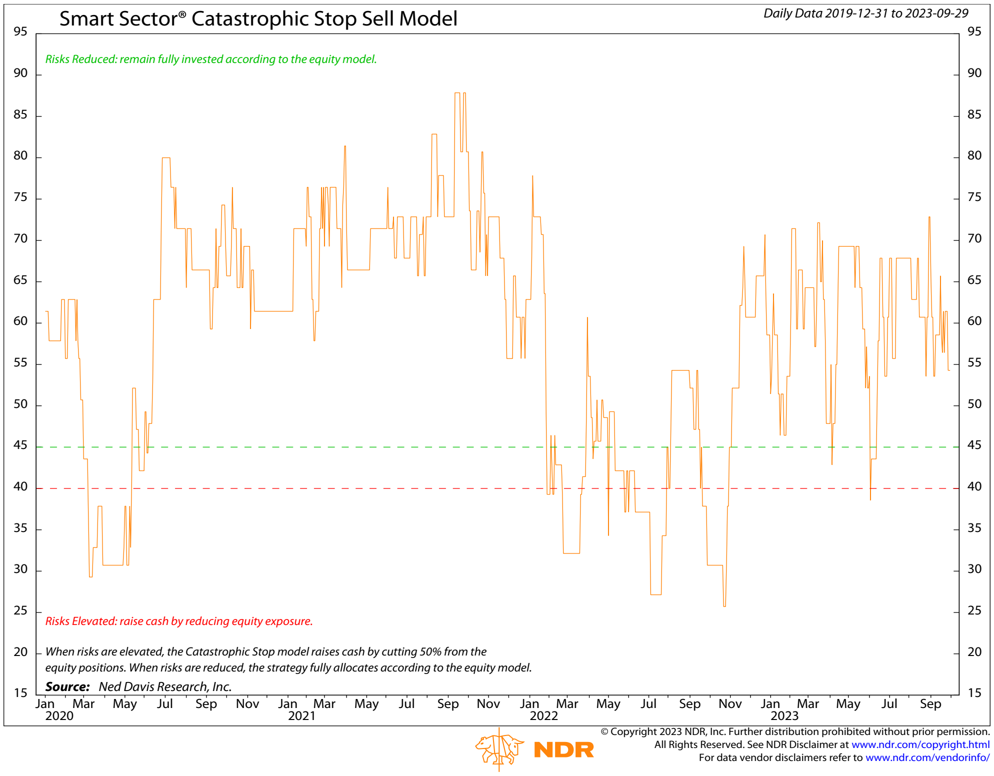
Smart Sector® Strategy

OCTOBER 2023

Catastrophic Stop Update

The NDR Catastrophic Stop Sell model combines time-tested, objective indicators designed to identify high risk periods for the equity market. The model (chart right) deteriorated from last month but entered October with a fully invested equity allocation recommendation.



The model's overall reading is driven primarily by bullish external influences such as trade, market sentiment, and high-yield spreads. However, price-based measures have weakened during the month—three additional indicators flashed a sell signal including supply vs. demand (chart left). For now, the weight-of-the-evidence recommends a fully invested allocation to equity sectors according to the model.

