In July, the S&P 500 Index, the Dow Jones Industrial Average (DJIA) and the NASDAQ-100 Index all recorded new all-time highs. July 2019 also marked the longest economic expansion in history, surpassing the 120-month expansion from 1991-2001.[1] However, on the last day of the month, the market showed disappointment after comments from U.S. Federal Reserve (Fed) Chair Jerome Powell indicated that July's 0.25% cut to the federal funds rate may not be the beginning of more interest rate cuts. The DJIA promptly dropped 300 points after Mr. Powell's comments.

Equity valuations, when adjusted for the low level of interest rates, appear to be reasonable at current levels. A little more than 50% of all stocks in the S&P 500 now have a higher dividend yield than the 10-year U.S. Treasury Note, which is the highest level in three years. While this comparison has been positive for stocks versus bonds, extremes or peaks in this measure, as we may be seeing now, have often led to interim market corrections.[2] Another potential negative is that investor sentiment has become more optimistic (negative from a contrary point of view) and is now at a level that has often led to some type of market correction in the past.[3]

Momentum is a major concern at the moment. We are seeing signs of lagging broader market participation. For example, the major market indexes hit new all-time highs in July, but the Russell 2000 Index has continued to significantly lag the large cap market averages. Both the Russell 2000 and the Dow Jones Transportation Average (DJTA) remain well below their highs of almost a year ago. In addition, stocks above their 10- and 30-week moving averages have not risen to new highs along with the major averages.[4] Finally, global stocks have continued to lag, with the MSCI All Country World Index ex-USA still well below the highs of January 2018 set more than a year and a half ago.[5]

The rise in optimistic investor sentiment coupled with the growing momentum divergences lead us to believe that the risk of a correction has risen and may have already begun with the recent Fed announcement. We therefore reduced portfolio exposure during July (as we did in June) and continue to retain an exposure to gold.

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

1. **Valuation:** In July, the S&P 500 median price-earnings ratio rose to 21.6, but it remains below its 15-year high of 26.8 reached in January 2018.[2] Given the low level of interest rates and the Fed's more dovish stance, valuations now appear to be more reasonable when adjusted for interest rates.

   As interest rates have declined, more than half of all stocks in the S&P 500 now have dividend yields above the 10-Year U.S. Treasury, which is the highest level in three years.[2] While this has been positive for stocks, extremes or peaks in this measure, as we may be seeing now, have often led to interim market corrections.

2. **Monetary factors and credit conditions**: Interest rates were stable during July. The 10-Year U.S. Treasury has remained at its lowest level since 2016. It closed the month at 2.02%, almost unchanged from the 2.00% level at the end of June.[6] From a long-term perspective, however, we continue to be concerned that sections of the yield curve have inverted. The yield on the 10-year U.S. Treasury fell below the federal funds rate during the last few months — which is the first time this has happened since the 2008-09 financial crisis.[7]

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3. **Sentiment:** Strength in the major market indexes in July produced increased optimistic investor sentiment. Bullish investor sentiment has now risen near its highest levels of the year, which is negative from a contrary point of view.[3]

4. **Momentum:** We are concerned by lagging broader market participation. Neither the Russell 2000 nor the DJTA have reached new highs with the other major averages this year. In addition, the MSCI World ex USA All Cap Index has not been able to reach the highs it set in early 2018.[5]

   Another divergence can be seen in the percentage of stocks above their 10-week and 30-week moving averages.[4] Neither of these measures has been able to set new highs along with the major market indexes, indicating fewer stocks rising to new highs alongside the major market averages. These types of divergences often precede some type of market correction.

[1] *Source: CFRA Research. July 1, 2019*
[2] *Source: Ned Davis Research. June 30, 2019*
[3] *Source: Ned Davis Research. July 30, 2019*
[4] *Source: Ned Davis Research. July 26, 2019*
[5] *Source: Ned Davis Research. July 19, 2019*
[6] *Source: U.S. Department of Commerce. August 1, 2019*
[7] *Source: Ned Davis Research. May 31, 2019*