In January, stock prices rebounded strongly from their December 2018 lows. Small cap stocks led the way up with gains of about 10% while other major averages recorded gains of just under 10%. * The reopening of the U.S. government after the longest government shutdown in U.S. history, indications by the U.S. Federal Reserve (Fed) that it would take a more accommodative policy in 2019 and some solid earnings reports at the end of the month all gave a boost to stock prices during January.

The December 2018 stock market decline improved the four pillars of our process and set the stage for the January rally. Investor sentiment turned rapidly pessimistic, which is a positive sign from a contrary point of view. Interest rates continued to ease, valuation measures improved and the market reached an extreme short-term oversold condition. We therefore increased our market exposure in January, adding a position in small cap stocks due to the superior relative strength of the group.

As we enter 2019, investor sentiment has returned to more neutral levels, interest rates and credit spreads have eased and valuation measures have stabilized—all good signs. The strong stock market rally also improved both our intermediate-term and long-term volume/breadth momentum models.

A number of our longer-term models, such as our longer-term investor sentiment models, indicate that we are still in the late corrective stages of the market cycle. Some potential headwinds in the coming months could be no progress on trade talks with China and another rise in interest rates. However, the improvement in the four pillars of our process, particularly the Fed's more dovish stance, the narrowing of credit spreads and the improvement in both our intermediate-term and long-term momentum indicators, are healthy signs.

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

1. **Valuation:** Rising earnings have brought valuations lower in recent months, which is positive. The median price-earnings ratio now stands at 20.2, well below its 15-year high of 26.8 reached in January 2018.** There is a growing perception that the market has reached peak earnings for this economic cycle and lower valuations reflect this lower assessment.

2. **Monetary factors and credit conditions**: Interest rates eased further in January from their October 2018 highs. Credit spreads also narrowed in January.*** These are very good signs and largely a result of Fed Chair Jerome Powell's more dovish statements. A continued narrowing of credit spreads would be a positive development for the longer-term market outlook.

3. **Sentiment:** At the end of 2018, the NDR Crowd Sentiment Poll reached its most pessimistic level since the February 2016 stock market bottom, which is a positive development from a contrary point of view.*** As the market rallied in January, bullish sentiment increased back to neutral territory but has not reached worrisome levels.

4. **Momentum:** The severe December market decline pushed the percentage of stocks above their 10- and 30-week moving averages to the most oversold levels in two years.**** This type of extreme oversold condition has often marked short-term market low points. Coupled with the improvement in our intermediate-term and long-term volume and breadth momentum models, we believe that the technical position of the market has improved

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**   Source: Bloomberg. January 31, 2019*
***   Source: Ned Davis Research. December 31, 2018*
**** Source: Ned Davis Research. January 29, 2019*
*****Source: Ned Davis Research. January 25, 2019*