Despite most major market averages changing little in June, volatility rose as daily price swings became more pronounced. The VIX, a measure of expected volatility implied by S&P options, rose from the 10-12 level into the 15-18 range. Some of this increased volatility centered on fears of a global trade war as the Trump administration threatened to impose tariffs on China and Canada, among others. The countries that would be directly affected by the tariffs have responded in turn with threats of retaliation measures of their own.

The fear of a trade war sparked a rally in small-cap stocks earlier in the month as they would be less adversely affected by global tariffs. The Russell 2000 Index climbed to an all-time high in the last half of the month. In addition, the technology sector resumed its market leadership position and the NASDAQ-100 hit a new all-time high in June. After interest rates rose to seven-year highs in May, rates moderated in June and trended lower during the month. Oil prices, however, surged during June rising to more than $74 per barrel.

We decreased our market exposure during June due to (1) an increase in optimistic investor sentiment, which is negative from a contrary point of view, (2) a loss of momentum in the broad market averages and (3) some divergences among major indices—specifically, financial stocks (often a good leading indicator of future economic activity) ended June near their lows for the year. We expect that the uncertainty of tariffs and their effect on the economy may weigh on the stock market until these issues are resolved. We positioned the portfolio a bit more defensively in June in response to model deterioration.

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

1. **Valuation:** The early 2018 market correction coupled with rising earnings brought valuations lower, which is positive. The median price-earnings ratio has now declined to 24.3 from its 15-year high of 26.8, reached in January 2018.*

2. **Monetary factors and credit conditions**: Interest rates continued to trend lower in June after reaching seven-year highs in May. The 10-year U.S. Treasury Note declined from May's high of 3.11% to 2.84% at the end of June.** The stabilization of interest rates in June is a positive development for equities. In addition, credit spreads (difference between the Barclays High yield Corporate Bond Yield and the 10-Year US Treasury Note yield) remain relatively narrow. A potential negative, however, is that the yield curve has continued to flatten. An inversion of the yield curve has often preceded economic weakness and stock market declines. We would caution that the yield curve has not yet inverted and that the lead time from a yield curve inversion to economic and stock market weakness could be anywhere from a month to a year or more away. We will be keeping a close eye on this indicator in the coming months.

3. **Sentiment:** As the market successfully tested its February lows during April–May, investor sentiment reached its most bearish level in over a year, which was a positive development and showed investor skepticism about the market. However, investor sentiment became more optimistic in June and we took that opportunity to decrease market exposure.

4. **Momentum:** Despite the rally in small-cap and technology stocks, the broad market averages have not made much progress since the beginning of the year and continued in this trading range during June. One divergence that we would note is in the U.S. financial sector, which is often an important indicator of future economic and stock market health. The sector has declined to its lows for the year, showing poor relative strength compared with the broader market averages. The weakness in European financial stocks has been even more pronounced—now down over 20% this year. Emerging market equities have also suffered severe declines, with the EEM ETF down almost 20% year-to-date. International markets have been weaker than the U.S. with the percentage of global stocks above their 200-day moving averages falling to its lowest level in two years.

   Divergences between the major market indices and the broad list of stocks reflect a loss of market momentum and are negative indicators, so we will be watching our models closely in coming months. Weakness in financial stocks is often a precursor to stock market weakness.

* Source: Ned Davis Research. July 5, 2018.
** Source: Bloomberg. June 29, 2018.

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