Smart Sector® International Strategy

JULY 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) improved from last month and entered July with a fully invested equity allocation recommendation.

Figure 1: Smart Sector® Catastrophic Stop Sell Model

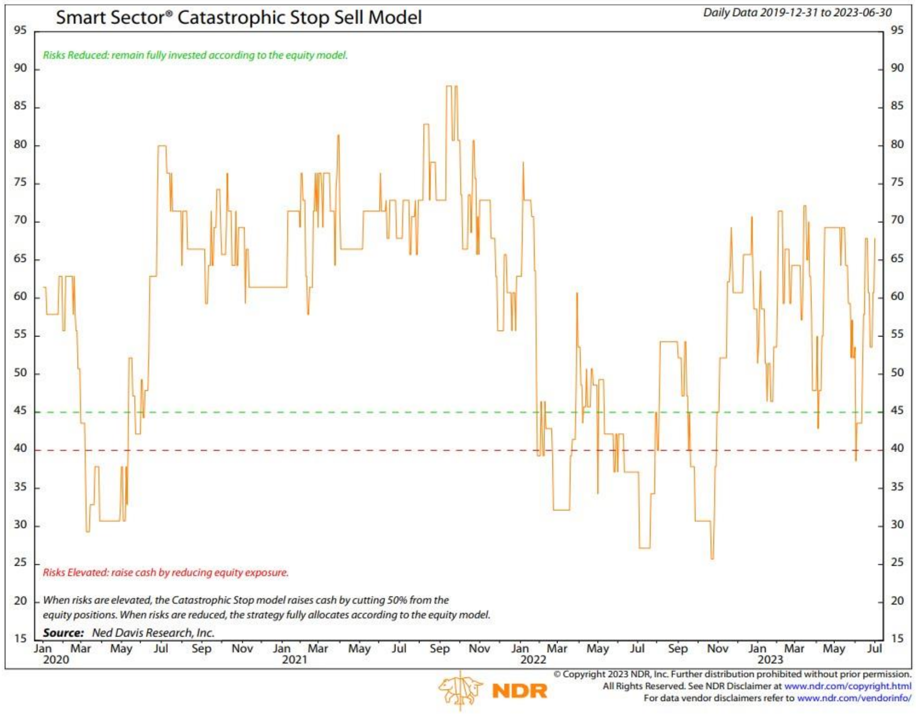


Figure 2: NDR Volume Demand Outpacing NDR Volume Supply: Bullish for Equity Exposure

The model improvement was driven by two internal (price-based) measures that moved bullish during the month—stronger global stock market breadth and stock volume demand outpacing supply (chart left). While external influences such as trade and market sentiment moved bearish during the month, it was partly offset by a bullish reading from high-yield and emerging market bond breadth. Some of these indicators will need to improve if the stock market rally is going to continue deep into the second half of the year.

Global Market Update

The ACWI ex. U.S. Total Return Index increased over 450 basis points in June. It was the index's largest monthly gain since January. Among the strongest-performing markets were Turkey, Peru, Poland, Italy, and Brazil, while the largest underperformers included the Czech Republic, Finland, Malaysia, Qatar, and Indonesia.

