Highlights

- Raising our cash allocation from 10% to 15%
- The Fed will begin reducing its balance sheet in October
- Technical indicator changed from green to yellow
- Geopolicical risks are quite high
- Recession threat is still low
- Valuations are high, and likely to get even higher

Key Market Indicators (KMI)

As a reminder, the KMI is a simple display of 4 different measures of market health. The value of this tool is that it helps to answer questions like "How aggressive should I be with my asset allocation?" or "Should I put new money to work right away, or should I hold back for a bit?" Here is the latest reading of the KMI Indicators:

The conditions of the 4 traffic lights changed in August. The Technical indicator went from green to yellow, based on a slight weakening in price momentum, market breadth, and market leadership. What does that mean in laypersons terms? The pace of the rally is slowing, there are fewer stocks participating in the rally, and there are fewer stocks that are leading the way higher in terms of their contribution to the total market gains.

Market **fundamentals** are still green. That's the primary reason why I am not ready to play aggressive defense yet.

Risk is flashing yellow, primarily due to high geopolitical tensions and the possibility of a serious policy mistake. What does that mean? Our disfunctional congress in the U.S. could do something that they think would be good for their reputation and image, but is harmful to the economy. President Trump could get on Kim Jong-un's last nerve and trigger a nuclear confrontation. The Fed could become too aggressive in unwinding their balance sheet, especially if the new charman is more of a hawk than Dr. Yellen.

The Telegraph

The New York Times

The New York Post

Valuations are the sole red light. Investors have been willing to accept high valuations so far. They apparently believe that pro-growth policies will still come to pass, and when that happens, it will boost earnings and bring valuations back into line with historical norms.

The 4 measures of market health from 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 Data Driving the KMI Traffic Lights

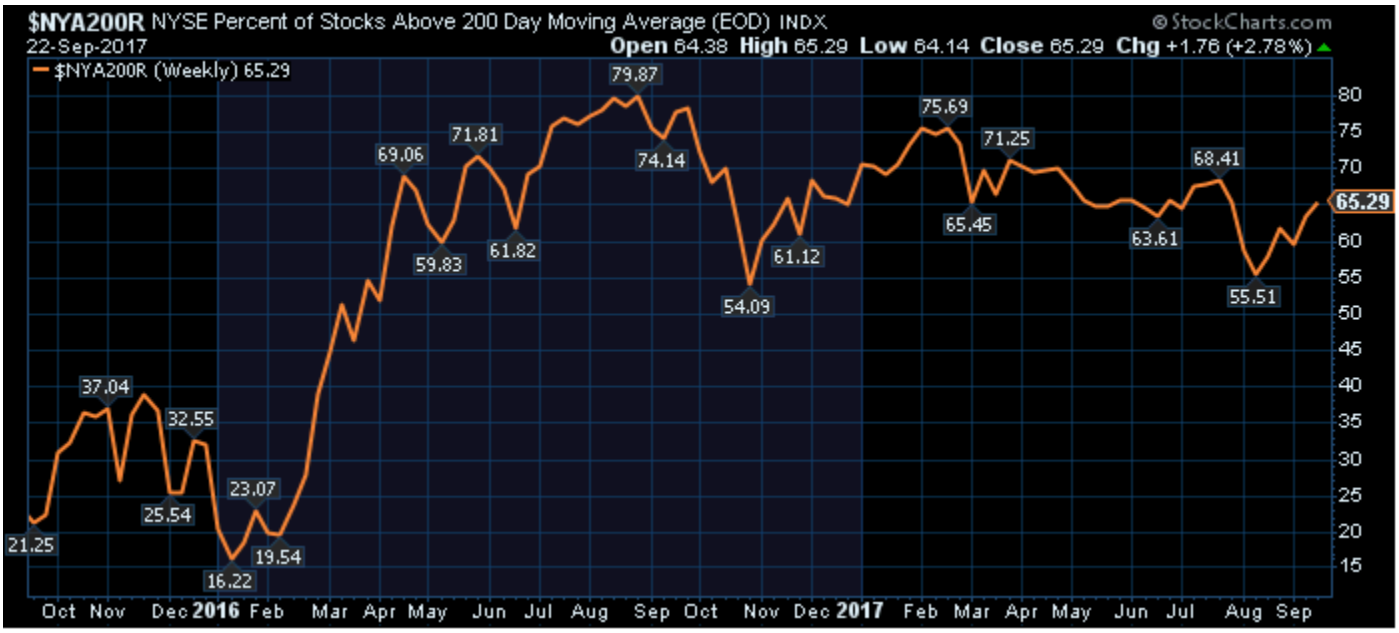
Fundamental	Feb	Mar	Apr	May	June	July	August	Trend
Revenue & Earnings	7.54	8.28	8.72	9.02	9.14	9.06	9.12	Up
Profit Margins	9.22	7.61	9.88	9.76	9.68	9.42	9.23	Up
Credit Conditions	6.11	7.18	6.21	7.76	7.23	7.04	6.98	Up

