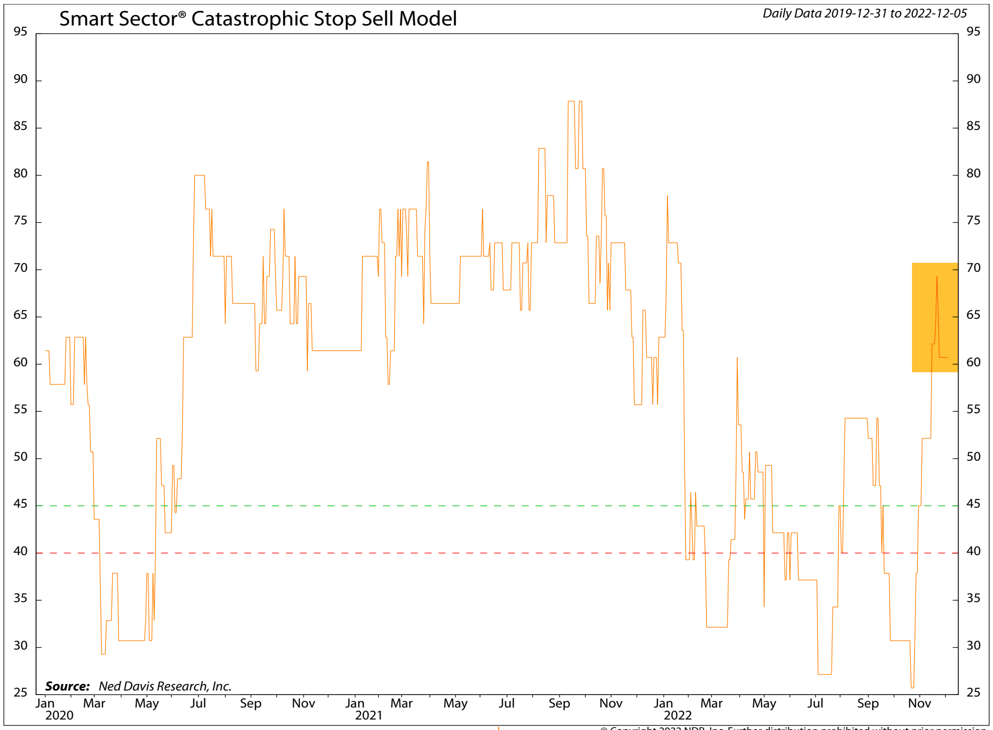
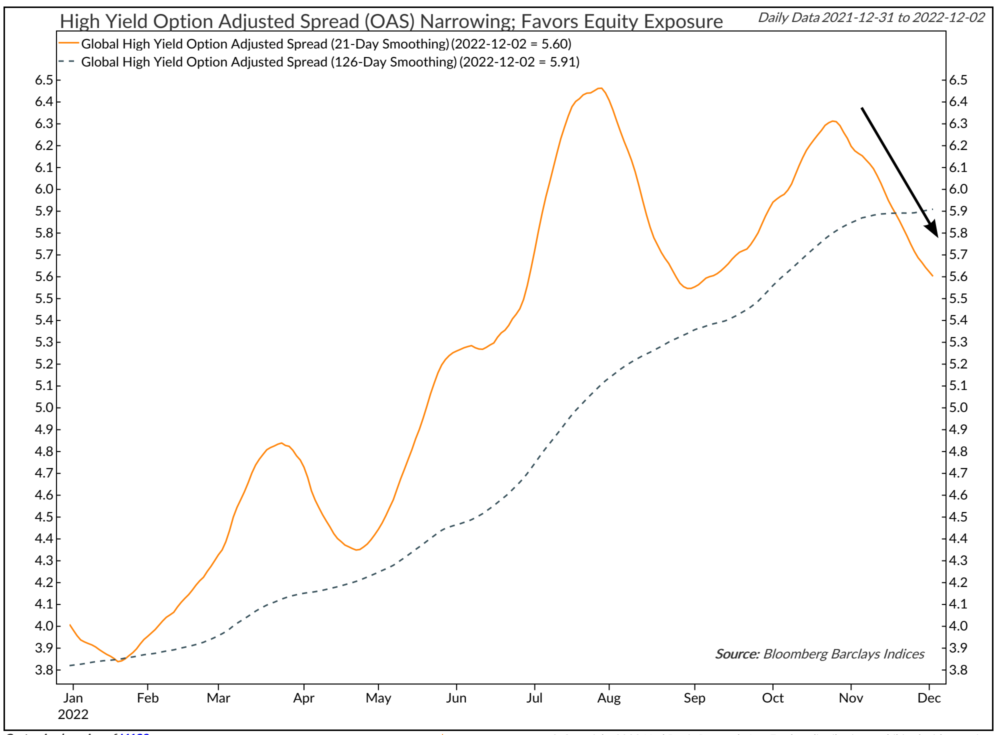
Smart Sector® Strategy

