Market Commentary January 2018

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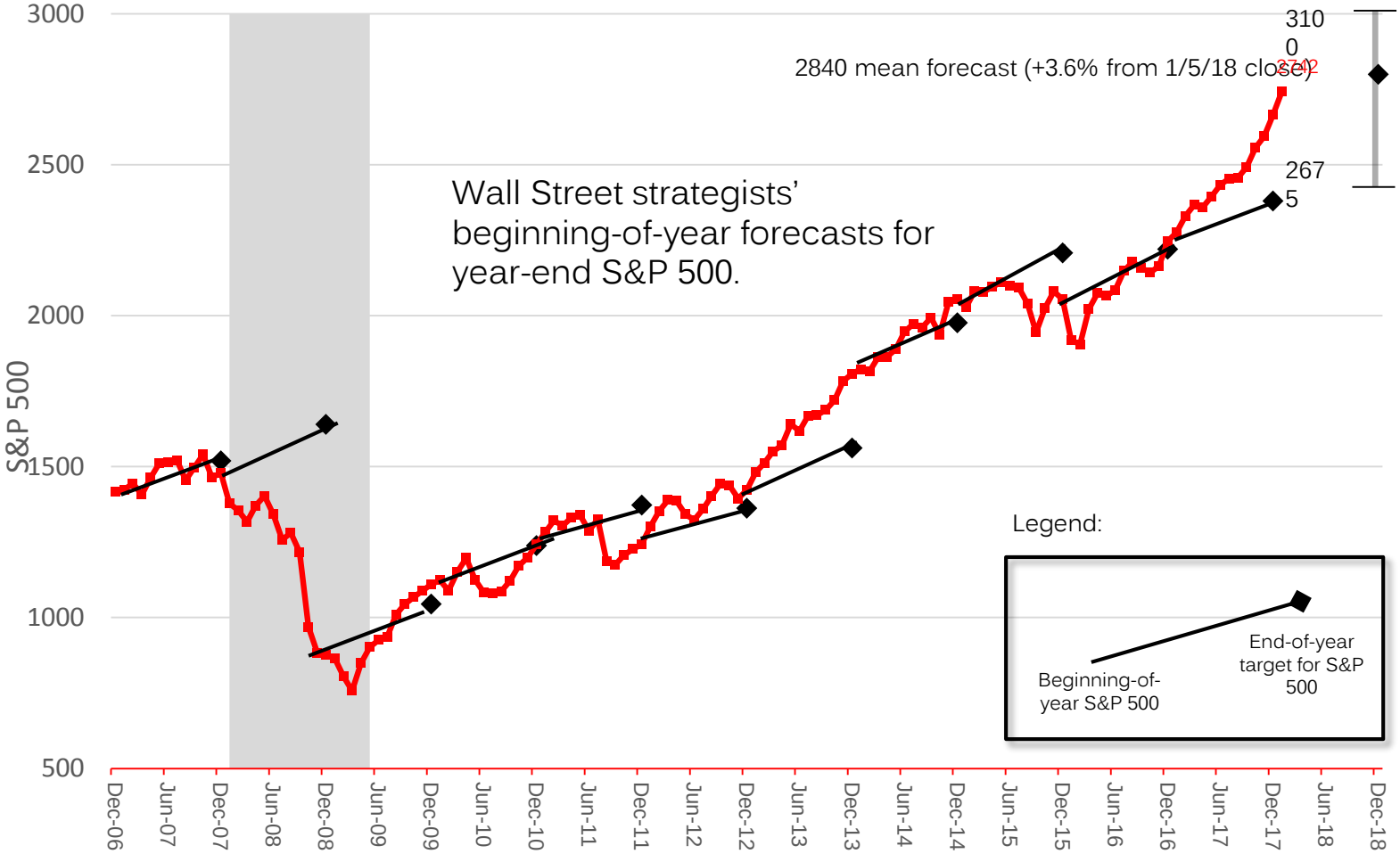
Stock Market

- record highs
- driven by global expansion and earnings surge
- lower $USD
- and cheap oil
- stocks are fully-, but not over-valued
- margins are likely sustainable
- Fed is still accommodative
- inflation is tame
- lack of irrational exuberance

Stock Market
S&P 500 Beginning-of-year Forecasts



Source: Standard & Poor's, data through January 5, 2018. *Barron's* survey of 10 Wall Street strategists, December 11, 2017.

