Market Update

May 1, 2022

The Russian invasion of Ukraine, global inflation, rising U.S. interest rates and a potential slowdown in worldwide economic activity took a big toll on stock prices in April. The S&P 500 Index dropped -8.72%, its worst performance during any April since 1970.[1] From January through April, the S&P 500 was down -12.92%.[1] Technology stocks were particularly hard-hit with the NASDAQ-100 Index down -13.34% for the month and lower by -21.06% for 2022.[1] Small cap stocks were also weak. The Russell 2000 Index fell -9.91% for the month and was lower by -16.70% for the year through April.[1] Defensive issues and large cap cyclical stocks showed slightly more relative strength. The Dow Jones Industrial Average declined by -4.82% for the month and was down -8.73% for January through April.[1]

The International Monetary Fund reduced its global growth estimate for 2022 from 4.4% to 3.6%, warning that Russia's invasion of Ukraine could lead to the fragmentation of the world economy into rival blocks.[2] The U.S. Commerce Department reported that U.S. gross domestic product (GDP) fell -0.4% in the first quarter.[2] This was the first decline in GDP since the early days of the pandemic and a sharp reversal from the rapid 1.7% growth in the fourth quarter of 2021.[2] However, consumer spending grew 0.7% in the first quarter of 2022 despite soaring gas prices and the continued wave of coronavirus infections related to the Omicron variant.[2] The 10-year U.S. Treasury Note yield climbed to just under 3% before easing back to end the month at 2.89%, up from 2.39% at the beginning of the month.[3] This was the highest yield for the 10-year U.S. Treasury Note since December 2018. Bond markets worldwide were also under pressure. The Bloomberg Global Aggregate Bond Index, a benchmark for government and corporate debt, fell -5.48% in April and was lower by -11.30% since the beginning of the year.[2]

Equity valuations continued to decline from their peak levels of a year ago due to better earnings comparisons and lower stock prices. However, equities remained in overvalued territory and were still high when adjusted for inflation. Investor sentiment turned increasingly pessimistic with the decline in stock prices, which is positive from a contrary point of view. On the monetary and credit fronts, the team's rate-of-change models for interest rates — for both Treasurys and corporates — remained in negative territory.

Following the first-quarter decline in GDP, investors wondered whether the U.S. Federal Reserve (Fed) would be able to engineer a soft landing without a recession, as happened in 1984, 1994 and 2004. The team's momentum models indicated that the stock market's internal position is somewhat weaker now than it was during those periods. And the Fed is unlikely to ease monetary policy as it did after those periods. Nonetheless, prior to most recessions, credit spreads widen, and the T-Bill/10-year U.S. Treasury yield curve inverts. So far, this has not happened. The team will be monitoring these indicators closely in coming months since the average stock market decline during a recessionary bear market has been over -30%.[4]

The team's volume and breadth momentum models remained negative during the month. The team maintained its robust defensive cash position to help weather any future market volatility while retaining its modest allocation to the large cap and value stocks sectors. The team would raise market exposure if volume and breadth momentum improved, interest rates stabilized, credit spreads remained narrow and investor sentiment remained pessimistic. The team would lower exposure further if interest rates continued their rise, credit spreads widened or if the team's short-, intermediate- and long-term volume and breadth momentum models deteriorated.

Continued next page
Disclosure next page

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

Valuation: Equity valuations have continued to improve but remained in overvalued territory. Price-earnings (P/E) multiples have declined from their high of 33.9x in early 2021 to 24.1x as of the end of April 2022.[4] But valuations were still above the 58-year median P/E ratio of 17.4x.[4] The team's measure of valuations adjusted for inflation also remained high. This measure could decline if inflation abates but continued inflationary pressures and a rise in interest rates would be negative for this valuation measure.

In March of 2021, the percentage of S&P 500 stocks with dividend yields greater than the 10-year U.S. Treasury Note climbed to an unprecedented high of 78%. Since then, interest rates have risen and this measure has plummeted. One year later, only 34% of S&P 500 stocks have a dividend yield greater than the 10-year U.S. Treasury Note yield. Whereas in the past many investors used the acronym "TINA" (There Is No Alternative) to describe the relationship between stocks and bonds, fixed-income yields have now become far more competitive when compared with equities. In the last decade, the tipping point for several market low points occurred when this percentage fell into the low 20% range or below, as it did in late 2018.[5]

Monetary factors and credit conditions: Interest rates continued to climb and the 10-year U.S. Treasury Note closed the month with a 2.89% yield, up from 2.39% at the beginning of the month. This increase kept the team's 26-week rate-of-change models for both the three-year U.S. Treasury Note and corporate bonds in negative territory. Further rises in interest rates would be negative for the team's rate-of-change models. However, a stabilization and/or decline in interest rates might suggest that the peak upward rates of change had been reached, which would be a positive development.

Credit spreads were still narrow through April although they have risen somewhat in recent months.[4] The spread between Treasurys and high yield corporate bonds was 408 basis points at the end of April. A rise above 500 basis points would be a negative development. The team will be watching credit spreads closely as the Fed moves to hike interest rates since a widening of spreads would be indicative of a deterioration in credit conditions.

Sentiment: Ned Davis Research's Crowd Sentiment Poll, a composite of a variety of sentiment indicators, has recently shown the most pessimism since the pandemic low two years ago. From a contrary point of view, this is a positive development. While this indicator has not yet reached the levels reached during 2018 and other market lows over the last decade, this is an indicator to watch closely as maximum pessimism is usually associated with market low points.[6]

Momentum: The team's intermediate volume and breadth momentum models continued in negative territory during April, as downside volume (supply) has exceeded upside volume (demand) since February. Since 1998, during those periods when supply has exceeded demand, the market has experienced a -5.30% negative annualized return while this condition persisted. A rise in upside volume above downside volume would be a positive development. Until then, the team believes the saying "Don't fight the tape" remains wise advice in these increasingly volatile markets.[4]

Continued next page
Disclosure next page

[1] *Source: Bloomberg. April 29, 2022*
[2] *Source: Bloomberg. May 1, 2022*
[3] *Source: U.S. Department of Treasury. May 1, 2022*
[4] *Source: Ned Davis Research. April 29, 2022*
[5] *Source: Ned Davis Research. March 31, 2022*
[6] *Source: Ned Davis Research. April 26, 2022*