LEUTHOLD FUNDS

October 31, 2024

3Q24 Market Commentary

Although we believe a U.S. recession is still in the cards, it is probably not imminent, considering the S&P 500 is near its all-time high.

Doug Ramsey
Chief Investment Officer

For the last few quarters, we've described the path of the U.S. economy as "pre-recessionary," an opinion proven to be too cynical, thus far. In the third quarter, Real Gross Domestic Product[1] (GDP) rose 2.7% from a year ago, more or less in line with the economy's long-term potential. That being said, recessions generally don't announce themselves with a steady, multi-quarter deterioration leading up to the actual downturn: The latest 2.7% figure is on par with the average growth rate seen during the final quarter of the last four economic expansions.

While we have been impressed by the U.S. economy's resilience during 2023 and 2024, we doubt a recession will be avoided over the next twelve months. The Index of Leading Economic Indicators[2] (LEI) was admittedly too early, raising a red flag when it first rolled over 2½ years ago. However, if an economic "soft landing" were the most likely outcome for 2025, the LEI should have already begun to improve.

Instead, in September, the LEI index declined for the 30th time in the past 31 months, and a renewed recession signal was sparked when the LEI's smoothed six-month rate of change worsened while the reading was in negative territory. The same pattern was observed four months before the 1990-1991 and 2008-2009 recessions. If all of that weren't enough, a recession rule devised by the Conference Board, which calculates the LEI, was also triggered in September.

Our own economic and monetary analysis is more comprehensive than the LEI, but it, too, began to raise caution flags far too early. However, unlike the Leading Economic Indicators, our disciplines emphasize *the action of the stock market itself* to confirm the message of other predictive tools.

We save our biggest asset allocation bets for times when the varied elements of our quantitative framework are in general agreement. Yet, throughout the last year, persistently rising stock prices suggested that our caution on the U.S. economy was either premature or just plain wrong. We've, therefore, kept our tactical strategies' stock weightings at above-neutral levels for nearly all of the last twelve months, with net equity exposure of 55-56% as of late October. It's hard to imagine this stance will endure for the *next* twelve months; nevertheless, our quantitative investment approach requires us to keep an open mind.

Although we believe a U.S. recession is still in the cards, it is probably not imminent, considering the S&P 500[3] is near its all-time high. The market upswing over the last year (+35%) has not only been strong but broad-based: In mid-October, for the first time since the bull market began in late 2022, eight bellwether[4] indexes we've tracked for many years made 12-month highs all in the same week. That action seems to confirm market strength; historically, as a bull market nears its end, those bellwethers have shown a tendency to peak out in advance of the blue-chip[5] indexes.

Similarly, there's no sign of distress in the corporate bond market, and that sort of "cohesive" market action is typically a short-term green light for both the

[1] GDP is a key indicator of a country's economic health; it measures of the total value of goods and services produced within a country or region over a specific period of time. A stock market index tracking performance of 500 of the largest U.S. companies.
[2] LEI s a composite index that predicts economic turning points by analyzing trends in a variety of economic indicators.
[3] A stock market index tracking performance of 500 of the largest U.S. companies. The 12-month-forward P/E ratio uses forecasted earnings.
[4] Indices that have historically led the direction of the overall stock market. These include the Dow Jones 65 Composite, Dow Jones Transportation Average, Dow Jones Utility Average, Russell 2000, S&P Financials, S&P 500 Cyclical Composite, Equal Weighted S&P 500, and NYSE Daily Advance/Decline Line.
[5] An index that tracks the shares of well-known and financially stable, publicly-traded companies known as blue chips.

economy and the major stock market averages. When an economic downturn draws nearer, we presume at least a handful of those bellwether indexes will begin to lag both the DJIA[1] and S&P 500.

Obviously, the stock market's valuation profile has deteriorated markedly as the rally has progressed. At its mid-October all-time high, the S&P 500 traded at 22x 12-month-forward EPS[2], 32x normalized EPS[2], and 20x cash flow per share[2]. Such levels are within a couple percentage points of those recorded at the two most expensive bull market peaks in history: March 24, 2000 and January 3, 2024.

