

The major market averages rallied in the first few weeks of May after successfully testing their February–April 2018 lows. Continued better-than-expected earnings and news that President Trump would meet with North Korea ruler Kim Jong Un in June were positive factors buoying the market. The market's uptrend stalled in mid-May, however, following the cancellation of the North Korean meeting. In addition, the Italian election unsettled the European and U.S. markets, raising the possibility that the next Italian general election would be a de facto referendum on Italy's membership in the euro.

While interest rates rose in early May to their highest levels in seven years, the trend reversed abruptly toward the end of the month and rates declined sharply. Oil prices, which had climbed sharply since their February lows, also reversed and fell to their lowest levels since April. During the last few days of the month, the markets were rattled by the prospect of tariffs and how their imposition would affect trade with Europe, Canada and China.

We increased our market exposure in early May and allocated to the technology sector due to attractive relative strength and positive momentum in that sector. As relative strength and momentum waned mid-month, we eliminated our technology position and reduced our overall market exposure. As of month end, we maintain a moderate exposure to equities.

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

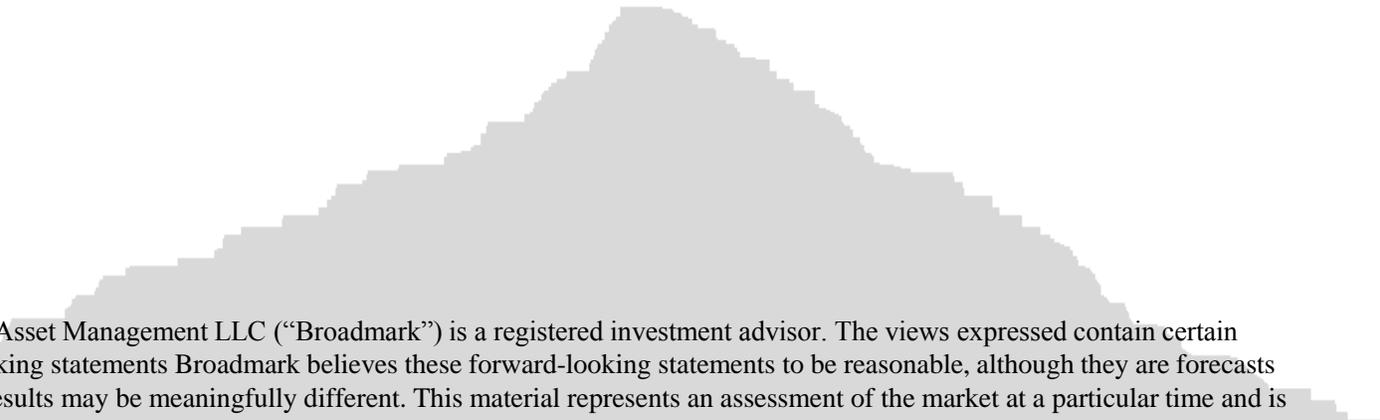
- 1. Valuation:** The early 2018 market correction coupled with rising earnings brought valuations lower, which is positive. The median price/earnings ratio has now declined to 24.1 from its 15-year high of 26.8, reached in January 2018.
- 2. Monetary factors and credit conditions:** Interest rates reached new seven-year highs early in May, but then abruptly reversed direction and ended the month at their April levels. The 10-year U.S. Treasury Note declined from a high of 3.11% to 2.84% at the end of the month.

The decline in interest rates late in the month and fall in the price of oil are potentially positive factors in our work. A stabilization of interest rates at current levels would be a positive development for equities. The late-May interest rate decline improved our rate of change indicators. However, while credit spreads remain at very low levels, it is significant to note that in the last few weeks of May, credit spreads widened. A continued widening of credit spreads would be negative in our work and we will be monitoring this indicator closely.

- 3. Sentiment:** As the market successfully tested its February lows during April–May, investor sentiment reached its most bearish level (positive, from a contrary point of view) in over a year. This shift was a positive development and continued to show investor skepticism about the market.

4. **Momentum:** Following the cancellation of the North Korea meeting and the Italian election, our short-term momentum models deteriorated and we moved to a more defensive position toward the end of the month. The financials sector, which had been strong during the market's rise, reversed course and showed a deterioration in relative strength at the end of the month. The financials sector is an important leading indicator of economic health, so continued weakness in this area would be a negative sign.

We will be watching our measures of volume and breadth closely in coming months. The market's weakness early in the year resulted in the lowest percentage of stocks above their moving averages in several years. While this percentage has recovered in recent months, only about 50%-60% of stocks are currently above their respective moving averages. If this indicator moved higher in coming months, it would indicate broader market participation and a healthier market. If the percentages decline while the major market averages advance, that would set up possible negative divergences and suggest future market vulnerability.



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