BROADMARK

Market Update

January 1, 2021

Stock prices continued their strong recovery into year-end 2020. The Dow Jones Industrial Average (DJIA) rose 3.41% and the S&P 500 Index advanced 3.84% in December, both recording all-time highs. For the year, the DJIA rose 9.72% and the S&P 500 was up 18.39% (with dividends reinvested). The market's uptrend was broad-based, particularly in the last half of the year. Small cap stocks joined the year-end rally, with the Russell 2000 Index scoring a gain of 8.65% in December — and also reaching a new all-time high. The Russell 2000 was up 19.93% for the year (with dividends reinvested). Technology and social communications stocks were the clear winners during 2020, with the NASDAQ-100 Index posting a gain of 5.11% for December and 48.88% for the year.[1]

The first shipments of coronavirus vaccines during December provided a major boost to investor optimism. Congress passed a stimulus bill to help those companies and workers who were still adversely affected by shutdowns. Investors also viewed former U.S. Federal Reserve (Fed) Chair Janet Yellen's appointment as the new Treasury Secretary in the Biden administration as signaling a closer relationship between the Fed and the Treasury and the possibility for further stimulus in 2021 to support the economy.

As the market surged to new highs, equity valuations rose. Low interest rates continued to make stocks attractive when compared with bonds or with holding cash. Recent data showed a record 92% allocation to stocks in the widely watched Rydex Funds indexes.[2] The latest readings were higher than those seen at the dot-com bubble peak in 2000 and the housing bubble peak in 2007. Equity mutual fund and ETF cash levels have now fallen to a record low of 1.7%.[2] History teaches us to be wary of the crowd at extremes and we are reaching extremes in investor sentiment, suggesting the potential for a pullback in prices as we enter the new year.

Nonetheless, the monetary picture continues to be positive, which is buttressed by the investment team's volume and breadth momentum models. Thus, despite the elevated equity valuations and increasingly bullish investor sentiment (negative from a contrary point of view), the investment team continues to follow two major principles of investing— "Don't fight the Fed" and "Don't fight the tape."

The investment team maintained its diversified investment positions during December. The portfolio is invested in large cap stocks as well as the technology, value, health care, consumer discretionary, materials and industrial sectors. The team would raise market exposure once investor sentiment returns to less optimistic levels provided that the team's volume and breadth models remain positive. Conversely, the team would become more defensive if there is a rise in the team's rate of change models for interest rates or if the team's volume and breadth momentum models were to deteriorate.

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

<u>*Valuation*</u>: Equity valuations have now reached levels not seen since the 2000 dot-com bubble. The median price-earning (P/E) ratio for the S&P 500 is 31.9x, just below the record of 33.3x recorded in March 2002.[3]
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 either cash or 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.

<u>*Monetary factors and credit conditions*</u>: Interest rates remained stable in December. The 10-year U.S. Treasury Note closed the month at a 0.93% yield, almost unchanged from the 0.92% yield at the beginning of the month.[4] While yields are at their highest levels since March 2020, the investment team's rate of change measures have not climbed into negative territory. In addition, credit spreads have continued to narrow.[3] A negative for the market would be if interest rates were to rise rapidly or if credit spreads were to widen.

Continued next page
Disclosure next page

Sentiment: Investor sentiment has reached highly optimistic levels (negative from a contrary point of view), as the major market averages rose to new highs during the month. In December, the NDR Daily Trading Sentiment Composite climbed to its most negative level since its February highs but showed some improvement at year-end.[3]

Recent data showed that a record 92% of assets in the widely watched Rydex Funds indexes were invested in stocks. The latest readings were higher than those seen at the dot-com bubble peak in 2000 and the housing bubble peak in 2007. Further, equity mutual fund and ETF cash levels have fallen to a record low of 1.7%.[2]

Our four-pillar process teaches us to be wary of the crowd at extremes. We have reached extremes in investor sentiment. A short-term pullback from current levels in early 2021 would therefore be natural, given this elevated level of investor optimism.

Momentum: Momentum continues to be strong. The team's measure of upside versus downside volume climbed to a new recovery high[3] and the market's breadth improved. Here too, as the market approaches overbought levels, some type of short-term correction would be normal. However, the longer-term volume and breadth momentum models remain positive.

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