Stock Market
S&P 500 Internals – Still Positive

The Leuthold Group
INSTITUTIONAL RESEARCH

STOCK MARKET | EQUITY STRATEGIES | QUANT | MARKET INTERNALS | INFLATION | OF SPECIAL INTEREST | BONDS

MAJOR TREND | PAULSEN | FUND FLOWS | GROUP WATCH | PORTFOLIOS | DOWNSIDE | COTW | AT RANDOM

The "Mo-Mo" Market Probably Isn't Finished

Reader Mode

LEUTHOLD GROUP ANALYSIS TOOL

DECEMBER 01, 2017 BY DOUG RAMSEY

Current Issue
November 2017

A period of distribution has preceded 11 of the last 12 bull market peaks, with only the mild 1976-78 bear market not foreshadowed by any prior breakdown in NYSE daily breadth. The median length of these distributive phases has been 35 weeks, during which the S&P 500 has earned a median total return of +9.4%. …

The irony is that—despite extremely high stock market valuations, tighter Fed policy, and a U.S. economy at full employment—the distribution phase under our definition has not even **begun**. The NYSE Daily Advance/Decline stood at a new cycle high yesterday, as did virtually every other measure of internal participation we'd look to for substantiation and reinforcement.

We find it difficult to believe that a bull market that's lasted almost nine years will come to an end without first moving through at least a brief phase in which breadth and leadership narrow significantly.

Source: The Leuthold Group, with permission.

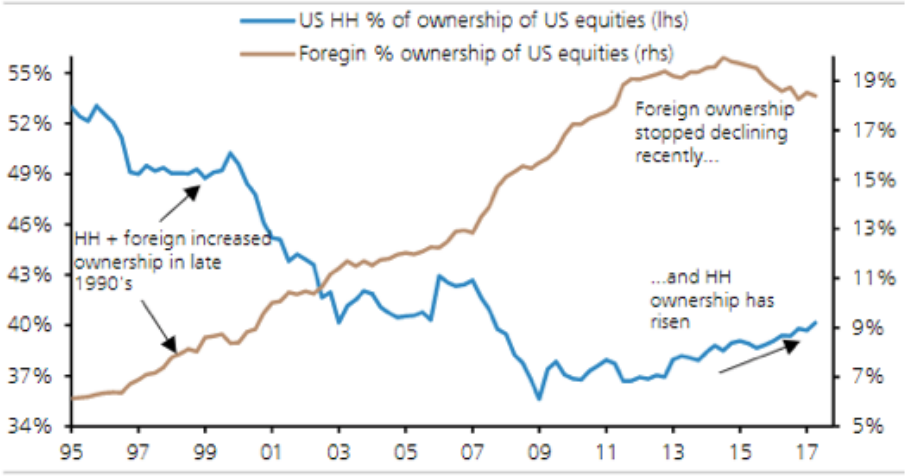
Stock Market
S&P 500 – Retail Demand Rising

Mom and pop investors set to drive 'the last phase of the bull market'

- Retail participation is considered a classic late-stage sign of a market rally, and money has been coming in from retail buyers and foreign investors, according to a UBS strategist.
- Exchange-traded funds that focus on stocks have taken in nearly $300 billion in 2017, setting a record.
- UBS remains bullish on the market in the near term, in fact projecting stocks could rise 25 percent in 2018 under the right circumstances.

