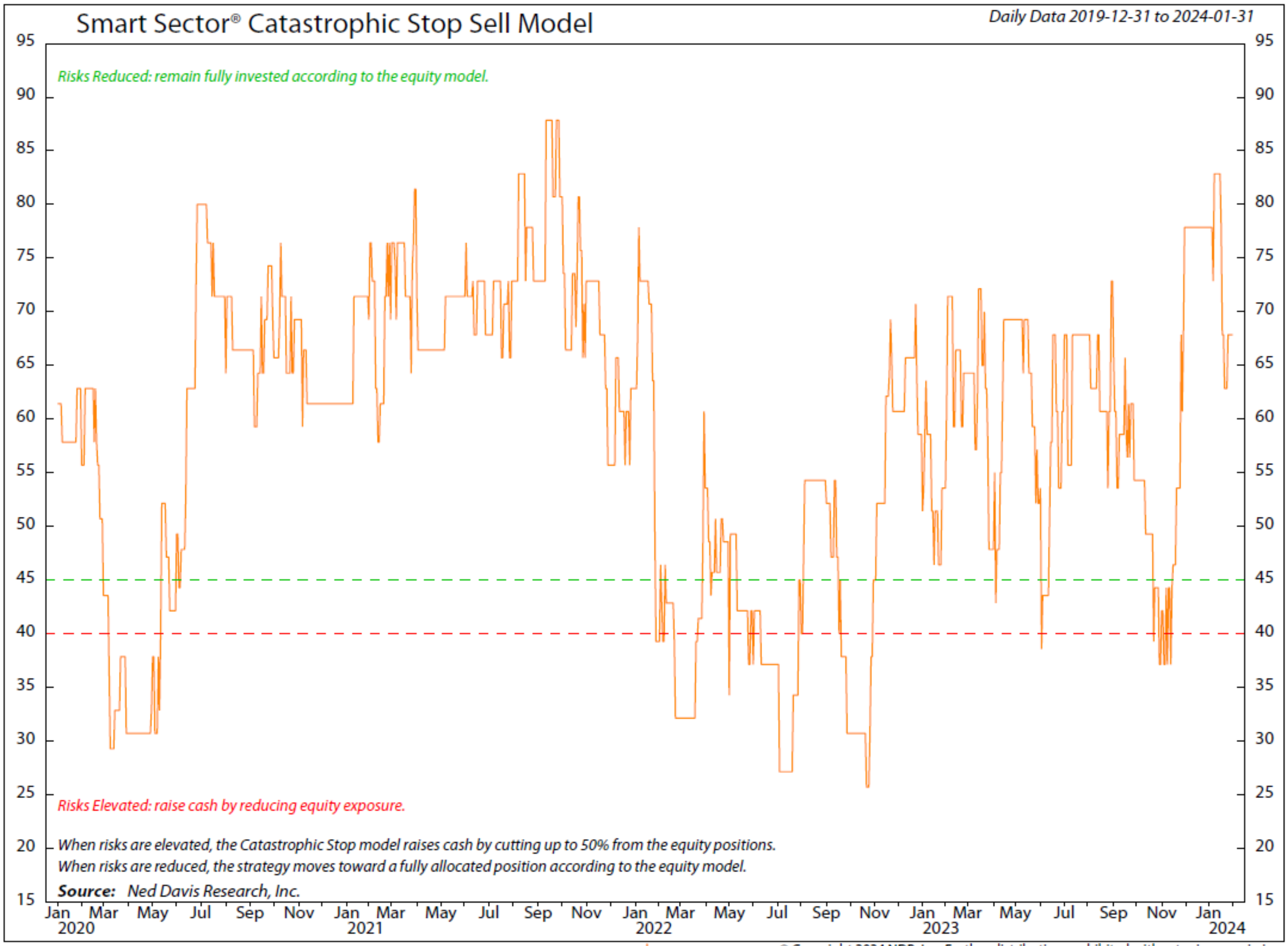
Smart Sector® Strategy

FEBRUARY 2024

Catastrophic Stop Update

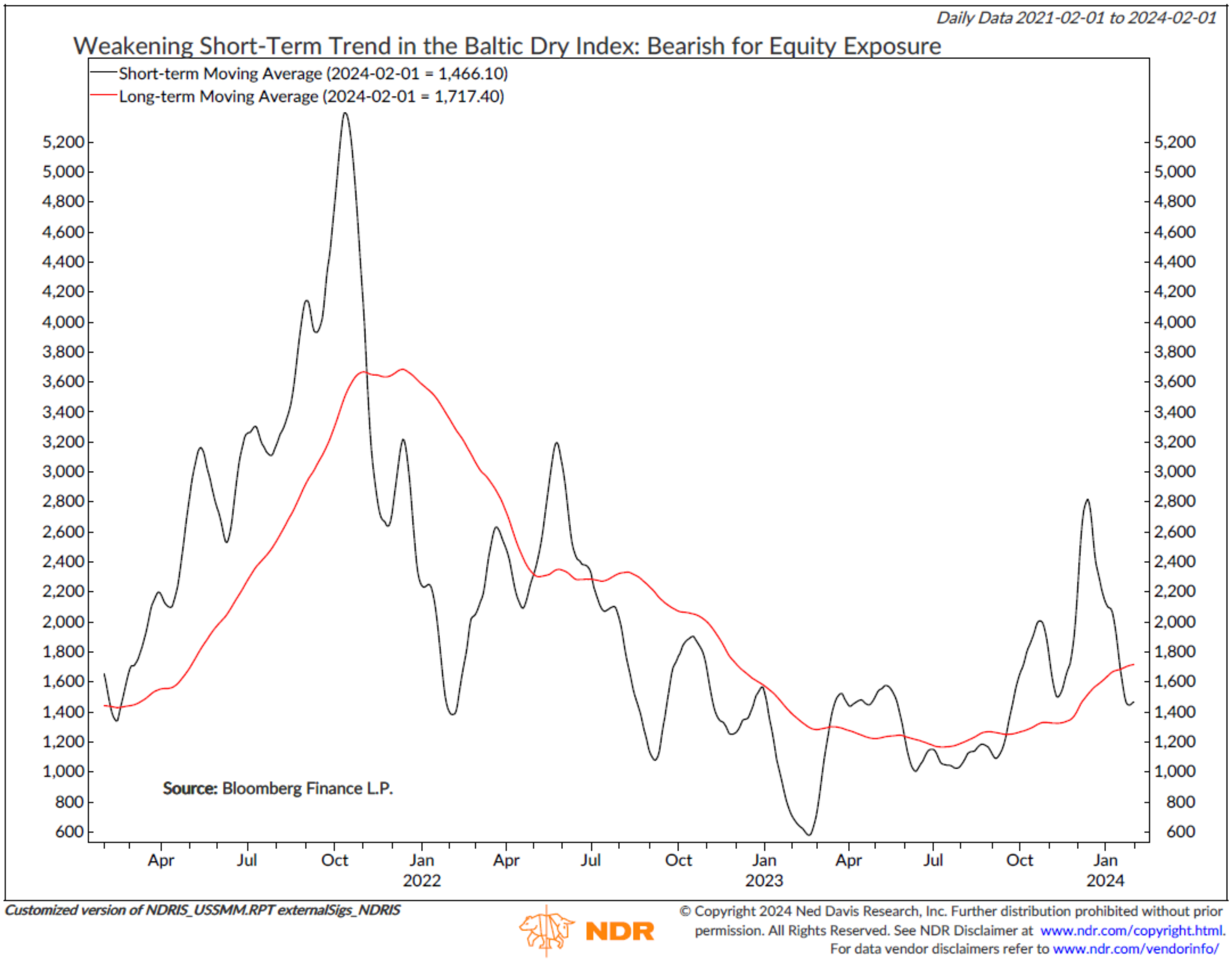
The NDR Catastrophic Stop Sell model combines time-tested, objective indicators designed to identify high-risk periods for the equity market. The model (Figure 1) weakened during the month but entered February with a fully invested equity allocation recommendation.

