

INSIDE THE STOCK MARKET

...trends, cross-currents, and outlook

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Should You Trust The Thrust?

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How Much For Your “Free Lunch?”

The 41% S&P 500 rally would be half as large if measured in terms of gold, and a “unit” of the S&P 500 now buys 70% fewer ounces of gold than it did in early 2000. Meanwhile, when denominated in either silver or Bitcoin, the stock market rally has been almost nonexistent.

Everyone Loves A Winner

The bullish consensus seems to be that unlimited Fed liquidity will lift all stock market and economic boats. However, past liquidity floods have tended to lift boats that were already the most buoyant. The “Y2K Liquidity Facility” and last fall’s emergency Fed intervention in the overnight repo market are two cases in which liquidity seemed to flow to where it was needed the least.

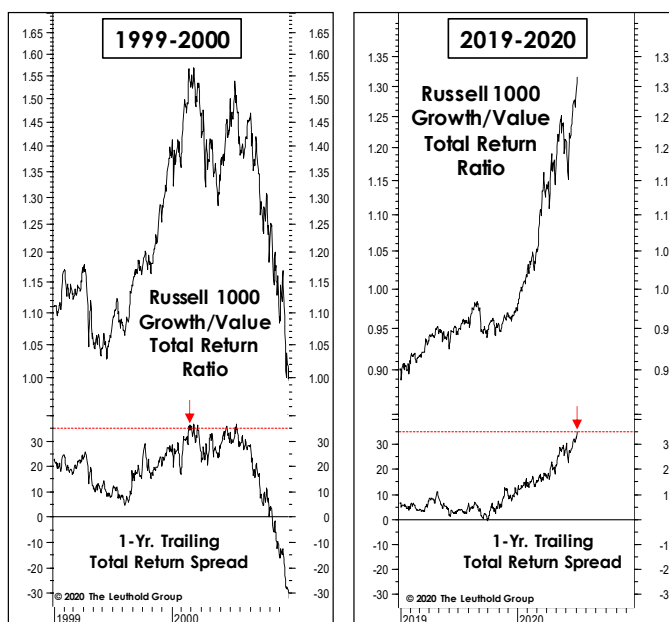
Different Paths, Same Ending?

For those who believe the economy “drives” trends in stock market leadership, consider the cases of 1999-2000 and 2019-2020.

One period featured real growth of 4%, peak EPS growth above 20%, and bond yields at 6%. The other could see a real GDP decline of 5-10% accompanied by an historic EPS collapse, and bond yields below 1%. One featured monetary restraint and a temporary federal surplus, while the other showcased historic extremes in all policy levers that likely represent only the leading edge of what’s to come.

Few economists would have decided to pile into Large Cap Growth stocks in either case. But a *psychologist* might have; emotions repeat more reliably than do economic trends.

The one-year Growth/Value spread has hit the same extreme seen in early 2000, yet the idea that major change might lay ahead seems preposterous to most investors... massive gaps like this one are rarely closed with the *market going up*.



Everyone Loves A Winner

President Trump is viewed as being more attuned to the stock market than any previous Commander-in-Chief—recognizing, of course, that this hurdle might have been fairly low.

Nonetheless, it's fun to think about what might spew forth from Trump's Tweets if he were really dialed into the nuances of market action. Imagine, for example, if he were to learn from a bootlegged copy of the July Green Book that the Russell 1000 Growth Index had gained 84% since Inauguration Day, while the Russell 1000 Value Index was *flat* over the same period. "You LOSER Value Managers need to put more pressure on the LAZY & INCOMPETENT CEOs of your Badly Underperforming companies!!!"

The thought that Jay Powell might be among those responsible for this, and many other inequities, would escape Trump (at least during this fleeting moment in which Powell appears to be back in his good graces).