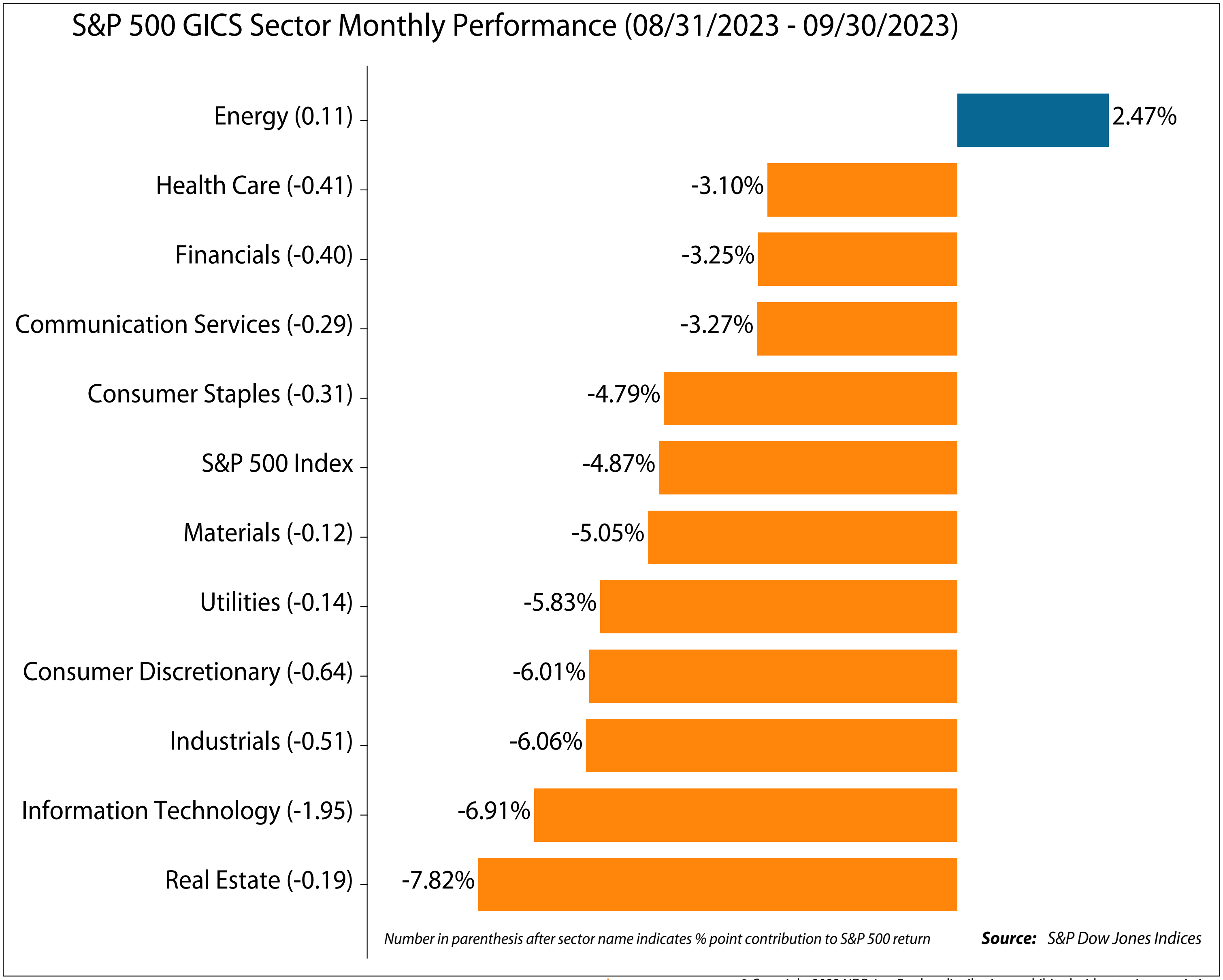
U.S. Market Update

For the second month in a row, the S&P 500 declined in September, dropping 4.8%. Breadth remained weak—10 of the 11 S&P 500 sectors posted negative returns for the month—Energy was the only sector with positive gains (chart below). Sectors inversely correlated to a rising 10-year yield—Real Estate, Tech, Consumer Discretionary, Utilities—underperformed the most.

The S&P 500 Index has fallen below previous support at the August 2022 highs. On the one hand, the pullback is coming during a seasonally weak time of the year, suggesting that the stage is being set for a year-end rally. On the other hand, the breakdown coincided with a breakout in bond yields across the Treasury curve. Investors may be belatedly taking the Fed's higher-for-longer rhetoric seriously just as economic data slows, arguing for more than a seasonal pause.

In reviewing our indicators, we came to three conclusions. First, technical damage has triggered negative signals from some trend and breadth indicators. Second, sentiment is approaching extremely pessimistic levels, suggesting that a year-end rally is not off the table. Third, macro conditions and long-term technicals leave open the possibility that the market is going through a topping process that could carry into 2024.

The sector model remained with a mix of cyclical and defensive leadership during the month. Entering October, the sector model is overweight Information Technology, Communication Services, and Utilities. Health Care and Financials remained marketweight. Industrials and Energy joined Consumer Discretionary, Consumer Staples, Materials, and Real Estate at underweight.



