Fourth Quarter 2018 Market Commentary

Doug Ramsey, CFA, CMT
Chief Investment Officer
January 31, 2019

We have reasoned over the last year that the long overdue move by global central banks to shrink their enormous balance sheets would have potentially dangerous consequences for not only stocks but, indeed, all risky assets. That assessment proved on the mark in 2018, when global stock and commodity market measures sank into bear market territory near year end. U.S. stocks declined across the board but held up better than most foreign markets—a pattern that's become very familiar to global investors over the last decade.

Last year's market declines helped reestablish better value in stocks, enough so that we boosted tactical portfolios' equity exposure from very low levels. Still, we are quite concerned that global-monetary policy is tightening in the face of a U.S. economy that is operating beyond estimates of its "full employment" potential. While such economic strength is undoubtedly welcomed on Main Street after several years of sluggish growth, such a backdrop can be hostile for Wall Street—as 2018 demonstrated.

Yields across the Treasury curve are bunched in an unusually tight range between 2.30% and 2.70%, levels that are still very low relative to long-term experience. But financial markets are most responsive—not to the level of monetary accommodation—but to the rate of change. On that basis, many measures of policy continue to deteriorate. For example, global central-bank liquidation of bonds, accumulated during years of an experimental quantitative-easing exercise, has actually accelerated since last fall's stock market peak. In the U.S., the growth rate in the broad M2 money supply has slowed to just over 4% from nearly 8% in mid-2017.

Just over a year ago, the five largest central banks were buying government and corporate bonds at an annualized rate nearing $1 trillion. A mere ten months later—in October 2018—those banks became net sellers of bonds on an aggregate basis, and we doubt it is mere coincidence that steep declines in stocks, commodities, and low-grade corporate debt began almost immediately. And, during the worst of the stock market rout, although the Fed signaled that it was set to pause rate hikes for a while, it has allowed its balance sheet to contract at an accelerating rate.

History shows that tighter monetary policy impacts financial assets first, with the economy and corporate profits weakening several months later. Right on cue, we have recently begun to observe the economic deterioration that the stock market began to sniff out about one year ago. Many members of the Eurozone reported near-recessionary conditions during the fourth quarter and China's sharp second-half deceleration resulted in its weakest year of economic growth since 1990. U.S. corporate earnings reports for the fourth quarter made frequent mention of a sharply decelerating global economy, and the moderately stronger dollar, versus a year ago, is also pressuring earnings comparisons.

Our internal estimates suggest that both S&P 500 earnings per share and the government's economy-wide measure of corporate profits will be down in 2019, as slower economic growth, globally, and rising U.S. wage inflation combine to squeeze profit margins. If 2018 profits turn out to be the peak for the business cycle, then the current trailing S&P 500 P/E multiple of 21x is far too high.

(continued)

The best-case scenario is that the economies of the U.S. and its major trading partners decelerate in 2019 just enough to let the Fed stand pat on interest rates, but not enough to result in a big shortfall in profits relative to current expectations. That's a pretty narrow tightrope for the economy to walk, but the rally during the first month of the year seems to be predicated on exactly that outcome. We are skeptical but are prepared to navigate that potential outcome if our market and economic disciplines show significant improvement.

Last year, our equity group-selection disciplines placed us in many leading industries, but individual stock selection within those groups was affected by an historically bad year for value-oriented strategies. Following a decade of growth-stock dominance, many observers are calling for a major swing in leadership toward value investment styles. We are not so certain but expect better results from our approach of buying the cheaper stocks within industry groups exhibiting good growth and momentum characteristics.

We continued to stay defensive within fixed income, favoring higher quality sectors such as Treasuries and investment grade corporates. The duration of our fixed income holdings is 5.2 years, versus 5.9 years for Bloomberg Barclays U.S. Aggregate and 6.9 years for Bloomberg Barclays Global Aggregate.

In our view, the move since September looks like an incomplete cyclical bear market—an assessment that's backed up by our Major Trend Index, other Leuthold disciplines, and our own instincts. Even the rebound off Christmas Eve lows has the signature of a bear market rally. We were fortunate to have covered part of our hedge near those Christmas lows when our tactical funds' net equity exposure briefly dipped below 30%. Today that exposure stands in the range of 42%. We'd no longer consider stocks "dangerously" overvalued, but that doesn't mean they can't fall considerably farther while the cyclical environment remains, well… dangerous. For those with the flexibility to manage stock market exposure, we remain convinced that a relatively defensive posture, at present, is the most sensible tactic.

We are thankful for your confidence and support of Leuthold Fund strategies. Your questions and comments are most welcome.

Sincerely,

Doug Ramsey, CFA, CMT
Chief Investment Officer

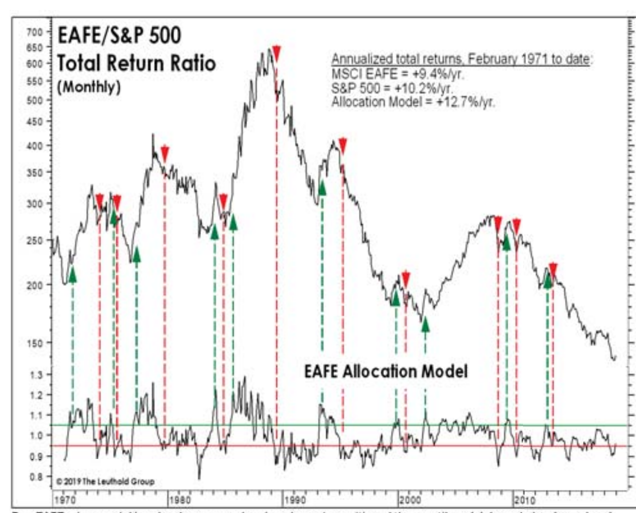
Sizing Up The Rally

There's an old saying that bear-market rallies look better than the real thing, yet the upswing off December lows looks even better than the typical bear-market rally. The 12.1% gain in the S&P 500 in 16 days—through January 17th—compares favorably to the median *and* average bear-market rally dating back to 1945 (+8.4% in four weeks and +10.6% in six weeks, respectively). But the variability around those statistics is huge, and the bear markets of 2000-02 and 2007-09 served up a total of seven interim rallies ranging from +12.0% to +24.2%. We wish there was an historical threshold that proved to be a definitive "bear killer," but there's not.