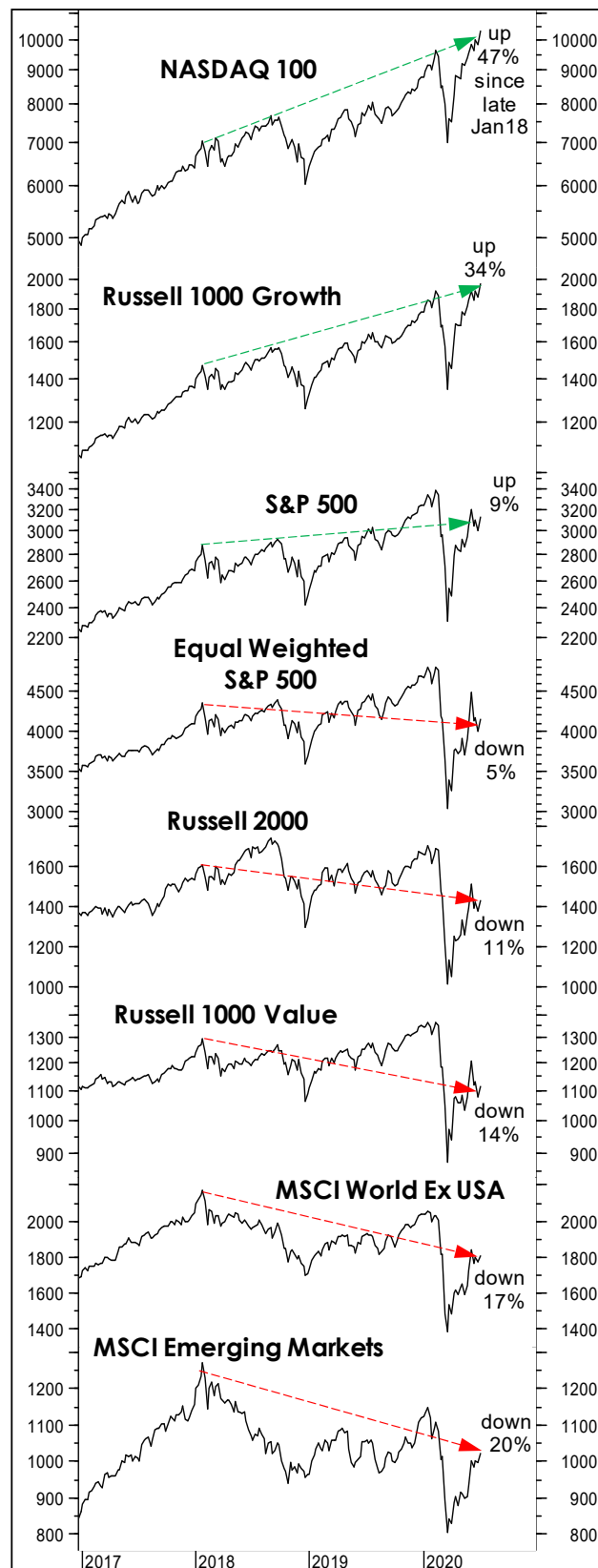
President Trump is obviously a momentum investor, based on his timely Twitter rotation away from the Dow and into the NASDAQ. But will he have the flexibility to tout new highs in the Russell 2000 when Small Caps finally have their day in the sun?

The bullish consensus seems to be that unlimited Fed liquidity will lift all stock market and economic boats. However, past liquidity floods have tended to lift boats that were already the most buoyant. The "Y2K Liquidity Facility" and last fall's emergency Fed intervention in the overnight repo market are two cases in which liquidity seemed to flow to where it was needed the *least*. The first few months of this country's MMT experiment have seen a similar market outcome.

The market's economic message is open to interpretation. The percentage gain in stocks implies a rapid road to recovery, but stock market *leadership* does not.

We think another leg down is likely before summer is over, one that's apt to provide clues as to the probable leaders of the next bull market.

Might Trump someday Tweet about the DAX, or the Shanghai Composite?



Performance figures from January 26, 2018 through July 2, 2020.

Low Single Digits?

We've always admired intellectual flexibility. At Davos in January, the co-CIO of a large hedge fund declared "the end of the boom-bust cycle." A few months later, following a plunge and substantial rebound, the founder of the same firm predicted a decade of negative returns for U.S. stocks.

We encourage similar diversity of thought in our shop, but even the pessimists among our ranks have a hard time making the case for a ten-year **negative** return (unless "Year Ten" happened to contain a bear market low).

We've typically used the S&P 500 P/E on Leuthold's 5-Year Normalized EPS as the foundation for any long-term return forecast. But with the current implosion in EPS likely to hit our Normalized estimate hard in the near term, we'll repeat the exercise using the S&P 500 P/E on Peak GAAP EPS.

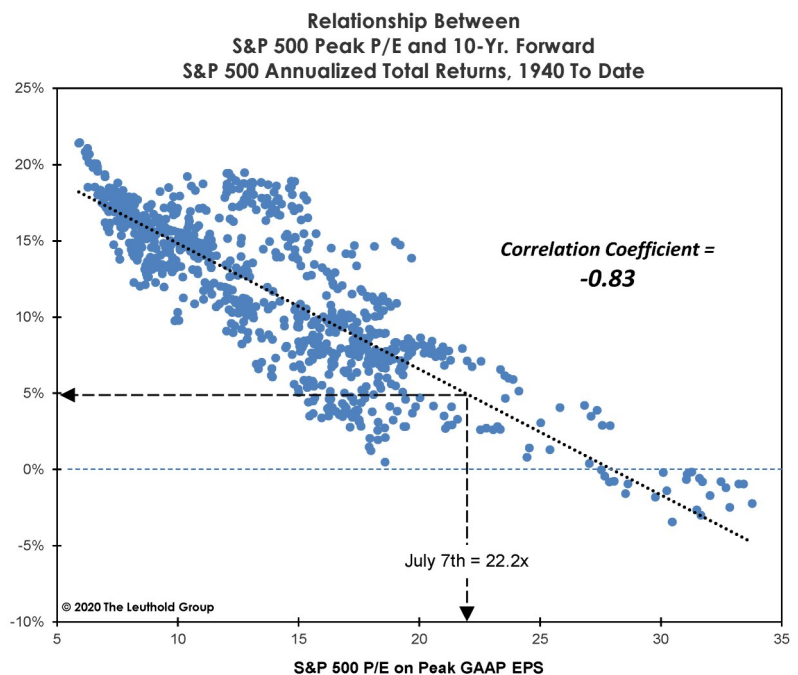
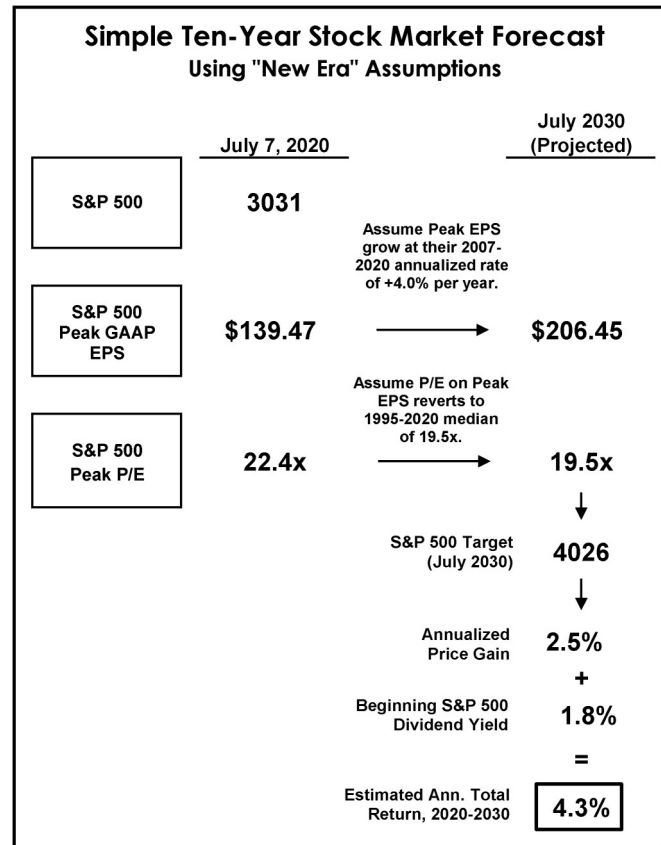
First, we'll assume that EPS will expand over the next decade at the **4%** annualized rate at which they grew from the 2007 business-cycle peak to the recent peak. That's 2% below the historical long-term growth rate, but a fair assumption given structurally slow GDP growth and an already elevated beginning profit margin.

