Despite the tragic COVID-19 death count reaching the 100,000 mark during May, stock prices continued to look to the future, buoyed by a decline in the number of coronavirus cases, anticipation of progress toward a vaccine and a resumption of economic activity. Most states allowed more areas of previously shuttered businesses to operate again. In addition, stocks were buttressed by U.S. Federal Reserve (Fed) initiatives to provide liquidity to the markets as well as the previously enacted fiscal stimulus programs. The S&P 500 Index notched a gain of a little over 4% in May.[1]

In the last few trading days of May, stocks sagged a bit due to renewed tensions between the U.S. and China. Investors began to focus on the possibility that the U.S. may impose sanctions on China over the recent security law passed in Hong Kong. The administration said that Hong Kong no longer enjoys a high degree of autonomy from China. In addition, the U.S. and Beijing continue to trade barbs over the coronavirus pandemic, which has sparked fears of a renewed trade war.

The investment team continued to see the four pillars of its investment process turn slightly more positive during May:

(1) Valuations have declined to more reasonable levels, particularly when adjusted for the continued low level of interest rates;

(2) Monetary policy has remained expansive and though credit spreads have remained wide, the Fed so far seems to have successfully addressed potential credit problems with its initiatives to provide liquidity to the corporate bond and mortgage-backed securities markets;

(3) Despite the strong stock market rally recently, investor sentiment has remained quite skeptical, which, from a contrary point of view, is positive for stock prices; and

(4) Several of the investment team's measures of market strength (or thrust) triggered positive signals and these models have historically had a good record of reliability. The team's intermediate- to longer-term measures of volume and breadth improved as well.

The investment team increased market exposure during May while maintaining a cash cushion in case of further volatility. The team had already begun to increase market exposure during April, targeting large cap stocks and technology stocks. In May the team increased its exposure to large cap stocks and added a position in small cap stocks due to improving relative strength. In order to raise exposure further, the investment team will need to see its longer-term volume and breadth momentum measures improve further. The team would lower exposure if investor sentiment recycles to optimism (which is negative from a contrary point of view), the market gets overbought and the longer-term volume and breadth momentum models once again turn negative.

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

Valuation: Valuations declined to their lowest level in over six years during the March market decline but rose in May along with stock prices.[2] We will likely begin to see price-earnings ratios rise in coming months as earnings decline. This is a normal occurrence in a business and stock market cycle, as the stock market is a leading indicator that discounts changes in earnings at inflection points.

Monetary factors and credit conditions: Interest rates remained stable in May. The 10-year U.S. Treasury Note began the month at a 0.64% yield and ended the month at 0.65%.[3] The Fed's aggressive moves to provide liquidity to the markets has been positive for equities. And while the team has been concerned that credit spreads rose to their widest level since the financial crisis of 2008–09,[4] the Fed's new quantitative easing program and the $2.3 trillion fiscal stimulus package seem to have successfully addressed credit issues — at least so far. A further narrowing of spreads from these levels would be positive for the monetary and credit picture.

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Sentiment: Despite the stock market's rally from the March low, investor sentiment has remained skeptical of the market's advance. Optimistic investor sentiment rose only modestly in May and remains at the low end of neutral territory. From a contrary point of view, this is positive for the market. [5]

Momentum: One way that the investment team assesses the durability of a market advance is by measuring the strength of upward thrust in terms of breadth — that is, advancing issues versus declining issues. One of the more reliable measures of thrust has been the percentage of stocks that have been able to climb above their 50-day moving averages. Historically, when this percentage has reached 90%, the record shows that stock prices have a good probability of being higher in the next several months to a year from the signal. This particular indicator reached the 90% level in May. [6]

Another important measure of breadth also fired in late May. Developed by influential investor Marty Zweig, this model measures a 10-day exponential moving average of advances divided by the total of advances and declines.

Upside volume versus downside volume also provides a good longer-term measure of market strength. The team's longer-term model of upside-downside volume dropped into negative territory during February, which was the first time that had happened since the fourth quarter of 2018. The model has improved since then and is on the cusp of crossing into positive territory,[6] which would be positive for stock prices.

[1] *Source: Bloomberg. April 30, 2020*
[2] *Source: Ned Davis Research. May 31, 2020*
[3] *Source: US. Department of Treasury. May 31, 2020*
[4] *Source: Ned Davis Research. May 28, 2020*
[5] *Source: Ned Davis Research. May 26, 2020*
[6] *Source: Ned Davis Research. May 29, 2020*