DECEMBER 2022

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 at right) entered December recommending a fully invested equity allocation.





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There was strong risk-on indicator improvement as the stock/bond relative strength ratio trended higher, the stock market's absolute trend rose, almost 90% of global equity markets traded above their intermediate-term trends, high yield option-adjusted spreads (OAS) (chart at bottom) narrowed, and high yield and Emerging Market bond breadth strengthened.

If the near-term market strength is temporary, the technical indicators should roll over and trigger another bearish signal. Conversely, if volume demand outpaces supply and global shipping rates improve, then it could indicate that the rally may persist well into the new year.

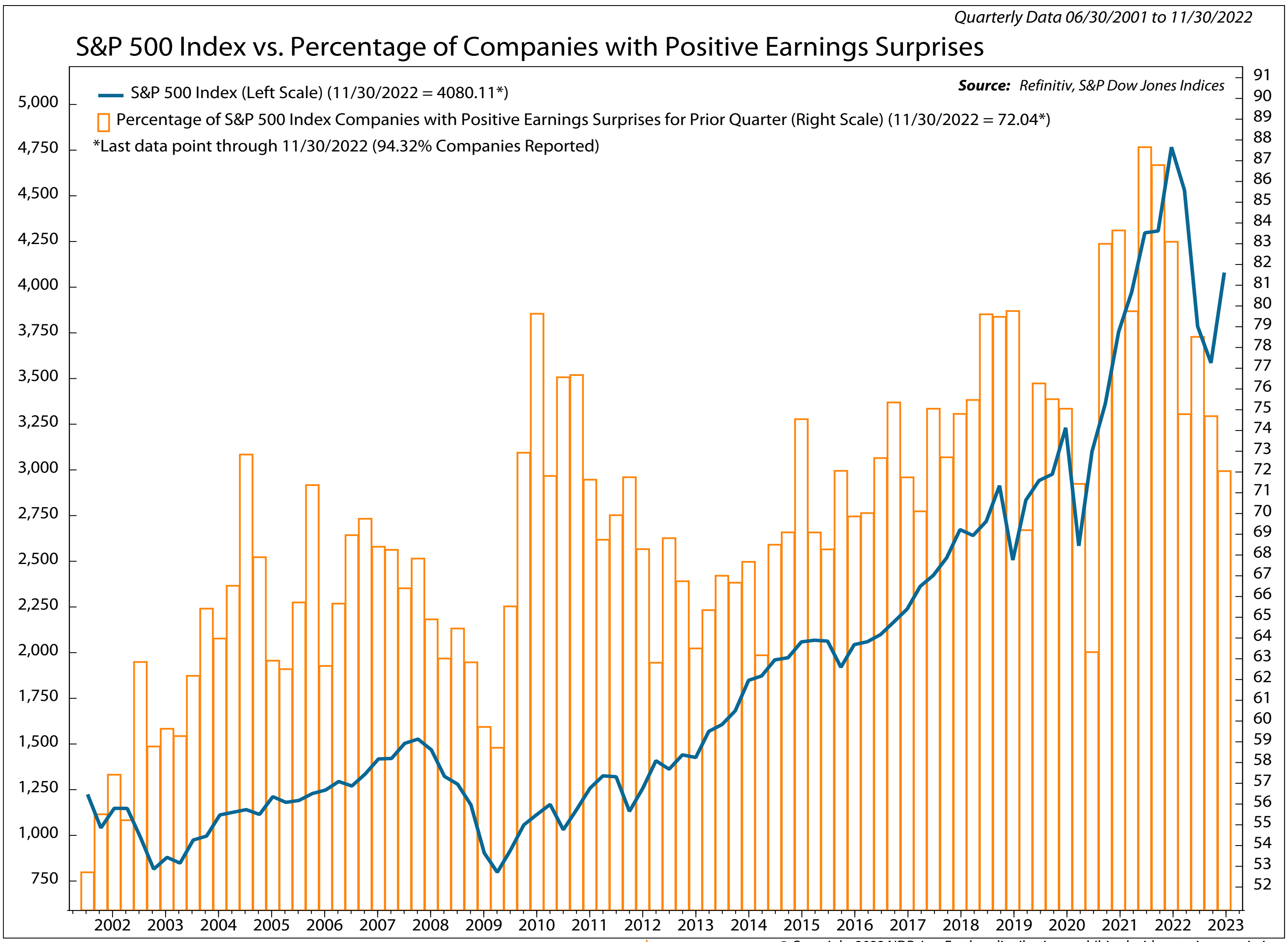
U.S. Market Update

