# Smart Sector® Strategy

AUGUST 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) was unchanged from last month and entered August with a fully invested equity allocation recommendation.

Figure 1: Smart Sector® Catastrophic Stop Sell Model

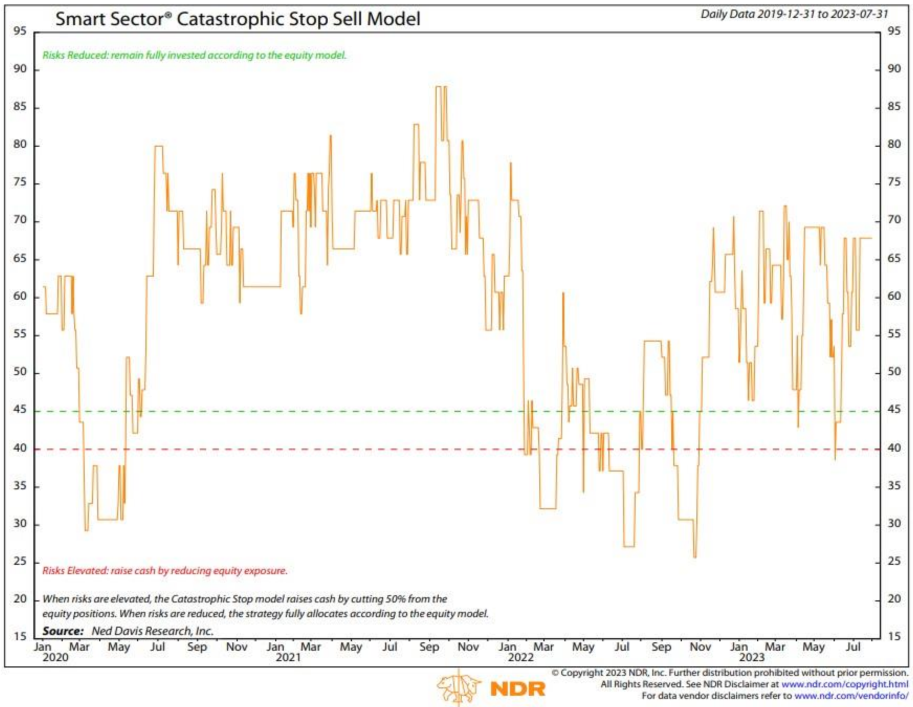
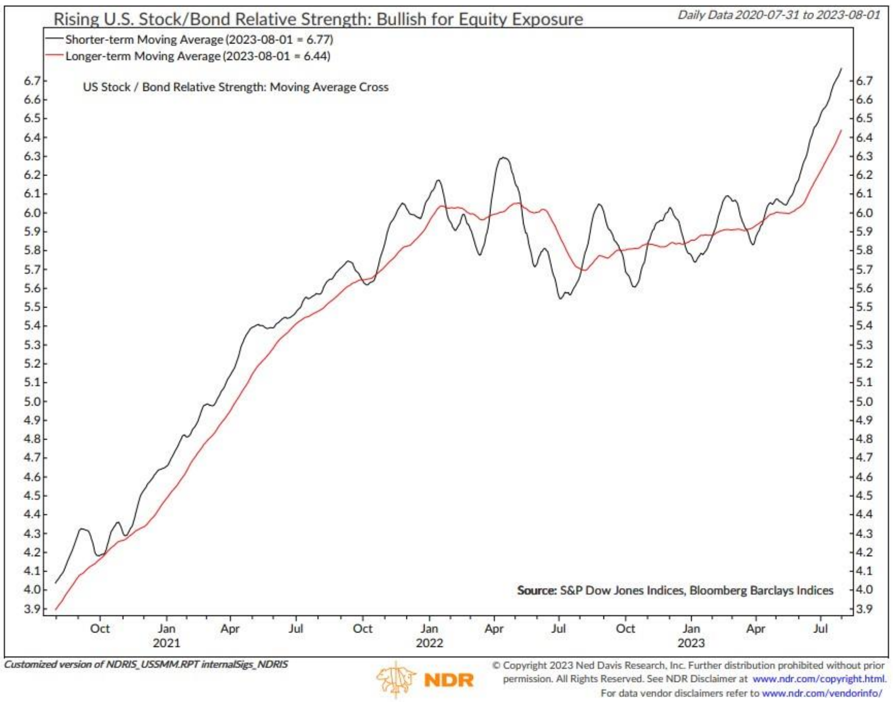