Technical	Feb	Mar	Apr	May	June	July	August	Score
Momentum	6.92	7.86	8.1	8.85	9.02	8.41	8.02	Up
Breadth	7.55	7.61	6.82	7.44	8.11	7.66	7.16	Up
Leadership	6.29	6.05	5.73	5.66	5.41	4.98	4.55	Down

Valuation	Feb	Mar	Apr	May	June	July	August	Score
Price Ratios	3.54	4.28	4.72	5.02	4.66	4.72	4.41	Up
Risk Premium	4.22	3.61	5.88	5.76	4.84	4.28	3.96	Down
Overbought	2.29	2.05	1.73	1.66	1.49	1.55	1.52	Down

Risk	Feb	Mar	Apr	May	June	July	August	Score
Recession Threat	8.21	6.15	7.62	5.21	6.04	7.06	7.17	Down
Bear Mkt Threat	6.11	8.08	6.21	7.76	7.23	7.88	7.81	Up
Volatility	5.23	6.37	5.81	5.44	6.11	4.27	3.88	Down

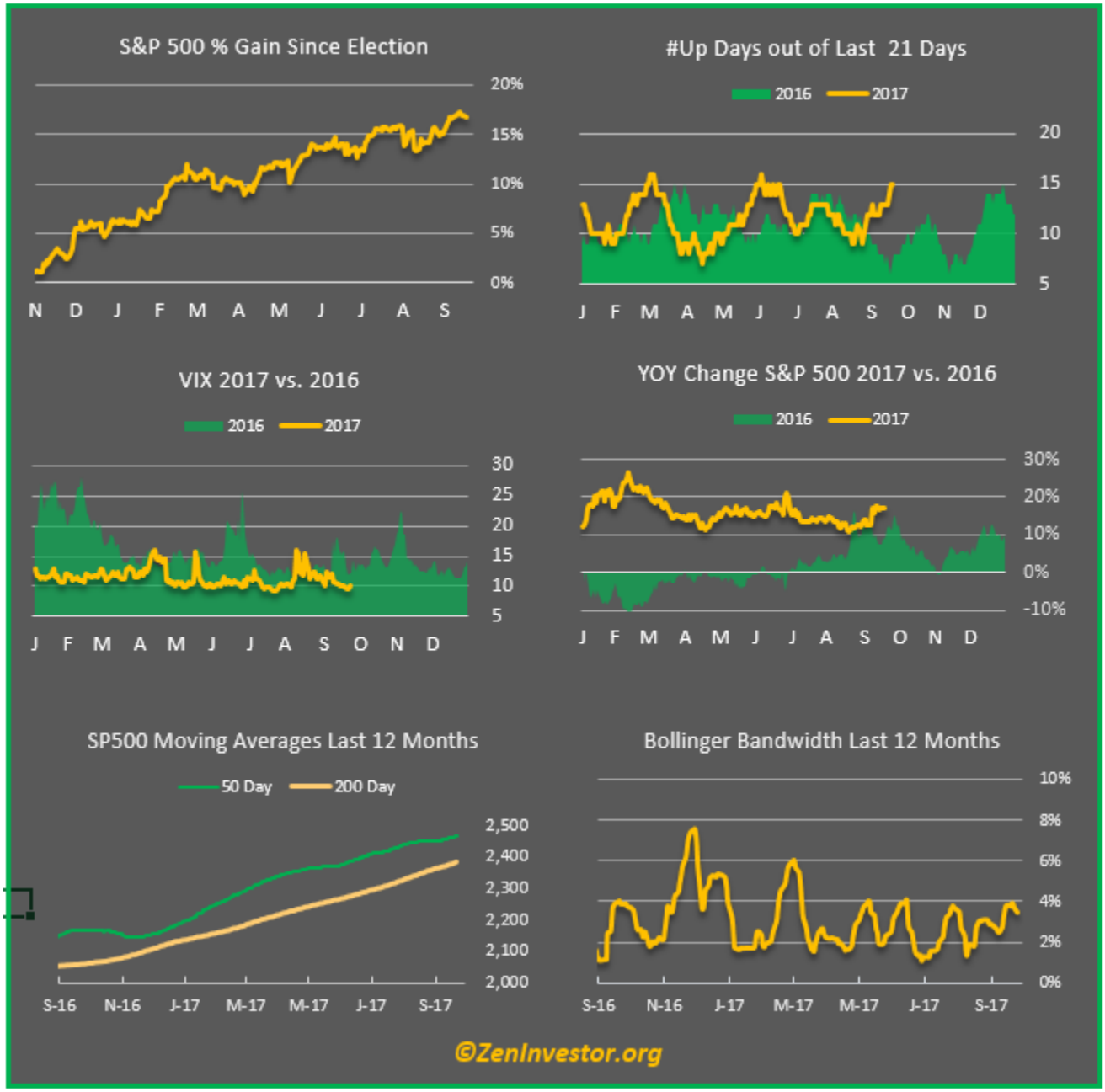
Percent of stocks that are trading above their 200-day moving average. (Right hand scale)



