LEUTHOLD FUNDS

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4Q23 Market Commentary

Even in a mild recession, we'd expect the federal deficit to top 10%, leaving no room for the Treasury to "finesse" the issuance of new bonds as it did in 2023.

Doug Ramsey
Chief Investment Officer

It's been more than twenty years since Dick Cheney told then-Treasury Secretary Paul O'Neill that "deficits don't matter." O'Neill was worried about a fiscal crisis—a concern that turned out to be at least twenty years too early.

Today's U.S. fiscal situation may not yet represent a crisis, but it's clear that deficits finally *do* matter. O'Neill was the last Treasury Secretary to see a twelve-month budget surplus. Today, despite an economy that continues to operate above projections of its full-employment potential, the trailing twelve-month federal deficit amounts to 6.5% of GDP[1]. As a result, the borrowing needs are so massive that the Treasury's once obscure Quarterly Refunding Announcement[2] has become a market event akin to an interest rate hike or cut by the Federal Reserve Board. (It should come as no surprise the Treasury managed the timing and mix of new debt issuance in a manner that offset the liquidity impact of some of last year's rate hikes.)

For some reason, those who are now the most vocal about the looming fiscal risks are not current policymakers, but *former ones.* After stepping down as president of the New York Federal Reserve Bank, economist Bill Dudley shed his "company man" image to become an outspoken Fed critic. On the fiscal side, former Treasury Secretary Robert Rubin said in January that the U.S. is in a "terrible place" in regard to its deficits and warned the markets could correct "savagely" when or if they begin to grasp those risks.

Financial markets can be capricious, sometimes ignoring obvious threats until they're practically center stage. The economist Rudiger Dornbusch said, "In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could."

That's good advice for economists who've abandoned their recession forecasts for the simple reason that a recession has not yet materialized. It's also wise counsel for the "deficits don't matter" crowd—of which virtually everyone in a policymaking position now seems to be a member. These days, fiscal conservatives are a rarer breed than black swans.

The Treasury Secretary, former Fed Chair Janet Yellen, hasn't yet suggested current deficits pose a real problem, and her recent management of the Treasury-auction calendar has been lauded as "clever." However, the sheer size of issuance required to fund the deficit will eventually overwhelm her ingenuity—or (if she's lucky)—her predecessor's.

How will this fiscal backdrop affect the investment outlook for 2024 and beyond? History is of limited help because there's no record of the U.S. government running such large deficits at full employment. Then again, the stimulus should keep inflation stickier in the coming months than we previously thought,

[1] Gross Domestic Product.
[2] A change in the Treasury Department's debt management policy.

potentially putting pressure on the S&P 500's[1] forward P/E ratio[2] that's about 25% above its 30-year average. On the positive side, large federal deficits have, historically, been associated with above-average corporate profit margins.

Eventually, inflation should drop sharply as the economy sinks into recession, perhaps in the second or third quarter. Even in a mild recession, we'd expect the federal deficit to top 10%, leaving no room for the Treasury to "finesse" the issuance of new bonds as it did in 2023. In that scenario, there would be enormous pressure on the Fed to intervene in the bond market, and the possibility it would launch some form of "yield curve control"[3] along the lines of Japan's recent experiment.

Despite looming economic concerns, our market disciplines suggest it's too early to adopt a fully defensive portfolio posture. Technical factors are mostly bullish, and the stock market is much stronger on a trailing twelve-month basis than any other time when a recession was imminent. But the lagged impact of nearly two years of tight Fed policy continues to hit the manufacturing and service sectors, and we fear it's only a matter of time before a self-reinforcing loop of production cuts, layoffs, and income contraction begins. A stock market correction accompanying such events would probably be the final blow that sends the economy into recession.

Our stock market analysis is currently scoring as "high neutral"; however, with the technical factors providing most of the lift, the assessment is more susceptible to a negative reversal than if the score was supported by favorable monetary conditions or more reasonable stock valuations. Entering February, net equity exposure in our tactical portfolios is 54-55%.

If inflation proves to be stickier than anticipated in the next few months, it could provide us with an opportunity to bump out the current 6.3-year duration[4] of fixed-income holdings. Our latest bond moves included boosting exposure to hard-hit mortgage-backed securities and upping the weight to investment-grade corporate bonds. Overall, we don't view fixed income as especially cheap relative to the inflation backdrop, but long-term expected returns have reset substantially higher from the bubble years of 2019-2021.

