BROADMARK

Market Update

August 1, 2020

A wave of new coronavirus cases swept across the United States during July, overwhelming some states and cities and lowering hopes for a rapid economic recovery. The economy contracted at a record annual pace of 32.9% in the second quarter of 2020, the worst contraction in modern American history.[1] At month-end, Republicans and Democrats were still debating provisions for a new stimulus package to provide fiscal support to businesses and workers.

The U.S. Federal Reserve (Fed) kept the federal funds rate unchanged at its July meeting and Fed Chairman Jerome Powell reiterated that the Fed would use the full range of its monetary tools to provide support for the ailing economy. This "whatever it takes" accommodative monetary policy has continued to support stock prices. The major market indices scored their fourth consecutive month of gains in July including the S&P 500 Index, which rose 5.64%.[1] Technology stocks continued to be the star performers, with the NASDAQ-100 Index gaining 7.41% in July after a slew of better-than-expected earnings results from major tech firms.[1] Four of the top technology companies now have a combined market value of over $5 trillion, about 20% of the value of the S&P 500.[1]

The investment team modestly reduced exposure to the technology sector during the month of July as the result of speculative activity and a deterioration in the sector's relative strength. The team increased exposure to large cap stocks and kept overall market exposure stable. At month-end, the portfolio was diversified between large cap stocks and the technology sector.

In order to raise exposure further, the investment team would need to see improvement in its longer-term measures of volume and breadth. While still in positive territory, these longer-term models have not kept pace with price action. As such, the team would lower exposure if the 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: Equity valuations have risen along with stock prices in 2020. Even when adjusted for inflation, valuations have now climbed to their highest level in a decade.[2] By any measure, stocks prices are overvalued at current levels.

Monetary factors and credit conditions: Interest rates declined in July. The 10-year U.S. Treasury Note began the month with a 0.69% yield and declined to 0.55% at month-end.[3] The 10-year U.S. Treasury yield has now fallen to its lowest level since its pandemic low during March when the yield briefly touched just below 0.50%.[3] The Fed's aggressive moves to provide liquidity to the markets have kept interest rates low, which has been positive for stock prices.

Sentiment: Optimistic investor sentiment rose into modestly negative territory in July.[4] No doubt some of this optimism has been centered on the stellar performance of the technology sector. Nonetheless, a further rise in bullish sentiment would be negative for stocks.

Momentum: The team has noted that the market's rise off of the March lows triggered some of our thrust indicators, confirming the likelihood of a more sustainable advance than merely a bear market rally. And while our longer-term breadth and volume models are also positive, neither have risen above the June highs despite the S&P 500 hitting new recovery highs in July. The team would like to see improvement in these models in order to be more confident of potential further gains and to erase this short-term divergence.

For example, the team's longer-term model of upside-downside volume crossed into positive territory in April but 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 new highs in stock prices.

The team would also like to see more stocks participate in the market's rally, which has been primarily concentrated in the large technology stocks. While the S&P 500 has now risen significantly from its March lows, only a little more than half of all New York Stock Exchange stocks have risen above their 30-week moving averages.[2] The team would like to see the market's breadth improve on any subsequent stock market strength.

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[1] *Source: Bloomberg. August 1, 2020*
[2] *Source: Ned Davis Research. July 31, 2020*
[3] *Source: U.S. Department of Treasury. July 31, 2020*
[4] *Source: Ned Davis Research. July 28, 2020*