COVID-19 cases began to decline in February as vaccines became more widely available throughout the U.S. Investor focus turned to a global economic recovery and the prospect of a new government stimulus package. U.S. Federal Reserve (Fed) Chair Jerome Powell said that the central bank is nowhere near pulling back its economic support measures, signaling that there is still a long way to go to reach the Fed's inflation and employment goals.[1] Market leadership switched from growth to cyclicals, as a widespread pickup in economic activity typically helps companies that are more sensitive to the economy. Growth stocks tend to command less of a premium in a strong economic recovery.

The change in market leadership could clearly be seen in sector performance during February. While the large cap indices such as the S&P 500 Index and Dow Jones Industrial Average gained 2.76% and 3.43%, respectively, during the month, the growth-oriented NASDAQ-100 Index declined -0.38%.2 Small cap stocks, which are typically expected to thrive in a more vigorous economic upturn, surged, with the Russell 2000 Index gaining 6.23%.[2] Investor expectations for a global recovery also helped global markets: the MSCI Emerging Markets Index gained 0.77% for February.

Equity valuations remain in historically high territory. And while low interest rates have made stocks attractive when compared with bonds or holding cash, anticipation for renewed vigor in economic activity caused a sharp move up in interest rates. The 10-year U.S. Treasury Note rose from 1.11% to 1.43% at month-end and had spiked as high as 1.61% during the month.[3] Despite this surge in interest rates, however, the investment team's rate of change indicators have not yet reached negative territory and credit spreads remain stable. The investment team's volume and breadth momentum models continued in positive territory.

The investment team maintained its diversified market exposure to large cap stocks, small cap stocks, emerging markets and the semiconductor sector in February. The team would raise market exposure once investor sentiment becomes less speculative provided that the team's volume and breadth models remain positive. Conversely, the team would become more defensive if the team's rate of change models for interest rates were to rise into negative territory or 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: A significant rise in interest rates would present a danger to the current elevated level of equity valuations. The percentage of stocks in the S&P 500 that have higher yields than the 10-year U.S. Treasury Note has recently fallen to 50.7%, its lowest level in over a year.[4] Despite the decline, this ratio is still high by historical standards. The ratio was 20% at the 2018 market peak.[4] Nonetheless, if interest rates continue upward, at some point, higher interest rates will result in a reassessment in the investment merits of stocks versus bonds.

Monetary factors and credit conditions: Interest rates rose in February to their highest level in over a year. The 10-year U.S. Treasury Note closed the month at a 1.43% yield, up from 1.11% at the beginning of the month after spiking to an intraday high of 1.61%.[3] Commodity prices have risen at their fastest annual rate since 2017. In addition, the 26-week rate of change for the Moody's Corporate Baa Bond Index yield has now moved up due to the recent rise in interest rates. [5]

Nonetheless, the investment team's rate of change indicators have a way to go before reaching levels seen at previous market peaks. In addition, credit spreads continue to narrow. Thus, despite the recent rise in rates, the maxim "Don't fight the Fed" continues to be a good guide when assessing monetary policy and credit conditions.

Sentiment: Investor sentiment improved during February and the investment team's daily sentiment composite reached its most pessimistic level (positive from a contrary point of view) in a few months.[5] While this is a positive development, from a longer-term perspective, investor sentiment remains quite optimistic. ETF equity inflows continue to be in record high territory [5] and margin debt is at an all-time high.[6]

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Momentum: The investment team's momentum measures of upside versus downside volume and the market's breadth are both positive. The market's leadership rotation from growth stocks to value/cyclical stocks is a normal occurrence in bull markets as the economic recovery gathers steam.

[1] *Source: Bloomberg. February 27, 2021*
[2] *Source: Bloomberg. February 28, 2021*
[3] *Source: U.S. Department of Treasury. February 28, 2021*
[4] *Source: Ned Davis Research. February 28, 2021*
[5] *Source: Ned Davis Research. February 26, 2021*
[6] *Source: Ned Davis Research. January 31, 2021*