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"We are quality value investors. We focus on companies with strong fundamentals, priced at a discount to their peers. We believe these companies will deliver superior returns over a market cycle."

August 1, 2017

Dear Client:

A growing number of investors believe the current bull market is looking increasingly vulnerable and not unlike the DotCom bubble in the late 1990's that ended very badly in March 2000. We believe there are a number of similarities but the differences are significant.

The dominant performance of a few very large information technology stocks over the last couple of years—Facebook, Apple, Amazon, Google and Netflix, familiarly known as the FANGs, is cited as the parallel to a comparable buying frenzy of a few large capitalization technology stocks in the aforementioned period. The FANGs have accounted for about one-third of the S&P 500's return this year, an amazing performance by a handful of stocks. And from 3/31/2017 to 5/15/2017, the FANGs appreciated by $260 billion *while everything else in the S&P 500 depreciated—by $260 billion!* That's dominance.

The five largest market capitalizations in the S&P 500 Index are four FANGs and Microsoft. Netflix is the only FANG that's not among the largest capitalizations. After this surge in Tech shares over the last two years, Information Technology now comprises 23% of the S&P 500 Index.

TABLE I
FANGS + MICROSOFT PERFORMANCE: PAST TWO YEARS

	7/29/2015	7/28/2017	% Change
Facebook	$94.01	$165.20	+76%
Alphabet	$657.50	$991.04	+51%
Apple	$121.30	$151.95	+25%
Amazon	$536.15	$1,039.45	+94%
Netflix	$114.31	$188.95	+65%
Microsoft	$46.70	$73.30	+57%
S&P 500	2,068	2,477	+20%

Growth strategies in general are doing well this year and extend beyond the FANGs. The S&P 500 Growth Index is up +17% while the S&P 500 Value Index has lagged severely and is up only +6%.

As impressive as the performances of the FANGs have been over the last two years, they pale relative to the returns of the major tech stocks over the last two years of the DotCom bubble:

TABLE II
PERFORMANCE OF LARGEST TECH MARKET CAPS: 3/31/1998 - 3/27/2000

	3/31/1998	3/27/2000	% Change
Cisco	$11.31	$77.00	+581%
Intel	$19.52	$65.66	+236%
Microsoft	$22.38	$52.84	+136%
Oracle	$5.26	$39.13	+644%
Nokia	$10.89	$54.31	+399%
S&P 500	1,102	1,461	+33%

To get an idea of the speculative frenzy in Technology shares over the last three months leading up to their 3/27/2000 peak, the InfoTech sector weighting advanced from 29% to 35%. *Six percentage points in three months!* At its Zenith, global technology stocks accounted for a full one-fourth of the total world equity capitalization.

