DAY HAGAN
ASSET MANAGEMENT

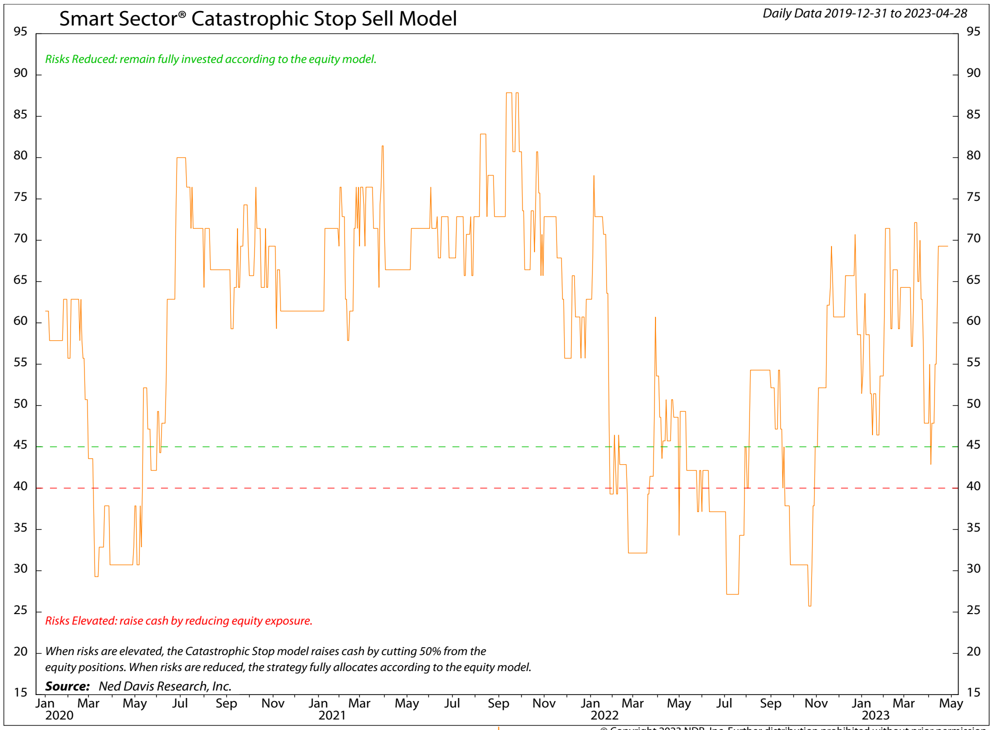
NDR
NED DAVIS RESEARCH

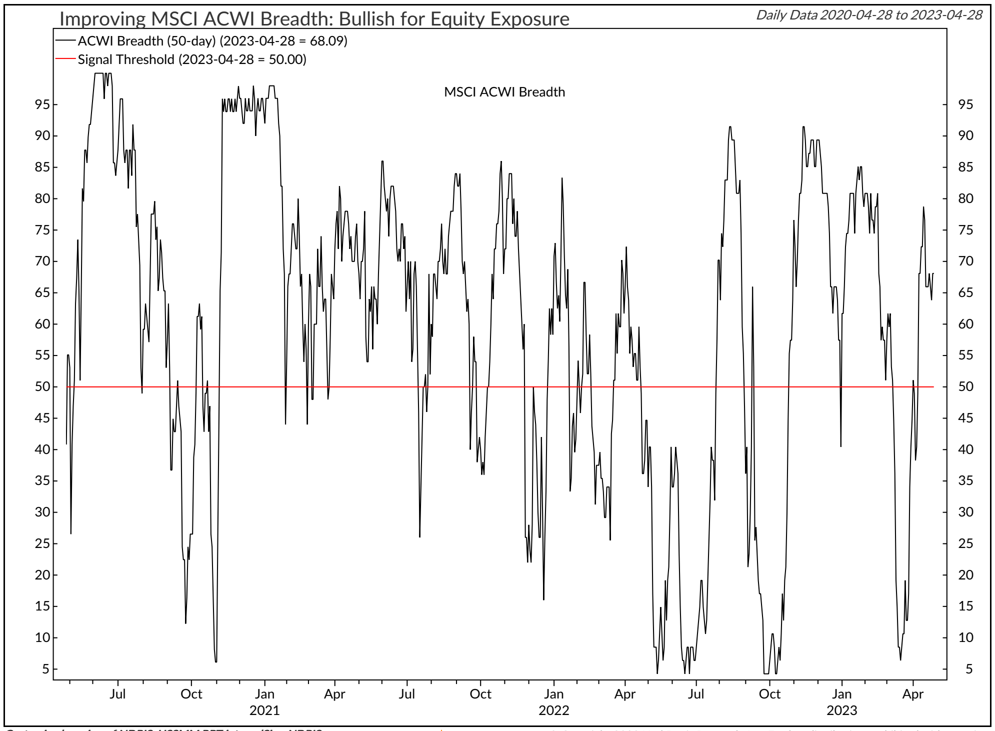
Smart Sector® Strategy

MAY 2023

Catastrophic Stop Update

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





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The model improvement was mostly driven by stronger technicals—stock/bond relative strength, global stock market breadth (chart left), and stock market short-term trend all improved to bullish levels during the month. In terms of external influences, breadth for High Yield and Emerging Market bonds and global trade (as measured by the Baltic Dry Index) remain bullish, while high-yield option-adjusted spreads remain bearish.

If stock volume demand outpaces supply and spreads narrow, then it could indicate the rally could be sustained. Conversely, if the stock market weakens in the near-term and investors return to fears of a recession, the stock market rally could be short-lived.