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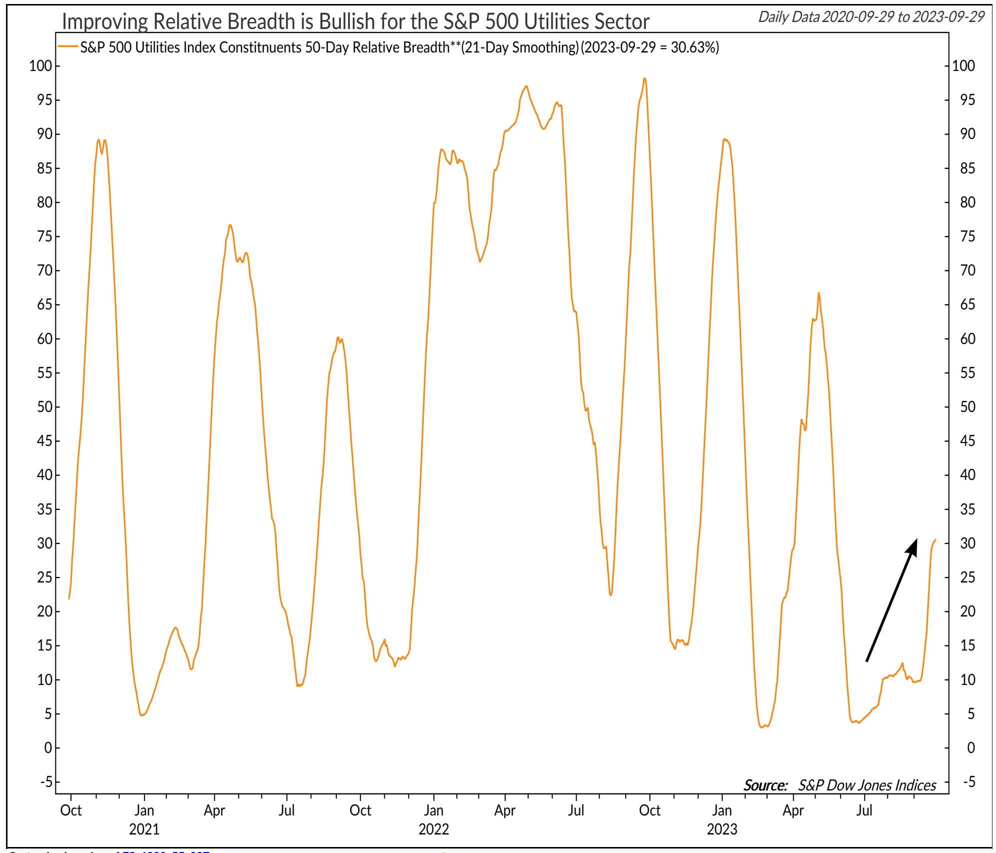
The Utilities sector's allocation rose by over 80 basis points in September and remains overweight. While the copper/gold ratio and manufacturing PMI are headwinds for the sector, rising oil prices, capacity utilization, valuation, and yields on investment grade utilities are bullish. Five of the seven internal (price-based) indicators are bullish—most recently, short-term breadth improved to a bullish level (chart right).



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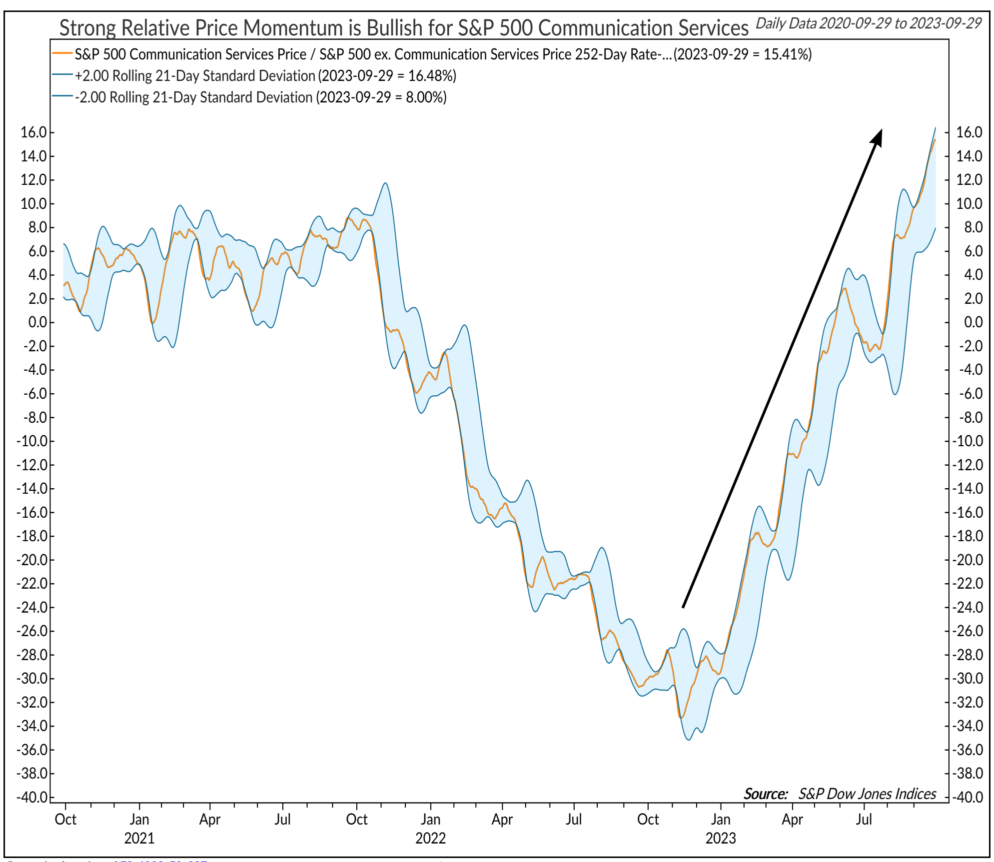

