Most major U.S. stock market averages continued their upward climb into October. There has been a rotational aspect to the market's advance. Early in the month, the international markets began showing better relative strength and we increased our international developed and emerging markets exposure. Toward the end of the month, technology had a modest correction and we took that opportunity to make an allocation to the leading sector.

The stock market's momentum is still strong. However, a few divergences have emerged in recent months. The Dow Jones Utility Average lagged the other major averages as interest rates ticked up in October, although utilities rallied at the end of the month back toward their September highs. In addition, our money flow models of upside and downside volume continue to indicate that institutional investors are taking a more cautious approach.

Sentiment measures showed an uptick in bullishness as the market climbed to new high. The most recent University of Michigan survey shows that a record high percentage of respondents expect the stock market to be higher a year from now. These bullish indicators are negative from a contrary point of view. Valuation measures also remain high, with the median price-earnings (P/E) multiple on the S&P 500 Index still near its highest level in over a decade. Reflecting our concern over the recent firmness in interest rates, heightened investor optimism and elevated valuations, we continue to hold a reasonable cash position as protection against any sudden setback.

On the positive side, despite the recent firmness in interest rates, credit spreads remain narrow. In addition, despite the optimistic sentiment readings (negative from a contrary point of view), recent data shows that flows into equity mutual funds (including ETFs) are only just beginning to rise into positive territory. These flows will likely rise, indicating increased buying and more bullish sentiment, before the market reaches a more significant top. Thus, while we believe that the stock market is overdue and vulnerable to a 5% or more correction at any time from current levels, our models do not yet indicate an ending to the long bull market.

An important indicator to watch in coming months is the rate of change of any interest rate rises. The greater the upside rate of change, the more of a shock to the market, which would likely be the catalyst to a stock market correction.

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 24.4, its highest level in over a decade, before declining to its most recent reading of 23.7 in October. On the other hand, 39% of all S&P 500 stocks still have a dividend yield above the 10-year U.S. Treasury Note. We are beginning to see an uptick in interest rates, which would change this metric in a negative way for U.S. stocks. If U.S. interest rates were to rise and credit spreads widen, that would exacerbate the current high valuations for U.S. equities. We will be keeping a close eye on changes in both valuations and interest rates in coming months.

2. **Monetary factors and credit conditions:** Interest rates firmed in October and the 10-year U.S. Treasury Note reached 2.45%, its highest level in six months, before settling back to 2.38% at the end of the month. It is no coincidence that rates firmed as the U.S. Federal Reserve embarked on its program to reduce the balance sheet. The two-year U.S. Treasury Note, for example, has now risen to its highest level since 2008. We will be closely watching the effect that the reduction in the balance sheet, coupled with potential rate hike in December, has on interest rates. Specifically, we will be watching how fast

interest rates rise. To do this, we keep a series of rate-of-change indicators on Treasurys, corporates, municipals, and more. A rapid upward rate of change would be negative while a gradual increase would be more positive.

The 26-week rate of change of the three-year U.S. Treasury Note has shot up in the last few weeks, reflecting the recent uptick in rates. Continued firmness in interest rates would likely turn this indicator more negative. 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 more bullish—negative from a contrary point of view—in October as the stock market reached its most recent highs. Each month, the University of Michigan Consumer Sentiment Survey asks respondents about the outlook for stock prices a year from now, and the latest reading is a record high, which is negative from a contrary point of view. In addition, flows into equity mutual funds (including ETFs) have recently showed more buying. We would anticipate that these flows into equity mutual funds and ETFs will continue to rise prior to a more significant market top.

4. **Momentum:** Momentum continues to be strong with most averages and the NYSE advance-decline line hitting new highs during the month. The interest-rate-sensitive utilities sector lagged the other averages during the month, although the Dow Jones Utility Average rallied back to test its September highs at the end of the month. Also, our models of upside and downside volume continue to show some divergence from the general market. While upside volume (demand) is still above downside volume (supply), downside volume has been rising and upside volume declining since the beginning of the year—another indication of potential market vulnerability as institutional investors become more cautious.