The U.S. equity market continued its rally in November, as the S&P 500 Total Return Index rose by more than 500 basis points. It was the second month in a row with positive returns, the best string of performance since August 2021. All 11 S&P 500 sectors registered positive returns in the month of November, and as a result, breadth readings have seen substantial improvement.

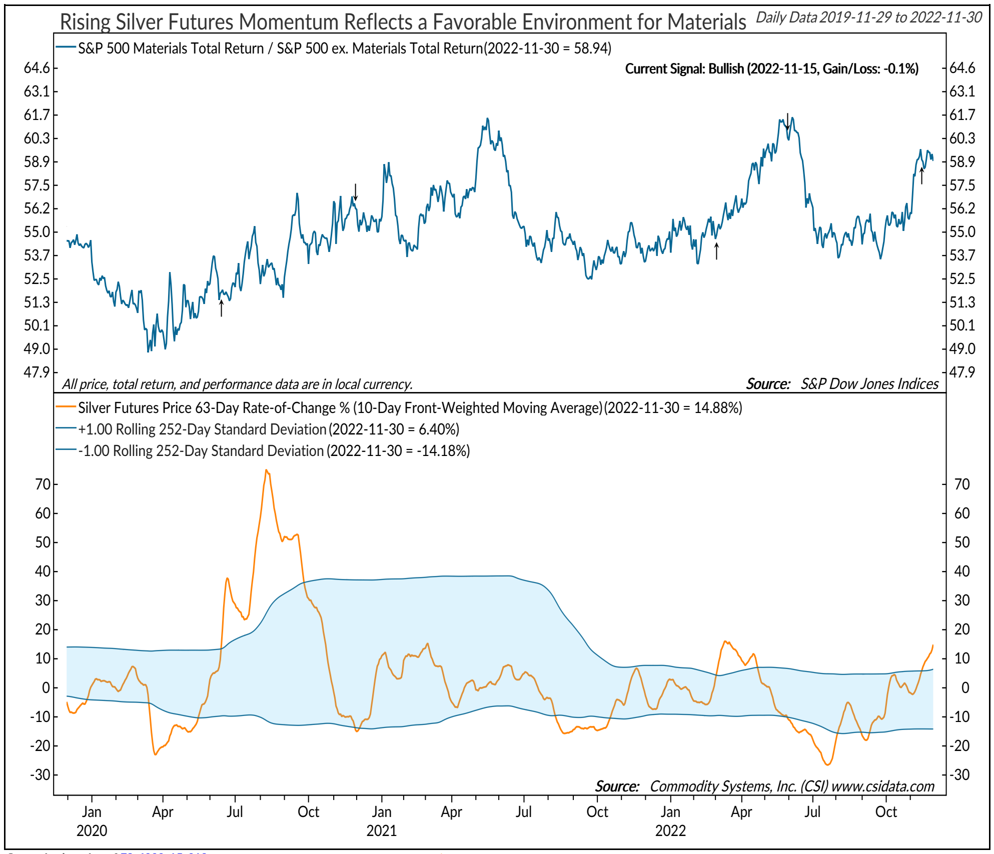
Equity markets continued to rise on hints that the Federal Reserve will soon downshift their rate hikes, which was reiterated in Chair Powell's speech on the last day of November. Rate hike downshifts are also likely in the short-term by the Bank of Canada and the Reserve Bank of Australia, providing more hope for a slowing and eventual pause of the global tightening cycle. Inflation measures appear to be rolling over from their recent highs, supporting more dovish Central Bank policies.