The move off December lows not only looks better than a typical bear-market rally, it is also a bit better than the median and average gains for the first 16 days following all post-WWII bear-market *lows* (S&P 500 gains of +9.7% and +10.1%, respectively).

For the past few years, we've suggested the most probable catalyst for a reversal in the multi-year underperformance of foreign stocks would be a U.S. bear market. The massive psychological swing accompanying major market declines typically gives rise to new leadership themes, which are generally very different from the incumbent winners. But foreign stocks have evidently bought into the media myth that a bearmarket decline must be at least 20%, because the mere 19.8% loss in the S&P 500 has failed to catalyze a turnaround in the relative fortunes of EAFE. Through January 17th, in fact, that index has enjoyed a bounce only half that of the S&P 500.

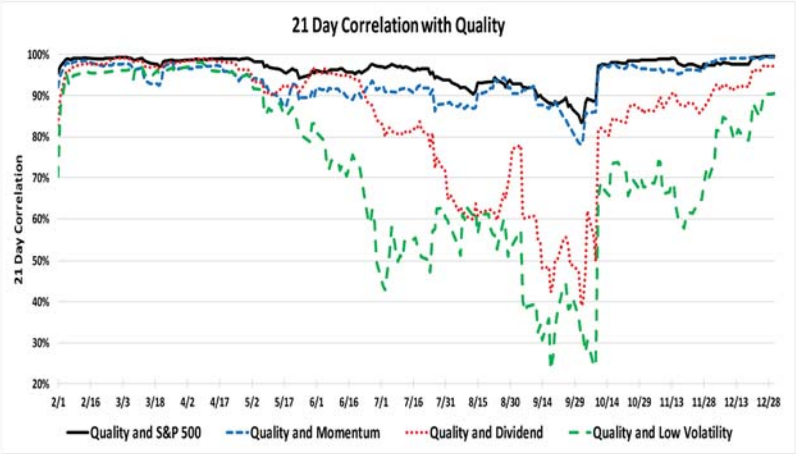
The allocation model (below right) has favored the S&P 500 over EAFE since July 2013. Note the model has been inflicted by several "whipsaw" signals, suggesting one should supplement this tool with other disciplines and/or fundamental views. If the model triggers in the months ahead, we'll be strongly inclined to believe a sustained leadership cycle for foreign stocks has kicked off—regardless of whether the bear market was completed in December or whether it remains in force.



Buy EAFE when model breaks above upper band, and remain positioned there until model drops below lower band, then switch into the S&P 500.

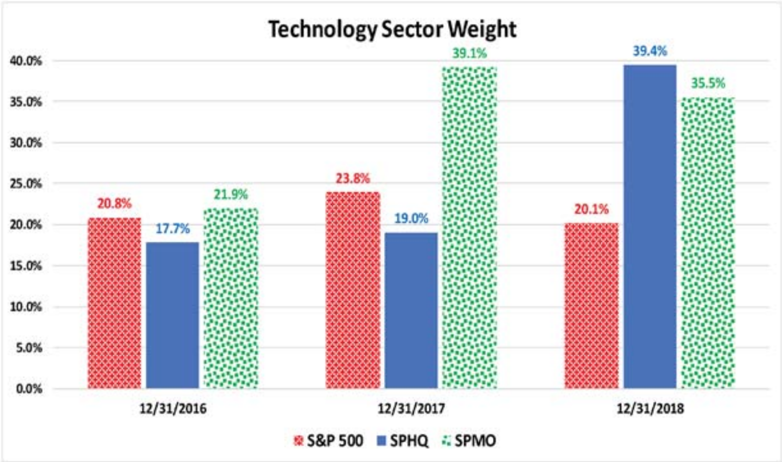
Incongruities In High Quality

Quality is one of the most popular and successful of the equity market's quant factors. It is intuitively appealing and serves as a useful defensive strategy in falling markets. Low Volatility and Dividend Growth are also defensive factors, while Momentum and High Beta are viewed as aggressive or bullish factors. These offsetting behaviors would seem to make for excellent diversification opportunities in equity portfolios, and for the most part, that is true. However, **Quality failed to display its defensive personality in the fourth quarter selloff**, **throwing a wrench into the workings of portfolio diversification and downside protection**.



The close correlation between Quality and Momentum in 2018 led us to investigate whether the Technology sector provided a common link between the two factors, and the answer is a resounding yes. Using SPHQ ETF to represent the S&P 500 Quality Index, we found that Technology was just 17.7% of the portfolio weight at the end of 2016. However, by year-end 2018, SPHQ held 39.4% in Technology—almost double the S&P 500 parent index and even outpacing the S&P 500 Momentum Index, represented by SPMO. The incredible business success of cloud computing giants made them eligible to join the High-Quality club, and the index holds several Tech titans including Microsoft, Visa, Mastercard, Nvidia, Cisco, Adobe, and Apple.

For Quality to once again become a defensive diversifier to Momentum, we will likely need to see a material change in the Technology weighting in one of these indexes.



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