Second, we'll estimate a Peak P/E ratio of 19.5x, ten years out, equal to the median figure for the 1995-to-date era of low interest rates and generally-high equity valuations. (Admittedly, that could be viewed as a generous assumption; the 1957-to-date median Peak P/E ratio is three points lower.)

That pair of assumptions yields an S&P 500 target of 4,026 for July 2030, which is 27% above current market levels. That works out to an annualized +2.5% price return, and, when combined with an assumed dividend yield equal to the current 1.8%, it produces a +4.3% ten-year annualized S&P 500 total return forecast. Interestingly, a regression line drawn through the scatterplot (Chart 1) yields essentially the same result. An initial Peak P/E of 22.2x (the July 7th level) corresponds with a projected S&P 500 ten-year compound return of just under +5%.

Remember, this forecast assumes that "New Era" fundamentals (slower EPS growth, higher P/E ratios) will hold.

Actual mileage is *guaranteed* to vary.



Should You Trust The Thrust?

Technicians were collectively slow to embrace the market rally, but, with stocks already up 40% or more, that view changed when several “breadth thrust” signals triggered in early June. Our preferred “thrust” measure—the NYSE Moving Balance Indicator—signaled on June 5th and registered a “super overbought” reading above the 80 threshold. In the 55-year history of such readings, there’s only been a single S&P 500 loss on a 12-month time horizon following the signal. The average return one-year out has been +20.2%.

There are two concerns with the latest bullish reading, with one, in part, causing the other. First, the S&P 500 return *preceding* our MBI thrust signal was +42.8%, almost triple the average slippage of +15% associated with all prior signals. That delay, along with already-high U.S. Large Cap valuations, situated the S&P 500 to be trading at 22.9x Peak EPS on the day of the signal—almost ten points above the average Peak P/E of 13.6x that accompanied the previous eleven signals (Table 1).

- It’s become fashionable to believe that valuations don’t matter in the face of the Fed’s and U.S. Treasury’s resolve to do “whatever it takes.” But in the three cases this signal was followed by a twelve-month gain of more than 30%, the *beginning* Peak P/E ratios were **7.8x, 7.5x, and 9.7x**.

Table 1
Track Record Of Super-Overbought MBI Readings

Date Of Super Overbought MBI Reading (80 or higher)	S&P Gain From Low To Signal	Days From Low To Signal	S&P 500 Peak P/E At Signal	S&P 500 Performance			
				1 Mo. Later	3 Mos. Later	6 Mos. Later	12 Mos. Later
January 16, 1967	15.2 %	67	14.6 x	4.6 %	8.0 %	10.0 %	13.7 %
August 31, 1970	17.7	68	13.5	3.3	7.0	19.0	22.1
January 13, 1975	16.1	69	7.8	8.7	18.4	31.6	33.2
January 6, 1976	13.5	76	10.0	9.0	10.7	10.7	13.0
August 24, 1982	12.6	8	7.5	7.3	16.4	26.1	42.5
January 14, 1987	14.2	74	15.7	4.9	6.3	18.2	-6.4
February 5, 1991	18.9	80	13.9	7.0	7.4	11.2	17.8
January 3, 1992	11.8	23	16.6	-2.3	-4.5	-1.8	3.9
March 23, 2009	21.6	10	9.7	2.5	8.5	29.4	42.7
July 12, 2016	17.7	104	20.1	1.1	0.5	5.4	13.5
January 9, 2019	9.9	10	19.8	4.8	11.7	16.1	26.7
June 5, 2020	42.8	52	22.9	-1.5			
Average (ex. 2020)	15.4 %	54	13.6 x	4.6 %	8.2 %	16.0 %	20.2 %

Repeat signals occurring in the following 26 weeks are not included.

