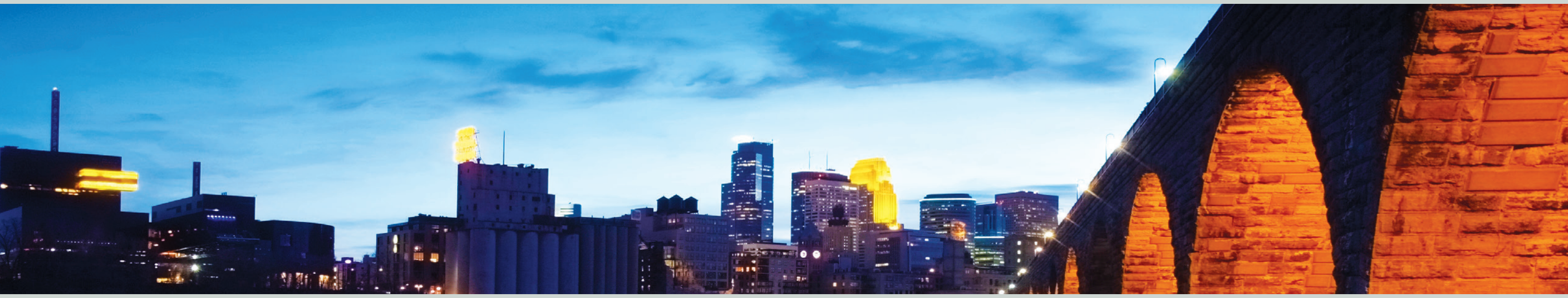
Second Quarter 2017 Market Commentary

Leuthold Weeden
CAPITAL MANAGEMENT



Doug Ramsey, CFA, CMT
Chief Investment Officer

While stocks have fallen short of the mid-year targets we published at the beginning of 2017, they've nonetheless delivered solid year-to-date gains. Through late July, the S&P 500 was up more than +10%, while the gain in the MSCI EAFE Index was almost +15%. The Russell 2000 was up just over +5%, although it is not uncommon for Small Caps to lag during the mature phase of a bull market (and in fact, for this market cycle, the relative performance of the Russell 2000 peaked way back in the spring of 2011).

Although YTD gains are not as strong as we'd forecasted, the internal condition of the stock market at its recent highs has been better than we expected. We think the market is "discounting" a continuation of the strong earnings rebound seen in the last three quarters. Momentum readings within in our Major Trend Index have managed to hold at the elevated levels reached during the market jump that immediately followed the presidential election; this sustained period of "overbought" readings is more characteristic of a *new* bull market than of one that's well into its *ninth year*. There's little-to-no evidence of the market "narrowing" process that traditionally warns the bull market — and, often, the economic expansion as well—has entered its final phase.

The list of disparate indexes and industry groups at, or near, cyclical highs is impressive, and includes the Dow Jones Transports, NYSE Financials, S&P Technology Index, S&P MidCap 400, the S&P 500 Equal Weighted Composite, and the weekly and daily NYSE Advance/Decline Lines. And, while we've already noted that U.S. Small Caps have generated only about half of the YTD gain of the S&P 500, Small Cap indexes like the Russell 2000 and S&P SmallCap 600 were nonetheless at new bull market highs in late July. The common media portrayal that the stock market has been lifted mainly by the likes of Mega Caps such as Apple, Amazon, Facebook, and Google is simply wrong.

Cyclical measures related to inflation, interest rates, and corporate profits remain bullish, although not as overwhelmingly as the technical tools. Our earnings "breadth" indicator, which measures results for all publicly-traded companies, shows very strong results for the current quarter. And thanks to the recent flattening of commodities prices, leading inflation measures have pulled back from the danger thresholds they had approached earlier this spring. We expect that wages, rather than commodities, are the likelier candidate to drive consumer price inflation toward the 2.5–3.0% zone over the next year.

Taken together, our economic and market analyses support above-average exposure to equities, and our tactical portfolios remain positioned on the upper end of their normal 30–70% range. While stock market valuations are admittedly high, the weight of the evidence suggests that the next significant market decline will probably begin from even higher valuation levels.

(Continued)

After struggling to identify major themes during 2016, our quantitatively-driven equity portfolios are performing well this year. There's been little change to the major sector allocations over the last several months, with Financials, Technology, and Consumer Discretionary dominating the list of Attractively-rated groups. The Energy sector looks interesting from a pure valuation perspective, but none of its underlying industry groups have begun to make a move higher in our rankings. Consumer Staples and Utilities sectors also rate poorly on a quantitative basis, and have none of the valuation appeal shown by the Energy sector. These two sectors benefited from the obsession with "low volatility" stocks that's existed throughout much of this bull market, but that obsession now seems to be fading.

