

The new year began with a continuation of the strong stock market advance as most major averages set new all-time highs at the beginning of January 2018. However, as interest rates ticked upward and the 10-year U.S. Treasury Note climbed to its highest level since 2014, the market succumbed to a few days of profit taking in the last week of the month.

As a result of the strong start to the year, several measures of investor sentiment climbed to the highest levels of bullishness for this cycle. Significantly, the smaller individual investor, who has largely stayed out of the advance in recent years, finally threw in the towel: the widely-watched American Association of Individual Investors (AAII) investor sentiment poll showed the most bullishness in seven years. In addition to the increased bullishness, valuation measures remain elevated with the median price-earnings (P/E) multiple on the S&P 500 Index at its highest level in 15 years.

Interest rates rose in January. Short-term interest rates rose to their highest levels since 2008 and the yield on the 10-year U.S. Treasury Note climbed above 2.70%—its highest level since spring 2014. This rise has caused our rate of change models of interest rates to climb toward negative levels. On the positive side, however, credit spreads remain narrow and the yield curve, while flatter, does not become worrisome until it actually inverts.


While market momentum has remained strong, two potential negatives are: (1) weakness in the interest rate-sensitive utilities and REIT sectors along with the potential negative effect of interest rate rises on other rate-sensitive areas, such as homebuilders; and (2) the percentage of stocks above their 10- and 30-week moving averages has been relatively flat as the market has risen to new highs.

In recognition of the high valuations, increased optimistic investor sentiment and rising trend in interest rates, we lowered the beta of the portfolio in January by eliminating exposure to some higher volatility sectors. The net effect of these changes was to maintain our exposure to the longer-term uptrend, but with lower volatility.

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 25.6, its highest level in almost 15 years.
- 2. Monetary factors and credit conditions:** Short-term interest rates climbed to their highest levels since 2008 and the yield on the 10-year U.S. Treasury Note rose above 2.70%—its highest level since spring 2014. This rise has caused the yield curve to become flatter, but it is not until the yield curve inverts that the market has historically run into trouble. The spread between the long-term U.S. Treasury bond and the 3-month Treasury bill is still positive by about 100 basis points. On the positive side, credit spreads remain narrow. Historically prior to most important corrections, credit spreads usually begin to rise, which has not happened yet.

3. **Sentiment:** Investor sentiment got far more bullish—negative from a contrary point of view—in January. 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. Short-term stock market corrections are often preceded by the individual investor finally giving in and getting bullish. Most recent data for January 2018 show a spike in bullishness for this sector. The AAI sentiment poll spiked to its most bullish level in seven years. Our models of investor sentiment indicate that the market is vulnerable to a short-term setback at any time.
4. **Momentum:** Momentum strength continues with most market averages and the NYSE advance-decline line hitting new highs in January. Volume measures are also positive. A potential negative is that 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 a year ago for stocks above both their 10- and 30-week moving averages. This indicator is not negative yet and the situation can persist for a while prior to a market peak; it should be watched in 2018. In addition, the interest rate-sensitive utilities and REIT sectors have been weak since late 2017. If other interest rate-sensitive and economically important sectors, like the homebuilders, begin to diverge from the major averages, it would indicate that caution is required and suggest a more meaningful correction. We will be closely watching for potential divergences in coming months.



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