Jeff Cox | @JeffCoxCNBCcom
Published 2:19 PM ET Wed, 6 Dec 2017 | Updated 5:16 PM ET Wed, 6 Dec 2017

CNBC



Source: Haver Analytics, UBS

"The improvement in US economic data the last 3 months supports the ~7% rally on its own, suggesting positioning is not excessive and a tax cut is also not fully priced."

"Historically, we believe that retail and foreign buyers are typically the marginal buyer during the last phases of a bull market."

– UBS strategist Keith Parker

Source: CNBC website, December 8, 2017.

Stock Market Arithmetic
Tax Bill's effect on 2018 S&P 500 Earnings

BARRON'S

Outlook 2018: The Bull Market's Next Act

By Vito J. Racanelli December 9, 2017

OUR PROGNOSTICATORS EXPECT S&P 500 earnings to climb to $145 in 2018 from an expected $131.45 this year. Most estimates assume that global growth will spur earnings gains, with an additional boost coming from U.S. tax cuts. Depending on the final tax bill, they figure that lower corporate taxes could be worth 5% to 10% of earnings growth, or anywhere from $7 to $14 a share. But in the unlikely event that no tax cuts are passed, the market could drop sharply.

The latest Thomson Reuters I/B/E/S consensus earnings forecasts for 2018 (previous slide) don't include much of a bump for the tax bill.