Rising interest rates have been a headwind for corporate profits. So, while sector leadership has been influenced by a higher interest rate environment, it has also been impacted by an earnings recession (S&P 500 year-to-year operating earnings growth has contracted for two-straight quarters). The S&P 500's earnings beat rate is at its lowest level since Q2 2020 (chart below). In the latest earnings season, Energy had the highest beat rate, while Communications Services had the lowest. Energy's high earnings beat rate was led by Equipment & Services, but all energy industries beat estimates in Q3 2022. For Communication Services, the beat rate represents the sector's lowest since Q2 2018. The interactive Media, Entertainment, and Media industries were drags on the sector's results.

Entering December, the sector model overweighted Value areas such as Energy, Materials, and Financials, as well as defensive sectors like Utilities and Consumer Staples. Industrials, Health Care, and Real Estate entered the month below benchmark allocation. Communication Services and Consumer Discretionary are two sectors that are significantly below benchmark weighting.



The Materials sector remains overweight, and the model increased the sector's allocation in December. Silver futures momentum (chart right) joined the bullish momentum from gold, natural gas, and copper, reflecting broadening commodity tailwinds for the sector. Favorable valuations and upward earnings revisions have provided additional support, which has been confirmed via strengthening price trends, strong momentum, and reduced volatility. However, industrial production for materials has weakened and is now bearish for the sector.