Figure 2: Rising U.S. Stock/Bond Relative Strength: Bullish for Equity Exposure




The model's steadiness is driven by five (of seven) internal (price-based) measures that remain bullish, including rising stock/bond relative strength (chart left). While external influences such as trade and market sentiment remained bearish, they're offset by bullish readings from high-yield and emerging market bond breadth, as well as high-yield option-adjusted spreads. For now, the weight of the evidence recommends a fully invested allocation to equity sectors according to the model.

## U.S. Market Update

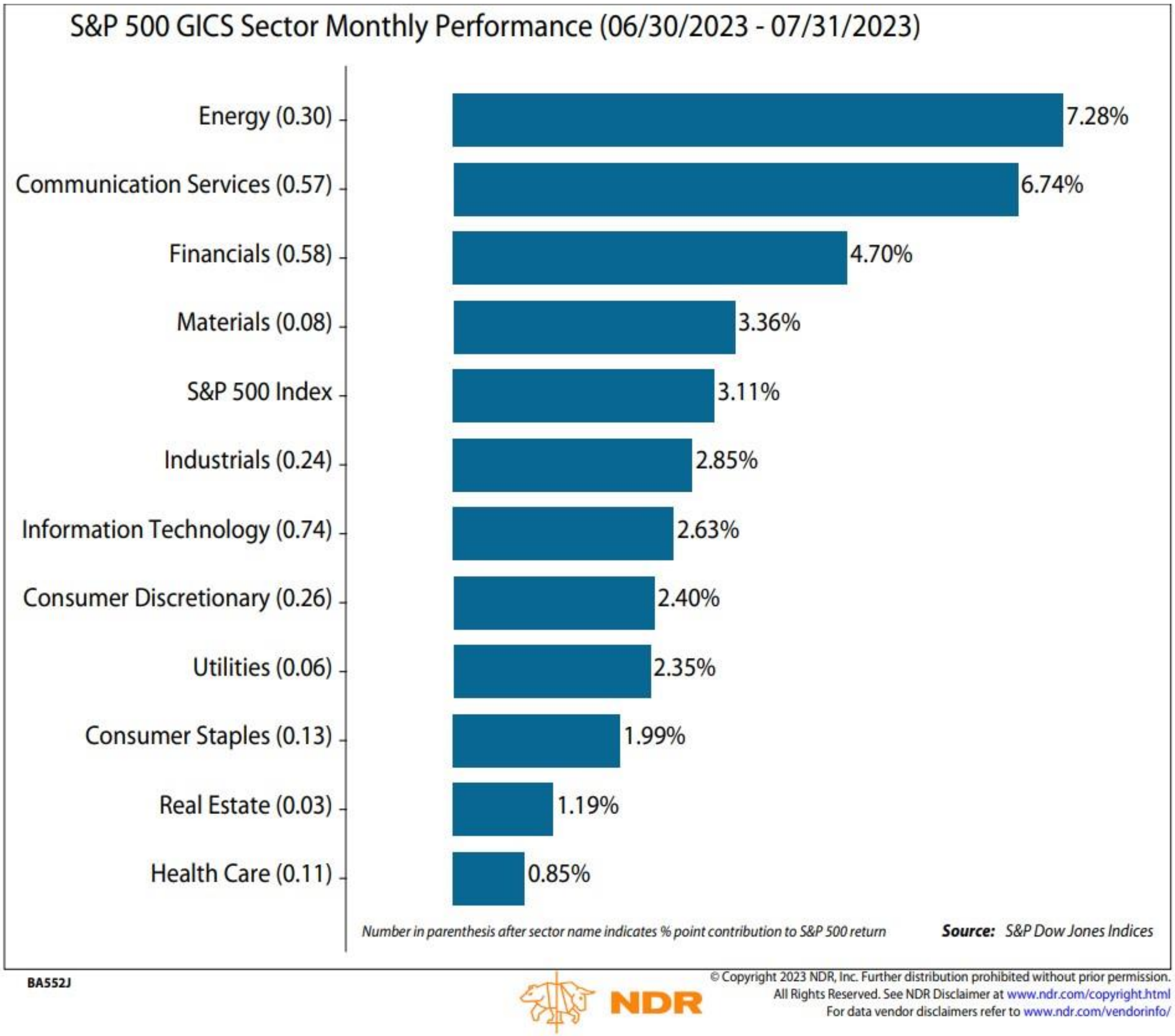
The S&P 500 gained 3% in July, up for the fifth month in a row. Breadth remained solid—all 11 S&P 500 sectors posted positive returns in July. Performance was led by cyclical Value sectors—Energy, Financials, and Materials—as well as Communication Services (chart below).

