 bps. A further narrowing of spreads would be a positive development.[5]

Sentiment: Ned Davis Research's Crowd Sentiment Poll, a composite of a variety of sentiment indicators, touched a new low for the year on the market's most recent sell-off, marking the most pessimism since the pandemic low in 2020 and before that the 2011 low. [6] This is a positive factor from a contrary point of view and this extreme bearishness could indicate that the market may have begun at least a temporary recovery from the recent lows.

Momentum: Stocks became deeply oversold in October with only 12% of all stocks trading above their 200-day moving averages.[5] The team's volume and breadth models also strengthened, and several measures of upside thrust were triggered, suggesting that the market may have more room to move on the upside.

[1] *Source: Bloomberg. October 31, 2022*
[2] *Source: New York Times. November 1, 2022*
[3] *Source: U.S. Treasury Department. October 31,2022*
[4] *Source: Ned Davis Research. October 31, 2022*
[5] *Source: Ned Davis Research. October 28, 2022*
[6] *Source: Ned Davis Research. October 25, 2022*