Highlights

- Global equities are set for the best first half since 1998, up 11%.
- Investors are still upbeat about the prospects for the pro-growth Trump agenda.
- The global economy is picking up strength, but the U.S. is beginning to lag behind.
- Risks remain: hawkish central bank comments; bear market for oil; Tech weakness.
- Geopolitical risks are high and rising; the smart money is moving to the sidelines.

Key Market Indicators (KMI)

I designed the KMI as a simple, intuitive picture of 4 measures of market health. The value of having this tool in your toolbox is that it helps to answer questions like "How aggressive should I be with my allocations to risk assets?" or "Should I put new money to work right away, or should I hold back for a bit?"

Pay particular attention to the red lights. One way to interpret the KMI is to set up a few rules for changing your risk exposure. For example, if there is one red light, hold off on putting new money to work in equities. Park it in bonds at least temporarily. If two red lights are present, play some defense. Cut your equity exposure by 10% or 20% and move that money to cash or bonds.

You get the idea. This newsletter will offer suggestions about what to do with your allocations, but ultimately it's a personal decision. For now, my recommendation is to stay 95% committed to your normal allocation to risk assets like equities. If your normal equity allocation is 70%, lets say, then a 95% commitment would reduce that to 66.5%.

Here are the 4 measured of market health for the KMI traffic lights.

1. Fundamental – are companies growing? Sales & earnings increasing? Profit margins expanding?
2. Technical – are stock prices rising? Trading volume increasing? Breadth & leadership o.k.?
3. Valuation – based on earnings & dividend growth, is the market cheap, fair, or expensive?
4. Risk – is a recession coming? Price momentum slipping? Volatility increasing?

The KMI Traffic Lights

Below is the latest reading of Key Market Indicators. Following that is a brief summary of what the lights mean.

Traffic Light Indicators

The traffic lights reflect the current state of four indicators of market strength.

They are based on trends observed over the last 6 months.

They forecast whether these trends are likely to persist over the next 6 months.

GO
A green light tells us that the trend is positive for this indicator, and is likely to remain so.

CAUTION
A yellow light tells us that the trend observed over the last 6 months is showing early signs of a possible reversal.

STOP
A red light tells us that the trend is clearly negative and it will likely remain so.

The conditions of the 4 traffic lights this month are mixed, but still maintain positive overall. Market fundamentals and technicals are flashing green. That's the reason I remain nearly fully invested in risk assets. Risk is flashing yellow, primarily due to stretched valuations. And valuations are the sole red light.

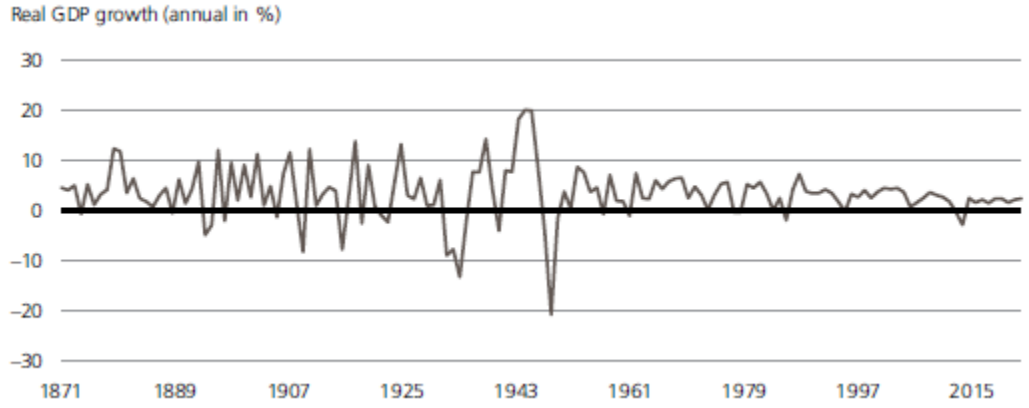
So far, investors are willing to ignore the red light for valuations. They believe that the Trump agenda will boost growth, add jobs, and lower taxes for all. Is this optimism justified by what's actually happening on the ground? The traffic lights will give us the answer as we move forward.

Geopolitical Landscape

The geopolitical landscape has become more stable recently, but just under the surface lurks a laundry list of potentially destabilizing threats. Russia, North Korea, China, Iran, Syria – all represent geopolitical land mines. As we move into the summer months, tensions have moderated. But the combination of high risk potential and an inexperienced cabinet in the White House creates increased risk of a policy miscalculation, and/or an aggressive response to threats, whether real or perceived.

Global Economy

US economic growth is slow, but also more stable than it has been in the past. The average change in growth over the past five years has been 0.6%, compared to the long-term average of 4.7%, and the pre-WWII average of 6.5%.