Figure 1: Smart Sector Catastrophic Stop Sell Model



The bullish reading from the model is driven by strong internals. Five of the seven price-based measures—including relative strength, trend, and breadth—remain bullish. However, external measures are more mixed. While option-adjusted spreads and high-yield and emerging market breadth are bullish, the short-term trend in global trade—as measured by the Baltic Dry Index—became bearish during the month (Figure 2). Furthermore, investor sentiment remains excessively optimistic, which is bearish for stocks. For now, the weight of the evidence recommends a fully invested allocation to equity sectors according to the model.

Figure 2: Weakening Short-Term Trend in the Baltic Dry Index: Bearish for Equity Exposure



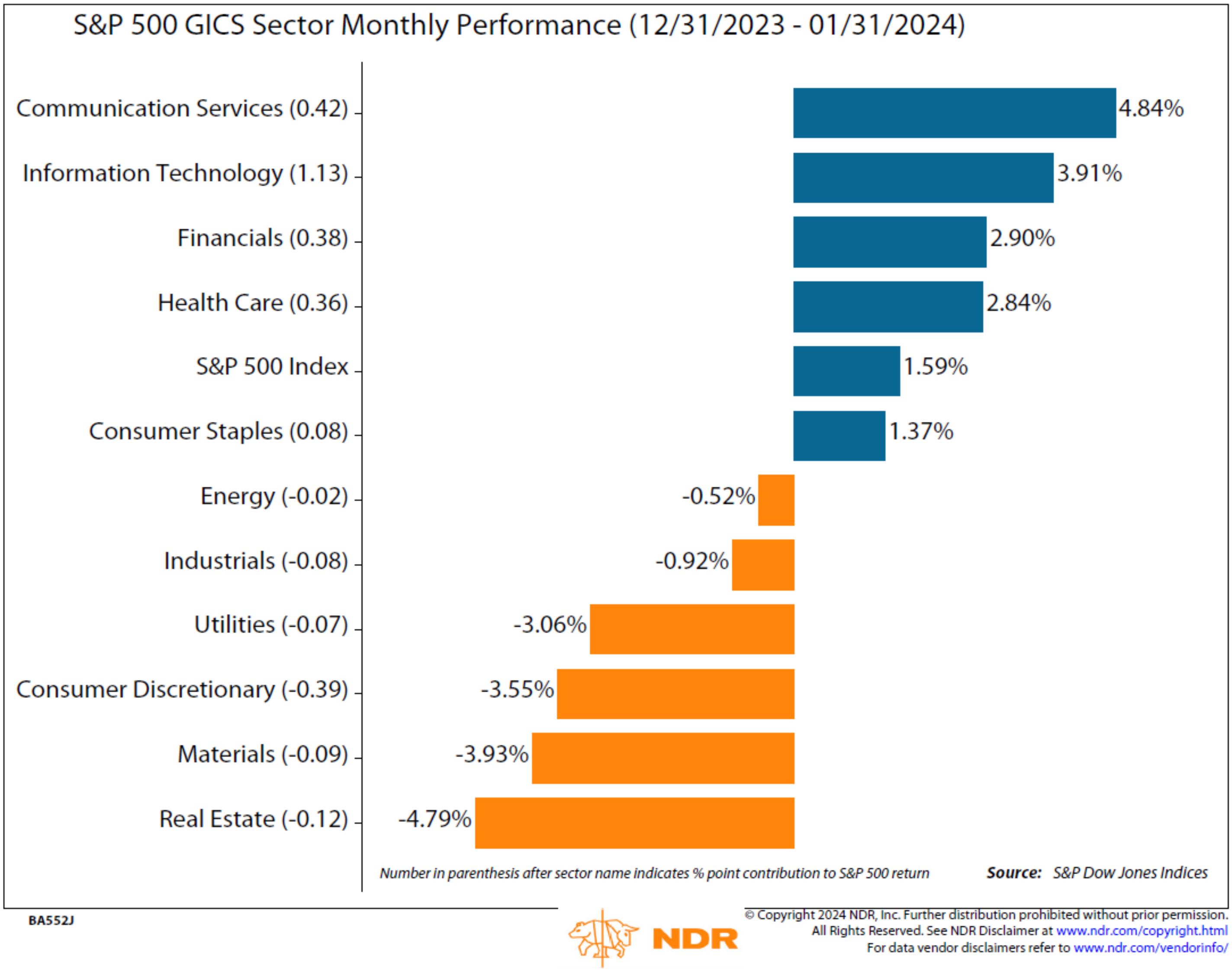
U.S. Market Update

The S&P 500 Total Return Index's end-of-year momentum carried into 2024, with a gain of about 1.7%. Breadth deteriorated, with 6 of 11 S&P 500 sectors posting positive price gains for the month (Figure 3). Several of the "Magnificent Seven" (Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta Platforms, and Tesla) continued their strong gains, which led to Communication Services and Information Technology being the top two best-performing sectors for the month.

