Technology and small-cap stocks led the market's rally in early July, with both representative indices hitting new all-time highs. However, at the end of the month, technology stocks were hit hard as Facebook's stock dropped 19% in one day after a surprisingly weak earnings forecast. The decline, which erased about $120 billion in market value, was the largest one-day drop in market value for a company in stock market history. A few days later, Twitter stock dropped 21% when the company reported that user growth had turned negative even as its quarterly results beat Wall Street expectations. The company said that average monthly users would decline further this year as Twitter removes fake and abusive accounts.

The major market averages, such as the S&P 500 Index and the Dow Jones Industrials Average (DJIA), recorded gains for the month, though neither index was able to best the January 2018 highs. The majority of stocks and the major market averages have been in a trading range since hitting their highpoints in January. Markets were buoyed during the month by news that the U.S. economy grew at a 4.1% pace—the highest in four years. In addition, fears of a global trade war were reduced when European Commission President Jean-Claude Juncker and President Trump agreed in principle to work toward a tariff solution. Nonetheless, the decline in the tech sector and the uncertainty regarding Chinese tariffs and trade continued to weigh on the market at the end of the month.

We held our market exposure steady during July due to (1) continued optimistic investor sentiment, which is negative from a contrary point of view, and (2) a loss of momentum in the broad market averages. The portfolio is invested primarily in large capitalization stocks with a healthy defensive cash position.

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 in our models. The median price-earnings ratio has now declined to 24.2 from its 15-year high of 26.8, reached in January 2018, though it is still high by historical standards.*
2. **Monetary factors and credit conditions**: Interest rates rose in July after reaching seven-year highs in May. The 10-year U.S. Treasury Note rose from 2.86% at the end of June to just below the 3.00% level at the end of July.** The stabilization of interest rates since the 10-year Treasury's high of 3.11% in May has been a positive development for equities. In addition, credit spreads remain relatively narrow. However, the annual rate of change of the consumer price index (CPI) reached 2.9% at the end of June 2018. This latest reading is the highest annual change in the CPI in five years. Higher inflation expectations could indicate higher interest rates ahead if this trend continues. A continued strong economy and higher inflation expectations would justify further Federal Reserve interest rate hikes and could conceivably lead to a further flattening of the yield curve. These developments would be consistent with the late stages of an economic cycle and we will be monitoring the indicators closely.
3. **Sentiment:** Investor sentiment got more optimistic as the market rallied in early July. The Hulbert Newsletter Stock Sentiment Index indicator rose to its most optimistic level (negative, from a contrary point of view) in almost three years. This rise has resulted in a deterioration in our investor sentiment models.

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4. **Momentum:** Despite the rally to new highs in small-cap and technology stocks earlier in the month, the broad market averages have not made much progress since the beginning of the year and have continued to trade below their January highs. Market tops are often signaled by fewer and fewer stocks rising to new highs. Despite the fact that the major averages are now near their all-time highs (and technology and small-cap stocks have actually risen to new highs in the last month), only a little more than 50% of all stocks are currently above their 10- and 30-week moving averages. This potential divergence between the widely-watched major averages and the rest of the market, coupled with the recent loss of market momentum, contributed to our decision to hold our market exposure steady during July with a healthy cash position.

* Source: Ned Davis Research. August 1, 2018.
** Source: Bloomberg. July 31, 2018.

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