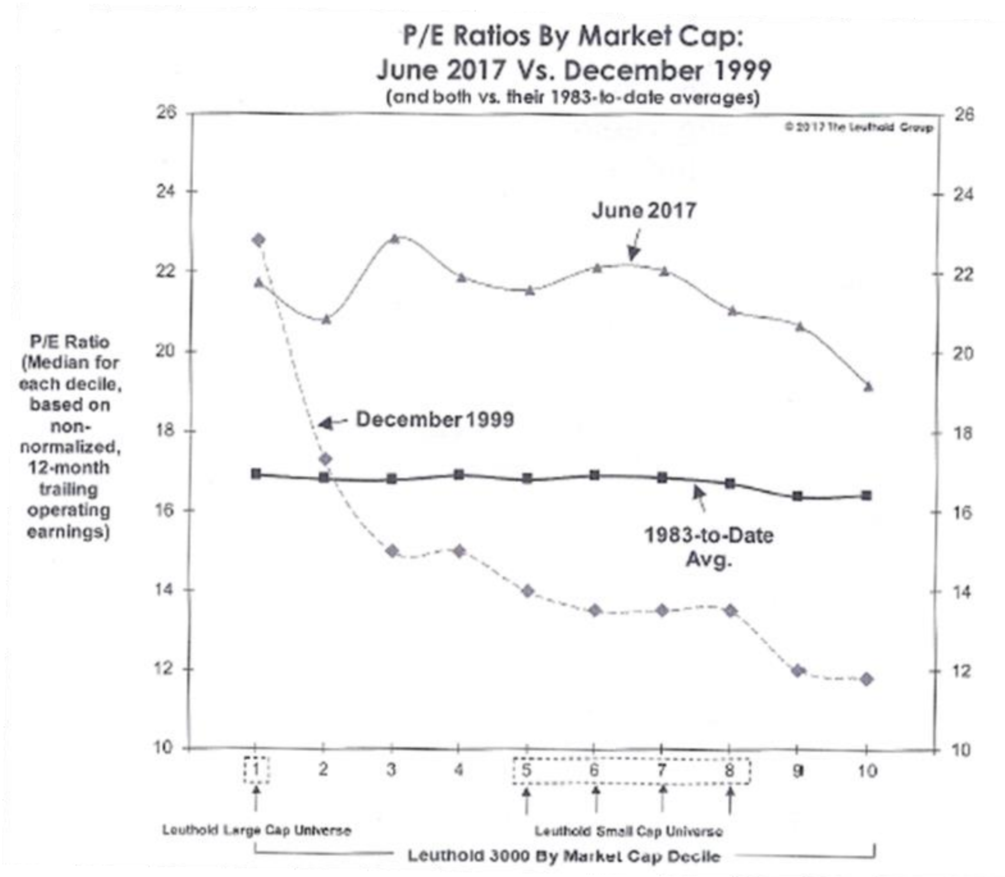
Speculation in tech shares went well beyond the largest capitalizations. Over the last two years of the DotCom frenzy, there was a huge plethora of tech IPOs, as investors stumbled all over themselves trying to get in on the action. Most of them had no earnings and many of them had no revenues and went to zero when the fun and games ended. Who could forget the favorite valuation metric at the time: "market capitalization per click."

There are some interesting valuation differences between the two periods. The current forward price/earnings (P/E) ratio of the S&P 500 is elevated at 17.6x, versus 15.2x both five years ago and 15 years ago, and is currently at its highest level since 2004. But it is still well below its 26x at the DotCom peak.

As shown in Chart I below, the current P/E ratios based on trailing earnings of The Leuthold Group's index of 3000 stocks are elevated across all capitalization deciles other than the bottom 10%. It ranges between 20x-22x, well above the 16x average over the past 35 years.

The P/E distribution by deciles at year end 1999 looked very different. At that time, the U.S. stock market had been in distribution mode for the past two years, leaving 80% of the Leuthold 3000 stocks trading at moderate-to-steep discounts to their long term averages. The feeding frenzy into the largest capitalization technology stocks and growth in general was fueled by the liquidation of small and midcap shares, particularly value stocks. At the peak, the median P/E of the 50 largest capitalizations in the Leuthold 3000 was 35x. Leuthold recently commented that this was likely the biggest market bifurcation in history.

CHART I



Source: The Leuthold Group

The disparity in performance by market capitalization and style in the period running up to the peak in the DotCom bubble was huge:

TABLE III
INDEX PERFORMANCE: 3/31/1998 - 3/31/2000

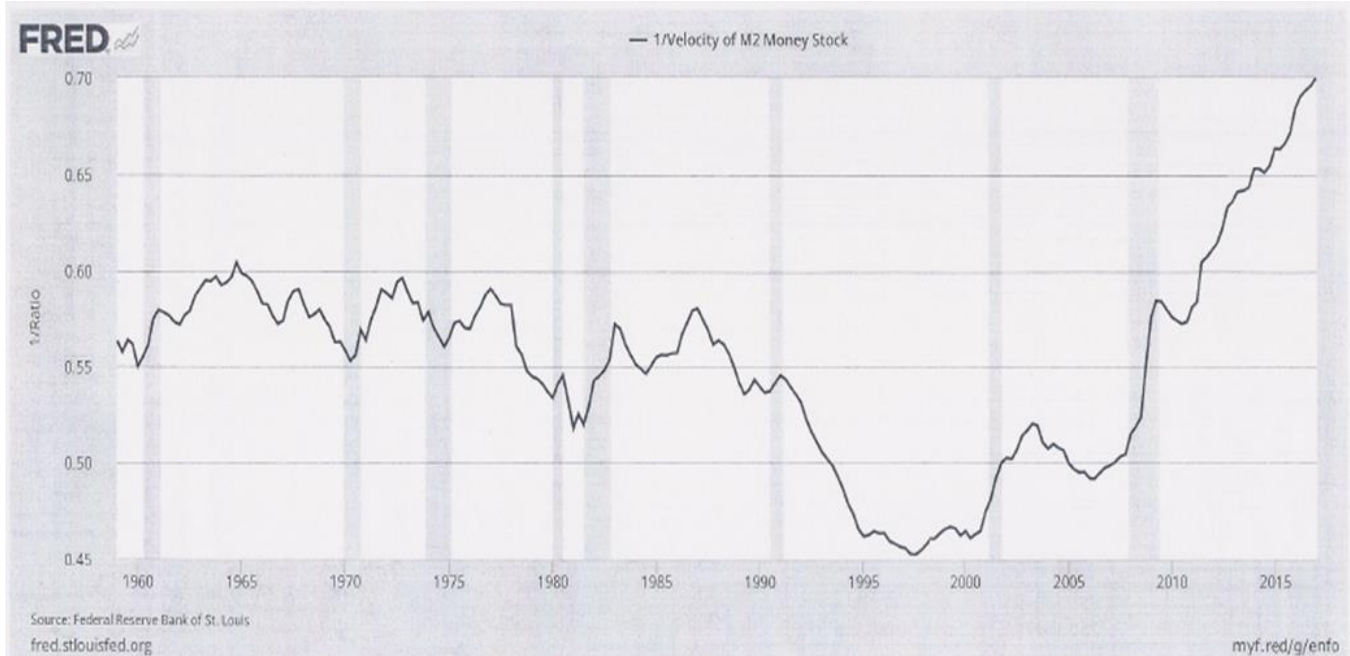
S&P 500	Russell 2000	Russell 2000 Value
+40%	+15%	-12%

The major market differences between the DotCom period and now are 1) the surge in the largest InfoTech stocks was much greater in the earlier period and that led to their extreme over-valuation while 80% of the market was in distribution and 2) while the performance of the FANGs in the current market has been substantial, there has been a much broader participation across the capitalization spectrum.

High valuations leave markets vulnerable to significant negative events, particularly a liquidity squeeze. The Fed was concerned about asset and economic overheating a year before the March 27, 2000 market peak. Consequently, it raised the Fed Funds rate 100 basis points from 4.81% in March 1999 to 5.85% a year later. In response, the 2-year Treasury rate increased 200 basis points from the end of 1998 to March 2000.

Early in the 20th century economist Alfred Marshall introduced a broad liquidity concept, Marshallian K. It works like this: When the broad money supply is rising faster than the nominal GDP, liquidity is abundant and provides the fuel to purchase assets—stocks, bonds, real estate, etc. Conversely, when the economy is growing faster than the stock of money, liquidity is squeezed and assets are sold. And Marshallian K had stopped rising prior to the market peak in March 2000.