The stock market has historically rallied after the first rate cut. When there has not been a recession, the rally has been stronger. At the January meeting, the Fed noted they want to see "greater confidence" that inflation is moving sustainably toward its 2% target. Powell indicated that March was not the Fed's base case for the first rate cut. We are still projecting a "soft landing" and the first cut to be closer to the May timeframe. With cyclical sectors like Financials, Information Technology, Industrials, and Communication Services tending to historically outperform during slow easing cycles, the improvement in the Financials sector's performance may be anticipating this type of environment.

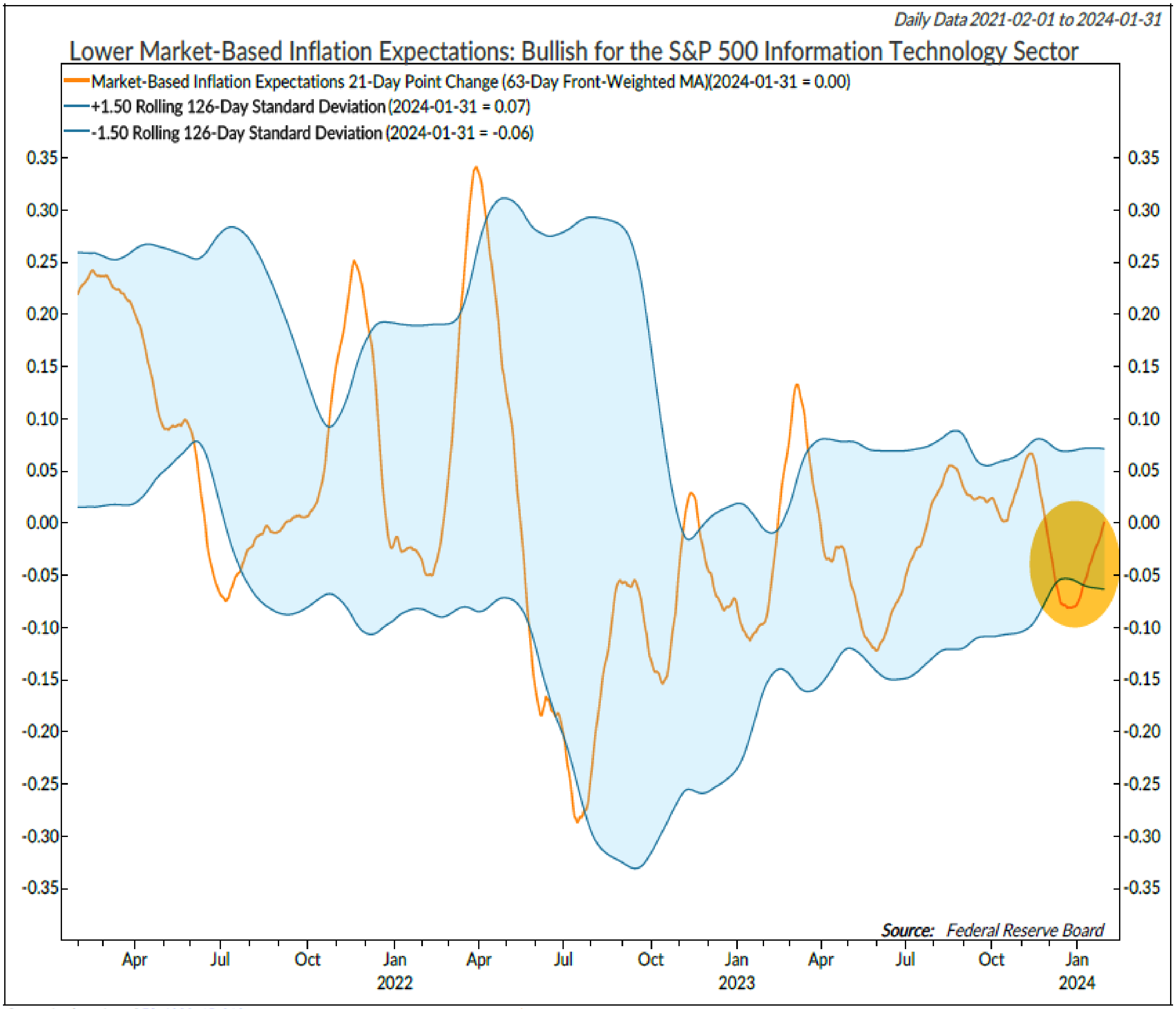
The sector model remained with a cyclical bias during the month, but there were some changes. Entering February, Financials and Communication Services improved and joined Information Technology and Health Care at overweight. Consumer Discretionary, Consumer Staples, Energy, and Real Estate are Neutral. Materials, Industrials, and Utilities are underweight.

