BROADMARK

Market Update

January 1, 2022

2021 was a year of growth for both the economy and the stock market. Most major market averages recorded all-time highs well into the end of the year. The S&P 500 Index recorded 70 new all-time highs, second only to the 77 new highs recorded in 1995.[1] The strength in stocks was fueled by good earnings growth, expanding price-earnings (P/E) multiples and accommodative Federal Reserve (Fed) policy, which kept interest rates historically low and credit spreads narrow.

Stocks ran into increased volatility in December as the Omicron variant of the coronavirus surged in the U.S. and globally. Many businesses, which had begun to reopen in anticipation of an ebbing of the pandemic, were forced to curtail or close operations as health officials warned that the Omicron variant could cause a surge in coronavirus infections and hospitalizations. Additionally, the uncertainty of the Biden administration's proposed legislation to address the ongoing pandemic and rebuild America's infrastructure dealt a setback to the market. And finally, significant supply chain disruptions occurred during the month, resulting in dislocations and rising prices. Inflation surged to its highest level in over 30 years.[2]

During 2021, equity valuations rose to levels not seen since the dot-com bubble of 2000 and the financial crisis of 2008. The median P/E multiple on the S&P 500 rose to a high of 34x earnings in May 2021 and equity valuations remained in historically high territory throughout the year. Inflationary pressures grew during the year and in November the Consumer Price Index (CPI) rose 6.8% year-over-year, the largest 12-month increase since June 1982.[2] As a result, the Fed announced a tapering of its asset purchases and signaled that it would likely begin raising interest rates in 2022. Interest rates rose with the 10-year U.S. Treasury Note ending the year at 1.52%, up from 1.43% at the beginning of December.[3]

Investor sentiment grew increasingly bullish during most of 2021 as stock prices rose. From a contrary point of view, this is a negative in our work because extremes in optimism usually signal caution. Stock market momentum, as measured by the investment team's volume and breadth measures, remained positive for most of the year but deteriorated toward year-end.

The investment team lowered market exposure in December as these measures indicated elevated market risk. The team was positioned in the large cap area, which has shown superior relative strength. Market exposure would be raised further if interest rates remain stable, credit spreads continue to narrow, investor sentiment grows more pessimistic and momentum remains positive. The team would lower market exposure further if interest rates rise, credit spreads widen or if the team's volume and breadth momentum models turn more negative.

The investment team has several concerns as we enter 2022. First, elevated absolute equity valuations could be adversely affected by a rise in interest rates. We believe interest rates are likely to rise in 2022, which would be negative for the financial markets. Investor sentiment has also climbed to very optimistic levels, which is negative from a contrary point of view. Finally, with divergences between the major market averages and the rest of the market, as well as the deterioration in the momentum models, the investment team believes that risks of a corrective market decline have increased as we enter the new year.

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

<u>Valuation</u>: Equities remained in overvalued territory although good earnings reports brought P/E multiples lower since their early 2021 peak. The median P/E ratio was 27.1x at the end of December, well above its 57.8-year median of 17.4x.[4] When P/E ratios were adjusted for inflation (the year-to-year change in the CPI), stocks were still in overvalued territory.[4]

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Monetary factors and credit conditions: Interest rates rose in December. The 10-year U.S. Treasury Note closed the month with a 1.52% yield, up from 1.43% at the beginning of the month. The team's 26-week rate of change for so the team will be watching this indicator closely.[4] 3-year U.S. Treasury Notes rose into negative territory[4] but the rate-of-change data for corporate bond yields did not confirm the negative readings on Treasurys. Nonetheless, further rises in interest rates would be negative for our rate-of-change models. Credit spreads ticked up a bit in December but were still narrow. A widening of credit spreads would be negative.

Sentiment: Investor sentiment declined in the fourth quarter from the extremely optimistic levels reached in the second quarter of 2021. This optimism was negative from a contrary point of view and was the most optimism we had seen in almost three years. While this bullish sentiment has declined from those extremes, it is still in negative territory.[5]

Momentum: The stock market's advance has been marked by a narrowing of leadership. Despite the S&P 500, Dow Jones Industrial Average and NASDAQ-100 Index hitting new all-time highs in the fourth quarter, only about half of all stocks were above their 10- and 40-week moving averages. At the end of December, the percentage of stocks above their 10-week moving averages was 50.7% and the percentage above their 40-week moving averages was 52.0%.[4] This is a meaningful negative divergence as the major averages have climbed to new highs. This divergence could be positively resolved by a broadening of participation by small cap stocks and the rest of the market. However, continued negative divergences would be negative for our momentum models. The team's breadth and volume measures declined with stock prices at the end of the month.

1 *Source: CFRA Research. January 4, 2022*
2 *Source: Bloomberg. January 4, 2022*
3 *Source: U.S. Department of Treasury. December 31, 2021*
4 *Source: Ned Davis Research. December 31, 2021*
5 *Source: Ned Davis Research. December 28, 2021*