In March, the stock market celebrated its first anniversary since the 2020 low with new all-time highs for the S&P 500 Index and the Dow Jones Industrial Average (DJIA). The S&P 500 rose 4.38% and the DJIA gained 6.78% for the month.[1] The superior performance of the DJIA reflected the continued rotation to value and cyclical companies, which are expected to do well in a cyclical economic recovery. By contrast, the NASDAQ-100 was up only 1.37% for the month, as growth stocks with higher price-earnings multiples took a back seat to cyclicals.[1]

The Biden administration announced plans to invest $2 trillion in spending and tax credits on a wide range of efforts to bolster the economy. However, it looks like plans to rebuild U.S. infrastructure may have a difficult path through Congress as Republicans object to the corporate tax hikes that will be required to pay for it. Democrats, on the other hand, think the package is not enough. If the package is broken into several parts, lawmakers may not complete negotiations until September or October, which will likely add an element of fiscal policy uncertainty into the markets. On the monetary front, Federal Reserve (Fed) Chair Jerome Powell and Treasury Secretary Janet Yellen were asked in congressional testimony if this increased spending would lead to a surge in inflation. Both reassured bond market investors that inflation would be transitory and policy would remain accommodative.

Equity valuations remain in historically high territory. And while low interest rates have made stocks attractive when compared with bonds or holding cash, anticipation of renewed vigor in economic activity has continued to drive up interest rates. The 10-year U.S. Treasury Note rose from 1.43% to 1.74% during March.[2] This rise in interest rates caused the investment team's rate of change indicators to enter negative territory. However, credit spreads remained stable indicating no immediate credit problems. The investment team will be monitoring its monetary and credit models closely in coming weeks and months. Volume and breadth momentum models continued in positive territory.

The investment team lowered its market exposure during March by eliminating its positions in small cap stocks, emerging markets and semiconductors. The team concentrated portfolio exposure in large cap stocks. The team would raise market exposure when 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 become more negative 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: Rising interest rates pose a potential threat 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 fallen to 47.76%, its lowest level in over a year.[3] Despite the decline, however, this ratio is still high by historical standards. For instance, the ratio was 20% at the 2018 market peak. Nonetheless, if interest rates continue upward, at some point, higher interest rates will trigger a reassessment of the investment merits of stocks versus bonds.

Monetary factors and credit conditions: Interest rates continued to rise in March. The 10-year U.S. Treasury Note closed the month at a 1.74% yield, up from 1.43% at the beginning of the month.[2] 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 into negative territory.[4]

Although the rise in interest rates is negative in our work, credit spreads are still narrow, suggesting that there are no major credit problems at present. The maxim "Don't fight the Fed" continues to be a good guide when assessing monetary policy and credit conditions. That said, the investment team is closely monitoring the negative rate of change readings, which could be an early indicator of future market weakness.

Sentiment: Investor sentiment remained optimistic (negative from a contrary point of view) in March.[5] In addition, the team's longer-term sentiment models have climbed into negative territory. Exchange-traded fund (ETF) equity inflows continued to be in record high territory[2] and margin debt hit an all-time high.[6]

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Momentum: "Don't fight the tape" has been the watchword for momentum. The investment team's measures of upside versus downside volume and the market's breadth are both positive. The market's leadership rotation from growth to value/cyclical stocks is a normal occurrence in bull markets as the economic recovery gathers steam.

[1] *Source: Bloomberg. March 31, 2021*
[2] *Source: U.S. Department of Treasury. March 31, 2021*
[3] *Source: Ned Davis Research. March 31, 2021*
[4] *Source: Ned Davis Research. March 26, 2021*
[5] *Source: Ned Davis Research. March 30, 2021*
[6] *Source: Ned Davis Research. February 28, 2021*

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