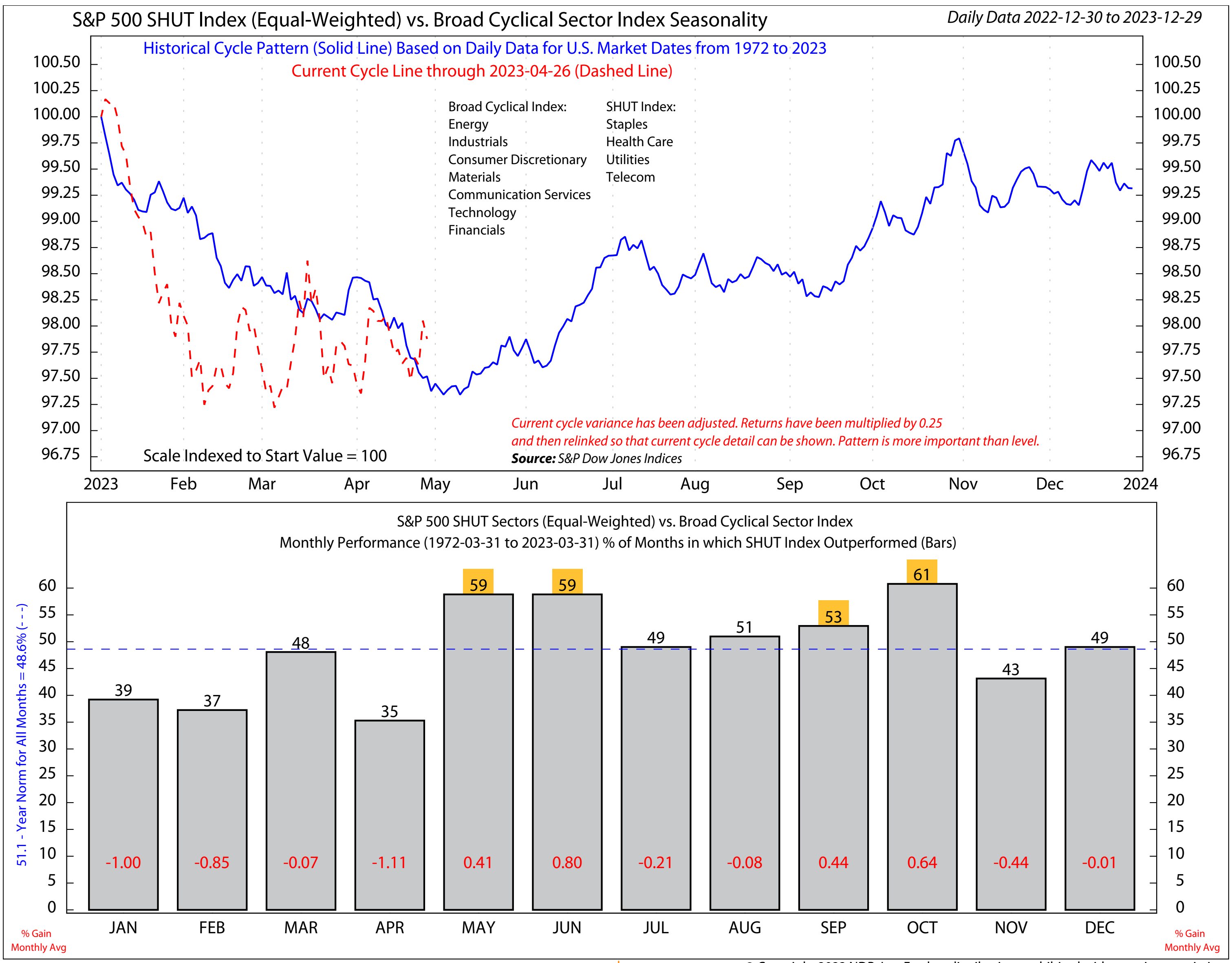
U.S. Market Update

The S&P 500 rallied for a second month in a row and was up about 1.6% on a total return basis for the month. Breadth remained strong—eight of the 11 S&P 500 sectors registered positive returns in the month of April. Leadership was overwhelmingly defensive with Consumer Staples, Health Care, and Utilities all outperforming the S&P 500 in April. As a result, the S&P 500 SHUT Index outperformed the Broad Cyclical Sector Index (chart below), which is in line with historical tendencies after the last rate hike.

The Wall Street adage “sell in May and go away” comes from the tendency for seasonal weakness to begin in May. For sectors, the seasonal pattern has meant a shift in leadership towards defensive sectors over cyclical sectors starting in May (top clip). Since 1972, the four best months for defensive sector leadership have all occurred over the May through October period (bottom clip).

This year, the seasonally weak stretch overlaps with several other headwinds for the market, including the late innings in the Fed and economic cycles, debt ceiling discussions, and a high level of complacency as measured by the VIX Index. NDR frequently highlights seasonal trends, but we do not include them in our models. However, we find it noteworthy when our models align with seasonality and historical studies.

The sector model has gotten in line with the cautious outlook in April, shifting more defensive during the month. Entering May, the sector model is overweight defensive sectors such as Health Care, Utilities, and Energy. Information Technology dropped to marketweight. All other sectors are underweighted with significant drops in allocation to Real Estate and Financials.



