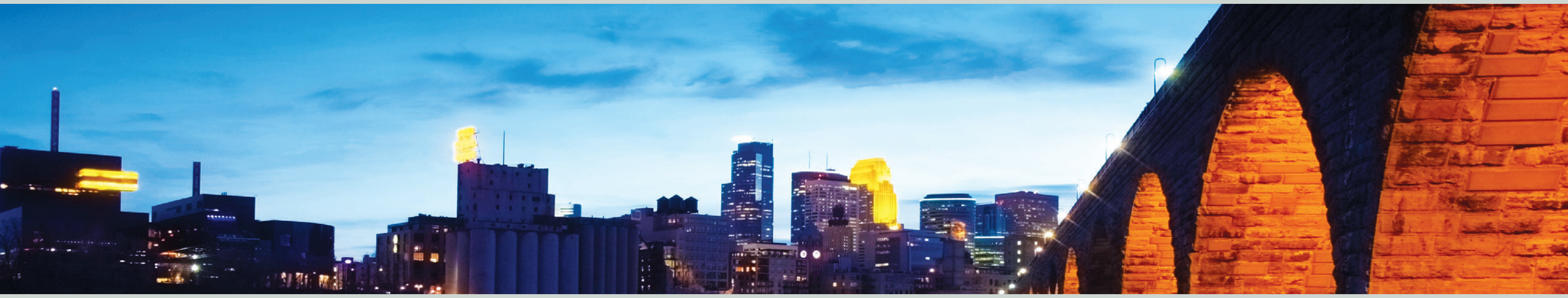
Leuthold Weeden
CAPITAL MANAGEMENT



Doug Ramsey, CFA, CMT
Chief Investment Officer

The most remarkable feature of this decade's stock and U.S. economic recoveries has been the lack of consumer and investor confidence that's accompanied them. Despite a tripling of the stock market from 2009 lows and a decline in the unemployment rate to 4.7%, there's nothing that remotely resembles the excitement that accompanied similar market and economic achievements during the late 1990s. But that may be in the process of changing. Confidence—along with the stock market—surged in the weeks following the presidential election, and in early 2017 there's talk of a rebirth of "animal spirits"—just as the bull market approaches its eighth birthday.

We're contrarians at heart, and the burst of optimism in the past two months certainly registers as a negative in our investor sentiment work. We've observed that while corporate and investor attitudes might have been subdued throughout much of the economic cycle, their *actions* haven't been quite so conservative. For example, issuance of low-grade debt during the last two years has far exceeded the levels of that near the top of the last business cycle (2006-2007), with lenders loosening loan covenants in predictable late-cycle fashion. Meanwhile, most of our Intrinsic Value measures have climbed above their 2007 peaks. It appears that these already-stretched measures of corporate fundamentals will become even more stretched before the onset of the next bear market and recession.

Our stock market disciplines remain moderately bullish, reflecting fairly uniform strength across all capitalization tiers and most equity sectors. Among the industries we consider to be market bellwethers, only the interest-sensitive Utilities has failed to join the major indexes at new highs. However, other interest-sensitive groups—like Banks, Brokerage, and Insurers—have strengthened on a relative basis as bond yields have climbed, suggesting that interest rates haven't moved up enough to provide serious competition to stocks. And we think there's a positive, offsetting "confidence" effect that's resulted from the move away from crisis-based interest rate policies.

Within our quantitative work, only the Intrinsic Value analysis rates as a serious concern. That's nothing new; this market initially moved into the overvalued zone in late 2013. While high valuations can't help us time the next downturn, they suggest that downside risks will be significant when market conditions eventually turn hostile. For now, however, we see little evidence that a bull market top is near, and our tactical portfolios are positioned with net equity exposure of 65%, near the top of our normal 30-70% range.

(Continued)

Our equity portfolios have outperformed the broader market in recent months as leadership has rotated into the Financials, Industrials, and Information Technology sectors—areas where our models see reasonable (if not cheap) valuations and solid fundamental trends. The rise in interest rates has led to an exodus from bond-like stocks such as Utilities, REITs, and Telecom Services. Valuations in these areas still look high even after their recent setback, and we expect them to underperform in 2017. Both the Energy and Materials sectors have recently improved in our quantitative work, but not quite enough to appear on the "Attractive list" from which new domestic industry group purchases are made. Thematically, the biggest extremity we currently observe is the gap between Low Volatility stocks (very overvalued) and High Beta stocks (moderately undervalued). Our industry group holdings are skewed toward the latter.