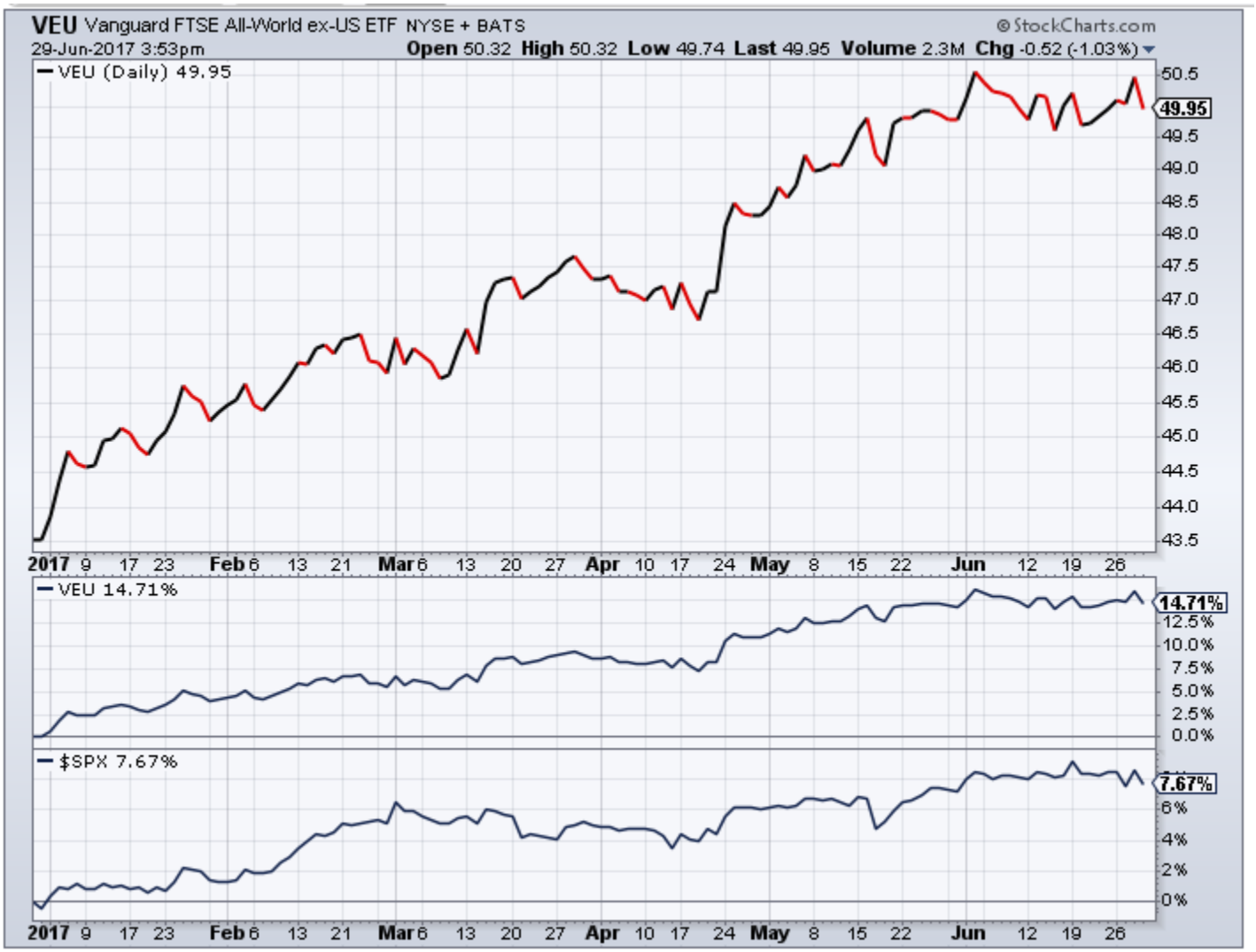
Source: UBS, IMF

With the U.S. economy stuck in low gear, the European economy is gaining momentum. That seems to be keeping global investors optimistic, and funds flowing into global markets whenever the slightest pullback arrives.