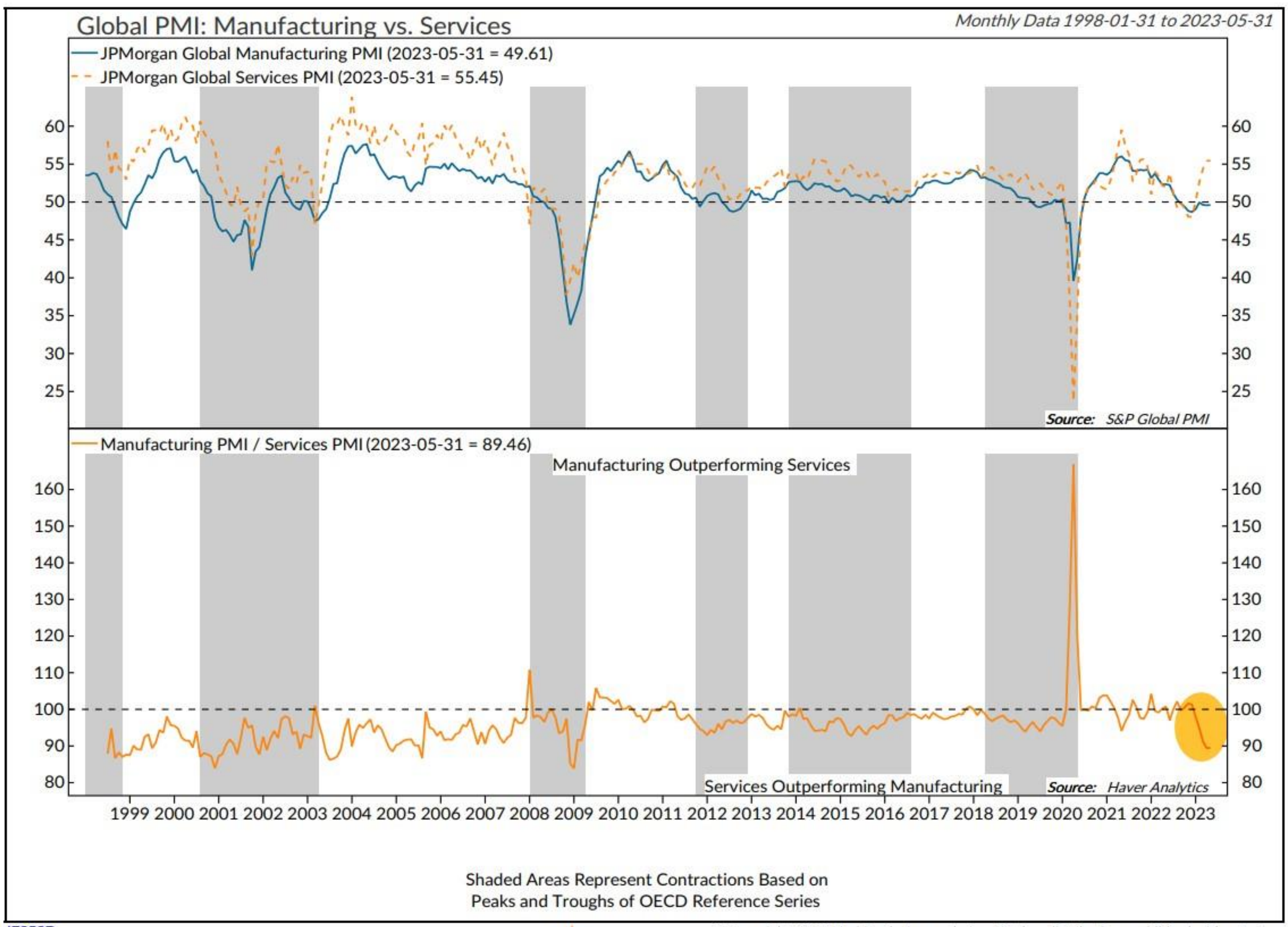
Global economic growth continued to accelerate in May, based on the S&P Global Purchasing Managers' Index (PMI) readings. The combined services and manufacturing global PMI rose to its highest level since November 2021. It was the sixth straight monthly increase, the longest winning streak since October 2009, when the global economy was just getting out of the Global Financial Crisis recession.

On an aggregate basis, the global economy appears to be in excellent shape, but it masks narrow leadership and sector-level divergences. Services continue to be the only growth driver, as manufacturing shrank for a third-straight month. The last such divergence between the services and manufacturing PMIs occurred in early 2009 (chart at bottom). Such gaps typically have not been indicative of an ominous economic future. Rather, they tend to happen either well into or towards the end of global slowdowns/recessions. This is because the more stable services sector often gains traction faster after economic bottoms.

Even so, the ability to maintain accelerating momentum will be more challenging in late 2023/early 2024. Businesses and households will continue to face tighter credit conditions in the U.S. and Europe as the impact of the past year's tight monetary policy continues to slowly work its way into the global economy. Stubbornly high inflation, particularly in the developed world, indicates that central banks will remain hawkish for longer. Meanwhile, China's growth will likely ease as pent-up demand is satisfied.