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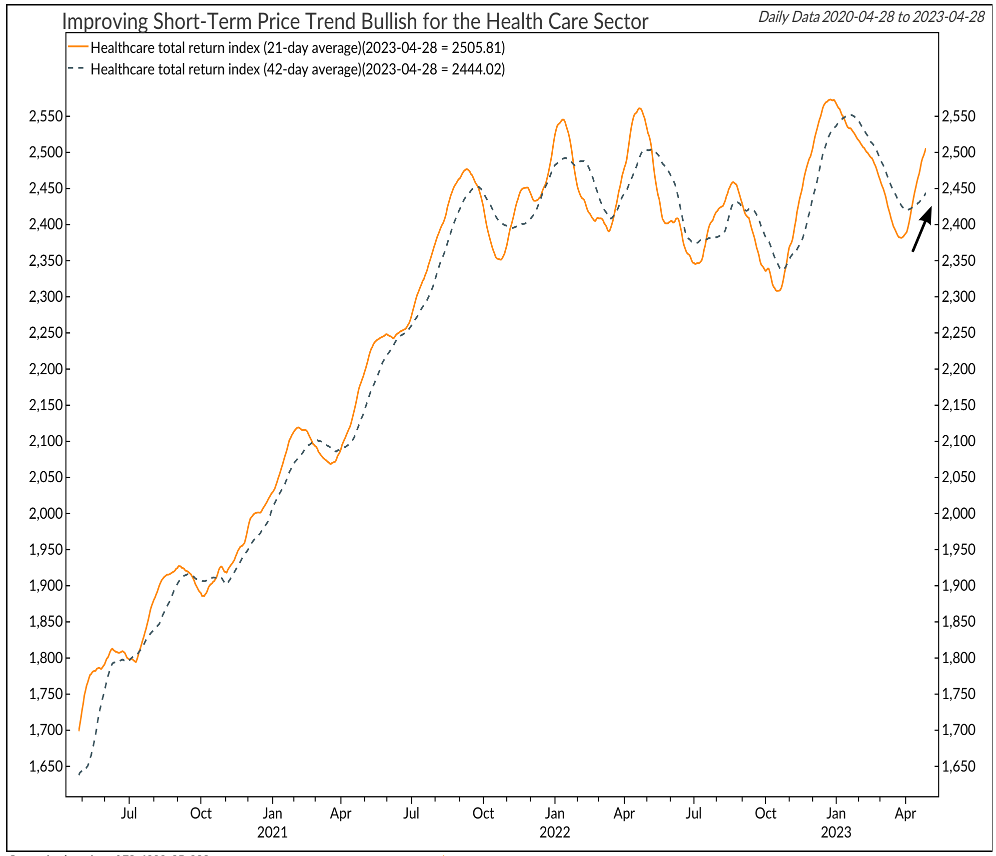
The Health Care sector's allocation rose significantly in April and is the largest overweight. The sector was up nearly 3% in April, primarily driven by Big Pharma stocks such as Eli Lilly (+15.3%), Merck (+8.5%), and Johnson & Johnson (+5.6%). On a fundamental basis, health care construction and relative spreads moved bullish during the month. This was confirmed by improving technicals—all six indicators are bullish, including absolute short-term price trend (chart right), relative price trend, relative drawdown, and breadth.



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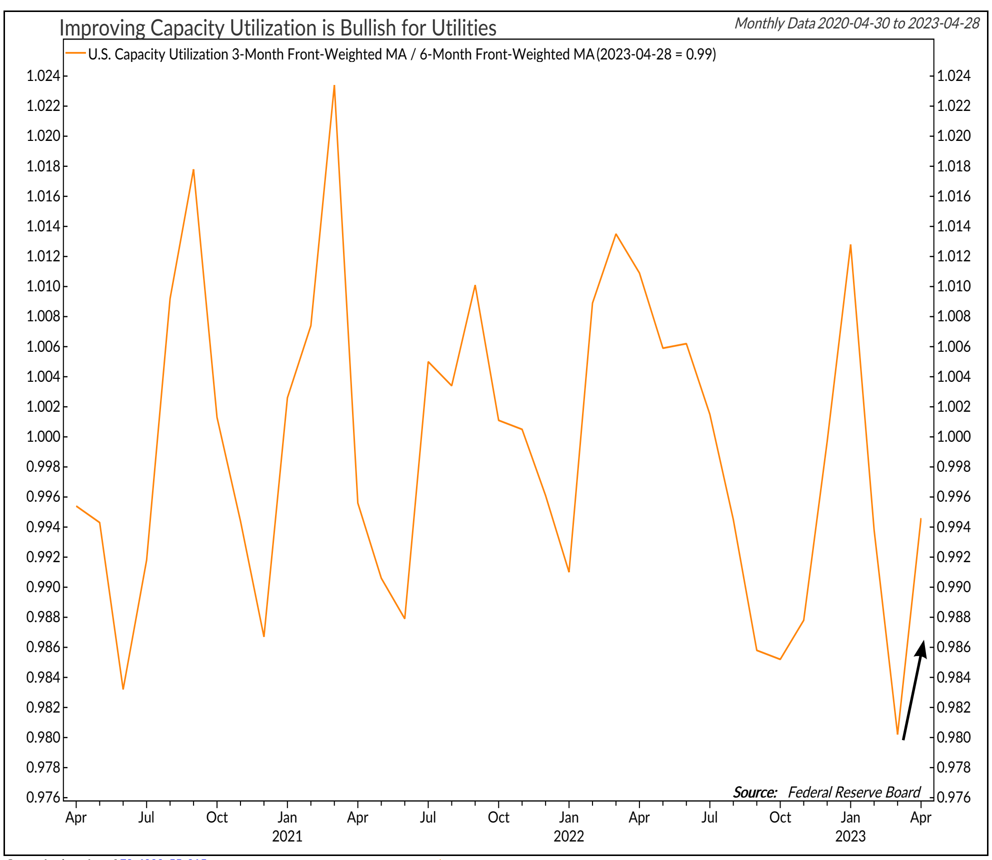