Details

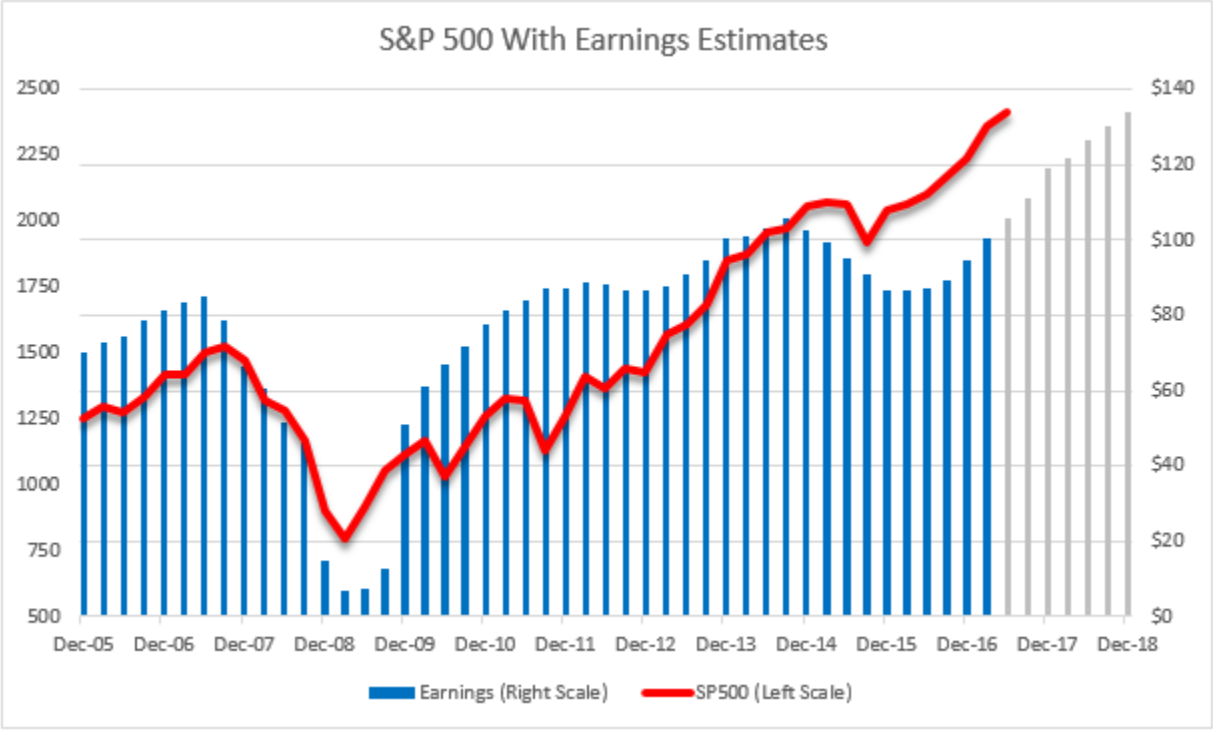
Global Markets

Whether or not it's justified by fundamental forces, the global stock and bond markets continue to move ever higher. We are clearly in a "buy-the-dip" regime, and it looks like it will continue, at least through the summer season. This is an especially good time to overweight European and Emerging Market equities. Valuations overseas are considerably more reasonable than in the U.S. markets, and growth prospects are better as well.



U.S. Markets

Since 1950 the U.S. stock market has averaged 15 new highs each year. In 2016 it made 18, and in just the first half of 2017, it has already logged 23 new highs. This is an impressive feat, but it comes with a caveat. The U.S. market has gotten a little ahead of itself, in my opinion. While it's true that earnings are accelerating, they are not keeping pace with stock prices. Something has to give. Either earnings have to accelerate even faster, or the stock market has to pause, or maybe come down a bit. However, I don't think it's a good idea to fight this tape yet. Take a look at this chart and you'll see that stock prices are at their highest premium relative to earnings since 2006.



Stock market outlook

Chart 1. S&P 500 with Zone of Death Parameters

Chart 1 shows the track of the year-over-year percent change in the S&P for the last 12 months. The green line represents the price level that is 10% above where the market was trading one year ago. The red line represents a 10% decline from year-ago prices. The **Zone of Death** is the area between these two lines.

The current reading is a healthy 14% gain over the last 12 months. We watch this line for early clues about deteriorating market momentum.

Chart 2. Market Momentum

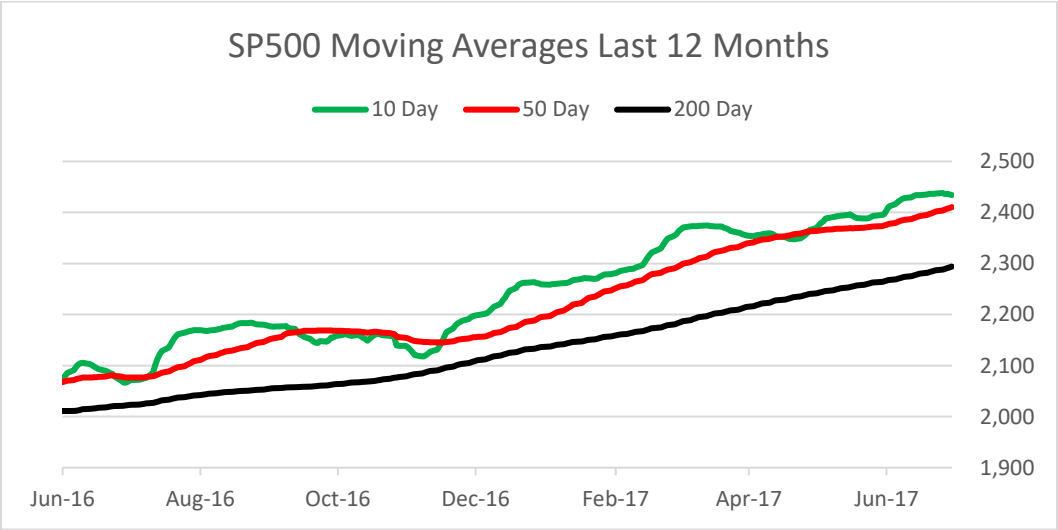


Chart 2 shows market momentum as represented by the relationship between the short term (green line), medium term (red line), and long term (black line) moving averages. The black line is the 200 day moving average. The red line is the 50 day moving average. The green line is the 10 day. The current state of this indicator is very healthy, which further supports our case that the bull market is still in place.