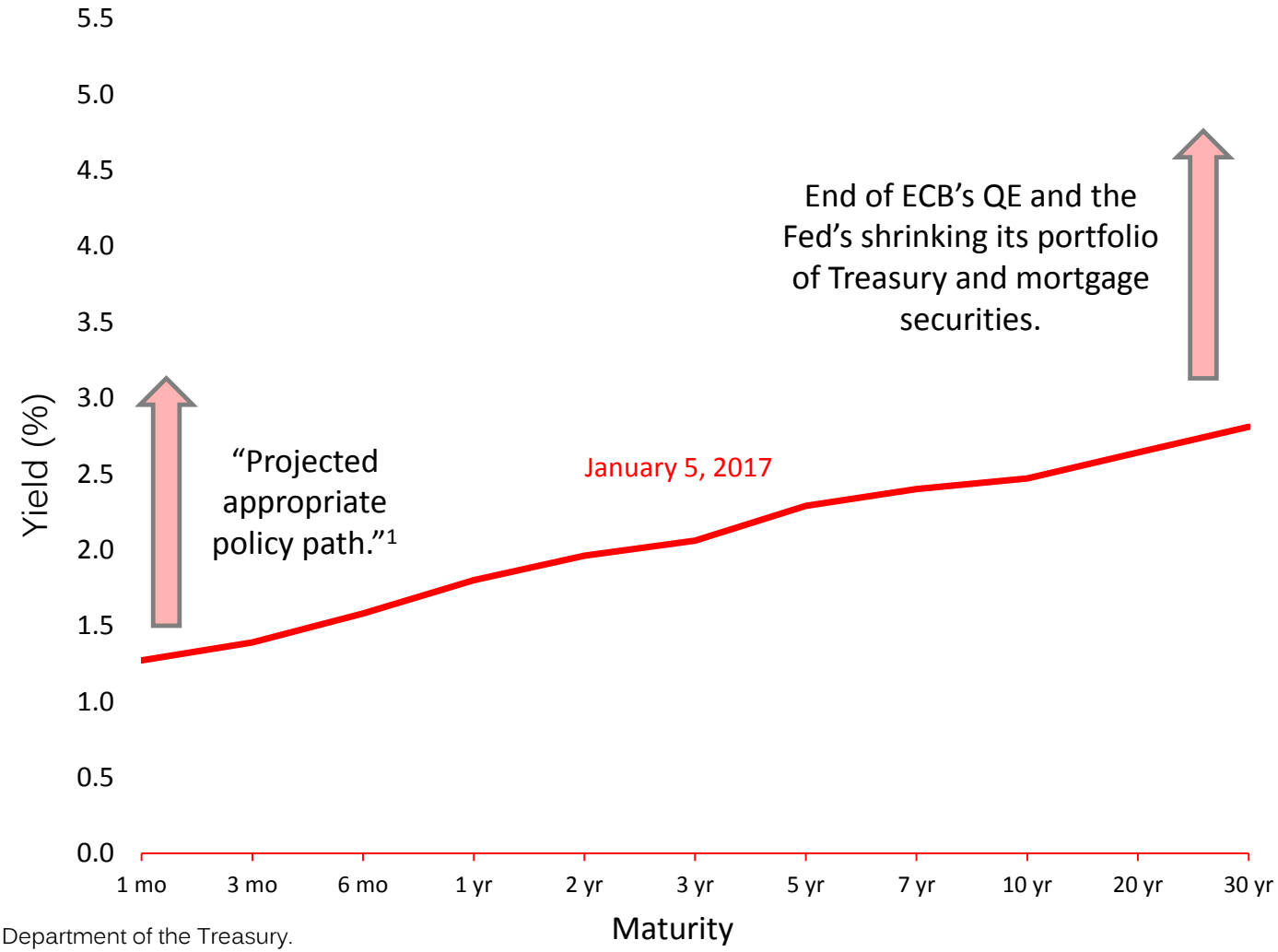
$152 - $159

vs. $147.23 consensus estimate (previous slide) as of 1/5/18

Fed policy

- on a path of steady hikes to 3% fed funds rate
- inflation has lagged Fed's forecast
- the Fed manages the yield curve
- the Fed has created every recession since the 1950s
- first rate hikes have signaled stock market lift-off
- the Great Unwinding: bond yields set to start rising

Federal Reserve Policy
Policy Normalization Means Guiding the Entire Yield Curve Higher



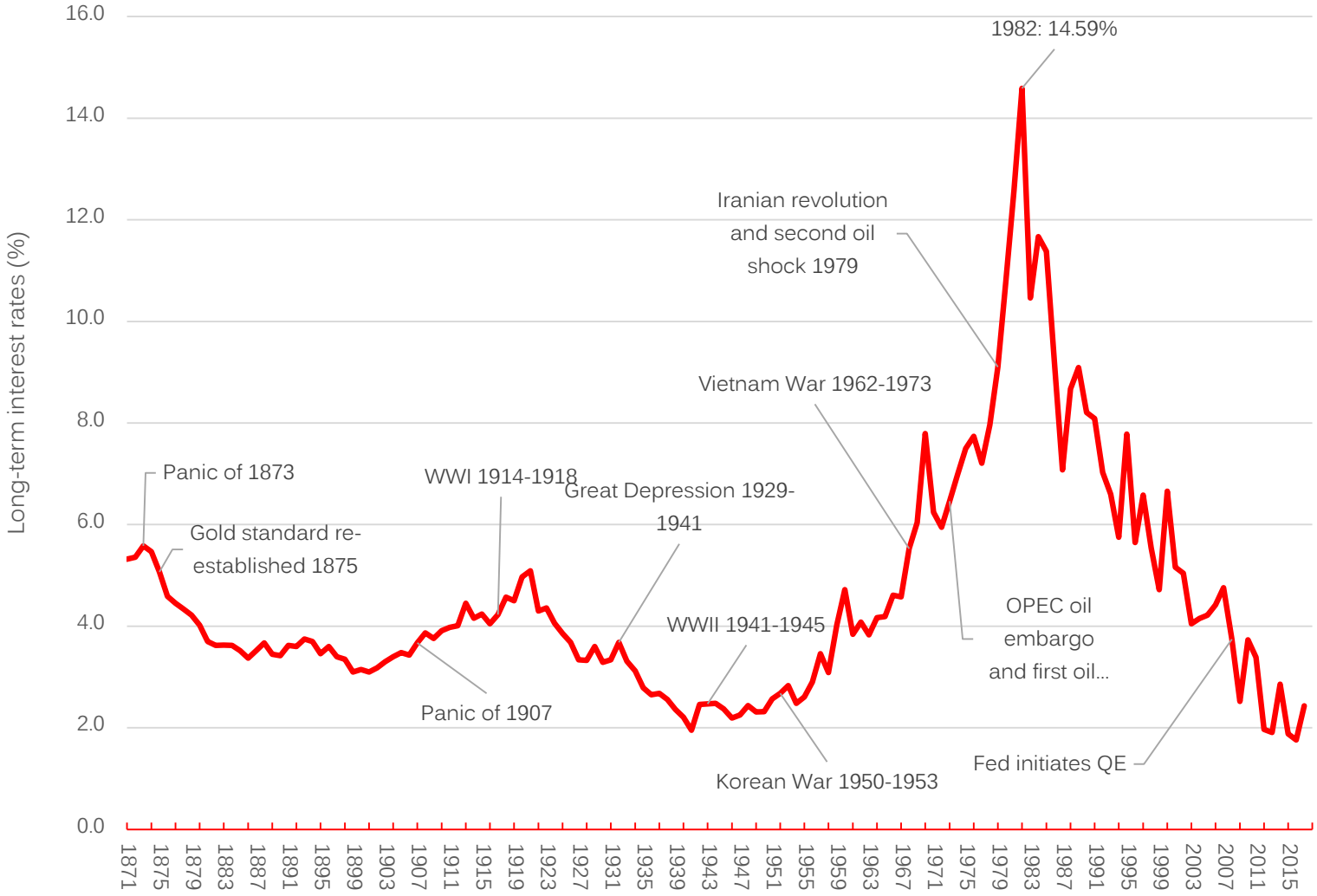
The Fed is allowing its bond portfolio to gradually run off; and the ECB is planning to taper its QE program. Those two actions will probably result in gradually higher bond yields such that the shape of the yield curve could remain sloped, as is presently the case, as the entire curve shifts higher.