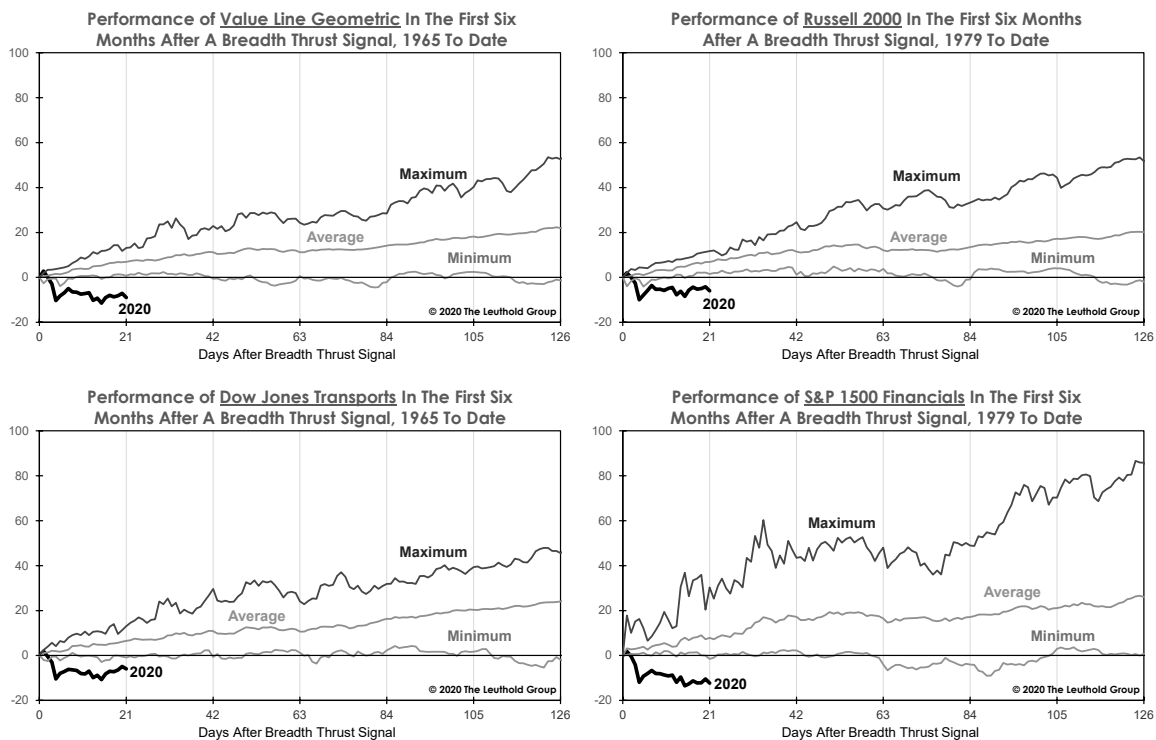
- While we typically use the S&P 500 index as the subject for this kind of tool, that is rarely where the best action is. As its name implies, a breadth thrust should be followed by exceptional strength in broad market measures. Table 2 shows that the typical six-month returns for Small Caps, Cyclical stocks (Transports and Financials), and the “average stock” (Value Line Geometric) have all been in excess of +20%. In the first month after the signal, however, these higher beta indexes tended to initially lag.

Table 2
Performance Of Various Indexes In The Six Months Following A “Breadth Thrust” Signal From The MBI

Date Of Super Overbought MBI Reading (80 or higher)	6-Mo. Performance				
	S&P 500	Russell 2000	Value Line Geometric Avg.	Dow Jones Transports	S&P 500 Financials
January 16, 1967	10.0 %	%	17.0 %	21.6 %	
August 31, 1970	19.0		21.7	42.9	
January 13, 1975	31.6		40.9	13.4	
January 6, 1976	10.7		17.6	23.1	
August 24, 1982	26.1	51.8	37.4	42.2	30.7
January 14, 1987	18.2	11.8	11.0	22.1	0.8
February 5, 1991	11.2	15.2	10.9	12.5	13.6
January 3, 1992	-1.8	-2.0	-1.4	-1.9	6.0
March 23, 2009	29.4	42.0	52.6	45.6	85.8
July 12, 2016	5.4	13.7	7.4	15.4	24.9
January 9, 2019	16.1	8.3	6.4	8.4	15.1
June 5, 2020					
Average (ex. 2020)	16.0 %	20.1 %	20.1 %	22.3 %	25.3 %

Should You Trust The Thrust? (continued)

With only a signal triggered (in addition to other similar measures), it's too early to jump to conclusions. But the early market feedback hasn't been promising, with all four of the higher beta measures in the accompanying four charts already trailing what had previously been the *worst-case* performance path. Failures of reliable tools are important signals in and of themselves. (For example, the January "rescission" of the late-2019 VLT BUY signals in the Energy sector kept our GS Scores negative toward those stocks during the 55% drop that followed over the next seven weeks.) It's too early to declare the "thrust" has failed, but we're keeping a close eye on these bellwethers.