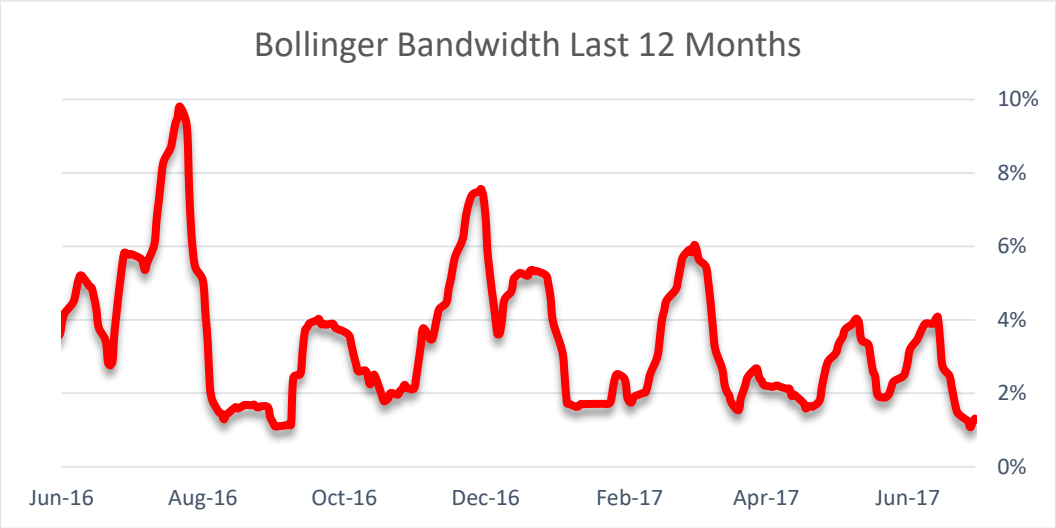
The next two charts show how calm the market has been over the past year. The Bollinger Bands represent the magnitude of daily price swings in the market, averaged over the last 20 days. It has been trending lower all year. This means that the tug-of-war between buyers and sellers has reached a near stalemate.

The Treasury-Junk Bond spread represents the strength of resolve among risky bond buyers, which implies that they're optimistic about the near-term economic future. As this number trends lower, bond buyers and other yield-seekers are becoming increasingly bold.

Charts 3 & 4. Volatility

Bollinger bandwidth is a measure of the daily variability of prices. Over the long term, the bandwidth is about 5%. Today it's less than half that, which indicates a calm and confident market. But notice the uptick over the last few days. It could be nothing but noise, but it's worth keeping an eye on.

The last three spikes in volatility are shown on the bandwidth chart. Brexit, the start of the Trump rally, and Trump's address to Congress all triggered mini-spikes in market volatility. Keep in mind that the Bollinger reading doesn't discriminate between up or down moves in the market. It just indicates that there's a disturbance in the force that merits further investigation.



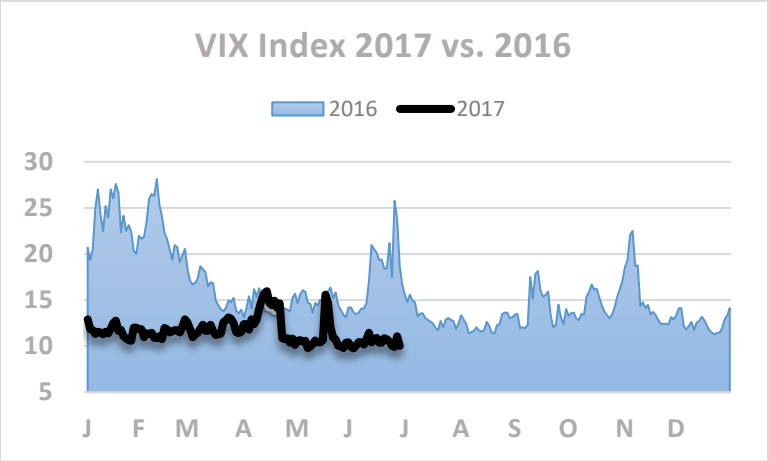
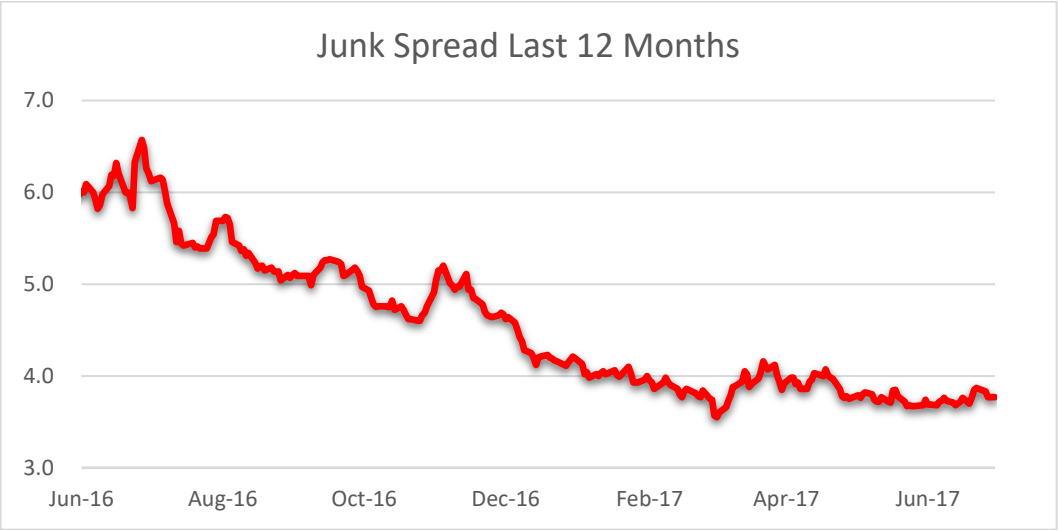


