BROADMARK

Market Update

March 1, 2020

Fear over the impact of the coronavirus on global economic growth hit the global markets hard during February with the major U.S. market indexes recording their worst month since February 2009. The S&P 500 Index was down -11.44% during the last week of February and declined -8.23% for the month.[1] This decline is one of the fastest and steepest stock market reversals since World War II, as the major averages had recorded all-time highs just days prior to the market's worst week since 2008. The pneumonia-like coronavirus was first identified in China and has now spread around the world, increasing fears of disruptions to worldwide commerce, particularly in Asia.

On the last day of February, Federal Reserve (Fed) Chair Jerome Powell issued a statement saying that the fundamentals of the economy remained strong but that the coronavirus posed evolving risks to economic activity. Powell indicated that the Fed would be closely monitoring developments and that it would act as appropriate to support the economy. Investors were buoyed by the Fed's statement and stock prices rose off their intraday lows on that day. Nonetheless, the flight to the safety of Treasury securities continued and interest rates declined to or near their lowest levels on record. The 10-year U.S. Treasury Note (10-year Note) ended the month with a yield of 1.13%, down from 1.54% at the beginning of February.[2] This is the lowest yield on the 10-year Note in modern U.S. history.

The investment team began lowering market exposure in January due to elevated optimistic investor sentiment (negative from a contrary point of view) and high equity valuations. As February's stock market weakness unfolded, the team lowered exposure to the maximum defensive position as the strategy's volume and breadth models both turned harshly negative. It was the first time that the team took a maximum defensive position since the severe stock market decline of late 2018.

With the Fed's statement of reassurance and interest rates at historically low levels, a positive for equities relative to bonds is that 70% of all stocks in the S&P 500 now have a higher yield than the 10-year Note — the highest percentage in over 50 years.[2] On the other hand, the decline in the longer end of the yield curve has once again caused the yield curve to invert. The 1-month Treasury Bill yield of 1.45% is now 32 basis points above the 10-year Note's yield of 1.13%.[3] As we have noted before, yield curve inversions have often preceded recessions and market downturns, although the timing is uncertain and has ranged from a few months to several years. Another danger signal on the otherwise positive monetary front that occurred in February is that one measure of credit spreads (the ratio of Bloomberg Barclays U.S. Corporate High Yield Bond Index yield to the yield on the 10-year Note) widened to its highest level in almost three years. Further deterioration in credit spreads from this point would be negative for the monetary picture, despite the low level of interest rates.

In order to raise exposure, the investment team will need to see its volume and breadth momentum measures stabilize and turn positive. The team would also like to see its measures of investor sentiment recycle toward more pessimism, which would be positive from a contrary point of view. This happened quickly during the last week of February. As has happened in years past, an interest rate cut by the Fed to provide liquidity to the market could quickly turn the market to the upside and mark a bottom. The team is closely monitoring Fed activity and will be quick to respond should this happen

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

1. **Valuation:** The S&P 500 median price-earnings (P/E) ratio stands at 21.8x at the end of February, declining from its highest level in a year.[2] The historically low level of interest rates and the Fed's more dovish stance have provided a generally positive environment for these higher valuations. However, while the median P/E ratio remains below its 15-year high of 26.8x reached in January 2018 [2], this indicator shows that the market has risen into overvalued territory on an absolute basis. On the other hand, a positive for equities is that 70% of the stocks in the S&P 500 have a higher dividend yield than the 10-year Note, the highest level in at least 50 years. Of course, this measure is based upon the current level of dividends. A slowdown in global economic activity due to the coronavirus could change this situation quite rapidly if corporations see a bleaker outlook for profits and reassess their dividend policies.

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One longer-term measure of equity valuation is flashing warning signals. Stock market capitalization as a percentage of nominal gross domestic product (GDP) has now risen to its highest level in 20 years — that is, since the dot.com top. From a long-term perspective, this indicator clearly shows that the market is in overvalued territory relative to GDP.

2. **Monetary factors and credit conditions:** Interest rates declined to modern day all-time lows in February. The 10-year Note yield ended the month at 1.13%, down from 1.54% at the beginning of the month.[3] While low and declining interest rates are generally positive for equities, credit spreads began to widen during February, which is a potential negative. One measure of credit spreads, the ratio between the Bloomberg Barclays U.S. Corporate High Yield Bond Index yield and the 10-year Note, has now widened to its most negative level in three years. Due to the low absolute level of rates, when measured in basis points, this spread has not yet entered negative territory — which is a positive sign. However, credit spreads are an important measure of economic activity and risk, and a further widening of spreads would be a significant negative factor in the otherwise favorable monetary picture.

3. **Sentiment:** The market's move to new highs in January and early February produced a significant increase in optimism among investors, which is negative from a contrary point of view. We commented last month that this measure would likely have to recycle to more pessimistic readings to indicate a market bottom. It appears that this process has already begun with pessimistic investor sentiment reaching levels not seen since the 2018 stock market decline. Coupled with the market's oversold condition, we see this as a positive development**.**

4. **Momentum:** With the market's severe weakness at the end of February, the team's measures of volume and breadth both declined sharply into negative territory. One measure of supply (down volume) and demand (up volume) improved during the stock market's rise to new highs in January and early February 2020. But this measure has reversed sharply, recording one of the steepest downturns in a decade. This type of reversal often leads to oversold extremes and at least temporary market low points. If the stock market does reach an interim low point and our volume and breadth models turn positive, it would be a signal to once again raise market exposure.

[1] *Source: Morningstar. March 5, 2020*
[2] *Source: Ned Davis Research. February 29, 2020*
[3] *Source: U.S. Department of Treasury. February 29, 2020*