By mid-July, the rally off the autumn lows met the definition of an NDR-defined bull market (a combination of market gains and time). The 2022 bear market decline of nearly 22% was in line with non-recession bear markets, as well as cyclical bear markets within secular bulls.

Factors that could contribute to a defensive rotation in the second half of the year include an aggressive Fed, a worsening economic outlook, and a moderation of stock market momentum. The biggest challenge for defensive leadership could be continued economic strength. Within cyclicals, Value sectors like Energy, Financials, and Materials have tended to be the most economically sensitive. However, multiple measures of extreme optimism represent a near-term risk for stocks and cyclical leadership.

The sector model remained with a mix of cyclical and defensive leadership during the month. Entering August, the sector model is overweight Energy, Health Care, Materials, and Utilities. Information Technology dropped to marketweight. Financials, Consumer Staples, and Real Estate are underweight.

**Figure 3:** S&P 500 GICS Sector Monthly Performance (06/30/2023-07/31/2023)



The Consumer Discretionary sector's allocation remains neutral. On a fundamental basis, while housing starts and discretionary spending remain headwinds for the sector, other indicators improved. Both consumer credit conditions (chart right) and earnings surprises moved to bullish levels during the month. This was confirmed by five of six technical indicators being bullish.

Figure 4: Improving Consumer Credit Conditions is Bullish for the S&P 500 Consumer Discretionary Sector