Chart 5. Interest rate spread between Junk and Treasury Bonds



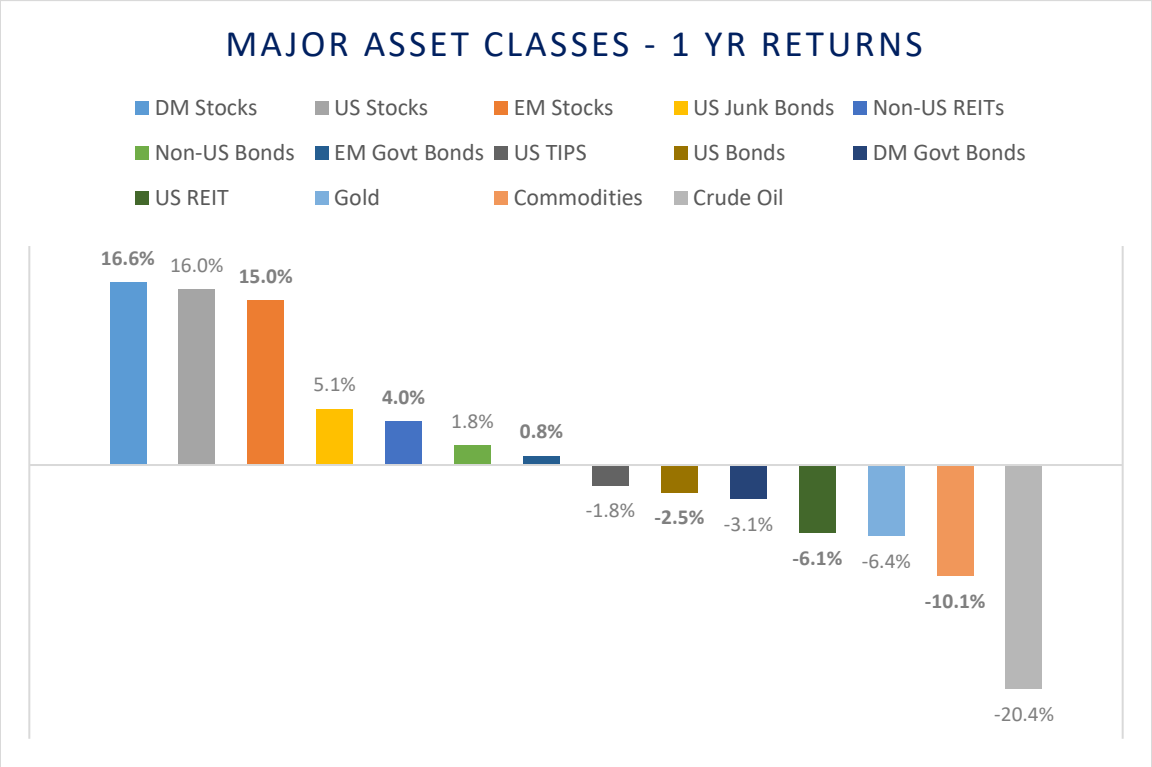
The Junk Spread is a measure of optimism/pessimism among bond investors and traders. When they are optimistic, and confident that the economy will continue to grow, they bid up prices of Junk bonds. As prices rise, interest rates come down. This narrows the spread between Junk and Treasury bonds.

But when bond investors become worried about the sustainability of economic growth, they back off on purchases of risky Junk bonds and turn instead to safer Treasuries. This widens the spread.

After a full year of narrowing, which reflects the increasing confidence of bond investors, the Junk-Treasury spread is now trading sideways. This may just be a temporary pause, but it could also be a sign that bond investors are becoming concerned about rising rates.

