U.S. equity markets continued to advance modestly through September 2014. The S&P 500 Total Return Index has gained 8.34% year-to-date. Volatility has begun to rise in response to negative developments out of Europe and increased geopolitical concerns. This persistent rise in equities over the past five years has largely been driven by easy global **monetary policy**, as every bull market is born out of easy monetary factors. In the US, there is a shift in monetary policy with the end of the bond buying program (QE) in late October. The first shift in monetary policy is often accompanied by a correction. Interest rates are currently low and stable, and spreads are narrow but beginning to widen. What becomes important as this shift occurs is the magnitude and speed of changes in interest rates, the shape of the yield curve and the direction of credit spreads. The underlying health of credit markets are the key to the direction of the equity markets.

While the direction in equity markets is determined by monetary factors and credit conditions, within the longer cycle there will be corrections driven by **investor sentiment**, based upon the reality that most classes of investors are wrong at extremes. The S&P 500 recently corrected approximately 4.5% from high to low, improving our sentiment models to positive on a short term basis and neutral yet improving on an intermediate term basis.

Our investment process was designed by looking back over the past 100 years at all conditions preceding economic recoveries and bull markets and those preceding economic recessions and bear markets. From a **valuation** standpoint, we look at trailing median S&P 500 PE ratios. They appear moderately overvalued on an absolute basis, but when adjusted for inflation and interest rates are about average on a historical basis. Some longer term measures of valuation are extreme. Price to Sales is at an all-time high, exceeding 2000 and 2007.

The way we tie these observations together is with a series of **momentum models** which look at various measures of the overall health of the market. Group behavior, inter-sector behavior and overall participation are key. Over the past few months we've seen a narrowing effect expressed in the under-performance of small-caps (Russell 2000) the percent of stocks making new highs and trading above their 10 and 30 week moving averages lagging. We'll need to monitor overall participation into any rally to gauge the health of the rally. If we see a resumption in momentum divergences as we rally, that would be worrisome. We will monitor advancing versus declining issues as well as group participation to assess the health of the advance.

Looking ahead

Once credit conditions and interest rates shift we will see a shift in the market. If spreads remain tame we should only expect a correction. However, if we see spreads widen we could see a steeper decline. The key to the long-term success of our strategy has been avoiding large drawdowns. Our goal is to have reasonably high exposure in bull markets and recoveries, and low to negative exposure in bear markets and recessions. We will continue to monitor the above important factors on a real time basis and adjust exposure accordingly.