

The U.S. stock market continued to climb higher in July with most major market averages rising to new all-time highs. A positive sign was that small- and mid-cap indices were able to record new highs and the NYSE advance-decline line confirmed the major market indexes' new highs during July. An important negative factor continued to be that our models of upside and downside volume lagged the price action of the averages, which may be an early warning sign of a possible late summer/fall market correction.

We increased our market exposure to 65% by mid-April during the market correction. However, in June and July, investor sentiment rose to more bullish levels (negative from a contrary point of view) and we did not see the type of net positive cumulative volume that usually sustains a meaningful advance.

As a result, we reduced our market exposure to below 50% at the end of June. In doing so, we eliminated our NASDAQ and Europe exposure due to deteriorating momentum in these areas.

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 Index is still above 23.0, just below its highest level reached in over a decade. Rising U.S. interest rates would exacerbate high valuations for U.S. equities and further rises in interest rates would be negative for valuation levels.
- 2. Monetary factors and credit conditions:** While we saw a rise in interest rates earlier in the year, since then interest rates have declined. These are significant indicators to watch, as widening credit spreads and a flattening yield curve are usually a precursor to a more significant cycle market decline. The Federal Reserve is about to embark on a program of reducing its balance sheet and we will be closely watching the effect that it has on interest rates.
- 3. Sentiment:** Investor sentiment became less optimistic (more positive from a contrary point of view) during the March-April market pullback, which provided a positive backdrop for the most recent market advance. As the market rallied in June and July, however, sentiment once again became more bullish (negative from a contrary point of view). In addition, the VIX, an indicator of implied volatility, reached historically low levels, indicating complacency among investors.

Nonetheless, one optimistic note is that we have not seen a meaningful increase in optimism among individual investors. We usually see the small investor climb on the bullish bandwagon prior to more meaningful stock market declines. This optimism has not happened yet, which is positive, from a contrary point of view.

- 4. Momentum:** Most major market averages climbed to new highs during July and the NYSE advance-decline line also recorded a new high, indicating broad market participation. Nonetheless, our net cumulative volume measures have not indicated significant new demand and have not yet confirmed these new highs.

It will be important to watch for other divergences if and when the market averages reach new highs in the near term.

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