BROADMARK

Market Update

May 1, 2020

The S&P 500 Index recorded its best month since January 1987, rising 12.68% in April.[1] This strong rally was bolstered by anticipation of a phased return to economic activity and hopes for development of a potential coronavirus treatment. More than a dozen states had either started or announced plans to allow previously shuttered businesses to operate again, although some public health experts warned that opening for business too early could be dangerous. The number of COVID-19 cases passed the one million mark during April and there have now been over 71,000 deaths in the U.S. from the virus.[2]

The market's strength benefited from new Federal Reserve (Fed) initiatives to provide liquidity to the markets. The Fed announced that it would pump an additional $2.3 billion into the U.S. economy.[3] This stimulus package comes on top of the Fed cutting its benchmark interest rate to near zero and supplying more than $1 trillion to purchase Treasury and mortgage-backed securities.[4] On the fiscal side, Congress passed an economic relief measure worth $483.4 billion that would replenish a popular small-business loan program and provide funding for hospitals facing financial shortfalls due to COVID-19.[1]

The investment team began to see some encouraging signs during April. First, valuations remained low as compared to the highs reached in 2018. Second, monetary policy was expansive and, although credit spreads remained wide, spreads had begun to narrow. Third, investor bearish sentiment reached its highest level since the 2008-2009 financial crisis and exceeded the bearishness seen at the stock market lows of 2016 and 2018. Fourth, several of the investment team's measures of market momentum reached their most oversold levels in many years. As a result, the team gradually increased market exposure during April, targeting large cap equities and technology stocks, sectors which have shown the most relative strength. In order to continue to increase exposure, the investment team will need to see its longer-term volume and breadth momentum measures improve further. The team is now watching a variety of thrust indicators, which measure the strength of market rallies in terms of volume and breadth.

On the other hand, it's important to remember that after major waterfall-type declines like the one that occurred in March, the market has often tested or broken its lows prior to the start of a sustained recovery. In coming weeks, if investor sentiment recycles to optimism (negative from a contrary point of view), the market gets overbought and our longer-term volume and breadth momentum models remain negative, the team could once again move to a maximum defensive posture and consider using short positions during any subsequent market decline.

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

Valuation: Valuations declined to their lowest level in over six years during the March market decline but rose during the April market advance. The S&P 500 median price-earnings ratio is now 21.7x, still well below its 15-year high of 26.8x reached in January 2018.[5] Due to the slowing economy, earnings will show a significant decline in coming months and price-earnings ratios will begin to rise from current levels. This is a normal occurrence in a business and stock market cycle. The stock market is a leading indicator that discounts changes in earnings at inflection points. Nonetheless, the recent stock market decline has brought equity valuations lower, which is positive.

Monetary factors and credit conditions: Interest rates were largely unchanged in April. The 10-year U.S. Treasury Note began the month at a 0.62% yield and ended the month at 0.64%.[6] The Fed's aggressive moves to provide liquidity to the markets has been positive for equities. And while the team was concerned that credit spreads rose to their widest level since the financial crisis of 2008-2009,[7] the Fed's new quantitative easing program and $2.3 trillion fiscal stimulus package have addressed credit issues. As a result, credit spreads have begun to narrow. A further narrowing of spreads from these levels would be positive for the monetary and credit picture.

Sentiment: Pessimistic investor sentiment reached levels not seen since the 2011 stock market low, which is positive from a contrary point of view. And despite the strong April stock market rally, investor sentiment has remained cautious, which is also positive. [7]

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Momentum: The team's measures of volume and breadth reached severely oversold levels during the March stock market decline, rivaling levels reached at or near other stock market bottoms. For instance, the percentage of stocks above their 10- and 30-week moving averages fell to their lowest levels since the 2008-2009 lows, and, before that, the 1987 low. [8] The other times these measures reached such extremes were at the market lows of 2011, 2016 and 2018.

While these types of oversold extremes often occur at or near market bottoms, sometimes there are multiple tests of the low, or new lows, prior to the final low point. That is why the team's investment process requires an upside confirmation of a change of trend before significantly raising exposure. We will be measuring the upward thrust of volume and breadth on any rally from oversold levels.

A key indicator of an intermediate- to long-term change in trend is upside versus downside volume. Currently, downside volume is still above upside volume. Since 1981, when downside volume has been above upside volume, the S&P 500 has recorded a -5.28% annual return.[7] A move of this indicator back into positive territory is one of the signals the team will be looking for to indicate a more durable change in trend.

[1] *Source: Bloomberg. April 30, 2020*
[2] *Source: CNBC. May 6, 2020*
[3] *Source: U.S. Federal Reserve. April 9, 2020*
[4] *Source: U.S. Federal Reserve. March 16, 2020*
[5] *Source: Ned Davis Research. April 30, 2020*
[6] *Source: US. Department of Treasury. April 30, 2020*
[7] *Source: Ned Davis Research. May 5, 2020*
[8] *Source: Ned Davis Research. May 1, 2020*