LEUTHOLD FUNDS

May 15, 2024

1Q24 Market Commentary

While it's too early to conclude that the yield-curve inversion has finally generated a "false positive," it has now lasted longer than any of the eight previous episodes, and the S&P 500's 18-month rally has also advanced higher than any of the prior post-inversion rallies.

Doug Ramsey
Chief Investment Officer

It's hard to believe, but May represents the start of the fifth year of the post-COVID economic expansion. (The official recession consisted of the 2020 shutdown months of March and April.)

Given the significant monetary tightening[1] of the past two years and the continuing slowdown in measures of U.S. economic growth, we'd be surprised if the expansion survives its fifth year. So far, it has certainly been worthwhile to give both the economy and the U.S. stock market the benefit of the doubt. Despite fairly sluggish real-GDP growth[2] of around 2%, and sticky consumer price inflation, the economy has avoided the recession that seemed almost unanimously expected by "blue-chip" economic forecasters a year ago. Meanwhile, the S&P 500[3] is up nearly 50% from its October 2022 bear market low.

The earliest of the recession signals arrived in the fall of 2022, just as the stock market was bottoming. In particular, the spread between the 10-year Treasury yield and three-month T-bill rate turned negative in November 2022. Such inversions in the Treasury yield curve correctly forecasted every one of the last eight U.S. recessions—with no false signals. While it's too early to conclude that this measure has generated a "false positive," today's inversion has now lasted longer than any of the eight previous episodes, and the S&P 500's 18-month rally has also advanced higher than prior post-inversion rallies.

That said, it's clear that the inverted yield curve (and, more broadly, tighter monetary policy) is wreaking its usual havoc on interest-rate-sensitive economic sectors. The manufacturing industry has been in a mild recession for 18 months, and the last two years' surge in mortgage rates has held home sales at extremely low levels (along with consumer durables' purchases that accompany home sales). Sales of new cars and trucks have leveled off at an annualized rate that's about 1.5MM vehicles below that recorded between 2016-2019.

While higher interest rates deserve most of the blame for weakness in these cyclical sectors, we think that persistently elevated prices in those same segments play a punitive role. In a normal manufacturing industry contraction, for example, new factory orders are apt to trend lower until price cuts finally trigger a rebound in demand. However, for the last several months, the ISM Manufacturing Survey[4] has shown that declining orders have been accompanied by *rising* prices. Similarly, in the market for existing homes, a 35% collapse in sales volume (vs. 2021-2022) might well have been expected to generate price concessions by sellers. But that's not (yet) the case: The median price for an existing single-family home has stayed sticky at around $400,000.

If viewed in isolation, the Federal Reserve's[5] actions of the last two years should have had a significant disinflationary effect by now. Remember, in the past two years, the Fed has (1) hiked the federal funds rate[6] by 500 basis points; (2) shrunk its own balance sheet by $1.5 trillion—or about 18%; and (3) overseen a Treasury yield-curve inversion that's persisted eight months longer than any previous inversion.

[1] Interest rates are increased by the central bank and money supply is reduced.
[2] A measure of economic growth, expressed by gross domestic product (GDP), from one period to another, adjusted for inflation or deflation.
[3] A stock market index tracking performance of 500 of the largest U.S. companies.
[4] An indicator of U.S. economic activity based on a survey of purchasing managers at more than 300 manufacturing firms.
[5] The central banking system of the United States.
[6] The interest rate at which banks and other depository institutions lend money to each other, usually on an overnight basis.

1Q24 Market Commentary (continued)

Why, then, is the economy still generating consumer inflation that's almost double the Fed's 2% target rate? As we speculated in last quarter's update, the answer is the increasingly unsustainable amount of deficit spending. While the last two years' shift in monetary conditions has been as dramatic as any tightening cycle in history, this fiscal largess has cushioned the blow. Since the yield curve inverted 18 months ago, there's been cumulative deficit spending at the federal level of about 8% of GDP! There's no historical cycle of monetary tightening that's seen a fiscal "offset" anywhere near that size. That's certainly helped to extend the economic expansion, but it also explains why rates of consumer price inflation (and producer price inflation, wage inflation, house prices, etc.) remain elevated. It's straightforward: An economy at full employment doesn't require aggressive fiscal stimulus—but when that stimulus is provided nonetheless, much of it simply drives up prices.

A full-employment deficit of 6% is unsustainable, but the economy and stock market might tolerate it for longer than we, and others, suspect. The huge fiscal deficits have certainly been a prop for corporate profit margins, which have barely been grazed by the past few years of high inflation. Overall, the weekly composite score of our expansive range of technical factors has steered our tactical portfolios to maintain a heavier weight in the stock market than the fundamental backdrop might justify, with net equity exposure in the 56-58% range, which is up a couple of percentage points from the average level during the first three months of 2024.