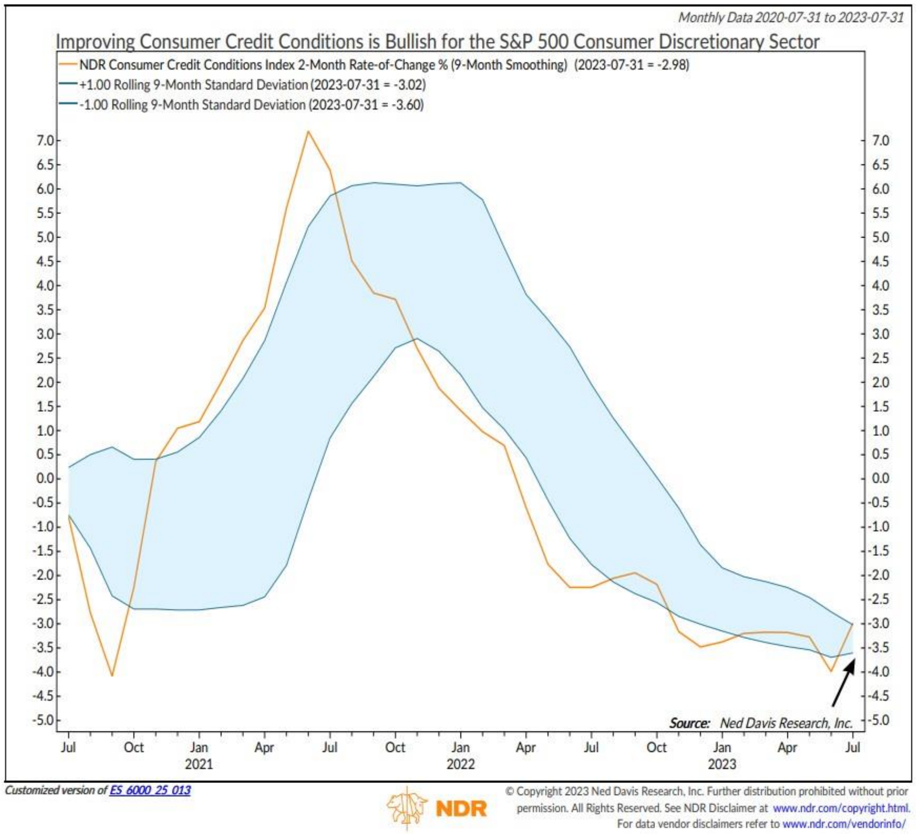
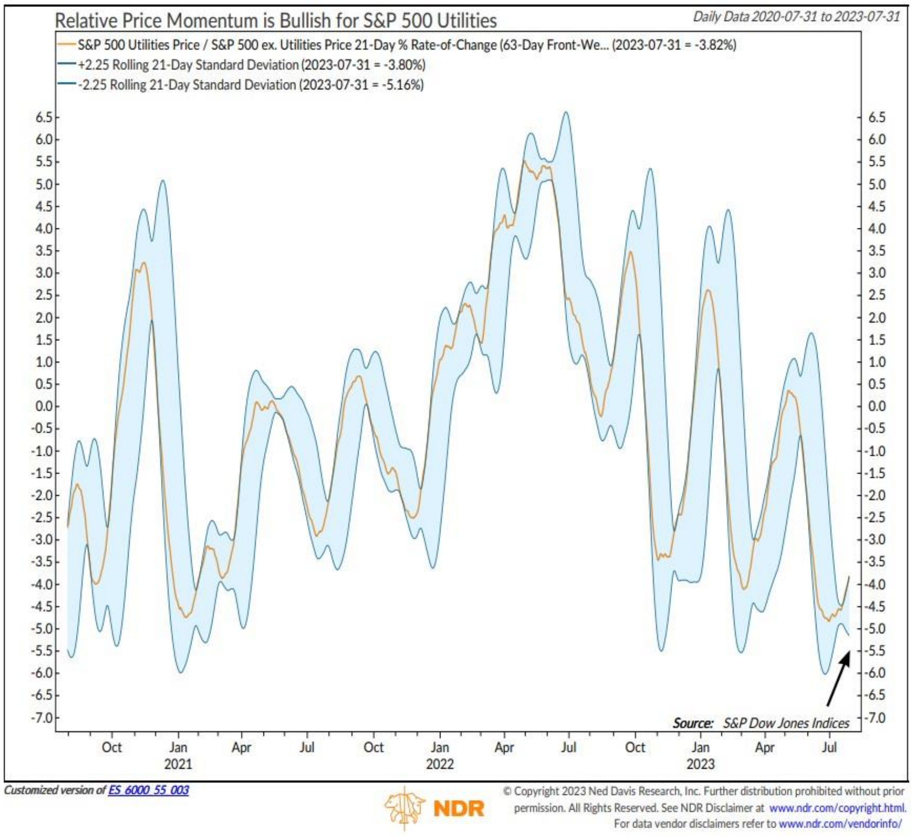



Figure 5: Relative Price Momentum is Bullish for S&P 500 Utilities




Allocation to the Utilities sector rose modestly in July and remained at overweight. While an improving copper/gold ratio (a measure of improving economic growth) moved bearish for this defensive sector during the month, there were several technical indicators that improved. Confirming the sector's short-term oversold condition, an improvement in relative price momentum (chart left), price reversal, and breadth flashed bullish signals.

