BROADMARK

Market Update

August 1, 2023

The Federal Reserve (Fed) raised interest rates by one-quarter point in July after a brief pause in June. The Fed has now raised interest rates in 11 of its last 12 meetings to a level not seen since just prior to the 2007 housing market crash. Despite higher interest rates, however, the U.S. economy has been resilient with gross domestic product expanding at an annualized 2.4% in the second quarter of 2023, higher than in the previous quarterly period and far above most market expectations.[1] The continued resilience of the U.S. economy was the primary reason for the strength in stock prices during July, in our opinion. The S&P 500 Index closed the month with a 3.21% gain, the Dow Jones Industrial Average was up 3.44%, the NASDAQ-100 Index gained 3.84% and the previously lagging Russell 2000 Index sprang back to life with a 6.11% gain.[1]

Equity valuations remain above their historical average. Adjusted for inflation, valuations are improving due to the decline in the Consumer Price Index. Nonetheless, both absolute and inflation-adjusted valuations remain elevated. Monetary policy continues to be negative as the Fed maintains its fight to bring inflation to the 2% level. Credit spreads remain narrow, however, and do not indicate any deterioration in credit conditions. Also, interest rates have remained relatively stable. The big change in recent months has been in investor sentiment. Several of the team's measures of investor sentiment have risen into solidly negative territory. Most notably, the retail investor, as measured by the American Association of Individual Investors (AAII) Sentiment Index, rose to its most optimistic level in two years, which is negative from a contrary point of view.

The stock market's strength has improved the team's volume and breadth models. Participation by small cap stocks and other areas that lagged in the market during the first half of the year has broadened with the market's strength. As a result of this improvement, the team rebalanced the portfolio in July by increasing allocation to the S&P 500 Equal Weight Index in addition to its position in the cap-weighted S&P 500. The team would raise exposure further if interest rates declined, investor sentiment again grew pessimistic and if the team's volume and breadth momentum models showed more improvement. The team would lower exposure if interest rates rose, credit spreads widened and if the team's volume and breadth momentum models once again deteriorated.

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) rose to 26.2x last month, its highest level in a year and almost 50% above the 59.4-year average of 17.6x.[2] It is important to note that much of the rise in valuations has come from an expansion of P/E multiples, not from increases in underlying earnings or profits. From a longer-term perspective, therefore, it appears that equity valuations are still too high and have further to decline during this cycle.

Monetary factors and credit conditions: Despite the Fed's July hike in interest rates, the 10-year U.S. Treasury Note yield rose only modestly to 3.96% from 3.86%.[3] In addition, credit spreads have declined in the last month.[2]

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Sentiment: Investor sentiment continued to get more optimistic in July. The AAII Sentiment Index soared to its highest level in two years and is nearing the level reached in early 2021.[4] Likewise, the team's intermediate- and short-term measures of sentiment have also risen to their highest levels since the market peak in January 2022.[5] While bullish investor sentiment can continue to fuel the rally and provide demand for a period of time, at extremes these readings will eventually lead to a market correction. Investor sentiment must therefore be judged to have now entered negative territory.

Momentum: The bright spot continues to be positive market momentum. The team's volume and breadth models remained positive in July. The broadening of market breadth alleviated some of the negative divergences in the performance of the leading tech and large cap stocks versus the rest of the market that occurred during the first half of the year. Ned Davis Research's "Big Mo" Multi-Cap Tape Composite, which measures the breadth within the S&P 500 industry groups, has now risen to its best level since the 2020 coronavirus pandemic.[4]

[1] *Source: Bloomberg. July 31, 2023*
[2] *Source: Ned Davis Research. July 31, 2023*
[3] *Source: U.S. Department of Treasury. July 31, 2023*
[4] *Source: Ned Davis Research. July 28, 2023*
[5] *Source: Ned Davis Research. July 25, 2023*