Source: U.S. Department of the Treasury.
[1] Federal Reserve projections released December 13, 2017.

Bond Yields

- lowest yields in history
- yields don’t make sense fundamentally
- yields held down until the ECB’s QE taper

Bond Yields
All-time low Bond Yields



Lowest long-term interest rates in U.S. history.

Source: Online Data Robert Shiller. Data through December 2017.

Inflation

- headline PCED +1.8%, +1.5% core
- headline CPI +2.2%, +1.7% core
- employment cost inflation rising
- productivity drives declining unit labor costs
- recent strong productivity drove unit labor costs *negative*
- inflation expectations are gradually rising

Point of View January 2018

Economy

full-employment economy operating at full potential

Q2 +3.1%, Q3 +3.2% GDP growth compared to +2.1% post-recession average
+2.6% GDP growth forecast

surge in LEI, small business optimism index, recovery in business investment
healthy growth in personal income, real DPI, strong retail sales
strong household balance sheets, savings rate, FICO scores and record low household financial obligations ratio
record high PMIs, strong hiring, record high job openings, new low unemployment rate, record low weekly unemployment claims, strong vehicle sales, rising housing starts

no inflation threat

THE WALL STREET JOURNAL.

Economy, Markets Rev Up

Consumer spending, home sales and business investment show rising optimism

BY JOSH MITCHELL AND NICK TIMIRAOS

"Not only do I think the economy's in good shape today, I think the economic expansion is going to continue for some time," New York Fed President William Dudley said in an interview with The Wall Street Journal Thursday."

Fed on Watch, Dudley Says

BY NICK TIMIRAOS

"More broadly, Mr. Dudley said the economy is doing well and the prospects for the expansion continue to 'look very, very good.'"

Source: *The Wall Street Journal*, December 1 & 2, 2017.