Figure 6: Long-Term Breadth is Bullish for the S&P 500 Information Technology Sector

Allocation to the Information Technology sector dropped over 100 basis points in July, moving the sector to marketweight. Tech gains have moderated over the past two months and have been more in line with benchmark returns. There were no indicator changes during the month. Three of the five external (macro-based) indicators—sales yield, inflation expectations, and earnings revision breadth— continue to be bearish. Four of the five internal (price-based) indicators, including long-term sector breadth (chart right) remain bullish.

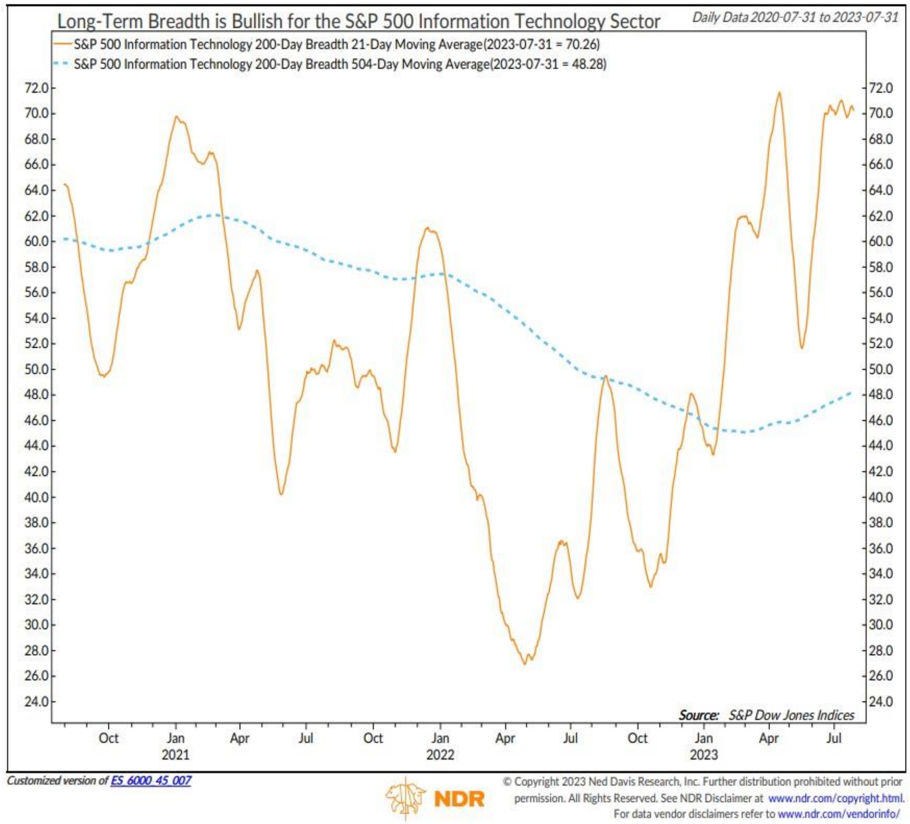
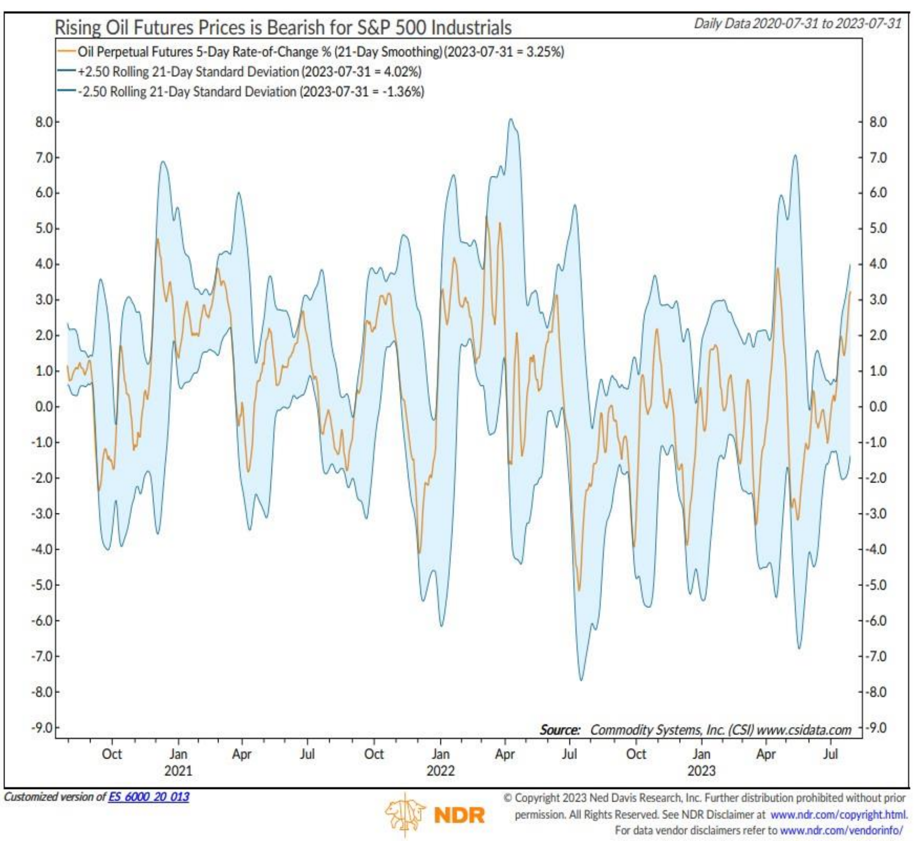



