BROADMARK

Market Update

July 1, 2023

After 10 consecutive interest rate hikes, the Federal Reserve (Fed) paused in June and kept the federal funds target rate steady. However, Fed Chair Jerome Powell indicated that there could be two more hikes to come by the end of the year. Chair Powell's comments caused some brief market weakness, but stocks rebounded strongly by the end of the month. The S&P 500 Index closed the month with a 6.61% gain, the Dow Jones Industrial Average was up 4.68%, the Nasdaq-100 Index gained 6.55% and the lagging Russell 2000 Index sprang back to life with an 8.13% gain.[1] The improved breadth of the market could be seen in the strong 7.72% gain for the S&P 500 Equal Weight Index.[1]

At its high in June, the S&P 500 had risen 20% from its October 2022 low, leading many analysts to say that a new bull market was underway. Indeed, historically, whenever the S&P 500 closed 20% above the prior bear market low, it gained an average of 14.5% over a five-month period before stumbling into a correction averaging 10%.[2]

Equity valuations remain above their historical average, both in absolute terms and relative to inflation. Monetary policy is negative as inflation remains stubbornly high. But credit spreads are narrow and do not indicate a deterioration in credit conditions. Also, interest rates have remained relatively stable. While the bond market was jittery over inflation and the pending debt ceiling resolution, the 10-year U.S. Treasury Note yield rose only modestly during June to 3.81% from 3.61% at the start of the month.[3] The big change this month in the team's four pillars was in investor sentiment. Several of the team's measures of investor sentiment rose into negative territory. Most notably, the retail investor, as measured by the American Association of Individual Investors (AAII) Sentiment Index, rose to its most optimistic level in almost a year, which is negative from a contrary point of view.

The stock market's strength improved the team's volume and breadth models. As a result of this improvement, the team added to market exposure in the large cap sector. The team would raise exposure further if interest rates declined, investor sentiment again grew pessimistic and if the team's volume and breadth momentum models showed more improvement. The team would lower exposure if interest rates rose, credit spreads widened and if the team's volume and breadth momentum models once again deteriorated.

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

Valuation: The S&P 500 median price-earnings (P/E) ratio (using trailing 12-month earnings) rose to 26.0x, its highest level in a year.[4] From a longer-term perspective, it appears that equity valuations are still too high and have further to decline during this cycle.

Monetary factors and credit conditions: Interest rates rose in June. The 10-year U.S. Treasury Note yield rose to 3.81% from 3.61%. Despite the concern over the banking system, however, credit spreads have remained stable, suggesting that the regional banking crisis has not spilled over into the general economy.[4] While Chair Powell has indicated the possibility of further rate hikes to come, if May's hike was the last rate hike of this cycle, since 1928 the stock market has been lower in the six- and 12-month periods more than half of the time after the final hike. If there are further hikes ahead, then the stock market could stay higher in coming months until the final hike.

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Sentiment: The most significant change in sentiment in June was the return of the retail investor. The AAII Index soared to its highest level in almost two years. Despite this rise, the AAII index has not reached the optimism achieved at the late 2021 market high.[4] However, the NDR Trading Sentiment Composite, which measures short-term investor sentiment, showed the most optimism in several months and is now in negative territory. Likewise, the NDR Crowd Sentiment Poll, which measures intermediate-term sentiment, has now risen to its highest level since the market peak in January 2022.[5] We would note that in the initial stages of a market rally, bullish investor sentiment fuels the rally and provides demand. It is at the extremes that investor sentiment becomes problematic. Nonetheless, investor sentiment must be judged to have now entered negative territory.

Momentum: The team's volume and breadth models improved in June. This improvement alleviated some of the negative divergences in the performance of the leading tech and large cap stocks versus the rest of the market that has persisted since the beginning of the year. Nonetheless, following such narrow market leadership, the stock market's return on average has been below its long-term norms one year later. The two worst periods came after two of the most notable periods of narrow leadership in Wall Street history: the Nifty Fifty era of the early 1970s and the dot-com bubble in the late 1990s.

[1] *Source: Bloomberg. June 30, 2023*
[2] *Source: Sam Stovall, CFRA Research. June 14, 2023*
[3] *Source: U.S. Treasury Department. June 30, 2023*
[4] *Source: Ned Davis Research. June 30, 2023*
[5] *Source: Ned Davis Research. June 26, 2023*

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