



## Are the Good Times “Rolling” Again?

Let the good times roll. The last time we started a letter with this phrase was the third quarter of 2012. The implication behind the phrase was awe that the stock market had rebounded so robustly from the depths of the financial crisis. While we were still positive our expectations were for modest returns going forward. Since then the S&P 500 is up about 40% with virtually no downside volatility to scare investors out of the market (or entice those with too much cash back in)! The last two years is a perfect example of why investing should be driven by a long-term strategy versus a reliance on forecasting.

So far financial markets in 2014 have been full of surprises. Just about all financial assets have done well with little volatility. In April, Bloomberg polled 67 economists and everyone predicted U.S. bond yield would be higher by October. Of course, interest rates have fallen steadily. Stocks have powered ahead, and even recent laggards, gold and emerging market stocks, did well. In the second quarter the S&P 500 rose by 5.2%, richly-valued small capitalization stocks gained 2%, while widely-shunned emerging market stocks led the pack with a 6.6% gain.

The stock market’s resilience and surprisingly strong performance so far in 2014 is not totally irrational. Most importantly, the world’s central banks continue to be very accommodating. The least dovish central bank since the financial crisis has been the European Central Bank (ECB). However, fears of deflation across the pond have ignited the ECB into action. In early June, the ECB took several aggressive steps to combat deflation including lowering interest rates, providing cheap loans to banks later this year, and cutting the rate on bank deposits parked overnight with the ECB to minus 0.1%, from zero. European politicians have also made significant progress on establishing a banking union which is needed to secure more stability to their financial system.

Additionally, economic data across the globe is strengthening. The Eurozone purchasing managers’ composite index rose to a three year high in April. Fears of a significant slowdown in China have eased as the government ramped up spending on infrastructure and gradually loosened monetary policy. In the U.S. despite a shocking 2.9% decline in GDP in the first quarter, consumer confidence is high while manufacturing, services, and employment figures have all been strong recently, all hinting of an improving economy.

Still there is plenty that could go wrong. Stock valuations are not cheap enough to provide support if there is an unexpected negative geopolitical or economic event like a spike in oil prices. Financial markets are eerily calm and common sense suggests that a stock market correction could occur at any time. The current takeover boom and reliance on share repurchases for growth are classic signs of the final stages of a bull market. While the predictions of hyperinflation as a result of quantitative easing didn’t materialize, recent inflation data has perked up. Over the last twelve months CPI rose by 2.1% while core CPI (ex-food and energy) was even hotter at 2.8%. The Federal Reserve is forecasting that these measures will ease in the coming months. If they do not, financial markets would likely react negatively.

**Our strategy the last few years has been to avoid taking big risks and enjoy the ride. While we have not changed course, we are getting a little nervous. The fact that many investors share that sentiment probably suggests the markets will confound everyone and drift higher.** Recently, JP Morgan held an institutional investment conference where only 5% of participants rated domestic equities as underpriced. Individual investors are equally negative. According to a survey of retail investors in 16 countries by State Street, cash allocations have risen to 40% in 2014, leading us to surmise that a little more recklessness needs to be present before a major correction develops.

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## OUTSIDE COMMENTARY

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**Major Trend Index 7-7-14**

We sense that the lack of volatility in the stock market in recent months is beginning to unnerve even the bulls, who seem increasingly compelled to do something in response to the relentless new highs. But the correct (and very difficult) approach is sometimes to simply stand pat. Our market disciplines have lately forced us to do exactly that, and the Major Trend Index for the week ended June 27th didn’t break from the pattern. The MTI rose 0.02 to 1.13, with none of the five categories managing a weekly swing of more than 20 points. Net equity exposure in the Core and Global Funds currently stands at 67% and 65%, respectively.

With the market advancing to cyclical highs, it’s no surprise that both the Intrinsic Value and Attitudinal categories fell to negative readings that challenge their own cyclical extremes. In recent months, the “median” stock in both the S&P 500 and the Leuthold 3000 has traded at or above the valuation levels seen in 2000 and 2007 (... although cap-weighted readings are nowhere near the extremes reached at the earlier of those two market highs).

At last Thursday’s S&P 500 bull market high of 1985.44, every major U.S. index other than the Russell 2000 had recorded a matching bull market high on that day or within a few days prior (... the Russell itself closed the day less than 0.1% from doing the same). The market is almost never this broad at a final bull market high, suggesting a final top market should be four to six months away at a minimum. But this impressive level of market “agreement” unfortunately doesn’t rule out a near-term correction; our Attitudinal category is better at predicting the latter, and its current level of -449 indicates that short-term risks are elevated.