

The U.S. stock market continued to climb higher in June 2017 with most major market averages rising to new all-time highs. The largest, well-known technology stocks and the NASDAQ-100 index continued to lead the way, although this leadership group and the general market suffered a sharp sell-off in the last half of the month. A positive sign was that small- and mid-cap indices were able to eke out modest new highs and the NYSE advance-decline line confirmed the major market indices' new highs. An important negative factor, however, was that our models of upside and downside volume did not confirm the market's new highs, which may be an early warning sign of a possible summer/fall market correction.

As we enter the eighth year of the recovery from the 2008-2009 financial crisis and attendant stock market advance, our models show that risks are elevated. We believe that the risks present in the market now require the prudent investor to begin planning for the long-overdue stock market correction, which may occur over the next six to 12 months.

Valuation is historically high by any measure. Measures of sentiment have reached quite optimistic levels (negative from a contrary point of view). The Federal Reserve (Fed) has embarked on a less accommodative monetary policy stance by gradually beginning to raise interest rates. Momentum is showing signs of flagging with the major market averages reaching new all-time highs; however, only about half of all stocks are above their 10- and 30-week moving averages.

Nonetheless, there are still important indicators that have not turned negative in a way that they usually do prior to more significant and extended stock market declines: principally, widening credit spreads and a flattening/inverted yield curve.

While valuations remain high, over 30% of all S&P 500 Index stocks have dividend yields that exceed the 10-year U.S. Treasury note. Despite the Fed's commitment to raising interest rates, the bond market is telling us it does not see a dramatic interest rate rise in the future. Importantly, credit spreads remain low and the yield curve remains normal. Prior to more extended stock market declines, credit spreads widen and the yield curve usually inverts. So far, we have seen little evidence of this happening.

While bullish sentiment has increased with the new highs in the averages, one would think we would see more euphoria. We have not seen the type of bullishness that usually accompanies tops in the market. Also, while some momentum divergences are occurring, they are not as striking or enduring yet as existed at previous important market highs.

Therefore, we maintain modestly long exposure to the stock market in order to provide our clients a reasonable return as the market advances. We have reduced long exposure modestly in the last month as the result of the elevated risks. We have also recently diversified our investments into areas that have shown positive relative strength, like technology and Europe.

Our assessment of the four pillars of our investment process is as follows:

- 1. Valuation:** The median price-earnings multiple on the S&P 500 is now at its highest level in over a decade, higher than prior to the 2008-2009 financial crisis, but not as high as prior to the 2000 dot-com bubble. With interest rates remaining near their lowest levels in 30 years, valuations could certainly go higher. Two important inflation indicators to watch are the consumer price index rising above 2% and the 10-year U.S. Treasury note rising toward the 3% level.

With valuation at historical extremes, it is possible to have a significant equity market decline without a recession, as in the case of 1962 and 1987. Any rise in inflation and increase in interest rates will have an impact on the percentage of stocks with yields above the 10-year U.S. Treasury note. As noted previously, over 30% of all S&P 500 stocks currently have dividend yields above the 10-year U.S. Treasury note. We would expect that this percentage would decline to a new low—below the 30% level toward zero—to indicate that we are seeing a significant change here. If this were to happen, it would have an important impact in the reallocation of institutional capital between stocks, bonds and cash, likely resulting in a reallocation from stocks to bonds and cash.

2. **Monetary factors and credit conditions:** The Federal Reserve Board has announced its intention to raise the general level of interest rates as inflation meets and/or exceeds the Fed's inflation target of 2%. The Fed has now raised the base federal funds rate three times since the financial crisis. Nonetheless, after a rise in interest rates earlier in 2017, interest rates have settled back to their previous levels. Most importantly, the yield curve remains positive. We would expect the yield curve to flatten and invert as we get nearer to an economic contraction and more significant stock market decline. The relative performance of financial stocks, an important leading indicator of credit conditions, is lagging badly and bears watching. Credit spreads remain quite low. We would expect credit spreads to rise considerably from current levels prior to greater vulnerability in the stock market.
3. **Sentiment:** Many measures of investor sentiment rose to highly optimistic levels (negative from a contrary point of view) in early 2017. Even so, the public remains skeptical. The American Association of Individual Investors (AAII) sentiment indicator, a proxy for the small investor, has not moved into the bullish camp yet (which is positive for the overall stock market, from a contrary point of view). Generally, the small investor is the last to hop on the bullish bandwagon.
4. **Momentum:** Our long-term momentum model remains positive. Upside volume has been consistently higher than downside volume since the beginning of the year. We watch for divergences in performance between the major market averages and the broad market. Market vulnerability is often characterized by the market averages doing well but the rest of the market showing poor relative strength. One measure of this is comparing the S&P 500 to the percentage of stocks above their 10- and 30-week moving averages. Ideally, new highs on the averages should be accompanied by the majority of stocks rising above their moving averages. Only about 70% of all stocks have been able to rise above their averages on the recent move to new highs by the major market averages. While not alarming, it could be an early warning sign of more divergences to come.

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