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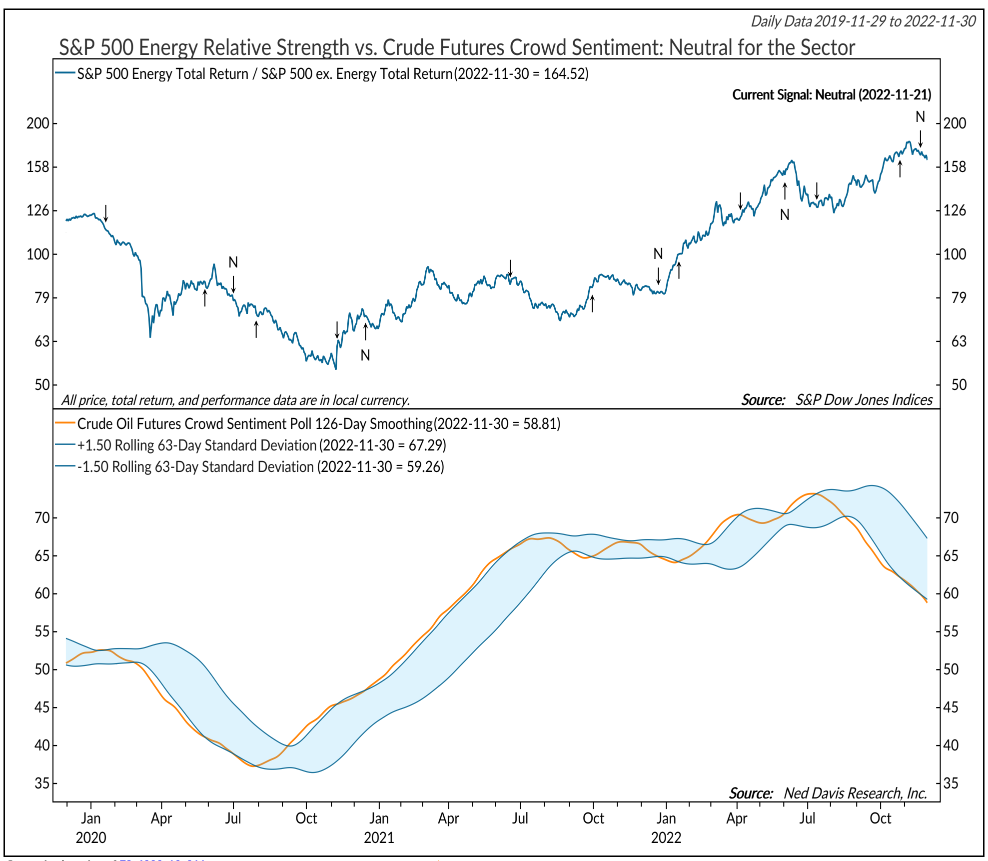

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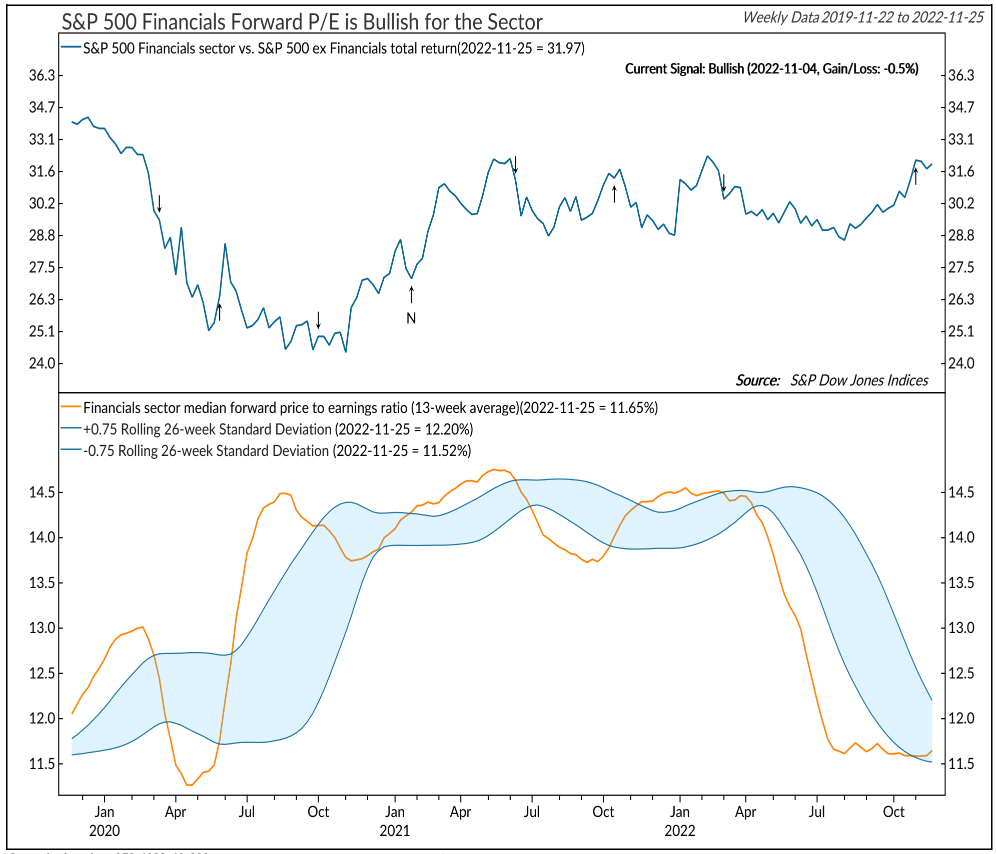
After nearly a 25% gain in October, Energy sector returns moderated to about 1%, but it continues to be overweight in our model. A weakening U.S. Dollar and favorable cash flow yield are tailwinds for the Energy sector, which are confirming the strong techincal readings. However, oil prices are off their highs and momentum is waning—something to keep an eye on. Lower oil prices has led to less optimism from investors, driving sentiment from a bullish to a neutral influence for the sector (chart left).

