In August, the rapid spread of the Delta variant of the coronavirus led to increased investor concerns over the potential for global supply chain problems and a more pronounced slowdown in U.S. and global growth. Asian markets weakened in August as Chinese authorities targeted a wide range of firms and industries (in addition to tech companies) with new regulations. Hong Kong's Hang Seng Index was down more than -20% from its most recent peak before rebounding at the end of the month.[1] Also weighing on investor's minds were the deadly attacks at the Kabul airport and the potential repercussions of a more chaotic withdrawal from Afghanistan than anyone had anticipated.

Despite these concerns, the S&P 500 Index, Dow Jones Industrial Average and NASDAQ-100 Index all recorded all-time highs in August, the seventh consecutive month of gains.[1] This market strength was bolstered by Federal Reserve (Fed) Chair Jerome Powell's remarks at the Fed's annual Jackson Hole meeting. Powell said that the Fed would likely begin to taper its asset purchases in the future but is not in a hurry to do so and would give the markets plenty of notice. Interest rates remained stable after his comments but showed a slight rise for the month. Credit spreads widened in August but are still narrow by historical standards.

As we noted in last month's commentary, the market continues to be characterized by divergences. The broad list of stocks has lagged the major market indices. There was some improvement in August as breadth became more positive but still only a little more than 60% of all stocks ended the month above their 10-week moving averages.[2] If this divergence between the large cap indices and the broad list of stocks continues, it could be the warning sign that often occurs prior to market corrections, although the timing of any market correction is always uncertain.

Investor sentiment was mixed in August. Short-term sentiment improved significantly with daily sentiment showing the most pessimism (positive from a contrary point of view) in a year. This is likely due to the reversal of the "reopening-of-the-economy" trade in which cyclical stocks that benefited from the economy reopening have declined while tech and growth stocks have strengthened. But longer-term investor sentiment is still quite negative (i.e., investors are overly bullish).

The investment team raised market exposure modestly in August by adding a position in financials due to increased relative strength in that sector. At month-end, the investment team had exposure to large cap stocks, technology, consumer staples and financials. The team would lower market exposure if interest rates were to rise once again or if the team's volume and breadth momentum models turned more negative, exacerbating the divergences between the major market averages and the broad list of stocks. The team would raise market exposure if investor sentiment remained pessimistic, interest rates and credit spreads remained stable, and if the team's volume and breadth models improved.

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

Valuation: The S&P 500 median price-earnings ratio has declined in the last month due to very strong earnings. But equities are still in overvaluation territory with the real generally accepted accounting principles (GAAP) earnings yield on the S&P 500 at its lowest level since the series began in 1967.[3] Historically, when the real earnings yield has been this low, the average return on the S&P 500 has been -10.6%.

Monetary factors and credit conditions: Interest rates rose slightly in August. The 10-year U.S. Treasury Note closed the month with a 1.30% yield, up from 1.20% at the beginning of the month.[4] The maxim "Don't fight the Fed" has been a good guide since the start of the bull market over a year ago and the monetary and credit environment continues to be a positive for the financial markets.

We would note, however, that Fed officials have indicated that they will slow their bond-buying program in the near future. The team will be keeping a close eye on interest rates and credit spreads. A rise in rates or a widening of spreads would be negative. Credit spreads have widened a bit in recent months, but they remain historically narrow at current levels.[2]

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Sentiment: Investor sentiment presents a mixed picture. Daily investor sentiment has improved in recent months, reflecting the market's volatility and the reversal of the "reopening" trade. The Ned Davis Research Daily Trading Sentiment Composite reached its highest level of pessimism (positive from a contrary point of view) in a year,[2] which is a positive development.

Longer-term measures of investor sentiment remain negative, however. The weekly NDR Crowd Sentiment Poll is in negative territory and investors hold a historically low level of cash relative to their stock holdings. The percentage of money market cash relative to stocks is now lower than it was during the market peaks of 2000 and 2007.[2] The low point in cash reserves was reached in 2008 at 9.06% and now stands at 9.40%

Momentum: Divergences between the major market averages and the broad list of stocks continued in August. While the S&P 500 hit a new all-time high during the month, only 60.8% of all stocks are above their 10-week moving averages.[3] This type of divergence, if it persists, usually indicates the possibility of some type of stock market correction.

1 *Source: Bloomberg. August 31, 2021*
2 *Source: Ned Davis Research. August 31, 2021*
3 *Source: Ned Davis Research. August 27, 2021*
4 *Source: U.S. Department of Treasury. August 31, 2021*