Stock prices continued to rise into the end of the third quarter as most major market indexes, including Dow Jones Industrials Average, Dow Jones Transportation Average, S&P 500 Index, Russell 2000 Index, NASDAQ-100 Index and NYSE Composite Index, recorded new all-time highs, reflecting broad-based rotational strength. As a result of this strength, we increased our market exposure in September with an allocation to the small-cap sector, which began to show good relative strength.

In this environment, some divergences have emerged. After recording a new high in early September, the Dow Jones Utility Average weakened at the end of the quarter as interest rates ticked upward in anticipation of a potential interest rate hike in December. In addition, our money flow models of upside and downside volume have indicated a more cautious approach from institutional investors. Our sentiment measures showed an uptick in bullishness as the market climbed to new highs, which is negative from a contrary point of view. Valuation measures remained high, with the median price-earnings (P/E) multiple at its highest in over a decade.

About half of the portfolio is held in cash reflecting our concern over the recent firmness in interest rates, heightened investor optimism and elevated valuations.

On the positive side, although ticking up a bit recently, interest rates remain low and credit spreads remain historically narrow. 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.

As we end the third quarter, we would consider a late 2017 correction as an opportunity to reinvest, provided that our models improved during that time. On the other hand, if interest rates rise and credit spreads widen, it would indicate the potential for 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 P/E ratio on the S&P 500 reached 24.3—its highest level 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. We are beginning to see an uptick 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 were to 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:** While we saw a rise in interest rates earlier in the year, rates have declined since then 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. In September, the Federal Reserve announced a program to reduce the balance sheet beginning in October 2017 and interest rates firmed at the end of the quarter. We will be closely watching the effect that this reduction in the balance sheet, coupled with potential interest rate hike in December, has on interest rates.

   The current yield curve spread is the narrowest it has been since early 2008, but is still positively-sloped. A continued narrowing of yields would be decidedly negative for the long-term stock market outlook. Credit spreads remain historically narrow. If interest rates remain low, 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. 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 got more bullish (negative from a contrary point of view) in September as the stock market reached its most recent highs. The NDR Crowd Sentiment Poll, a composite of a variety of sentiment indicators (put/call ratios, stock market letters, asset flows, etc.), confirms that in the last few weeks of September, investors did get more optimistic, which is negative from a contrary point of view. The CBOE VIX Index, a measure of implied volatility, reached an extremely low level in September, returning towards the July 2017 lows. This drop indicates complacency among investors and supports our thesis that a market correction of 5% or so is possible at any time. The other instances that the VIX reached such low levels were in late 1993, 2005, 2007 and 2014. During each of these times, within a period of months the market was eventually vulnerable to a least a 5% pullback. Our sentiment models indicate market vulnerability to a correction, which is buttressed by a recent move to increased bullishness on the part of the individual investor, who got more bullish as the market reached its September highs.

4. **Momentum:** Momentum strength continues with most averages and the NYSE advance-decline line hitting new highs during the month. Our models of upside and downside volume, however, are showing some divergences from the general market. 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 potential market vulnerability.