Optimism, Momentum
Europe is Booming

Purchasing Managers' Index®
MARKET SENSITIVE INFORMATION
EMBARGOED UNTIL 1000 (CET) / 0900 (UTC) January 4th 2018

IHS Markit Eurozone Composite PMI® – final data

Includes IHS Markit Eurozone Services PMI®

Eurozone economic growth highest since early-2011

Key findings:

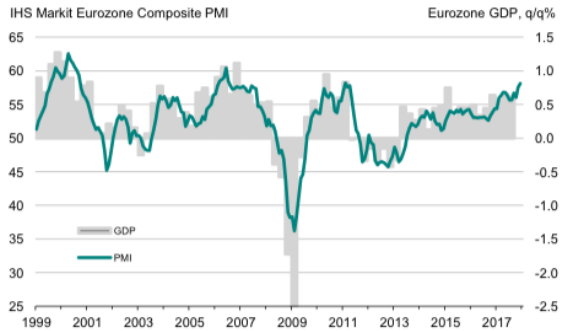
- Final Eurozone Composite Output Index: **58.1** (Flash: 58.0, November Final: 57.5)
- Final Eurozone Services Business Activity Index: **56.6** (Flash: 56.5, November Final: 56.2)

Data collected December 5-18

The euro area economy gathered further growth momentum at the end of 2017, spurred on by a near-record expansion of manufacturing production and the steepest increase in service sector activity for over-six-and-a-half years.

The final **IHS Markit Eurozone *PMI*® Composite Output Index** posted 58.1 in December, up from 57.5 in November, to register its highest reading since February 2011. The headline index has signalled growth for 54 successive months, with the average level during quarter four the best since the opening quarter of 2011.

IHS Markit Eurozone Composite PMI



Sources: IHS Markit, Eurostat.

Countries ranked by output growth*: December

Ireland	60.2	21-month high
France	59.6 (flash: 60.0)	2-month low
Germany	58.9 (flash: 58.7)	80-month high
Italy	56.5	8-month high
Spain	55.4	3-month high

** Composite Output PMI against GDP comparisons for Germany, France, Italy and Spain are included on page 3 of this press release.*

Source: IHS Markit Ltd., January 4, 2018.

Optimism, Momentum
Global Economies are Booming

MARKET SENSITIVE INFORMATION
EMBARGOED UNTIL: 1100 (New York) / 1600 (UTC) January 4th 2018

J.P.Morgan Global Manufacturing & Services PMI™

Produced by J.P.Morgan and IHS Markit in association with ISM and IFPSM

Global economic growth strengthens at end of 2017

The global economy ended 2017 on a firm footing. Output rose at the fastest pace since March 2015, underpinned by the steepest increase in new business in three-and-a-half years. The expansion remained broad-based, with economic activity rising across the six sectors covered by the survey (consumer, intermediate and investment goods and business, consumer and financial services).

The J.P.Morgan Global All-Industry Output Index[1,2] – which is produced by J.P.Morgan and IHS Markit in association with ISM and IFPSM – posted 54.4 in December, up from 54.1 in November. The headline index has signalled expansion for 63 successive months.

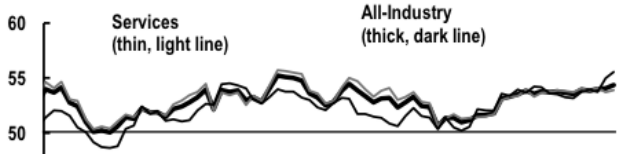
Please note that, due to later-than-usual release dates, final PMI data for the Japan manufacturing, Japan services and Thailand manufacturing sectors for December 2017 were not available for inclusion in the Global PMI numbers.

Commenting on the survey, David Hensley, Director of Global Economic Coordination at J.P.Morgan, said:

"The global PMI indicates the rate of global economic expansion gathered momentum in December, with output rising at a pace last achieved in early-2015. Forward-looking indicators such as new orders and backlogs of work also point to the current solid upturn being extended into the start of 2018. Growth in the goods-sector appears to be especially strong."