Figure 7: Rising Oil Futures Prices is Bearish for S&P 500 Industrials




Industrials' allocation declined 100 basis points, moving it to a slight underweight. Four of the seven external indicators are now bear¬ish, with rising oil futures prices moving to a negative level for the sector during the month (chart left). However, four of the six internal (price-based) indicators remain bullish. Only 3-month volatility and a relative strength index are bearish.

Consumer Staples' allocation rose slightly in July, but it remains the largest underweight position. The sector was up about 2% in July but lagged the S&P 500 benchmark. On a fundamental basis, credit conditions and economic surprises remain bullish for the sector. However, the majority of external measures are bearish. While most price-based measures are also bearish, a short-term overbought/ oversold indicator moved bullish during the month (chart right). Keep in mind, though, relative strength is still very close to the bottom of its recent range, so this indicator could get whipsawed.

Figure 8: Reversal from a Short-Term Oversold Level is Bullish for S&P 500 Consumer Staples

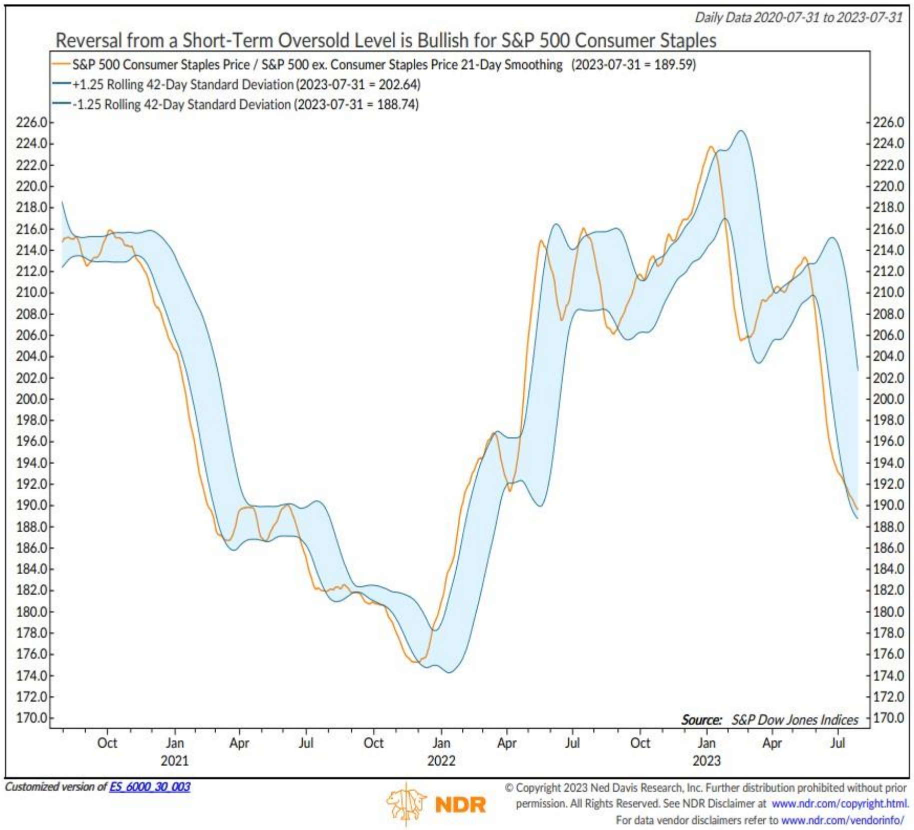