Fixed income holdings in our tactical portfolios range from 20-25%, below the normal minimum of 30%. We believe a cyclical bear market in bonds began last July, and we've positioned portfolios for a continued rise in interest rates over the next 12 months. The duration of our fixed income holdings stands at 5.2 years (versus 5.9 years for the benchmark), and we're looking for a tactical opportunity to trim duration further in the next few months. We've maintained above-average exposure to corporate credit, which has rallied sharply in the wake of the presidential election. We expect credit conditions to remain favorable for at least the first half of 2017.

Cash holdings in our tactical portfolios remain relatively high, ranging from 11-15%. We expect to move some of these assets into higher-yielding fixed income instruments during the year.

We appreciate your interest. Thank you.

Sincerely,

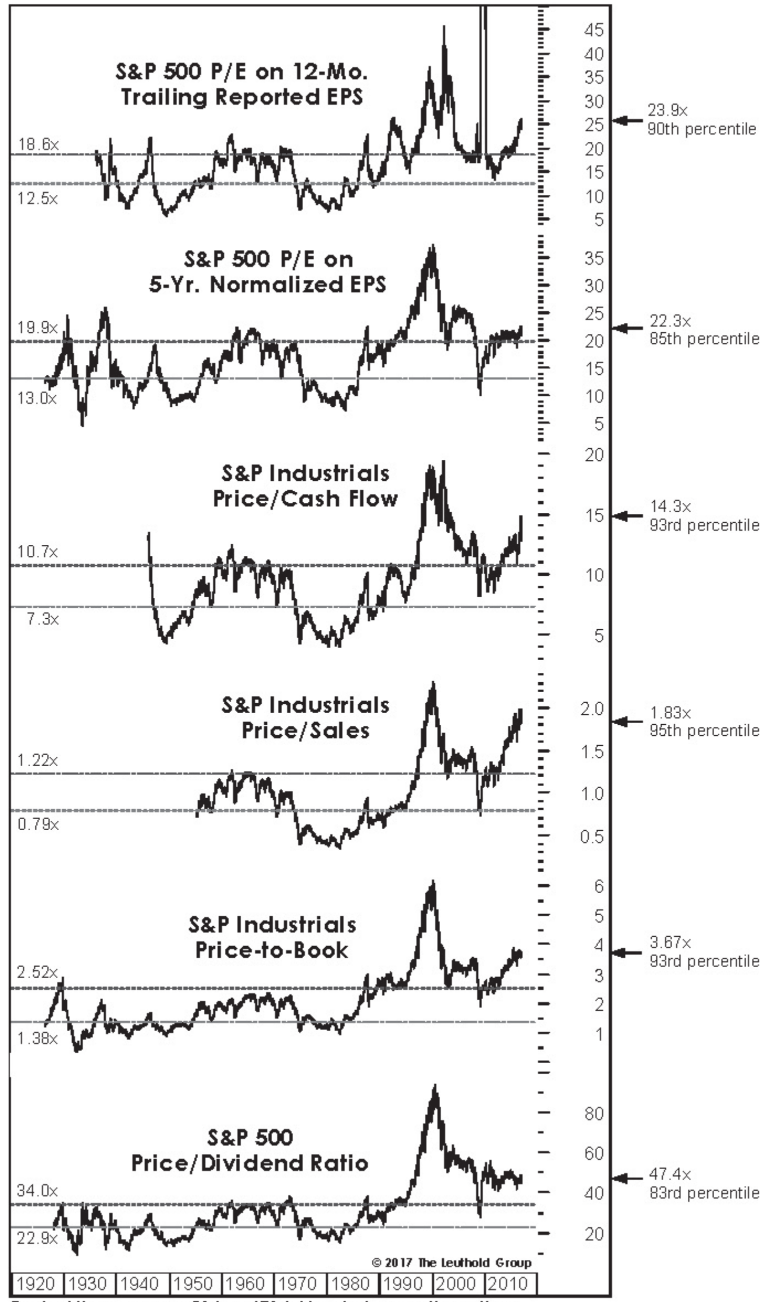
Doug Ramsey, CFA, CMT
Chief Investment Officer

Stock Market Valuations

We remain cyclically bullish, but it would be intellectually dishonest to try to make a serious valuation case for the stock market now. The "Big Six" valuation ratios in the chart are all sitting in either the ninth or tenth decile of historical readings. However, the worst looking of these metrics, Price/Sales, is the only one we'd consider to have entered the bubble zone. Its current 1.83x reading is higher than 95% of all prior observations. We've paid closer attention to this ratio in the last year or so because: (1) sales are more difficult to manipulate than cash flows and EPS; and, (2) it has the strongest (inverse) correlation with subsequent market returns of any component within our Intrinsic Value measures.

