The stock market got off to a good start in January with all the major market indexes posting gains. Technology stocks led the way with the NASDAQ-100 Index jumping 10.67%.[1] Small cap stocks were also strong with the Russell 2000 Index rising 9.75%.[1] The S&P 500 Index was up 6.29% but the Dow Jones Industrial Average trailed the other averages with a smaller gain of 2.93%.[1] Lower inflation expectations, declining interest rates and hopes that the Federal Reserve has reached its maximum point of tightening all contributed to the market's strength. Bolstering these expectations were reports that consumer spending fell in both November and December 2022 and consumer prices rose 5% in the year through December, the slowest pace in more than a year.[2] The 10-year U.S. Treasury Note yield fell from 3.79% at the beginning of the month to 3.52% at the end of the month.[3]

While equity valuations were still above their historical mean, valuations improved in the last year with a decline in inflationary expectations. Inflation fears now appear to be shifting to a widely anticipated decline in earnings. However, some of the January strength could be attributed to recent earnings reports having held up better than many had expected. On the monetary front, yields at the long end of the yield curve have declined, although short-term interest rates remain sticky, resulting in a continued inversion of the yield curve. The three-month/10-year U.S. Treasury yield curve reached the most negative since the 2008-09 financial crisis. Historically, while timing is always uncertain, this inversion has often been a leading indicator of a future recession. In addition, since 1962 the market has shown a negative return during the periods when the 3-month/10-year yield curve was inverted. The market's momentum has shown improvement in the last month. The team's volume and breadth momentum models have improved and are now nearing positive territory. In fact, the strength in the last month has triggered several upside thrust indicators. A confirmation of these thrust indicators by our Volume/Breadth-Based Momentum model would be necessary to confirm these positive thrust indications.

The team remained defensively positioned during January. In view of the improvement in momentum, however, the team stands ready to raise exposure if interest rates continue to moderate, investor sentiment returns to pessimistic levels and if the team's volume and breadth momentum models turn positive. The team would maintain its maximum defensive positioning if interest rates once again began to rise, investor sentiment remains optimistic and if the team's volume and breadth momentum models do not improve.

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

Valuation: Price-earnings ratios adjusted for inflation (defined as the year-to-year change in the Consumer Price Index (CPI) have declined from their lofty levels of a year ago and are now at their lowest level in two years. However, equity valuation by this measure is still above its historical mean. The team believes that this readjustment process may have further to go before equities become more fairly valued.[4] A decline in either stock prices or earnings or both would improve valuations.

Monetary factors and credit conditions: The yield curve comparing the three-month U.S. Treasury Bill yield with the 10-year U.S. Treasury yield is now at its greatest inversion since the 2008-09 financial crisis. This inversion has occurred less than 12% of the time since 1962. Historical statistics show that during times that these inversions persisted, the S&P 500 declined at an annual rate of -1.15%.[4]

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Sentiment: The market's January rally propelled the team's daily investor sentiment model to its most optimistic level in two years. This is negative from a contrary point of view and suggests at least a temporary stock market pullback might be on the horizon in the near term after the strong January gains.[4]

Momentum: The team's breadth momentum model, which measures the breadth of Standard & Poor's industry groups, has now reached its best level in a year.[5]

While this is a positive development, the team's volume momentum model, which compares upside volume with downside volume, has also improved but has not yet reached positive territory.[4] Continued strength in both these models would be a very positive sign for the market.

[1] *Source: Bloomberg. January 31, 2023*
[2] *Source: CBS News. January 27, 2023*
[3] *Source: U.S. Department of Treasury. January 31,2023*
[4] *Source: Ned Davis Research. January 31, 2023*
[5] *Source: Ned Davis Research. January 27, 2023*