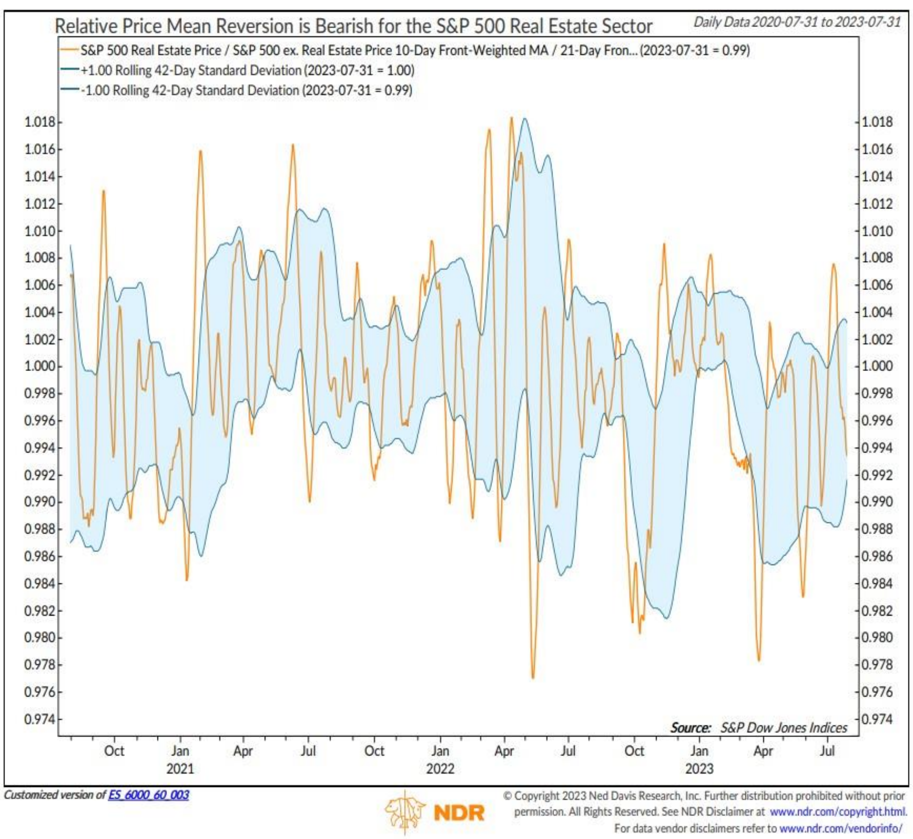



Figure 9: Relative Price Mean Reversion is Bearish for the S&P 500 Real Estate Sector




Allocation to the Real Estate sector dropped in July, which moved it to an underweight position. On a fundamental basis, the major¬ity of external indicators are bullish, including business credit conditions which now provide a tailwind for the sector. However, technicals de¬teriorated with an additional indicator flashing bearish during the month (chart left).

## Summary

The sector model remained with a mix of cyclical and defensive leadership during the month. Entering August, the sector model is overweight Energy, Health Care, Materials, and Utilities. Information Technology dropped to marketweight. Financials, Consumer Staples, and Real Estate are underweight. The sector model uses sector-specific indicators to determine opportunities and identify risks in an objective, weight-of-the-evidence approach.

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## 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 utilizes 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 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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