

The stock market advance that began following the November 2016 election continued into February 2017, but paused in March and early April with a 3% correction of the uptrend.

The market regained momentum in the last week of April, spurred by the French election. Global markets were encouraged by the strong showing of centrist candidate Emmanuel Macron and worldwide markets rallied strongly. The market was led by the NASDAQ Composite, which quickly made a new all-time high above the 6,000 level. The Russell 2000 Index followed the NASDAQ to new highs and the other major averages were just below their all-time highs at the end of April.

Investor sentiment became warier of the market during the modest correction, which was positive from a contrary point of view. Our sentiment indicators improved in March and April, setting us up for the market rally into the end of the month with the French election as the catalyst. We increased market exposure during the March-April correction with a small position in the eurozone index ETF and positions in the large-cap sector as represented by the S&P 500 Index ETF, the Dow Jones Industrials Average ETF and the NASDAQ 100 ETF.

The U.S. stock market continues to anticipate measures that would help American business. Lower corporate tax rates, deregulation and an increase in infrastructure spending are expected to add momentum to a gradually strengthening economic backdrop. We would point out that this optimism is occurring against a backdrop of the highest price-earnings multiples in a decade. Any disappointments to this “Goldilocks” scenario might set the stage for a larger market sell-off once this market advance ends.

In recent commentaries, we have noted some disturbing longer-term negative fundamental developments like high valuation levels and future continued interest rate hikes. We would view a return of investor sentiment back to the bullish levels of early 2017 as negative. One recent negative development has been that there has not been the type of net positive cumulative volume into the recent rally that usually sustains a meaningful advance. This divergence between volume and price action, coupled with high valuations, rising interest rates and potential bullish sentiment, could well lead to a more meaningful correction in coming months. Nonetheless, our longer-term momentum model remains positive and we retain moderate-to-high market exposure.

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 is still above 24.0, just below its highest level in over a decade. Rising U.S. interest rates will 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:** Our rate of change indicators on interest rates turned negative earlier in the year. Since then, however, interest rates have declined. Nonetheless, credit spreads have widened a bit in recent weeks and the yield curve has flattened a bit. These indicators are significant to watch as widening credit spreads and a flattening yield curve are usually a precursor to a more significant cycle market decline.
- 3. Sentiment:** Investor sentiment became less optimistic (and therefore more positive from a contrary point of view) during the March-April market pullback. This shift provided a positive backdrop for the most recent market advance, spurred by the French election. If the NDR Crowd Sentiment Poll quickly climbs back to reflect high optimism, it would be negative in our work.
- 4. Momentum:** The late April 2017 market advance, spurred by the French election, was relatively broad based with the NASDAQ-100 and Russell 2000 reaching new all-time highs, as noted previously. The broader market indexes were just below their all-time highs at the end of April.

It will be important to watch for divergences if and when the market averages reach new highs in coming months. One indicator to watch is the percentage of stocks above their 10- and 30-week moving averages. The fact that this indicator has not confirmed the early 2017 market highs may be a precursor to further divergences. In addition, our money flow models show that there has not been the type of net cumulative upside volume accompanying the late April 2017 market advance. We are watching this divergence carefully as it could be a precursor for greater market vulnerability in coming months.

