

The S&P 500 Index began 2024 by setting a new all-time high, recouping all its 25.4% loss from January 3, 2022, through October 12, 2022.¹ This milestone reflected continued strong economic growth. Gross domestic product expanded at a seasonally adjusted annual rate of 3.3% in the final quarter of 2023.¹ While that is down from the sizzling 4.9% growth in the third quarter, it was well above the 2% advance predicted by economists in Bloomberg's year-end survey.¹ In addition, inflation continued to moderate with the Personal Consumption Expenditures (PCE) price index moving below 3% for the first time since March 2021.¹

The Federal Reserve (Fed) did not cut interest rates in January as some investors had hoped. Despite this disappointment, the 10-year U.S. Treasury Note remained stable at 3.99%, up only slightly from 3.95% at the beginning of the month.² Also, credit spreads remained narrow and showed no deterioration in credit conditions.

Volume and breadth momentum models improved in January and the team raised market exposure modestly, largely due to this improvement. However, while the major averages all gained ground in January, the narrowness of the market's leadership continued to be a concern in our work. For example, the S&P 500 climbed 1.68%, the Dow Jones Industrial Average was up 1.31% and the NASDAQ-100 Index rose 1.89%.¹ However, the Dow Jones Transportation and Utility Averages were down 3.23% and 2.41%, respectively, while the Russell 2000 Index was the weakest of all, dropping 3.89%.¹ In fact, the Russell 2000 remains almost 20% below its 2021 high despite the new highs in the major averages.¹

Both absolute equity valuations and valuations adjusted for inflation remained above their historically fairly valued levels. We consider monetary policy to be negative-to-neutral until the Fed lowers interest rates. Investor sentiment has become increasingly optimistic in recent months, which is a negative in our work. Both our intermediate- and short-term measures of investor sentiment were in negative territory. The team would raise exposure if our volume and breadth momentum models showed further improvement. The team would decrease exposure if interest rates again began to rise, credit spreads widened and if volume and breadth momentum models failed to improve from current levels.

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

Valuation: The S&P 500 median price-earnings (P/E) ratio (using trailing 12-month earnings) remained elevated at 25.7x. Valuations are still above the 59.9-year average of 17.6x.³ When we adjust valuations for inflation using the Consumer Price Index, we also get a 25.7x P/E ratio. From a longer-term perspective, therefore, it appears that equity valuations have further to decline to reach more fairly valued levels during this cycle.

Monetary factors and credit conditions: The 10-year U.S. Treasury Note ended the month with a 3.99% yield, up slightly from 3.95% at the beginning of the month. As has been the case during most of the year, credit spreads remained narrow. We would note that while the high-yield credit spread ratio has narrowed near its lowest level in almost a decade, indicating no signs of significant credit problems, this ratio (high-yield bonds divided by 10-year Treasuries) is now nearing readings of excessive optimism, which has historically been negative from a contrary point of view.³

Sentiment: Both our daily and intermediate measures of investor sentiment showed greater optimism in January, which is negative from a contrary point of view. Investor sentiment measures have backed off from their December 2023 highs but remained in negative territory. In particular, the NDR Crowd Sentiment Poll has been in its excessive optimism zone for 45 days, its 11th longest streak on record.⁴ Historically, market returns have been weaker than average for a few months after this measure falls out of its optimistic zone. Therefore, while optimistic investor sentiment can stay elevated for a time, our investor sentiment models indicate risk from these levels.

Momentum: The team's measures of momentum improved in January. The team's market breadth model has bounced back into positive territory after a dip at the end of 2023.⁵ Upside volume has risen above downside volume, but the market's upside volume has not been as strong as breadth.⁴ We would like to see more upside volume to raise market exposure further.

¹ Source: Bloomberg. January 31, 2024

² Source: U.S. Department of Treasury. January 31, 2024

³ Source: Ned Davis Research. January 31, 2024

⁴ Source: Ned Davis Research. January 30, 2024

⁵ Source: Ned Davis Research. January 26, 2024

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