BROADMARK

Market Update

February 1, 2022

Stocks kicked off the new year with their largest decline since the bull market began in the spring of 2020. Small cap stocks and the technology sector were the weakest areas, with the Russell 2000 Index down -9.63% and the NASDAQ-100 Index off by -8.49%.[1] The S&P 500 Index slipped almost -10% in the first few weeks of January but ended the month down -5.17%.[1] Cyclical and defensive stocks held up best with the Dow Jones Industrial Average lower by -3.24%.[1]

The good economic news was that the U.S. economy surged by 5.7% in 2021, the largest annual increase since 1984.[1] The bad news was that inflation also surged, interest rates rose and the U.S. Federal Reserve (Fed) announced that it would begin hiking interest rates. The Consumer Price Index (CPI) rose 7% year-over-year in December 2021, its highest level in 40 years,[1] while the 10-year U.S. Treasury Note yield reached its highest yield since late 2019. Fed Chair Jerome Powell indicated an interest rate hike would occur in March and made it clear that policymakers would act as needed to cool the hottest inflation in 40 years. The central bank also said that it would start to shrink its balance sheet after rate increases begin. Adding to the uncertainty in January was President Biden's warning that Russia may invade Ukraine in mid-February. The Kremlin continued to deny that it has any intentions of an invasion despite massing thousands of troops, tanks and equipment near its neighbor's eastern border.

Equity valuations have been elevated for quite some time on an absolute basis. With the recent higher inflation rates, valuations relative to inflation have confirmed those high absolute valuations. Investor sentiment grew increasingly bullish last year as stock prices rose but dropped into more positive territory in January. The investment team's rate-of-change models for interest rates — for both Treasurys and corporate bonds — climbed into negative territory. Two bright spots in the monetary and credit picture were that credit spreads remained narrow and the yield curve, while flattening, had not inverted, which would be a negative signal. The 10-year U.S. Treasury Note rose as high as 1.88% during the month before settling at 1.79%, up from 1.63% at the beginning of the month.[2]

The team decreased market exposure to a maximum defensive position in January due to deterioration in its volume and breadth momentum models. Rising interest rates and the deterioration in the rate-of-change indicators also contributed to the more defensive posture. The team is now looking for signs that would indicate the next buying opportunity following the market's correction. Market exposure would be raised if momentum improved, interest rates stabilized, credit spreads remained narrow and investor sentiment grew more pessimistic. The team would remain in a defensive posture — and possibly initiate short positions — if interest rates rose, credit spreads widened or, most importantly. if the team's volume and breadth momentum models remained negative.

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

Valuation: Equities remained in overvalued territory in January. While price-earnings multiples declined from their peak in early 2021, the team's measure of valuations adjusted for inflation remained high.[3] Continued inflationary pressures and a rise in interest rates would be negative for this valuation measure.

Monetary factors and credit conditions: Interest rates rose in January. The 10-year U.S. Treasury Note closed the month with a 1.79% yield, up from 1.63% at the beginning of the month. The team's 26-week rate of change for 3-year U.S. Treasury Notes rose into negative territory.[4] The rate-of-change data for corporate bond yields also climbed into negative territory. Further rises in interest rates would be negative for our rate-of-change models.

Continued next page
Disclosure next page

Sentiment: Investor sentiment improved in January as stock prices declined. Investors showed increased pessimism, which is positive from a contrary point of view.[5] From a longer-term perspective, however, some measures of speculation were still high in January. Margin debt as a percentage of gross domestic product (GDP) remained near its all-time high, indicating a level of speculation that compares with the 2000 dot-com bubble and the 2008-2009 financial crisis. This measure of speculation, as well as large inflows into equity mutual funds, indicate a high level of optimistic investor sentiment, which is negative from a contrary point of view.[6]

Momentum: The team's intermediate- and long-term volume and breadth momentum models both turned negative in January. This was the first time this has happened since the pandemic-related market decline in early 2020.[3] Momentum acts as the team's risk management tool and these negative readings guided the team to take a maximum defensive position.

[1] *Source: Bloomberg. January 31, 2022*
[2] *Source: U.S. Department of Treasury. January 31, 2022*
[3] *Source: Ned Davis Research. January 31, 2022*
[4] *Source: Ned Davis Research. January 28, 2022*
[5] *Source: Ned Davis Research. January 25, 2022*
[6] *Source: Ned Davis Research. December 31, 2021*