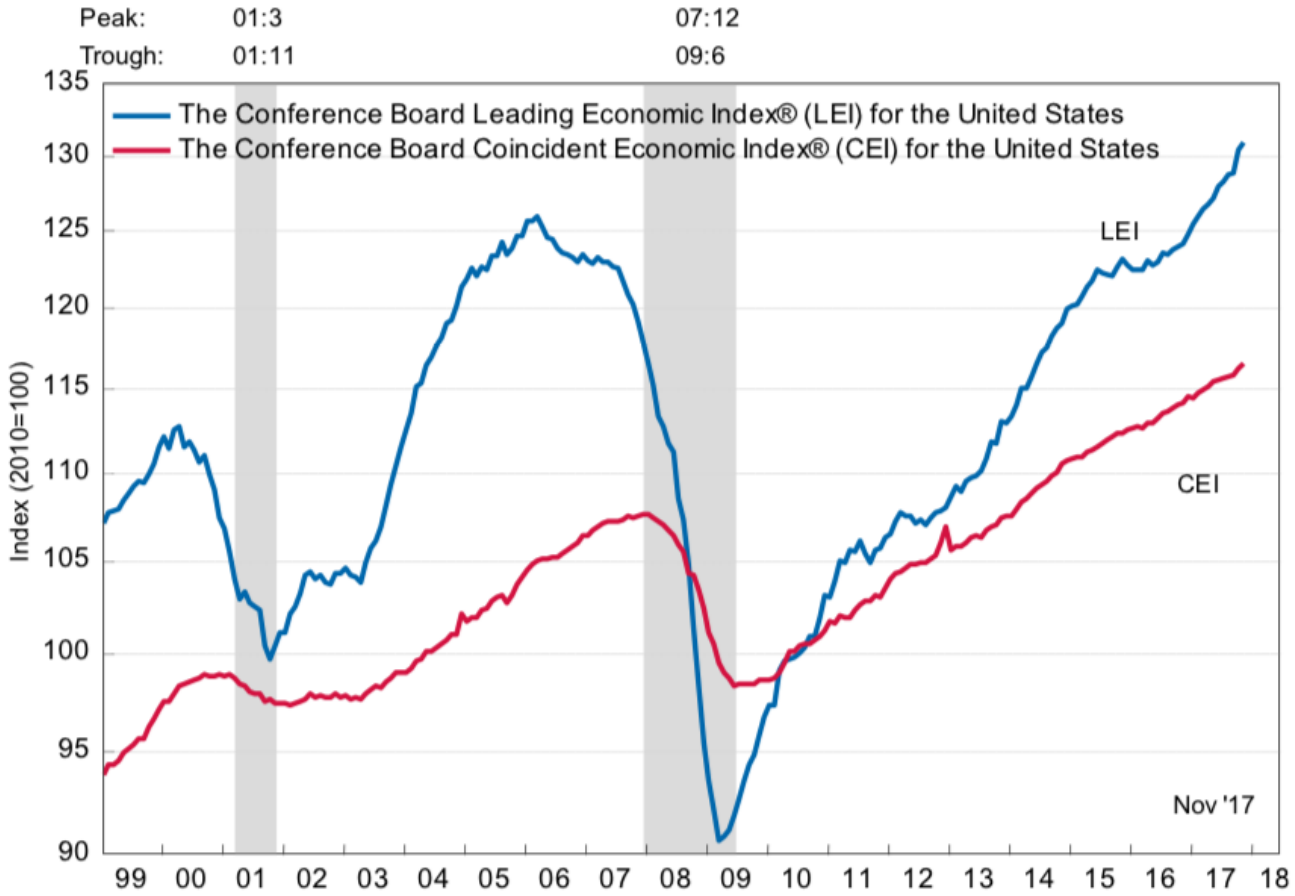
JPMorgan global PMI output

Diffusion Index, sa



Source: IHS Markit Ltd., January 4, 2018.

Economic Data
U.S. Index of leading Economic Indicators – Surge in 2017



The Conference Board Leading Economic Index® (LEI) components: 1) average weekly hours worked, manufacturing; 2) average weekly initial unemployment claims; 3) manufacturers' new orders – consumer goods and materials; 4) ISM index of new orders; 5) manufacturers' new orders, nondefense capital goods; 6) building permits – new private housing units; 7) stock prices, S&P 500; 8) Leading Credit Index™; 9) interest rate spread; 10-year Treasury less fed funds; 10) index of consumer expectations.,
Source: ©The Conference Board. Data through November, released December 21, 2017.