Entering July, the non-U.S. equity Core model overweighted Canada and Australia, marketweighted Japan and China, and underweighted the U.K., France, Switzerland, and Germany. The Explore model favored Mexico, South Korea, Poland, Taiwan, and India.

Figure 3: Global PMI vs. Central Bank Breadth



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Core Allocations

Japan's allocation is neutral relative to the benchmark but remains our largest absolute holding. In May, the composite (services and manufacturing) PMI reached its highest level in almost ten years (chart at right), and inflation swap rates rose, suggesting robust economic growth. The Japan Ministry of Finance's Business Outlook Survey demonstrated an improved outlook from large corporations. Japan's cyclically adjusted price-to-earnings ratio has been trading near its cheapest levels since the early 1980s.

The technicals have aligned with the externals (macroeconomic, fundamental, and sentiment data), as trend, momentum, and breadth indicators are bullish on the market. Furthermore, this year non-residents of Japan have had their largest net purchases of Japanese equities from over the last ten years.

Figure 4: Japan Composite (Manufacturing & Services) PMI

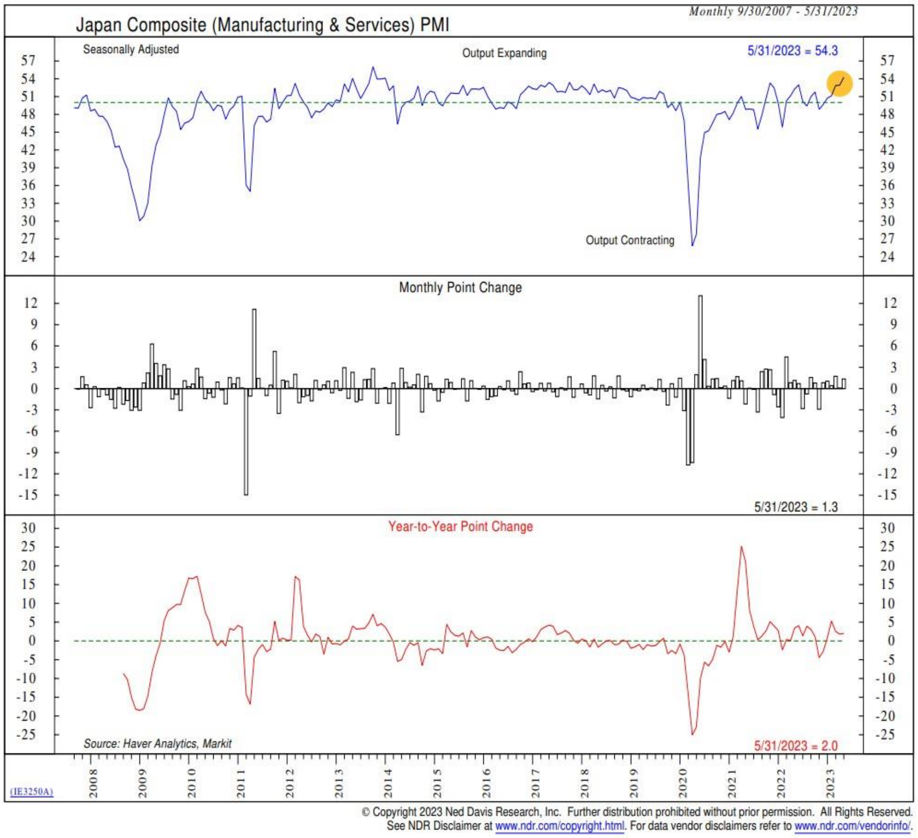


Figure 5: MSCI Australia Price Return Index (in local currency)

Australia shifted to overweight status this month. Trend, momentum, and breadth measures are bullish on the market, which is less than 5% from its all-time high (chart at left). Relative valuations within the market remain attractive as Australia's earnings yield is almost 300 bps above the 10-year government bond yield. Australia's inflation slowed this past month as it dropped to 5.6% for May. Australia's central bank responded by leaving its official cash rate unchanged.