Our tactical portfolios continue to target a low fixed income allocation of around 20%, reflecting the lack of long-term opportunity we see for this asset class. Fixed income holdings have a current duration of 5.5 years, a figure that we will probably trim in the next few quarters. Given historically tight corporate credit spreads, we sold our small remaining position in High Yield bonds during the second quarter, preferring instead to concentrate on High Quality Corporate bonds.

Please let us know if you have any questions. Thank you.

Sincerely,

Doug Ramsey, CFA, CMT
Chief Investment Officer

Valuations Today Versus The Tech Bubble Peak

We've generally spoken of the market's "broad participation" as a good thing. From a purely technical point of view, it is. But it has also produced a market that's broadly overvalued—and the comparison against even the March 2000 bubble peak isn't close. Today, we have all but the bottom decile of the Leuthold 3000 stock universe trading above 20x trailing EPS—very different than late-1999, when only the **top decile** traded north of 20x (and when the Top 50 of the Leuthold 3000 traded at a median P/E of 35x).

While Chart 1 looks frightening, it draws a comparison that's not entirely fair. By the end of 1999, the U.S. market had been in "distribution" mode for almost two years—with 80% of the Leuthold 3000 trading at moderate-to-steep discounts to their long-term P/E averages. There's no doubt that was the most "bifurcated" juncture in stock market history.

Since today's stock market remains internally strong, it might be more appropriate to compare current valuations to those prevailing at a similar point during the 1990s' bull. Based upon many measures, the month-end "internal" peak of that cycle occurred in March 1998—a full two years in advance of the "external" high in the blue chip averages. Chart 2 shows that the early 1998 "cap-structure" in P/E ratios was very similar to today's, although the preference for Large Caps was more evident. Median P/E ratios for deciles three through nine are almost identical for both periods.

Assuming this bull market ends with a traditional, multi-month distribution process, one might expect today's P/E "curve" to bend into a somewhat more negative slope (akin to that of December 1999 in Chart 1) than exists today. That implies better relative action in Large Caps, still ahead, leading up to the eventual cyclical peak.

Chart 1

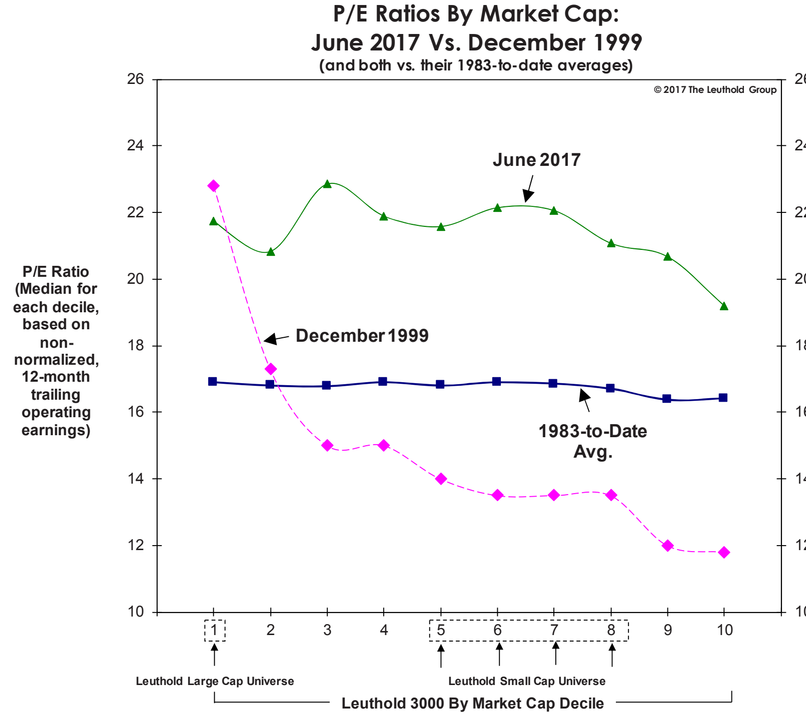
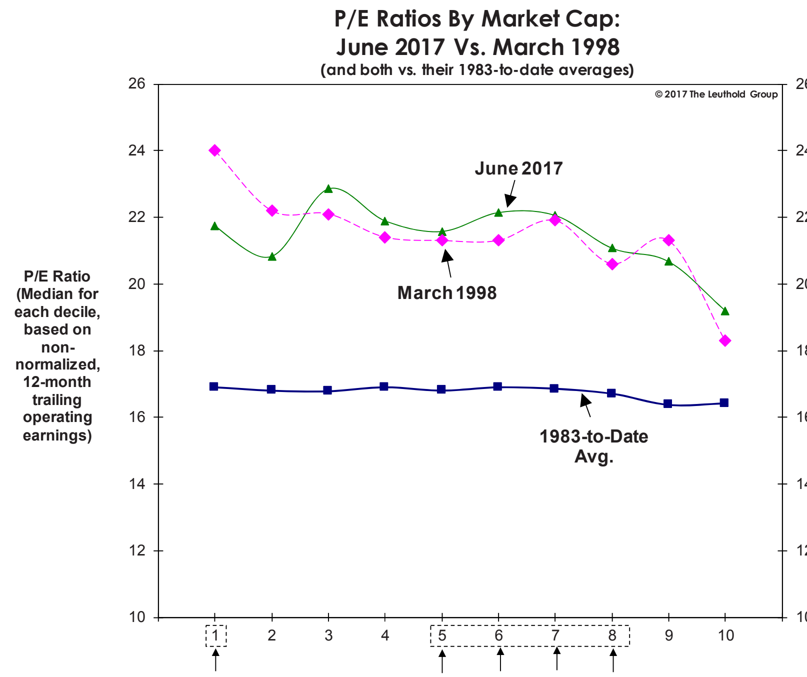