Many pundits would contend that a stock market bubble can't exist (or even *develop*) with consumer pessimism as widespread as it is today. We are not so sure, and prefer to take a more mathematical approach when it comes to defining a market bubble.

On that score, we don't think U.S. large-cap stocks quite qualify as a mania because, from a quantitative perspective, the stock market has failed to breach the valuation thresholds we use to identify a bubble. However, it bears repeating: If the market peaks out here, it will represent the third most expensive top in the history of our valuation work, and bubble deniers will have missed the forest for the trees.

If you have any questions, please reach out to us. We appreciate your ongoing support!

Sincerely,

Doug Ramsey, CFA, CMT
Chief Investment Officer

Other Market Notes

STEVE LEUTHOLD'S SAGACIOUS ADVICE: "TEN LESSONS I HAVE LEARNED"

It's been just over a year since we lost our friend and the founder of this firm, Steve Leuthold. We deeply miss his counsel, candor, creativity, and cantankerous nature (and, some days, even his Copenhagen-contaminated coffee).

Near the turn of the millennium, Steve compiled a list of "Ten Lessons I Have Learned" as part of an essay, "Managing Your Mother Lode... Your Serious Money." It was later published in the 2002 book, *The Global-Investor Book of Investing Rules: Invaluable Advice from 150 Master Investors*. In homage to Steve, we're reprinting the first five, here, along with his introduction. Next quarter we'll publish the second half.

* * * * * *

What follows applies to personal investing, but it is also a wise philosophy for portfolio managers and other investment professionals, alike.

At the tender age of 23, I was a retail stockbroker at Paine Webber. From 1961-1966, I dealt with individual investors, traders, and a few high-roller speculators. That period included two bear markets (1961 and 1966) and, in retrospect, the experience was invaluable as an education in human nature and investor psychology.

Greed and fear are critical stock market elements and also the twin barriers along the road to long-term investment success. In truth, I probably learned more about investor psychology in those years as a retail broker than in the next 35 years as a relatively detached analyst, portfolio manager, and investment strategist. For a sincere understanding of investor psychology, I think it is necessary to deal directly on the front lines with investors versus the more insulated positions of the latter.

Anyway, after more than four decades in various positions in the investment business, here is my version of the Ten Commandments: The ten lessons I think are most important to remember when managing one's serious money—one's mother lode. I learned these only after first violating nearly every one of them!

I. Know Thyself

Everyone has their own investment strengths and weaknesses. It is particularly important to understand one's weaknesses to defend against and compensate for them. Here are some examples:

- *You hate to admit you're wrong, so you have difficulty taking a loss.*
- *You're a sucker for sexy tech stocks.*
- *You're inherently pessimistic.*

II. Discipline Is Essential

Establish your own personal set of investment disciplines, carefully considering and counteracting your specific investment weaknesses. Write them down and keep them under your desk blotter and in your wallet or pocketbook. Check them each time you plan to buy or sell. Revise the disciplines from time to time, but no more than once a year—and never when emotions are high.

III. Always Consider Risk As Well As Reward

Before making an investment, consider how much you might lose if it doesn't work out. Focus on the downside as well as the upside—the potential risk and potential reward. Does it make sense if the prospective one-year gain is 25%, but if things go wrong, the risk is a 50% loss? While admittedly an inexact exercise, one can apply this mental discipline not just to individual stocks, but to an entire asset class (bonds, stocks, real estate), equity sector, or theme.

IV. Cash Is Not Trash

Cash reduces overall portfolio risk in down markets. But, more importantly, cash reserves are the ammunition to take advantage of unanticipated opportunities. Cash can be a great offensive weapon (see the next "Commandment").

V. Always Consider A Market Crisis As A Potential Market Opportunity

Your emotions say, "Sell, Sell, Sell!" But your previously established, personal disciplines say, "BUY!" Alas, a great opportunity can be lost if you don't have cash in reserve.

Crisis opportunities may develop once or twice a year. At those times, even traditionally conservative investors should contemplate using margin-buying power. But, remember, buying on margin should be reserved for extraordinary circumstances.

Leverage should never be one's standard operating procedure when managing your "mother lode." Maximum leverage (maximum margin) supports your mother-lode portfolio like a rope supports a hanged man.

Other Market Notes

BUBBLE OR NO BUBBLE?

Is the stock market forming another bubble? Market "sentimenticians" assure us it's not, and rightly point out that today's AI craze is not yet on par with the silliness of the meme[1] stock and SPAC[2] manias of 2021. But, what does the stock-market math tell us?

