The robust rally that began following the November 2016 election continued into early January 2017. During January, the S&P 500 index climbed to an all-time high of 2,300 and the widely-followed Dow Jones Industrial Average reached an all-time high of 20,000. The S&P 500 ended January 2017 with a gain of 1.90%.

As a result, investors became far more optimistic about the future and many measures of investor sentiment reflected this optimism. The increase in optimistic sentiment indicates to us that the market may be vulnerable to a correction from these all-time high levels.

How much of a correction? At the moment, we believe that the major market averages may be vulnerable to a 4-8% pullback from current levels. Accordingly, we have positioned our portfolios to be more defensive.

Nonetheless, we would point out that we do not yet have enough evidence to indicate the beginning of a major stock market decline. Credit spreads have not widened, and in fact they have narrowed, indicating a continued relatively healthy credit environment. Also, while we are still seeing some deterioration in momentum, most market averages are in gear as the new highs were recorded.

Our current 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 reached 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 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 cyclical 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 and this is another reason we have become a bit more defensive in our equity exposure. However, we have not yet seen the small investor throw in the towel and get bullish. A proxy we use for small investor sentiment is the American Association of Individual Investors (AAII) survey of bulls and bears. The AAII asks the question, “Where’s the market headed over the next six months?” This poll shows 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 US equity indexes rose to new all-time highs in January 2017. In addition, financial stocks remain strong on a relative strength basis, which is usually a good sign for equities. There are some signs that the market’s momentum is slowing. Nonetheless, we believe that this divergence indicates a corrective phase for the market, not the beginning of a major decline.