Asset Class Leaders & Laggards

As I noted earlier, the U.S. stock market has now fallen behind foreign stock markets. On a 1-year basis, we can see that Developed Market, U.S., and Emerging Market stocks are essentially tied for the lead in performance. Commodities and Crude Oil are the worst performers.



Picks & Pans

ZI 10 Best ETFs: The 10 most undervalued asset class ETFs

Symbol	Name	1 Year
VXX	iPath S&P 500 VIX Short Term Futures ETF	-77.35%
GAZ	iPath Bloomberg Natural Gas ETN	-41.82%
OIL	iPath S&P GSCI Crude Oil ETN	-26.52%
RING	iShares MSCI Global Gold Miners ETF	-22.79%
JJA	iPath Bloomberg Agriculture ETN	-18.04%
SIL	Silver Miners ETF	-17.25%
MOM	U.S. Market Neutral Momentum Fund	-15.80%
FRAK	VanEck Vectors Fracking ETF	-15.78%
NGE	Global X MSCI Nigeria ETF	-14.72%
EDV	Vanguard Extended Duration Treasury ETF	-11.64%

ZI 10 Worst ETFs: The 10 most overvalued asset class ETFs

Symbol	Name	1 Year
PSI	Powershares Dynamic Semiconductor ETF	63.73%
EWO	iShares MSCI Austria ETF	53.71%
KBWB	PowerShares KBW Bank ETF	52.67%
IAI	iShares US Broker-Dealers-Exchanges ETF	52.53%
JETS	U.S. Global Jets ETF	50.68%
KRE	SPDR S&P Regional Banks	49.26%
GREK	Global X MSCI Greece ETF	48.24%
EPOL	VanEck Vectors Poland ETF	47.57%
BBP	BioShares Biotech Products Fund	47.27%
IBUY	Amplify Online Retail ETF	46.33%
KOL	VanEck Vectors Coal ETF	45.29%

ZI 10 Best Stocks: The 10 most undervalued stocks

Company	Ticker	Current Price	Avg Daily $Volume	P/E using 12 mo Est	Price/ Sales	Price/ Book	Earnings Est Revisions	Technical Grade	Funda-mental Grade
Greenbrier Cos	GBX	$48.25	22,462,410	13.59	0.64	1.20	1.60	A	B
Owens Corning	OC	$66.41	60,115,484	16.55	1.25	1.88	1.08	B	B
Rci Hospitality	RICK	$24.38	3,840,057	16.64	1.75	1.75	9.33	A	A
Renewable Energ	REGI	$12.75	6,617,700	7.68	0.23	0.83	34.96	A	A
Schnitzer Steel	SCHN	$24.10	13,640,993	18.54	0.41	1.26	20.37	B	A
Synnex Corp	SNX	$120.29	35,935,572	14.26	0.32	2.27	5.83	B	A
Worthington Ind	WOR	$47.76	17,348,862	15.82	1.01	2.83	3.42	B	B

Only 7 stocks qualified for this strict screening algo. I considered loosening the parameters to get 10 names, but decided to stay true to the algo rules. With market valuations as stretched as they are now, there are just fewer cheap stocks out there.

The 7 stocks that did qualify have two things going for them. They are undervalued (cheap), and they get high marks for fundamental strength. Don’t rush out and buy them based on this list alone. Consider this a watch list that bears further study.

ZI 10 Best Shorts: The 10 most overvalued stocks

Company	Ticker	Current Price	Avg Daily Volume	P/E using 12 mo Est	Debt/ Equity	% Chg Earnings Est This Year	% Chg Earnings Est Next Year	Technical Grade	Funda-mental Grade
Blackhawk Netwk	HAWK	$44.05	510,863	79.2	0.6	-67.6	-53.3	C	D
Cf Indus Hldgs	CF	$27.43	3,921,102	876.4	0.9	-243.8	-58.6	D	F
Covanta Holding	CVA	$13.20	1,673,389	545.6	6.7	-47.0	-38.6	D	F
E.L.F. Beauty	ELF	$27.12	716,059	71.4	1.0	-18.4	-21.0	C	D
Hertz Glbl Hldg	HTZ	$11.42	9,326,566	130.3	15.3	-157.9	-59.7	D	F
Primo Water Cp	PRMW	$12.81	191,073	188.9	4.3	-126.9	-3.8	F	F
Usa Truck Inc	USAK	$8.83	137,675	223.2	2.1	-201.0	-33.3	D	F

There were at least 10 stocks that qualified for this list, but I decided to include only the top 7. Why, you ask? Because I'm a sucker for symmetry. I know, it's a character defect but hey – it is what it is.

The stocks in the above table are the bottom of the barrel, in terms of high valuations, and low marks for fundamental and technical soundness. Consider them as short candidates, but do your own due diligence before acting on them. Some of them are hard to borrow, so you may not be able to short them at all.

Our Forecast for the U.S. Economy

Moderate expansion - Probability: 70%
Corporate earnings are on the rise. This improving trend should continue with S&P 500 earnings growth turning even more positive in the 2ND quarter. The pickup in growth overseas will help the U.S. economy in two ways. Higher demand for our exports, and increased foreign earnings for U.S. based companies with overseas operations.

