BROADMARK

Market Update

February 1, 2020

Stocks began the new year on a positive note, reflecting investor optimism about "Phase 1" of U.S.-China trade talks and some solid fourth quarter 2019 earnings reports. However, the tide turned in the second half of the month as investor attention focused on a larger issue: the coronavirus. This pneumonia-like virus was first identified in China and has now spread around the globe, resulting in disruptions to worldwide commerce, particularly in Asia. Fears of a global economic slowdown caused significant weakness in the Asian stock markets, which spread to U.S. stocks as well. The Dow Jones Industrial Average fell 600 points on the last day of the month. While fears of the coronavirus took center stage, Brexit finally became a reality, which added to the uncertainty over global growth.

Our momentum models began the year in overbought territory. In addition, the models showed a significant rise in optimistic investor sentiment (negative from a contrary point of view) and equity valuations climbed to their highest level in a year. We eliminated exposure to the small cap sector early in the month due to lagging relative strength in that sector. We also lowered overall market exposure as a result of elevated investor sentiment, higher valuations and a deterioration in momentum.

In order to raise exposure further, momentum measures would need to show some relief in the overbought condition. The market's late-January weakness seems to have begun this corrective process. However, we would also like to see a decline in investor bullishness. Better relative strength among the lagging sectors would also be a positive. Further strength in the Russell 2000 Index, the Dow Jones Transportation Average and international stocks would be evidence of broader market participation. On the other hand, if momentum continues to deteriorate and the broader market continues to lag the major market averages, we are prepared to move to a more defensive posture. Currently, we are comfortable with the strategy's reduced market exposure but ready to adjust exposure quickly in response to a change in the models.

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

1. **Valuation:** The S&P 500 median price-earnings (P/E) ratio rose to 23.8x at the end of January—near its highest level in a year.[1] The historically low level of interest rates and the more dovish stance from the U.S. Federal Reserve (Fed) have provided a positive environment for these higher valuations. However, while the median P/E ratio remains below its 15-year high of 26.8x reached in January 2018,[1] this indicator shows that the market has risen into overvalued territory on an absolute basis. Relative to the low levels of interest rates and inflation, the market is somewhat less overvalued. However, a rise in interest rates would be a negative factor for valuations.

2. **Monetary factors and credit conditions**: Interest rates declined significantly during January. The 10-year U.S. Treasury Note yield ended the month at 1.51%, down from 1.92% at the end of 2019.[2] Interest rates have now declined to the all-time lows reached in mid-2016. The Fed's interest rate cuts during 2019 provided a bullish monetary background for stocks and this continues to be the case. In addition, our rate of change indicators remain in positive territory and have a way to go before they flash any warning signals. Nonetheless, credit spreads began to widen during January. While credit spreads still remain at historically narrow levels, a widening of spreads would be a negative factor in the otherwise favorable monetary picture.

3. **Sentiment:** The market's move to new highs in January produced a significant increase in optimism among investors, which is negative from a contrary point of view. Our indicator of daily investor sentiment rose to its highest level in over a year during January. This rise in bullish investor sentiment has a way to go before returning to neutral to positive readings.

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4. **Momentum:** Our measures of volume and breadth reached overbought territory at the beginning of the year. With the market's weakness late in the month, these measures have begun to correct that overbought situation. Volume and breadth will be monitored closely in coming weeks. Further stock market weakness would deteriorate our models and could signal that we take a more defensive position. On the other hand, if the stock market stabilizes and our intermediate- and long-term models remain positive, we could increase exposure once the market correction is complete.

[1] *Source: Ned Davis Research. January 31, 2020*
[2] *Source: U.S. Department of Treasury, January 31, 2020*