Germany maintained its underweight position. The weakening trend and breadth have been driven by declining ETF asset levels and falling economic sentiment. The Ifo German business climate survey data missed expectations to a level consistent with recession risk. At the same time, inflation remains way above the European Central Bank's (ECB) 2% target. But Germany has among the highest unit labor cost growth (chart at right). This is important in determining inflation since it incorporates productivity.

Figure 6: Germany: Unit Labor Costs (Seasonally Adjusted)

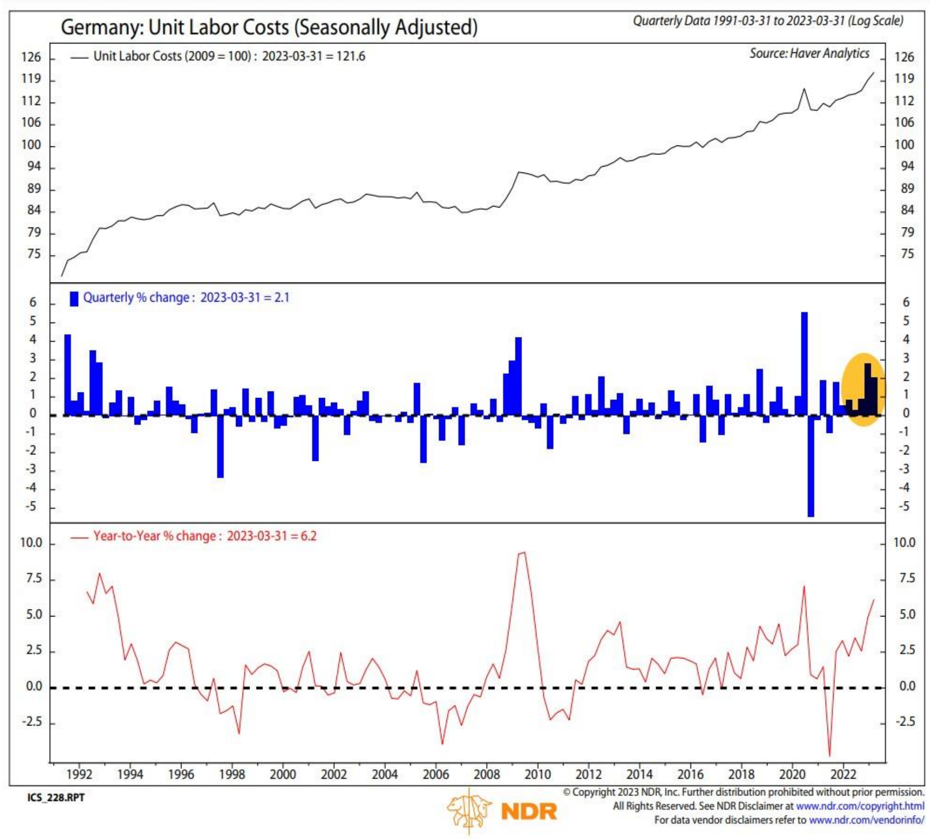
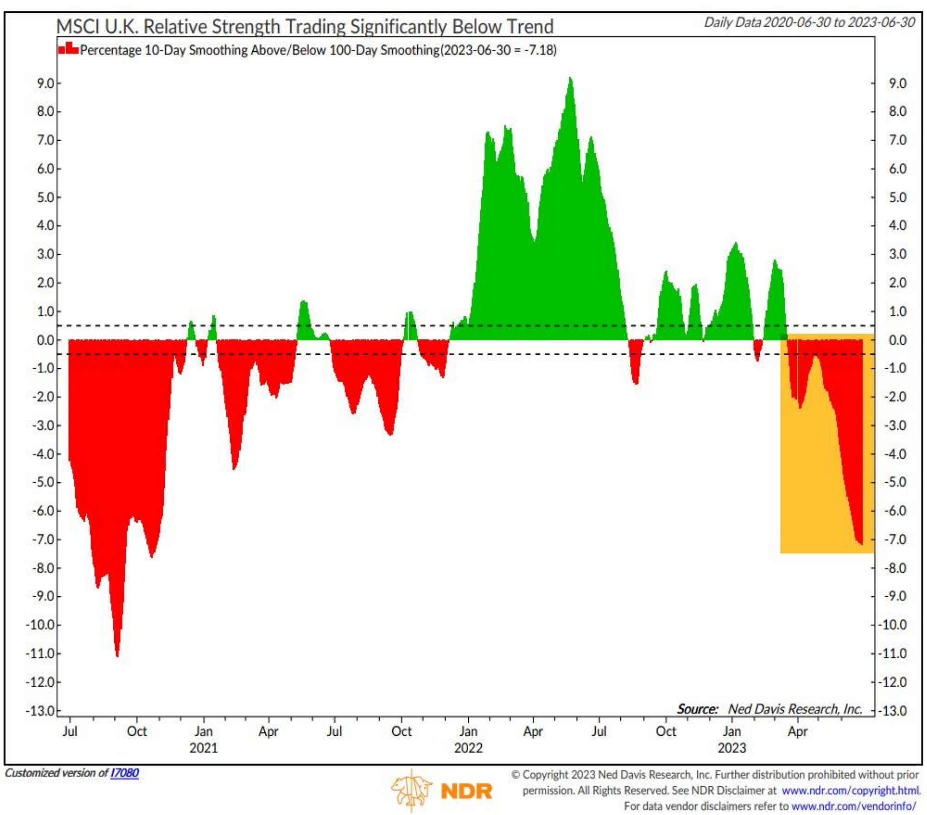


