Broadmark

Market Update

October 1, 2018

The Dow Jones Industrial Average (DJIA) and the S&P 500 Index both hit new all-time highs in September after brief corrections earlier in the month. Investors continued to be buoyed by strong economic fundamentals: a strengthening economy, historically low unemployment, a tax cut, an uptick in wage growth and positive corporate earnings. On the negative side, Walmart and several other international companies issued warnings that trade tariffs with China could hurt future business. Technology and small-cap stocks, as well as the broader-based NYSE Composite Index, failed to confirm the new highs achieved by the DJIA and S&P 500. Further, only about half of all stocks are above their 30-week moving averages. Overseas stock markets have been weak despite the strength in the U.S.: the MSCI EAFE Index's max drawdown is about 10% for the year and the MSCI Emerging Markets Index's max drawdown is about 20%.*

Divergences have increased between the performance of the major market averages and the broad list of stocks. In addition, the strongest sectors during the month were large-cap stocks and defensive sectors such as utilities, consumer staples and telecoms. This strength may indicate that institutional investors are reallocating assets away from equities and into fixed income and cash as interest rates rise. This potential reallocation process is particularly important now as equity valuations remain high. The Federal Reserve (Fed) raised the fed funds rate in the last week of September for the eighth time since December 2015. Yields on the 13-week Treasury Bill and the 2-year Treasury Note climbed to their highest levels since 2008 while the longer maturities rose to nearly their highest levels of the year.**

In view of these increased risks, we reduced the beta, or volatility, of the portfolio during September by eliminating our exposure to the high volatility technology sector, which showed deteriorating relative strength, replacing it with large-cap stocks. We therefore continue to have exposure to the large-cap sector to participate in any further market strength but also hold a healthy allocation to cash as a defensive measure. Our process allows us to move quickly to protect the portfolio in the event of a market correction.

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 positive. The median price-earnings ratio has continued to decline and now stands at 23.8, 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.

2. **Monetary factors and credit conditions**: Intermediate- and long-term interest rates rose in September. The U.S. 10-year Treasury Note yield rose from 2.86% at the end of August to 3.05% at the end September.**** While longer-dated maturities remain slightly below their May highs, short-term interest rates ticked upward during September along with the Fed's hike in the fed funds rate. The 2-year U.S. Treasury Note rose to 2.83% during September, its highest level since spring 2008, reflecting an improving economy, rises in consumer prices and wage gains.**** A strong economy may lead to further Fed rate hikes and a flattening or inversion of the yield curve. However, we emphasize that the yield curve is still positive and there has not been any widening of credit spreads. These developments usually occur prior to more significant stock market weakness and we will be watching these indicators closely over the coming months.

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3. **Sentiment:** Investor sentiment declined somewhat from the more negative levels reached in August. Optimistic investor sentiment (negative from a contrary point of view) reached historically elevated levels (negative) at the beginning of the year and has remained below those levels since then.

4. **Momentum:** While the DJIA and S&P 500 reached new all-time highs in September, only about half of all stocks are above their 30-week moving averages. These percentages fell from almost 60% only a month before despite the strength in the DJIA and the S&P 500.*** We noted last month that this potential negative divergence could be corrected if the broader market were to strengthen. That has not yet occurred and this indicator has gotten somewhat more negative, which signals that the underlying market is not as healthy as the major market averages would indicate. We are continuing to monitor our models closely to respond quickly to any future changes in momentum.

** Source: Bloomberg. October 3, 2018*
*** Source: U.S. Department of Treasury. September 29, 2018*
**** Source: Ned Davis Research. September 29, 2018*
*****Source: Bloomberg. September 29, 2018*