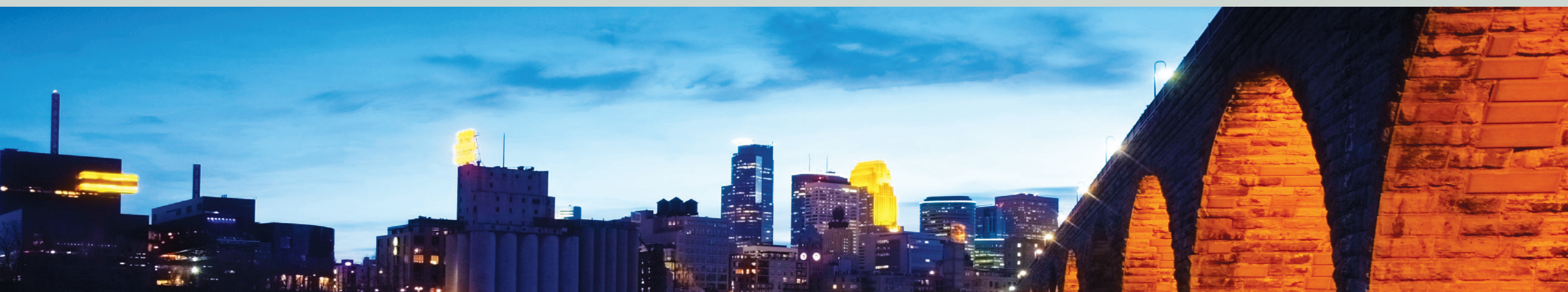
# Third Quarter 2017 Market Commentary

Leuthold Weeden
CAPITAL MANAGEMENT



**Doug Ramsey, CFA, CMT**
**Chief Investment Officer**

The stock market ended the third quarter with a surge into the S&P 500 target zone of 2,550-2,600 that we established at the beginning of 2017, and it did so with the backing of much broader leadership than we had expected at the onset of the year. Blue chip stocks (both domestic and international) have been the biggest winners—which fits the historical tendency for those stocks to perform well in the late stages of a cyclical bull market. But, Mid and Small Caps managed to match the blue chips' gains during the third quarter after lagging during the first half of the year.

The new bull market highs recorded during late October were some of the broadest we've observed throughout the entire 8 1/2-year bull market, extending beyond the capitalization tiers noted above to include traditional leading groups like Transportation stocks, Banks, and Utilities, along with various cyclical industries that have also tended to roll over in advance of the final bull market peak. From the perspective of pure price action, the latest market highs look nothing like those observed at the last several bull market peaks. In each of those prior instances, the market had suffered significant "internal" damage by the time the S&P 500 and Dow Jones Industrial Average made their final peaks, with secondary stocks and various bellwether industry groups usually having underperformed for many months beforehand.

Based solely on the market's favorable momentum, breadth, and leadership trends, we would expect the market to be trading at even higher levels in the next three to six months. But these bullish "technical" considerations have been partly offset by deterioration in our Intrinsic Value measures. Remember, the current 20-month bull market rally commenced from valuation levels that were already fairly lofty, and the breadth of the upside move—while bullish from a technical point of view—has resulted in a market that is now more broadly overvalued than even that of the late 1990s' market mania. For example, the median Price/Earnings ratio for our domestic "Leuthold 3000" stock universe reached its highest level in history this month (late October) at 23.6x, while the S&P 500 median Price/Sales ratio has traded in record territory for more than a year.

Valuations are not the stock market's only challenge. With the U.S. unemployment rate recently falling to the 4.2% level, we must consider the likelihood that this cycle's best news on inflation and corporate profitability may already be behind us. In fact, several of our economic measures have reached thresholds where they've historically proven "too hot" for both the stock and bond markets. Our leading inflation indicators continue to trend slowly upward, and the Federal Reserve will soon announce the details of its plan to begin to shrink the $4.5 trillion balance sheet it built up during the years of Quantitative Easing. It's difficult to imagine that even a small liquidation of the Fed's massive bond holdings will be pulled off without some stock market hitch.

(continued)

The late phase of a bull market generally features well-defined trends in industry group leadership; this is an environment that's ideal for our quantitative approach. Our equity portfolios are well ahead of their benchmarks this year, with the models correctly capturing big moves in several Technology, Health Care, Industrials, and Financials groups, while sidestepping underperformers like Energy, Utilities, Telecom, and Consumer Staples. Although our portfolios are concentrated in some of the year's best-performing groups, our holdings continue to trade at substantial discounts to the market averages on measures like Price/Earnings and Price/Cash Flow ratios. In essence, our equity portfolio strategy is to exploit Value characteristics, but only within those industries exhibiting top-tier Growth and Momentum characteristics (…"cheap stocks in strong groups," as we often say).