Figure 7: MSCI U.K. Relative Strength Trading Significantly Below Trend



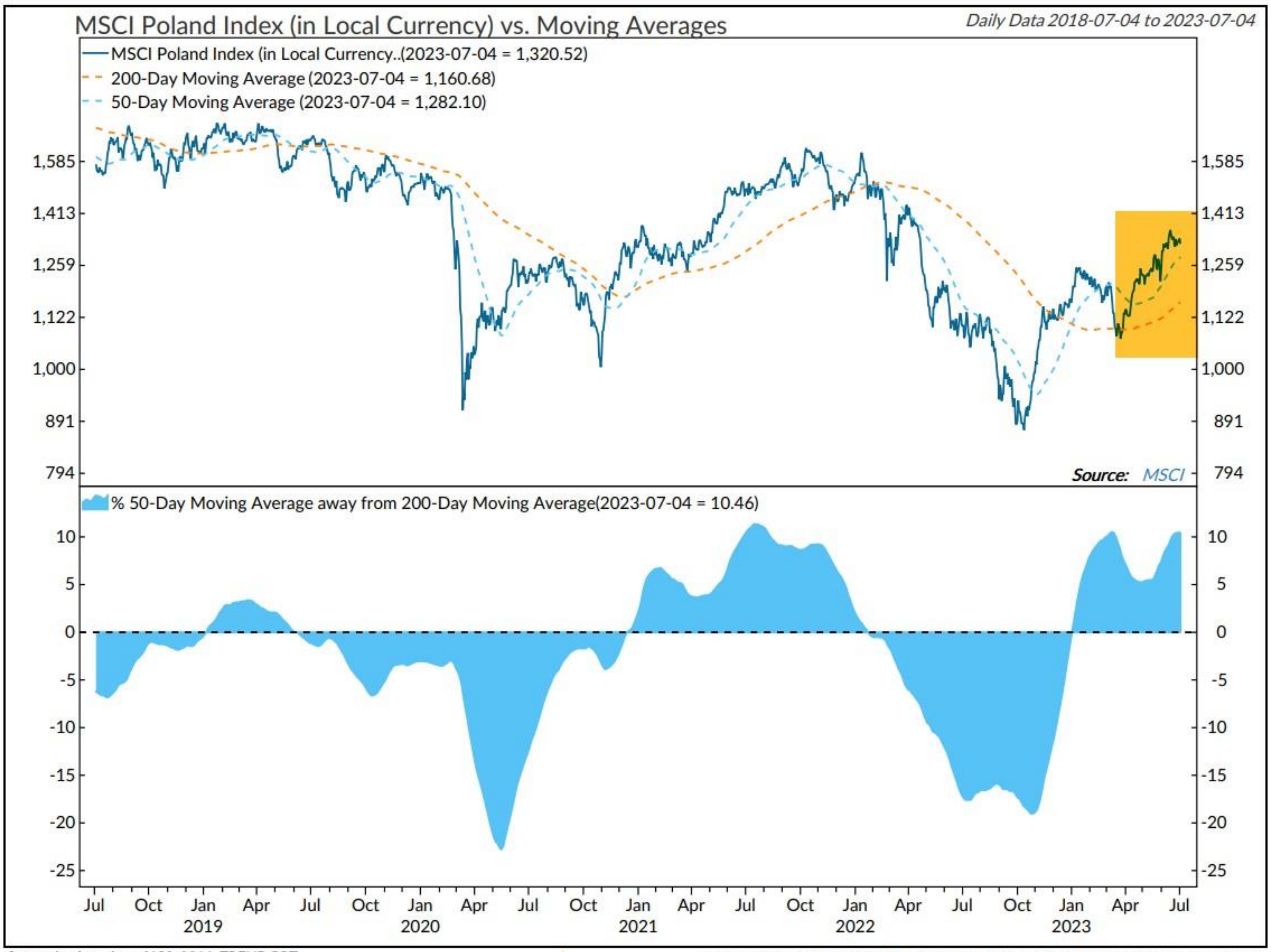
The U.K. dropped to the largest underweight allocation this month. Only two of its indicators are bullish. Sentiment has gotten pessimistic, which may drive a near-term bounce. However, economic measures are weak, and the price-based indicators have deteriorated. The U.K.'s relative strength to the world has fallen to its lowest level below trend since 2021 (chart at left).

