BROADMARK

Market Update

October 1, 2019

Despite slowing economic growth, ongoing trade tensions and a presidential impeachment inquiry, U.S. equities recovered in September and ended the month with modest gains. Mid and small cap stocks recovered some of their declines, but large cap stocks continued to outperform these asset classes. While the large cap indexes hit new all-time highs in 2019, small cap stocks, the Dow Jones Transportation Average and global stocks are still below their 2018 highs.[1]

A positive for the market is that equity valuations, while elevated on an absolute basis, are more reasonable when adjusted for interest rates. While interest rates rose in September, rates remain low by historical standards, the U.S. Federal Reserve (Fed) has taken an accommodative stance and credit spreads have not widened significantly. Additionally, investor sentiment has been more optimistic (negative from a contrary point of view) but is still not in what we would consider dangerous territory. The market negatives are more longer-term related: The yield curve has inverted, and while momentum is still positive, strength in large cap stocks continues to mask lagging participation in the broader list of stocks.

We reduced overall market exposure slightly during September. We eliminated our exposure to small cap stocks and sold our position in gold due to deteriorating relative strength in those sectors. At the end of the month, the portfolio was invested in large cap and technology stocks due to their solid relative strength.

If investor sentiment gets more bearish (bullish from a contrary point of view) and momentum improves with greater participation by the lagging sectors, we would likely raise exposure since that would be evidence that the market had the potential to push upward through the recent July 2019 highs. However, if sentiment once again gets optimistic, momentum wanes, and we continue to see lagging broader market participation, we would lower exposure to a more defensive portfolio posture.

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

1. **Valuation:** In September, the S&P 500 median price-earnings ratio maintained its 21.6x reading of recent months and still remains below its 15-year high of 26.8x reached in January 2018.[2] Given the historically low level of interest rates and the Fed's more dovish stance, valuations now appear to be reasonable when adjusted for interest rates.

2. **Monetary factors and credit conditions**: Interest rates rose slightly in September from the historically low levels reached last month. The 10-year U.S. Treasury Note yield rose from just under 1.50% at the beginning of the month to 1.68% by the end of the month.[3] Current low interest rates and the anticipation that the Fed will once again cut interest rates before the end of the year creates a bullish monetary background for stocks.

   In fact, our indicator of the 26-week rate of change of the Moody's Baa bond yield has reached bullish territory.[4] 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.

   From a long-term perspective, however, we continue to be concerned that the yield curve has inverted.[4] The yield on the 3-month U.S. Treasury Bill is now slightly above the yield on the 30-year U.S. Treasury Bond. The yield curve inversion, however, is a leading market indicator—typically this inversion happens anywhere from a few months to several years before significant economic and stock market weakness.

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High yield corporate spreads are also an important factor to watch in coming months. Signs of any disruptions in the economy will likely show up in the spread between high yield corporate bonds and U.S. Treasurys. Currently, while the spread (as measured in basis points) remains benign, the ratio between high yield corporate bonds and Treasury yields has now risen to its highest level since 2016.[4] The ratio is a more sensitive indicator than spread and leads the spread (as measured in basis points). Coupled with an inverted yield curve, rising credit spreads would be a warning sign of potential future economic and stock market weakness.

3. **Sentiment:** The market's recovery in September produced more bullishness among investors (negative from a contrary point of view). However, while investor sentiment rose, it has not yet risen to the optimistic levels reached earlier in the year. [5]

4. **Momentum:** Momentum remains positive, but we continue to see divergences between the major market indexes and the rest of the market. For example, while the S&P 500 is within a few percentage points of its all-time high, less than 60% of all stocks are above their 10- and 30-week moving averages. [4] Further, the peaks in these percentages were reached earlier in the year and have not been reached since. If the major averages hit new highs and the broad list of stocks does not participate, we would consider that a negative for the market.

[1] *Source: Bloomberg. September 30, 2019*
[2] *Source: Ned Davis Research. August 31, 2019*
[3] *Source: U.S. Department of Treasury. September 30, 2019*
[4] *Source: Ned Davis Research. September 27, 2019*
[5] *Source: Ned Davis Research. September 24, 2019*