The Financials sector has been seeing steady improvement in our model since August. For December, the sector moved to an overweight allocation, as investors likely anticipate the end of the tightening cycle sometime in Q1 2023. Historically, the 10-year Treasury yield typically peaks at or before the end of a tightening cycle. Despite Financial company margins continuing to contract in Q3, investors appear to be bottom fishing in this large Value sector as the forward P/E is attractive at less than 12x (chart right).



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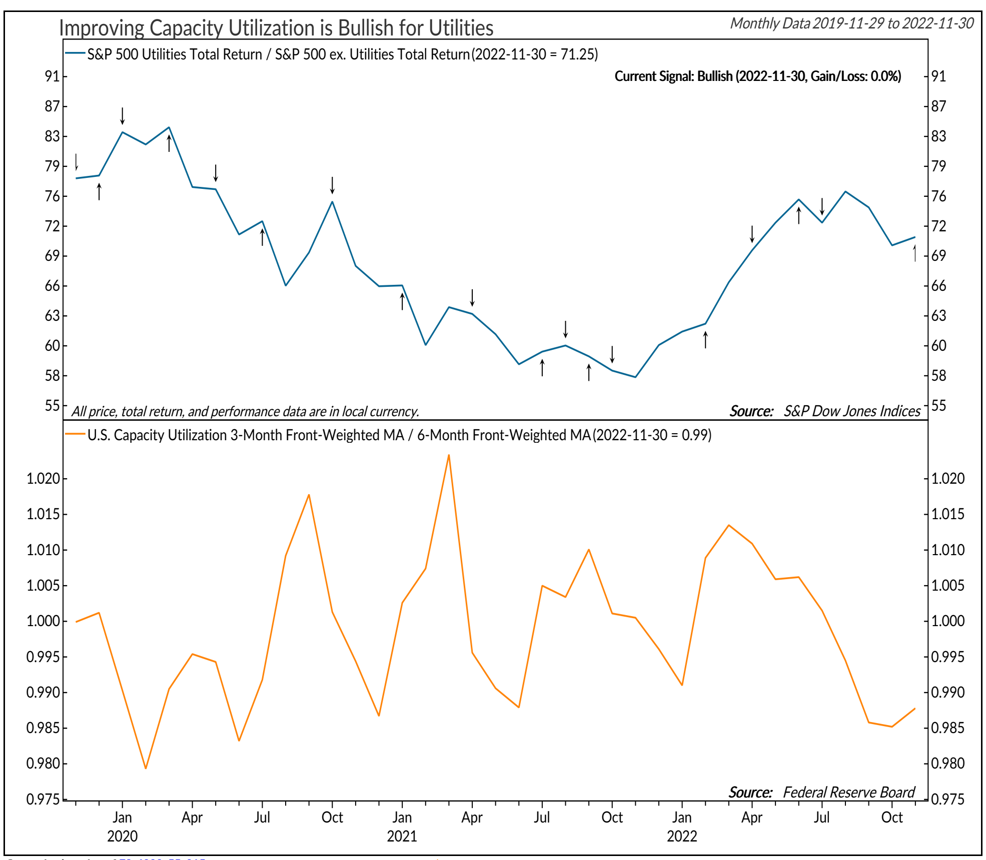