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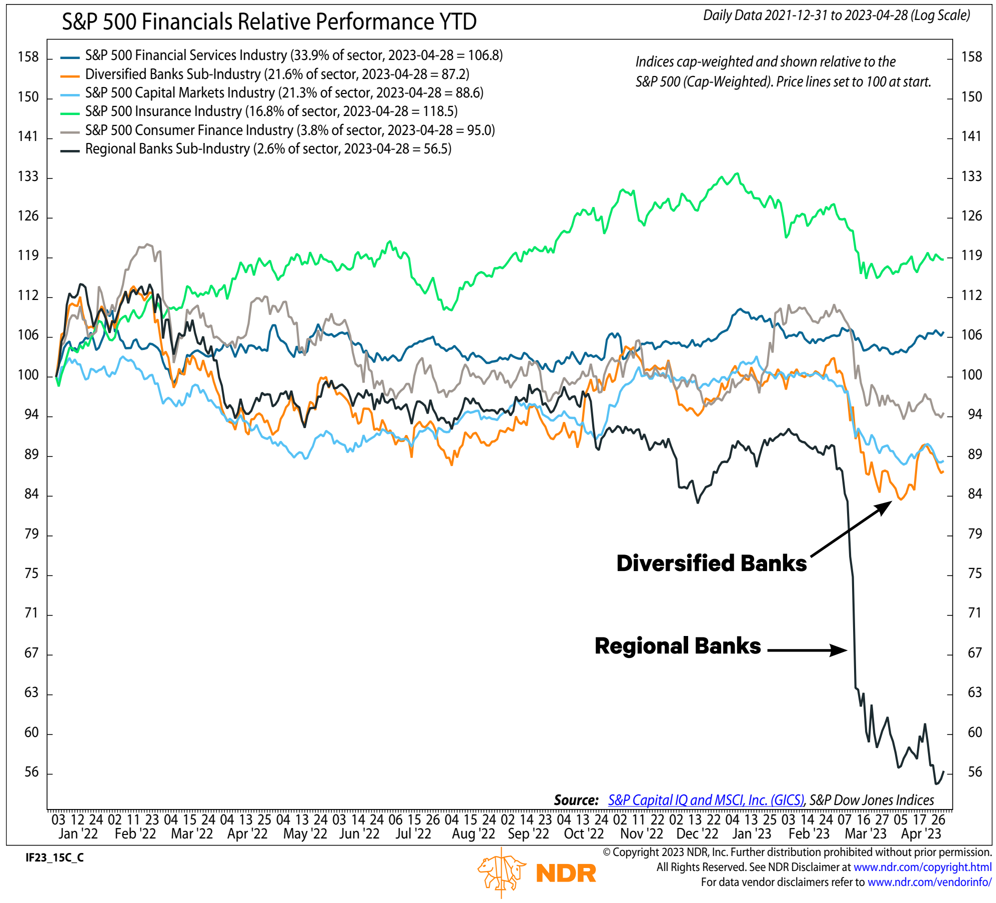
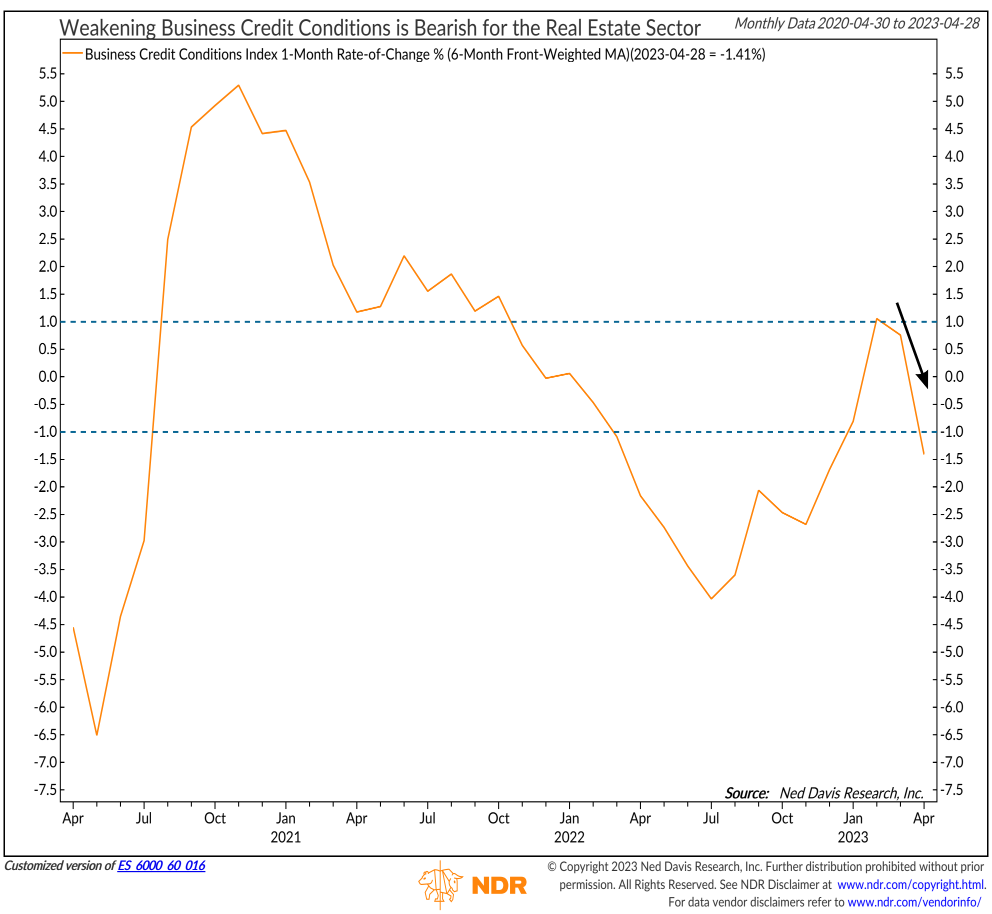
Allocation to the Utilities sector rose in April, moving it from a slight overweight to a significant overweight position. On a fundamental basis, capacity utilization (chart left) and the copper/gold ratio (a measure of slowing economic growth) moved bullish for the sector. Two more technical measures moved bullish for the sector—relative price trend and relative reversals.