Strong expansion - Probability: 10%
Higher interest rates and rising commodity prices, driven by improving global growth prospects, could produce stronger-than-anticipated S&P 500 EPS growth as energy and financials – roughly 25% of S&P 500 profits – could see a meaningful profit improvement.

Growth recession - Probability: 10%
A downturn in US and global growth could lead to weaker-than-projected revenues for S&P 500 companies. Wage pressures, unaccompanied by improving consumer and business demand, could pressure profit margins and earnings growth rates.

Outright recession - Probability: 10%
Our indicators, both leading and coincident, point to continued growth in the U.S. We view the election of Donald Trump as a source of uncertainty for the global economy and markets. Other risks would be a major terrorist attack, a policy mistake by the Fed, or the onset of a trade war between the U.S. and China or Mexico or Canada.

Key Recession Indicators

The risk of the US economy sliding into recession in the next 6 months is very low - just 10% as of the end of April. We base this estimate on a combination of factors (see the table below) that have proven accurate in calling turns in the business cycle. Our model will tell us when the conditions are in place for a turn in the cycle.

The latest readings (for May 2017) show a slight improvement over last month's numbers. The two leading indicators, Market Stress and Market Trend, are forecasting continued economic growth and positive market momentum for the next 3 to 6 months. The coincident indicators are confirming this outlook.

The takeaway from all of this is that the economy is strong enough to support the stock market. In the absence of a recession, corrections in the stock market are limited. It's not unusual to see a 10% to 15% decline in the market without a recession taking place. We think the probability of a correction of this magnitude, in the next 3-6 months, is about 40%. That's high enough for us to raise a little cash, so that we will be in a better position to buy stocks at cheaper prices over the next few months.

Recession Watch

Indicator	Dec	Jan-17	Feb	Mar	Apr	May	Jun est.
R-Score	355	278	256	279	258	269	258
Employment	1.7	1.8	1.8	1.7	1.6	1.5	1.4
Ind Production	0.8	0.0	0.3	1.5	1.2	1.7	1.6
Market Trend	9.5	17.5	19.1	14.4	15.3	13.7	12.2
Market Stress	15.5	19.5	26.4	24.7	22.5	25.1	27.7
Junk Spread	4.2	4.0	4.1	3.9	3.7	3.6	3.4

Red numbers indicate warning, based on these parameters:

R-Score	< 200	This indicator combines the treasury yield curve, inflation, and unemployment.
Employment	< 1%	Year-on-year changes in private non-farm employment.
Ind Production	< 1%	Year-on-year changes in industrial production.
Market Trend	< -5%	Year-on-year changes in the S&P 500 index.
Market Stress	< 0	△△Combination of stock market price change and the unemployment rate change.
Junk Spread	> 7.5%	Difference between Junk bond yield and Treasury bond yield

Our Forecast of Asset Prices

12 Month Forecast of Asset Prices

Asset Class	Benchmark	Current Value	12 Month Forecast
Stocks			
U.S.	S&P 500	2420	2250
Non-U.S. Developed	VEA	41.31	43.00
Emerging Markets	EEM	41.56	43.00
Bonds			
U.S. Govt	10yr T-Bond	2.3%	2.9%
U.S. Corporate	Current Yield	3.2%	4.2%
U.S. High Yield	Current Yield	5.6%	6.8%
Munis	Current Yield	2.0%	2.5%
Other			
Gold	Spot	1242	1300
Oil	WTI	46.11	53
NatGas	Henry Hub	3.01	3.55

As of 5/29/17 *Source: Bloomberg; Atlanta Fed; UBS*

For now, we expect a continuation of the rally that could take the S&P 500 to 2500, or maybe even a little higher. But at some point, the effect of gravity (valuations) and rising rates will start to weigh on the stock market. Valuations are stretched, and the market can't sustain itself without a sizeable boost in corporate earnings. The 8% increase that analysts are predicting will only bring valuations closer to long term averages.

In addition, the risks of a serious policy mistake by the new administration will probably cause a spike in volatility at some point. The question then becomes, how resilient will the economy be to these events? That's why I'm calling for a flat year. And it would not surprise me to see an intra-year drawdown on the order of 15% or so, before recovering to end the year flat.

As long as the internal indicators of market health and economic expansion remain positive, I will continue to advocate a fully invested asset allocation. As I said earlier, raising a little extra cash would be fine, but take it slow.

Subscribers to this letter will get advanced warning from me before I go public with a major change to a defensive posture.

Asset allocation

Our asset allocation models have not changed from last month. The global economy is growing, earnings are improving, stock markets are rallying, and valuations are reasonable except in the U.S. market. As long as the status quo continues, our allocations won't change much, if at all.

But we all know that eventually this party will end. The best anyone can hope for is when it does end, the damage will be moderate and the recovery will be swift. But we can't avoid the next recession or the next bear market. To borrow a line from the movie **No Country for Old Men…**

"You can't stop what's coming."

