Stocks began August on a positive note, rising about 5% in the first few weeks and extending the gains from the June lows.[1] The stock market ran into resistance at mid-month, however, following U.S. Federal Reserve (Fed) Chair Jerome Powell's hawkish comments at the Fed's annual symposium in Jackson Hole, Wyoming. Chair Powell reiterated the Fed's commitment to tightening monetary policy to bring down inflation. After the announcement, stocks promptly reversed course and declined into the end of the month. During August, the S&P 500 Index fell -4.08%, the NASDAQ-100 Index lost -5.11% and the Russell 2000 Index was down -2.05%.[1] Bonds also declined sharply, and the 10-year U.S. Treasury Note ended the month with a 3.26% yield, up significantly from 2.60% at the beginning of the month.[2] The market's weakness strengthened some market observers' view that the recent market recovery has been merely a bear market rally to be followed by new lows. These observers point to tightening monetary policy by the Fed, inflation, possible declines in corporate earnings and profit margins, an economic slowdown in China and geopolitical tensions.

While the investment team cannot rule out the possibility that the market is experiencing a bear market rally, historical precedent tells us that in none of the earlier 13 bear markets since 1946 has a retracement of 50% of the decline, which occurred in August, been followed by a subsequent sell-off that exceeded the prior low.[3] In addition, the 50% retracement test worked for all but one of the 21 declines in excess of 15% since WWII.[3] The bear market of 1973-75 was the sole exception.

Equity valuations have declined well below their peak levels of a year ago. While this is positive, valuations often overshoot on the downside before the longer-term cycle is complete, and we might expect this measure to fall into undervalued territory sometime in the future before stocks are ready for a new sustained bull market. Investor sentiment, which had been a bright spot in the investment team's work as the market reached its June lows, rose back into negative territory as investors became more optimistic (negative from a contrary point of view). With the recent late August decline, however, investor sentiment turned more pessimistic, which is a positive sign. On the monetary and credit front, the recent rise in interest rates and the widening of credit spreads is negative.

The most significant change in the investment team's four pillar process following the market's June low has been in the team's volume and breadth momentum models. Signs of internal technical strength began in late July with several of the investment team's thrust signals firing, followed by additional firing from other thrust models. The team raised market exposure in early August but the rapid deterioration in momentum caused the team to cut back exposure to a more defensive position by month-end. The team would add to exposure if momentum became more positive, interest rates stabilized, credit spreads narrowed and investor sentiment grew more pessimistic. The team would lower exposure once again to a maximum defensive posture if interest rates rose, credit spreads widened or if the team's volume and breadth momentum models deteriorated further.

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

Valuation: The median price-earnings (P/E) multiple on the S&P 500 has declined from its high of 33.9x in early 2021 to 22.4x as of the end of August 2022. However, valuations were still above the 58.5-year median P/E ratio of 17.4x.[4] While this is positive for equities, a long-term view of this measure suggests that just as the market got to overvalued levels in 2021, we may see this measure fall into undervalued territory at some point in the future. On the other hand, this long-cycle view may take several years to unfold.

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Monetary factors and credit conditions: Interest rates rose significantly in August. The 10-year U.S. Treasury Note yield ended the month with a 3.26% yield, up from 2.60% at the beginning of the month. The 10-year/2-year U.S. Treasury yield curve has been inverted for several months. And now the 3-month/10-year curve looks like it is not far behind, having fallen to its lowest level since just after the 2020 pandemic-related stock market decline.[5] This is a negative development. However, we must remember that inversions of the yield curve have occurred coincident with market bottoms but also have persisted for a year or more before further weakness. Nonetheless, continued Fed tightening is a negative in the team's work.

Credit spreads widened in August. The spread between the yields on the Bloomberg U.S. Corporate High-Yield Bond Index and the 10-year U.S. Treasury Note stood at 531 basis points (bps) at the end of August, above its 22.6 year mean of 506.2 bps.[6] While this is not cause for alarm yet, a further widening of spreads would be a negative development.

Sentiment: Ned Davis Research's Daily Trading Sentiment Composite, a composite of a variety of shorter-term sentiment indicators, showed greater pessimism as the market declined in the last few weeks of August. [6] Investor sentiment has grown more pessimistic, which is a positive sign from our point of view.

Momentum: Momentum weakened with the market's late August decline and the team's longer-term volume and breadth models stalled in their improving trend. For instance, the team's supply-demand model of upside versus downside volume was on an improving trend as the market rallied off its June lows. However, upside volume has not been able to overtake downside volume [6] and this model remained in negative territory.

1 *Source: Bloomberg. August 31, 2022*
2 *Source: U.S. Federal Reserve. August 31, 2022*
3 *Source: CFRA Research. August 31,2022*
4 *Source: Ned Davis Research. August 31, 2022*
5 *Source: Ned Davis Research. August 26, 2022*
6 *Source: Ned Davis Research. September 1, 2022*

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