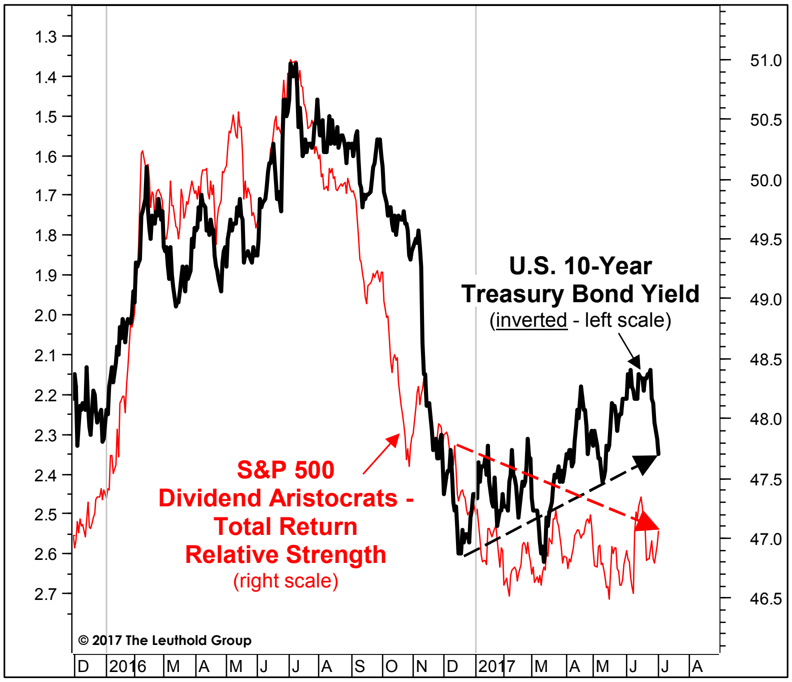
Chart 2



Bonds And Aristocrats

The last year has been a difficult one for any person or theme tied to the "establishment"—including mainstream Republicans, mainstream Democrats, EU commissioners and lobbyists, and, yes, even one of the established leaders of the cyclical bull market—the S&P 500 Dividend Aristocrats. Our worries over the group's inflated valuations eventually proved well-founded, as these blue bloods relinquished years of relative outperformance during last year's second half. And now, after a six-month respite, we think the "blood"-letting is set to resume.

Lately we've been intrigued by the breakdown in the longstanding, inverse relationship between bond yields and the relative performance of the Aristocrats. If this relationship had held true, the March-June bond market rally "should" have been associated with a relative rebound in the Aristocrats and other bond-like stocks. When that rebound failed to develop, we were left wondering how poorly the Aristocrats might respond when and if the bond market again turns hostile. With yields rising sharply in the last two weeks, we could soon find out.



Leuthold Weeden
CAPITAL MANAGEMENT

33 S. 6th Street, Suite 4600
Minneapolis MN 55402

612.332.9141

info@LWCM.com
www.LWCM.com