Our Current Asset Allocation

Investor Risk Profile ----->	Conservative	Moderate	Aggressive
Summary			
Stocks	**33.5**	**38.0**	**53.0**
Bonds	**37.5**	**35.0**	**25.0**
Commodities	**4.0**	**5.0**	**5.0**
Cash	**12.0**	**10.0**	**8.0**
Non-traditional assets	**13.0**	**12.0**	**9.0**
	100.0	**100.0**	**100.0**
Details			
US Large Cap Stocks	8.0	10.0	14.0
US Mid Cap Stocks	4.0	6.0	8.0
US Small Cap Stocks	4.0	3.0	5.0
US Stocks Total	**16.0**	**19.0**	**27.0**
Intl Developed Mkt Stocks	9.5	10.0	14.0
Intl Emerging Mkt Stocks	8.0	9.0	12.0
Non-US Stocks Total	**17.5**	**19.0**	**26.0**
US Treasury Bonds	5.0	3.0	2.0
US Muni Bonds	20.0	17.0	9.0
US Corporate Bonds	3.0	4.0	2.0
US High Yield Bonds	3.5	4.0	5.0
US Bonds Total	**31.5**	**28.0**	**18.0**
Intl Developed Mkt Bonds	3.0	3.0	2.0
Intl Emerging Mkt Bonds	3.0	4.0	5.0
Non-US Bonds Total	**6.0**	**7.0**	**7.0**
Cash Total	**12.0**	**10.0**	**8.0**
Energy	1.0	1.0	1.0
Precious Metals	1.0	1.0	1.0
Crops & Livestock	2.0	3.0	3.0
Commodities Total	**4.0**	**5.0**	**5.0**
Hedge Funds	8.0	6.0	4.0
Managed Futures	5.0	6.0	5.0
Non-traditional assets Total	13.0	12.0	9.0
	100.0	100.0	100.0

As of 5/26/17

(The above allocation is for taxable accounts with an investment horizon of 20 or more years.)

Tax-deferred accounts

Asset allocation: tax-deferred

Investor Risk Profile ----->	Conservative	Moderate	Aggressive
Summary			
Stocks	**29.0**	**38.0**	**51.0**
Bonds	**42.0**	**35.0**	**27.0**
Commodities	**6.0**	**5.0**	**5.0**
Cash	**14.0**	**12.0**	**10.0**
Non-traditional assets	**9.0**	**10.0**	**6.0**
	100.0	**100.0**	**99.0**
Details			
US Large Cap Stocks	9.0	12.0	17.0
US Mid Cap Stocks	3.0	5.0	7.0
US Small Cap Stocks	2.0	3.0	6.0
US Stocks Total	**14.0**	**20.0**	**30.0**
Intl Developed Mkt Stocks	10.0	10.0	12.0
Intl Emerging Mkt Stocks	5.0	8.0	9.0
Non-US Stocks Total	**15.0**	**18.0**	**21.0**
US Treasury Bonds	20.0	15.0	10.0
US Muni Bonds	0.0	0.0	0.0
US Corporate Bonds	7.0	5.0	2.0
US High Yield Bonds	8.0	8.0	8.0
US Bonds Total	**35.0**	**28.0**	**20.0**
Intl Developed Mkt Bonds	4.0	3.0	2.0
Intl Emerging Mkt Bonds	3.0	4.0	5.0
Non-US Bonds Total	**7.0**	**7.0**	**7.0**
Cash Total	**14.0**	**12.0**	**11.0**
Energy	2.0	2.0	2.0
Precious Metals	2.0	1.0	1.0
Crops & Livestock	2.0	2.0	2.0
Commodities Total	**6.0**	**5.0**	**5.0**
Hedge Funds	6.0	6.0	3.0
Managed Futures	3.0	4.0	3.0
Non-traditional assets Total	9.0	10.0	6.0
	100.0	100.0	100.0

As of 5/26/17

(The above allocation is for tax-deferred accounts with an investment horizon of 20 or more years.)

Final Thoughts

You can probably tell that I'm concerned about the sustainability of the global economic expansion and the attendant bull market in stocks and bonds. I will remain fully invested (almost) for now, because I've seen this movie before.

The U.S. stock market is overvalued, and investors are still counting on the Trump pro-growth agenda to make it through congress and become the law of the land. Maybe it will, and maybe it won't. But the market is priced for perfection,

meaning that investors are acting as if the agenda will pass in its entirety, and in fairly short order. I think this might be a little too optimistic.

We may be getting close to the final phase of this historic bull market. The blow-off stage can take months, or even years to play out. I'll leave you with one piece of advice on this topic. Don't be the Greater Fool. If you are tempted to buy a stock, bond, or fund simply based on "fear of missing out," or "there is no alternative," there is a good chance you might be counting on a Greater Fool to come along and take it off your hands at a higher price. That is usually a mistake. For a more detailed explanation of The Greater Fool Theory, see this article.