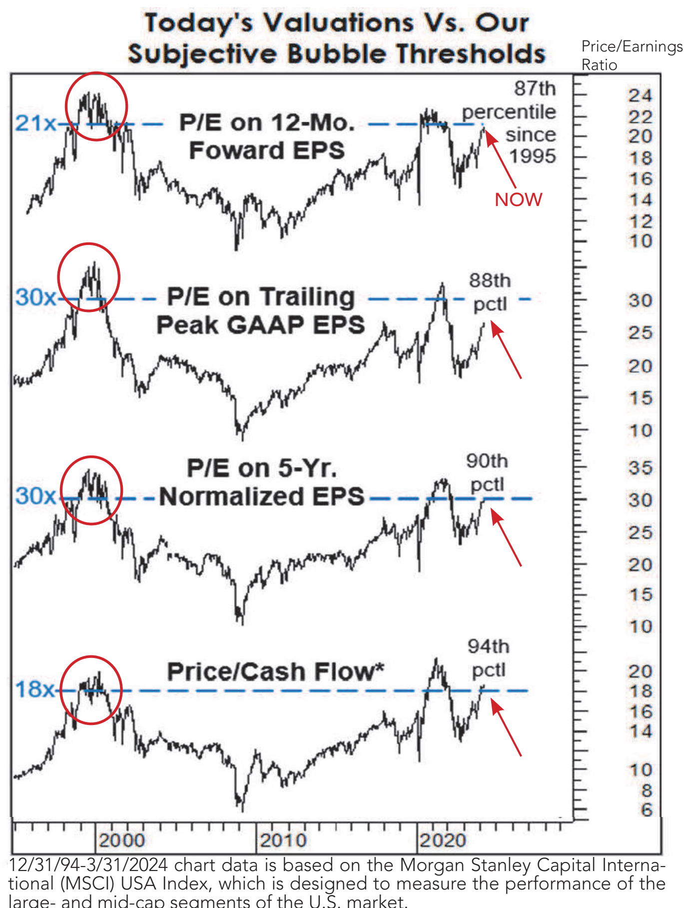
With the benefit of hindsight, the markets of 1999-2000 and late 2020-2021 were genuine bubbles, and the chart shows well-defined levels that four conventional valuation metrics* broke through during those manias.

Today's market now appears perched on a bubble "borderline," as three of the four valuation measures are dangerously close to breaching those past mania thresholds. We believe that any push higher will take the market back into bubble territory.

Some observers of market psychology won't agree, and we concede that FOMO/YOLO is not yet where it was throughout 2021. In the end, though, it's about what you pay, not how you feel.

[1] A stock that gains popularity among retail investors through social media.

[2] A special purpose acquisition company (SPAC) is a publicly traded company created for the purpose of acquiring or merging with an existing company.



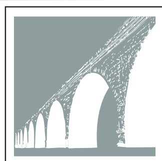
12/31/94-3/31/2024 chart data is based on the Morgan Stanley Capital International (MSCI) USA Index, which is designed to measure the performance of the large- and mid-cap segments of the U.S. market.

**S&P 500 Valuations:
Today Versus The Three Priciest Bear Market Lows In History**

© 2024 The Leuthold Group	Forward P/E	Peak P/E	Normalized P/E	Price/ Cash Flow*	Price/ Sales	Price-to-Book*	Average Downside
March 28, 2024	20.9	26.5	30.1	18.4	2.85	4.73	
October 9, 2002	13.5	14.4	17.0	11.4	1.09	2.29	
March 23, 2020	13.0	16.5	18.1	10.5	1.61	2.50	
October 12, 2022	15.1	18.1	22.7	12.9	2.15	3.61	
Average For 2002, 2020 & 2022	13.9	16.3	19.3	11.6	1.62	2.80	
Pct. Downside to Average Low	-33.6	-38.5	-35.9	-36.9	-43.3	-40.8	-38.2

*Data for MSCI United States Index

*P/E (price-to-earnings) ratio is calculated by dividing a company's market value price per share by a company's earnings per share; Forward P/E ratio uses forecasted earnings in the calculation; Trailing P/E ratio on peak GAAP earnings uses the last 12 months of actual earnings derived from generally accepted accounting principles (GAAP); P/E ratio on 5-year normalized EPS uses five-year arithmetically-averaged annual earnings, looking six months ahead and 54-months back; Price/Cash Flow measures the value of a stock's price relative to its operating cash flow per share; 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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Past performance does not guarantee future results. Investing involves risk, principal loss is possible. Index performance does not reflect fund performance and it is not possible to invest directly in an index.

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