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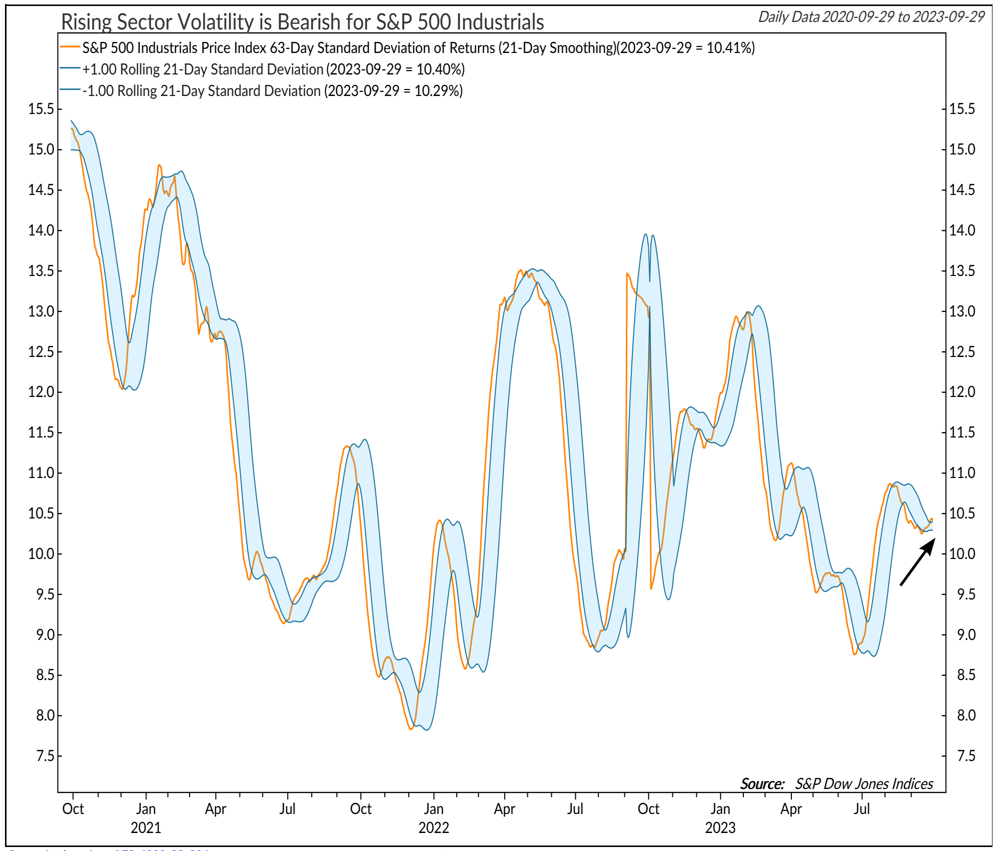
The Communication Services sector's allocation rose by over 50 basis points and remained overweight. Among the "Elite Eight" stocks in the S&P 500, Alphabet has performed the best. The sector's Telecom- and Media-related companies have also performed better in Q3 after lagging the S&P 500 during the first half of the year. While the 10-2 yield curve remained bearish for the sector, a narrowing option-adjusted spread, valuation, and earnings revision breadth remained bullish. This was confirmed by internal (price-based) indicators, as five of six indicators remain bullish, including strong relative price momentum (chart left).

Industrials' allocation dropped over 50 basis points and was downgraded to underweight. On a fundamental basis, rising commodity prices moved bullish for the sector during the month. However, valuation, oil futures prices, and consumer confidence remain headwinds. This was confirmed by weakening technicals, as now four of the six price-based measures are bearish—sector volatility moved bearish for Industrials during the month (chart right).