The chart above shows the weakening of market breadth. Notice that breadth peaked in August 2016, at 79.87, and since then has been making a series of lower-highs. The latest reading of 65.29 is a rebound from last month's 55.51, but unless it breaks above 68.41, the weakening trend will continue. The level to watch is 50. If it breaks below that level, the market could be vulnerable for a pullback.

U.S. Markets

Below is an array of charts I use to get an overall sense of current trends, and whether these trends are more likely to continue, or possibly begin to roll over. I find it hard to look at these charts and find anything amiss. No matter how you slice it, market trends are positive and volatility is subdued. But it's the market internals that concern me, rather than the headline numbers that these charts convey.



U.S. Stock Market

Why do I bother to make forecasts about the market and the economy, knowing that doing so is almost futile? The simple answer is that my clients, subscribers, and readers want me to. When someone asks me what I think about the market, I would rather not say "I don't know where the market may be headed next." If I did say that, I would score points for honesty. But I would not be giving my audience what they want, which is my opinion based on my experience and my familiarity with market history.

I know how to take the measure of the market's health today, and make an educated guess about where it may be headed a year from now, or 3 years from now, based on market history and theory. I believe that is really what my clients want.

Accordingly, I offer a range of possible outcomes, along with my estimate of how likely it is for each one to play out.

Here is my forecast for the U.S. stock market over the next 12 months.

Continuation of the current uptrend - Probability: 45%
Corporate earnings are strong. Economy is still expanding. Inflation is subdued. Ride the wave.

Acceleration of the uptrend - Probability: 10%
Passage of tax cuts, infrastructure spending, or budgetary reform could spark another surge in stock prices.

Correction of 10% to 20% - Probability: 30%
A downturn in US and global growth could lead to weaker-than-projected revenues and earnings. Wage pressures due to the tightening labor market could pressure profit margins and earnings growth rates.

Bear market decline of 20% or more - Probability: 15%
Another bear market is inevitable. There are many risks in this market, and a top can come at any time. But momentum favors a continuation of the bull market, and a delayed arrival of the next bear.

Here is what the bulls and bears are quibbling over today:

Bull Case	Bear Case
Market is making new highs frequently. Buy-the-dips is the prevailing regime.	Market is expensive. Second highest valuation of all time. High valuations lead to lower future returns.
The market is being supported by stubbornly low interest rates.	Geopolitical risks are high. U.S. political risk is high.
Markets are calm.	The Fed is about to embark on a long-term process of shrinking its balance sheet.
Earnings growth is solid, margins are healthy.	Some big players are bearish: Goldman, Howard Marks, Jeremy Grantham, Soros, Druckenmiller, Gundlach, Wells Fargo, Russell Investments, Raymond James, SocGen.
Investor, consumer, and business sentiment is high. Lots of optimism about lower taxes, deregulation, and infrastructure spending.	U.S. government and corporate debt is alarmingly high.
Threat of a debt crisis in China has diminished somewhat.	The Fed is telegraphing further increases in rates.
Threat of recession is low.	Moral hazard exists as investors expect Fed to ride to the rescue if the market starts to falter.
The U.S. dollar is cheap, which helps exports.	Market participation and leadership is narrowing.