"The U.S. LEI rose again in November, suggesting that solid economic growth will continue into the first half of 2018. In recent months, unemployment insurance claims have returned to pre-hurricane levels. In addition, improving financial indicators, new orders in manufacturing and historically high consumer sentiment have propelled the U.S. LEI even higher."

This chart shows how the LEI has definitively rolled over well in advance of the last two recessions.

Jobs

- full-employment
- new jobs will soon be limited
- good news in part-timers data
- record job openings
- declining participation rate due toy aging
- strong relative U.S. job formation forecast long-term
- strong real wage and income growth
- mean and median incomes bottomed
- myth: "… but we're not creating good jobs"

Investment Strategy
2018 Forecasts

Source: *Barron's,* December 11, 2017.

Wall Street Forecasts: 2018

Investment strategists expect U.S. stocks to head higher next year, propelled by economic growth and earnings gains. They're bullish on financials and tech, but cautious on consumer staples and utilities. Their mean S&P 500 forecast: 2840.

	Stephen Auth, FEDERATED	Jeffrey Knight, COLUMBIA THREADNEEDLE	David Kostin, GOLDMAN SACHS	Dubravko Lakos-Bujas, JPMORGAN	Tobias Levkovich, CITI RESEARCH
S&P 500 2018 TARGET	3000	2750	2850	2800*	2675
S&P 500 EPS 2018**	$150.00	$144.00	$150.00	N/A	$141.00
U.S. GDP GROWTH 2018	2.90%	2.75%	2.50%	2.30%	2.70%
10-YR TREASURY YIELD 2018	2.75%	3.10%	3.00%	2.70%	2.75%
FAVORITE SECTORS	Financials, Energy, Health Care	Materials, Energy,	Financials, Industrials	Financials, Industrials, Energy, Materials	Financials, Energy, Consumer Discretionery
AVOID	Consumer Staples, Utilities	Health Care, Utilities	Consumer Staples, Utilities, Real Estate, Cons. Discretionary	Info Tech, Cons. Staples, Utilities, Real Estate	Health Care, Cons. Staples, Telecom, Info Tech, Utilities

	John Praveen, PGIM	Rob Sharps, T. ROWE PRICE	Savita Subramanian, BofA MERRILL LYNCH	Mike Wilson, MORGAN STANLEY	Ed Yardeni, YARDENI RESEARCH
S&P 500 2018 TARGET	2925	2775	2800	2750	3100
S&P 500 EPS 2018**	$139.30	$150.00	$139.00	$145.00	$147.00
U.S. GDP GROWTH 2018	2.80%	2.50%	2.40%	2.10%	3.00%
10-YR TREASURY YIELD 2018	3.00%	2.75%	2.90%	1.95%	2.75%
FAVORITE SECTORS	Financials, Industrials, Info Tech	Financials, Health Care	Financials, Info Tech, Materials	Industrials, Energy, Info Tech, Financials	Industrials, Financials, Info Tech, Consumer Discretionary
AVOID	Utilities, Consumer Staples	Energy	Consumer Discretionary, Utilities, Real Estate	Cons. Staples, Real Estate, Telecoms, Cons. Discretionary	Telecoms, Utilities, Consumer Staples

*2018 midyear forecast; **Some 2018 earnings estimates don't reflect potential tax cuts; Note: Some GDP and yield estimates are from the firm's economists and bond strategists N/A=Not Available

Investment Strategy
Setting Expectations

weighted expected return

60% X 8% =	4.8%
40% X 2.3% =	.9%
	5.7%

Fixed income returns can no longer boost portfolio total returns as they have over the last 40 years.

Expect very modest fixed income returns going forward.

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