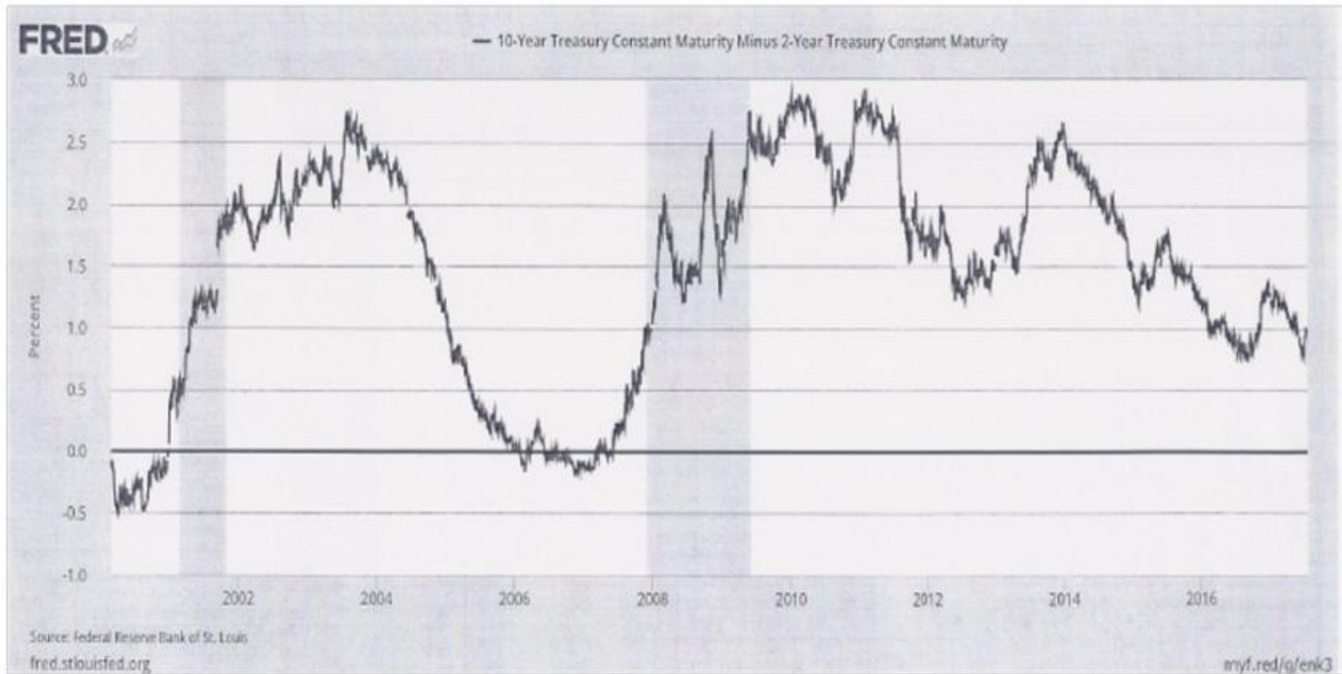
CHART II
MARSHALLIAN K BROAD LIQUIDITY



Source: Federal Reserve Bank of St. Louis

Consequently, the yield curve (10-year Treasury yield minus 2-year Treasury yield) inverted. An inverted yield curve is the kiss of death for risk assets. Over-valued assets don't generally collapse on their own. They do, however, when liquidity starved, and that was the catalyst that popped the bubble in March 2000.

CHART III
THE YIELD CURVE



Source: Federal Reserve Bank of St. Louis

The most over-valued assets, or those with the weakest fundamentals, always suffer the biggest falls as liquidity contracts. Such was the fate of the large cap Tech stocks following their peak on March 27, 2000. And it only took a year.

TABLE IV
PERFORMANCE OF LARGEST TECH STOCKS: 3/31/2000 - 3/31/2001

	3/31/2000	3/31/2001	% Change
Cisco	$77.00	$15.81	-79%
Intel	$65.66	$26.31	-60%
Microsoft	$52.84	$27.34	-48%
Oracle	$39.13	$14.98	-62%
Nokia	$54.31	$24.00	-56%

The most *undervalued* stocks, small cap value equities, actually managed to appreciate during the year following the market peak despite the liquidity squeeze. But an alarmed Fed quickly reversed its tight monetary policy and started cutting the Fed Funds rate. Meanwhile, private credit demands collapsed during the recession, and, combined with the easier monetary policy, liquidity surged. Marshallian K reversed its slide, and that ended the inverted yield curve environment as the 2-year rate fell below the 10-year. Over the five year period following the market peak, the unwanted and unloved small cap value stocks actually doubled while the large cap-dominant S&P 500 dropped -15%.

