

What matters most is?... What happens next

Wondering whether investors are still concerned about the market? Wonder no more, they are concerned.

For the past few years many investors have been tentative about the markets and until late last year it seemed justifiable because:

- Performance of the market index was driven by a few companies with little breadth of participation
- Market leaders were great companies but have very expensive valuations
- Economic and Earnings reports were middling and improvement uncertain

So, what changed? Has recent market performance been driven by the election? Factors that were prominent in companies whose stocks rose after the election are not driving stock prices today. Expectations of overall economic improvement are more likely the driving force. Short term events may trigger the market but typically are not the only driving force behind major trend changes. Influential investor Benjamin Graham is famous for saying: "In the short run, the market is a voting machine but in the long run, it is a weighing machine." Another way of saying that anything can happen in the short term but in the long-term market performance will be driven by expectations of economic and fundamental factors that drive stock prices.

Where are the pockets of opportunity if breadth (wider participation of more companies) improves?

- Good quality "Value" stocks have lagged Growth stocks by a wide margin.
- International market valuations still lag that of the U.S. Global economics are improving
- Small stocks are also out of favor – no improvement here is not a good sign

What is driving the market and what can move it forward or indicate a time to be more cautious?

- Earnings disappointments and negative revisions – **positive for now**
- Increased Volatility (1%+ daily change more common) – **very few +/- 1% days**
- Investor complacency and over-confidence-No Fear! **Raging Bulls not visible yet**
- Investor and Business confidence - **has improved**
- Too late? **Bull market is young as it surpassed to '2000 high only in '2013**

We cannot rule out an event driven correction and Washington seems bent on delivering disappointment or at best, nothing. Wall Street may prefer the latter as history shows gridlock is better for the market. A positive surprise such as a tax reduction or repatriation of assets in a tax holiday could boost the market at least short term. We are more interested on the impact of such events on corporate earnings and from our view they would likely benefit.

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OUTSIDE COMMENTARY

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For many months, we've noted that the MTI's unusually high reliance on the Momentum/Breadth/Divergence category would one day leave it vulnerable to only a mild deterioration in technical conditions. That's exactly what transpired during the last few weeks, with fairly minor chart damage and a drop in one of our major momentum models to neutral combining to deliver a 110-point blow to the Momentum category. The net reading of +906 remains bullish, and would be enough to carry the day in virtually any other market environment. And it's worth noting that only one of the eight components of the "Red Flag Indicator" (the Dow Jones Utilities) sounded a warning at the latest S&P 500 high made last Monday, August 7th. On this basis alone, the odds favor even higher highs on the DJIA and S&P 500 three or four months out. But this analysis doesn't rule out a correction—even a double-digit one (although that's not our current expectation).

The Economic work has been a disappointment over the last month, and was ultimately a co-equal conspirator in the MTI's drop into the neutral zone. Recent weakness has been related to the Lumber/Gold Oscillator, a credit conditions indicator based on the B AA-AAA corporate spread, and the breakout in currency volatility. And although the broad commodity indexes have shown little movement in the last few months, our 70-commodity diffusion index is far below its bearish threshold of 70%.

Finally, we had expected a bigger boost in the Attitudinal work than the 20 point gain that was recorded.