Fixed income holdings in our tactical funds remain near an historical low, around 20-22% of portfolio assets. Yields on 10-year Treasuries fell to a 2017 low of 2.05% on September 7th, and we took advantage of that market strength by trimming the duration of our bond portfolio to 4.5 years, from 5.1 years previously. Bond market investors have become so conditioned to benign inflation numbers that we think even a modest acceleration in consumer price inflation to the 2.75-3.00% level could trigger a sharp rise in long-term rates. Wage inflation has already entered that zone.

Within the Corporate bond sector, we still favor high grade Corporates over Junk bonds. The latter trade at some of the tightest spreads in history, relative to Treasuries, and do not offer a favorable risk/reward tradeoff.

We appreciate your interest.

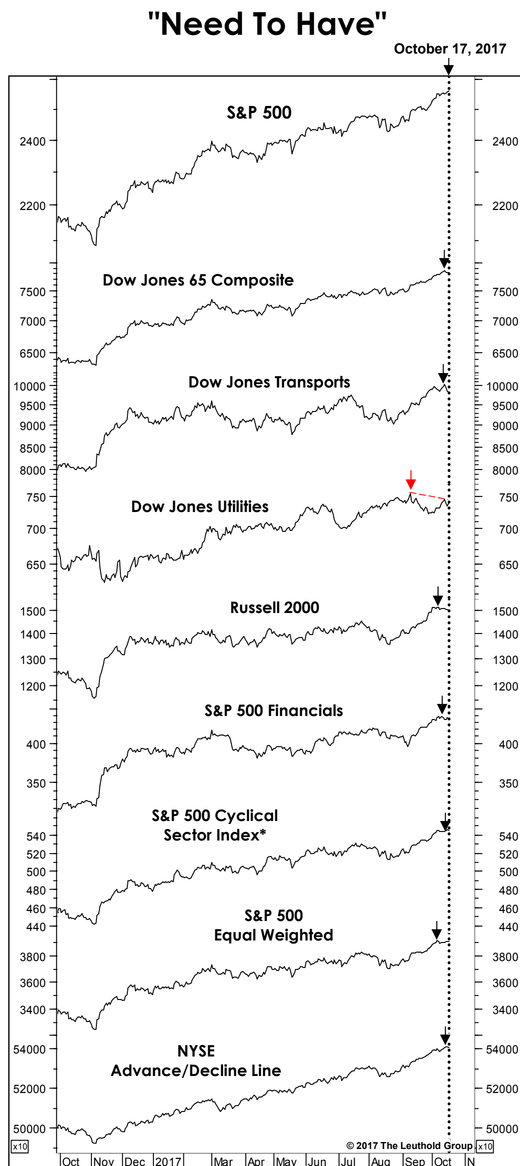
Sincerely,

Doug Ramsey, CFA, CMT
Chief Investment Officer

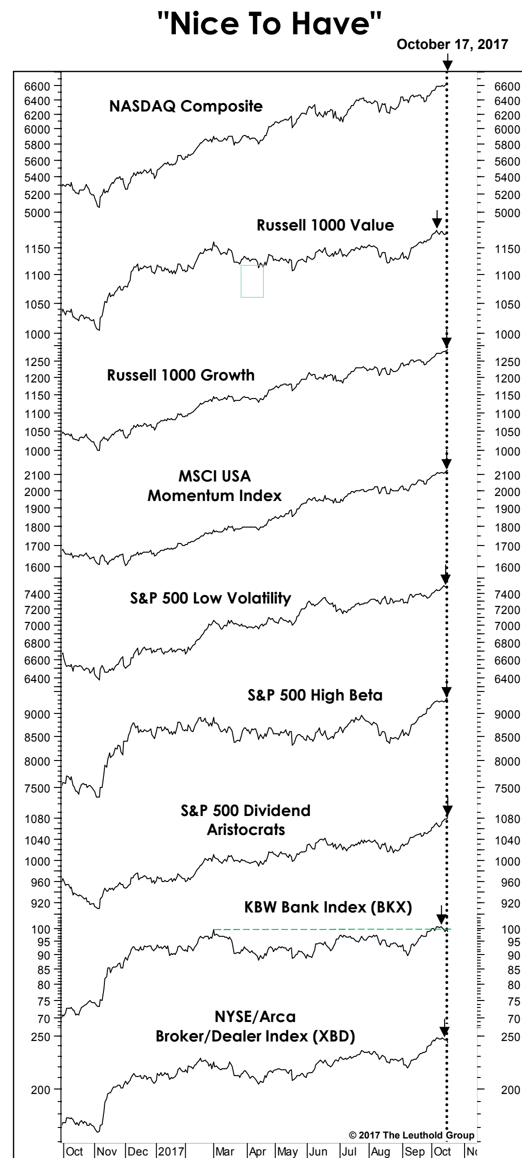
## Better To ‘Have’ Not ‘Need’

