BROADMARK

Market Update

August 1, 2022

The Federal Reserve (Fed) raised the federal funds rate by 75 basis points (bps) in July, the second consecutive 75-bps hike this year.[1] The Fed has now taken some of the most aggressive actions since the Federal Open Market Committee (FOMC) began announcing federal funds actions in 1990. Only during the years of 1980–1981 was the Fed more aggressive — with four consecutive increases of 100 bps in the discount rate.[2] In the days following the Fed announcement, the Bureau of Economic Analysis reported that the U.S. economy shrank again for the second straight quarter at a 0.9% annualized rate. Historically, two consecutive quarterly declines in gross domestic product (GDP) have often signaled a recession. Despite these reports of economic weakness, the U.S. Department of Commerce reported that personal consumption expenditures, the Fed's preferred inflation gauge, rose 6.8% from a year ago in June, the sharpest rise since January 1982.[3]

Against this rather gloomy backdrop of declining economic activity and continued inflation, Fed Chair Jerome Powell strongly reaffirmed the Fed's determination to bring inflation back to the 2% level. Investors were buoyed by Powell's comments and stocks continued to rise from their mid-June lows. In July, the S&P 500 Index gained 9.22%, its best monthly gain since November 2020.[2] The NASDAQ-100 Index rose 12.60% and the Russell 2000 Index was up 10.44%.[2] Bond prices also continued their upward climb with the 10-year U.S. Treasury Note yield falling from 2.88% at the beginning of the month to 2.67% at month-end.[4]

Some observers have noted that two consecutive down quarters in GDP has usually indicated that we are in a recession. Others have said that we may be in a "technical" recession since job growth and wage increases have remained so strong. For example, the U.S. Department of Labor reported that wages and benefits rose 5.1% in the second qu the fastest rate of increase since 2001.[5] This is an unusually mixed picture but is important since historically the stock arter, market has typically bottomed prior to the end of a recession. If we are indeed in a recession, technical or not, we should be on the lookout for signs of a possible bottom in stocks.

In the post-WWII period, the Fed has usually stopped its tightening cycle before the economy has entered a recession. The only exception was during 1973-1974 when the recession started in November of 1973, but the Fed kept hiking rates into April 1974.[6] Currently, external factors such as the coronavirus pandemic and the war in Ukraine have complicated the economic picture. As a result, the Fed is in an unusual position of tightening into an economic downturn. The investment team will look to the four pillars of its investment process to guide its actions through these unusual times.

Equity valuations were below their peak levels of a year ago, which is positive. However, equities remained in modestly overvalued territory and were still relatively high when adjusted for inflation. On the monetary and credit front, credit spreads have remained stable and interest rates have declined well off their June highs, which are both positive developments. Investor sentiment, which had been a bright spot in the investment team's work as the market reached its June lows, was back in neutral territory in July as investors became more optimistic (negative from a contrary point of view) with the market's rally.

The market's July rally showed signs of internal technical strength with several of the investment team's thrust signals firing. For instance, there were two back-to-back 10-to-1 upside days in terms of advancing issues versus declining issues, which were followed by several other thrust signals in the final days of the month.[6] Further signs of upside thrust would suggest upside potential for stocks and the team will be watching closely for more signs of improving market momentum.

Continued next page

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The investment team retained a defensive portfolio position in July. However, the team will raise market exposure if volume and breadth momentum improve, particularly if there are further upside thrust readings given by our volume and breadth models. The team would adopt a defensive position if interest rates rose, credit spreads widened or if the team's short-, intermediate- and long-term volume and breadth momentum models deteriorated.

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

Valuation: Equity valuations have continued to improve but remained in modestly overvalued territory. The median price-earnings (P/E) multiple on the S&P 500 declined from its high of 33.9x in early 2021 to 22.7x as of the end of July 2022, ticking up a notch from June due to the rise in stock prices. Valuations were still above the 58.4-year median P/E ratio of 17.4x.[6] The team's measure of valuations adjusted for inflation also remained relatively high.

Monetary factors and credit conditions: Interest rates declined in July. After reaching a yield of 3.48% in June, the 10-year U.S. Treasury Note yield declined considerably and closed July with a 2.67% yield, down from 2.88% at the beginning of the month.[4] Credit spreads also remained stable in July. [7] A widening of spreads would be indicative of a deterioration in credit conditions. However, despite the Fed's interest rate hikes, we have not seen this type of deterioration.

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 stock market decline.[8] However, despite the two down GDP quarters, credit spreads have remained stable and interest rates have fallen significantly from their highs, largely due to the Fed's determination to fight inflation. It is good to remember that inversions of the yield curve have sometimes occurred coincident with market bottoms and at other times have persisted for a year or more before any further stock market weakness. Right now, investors are focused on the Fed using its tools to fight inflation, which is a positive development from a monetary and credit point of view.

Sentiment: Ned Davis Research's Daily Trading Sentiment Composite, a composite of a variety of shorter-term sentiment indicators, has shown the most optimism since March during this most recent market rally.[7] Thus, while this indicator had turned positive at the June lows, it climbed back into neutral territory in July.

Momentum: The stock market recorded two back-to-back days in which advancing issues led declining issues by a margin of 10-to-1 in July. This was followed by several other thrust signals, which were triggered in the final days of the month. We consider these positive developments.

[1] *Source: U.S. Federal Reserve. July 28, 2022*
[2] *Source: Bloomberg. July 29, 2022*
[3] *Source: U.S. Department of Commerce and Bloomberg. July 29, 2022*
[4] *Source: U.S. Department of Treasury. July 29, 2022*
[5] *Source: U.S. Department of Labor. July 29, 2022*
[6] *Source: Ned Davis Research. July 31, 2022*
[7] *Source: Ned Davis Research. July 28, 2022*
[8] *Source: Ned Davis Research. July 22, 2022*

Continued next page
Disclosure next page