TABLE V
INDEX PERFORMANCE: 3/31/2000 - 3/31/2005

	Russell 2000 Value	Russell 2000	S&P 500
3/2000 - 3/2001	+20%	-15%	-22%
3/2000 - 3/2005	+105%	+22%	-15%

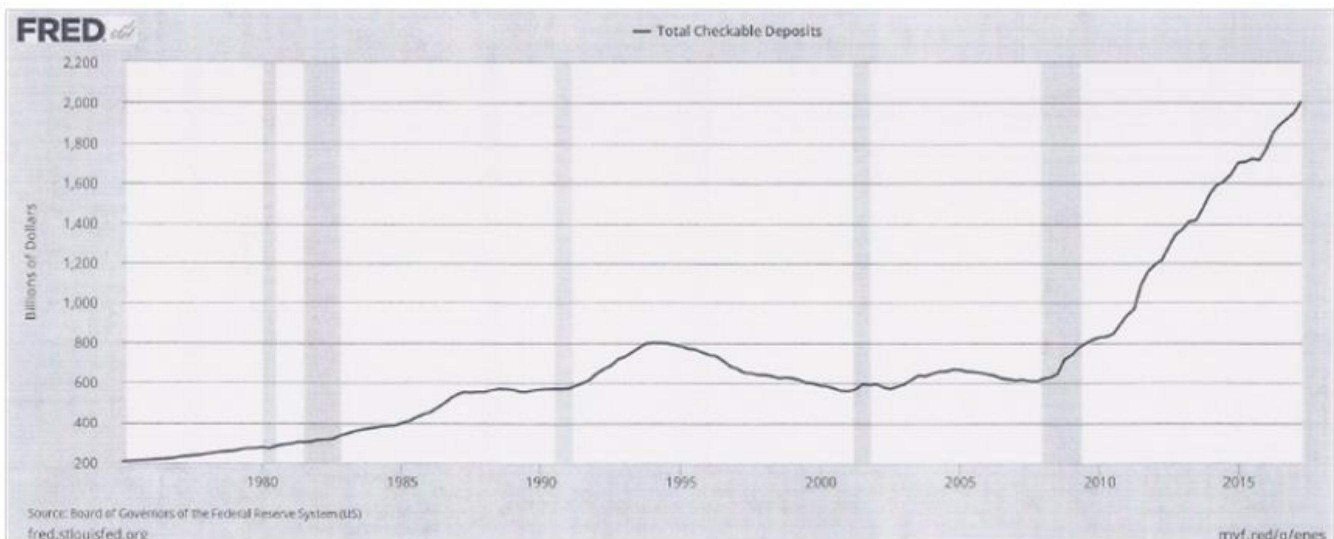
Plentiful liquidity has driven the current 8-year+ bull market. And it remains very abundant today, keeping rates below their neutral levels across the entire yield curve. Such was not the case in 2000 when rates were much higher.

TABLE VI
INTEREST RATES

	Fed Funds	2-Year Treasuries	10-Year Treasuries
3/2000	5.85%	6.51%	6.39%
7/2017	1.04%	1.37%	2.35%

Broad liquidity, Marshallian K (see Chart II above), continues to increase, and the yield curve is positively sloped by 100 basis points (refer to Chart III.) Moreover, the U.S. banking system is flush with liquidity as deposits have exploded over the past 8 years. Loan growth has not kept pace, driving the Loan-to-Deposit ratio to its lowest level in years.

