While stock market valuations moderated slightly in late 2016, most measures of stock market valuation remain at their highest levels in over a decade. In this high valuation environment, the stock market is particularly sensitive to interest rate increases. With interest rates gradually rising and sentiment at the most optimistic levels in over a year (negative territory from a contrary point of view), accompanied most recently by higher levels of relative corporate insider selling, we believe that the U.S. equity market is now vulnerable to a 6%–10% market correction. This could occur at any time. Accordingly, we have positioned our portfolios to be more defensive after participating in the most recent post-election rally in the areas of the greatest relative strength.

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 at 22.8x, 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:** There is now 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 a December 2016 high of 2.59%, its highest level since 2014. 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. Many of the sentiment indicators that we look at show that optimism has reached its highest level (or the most negative level from a contrary standpoint) in almost two years. While most investors are generally wrong at market turning points—hence our contrary approach to assessing investor sentiment—we have found that one group of investors often gets it right—corporate insiders. We believe it is significant that at the same time we have seen optimism by the public reach its highest level in several years, we have seen the most relative corporate insider selling in over two years. These high relative levels of relative corporate insider selling, accompanied by optimism on the part of the public, is often a precursor of potential stock market vulnerability.
4. **Momentum**: While there was a rotational aspect to sector and industry group participation during the late 2016 stock market rally, we believe it is significant that though the U.S. stock market rose to new all-time highs in late 2016, the percentage of stocks above their 10- and 30-week moving averages has remained well below levels reached earlier in 2016. These divergences also suggest the possibility for a 6%–10% market correction.