The “Next Big Thing” May Not Be Big

The COVID-19 outbreak understandably scuttled the 11th anniversary celebrations that had been planned for both the bull market and the economic expansion. However, there’s one trend that’s lasted almost as long that hasn’t definitively come to an end. The current **Large Cap Leadership Cycle** hit its nine-year mark in April—the longest cycle outside of that which followed WWII (11 1/2-years’ duration). The current span has generated an S&P 500 return of +184%, almost double the total return of the Russell 2000 (+94.4%). The 89% performance spread between Large and Small Caps is in proximity to the +102% average return for all seven Large Cap Cycles dating back to 1926 (Table 1).

The economic shutdowns have certainly favored big over small. On the other hand, years of negative real interest rates have kept hundreds of publicly-traded Small Caps economically viable (though not profitable). Small Caps would certainly benefit if there was a whiff of inflation beyond just financial assets. Yet, regardless of inflation or the interest rate backdrop, we expect Small Caps to wrest control of leadership as confidence in an economic recovery builds—although that may not be until investors experience another stock market “gut check” in the weeks or even months ahead. Our view is based on both the “absolute” appeal of Small Cap valuations as well as our expectation that some of the fat Large Cap P/E premium will deflate as economic fears slowly subside.

Table 1
Leadership Cycles In Large and Small Cap Stocks, 1926 To Date

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Market Leader	Dates	Cumulative Small Cap Total Return	Cumulative Large Cap Total Return	Spread, Leader Minus Laggard	Length Of Cycle
Large Caps	January 1926 - December 1931	-75.8 %	-14.1 %	61.7 %	72 mos.
	April 1937 - June 1939	-67.8	-31.6	36.2	27
	June 1946 - December 1957	106.0	296.1	190.0	139
	January 1969 - June 1973	-45.7	16.0	61.7	54
	August 1983 - October 1990	15.3	146.3	131.0	87
	March 1994 - March 1999	61.2	206.8	145.5	61
	→ April 2011 To June 2020	94.4	183.6	89.3	111 ←
			Average:	102.2	79 mos.
			Median:	89.3	72 mos.
Small Caps	January 1932 - March 1937	700.0 %	189.7 %	510.3 %	63 mos.
	July 1939 - May 1946	1030.0	162.0	868.0	83
	January 1958 - December 1968	984.6	272.0	712.6	132
	July 1973 - July 1983	889.9	152.3	737.6	121
	November 1990 - February 1994	136.4	70.0	66.4	40
	April 1999 - March 2011	148.0	27.7	120.3	144
			Average:	502.5	97 mos.
			Median:	611.5	102 mos.

Small Cap data from Ibbotson for 1926-1978; Russell 2000 thereafter.
Large Cap data for S&P 500.

While Small Caps are not nearly as cheap as at the beginning of their 1990-1994 cycle, they compare favorably to the levels seen at the onset of the 12-year leadership cycle in April 1999 (Table 2). In fact, today’s median Small Cap Normalized P/E, Price/Cash Flow, and Price/Book ratios are *below* the levels prevailing at the commencement of that prior cycle; the latter two measures now sit in their respective bottom decile based on 1994-to-date history. Yes, economic risks are high, but Small Cap valuations compensate for that much more generously than do U.S. Large Caps.

Table 2
**S&P SmallCap 600 Median Stock:
Today Versus Start Of Last Small Cap Leadership Cycle In March 1999**

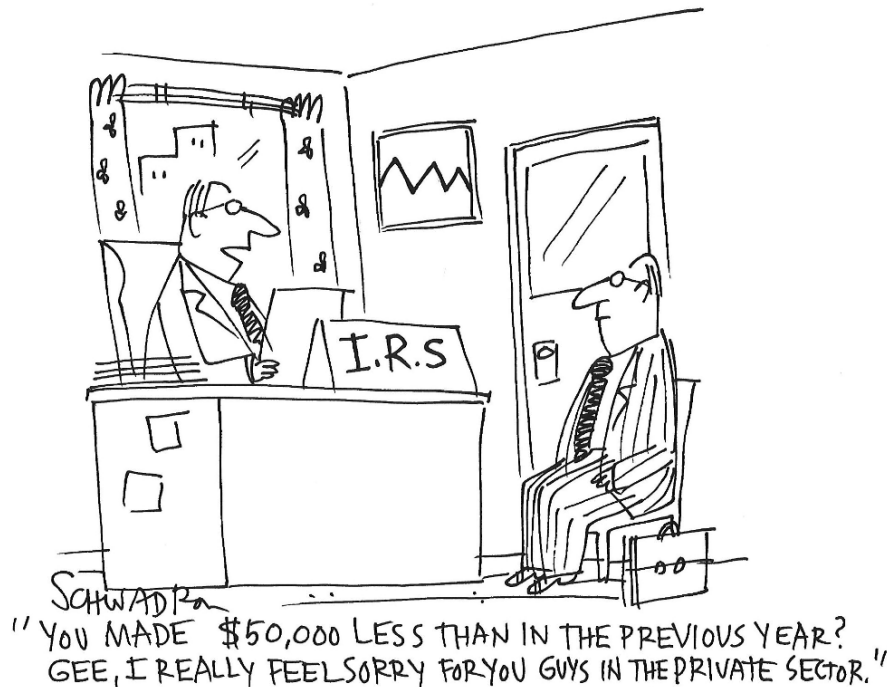
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Dates	Trailing P/E	Normalized P/E	Price/ Cash Flow	Price/ Sales	Price-to- Book	Average
June 30, 2020	19.5 x	20.6 x	9.1 x	1.12 x	1.53 x	
March 31, 1999	15.6	21.5	9.9	0.90	1.87	
Pct. Above/Below Mar99 Level	25.1 %	-4.3 %	-8.1 %	24.7 %	-18.2 %	3.8 %

How Much For Your “Free Lunch?”