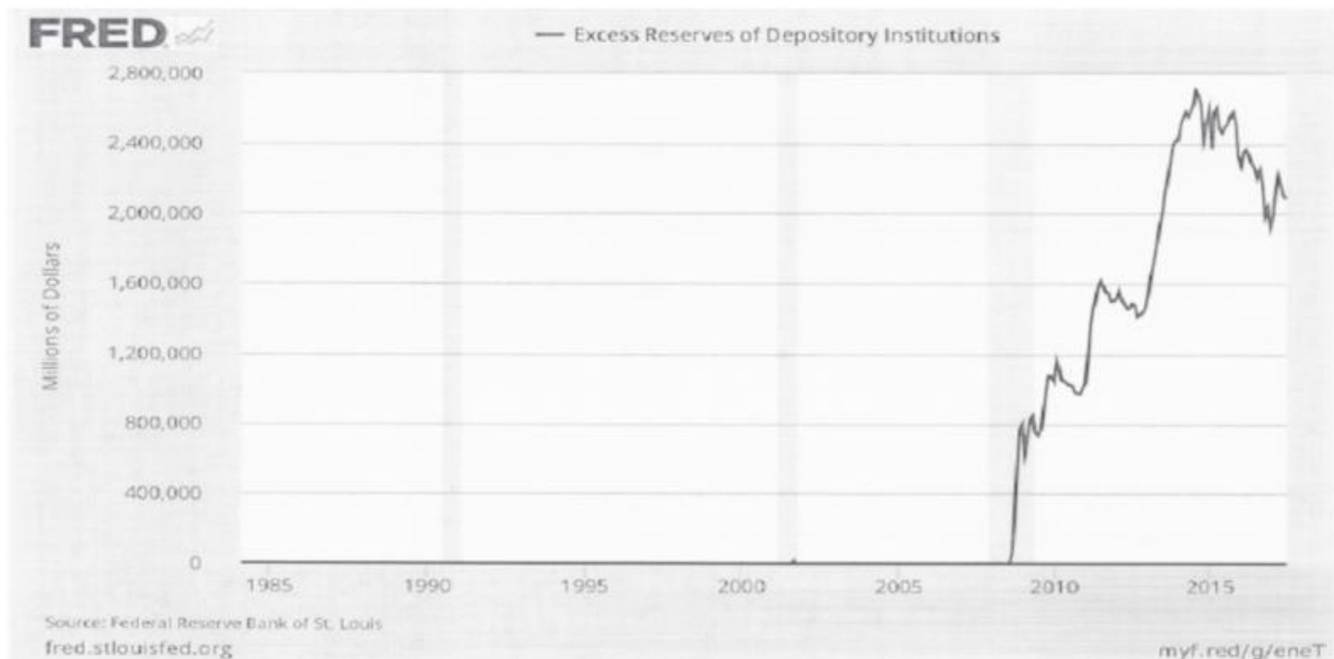
CHART IV
TOTAL CHECKABLE DEPOSITS



Source: Federal Reserve Bank of St. Louis

In addition, the banking system is flush with $2 trillion of excess reserves that are available to fund lending opportunities. Capital ratios are very healthy, and many believe them to be redundant. The banking system is now in the strongest position we've experienced in our career.

