The market advance that began following the November 2016 election continued into February 2017. The S&P 500 Index climbed to an all-time high of over 2,300 while the Dow Jones Industrial Average reached an all-time high of 20,800. The S&P 500 ended February with a gain of 3.97% for the month and almost 6% year-to-date.

Investors anticipated that the Trump administration would enact measures that would help American business and add momentum to a gradually strengthening economic backdrop, including lower corporate tax rates and an increase in infrastructure spending. As a result, investors have become far more optimistic about the future with many measures of investor sentiment reflecting this optimism. The NDR Crowd Sentiment Poll, which includes a variety of investor sentiment measures, set a new high for optimism in late February, rising to its highest level in two years. We look at this indicator from a contrary point of view, therefore this level is negative in our work. However, the smaller investor has not yet completely climbed on the bull bandwagon. Thus, while we believe bullish sentiment is setting the stage for a correction, we may see further gains prior to a more meaningful decline.

We continue to have prudent exposure to equities in our portfolio, but believe that the major market averages may be vulnerable to a 6%-10% pullback in coming months. Rising interest rates and a tightening Federal Reserve would likely be catalysts.

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 20.0, just below its highest level in over a decade. Rising U.S. interest rates will exacerbate high valuations for U.S. equities.

2. **Monetary factors and credit conditions:** As noted previously, there is a widespread perception among investors that economic growth is a top priority for the new Trump administration. Reflecting this prospective increase in economic activity, the 10-year Treasury note has risen from a July 2016 low of 1.35% to its current level in the 2.50% range. Our rate of change indicators on interest rates are now turning negative. However, we have not yet seen credit spreads widen and the yield curve remains steep. Widening credit spreads and a flattening yield curve are usually a precursor to a more significant cycle market decline.

3. **Sentiment:** Investor sentiment has become far more optimistic following the U.S. election and the subsequent stock market rise. This optimism is negative in our work, which is another reason we have become a bit more defensive in our equity exposure. The NDR Crowd Sentiment Poll indicates that optimism has reached its highest level (or the most negative level from a contrary standpoint) in two years. However, we have not yet seen the small investor throw in the towel and get bullish. A proxy we use for smaller-investor sentiment is the American Association of Individual Investors (AAII) survey of bulls and bears, which asks members where they think the market is headed over the next six months. This poll indicates that the small investor has not yet fully climbed on the bullish bandwagon. Our experience is that the market does not usually have a significant decline until these investors get bullish.

4. **Momentum:** Most of the major U.S. equity indexes rose to new all-time highs in February 2017. In addition, financial stocks remained strong on a relative basis, which is usually a good sign for equities in general. There are some signs that the market's momentum is slowing. For instance, on the market's recent climb to new highs, the percentage of stocks above their 10- and 30-week moving averages has not confirmed the highs. Nonetheless, we believe that this divergence indicates a corrective phase for the market, not the beginning of a major decline.