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 3rd 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. But the chance of a recession in 2018 is not zero. Like him or not, Donald Trump is a source of uncertainty (intentionally, in his own words) for our allies, our enemies, and our capital markets. In the event of a major global incident, such as a serious miscalculation by policy makers, a nuclear incident, or perhaps a trade war between the U.S. and China or Mexico or Canada, the odds of a recession will undoubtedly increase.

Picks & Pans

10 Best ETFs: The 10 most undervalued asset class ETFs

Symbol	Name	1 Year
SGG	iPath Dow Jones-UBS Sugar ETN	-41.0%
NIB	iPath Dow Jones-UBS Cocoa ETN	-36.0%
SIL	Global X Silver Miners ETF	-26.8%
UNG	United States Natural Gas Fund	-25.0%
EGPT	VanEck Vectors Egypt Index ETF	-23.5%
JO	iPath Dow Jones-UBS Coffee ETN	-23.4%
GDXJ	VanEck Vectors Junior Gold Miners ETF	-23.4%
PSCE	PowerShares S&P SmallCap Energy Portfolio	-18.9%
QAT	iShares MSCI Qatar Capped ETF	-15.7%
AGF	DB Agriculture Long ETN	-13.6%

10 Worst ETFs: The 10 most overvalued asset class ETFs

Symbol	Name	1 Year
ARKW	ARK Web x.0 ETF	61.3%
GRN	iPath Global Carbon ETN	59.4%
REMX	VanEck Vectors Rare Earth/Strategic Metals ETF	59.2%
ARKK	ARK Innovation ETF	55.2%
CHIM	Global X China Materials ETF	55.0%
PLND	VanEck Vectors Poland ETF	54.4%
LIT	Global X Lithium ETF	53.8%
EWZS	iShares MSCI Brazil Small-Cap ETF	52.8%
COPX	Global X Copper Miners ETF	49.2%
PSI	PowerShares Dynamic Semiconductor	48.6%

10 Best Stocks: 10 fairly-priced stocks with rising earnings estimates

Company	Ticker	Current Price	Avg Daily $ Volume	Price to Sales Ratio	Price to Book Ratio	% Chg Earnings Est This Year	Technical Grade	Funda-mental Grade
Alcoa Corp	AA	$45.38	189,732,096	0.8	1.0	3.9	A	B
Bayer A G -Adr	BAYRY	$33.03	5,479,175	2.1	2.8	5.0	B	A
Contl Ag-Sp Adr	CTTAY	$50.87	1,674,910	1.1	3.1	3.1	A	B
Movado Grp Inc	MOV	$26.90	4,818,538	1.2	1.3	13.9	A	B
Oxford Inds Inc	OXM	$60.16	13,079,536	1.0	2.5	0.8	B	B
Sanderson Farms	SAFM	$163.82	67,530,056	1.2	2.7	12.8	A	A
Xcerra Corp	XCRA	$9.88	4,716,371	1.4	1.7	7.2	B	A

The stocks in the above table are enjoying their moment in the sun. Everything seems to be humming along smoothly. But we all know what happens when things get too quiet – things get louder and crazier.

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
Amc Entertainmt	AMC	$15.90	3,562,481	111.93	1.96	-235.62	-49.89	D	D
Atn Intl Inc	ATNI	$50.75	100,572	97.29	0.18	-32.18	-86.47	D	C
Blackbaud Inc	BLKB	$84.97	216,486	51.09	1.45	-4.54	-6.68	D	D
Cott Corp Que	COT	$14.94	851,438	50.14	2.46	-33.33	-12.97	F	D
First Majestic	AG	$7.14	3,363,186	96.63	0.05	-82.35	-67.86	F	D
Howard Hughs Cp	HHC	$115.80	176,669	56.86	1.01	-45.16	-45.87	F	F
Upland Software	UPLD	$20.29	109,410	51.62	0.71	-10.53	-17.50	F	C

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.

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 August. 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 August 2017) show a slight deterioration 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 45%.

Recession Watch

Indicator	Mar	Apr	May	Jun	July	Aug	Sep (est)
R-Score	279	270	269	275	267	255	250
Employment	1.9	1.7	1.8	1.7	1.7	1.7	1.6
Ind Production	1.3	2.0	2.3	2.1	2.4	1.5	1.7
Market Trend	17.1	13.7	16.0	16.8	14.2	13.1	15.0
Market Stress	24.7	27.4	23.5	25.7	25.9	24.1	23
Junk Spread	3.9	3.7	3.7	3.8	3.6	3.9	3.6

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

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.