From a purely technical point of view, if a bear market is born during October 2017, it would have to be considered the result of some sort of “immaculate conception.” The critical Red Flag Indicators (“Need To Have” on chart) were (almost) all perfectly aligned with the S&P 500 at its latest high (as this is written), and a secondary set of indexes that we consider less critical—but still “Nice To Have”—has also been making new highs in virtual lockstep with the blue chips. There remain leaders and laggards (Growth and Momentum over Value, Cyclicals over Defensives), but that’s **very different from saying there are major internal divergences**… and those who claim to see divergences are simply squinting too hard, in our opinion.

This remarkable level of bullish “agreement” across the U.S. market stacks the odds heavily against an imminent cyclical top, but it doesn’t rule out the possibility of a short-term setback. Based on our shorter-term concerns (so far proven to be unfounded), we’ve recently held our tactical funds’ net equity exposure at lower levels (61-62%) than during the January-July period (when unhedged exposure ranged between 66-69%).




*Equal-weighted composite of Consumer Discretionary, Industrials & Materials sectors.



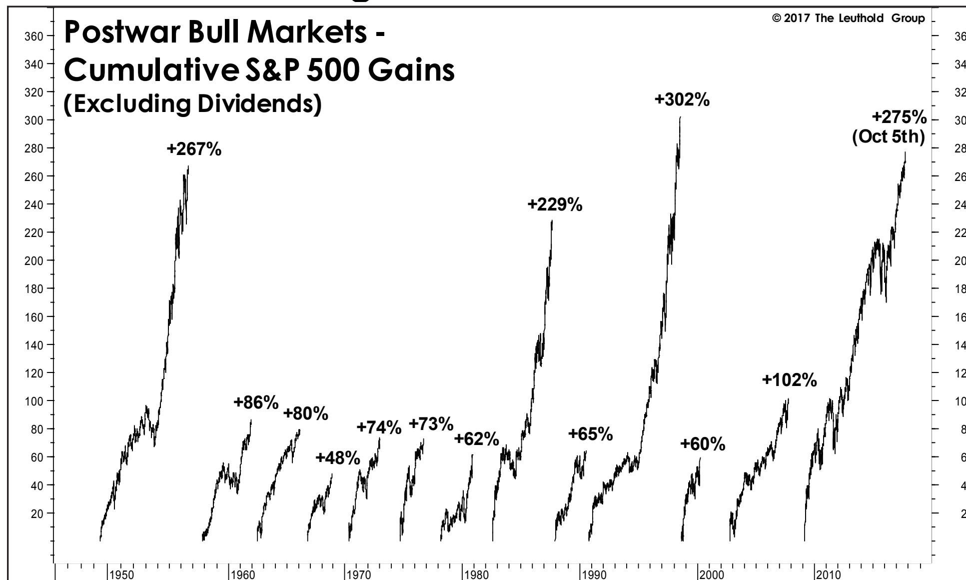
### Year Of The G.O.A.T. ?

Entering 2017, we expected a stock market "melt-up" to the 2,550-2,600 level on the S&P 500—a move we thought might run into trouble by late summer. (Veteran market watchers should have immediately recognized our rookie mistake of assigning dates and numbers to this forecast!) In October, the S&P 500 first reached that target zone with an October 5th close of 2,552—only 13 days after the astronomical end of summer. Now what?

In this cycle, the Fed has been notorious for "moving the goalposts" on the economic conditions required for rate hikes. That, in turn, requires us to move our goalpost by 100 S&P 500 points, to a likely year-end zone of 2,650-2,700.

If the S&P 500 notches a close above 2,717, this bull market will become the **G**reatest (postwar) cyclical bull **O**f **A**ll **T**ime—eclipsing even the 1990-1998 gain of +302%. It's already been a good year for G.O.A.T.s, with Tom Brady, Roger Federer, and Floyd Mayweather all cementing their claims. With the S&P 500 less than 7% away, why not?

## Closing In On The 1990s Bull

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