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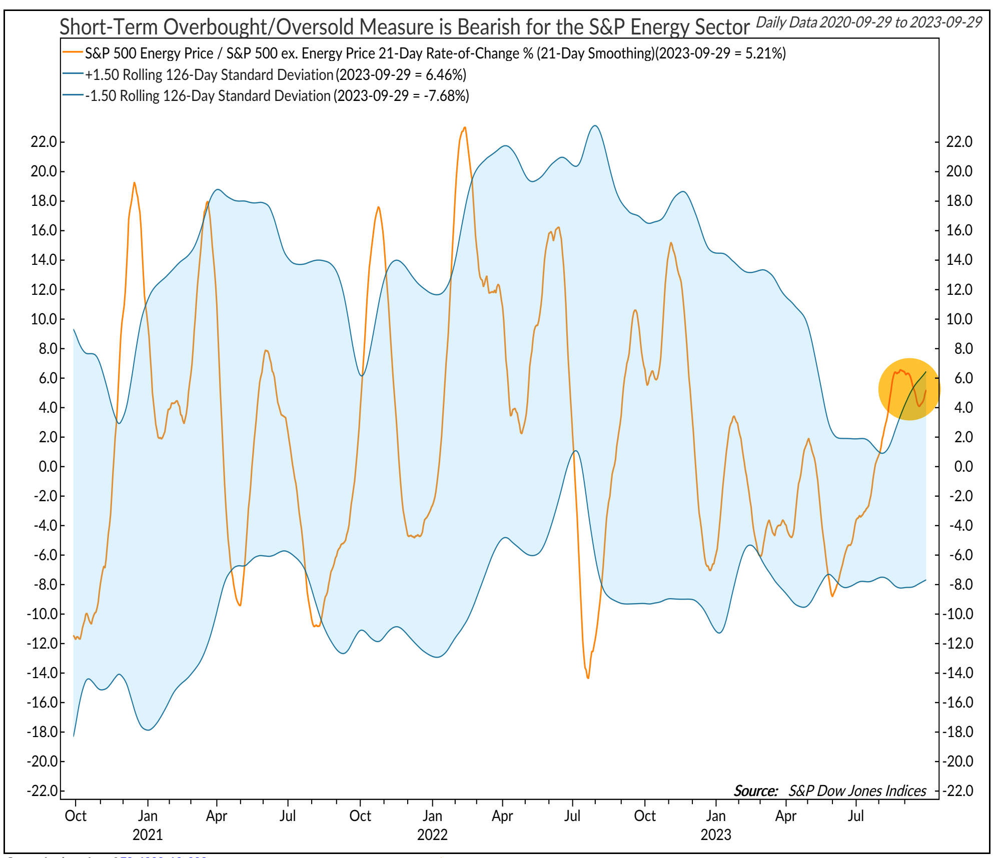

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The Energy sector's allocation dropped by over 25 basis points and was downgraded to underweight. On a fundamental basis, indicators are mixed. Crude futures sentiment and worldwide rig count are bullish, but are offset by crude spot prices, supply, and valuation which remain bearish. Technicals are also mixed. With a sharp rise in price over the past month, the Energy sector got short-term overbought, a bearish development (chart left).

Summary

Entering October, the sector model remained with a mix of cyclical and defensive leadership. The model is overweight Information Technology, Communication Services, and Utilities. Underweights include Industrials, Energy, Consumer Discretionary, Consumer Staples, Materials, and Real Estate. The sector model uses sector-specific indicators to determine opportunities and identify risks in an objective, weight-of-the-evidence approach.

Smart Sector® Strategy

Strategy description

- The Smart Sector® with Catastrophic Stop strategy combines two Ned Davis Research quantitative investment strategies: The NDR Sector Allocation and the NDR Catastrophic Stop.

The process is based on the weight of the evidence

- The fund begins by overweighting and underweighting the S&P 500 sectors based on Ned Davis Research's proprietary sector models.
- Each of the sector models utilize sector-specific, weight-of-the-evidence composites of fundamental, economic, technical, and behavioral indicators to determine each sector's probability of outperforming the S&P 500.
- Sectors are weighted accordingly relative to benchmark weightings.

When market risks become extraordinarily high — reduce your portfolio risk

- The model remains fully invested unless the Ned Davis Research Catastrophic Sell Stop (CSS) model is triggered, whereupon the equity-invested position is trimmed to 50%.
- The NDR Catastrophic Sell Stop model combines time-tested, objective indicators designed to identify periods of high risk for the broad U.S. equity market. The model uses price-based, breadth, deviation from trend, fundamental, economic, interest rate, behavioral and volatility-based indicator composites.

When market risks return to normal — put your money back to work

- When the NDR CSS model moves back to bullish levels, indicating lower risk, the strategy moves back to fully invested.

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