Elevated valuations don't rule out additional gains over the next several months. At the same time, they should severely temper the expectations of long-term stock investors, especially those whose portfolios are concentrated in richly priced mega-cap stocks. (In fact, we'd argue that the S&P 500—though considered a diversified stock index—is itself overly exposed to the exorbitantly valued mega caps!)

On the positive side, valuations for mid-cap and small-cap stocks are fairly close to their 30-year averages, and we would not be surprised to see them outperform the S&P 500 by several percentage points *per year* for the next several years. Emerging-market stocks are also considerably cheaper than large-cap domestic equities, but our analysis suggests it is too early to build a significant position there.

While the yield on long-term U.S. Treasury bonds is up dramatically from that recorded during the COVID pandemic, it's still well below the "fair value" projection. In fact, the outlook for rising inflation continues to push that estimate higher: Today, the 10-year Treasury yield stands at 5.5%, roughly 1.25% above today's actual yield. With a 15% fixed-income allocation in tactical portfolios, we continue to be substantially underweight compared to our normal guideline levels.

This bull market has overcome great odds from an economic, monetary, and valuation perspective, yet the continued underlying strength of broad-based equities advises against the odds of an impending bull market top. While we view the cyclical backdrop for stocks as high risk, our quantitative analysis aligns with the message of market internals, telling us it's too early for a shift to a more defensive posture.

In the meantime, our tactical portfolios' neutral stance still benefits from stock market gains even though they typically won't rival fully-invested strategies. However, that's the norm in any bull market, due to their 70% equity ceiling.

Conversely, by straddling the line between positive and negative until the market relays a more definitive message, there is the advantage for our tactical portfolios to outpace during interim corrections, volatility, and performance divergences among differing styles and market-cap flavors.

Please let us know if you have any questions. We appreciate your ongoing support!

Sincerely,

Doug Ramsey, CFA, CMT
Chief Investment Officer

[1] Dow Jones Industrial Average is one of the oldest and most commonly followed equity indexes composed of 30 prominent U.S.-listed companies.

[2] 12-month-forward EPS is an estimate of a company's earnings per share (EPS) over the next 12 months; Normalized EPS is the five-year arithmetically-averaged annual earnings-per-share looking six months ahead and 54-months back; Cash flow per share is the share price divided by cash flow per share.

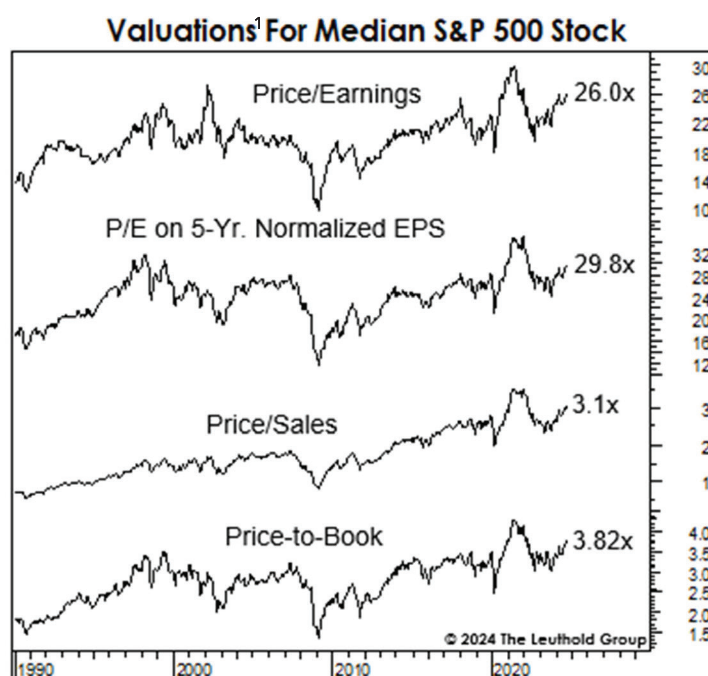
Other Market Notes

IT'S ALL RELATIVE

S&P 500 valuations have rebounded to levels much closer to their 2021 highs than corresponding figures for the *median* large-cap stock. That said, all five of the median valuation measures[1] we track are substantially above the levels seen at the three prior bull market peaks (March 2000, October 2007, and February 2020).