The so-called Federal Reserve “put” is again at the forefront of the bullish case for stocks, even though said “put” mysteriously went missing during the six-week, 34% market smash earlier in the year. Whether or not it actually exists, the thought that such a wonderful options contract might exist is comforting—and even more so because it’s perceived either to be **free**, or to be paid for by our children or grandchildren.

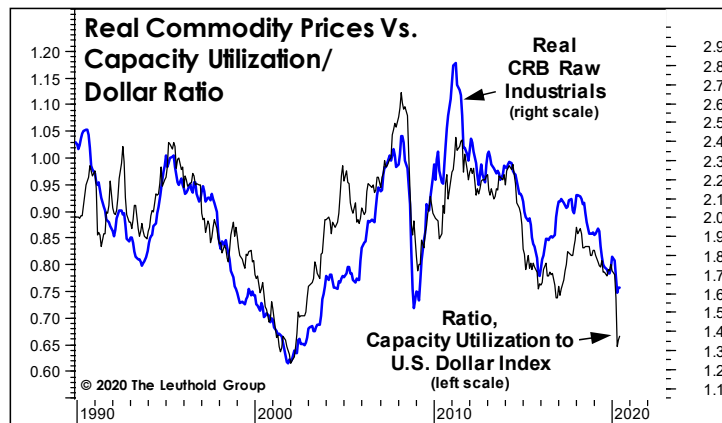
Neither is true. There’s a significant cost, and various measures suggest the bill will not wait for our offspring, let alone their offspring. The 41% S&P 500 rally would be half as large if measured in terms of gold, and a “unit” of the S&P 500 now buys 70% fewer ounces of gold than it did in early 2000. Meanwhile, when denominated in either silver or Bitcoin, the stock market rally has been almost nonexistent. The Bulls assume that stocks will ride the wave of printed money, but so far in 2020, the money supply has appreciably “outperformed” stocks. Since we can’t own M1 and M2 outright, some gold and silver is appropriate.

S&P 500 Rebound In Dollars And Other Accounting Units

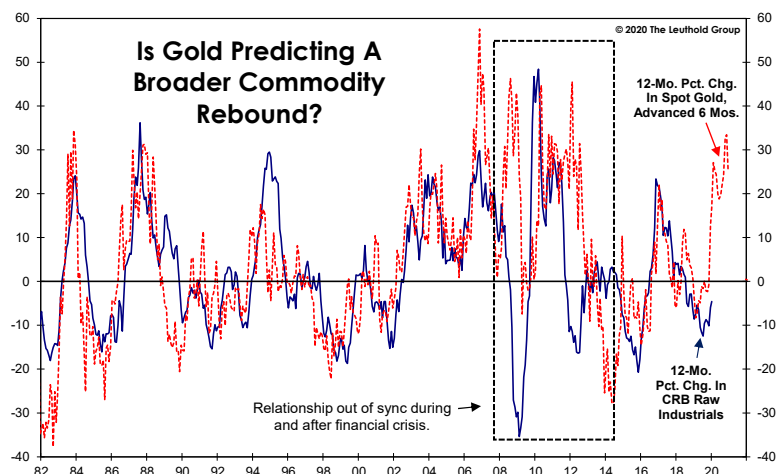


Commodity Comeback?

Many analysts thought the last cycle would end with a bit of “fire” in the form of higher commodity and consumer prices, and they might well argue they would have been right if not for the eruption of COVID-19. In the cycle’s last few years, however, we reasoned that low capacity-utilization rates and a strong dollar would keep a lid on a commodity comeback. In fact, the ratio of those two variables moved in virtual lockstep with industrial-commodity prices last decade. Usually, simple is best.



In the near future, the Capacity Utilization/Dollar ratio is almost certain to stage a big rebound, which is a positive for industrial commodities. (Copper, which is not a member of CRB Raw Industrials, has already sniffed this out.) Moreover, strength in gold prices has usually preceded gains in industrial commodities with about a six-month lag. This all suggests an important low in the CRB Raw Industrials has been made, but for now we’d prefer to own gold (which has a 5% allocation in our tactical portfolios).

