In April, U.S. Federal Reserve (Fed) Chair Jerome Powell said that the economy was at an "inflection point" and on the cusp of growing more quickly. These comments were supported by March's retail sales figures, which surged 9.8%.[1] In addition, four out of five companies reported earnings that either met or exceeded expectations. Asian financial markets, however, came under pressure as COVID-19 cases surged in the region. India's medical system was overwhelmed by the number of cases, and deaths in Brazil passed 400,000. While the U.S. and other countries with high vaccination rates will likely avoid the worst of the setback, the increase in COVID-19 cases overseas has raised questions over the global reflation trade.

Both the S&P 500 Index and the Dow Jones Industrial Average (DJIA) reflected the strong U.S. economic performance and rose to new highs in April. The S&P 500 rose 5.34% and the DJIA gained 2.78% for the month.[1] Despite concerns over the Biden administration's plan for a hike in the corporate tax rate and a significant increase in the long-term capital gains tax rate, stocks remained strong into the end of the month. Interest rates, reflecting investor's reassessment of the prospects for inflation, declined slightly during the month.

Equity valuations have remained in historically high territory and investor sentiment has now reached the level of optimism that usually leads at some point to a market pullback. However, monetary policy is accommodative and credit spreads are narrow. The team will be watching the Fed for any indication prior to the June Federal Reserve Board meeting that might suggest future tapering. Any hints of a less accommodative Fed might serve as a trigger to the long-awaited market correction.

After lowering market exposure several months ago, the investment team held market exposure steady throughout April, enabling the portfolio to participate in the market's move upward while still holding a cash position for cushioning. The team would raise market exposure once investor sentiment becomes less speculative, provided that the team's volume and breadth models remain positive. The team would become more defensive if the team's volume and breadth momentum models were to deteriorate.

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

Valuation: The S&P 500 median price-earnings multiple has climbed above its 2002 peak.[2] The previous high was 33.0x in 2002 and the current level is now 33.5x.[2] If profits continue to meet or exceed expectations in the first half of 2021 as expected, we could be seeing a cyclical peak in this ratio. The peak in price-earnings ratio coming a year or more after the stock market bottom is entirely consistent with stock market history.

Monetary factors and credit conditions: Interest rates eased in April. The yield of the 10-year U.S. Treasury Note declined to 1.65% from 1.69% recorded at the beginning of the month.[3] The recent easing of interest rates has moved the 26-week rate of change for the Moody's Corporate Baa Bond Index yield from negative back into the neutral zone.[2]

Credit spreads are still narrow, suggesting that there are no major credit problems at present.

This easing of rates has been favorable for the equity markets. However, commodity prices, which may be a leading indicator of future consumer prices, have surged in the last several months. The Reuters Continuous Commodity Index annual rate of change, using a three-week moving average, has now risen to its highest level since the Arab Oil Embargo in the early 1970s.[2]

The maxim "Don't fight the Fed" has been a good guide when assessing monetary policy and credit conditions. However, the investment team is closely monitoring the rate of change readings. An uptick in these readings could be an early indicator of a further rise in interest rates and potential future market weakness if interest rates move up again.

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Sentiment: Optimistic investor sentiment surged in April (negative from a contrary point of view). The American Association of Individual Investors (AAII) poll represents individual retail investors who tend to increase their stock purchases as the market approaches more risky levels. While these investors were largely pessimistic through most of 2020, they are now showing excessive optimism with bullishness reaching its highest level in three years.[2]

In addition, investors have now purchased a record amount of equity exchange-traded funds (ETFs). The 50-day moving average shows that the purchase of these largely passive investment vehicles has reached record highs in the last few months.[4] History teaches us that the most buying by the public will likely occur as the stock market nears its high point.

Momentum: "Don't fight the tape" has been the watchword for momentum. The investment team's measures of upside versus downside volume and the market's breadth are both positive. The investment team sees a minor divergence with the DJIA and S&P 500 reaching new all-time highs while only about 62% of all stocks are above their 10-week moving averages.[2] However, this divergence likely reflects the recent market rotation, which is a healthy phase of a market advance. Nonetheless, a continuation of this divergence would indicate a deterioration in market momentum.

[1] *Source: Bloomberg. April 30, 2021*
[2] *Source: Ned Davis Research. April 30, 2021*
[3] *Source: U.S. Department of Treasury. April 30, 2021*
[4] *Source: Ned Davis Research. May 3, 2021*