BROADMARK

Market Update

July 1, 2020

Stock prices began the month of June on a positive note but on June 11 the Dow Jones Industrial Average (DJIA) dropped 1,861 points (or 6.9%),[1] as U.S. Federal Reserve (Fed) policymakers highlighted the ongoing economic concerns spurred by the coronavirus pandemic and measures taken to contain it. As the month progressed, COVID-19 cases rose in Texas, Florida, Arizona, California and other states. Some city and state officials in hot spots began reversing previously announced opening plans. The World Health Organization warned that the world is far from seeing the end of the pandemic, stating that "the worst is yet to come." And Fed Chair Jerome Powell warned that the path forward for the U.S. economy was "extraordinarily uncertain."

Nonetheless, the S&P 500 Index posted a gain of 1.84% in June while the Russell 2000 Index was up 3.53%. The technology sector continued to lead the market, with the NASDAQ-100 Index gaining over 5% for the month.[2] The Fed remained accommodative with asset purchases, which include some corporate bonds and ETFs. Additionally, there was talk of another round of fiscal stimulus to help small businesses.

The first six months of the year were one for the record books. Stock prices experienced their biggest quarter-to-quarter swing in more than 80 years. The February to March decline was one of the steepest (and quickest) declines on record, followed by one of the sharpest (and quickest) advances in history. For the first half of the year, the S&P 500 declined by -4.04%, the DJIA was down -9.55% and the Russell 2000 declined -12.98%. However, the technology sector remained strong; the NASDAQ-100 posted a gain of 12.11% for the first half of the year.[2]

The investment team decreased market exposure during June. This was due to deteriorating relative strength in sectors such as small cap stocks and emerging markets. The team eliminated positions in these areas, leaving the portfolio primarily invested in large cap stocks and the technology sector. In addition, the team's volume and breadth-based momentum models began to weaken during the month and overall market exposure was reduced accordingly. The team currently holds a higher cash position as a cushion against volatility. In order to raise exposure further, the investment team would need to see its longer-term volume and breadth-based momentum measures improve. The team would lower exposure if the longer-term volume and breadth momentum models once again turn negative.

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

Valuation: Valuations have risen along with stock prices in 2020 and we will likely begin to see price-earnings (P/E) ratios rise in coming months as earnings decline. This is a normal occurrence in a business and stock market cycle since the stock market is a leading indicator that discounts changes in earnings at inflection points. We would note that 75% of all stocks in the S&P 500 have a higher dividend yield than the U.S. 10-year Treasury Note.[3] Thus, while P/E multiples will likely climb due to lower earnings, the offset is that stocks still appear to be more reasonably valued when compared to the low level of interest rates.[3]

Additionally, there has been much talk of overvaluation among the strong growth and tech stocks due to their robust gains this year. However, the P/E multiple of the NASDAQ-100 is currently at 30.6x, only slightly above the 34-year median of 27.0x and still below the multiples of just a few years ago.[4] These growth and technology stocks are still far below the extreme levels recorded during the dot-com bubble in the late 1990s to 2002.[4]

Monetary factors and credit conditions: Interest rates remained stable in June. The 10-year U.S. Treasury Note began the month at a 0.65% yield and ended the month at 0.66%.[5] The Fed's aggressive moves to provide liquidity to the markets has been positive for equities. And while the investment team has been concerned that credit spreads rose to their widest level since the financial crisis of 2008-2009,[4] the Fed's new quantitative easing program and the $2.3 trillion fiscal stimulus package seem to have successfully addressed credit issues (so far). Nonetheless, credit spreads have ticked up a bit recently and we will be watching them carefully going forward. A rise in credit spreads would be negative for stock prices.

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Sentiment: Despite the stock market's rally from the March low, investor sentiment has continued to be skeptical of the market's advance. Optimistic investor sentiment is now only in neutral territory and has yet to reflect excessive optimism. From a contrary point of view, this is positive for the market.[4]

Momentum: Upside volume versus downside volume provides a good longer-term measure of market strength. Historically, when upside volume has been above downside volume, the S&P 500 has recorded a 9.46% annualized gain. When downside volume has exceeded upside volume, stock prices have recorded a -4.32% annualized loss. The team's longer-term model of upside versus downside volume dropped into negative territory during February, which was the first time that had happened since the fourth quarter of 2018. The model crossed into positive territory in April and currently is still positive. However, further weakness and a decline into negative territory would call for a more defensive posture.[4]

1 *Source: Bloomberg. June 11, 2020*
2 *Source: Bloomberg. July 1, 2020*
3 *Source: Ned Davis Research. May 31, 2020*
4 *Source: Ned Davis Research. June 30, 2020*
5 *Source: U.S. Department of Treasury. June 30, 2020*