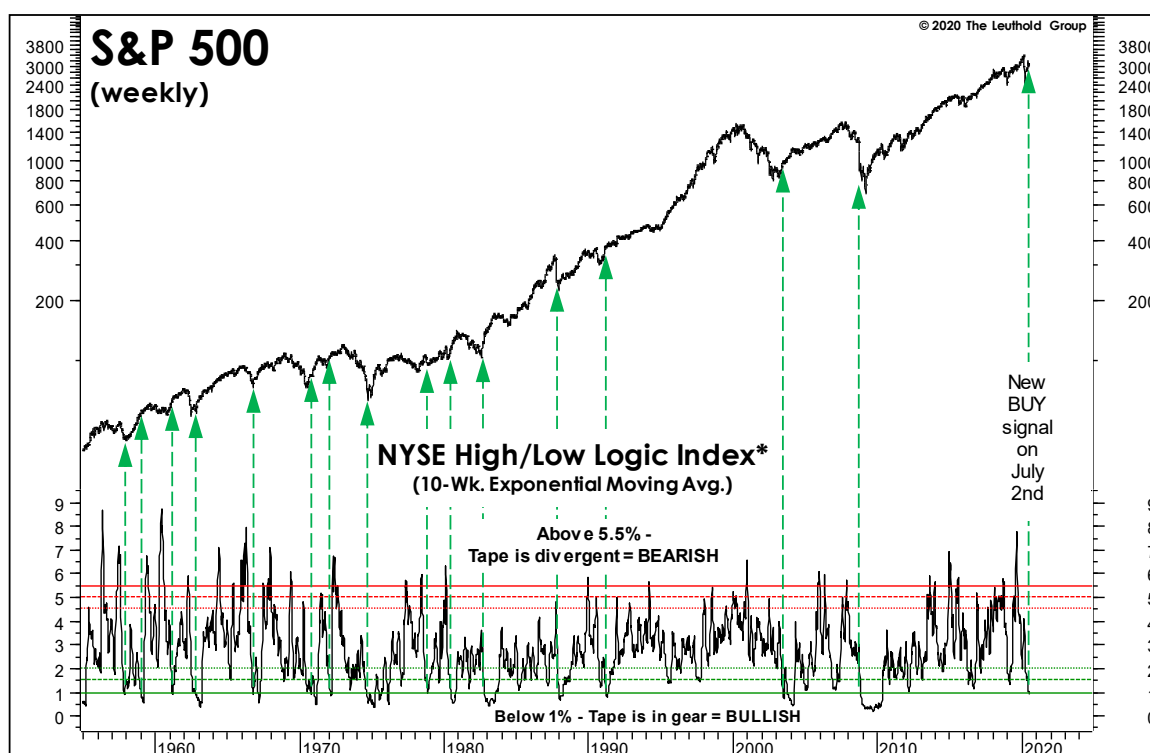


The High/Low Says “Buy High!”

We’ve written periodically about the likely distortion of market breadth figures resulting from High Frequency Trading, the domination of ETFs, and (we believe, most importantly) the decimalization of stock quotations. Our concerns led us to expand our technical arsenal, and one of the gems we uncovered in that process was the High/Low Logic Index (HLLI).

Both the NYSE and NASDAQ versions of the HLLI forewarned of several important setbacks in recent years. But even close followers of this work might be surprised to learn the indicator can also turn *bullish*, and the NYSE 10-Wk. High/Low Logic Index did just that in the week ended July 2nd.

- This is the first major BUY signal from the NYSE HLLI since November 2008, and only the fourth such signal in the last 30 years. (The NASDAQ version of the indicator closed July 2nd within a fraction of its own BUY trigger.)



- The HLLI BUY signal is great news for those investment dinosaurs with a horizon as long as twelve months. The indicator has been perfect over that stretch, with an average gain of 17.5% and zero losses. However, small drawdowns in the initial months following a signal haven’t been unusual. Finally, we simply can’t resist our need to “taint” this purely technical study with an important fundamental observation: The market is significantly more expensive now (based on Peak P/E) than at any other major HLLI BUY signal. **Context matters.**