Our Current Asset Allocation

Investor Risk Profile ----->	Conservative	Moderate	Aggressive
Summary			
Stocks	**33.5**	**36.0**	**50.0**
Bonds	**34.5**	**32.0**	**22.0**
Commodities	**4.0**	**6.0**	**7.0**
Cash	**17.0**	**15.0**	**13.0**
Non-traditional assets	**11.0**	**11.0**	**8.0**
	100.0	**100.0**	**100.0**
Details			
US Large Cap Stocks	8.0	8.0	12.0
US Mid Cap Stocks	4.0	5.0	7.0
US Small Cap Stocks	4.0	3.0	5.0
US Stocks Total	**16.0**	**16.0**	**24.0**
Intl Developed Mkt Stocks	9.5	10.0	14.0
Intl Emerging Mkt Stocks	8.0	10.0	12.0
Non-US Stocks Total	**17.5**	**20.0**	**26.0**
US Treasury Bonds	5.0	3.0	2.0
US Muni Bonds	17.0	14.0	6.0
US Corporate Bonds	3.0	4.0	2.0
US High Yield Bonds	3.5	4.0	5.0
US Bonds Total	**28.5**	**25.0**	**15.0**
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	**17.0**	**15.0**	**13.0**
Energy	1.0	2.0	3.0
Precious Metals	1.0	2.0	1.0
Crops & Livestock	2.0	2.0	3.0
Commodities Total	**4.0**	**6.0**	**7.0**
Hedge Funds	7.0	6.0	4.0
Managed Futures	4.0	5.0	4.0
Non-traditional assets Total	11.0	11.0	8.0
	100.0	100.0	100.0

As of 9/26/17

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

Asset allocation: tax-deferred

Investor Risk Profile ----->	Conservative	Moderate	Aggressive
Summary			
Stocks	**27.0**	**36.0**	**49.0**
Bonds	**41.0**	**35.0**	**27.0**
Commodities	**6.0**	**5.0**	**5.0**
Cash	**14.0**	**15.0**	**13.0**
Non-traditional assets	**9.0**	**9.0**	**6.0**
	97.0	**100.0**	**100.0**
Details			
US Large Cap Stocks	8.0	10.0	15.0
US Mid Cap Stocks	3.0	5.0	7.0
US Small Cap Stocks	2.0	3.0	6.0
US Stocks Total	**13.0**	**18.0**	**28.0**
Intl Developed Mkt Stocks	9.0	10.0	12.0
Intl Emerging Mkt Stocks	5.0	8.0	9.0
Non-US Stocks Total	**14.0**	**18.0**	**21.0**
US Treasury Bonds	19.0	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	**34.0**	**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	**17.0**	**15.0**	**13.0**
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	5.0	3.0
Managed Futures	3.0	4.0	3.0
Non-traditional assets Total	9.0	9.0	6.0
	100.0	100.0	100.0

As of 9/26/17

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

Final Thoughts

I try my best to listen to the data, rather than my emotions. I have my own set of indicators for the market and the economy. They are not foolproof, but they have saved me and my clients a lot of money, time, aggravation, and worry over the years. I hope that this gives you comfort from the concern that I might be turning outright bearish. I am not.

But I admit that I am getting increasingly concerned about valuations, geopolitical risks, and monetary risk. But until I see some tangible evidence that the economy is about to roll over, I will continue to participate in this historic bull market.

The U.S. stock market today is priced for perfection. Investors are acting as if the pro-growth Trump agenda will become a reality, and soon. I think this is too optimistic. It's becoming clearer with each passing month that the Republican leaders in the House and Senate are not simply going to acquiesce to Trumps demands. They are showing an increasing willingness to push back on his impulsive behavior, especially when Trump cozies up to Chuck & Nancy in an obvious middle-finger to Mitch & Paul.

The Whites of Their Eyes

The famous order "Don't fire until you see the whites of their eyes" was popularized in stories about the battle of Bunker Hill. Whether it was actually said in this battle, it was clear that the colonial military leadership were regularly reminding their troops to hold their fire until the moment when it would have the greatest effect, especially in situations where their ammunition would be limited. *Source.*