Looking ahead, as market conditions change, we will continue to take cues from our quantitative disciplines as they identify new themes that could be the next long-term leaders across the range of asset-class opportunities. Please let us know if you have any questions. Thank you for your ongoing support!

Sincerely,

Doug Ramsey, CFA, CMT
Chief Investment Officer

[1] Stock market index tracking the performance of 500 of the largest U.S. companies.
[2] Forward Price/Earnings ratio divides the current share price of a company by its estimated future ("forward") earnings per share.
[3] A monetary policy tool used by central banks to manage interest rates along the yield curve.
[4] The number of years it takes to receive a bond's true cost, weighing in the present value of all future coupon and principal payments.

Other Market Notes

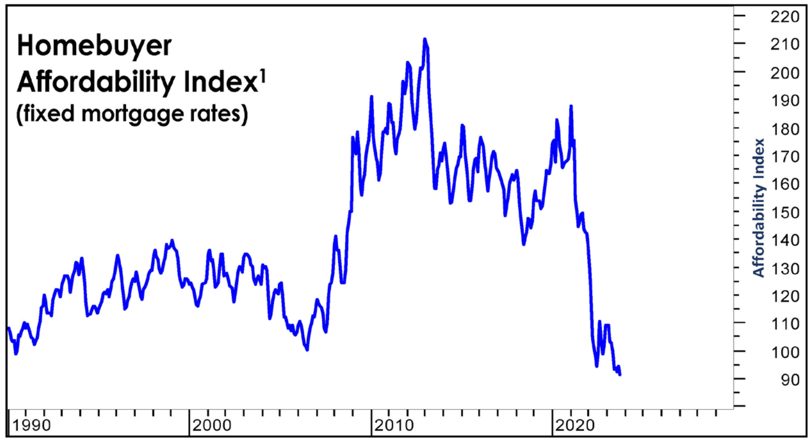
ARE CONSUMERS READY TO CRACK?

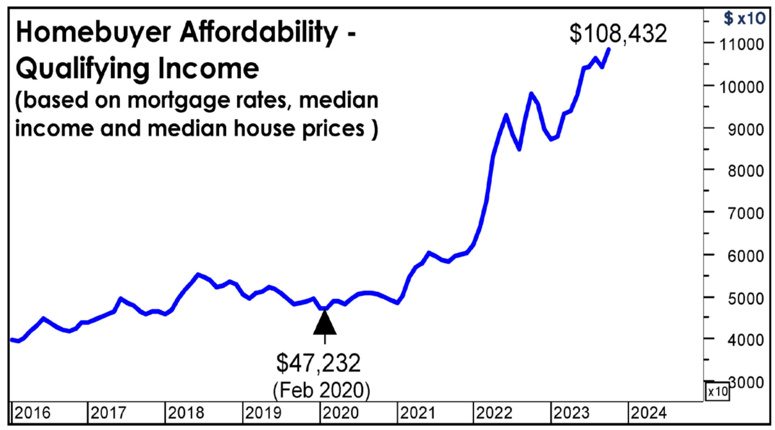
Some economists contend that a recession will be averted because of consumer resilience. It's an argument we've heard in advance of every recession in our career. But, while consumption remains more than 70% of GDP, production is the driver of the economy. When production growth weakens (and it is still doing so), income growth slows and consumption soon responds.

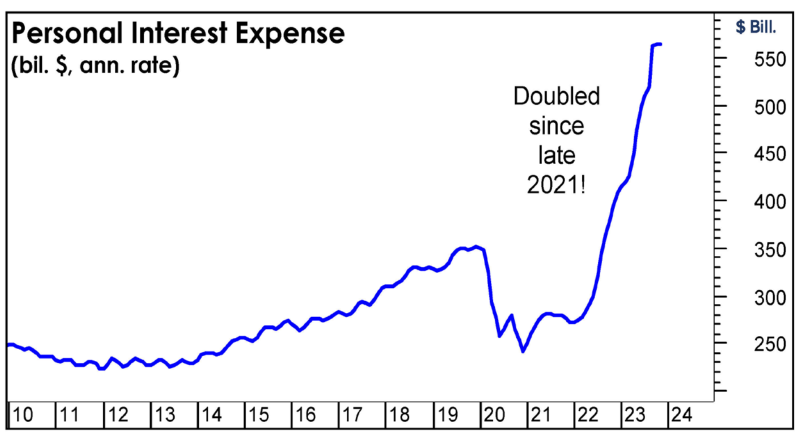
That said, we're impressed that consumer spending has held up so well in light of the cumulative inflation of the past three years (and the rate hikes of the last two years). The excess savings resulting from pandemic stimulus has been an important prop, and a new study from the Federal Reserve indicates there's still a few months' worth yet to be spent.

