Rod Smyth
CHIEF INVESTMENT STRATEGIST

US Stocks – A Bit Stretched, But New Highs Confirm Bull Market

As the Dow Jones approaches the 20,000 level, up from 18,000 just prior to the election we are assessing our tactical position. In doing so, we focus on the broader S&P 500, shown in the chart below, which has not been quite as strong as the Dow during the last month, but which has also had an impressive move higher.

As we seek to determine whether to maintain our current risk position, part of our discipline involves an analysis of both the trend of the market and investor sentiment. In short, we are encouraged by the acceleration in the pace of the 200-day moving average (one of our tactical rules is “don’t fight the trend”). However, we must also acknowledge that investor sentiment has gone from pessimism to optimism in the last month, and one of our other rules is “beware the crowd at extremes”. Last week, we set out our fundamental case for US stocks having another positive year. This week, we will look more tactically and address both the trend and sentiment.

Source: Thomson Reuters Datastream, RIverFront Investment Group. Past performance is no guarantee of future results.

The trend is currently rising. In the chart above, we show the S&P 500 price index along with its 200-day moving average, which we regard as the primary trend. In making our tactical decisions we focus on the 200-day, which began to rise in May of this year, having peaked in August 2015. From a purely trend perspective, the message is encouraging. The S&P 500 first broke above 2100 in February 2015, but struggled to make progress for the next 18 months, during which two notable declines caused the primary trend to fall. The index finally broke decisively above the 2100 level in July of this year and re-tested that level and the rising 200-day moving average in early November.

When an index breaks decisively above a resistance level and a range that has held for over a year, from a technical perspective, we believe the kind of strength seen over the last month is not unusual or, by itself concerning.

Sentiment approaching optimistic extremes. We believe this is an important time for investors to be able to quantify their longer term asset allocation and risk tolerance. At RiverFront, we do this for our asset allocation portfolios based on our Price Matters® strategic allocations, which optimize portfolios to timeframes. To the extent that portfolios have had a tactical overweight to risk assets, our current readings on sentiment suggest that it may be prudent to consider returning closer to that long-term level.

In assessing the timing of such a move, we combine both sentiment and trend and weigh the odds from similar periods in history. We look at a number of measures of sentiment, recognizing that optimistic extremes can reduce the odds of the market advancing. One of our preferred measures of sentiment is produced by Ned Davis Research. Their daily sentiment measure is currently close to all time high levels, as is often the case following a strong advance. Their weekly measure is also at elevated levels. Importantly though, we have learned that optimistic extremes in sentiment when the primary trend is rising, is more likely a signal of a potential consolidation in prices than of a change in the primary trend. We must stress that our findings are based on historical averages, and we are very respectful of the challenges of making these kind of tactical decisions. Should we choose to lower risk, our mindset will likely be to bring portfolios closer to their long-term targets.

In conclusion: Measures of investor sentiment and anecdotal conversations with investors make us aware that a mood shift has occurred and that some investors are clearly worried that US stocks have indeed gone too far too fast. We caution against becoming bearish simply because US stock indices have risen. Our studies of trends and sentiment suggest that the current combination of the two may present an opportunity to return portfolios closer to long-term target norms, but do not indicate to us that risk should be brought below those norms.

Important Disclosure Information:

Past performance is no guarantee of future results.

RiverFront's Price Matters® discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation.

Strategies seeking higher returns generally have a greater allocation to equities. These strategies also carry higher risks and are subject to a greater degree of market volatility.

In a rising interest rate environment, the value of fixed-income securities generally declines.

RiverFront Investment Group, LLC, is an investment adviser registered with the Securities Exchange Commission under the Investment Advisers Act of 1940. The company manages a variety of portfolios utilizing stocks, bonds, and exchange-traded funds (ETFs). RiverFront also serves as sub-advisor to a series of mutual funds and ETFs. Opinions expressed are current as of the date shown and are subject to change. They are not intended as investment recommendations.

Index Defintions:

It is not possible to invest directly in an index.

Standard & Poor's 500 Index (S&P 500) measures the performance of 500 large cap stocks, which together represent about 75% of the total US equities market.

RIVERFRONT INVESTMENT GROUP
1214 East Cary Street, Richmond, Virginia 23219 TEL 804) 549-4800 RIVERFRONTIG.COM