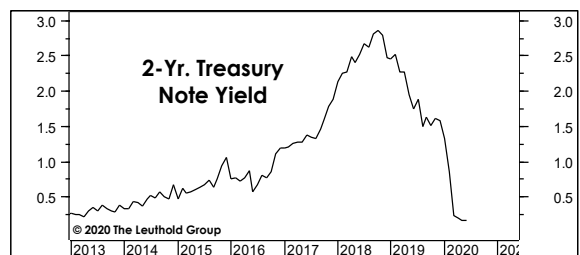
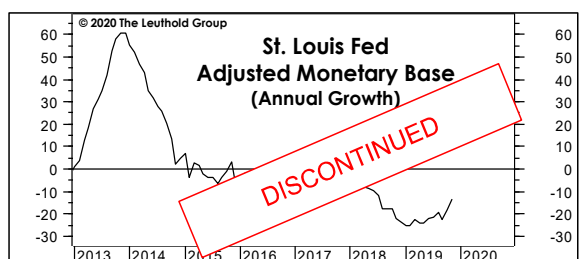
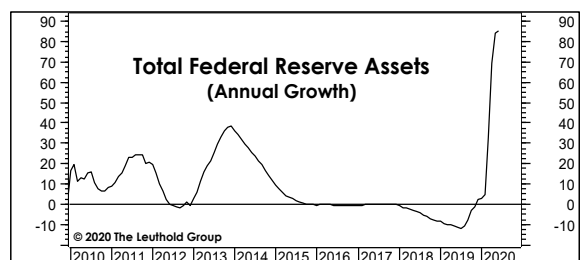
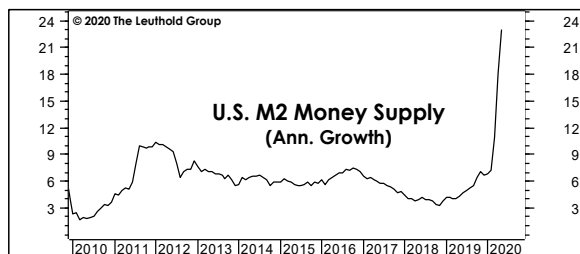
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Date 10-Wk EMA of NYSE High/Low Logic Index Drops Below 1.0	S&P 500 Peak P/E At Signal	S&P 500 Performance			
		4 Wks. Later	13 Wks. Later	26 Wks. Later	52 Wks. Later
November 1, 1957	11.0 x	3.2 %	3.1 %	8.0 %	26.9 %
January 9, 1959	15.1	-2.5	0.8	7.4	6.7
March 3, 1961	17.3	1.7	4.3	6.6	9.7
October 19, 1962	15.1	8.2	17.3	24.5	31.9
October 7, 1966	12.7	10.4	12.3	22.1	32.9
October 9, 1970	14.1	-1.0	8.4	20.0	16.8
March 3, 1972	17.8	-0.7	1.7	3.3	4.0
August 30, 1974	8.1	-10.0	-3.0	16.2	20.4
November 17, 1978	8.4	1.0	4.5	5.8	9.9
June 27, 1980	7.6	4.1	8.9	17.7	14.3
October 29, 1982	8.7	0.9	8.1	23.0	22.2
December 19, 1987	14.9	1.2	8.8	8.6	10.9
March 29, 1991	11.0	3.2	3.1	8.0	26.9
June 20, 2003	18.5	-0.2	4.1	9.3	14.0
November 7, 2008	10.9	-5.9	-6.7	-0.2	14.9
July 2, 2020	22.4				
Average (ex. 2020)	13.3 x	0.9 %	5.0 %	12.0 %	17.5 %

Repeat signals occurring in the following 26 weeks are not included.

Stimulus Gone Wild!

Charts 1-8

Monetary Mayhem!



Market perma-bulls deserve high marks for their persistence, but we're going to deduct some points for lack of creativity.

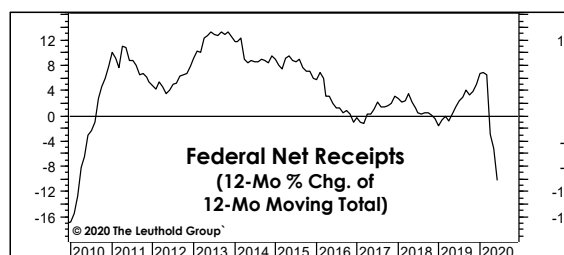
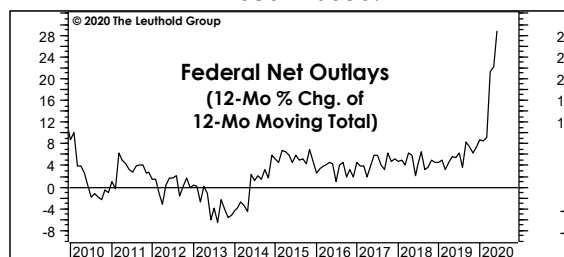
Despite all that's transpired in 2020, their case is exactly the same as six months ago: Extreme stimulus (exhibited by Charts 1-8) won't "allow" a significant stock market drop, nor any further economic deterioration.

In the February Green Book, we published a page of quotes capturing the stimulus-inspired silliness, including a hedge fund co-CIO who proclaimed "We've probably seen the end of the boom-bust cycle," and a *Barron's* article declaring, "There's no recession coming... the Fed will make sure of that."

It's not as if the Fed (and, increasingly, the U.S. Treasury) are trying to revive a patient that had been deprived of basic sustenance. To the contrary, this patient was fat and happy—a full-employment economy force-fed by "excess" money-supply growth (the Marshallian K), and deficit spending at a level usually seen only in wartime. (One strategist called it the "foie gras" economy.)

For years, investors fretted that the failure to normalize interest rates would leave the Fed with little ammo to combat the eventual recession. But they probably didn't imagine (nor did we) that the Fed would soon be directly underwriting the explosion in federal outlays. Japan's experience with the same policy formula doesn't inspire much confidence. Yet, it's the newest "new thing," therefore bullish imaginations are running wild.

Fiscal Fiasco!



Stimulus Gone Wild! (continued)

Bulls assume that the explosion, both in money and federal spending, will somehow find its way into stock prices, but that hasn't always been the case.

Chart 9 shows that the stock market has failed to fully capitalize on the past two decades' flood of money and credit. While the S&P 500 has about doubled since January 2000, M2 money supply has *quadrupled*, and the federal debt has nearly *quintupled*.

Some might accuse us of cherry-picking the top of the Tech bubble for the starting point of this comparison. However, a number of valuation measures are not too far from that historic peak, including the S&P 500 Price/Sales ratio (Chart 10).

In retrospect, we wish that the only futures contract based on an economic statistic—the short-lived CPI futures—had managed to flourish. By now, there might be futures based on figures we *know* are going to rocket higher, like federal debt and M2. In the decade ahead, the S&P 500 won't come close to matching the gain in either of those series.

