The U.S. economy grew strongly in the most recent quarter. Gross domestic product surged at a 4.9% annualized rate from July through September, the strongest showing since late 2021.[1] At the same time, the fiscal deficit has expanded to levels rarely seen during times of full employment. This has pushed up interest rates on mortgages, credit cards and business loans. While the Federal Reserve (Fed) has held its key federal funds rate steady since July, the 10-year U.S. Treasury Note yield has risen a full percentage point in less than three months, briefly reaching 5.00% for the first time since 2007.[2]

Small cap stocks were particularly weak in October with the Russell 2000 Index falling -6.82%.[1] Smaller declines were recorded by large cap stocks and tech with the Dow Jones Industrial Average down -1.26%, the S&P 500 Index off -2.10% and the NASDAQ-100 Index lower by -2.04%.[1]

Both absolute equity valuations and valuations adjusted for inflation have improved in the last month but have still not declined to historically fairly valued levels. Monetary policy continues to be negative as the Fed maintains its fight to bring inflation down to the 2% level. One positive change in the last month has been the improvement of the investment team's measures of investor sentiment. Measures of volume and breadth momentum remain negative. Reflecting these readings, the investment team remained in a defensive posture during October and initiated a modest net short position during the month. The remainder of the portfolio was invested in short-term U.S. Treasury securities through the BIL (SPDR Bloomberg 1-3 Month T-Bill ETF), which enables the portfolio to take advantage of the rise in Treasury bill rates. At month-end, both the 1-month and 3-month U.S. Treasury Bill rates yielded in excess of 5.50%.[2]

The team would increase its short position opportunistically if interest rates continued to rise, credit spreads widened and if the team's volume and breadth momentum models remained negative. The team would raise exposure if interest rates declined, investor sentiment reached a pessimistic extreme and if the team's volume and breadth momentum models returned to positive territory.

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) fell to 22.8x last month after reaching the highest level in a year in July. However, valuations are still above the 59.7-year average of 17.6x.[3] Valuations adjusted for inflation declined as well but they are still in elevated territory. From a longer-term perspective, it appears that equity valuations have further to decline to more fairly valued levels during this cycle.

Monetary factors and credit conditions: The 10-year U.S. Treasury Note ended the month with a 4.88% yield, up from 4.69% after briefly touching 5.00% intramonth. As has been the case during most of the year, however, credit spreads remained narrow. We would note that while credit spreads have narrowed near their lowest levels of the year, indicating no signs of significant credit problems, the high-yield ratio (high-yield corporate bonds divided by 10-year Treasurys) is now nearing readings of excessive optimism, which has historically been negative from a contrary point of view.[3]

Sentiment: Investor sentiment has now entered modestly positive territory as pessimism has risen. Both the intermediate-term and daily measures of investor sentiment are now modestly positive.[3]

Momentum: Both measures of volume and breadth remain negative. Breadth is as negative as it has been in over a year [4] and volume has remained negative since September.[3]

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[1] *Source: Bloomberg. October 31, 2023*
[2] *Source: U.S. Department of Treasury. October 31, 2023*
[3] *Source: Ned Davis Research. October 31, 2023*
[4] *Source: Ned Davis Research. October 27, 2023*

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