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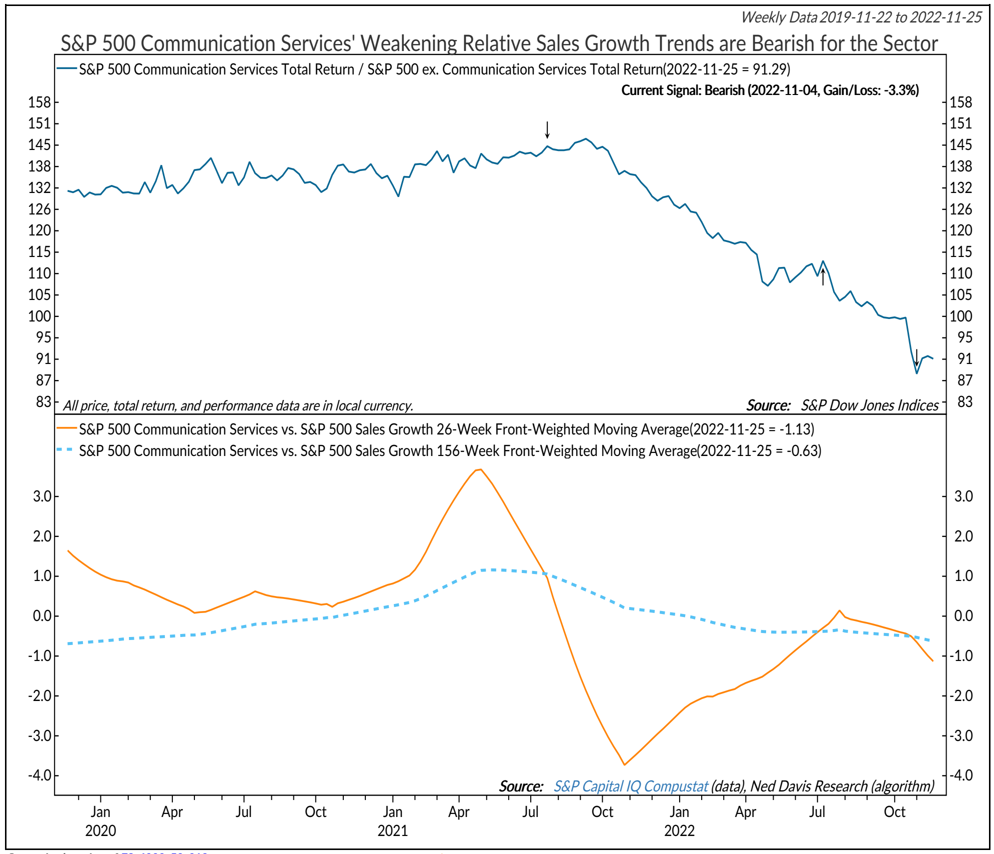
Utilities jumped from underweight to overweight on technical improvement as trend, momentum and relative price reversals are now bullish. Utilities is considered a bond proxy sector because a relatively large portion of its total return is derived from dividends. At about 3%, the sector sports the third-highest dividend yield behind only Real Estate and Energy. While bond proxy correlations with yields are weaker than pre-COVID levels, they remain negative and have been trending lower throughout the year. On a fundamental basis, capacity utilization improved in November off its lows, which is bullish for the sector (chart left).

Communication Services' allocation dropped sharply and is now well below benchmark weighting. While Meta and Alphabet's stock prices recovered in November (+26% and 7%, respectively), Walt Disney's stock price struggled (-8%) during the month. Walt Disney management recognized there were strategic issues and hired back Bob Iger as CEO. In general, cyclical Growth sectors have had a tough year. Antitrust suits continue to provide a cloud of uncertainty and subscriber growth for streaming services is becoming more difficult as competition rises. Widening OAS, weak earnings revisions, elevated relative valuations, and weaking sales growth trends (chart right) are headwinds for a sector with rising volatility and declining price trends.