We don't know how the Fed's research dealt with the resumption of student loan installments last October, but it's been reported that 40% of borrowers did not make their initial payment. Meanwhile, among seniors aged 65-79, the share with a mortgage rose to 41% in 2022, up from 24% in 1989. The percentage with a mortgage aged 80+ increased from 3% to 31% during the same time!

Finally, though we're reminded daily that most homeowners are locked into very low rate mortgages, rate hikes on credit cards and car loans have lifted personal interest expense by more than 40% from pre-pandemic levels.







[1]The Homebuyer Affordability Index measures whether a typical family can afford mortgage payments on a typical home: A value of 100 means that a family with the median income has exactly enough money to qualify for a mortgage on a median-priced home.
Homebuyer Affordability Qualifying Income: The monthly income a household should have in order to buy the home.
Personal Interest Expense: All interest other than home mortgage interest or Mortgage Interest.

Other Market Notes

CHECKING IN ON "MEDIAN" VALUATIONS

While the year-end rally was broad, it did precious little to close the performance gap between the "average" S&P 500[1] stock and the S&P 500 index. The 2023 shortfall of 12.70% in the equal-weighted S&P 500 compared to the cap-weighted[2] version was its second-worst annual showing. Only 29% of underlying S&P 500 stocks managed to beat the index last year, and the share of large cap managers who outperformed was much lower.

Annual Spread Between Equal-Wtd. & Cap-Wtd. S&P 500

1992	8.2	2000	17.8	2008	-2.5	2016	3.0
1993	5.4	2001	11.2	2009	19.8	2017	-2.7
1994	0.0	2002	3.9	2010	7.0	2018	-3.2
1995	-5.2	2003	12.3	2011	-1.9	2019	-2.3
1996	-3.7	2004	6.2	2012	1.9	2020	-5.8
1997	-4.3	2005	3.4	2013	4.0	2021	0.6
worst year → 1998	-16.3	2006	0.4	2014	1.0	2022	6.3
1999	-9.3	2007	-3.6	2015	-3.4	2023	-12.7 ← 2nd worst year

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Thanks to the lagging action of large caps, in general, the average valuation profile has improved relative to that of the market-cap weighted S&P 500. The median stock's Price/Cash Flow[3] ratio of 15.6x is 10% below the S&P 500 cap-weighted ratio of 17.4x. That compares with a median long-term discount of 1%, but is still much better than the -20% threshold we'd deem to be a relative valuation "washout" (a level touched during the COVID panic).

Of course, this valuation metric hides the inconvenient truth that both segments are historically expensive. Although we'd now consider the broad list of large caps to be cheaper than the cap-weighted index, four of the five metrics[3] we track for the median stock have returned to their top deciles, with the Normalized P/E[3] ratio being the lone holdout (88th percentile). Those who've pitched a tent in the soft-landing camp might want to consider if that possibility could now be fully priced in.

S&P 500 Median Stock Valuations

© 2024 The Leuthold Group	Trailing P/E	Normalized P/E	Price/ Cash Flow	Price/ Sales	Price-to-Book	Average
December 29, 2023	24.9 x	27.7 x	15.6 x	2.71 x	3.44 x	
1990-To-Date Percentile	94	88	93	94	92	92

[1] The average (or median) S&P 500 stock or the Equal-Weighted S&P 500: includes the same constituents as the Capitalization-Weighted S&P 500, but each company in the EW version is allocated a fixed weight (0.2%) of the index total.

[2] The Cap-Weighted S&P 500 is the same as the S&P 500 index, which calculates performance by each stock's float-adjusted market capitalization.

[3] Price/Cash Flow is the share price divided by cash flow per share; Normalized P/E (Price/Earnings) is a simple average of five years of earnings, using 18 quarters of actual earnings and two quarters of estimated earnings; Trailing P/E is calculated by dividing the current market value, or share price, by the earnings per share over the previous 12 months; Price/Sales is current stock price divided by revenue per share; Price-to-Book is the ratio of the market value of a company's shares (share price) over its book value of equity.

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150 South Fifth Street, Suite 1700
Minneapolis MN 55402

612.332.9141
info@LeutholdFunds.com | https://Funds.LeutholdGroup.com