The Financials sector's allocation declined sharply in April and dropped back to underweight. Regional Banks was hit hardest in the aftermath of the recent bank failures, but underperformance within the sector was widespread (chart right). On a fundamental basis, the 10-2 yield curve, business credit conditions, U.S. Financial investment grade spreads, bank loan growth, and valuation remained bullish for the sector. However, over the past month, economic surprises dropped and moved bearish for the sector. This was confirmed by weakening technicals. The improvement in a relative overbought/oversold indicator was more than offset by weakening relative price trend and the sector's 21-day volatility.





Interest-rate sensitive Real Estate saw a sharp decline in allocation in April, moving it from an overweight to a significant underweight. The sector saw deterioration in industrial production for construction supplies, business credit conditions (chart left), as well as a drop in mortage applications on still-elevated mortgage rates. While relative price deviation from trend remains bullish, the sector became short-term overbought, and joined three other bearish technical measures during the month.

Summary

The sector allocation strategy's message is overwhelmingly defensive with overweights to Health Care, Utilities, and Energy. Cyclical sectors such as Financials, Industrials, Consumer Discretionary, and Materials are all at underweight. 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 immediately moves back to fully invested.

For more information, please contact:

Day Hagan Asset Management

1000 S. Tamiami Trl

Sarasota, FL 34236

Toll Free: (800) 594-7930

Office Phone: (941) 330-1702

Website: https://dayhagan.com/ or https://dhfunds.com/

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