Stock prices rallied in early October on hopes of agreement on a stimulus package prior to the November 3rd election. However, after being up as much as 5% mid-month, the S&P 500 Index plunged in the final week of the month as hopes for a stimulus package faded. The S&P 500 finished the month down -2.66% (with dividends reinvested).[1] The recent higher market volatility has also reflected investor uncertainty over the upcoming election and a rise in COVID-19 cases to their highest levels since the onset of the pandemic earlier in the year. Europe also saw a sharp rise in coronavirus infections, leading European equities to sink to a five-month low.[1]

Equity valuations remain elevated, particularly for the leadership stocks in the technology and social communications space. The top eight leadership stocks are now selling at an average price-earnings ratio of over 40x.[1] Also, while monetary policy and credit spreads remain generally positive, interest rates rose in October with the 10-year U.S. Treasury Note climbing to its highest level since March 2020.[2] A further rapid rise in interest rates could trigger negative readings in the investment team's rate of change models. A sudden rise has often been a precursor to future market weakness. The team's volume and breadth measures of momentum deteriorated at the end of the month. The team would like to see a strengthening of market internals prior to raising market exposure.

The investment team eliminated exposure to cyclicals, technology stocks, gold and small-cap equities during October due to deterioration in relative strength in those sectors. At month-end, the team retained positions in the large-cap and the consumer discretionary sectors while holding a healthy cash position as a cushion against potential higher market volatility prior to the November election.

The investment team would raise market exposure if its volume and breadth momentum models stabilize and strengthen and investor sentiment gets more pessimistic (positive from a contrary point of view). The team would become more defensive if a rise occurs in the team's rate of change models for interest rates or if its longer-term volume and breadth momentum models were to deteriorate.

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

Valuation: While it is normal for equity valuations to rise as earnings decline during a recession and recovery period, price-earnings ratios have now climbed to their highest level in almost 20 years.[3]

Nonetheless, about two-thirds of all stocks in the S&P 500 still have a dividend yield higher than the 10-year U.S. Treasury Note.[3] Thus, despite the absolute overvaluation of equities by historical standards, the low level of interest rates has made stocks more attractive when compared to their competition from the fixed-income sector.

The danger to equity valuations from here would be if interest rates were to rise rapidly, causing a reassessment in the investment merits of stocks versus bonds. In October, interest rates rose to their highest level in seven months and a further rise in interest rates would be negative for equity valuations.

Monetary factors and credit conditions: Interest rates rose in October. The 10-year U.S. Treasury Note closed the month with a 0.88% yield, up from 0.68% at the beginning of the month. Yields are now at their highest level since March 2020. The investment team is closely monitoring the rate of change of interest rates, which is a sensitive indicator to any future change in interest rates. One such measure is the 26-week rate of change of the 3-year U.S. Treasury Note. This indicator got very bullish as interest rates declined earlier in the year. However, over the last month, this indicator has climbed back into more neutral territory. A continued rise in interest rates could push this indicator into negative territory so it bears watching in coming weeks.[4] The team will also be monitoring for any widening in credit spreads — although credit spreads currently remain narrow.

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Sentiment: Investor sentiment got more pessimistic (positive from a contrary point of view) at the end of October. However, the investment team would like to see increased pessimistic sentiment in order to bring this indicator back into positive territory. [4]

Momentum: Momentum deteriorated during October. The team's measure of upside versus downside volume has been in positive territory since April but has not made much progress since then.[4] The team would like to see an increase in upside volume versus downside volume and better market breadth to accompany any upward move in stock prices.

[1] *Source: Bloomberg. November 1, 2020*
[2] *Source: U.S. Department of the Treasury. October 31, 2020*
[3] *Source: Ned Davis Research. October 31, 2020*
[4] *Source: Ned Davis Research. October 30, 2020*