Some Room for Caution?

Our letter that accompanied the third quarter 2017 performance report ended with this statement: **The bottom line is the path of least resistance for stocks appears to be higher, and we will wait for either unreasonably high valuations or a pick-up in volatility before we go to a defensive posture in the portfolios. Pretty much as soon as the ink was dry the stock market started to show signs of fatigue.**

The volatility isn't completely obvious by looking at the S&P 500 as it continues to trade near all-time highs. However, this past quarter's earnings season saw an unusually high number of stocks fall by double-digits. Much of this occurred in the small- and mid-capitalization (cap) part of the market where stocks have declined so far this quarter despite large caps continuing to forge ahead. In addition the lust for growth stocks continues this quarter with large cap growth up by 4% and large cap value down slightly. There is evidence of diminishing momentum in large cap stocks, too. The proportion of S&P 500 stocks trading above their 50-day moving averages slumped to 64%, the lowest since July, and down from nearly 80% in the middle of last month, according to Strategas Research Partners.

The junk bond market is also flashing warning signals. Yields remain historically low but have moved noticeable higher this quarter. Many times in the past a sell-off in junk bonds has preceded a stock market correction so this development needs to be monitored.

Bullish investors will rightly argue that there are few, if any, bubble stocks trading today like there were in the Tech bubble at the end of the last century. However, the madness of crowds is occurring, just not in the stock market. The craziness in happening in something called cryptocurrencies which are digital currencies. The price of bitcoin, the most well-known cryptocurrency, has soared by more than 700% in 2017. Another one called Ethereum is up a mind-boggling 3,900%.

Because of these observations we raised some cash in the portfolios**. We want to be clear that we are not sounding an alarm bell but rather are acknowledging that risks are rising in the stock market.** The observed divergences could be random in nature we could very well reinvest the cash. However, TW's strategy has always been to err on the side of caution which has allowed us to consistently outperform during weak markets, a track record we want to maintain.

James Tillar, CFA and Steve Wenstrup

OUTSIDE COMMENTARY

LEUTHOLD GROUP *
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Stock Market Observations

We remain bullish on stocks but with very limited visibility into 2018. A key reason is that **the most bullish elements of our work are those with shorter horizons—many of them part of the MTI's Momentum/Breadth/ Divergence category**. Year-to-date, the average weekly reading for this composite of 40 indicators is significantly higher than that of any other year in its 42-year history.

We argued for many months that a market can be "FAANG-dominated" and yet still be broadly inclusive. That may have begun to change. **The Equal Weighted S&P 500 had an especially bad (relative) month in October, and the Russell 2000 has not confirmed the last month's worth of S&P 500 cycle highs**—meaning it now joins the Dow Jones Utilities as an official Red Flag under the simple tally we've monitored over the last year.

Once again, though, a single day of market strength could erase these two cracks, leaving us with a "fully confirmed" S&P high that would statistically be tough to bet against in the short term. And for those requiring even more, the calendar has just turned favorable.

*Leuthold Group is an Institutional Research Firm