Investors were cheered in December by the success in achieving tax reform and expectations that corporate and individual tax cuts would boost gross domestic product and consumer spending in 2018–2019. Year-over-year retail sales also showed an increase for the holiday season. As a result, most of the major stock market indices recorded new all-time highs in December, ending the year on a strong note with gains across the board.

Our models of investor sentiment showed increased optimism at the end of the 2017, which is negative from a contrary point of view. In December, we finally began to see indications that the individual investor was showing more optimism, which usually indicates heightened short-term market vulnerability. Valuation measures climbed to new highs, with the median price-earnings (P/E) multiple on the S&P 500 Index at its highest level in almost 15 years.

However, while optimistic investor sentiment and high valuations indicate caution, the monetary and credit picture remains more neutral than negative. Despite the widely anticipated December 2017 hike in the Federal Funds rate, credit spreads have remained narrow and interest rates continue to be stable. While the yield curve is flattening, it does not become a negative indicator in our work until there is an actual inversion, i.e., short rates rise above long rates.

During 2017, we were well served by following the market maxims “Don’t fight the Fed” and “Don’t fight the tape.” Accordingly, our investors and their portfolios were able to participate in and benefit from the stock market’s 2017 rise. In 2018, if interest rates rise and credit spreads widen (“Don’t fight the Fed”) and we see a divergence between the major market averages and the rest of the market (“Don’t fight the tape”), we would likely see an increase in volatility. At that time, our models would indicate a more defensive posture. Until then, we continue to hold a portfolio that is well diversified among sectors so as to participate in the rotational nature of the market’s advance. At the same time, we also hold a cash position in the portfolio in recognition of the high valuations and increased optimistic investor sentiment.

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

1. **Valuation:** Valuation remains elevated by any measure. The median P/E ratio on the S&P 500 reached 25.2, its highest level in almost 15 years. Despite these high valuations, stocks have provided stiff competition to bonds in recent years since over one-third of stocks in the S&P 500 provided a dividend yield higher than the 10-year U.S. Treasury Note. In December, this ratio declined to 31%, its lowest level in three years. While this percentage is still quite high by historical standards, higher interest rates and/or continued stock market strength in the new year would change this metric in a negative way for U.S. stocks.
2. **Monetary factors and credit conditions:** The yield curve continues to flatten. During 2017, the 3-month Treasury note rose 94 basis points (bps) whereas the 30-year Treasury note declined by 33 bps. While there is a good deal of commentary and opinion on a flattening yield curve, history shows that the stock market often rises as the yield curve flattens. Only when the yield curve actually inverts do we see increased market vulnerability. The yield curve (U.S. 30-Year Treasury Bond yield minus the U.S. 3-Month Treasury Bill yield) is flattening, but is still over 100 bps away from an inversion.

Monetary factors and credit conditions: cont'd

We will be closely watching the effect that the continuing reduction in the balance sheet, coupled with recent December rate hike, might have on interest rates in early 2018. If interest rates do not rise further, the yield curve stays positive, and credit spreads remain narrow, it would be healthy for the market and indicate that declines from current levels may be buying opportunities. On the other hand, if interest rates rise, the yield curve flattens, and credit spreads widen, it could be the first sign of more significant market weakness ahead.

3. **Sentiment:** Investor sentiment got far more bullish—negative from a contrary point of view—in December as the major market averages rallied to new highs. The Ned Davis Research Crowd Sentiment poll jumped to its most bullish (i.e., negative) reading in over 10 years and made a new high for this market cycle. Further, while the individual investor has not embraced the bull market in the last few years, recent data shows an increase in bullish sentiment among individual investors. A rise in individual investor bullishness would be negative for the market and will be watched as we enter 2018.

4. **Momentum:** Momentum continues to be strong with most market averages and the NYSE advance-decline line hitting new highs in December 2017. The rotational nature of the advance is positive, from a technical point of view. Volume measures have also picked up and are now positive. A potential negative is that fewer and fewer stocks have been able to hit new highs as the market has risen. The percentage of stocks in the S&P 500 that have hit new highs peaked in January 2017 for stocks above their 10-week and 30-week moving averages. This dynamic can persist for a while prior to a market peak, but should be watched as we enter 2018.

In summary, the U.S. stock market climbed steadily to new all-time highs in 2017 and volatility declined to its lowest level in many years. Continued low and stable interest rates, a strengthening economy, and investor anticipation of the administration's efforts to stimulate the economy all contributed to the market's steady rise during the year. As we enter 2018, the negatives in our models are that stock valuations are high by any measure and investor optimism has reached levels usually associated with market corrections. On the positive side, our models of monetary and credit measures remain more neutral than negative and our volume and breadth momentum models remain positive.