BROADMARK

Market Update

October 1, 2020

After six months of steady gains, stock prices finally took a breather in September and registered their first monthly loss since March. The S&P 500 Index declined -3.80% during the month while the Dow Jones Industrial Average fell -2.18% (with dividends reinvested).[1] The NASDAQ-100 Index, which has been in a leadership position but is also more volatile, registered a decline of -5.67% (with dividends reinvested).[1] While the U.S. Federal Reserve (Fed) said that its accommodative policy would likely extend into 2023, Fed Chairman Jerome Powell warned of a slow economic recovery due to the effects of the COVID-19 pandemic. Some recent economic news, such as United Airlines and American Airlines cutting a combined 32,000 jobs and Disney's layoff of 28,000 employees, suggests that the recovery may be slowing faster than analysts had previously thought.[1]

Several of the investment team's models strengthened during September: Investor sentiment got more pessimistic, which is positive from a contrary point of view; the market's overbought situation was relieved; and several of the team's measures of the rate of change of interest rates entered positive territory. Nonetheless, the team eliminated exposure to the more volatile technology and communication services sectors due to deteriorating relative strength. At month-end, the portfolio had a position in large cap stocks and a smaller position in the consumer discretionary sector. The team continued to hold a healthy cash position as a cushion, as the stock market will likely remain volatile as the November 3rd election approaches.

The team would raise market exposure further if a broadening of participation by the rest of the market and a stabilization and an improvement in the longer-term measures of volume and breadth occurs. The team would become more defensive 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, price-earnings ratios have now climbed to their highest level in almost 20 years.[2] In addition, stock market capitalization as a percentage of nominal gross domestic product (often called the "Warren Buffett indicator") has now climbed to its highest level ever, eclipsing the highs set during the 2000-2002 dot-com bubble.[2] By any measure, stock prices appear to be overvalued at current levels.

Monetary factors and credit conditions: Interest rates remained stable in September. The 10-year U.S. Treasury Note closed the month with a 0.68% yield, with little change during the month.[3] So long as interest rates remain stable and credit spreads do not widen, the monetary and credit backdrop continues to be positive. However, the investment team is closely monitoring the rate of change of interest rates, which is a sensitive indicator to any future change in rates. One such measure is the 26-week rate of change of Moody's Corporate Baa Bond Index yield. Currently, this indicator is positive.[4] The team will be monitoring for any widening in credit spreads, but currently credit spreads remain relatively narrow.

Sentiment: Investor sentiment, which became overly optimistic (negative from a contrary point of view) last month, returned to more positive levels during the September stock market correction. The Ned Davis Research daily trading sentiment composite is now in positive territory and is at its best level in several months.[2]

Momentum: The investment team would like to see more stocks participate during any upward move from the market's September correction and also see its longer-term model of upside-downside volume improve. While this model moved into positive territory in April and has remained positive, it has not made much progress since then.[2] The team would like to see an increase in upside volume versus downside volume to accompany any upward moves in stock prices.

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[1] *Source: Bloomberg. October 1, 2020*
[2] *Source: Ned Davis Research. September 30, 2020*
[3] *Source: U.S. Department of the Treasury. September 30, 2020*
[4] *Source: Ned Davis Research. September 25, 2020*