For decades, we've employed a quantitative approach to consider the level of potential downside risk for stocks (or upside potential) based on how far the S&P 500 is away from its longer-term historical median valuation.

Today, the median S&P 500 stock—while considerably less pricey than the index, overall—would lose 15% if these five valuation yardsticks merely declined to levels at the *top* of the four previous bull markets. Investors are ill-prepared for such a reversion to a prior *"peak"*—let alone a full-blown retreat to median historical levels that will undoubtedly come to pass.



Monthly data through September 30, 2024

S&P 500 Median Stock:
Reward/Risk Analysis Versus "New Era" Bull Market Highs

© 2024 The Leuthold Group	Date	Trailing P/E	Normalized P/E	Price/ Cash Flow	Price/ Sales	Price-to-Book	Upside/ Downside
	September 30, 2024	**26.3 x**	**29.8 x**	**16.8 x**	**3.10 x**	**3.82 x**	
Bull Market Highs	March 24, 2000	18.7	22.4	11.4	1.40	2.92	
(1995 To Date)	October 9, 2007	19.2	24.2	12.9	1.78	3.16	
	February 19, 2020	23.5	29.1	15.3	2.78	3.48	
	January 3, 2022	24.9	33.8	18.0	3.43	4.10	
	Average	**21.6 x**	**27.4 x**	**14.4 x**	**2.35 x**	**3.42 x**	
	Upside/Downside to Average High	**-18.0 %**	**-8.1 %**	**-14.3 %**	**-24.3 %**	**-10.6 %**	**-15.1 %**

[1] Trailing P/E Ratio = current stock price divided by earnings per share (EPS) over the previous 12 months; Normalized P/E Ratio = five-year arithmetically-averaged annual earnings, six-months ahead and 54-months back; Price/Cash Flow = a company's market cap divided by the most recent fiscal year's operating cash flow; Price/Sales = a company's market capitalization divided by the most recent year's revenue; Price/Book = a company's current stock price per share divided by book value per share.

Other Market Notes

S&P 500: RELENTLESS, BUT RISKY

The S&P 500's September gain was its fifth consecutive monthly increase, and the tenth out of the last eleven months. If the index is up in October, it will mark the first year since 1942 in which each of the seasonally "weak" months (May through October) recorded a gain.

Of course, considering that the bull market didn't succumb to the Federal Reserve's interest-rate hikes of 500 basis points[1] between early 2022 and mid-2023, or two years of Fed balance-sheet shrinkage[2], or a persistently inverted yield curve[3], why would the bull market conform to some silly seasonal pattern?

Added to that, more votes than ever are apt to be cast in November's U.S. election on the principle of "the lesser of two evils." Yet, through September, the S&P 500's 2024 performance has been the best for a presidential election year since 1928.

This is a time when we are especially appreciative that our investment decisions are driven by a quantitative, disciplined methodology, which removes the potential for personal biases, gut instincts, and knee-jerk reactions to cloud objectivity.

Years When S&P 500 Gain Through September > 20%

	Year	S&P 500 Jan-Sep Gain	S&P 500 Oct-Dec Return
pre-election yr. →	1927	27.1	3.0
election yr. →	1928	21.0	13.9
	1929	23.9	-28.9
	1933	42.7	2.7
pre-election yr. →	1935	22.0	15.9
pre-election yr. →	1943	23.6	-3.4
	1945	21.7	7.4
	1954	30.2	11.4
pre-election yr. →	1955	21.4	4.1
	1958	25.2	10.3
pre-election yr. →	1967	20.4	-0.2
pre-election yr. →	1975	22.3	7.5
pre-election yr. →	1987	32.9	-23.2
	1989	25.7	1.2
	1995	27.2	5.4
pre-election yr. →	1997	27.9	2.4
election yr. →	2024	20.8	
	Averages:		
	If Jan-Sep > 20%	**25.6**	**1.9**
	If Jan-Sep < 20%	**0.8**	**3.0**

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[1] 100 basis points are equivalent to 1%.

[2] A shrinking Fed balance sheet reduces the money supply, which can push up interest rates.

[3] An inverted yield curve is a condition in which yields on some shorter-term securities are higher than those for some longer-term securities. This is often a signal of a pending recession.

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