Market Update

September 1, 2020

Stock prices continued their strong upward push during August with the S&P 500 Index gaining 7.19% and the NASDAQ-100 Index up 9.59%, both registering new all-time highs and recording the best August since 1986.[1] The stock market's strength reflected the continued accommodative policy by the U.S. Federal Reserve (Fed), low interest rates and some better-than-expected economic reports. Additionally, while COVID-19 cases reached the six million mark, there were some encouraging reports that development of a vaccine was progressing and would potentially be available in early 2021.

The stock market advance in August was characterized by strong leadership from technology and social communications stocks. However, there has been relatively lackluster performance by the broad list of stocks. For example, according to Goldman Sachs Global Investment Research, the top five stocks in the S&P 500 now account for 24.4% of the index, which is higher than the 18% recorded for the top five stocks during the 2000 dot-com bubble.[2] Also, while the S&P 500 and NASDAQ-100 have been able to record new all-time highs, the Dow Jones Industrial Average, the Russell 2000 Index and most major foreign stock indices have still not been able to recover to their highs set in 2018.[3] The investment team would like to see a broadening of participation to bring the market back on track. A continued narrowing of market leadership is a negative sign for future stock prices.

While it is normal that equity valuations rise as earnings decline during a recession, price-earnings (P/E) ratios have now climbed to their highest level since just after the 2000 dot-com bubble.[3] In addition, investor sentiment has gotten more optimistic and has now reached negative territory. The market's upward move has also caused some of the investment team's momentum models to climb into overbought territory. Any unexpected rise in interest rates, disappointment with a new stimulus package from Congress or uncertainty over the upcoming election could be potential catalysts for a correction to the market's upward trend.

During August, the investment team diversified the portfolio by adding exposure to the consumer discretionary sector in addition to the strategy's existing positions in the large cap and technology sectors. The team eliminated exposure to small cap and large cyclical stocks as a result of deterioration in relative strength and the narrowing of market leadership. In order to raise exposure further, the investment team will need to see a broadening of participation by the rest of the market and an improvement in the longer-term measures of volume and breadth. The team would lower exposure if its longer-term volume and breadth momentum models were to once again turn negative.

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, P/E ratios have now climbed to their highest level in almost 20 years.[3] By any measure, stocks prices must be deemed to be overvalued at current levels.

Monetary factors and credit conditions: Interest rates rose modestly in August. The 10-year U.S. Treasury Note began the month with a 0.69% yield and inched up to 0.72% at month-end.[4] Fed Chairman Jerome Powell announced two major adjustments to Fed monetary policy: (1) It will no longer "remove the punchbowl" in anticipation of a robust job market posing an inflationary risk and (2) it will replace its rifle with a shotgun, meaning that instead of specifically aiming for the 2% inflation level, the Fed will take a broader view by targeting a range of inflation rates that average 2%. The investment team will be closely monitoring interest rates in coming months. For instance, while the team's 26-week rate of change of the 3-Year U.S. Treasury Note yield has been solidly in positive territory as interest rates have declined, any move upward in rates from these levels would move this indicator toward neutral to negative territory.[5]

Sentiment: Optimistic investor sentiment rose into negative territory during August.[6] No doubt some of this optimism has been centered on the stellar performance of the technology and social communications sectors. Nonetheless, this rise in bullish sentiment suggests the market's vulnerability to some type of market correction.

Continued next page
Disclosure next page

<u>Momentum</u>: The investment team would like to see more stocks participate in the market's rally, which has been primarily concentrated in the technology and social communications sectors. In addition, the team would like to see its longer-term model of upside-downside volume improve. While this model moved into positive territory in April, it has not made much progress since then.[6] The team would like to see an increase in upside volume versus downside volume to accompany any new highs in stock prices.

[1] *Source: Bloomberg. August 31, 2020*
[2] *Source: Goldman Sachs Global Investment Research and Ned Davis Research. August 31, 2020*
[3] *Source: Ned Davis Research. August 31, 2020*
[4] *Source: U.S. Department of the Treasury. August 31, 2020*
[5] *Source: Ned Davis Research. August 28, 2020*
[6] *Source: Ned Davis Research. September 1, 2020*