Explore Opportunities

Among the top-ranked Explore markets are Mexico, South Korea, Poland, Taiwan, and India:

- The South Korea, Poland, Taiwan, and India regions have improving year-over-year trends in positive earnings revisions. Mexico's percentage of positive earnings revisions now stands at a solid 78.9%.
- Poland (chart at bottom), South Korea, Taiwan, India, and Mexico have favorable price trends as their 50-day moving averages trade above their counterparts.
- Over the last 21 days, South Korea and Poland have reached levels that are more than one standard deviation oversold, which historically has provided a near-term bounce opportunity. Taiwan and Mexico are nearly -0.8 standard deviations oversold.
- Poland, Mexico, India, and South Korea have low market capitalization-to-GDP ratios, which typically indicate favorable valuation. Taiwan's Forward P/E is just 15.5x, and Price/Cash Flow is 9.5x. Mexico's F/PE is 11.6x, and Poland is trading at just 7.6x forward earnings expectations.

Figure 8: MSCI Poland Index (in Local Currency) vs. Moving Averages



Summary

The Catastrophic Stop model improved from last month, as it continues to recommend a fully invested allocation.

Entering July, the non-U.S. equity Core model overweighted Canada and Australia, marketweighted Japan and China, and underweighted the U.K., France, Switzerland, and Germany. The Explore model favored Mexico, South Korea, Poland, Taiwan, and India.

The models combine macro, fundamental, technical, and sentiment indicators to determine opportunities and identify risks in an objective, weight-of-the-evidence approach.

Strategy Description

- The Smart Sector® International strategy combines three Ned Davis Research quantitative investment strategies: The Core International, Explore International, and the NDR Catastrophic Stop.

The process is based on the weight of the evidence

Core Allocation

- The fund begins by overweighting and underweighting the largest non-U.S. equity markets based on Ned Davis Research's proprietary models.
- Each of the models utilize market-specific, weight-of-the-evidence composites of fundamental, economic, technical, and behavioral indicators to determine each area's probability of outperforming the ACWI ex. U.S. Markets are weighted accordingly relative to benchmark weightings.

Explore Allocation

- To select smaller markets, the fund uses a multi-factor technical ranking system to choose the top markets. The markets with the highest rankings split the non-Core model allocation equally.

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 us at:

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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