Spurred by the French presidential election of Emmanuel Macron, global markets rose in May 2017, some to new all-time highs. In the U.S., the Nasdaq Composite Index led the way. While other major market averages also advanced, several failed to follow the Nasdaq into new high territory at the end of the month—the Russell 2000 Index and the transportation and financial sectors, in particular. These variances could be corrected in short order, although it could also be the beginning of a divergence between the market leadership and the broader market. These types of divergences often occur prior to market corrections.

Our sentiment indicators improved during the March-April market correction and we increased market exposure with a small position in the eurozone and positions in the large cap U.S. sector as represented by the S&P 500 Index ETF, the Dow Jones Industrials Average ETF and the NASDAQ 100 ETF. By mid-May, however, sentiment became more bullish (negative from a contrary point of view) and we did not see the type of net positive cumulative volume that usually sustains a meaningful advance. As a result, we reduced our market exposure modestly in mid-May, reducing our position in the S&P 500 Index but retaining the other positions.

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 23.8, 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:** While we saw a rise in interest rates earlier in the year, since then interest rates have declined and remained steady. 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. As the market rallied in May, sentiment once again became more bullish (negative from a contrary point of view). On an optimistic note, the small investor usually climbs on the bullish bandwagon prior to more meaningful stock market declines, and the American Association of Individual Investors (AAII) sentiment indicator indicates that the small investor remains very skeptical of the market, which is positive, from a contrary point of view.

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.