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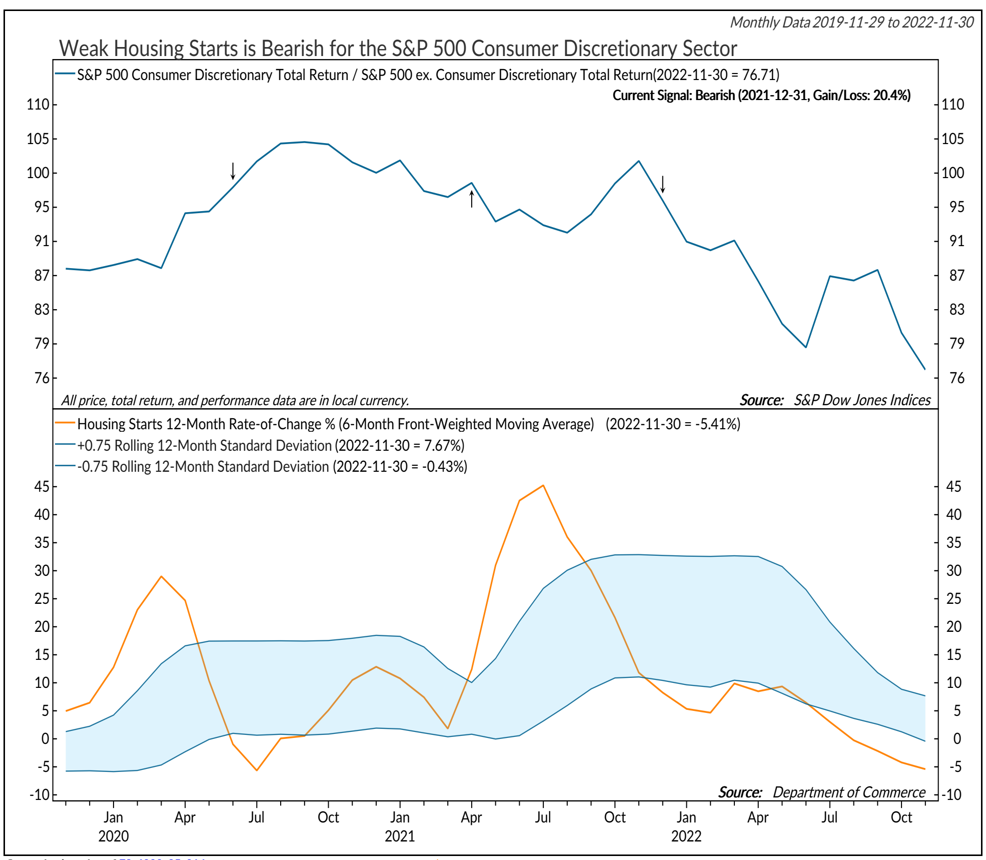

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The Consumer Discretionary sector's allocation was steady and remains the most underweight sector. While consumer services areas continue to recover from their COVID lows, durable good sales remain under pressure from higher interest rates. Amazon and Tesla, which together make up about 40% of the sector, had negative returns in November. Weak consumer credit conditions, discretionary consumer spending trends, earnings surprises, December seasonal tendencies, and housing starts (chart left) are all headwinds for the sector.

Summary

The sector allocation strategy has been influenced by rising rates and an earnings recession, resulting in more Value and defensive sector leadership. Energy, Materials, Financials, Utilities, and Consumer Staples are overweight, while Communication Services, Consumer Discretionary, Real Estate, Health Care, and Industrials are underweight. The sector model uses objective, sector-specific indicators to determine opportunities and identify risks.

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.

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