Figure 3: S&P 500 GICS Sector Monthly Performance (12/31/2023-01/31/2024)



Information Technology's allocation rose sharply during the month and is now the largest overweight position. The S&P 500 Information Technology Index was the second-best performing sector in January (+3.9%), with Nvidia and Microsoft contributing the most to the sector's gains. On a fundamental basis, valuation improved to neutral, and inflation expectations flashed a bullish signal (Figure 4). Technicals confirm with one of the overbought/oversold indicators joining the other four internal (price-based) at a bullish reading during the month.

Figure 4: Lower Market-Based Inflation Expectations: Bullish for the S&P 500 Information Technology Sector.



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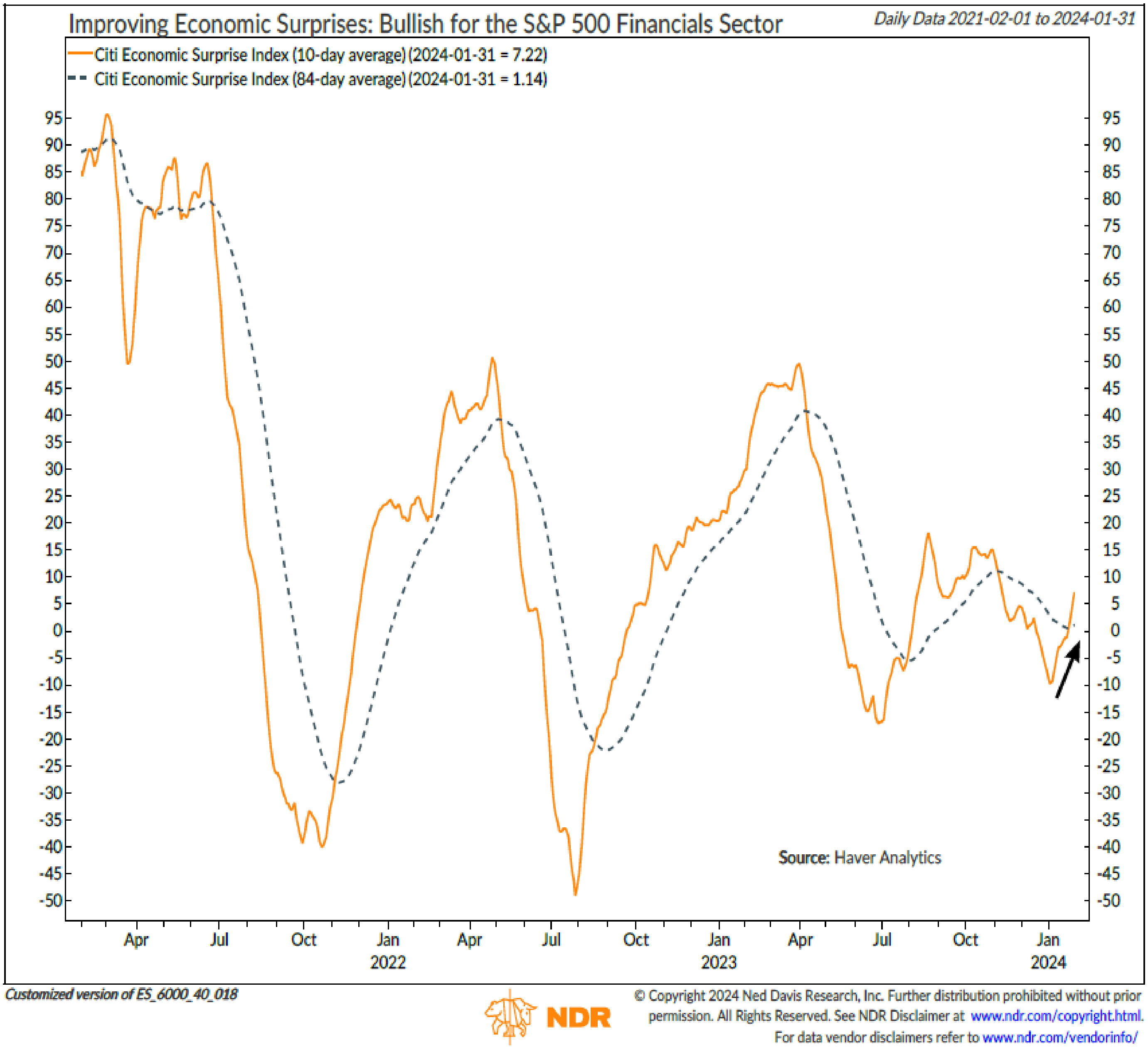
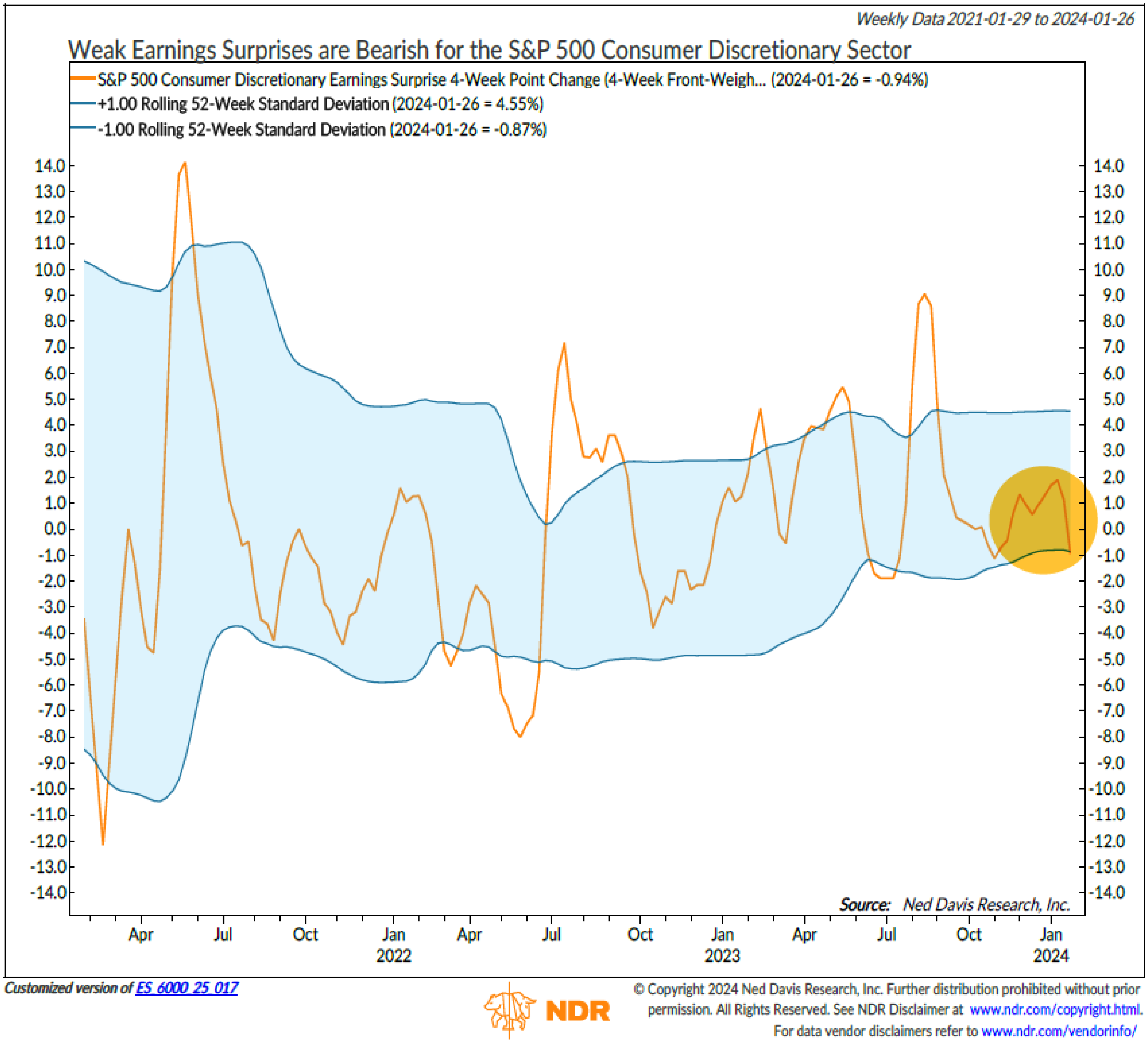
The Financials sector's allocation rose during the month, boosting it to an overweight position. On a fundamental basis, while the U.S. dollar and bank loan growth remain headwinds for the sector, economic surprises (Figure 5) and the 10-2 yield curve moved bullish during the month, joining business credit conditions and Financials' investment grade option-adjusted spreads. Additionally, the sector tends to outperform during slow easing cycles, gaining about 21% six months after the first cut, on average. Technicals confirm with four of the six internal (price-based) indicators now bullish.