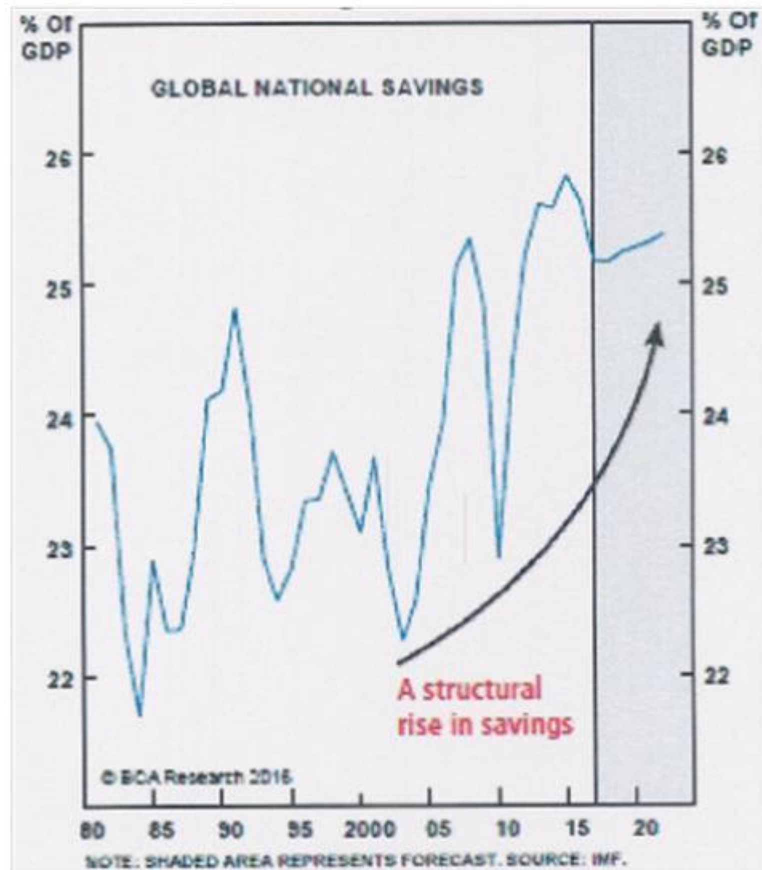
CHART V
BANKING SYSTEM EXCESS RESERVES



Source: Federal Reserve Bank of St. Louis

We've discussed the huge surplus of global savings many times in our past letters. It, along with extreme monetary ease among the world's major central banks has been the major factor suppressing interest rates along the entire yield curve. And global savings remain high and continue to increase, driven by the very large savings rate disparities among the world's economies.

CHART VI
SURFEIT OF SAVINGS



Source: BCA Research

Global savings rates will remain high until there's a surge in capital spending and/or substantial infrastructure initiatives. Until then, excess global savings will remain a powerful force suppressing long interest rates even as the Fed tightens gradually.

Liquidity is abundant at the micro level as well. As noted above, total bank deposits are massive, and the majority of them are retail. Most large wealth management firms provide information about the aggregate cash positions in their clients' accounts. The feedback we get is mixed. Some report little change in cash positions while others indicate modest increases or decreases. UBS did report that their very high net worth clients maintained substantial cash positions throughout the Bull Market and remain at a very high level of 35%.

Alternative asset strategies, private equity, venture capital and commercial real estate continue to enjoy substantial success raising capital for new fund offerings despite the very high cash positions in existing funds. Cash in PE and VC funds combined was $843 billion at the end of the first quarter, up almost $300 billion over the past five years. That's a lot of dry powder to chase deals at a time when it's very difficult to find compelling values that will meet their clients' return objectives. To do so, requires a lot more leverage.

Naturally, there's a lot of focus on what the Fed does next. Janet Yellen indicated that they will start shrinking its bulging balance sheet soon, but the path to lower levels will be gradual. There is no need for the Fed to sell bonds outright. It is more likely that it will let bonds mature without replacing them and use reverse repos liberally.

The path of inflationary pressures will determine how aggressively the Fed tightens. So far, reported inflation remains tame as the Fed's favorite measure is under +2%. However, that won't change the Fed's intent to transition from an easy monetary policy to a period of restraint as it shrinks its balance sheet. The turn in interest rates will be gradual, but their 35-year secular decline is definitely over. Rates will likely be higher a year from now and higher yet in two years.

