BROADMARK

Market Update

October 1, 2023

Stocks declined in September for the second consecutive month, as investors continued to be concerned that the U.S. economy in general and unemployment in particular are stronger than the Federal Reserve (Fed) wants. The stronger-than-expected economic activity increased the likelihood that the Federal Open Market Committee would raise rates at either or both the November and December meetings and delay the start of the rate-cutting cycle until mid-2024. In addition, there were several negative developments weighing on the market such as the United Auto Workers strike, high consumer debt and the surge in both the 10-year U.S. Treasury Note yield and U.S. dollar. The U.S. dollar is up 6.5% since the July high and oil is up 65% from its trough.[1] The S&P 500 Index closed the month with a loss of -4.77%, the Dow Jones Industrial Average was down -3.42% and the Nasdaq-100 Index declined -5.89%.[1] The Russell 2000 Index fell -5.01% while the equal-weighted S&P 500 Index lost -5.08%.[1]

Equity valuations remained above their historical average. Adjusted for inflation, valuations began to improve due to the decline in the Consumer Price Index. Nonetheless, both absolute and inflation-adjusted valuations remain elevated. Monetary policy continued to be negative as the Fed maintains its fight to bring inflation to the 2% level, with interest rates rising to their highest levels since the 2008–2009 financial crisis and the possibility of further hikes ahead. One positive note is that the team's short-term measure of investor sentiment improved after July's negative readings.

The investment team's volume and breadth models both dropped into negative territory, which triggered the team's disciplined risk management process. The portfolio management team took the portfolio to a maximum defensive posture. This defensive exposure has allowed the portfolio to take advantage of the rise in Treasury bill rates. At month's end, both the 1-month and 3-month U.S. Treasury Bill rates yielded more than 5.50%.[2]

The team would consider initiating opportunistic short sales if interest rates continued to rise, credit spreads widened and if the team's volume and breadth momentum models deteriorated. The team would raise exposure if interest rates declined, investor sentiment reached a pessimistic extreme and if the team's volume and breadth momentum models showed improvement.

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) fell to 23.8x last month after reaching the highest level in a year in July. Valuations are still above the 59.6-year average of 17.6x.[3] Much of the rise in valuations this year has come from an expansion of P/E multiples rather than from increases in underlying earnings or profits. From a longer-term perspective, therefore, it appears that equity valuations have further to decline to more fairly valued levels during this cycle.

Monetary factors and credit conditions: The 10-year U.S. Treasury Note yield rose to 4.59% at the end of the month, up from 4.18% at the beginning of September. As has been the case during most of the year, however, credit spreads remained narrow. However, we would note that while credit spreads have narrowed to their lowest levels of the year, indicating no signs of significant credit problems, the high-yield ratio (high-yield corporate bonds divided by 10-year U.S. Treasurys) is now nearing readings of excessive optimism, which has historically been negative from a contrary point of view.[4]

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Sentiment: Investor sentiment has backed off from the more extreme optimistic levels reached at the end of July. The team's intermediate-term measure of sentiment has declined into neutral territory while the more sensitive daily sentiment composite is nearing positive territory.[5]

Momentum: The team's measures of volume and breadth both turned negative in September. Ned Davis Research's "Big Mo" Multi-Cap Tape Composite, which measures breadth within the 11 S&P 500 industry groups, fell into negative territory.[4] Down volume (supply) exceeded up volume (demand), which turned this indicator into negative territory as well.[4]

[1] *Source: Bloomberg. September 30, 2023*
[2] *Source: U.S. Department of Treasury. September 30, 2023*
[3] *Source: Ned Davis Research. September 30, 2023*
[4] *Source: Ned Davis Research. September 29, 2023*
[5] *Source: Ned Davis Research. September 26, 2023*