Figure 5: Improving Economic Surprises: Bullish for the S&P 500 Financials Sector



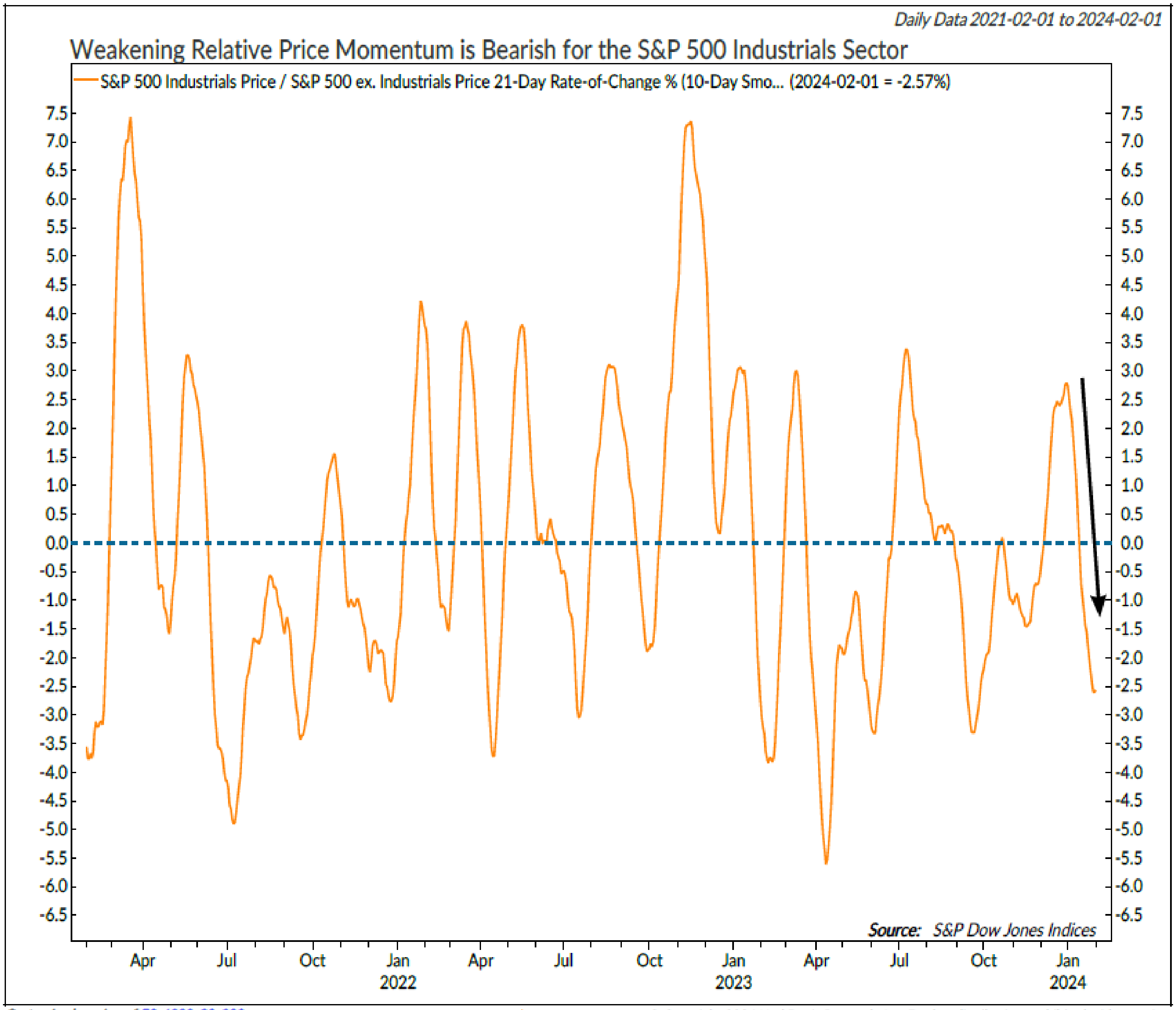
The Consumer Discretionary sector allocation dropped sharply, and the sector was downgraded from overweight to neutral. The positive monthly gain from Amazon (+2.1%) was more than offset by the significant drop by Tesla (-24.6%), which helped drive bearish signals from four of the six price-based indicators. On a fundamental basis, the improvement in long-term rates was offset by continued weakness in discretionary spending and earnings surprises (Figure 6).

Figure 6: Weak Earnings Surprises are Bearish for the S&P 500 Consumer Discretionary Sector



The Industrials sector's allocation dropped and is now a significant underweight. On a fundamental basis, indicators remain mixed, including valuation measures. While the U.S. dollar remains a tailwind, commodities and industrial production are neutral, and crude oil futures prices and consumer confidence are bearish. However, internals have deteriorated—five of six price-based measures are bearish, including two price momentum indicators (Figure 7) that flashed negative signals during the month.

Figure 7: Weakening Relative Price Momentum is Bearish for the S&P 500 Industrials Sector



Summary

The sector model remained with a cyclical bias during the month, but there were some changes. Entering February, Financials and Communication Services improved and joined Information Technology and Health Care at overweight. Consumer Discretionary, Consumer Staples, Energy, and Real Estate are Neutral. Materials, Industrials, and Utilities are underweight. The sector model uses sector-specific indicators to identify opportunities and risks in an objective, weight-of-the-evidence approach.

NDR Strategists contributing to this publication: Brian Sanborn, CFA, Ed Clissold, CFA, Rob Anderson, CFA, Thanh Nguyen, CFA, Tim Hayes, CMT, Joe Kalish

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/

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 may be trimmed by up 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 will reverse toward being fully invested.

For more information, please contact us at:

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Toll Free: (800) 594-7930

Office Phone: (941) 330-1702

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

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