While the other five ratios are high, we wouldn't consider them "bubbly." The S&P 500 Price/Dividend ratio is the least extended of the measures, with a reading that's "only" in the 83rd percentile. It's a sad state of affairs when the most appealing measure of long-term stock market valuation is a 2.1% dividend yield.

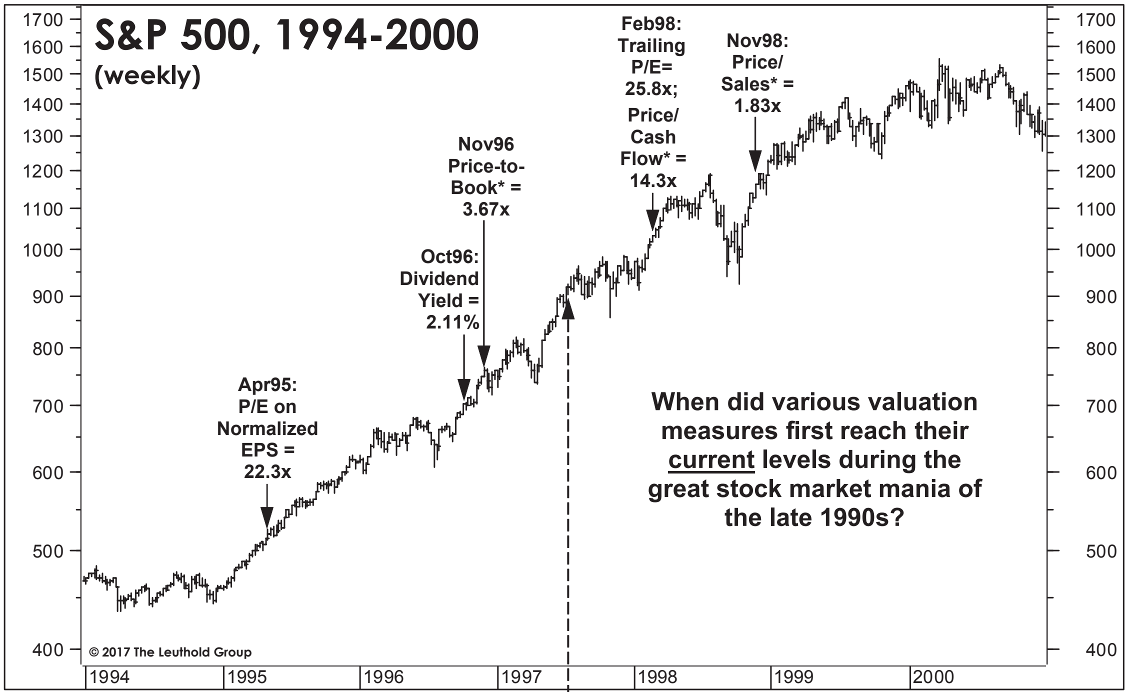
We've been bothered by recent years' complacency regarding market valuations—a complacency which didn't exist in the late 1990s. Yes, valuations at the 2000 market peak were considerably higher than today's, but professionals were cognizant of the valuation risks as early as 1995. Today, valuations are recognized as high, but not especially dangerous, because *we've been here (and much higher) before*. And since the late 1990s taught everyone that "valuations are not a timing tool," why worry until cyclical conditions (monetary, technical, sentiment) turn hostile? However, while we're worried about that mindset, we must also admit we're *of* that mindset. Cyclical conditions—as captured in our quantitative and other disciplines—suggest that the stock market won't likely tip over until it's reached even higher valuations. We've coined a catchy name for this viewpoint: the "Greater Fool Theory."



Dashed lines represent 30th and 70th historical percentile readings.
Valuation levels associated with these percentiles are shown at far left.

Stock Market Valuations (continued)

We've mapped current valuation levels of the "Big Six" ratios to see when they first hit these same levels in the latter half of the 1990s. It doesn't look as bad as we had expected. Based on a consensus of the six measures, today's market valuation corresponds "only" to the summer of 1997—more than two-and-a-half years prior to the ultimate market peak. We feel safe in saying that valuations reached in early 2000 won't be seen again in our lifetimes… but not as safe as we felt one, two, or three years ago.



*Price-to-Book, Price/Cash Flow and Price/Sales are for the S&P Industrial Average; remaining statistics are for the S&P 500.

Based on a median of the six measures shown above, the S&P 500 today trades at a valuation level first reached in July 1997 (… with the S&P 500 at 900).

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