After posting seven consecutive months of gains, stocks ran into headwinds in September, with all the major stock market indices showing losses. Investors worried about rising inflation, increasing interest rates, reduced forecasts for consumer confidence, weak gross domestic product (GDP) growth, and a decline in corporate profits. In addition, Federal Reserve (Fed) Chair Jerome Powell acknowledged that the impact and bottlenecks related to the economy's reopening have been larger and longer lasting than anticipated. Powell's comments after the Fed's September meeting raised questions as to whether the surge in inflation was truly transitory and whether the Fed might have to start lifting interest rates sooner than expected. Other market concerns included fears of a potential slowing of China's economy due to stringent coronavirus controls and tight curbs on property after a large property developer's potential debt default. In Europe, inflation in the eurozone hit 3.4% in September, a 13-year high.[1] The spike in natural gas prices and soaring cost of energy were the latest worries for markets becoming increasingly concerned the world may be facing stagflation-like risks, whereby rising prices are accompanied by sluggish economic growth.

Growth and technology stocks were hardest hit during the month with the NASDAQ-100 Index dropping -5.69%. The S&P 500 Index declined -4.65% and the Dow Jones Industrial Average fell -4.20%. Small cap stocks held up a little better with the Russell 2000 Index down -2.95%.[2] Interest rates rose during the month and the yield on the 10-Year U.S. Treasury Note jumped from 1.30% at the beginning of the month to 1.52% at month's end.[3] With the current high level of absolute equity valuations, further increases in interest rates would be negative for equity valuations.

Investor sentiment improved markedly in September with daily sentiment showing the most pessimism (positive from a contrary point of view) since the coronavirus pandemic-related market decline in early 2020. On the momentum side, only 46.8% of all stocks ended the month above their 10-week moving averages.[4] The investment team would like to see this indicator recycle to bring the broad list of stocks into alignment with the market averages.

The investment team lowered market exposure in September and eliminated its exposure to the financials and consumer staples sectors due to declining relative strength. At month-end, the portfolio had exposure to large cap stocks and technology. The team would raise market exposure if interest rates and credit spreads were to stabilize and if the team's volume and breadth models were to improve. The team would lower market exposure further if interest rates were to rise, credit spreads widened or 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: Equity valuations improved in September with the S&P 500 median price-earnings (P/E) multiple falling due to strong earnings. The S&P 500 P/E ratio has declined to 27.8x from its high of 33.9x in March. Nonetheless, equities remain in overvalued territory and the team would like to see this ratio decline toward its 57.6-year median of 17.3x.[5]

Monetary factors and credit conditions: Interest rates rose in September. The 10-year U.S. Treasury Note closed the month with a 1.52% yield, up from 1.30% at the beginning of the month.[3] The 26-week rate of change for the 3-year U.S. Treasury Note is just reaching the border of negative territory. Further rises in interest rates would be a negative development.[4]

Sentiment: Investor sentiment improved markedly in September as investors became as pessimistic (positive from a contrary point of view) as they have been since the pandemic-related decline of early 2020. The Ned Davis Research Daily Trading Sentiment Composite reached its highest level of pessimism (positive from a contrary point of view) in two years.[5] This is a positive development.

Momentum: Divergences between the major market averages and the broad list of stocks continued in September. Only 46.8% of all stocks were above their 10-week moving averages.[4] The investment team would like to see this indicator recycle into more oversold territory. This type of oversold condition would serve to get the broad list of stocks in alignment with the major market averages.

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[1] *Source: Bloomberg. October 1, 2021*
[2] *Source: Bloomberg. September 30, 2021*
[3] *Source: U.S. Department of Treasury. September 30, 2021*
[4] *Source: Ned Davis Research. September 24, 2021*
[5] *Source: Ned Davis Research. September 30, 2021*