Several major market indexes recorded new all-time highs in August, including both the Dow Jones Industrial Average and S&P 500 Index, which reflected the relative strength in the large-cap sector. The leadership of tech stocks came back to life in August and the NASDAQ-100 rose to a new all-high time in the last few days of the month. The Dow Jones Utility Average was also strong, reflecting a decline in interest rates.

It is notable that the Dow Jones Transportation Average, Russell 2000 Index, S&P MidCap 400 Index and NYSE Composite Index all closed the month below their July highs. In addition, the advance-decline line for all NYSE stocks was significantly weaker than the overall market and failed to record a new high. Our money flow models of upside and downside volume confirmed these negative divergences, indicating that institutional money flows are now favoring defensive stocks, which is evident in the relative performance of the large-cap sector and more defensive areas like utilities. Accordingly, we maintain a relatively high cash position and a lower exposure to the market, all in large-cap stock indexes, reflecting the relative strength in that area.

On the positive side, interest rates remain low and credit spreads remain historically narrow. Thus, while we believe that the stock market is overdue for and vulnerable to a 5% plus correction at any time, our models do not yet indicate an end to the long bull market. We therefore consider a late 2017 correction as an opportunity to reinvest, provided that our models have improved during that time. On the other hand, if interest rates rise and credit spreads widen, we believe it indicates a more significant market decline.

Our assessment of the four pillars of our investment process is as follows:

1. **Valuation:** Valuation remains elevated by any measure. The median price-earnings ratio on the S&P 500 is 24.0, just below its highest level reached in over a decade. On the other hand, 42% of all S&P 500 stocks still have a dividend yield above the 10-year U.S. Treasury Note. A rise in interest rates would change this metric, but currently the stock market is quite competitive with the yields available in the fixed-income sector.

   If U.S. interest rates were to rise and credit spreads widen, it would exacerbate high valuations for U.S. equities. Disappointments in earnings could also drive valuations higher and increase market risk. We will be keeping a close eye on changes in both valuations and interest rates in coming months.

2. **Monetary factors and credit conditions:** Since the rise in interest rates earlier in the year, rates have declined and credit spreads remain narrow. These are significant indicators to watch, as widening credit spreads and a flattening yield curve are usually precursors to a more significant cyclical market decline. The U.S. Federal Reserve is about to embark on a program of reducing its balance sheet and we will be closely watching the effect that has on interest rates.

   If interest rates remain low, the yield curve stays positive and credit spreads remain narrow, it would be very healthy for the market and indicate that declines from current levels may be buying opportunities. If interest rates rise, the yield curve flattens and credit spreads widen, it could be the first signs of more significant market weakness ahead.

3. **Sentiment:** Investor sentiment was generally bullish (negative from a contrary point of view) in August as the stock market reached its most recent highs. The NDR Crowd Sentiment Poll, a composite of a variety of sentiment indicators, including put/call ratios, stock market letters, asset flows, etc., shows that in the last few weeks of August, investors got more cautious, which is bullish from a contrary point of view.

   While our sentiment models indicate market vulnerability to a correction, one optimistic note is that individual investors remain very cautious. The small investor usually climbs on the bullish bandwagon prior to more meaningful stock market declines, but the individual investor has remained very skeptical of the market, which is positive from a contrary point of view.

4. **Momentum:** During August, there were negative divergences between the large-cap and defensive sectors and the broader market averages, which indicates that large institutional investors are getting more cautious and are reallocating capital to lower beta, more defensive securities. While upside volume (demand) is still above downside volume (supply), downside volume is rising and upside volume is declining, despite the major market indices' rise to new highs in August—another indication of market vulnerability.