BROADMARK

Market Update

March 1, 2023

All the major stock market indexes gave back some of their January gains during February. Inflation once again became a concern as retail sales were strong and the labor market remained tight. The Personal Consumption Expenditures Price Index, the preferred inflation index of the Federal Reserve (Fed), rose 0.6% in January and 5.4% from last year.[1] The Chinese economy also showed signs of a stronger rebound with manufacturing posting its biggest improvement in more than a decade and both services and housing ticking upward. The S&P 500 Index fell -2.45% for the month but was still up +3.68% year to date as of the end of February.[1] Technology stocks held up better than the broader averages with the NASDAQ-100 Index losing only -0.37% in February.[1] The index was still up +10.26% year to date as of the end of February.[1] The Russell 2000 Index was down -1.69% for the month and was up +7.89% for 2023 as of the end of February.[1] The Dow Jones Industrial Average has been the weakest of the major averages and was lower by -3.94% in February and was down -1.13% for 2023.[1] Fears that the Fed will continue to hike interest rates in the face of strong economic statistics caused interest rates to climb. The 10-year U.S. Treasury Note yield rose from 3.39% at the beginning of February to end the month with a yield of 3.92%.[2] Six-month to one-year U.S. Treasury securities jumped above the 5.00% level for the first time in over a decade.[2]

Equity valuations were still above their historical mean, both in absolute terms and relative to inflation. On the monetary front, the three-month/10-year U.S. Treasury yield curve reached the most negative inversion since 1981. The year-to-year growth in money supply (M2 plus equity and bond mutual funds plus ETFs) versus the growth in industrial production fell to its lowest level since 1970, indicating a sharp drop in liquidity. While some of that decline is an offset to the huge surge in liquidity during the coronavirus pandemic, this type of steep drop in liquidity, if it continues, is not healthy for financial markets. The market's January upward momentum stalled in February, as indicated by the deterioration of the investment team's volume and breadth momentum models.

The team remained defensively positioned, taking advantage of the continued rise in short-term interest rates. The bulk of portfolio cash positions are invested in short-term U.S. Treasury securities now yielding over 4%, which will increase if short-term interest rates continue to rise. The team will maintain its maximum defensive positioning if interest rates continue to rise, investor sentiment remains overly optimistic and if the team's volume and breadth momentum models do not improve. The team stands ready to raise exposure if interest rates decline, investor sentiment returns to pessimistic levels and the team's volume and breadth momentum models turn positive.

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

Valuation: The S&P 500 median price-earnings ratio (using trailing 12-month earnings) now stands at 24.0x, well below its 2021 high of 34.0x but still above its 59-year median of 17.5x. The team believes that this readjustment process in valuations may have further to go before equities become more fairly valued.[3]

Monetary factors and credit conditions: The Fed's interest rate hikes and balance sheet reductions have reduced liquidity. The year-over-year change in real liquidity (M2 plus equity and bond mutual funds and ETFs) as compared with the growth in industrial production has fallen to its lowest level in at least 50 years. Generally, when the growth in real liquidity falls below the growth in industrial production, there is less liquidity in the system to support future growth. While a great deal of this decline is a result of the enormous liquidity pumped into the system during the pandemic, such a dramatic drop in liquidity should be monitored carefully. Any future disruptions to the system as the result of a liquidity crisis will likely show up in credit spreads. But so far, credit spreads have remained narrow and are still below their long-term average.[4] The team will be monitoring credit spreads closely in the coming months.

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Sentiment: The team's daily investor sentiment model shot to its most optimistic level (negative from a contrary point of view) in two years during the most recent January rally. While this sentiment measure has declined from those lofty levels, it has so far returned only to neutral territory in February. Some further stock market weakness may be necessary to register more pessimism, which would be positive from a contrary point of view.[3]

Momentum: The team's breadth momentum model, which measures the breadth of Standard & Poor's industry groups, reached its best level in a year during the January rally.[5] While this is a positive development, the team's volume momentum model, which compares upside volume with downside volume, has not yet reached positive territory.[3] Continued strength in both these models would be necessary for our volume and breadth momentum model to turn positive. Currently, they are not yet in alignment.

1 *Source: Bloomberg. March 1, 2023*
2 *Source: U.S. Department of Treasury. February 28, 2023*
3 *Source: Ned Davis Research. February 28,2023*
4 *Source: Ned Davis Research. January 31, 2023*
5 *Source: Ned Davis Research. February 24, 2023*