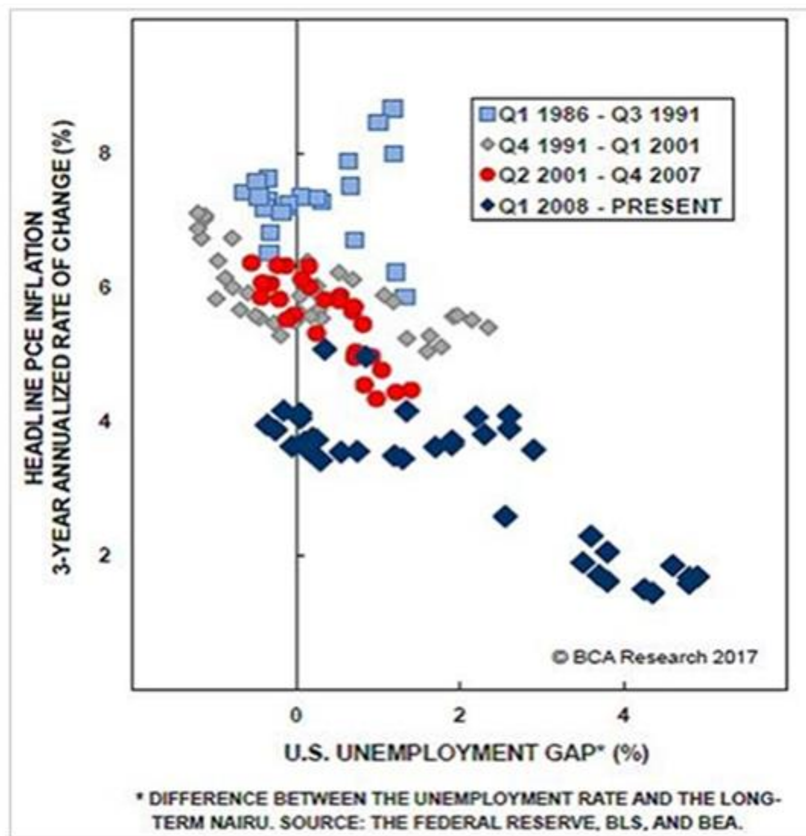
And one can't be complacent about the possibility of an upside inflation surprise. There is growing anecdotal evidence of labor shortages and upward pressure on wages in some industries. Initially, higher wages could suppress profit growth, but as capacity becomes constrained, corporate pricing power will resurface.

But as long as interest rates remain low, investors will venture out the risk curve, pushing asset prices higher despite the challenged valuations. Historically, higher valuations are not the only sign of speculation. One potentially worrisome development is increased client borrowing activities employing rising portfolio valuations as collateral. These balances are roughly $100 billion and growing rapidly.

Higher asset values are driving aggregate net worth to record levels, and individual wealth is up +7% over the past year. The real economy is impacted by the wealth effect, and as the economy grows, the pressure on physical and labor resources increases. And at some point, if the process continues unabated, the general price level will rise.

Historically, diminished slack has led to higher inflation, and most of the slack in the U.S. economy has disappeared. In addition, some secular trends will reinforce the cyclical inflationary pressures. Weak demographic trends in developed economies, and soon in China, are limiting the growth in the labor force, plus productivity growth remains stubbornly low. According to the Bank Credit Analyst's Global Investment Strategist, the 2020's could turn out to look an awful lot like the inflationary environment of the 1970's. And for those who lived through that period, that's a depressing prospect. We're not in that camp because much could happen to derail such a dire projection. But make no mistake, the possibility of higher inflation is a concern.

CHART VII
DIMINISHED SLACK LEADS TO HIGHER INFLATION



Source: BCA Research

Credit demands will rise as higher inflation will drive nominal GDP growth higher, squeezing out the excess liquidity. The challenge to monetary authorities is to guide the economy to a soft landing, and that is daunting. Historically, they've not been very successful at it. And the longer the period of over-heating, the greater the pain in capital markets and the real economy when monetary policy ultimately tightens. We saw that movie in 1999 and 2000, and it wasn't pretty as we documented above.

The good news is we're not there yet. Excess liquidity will likely drive asset prices and their valuations higher. But the higher they go, the greater the pain when the Fed decides the game is over.

Best regards,

Timothy G. Dalton, Jr.
Chairman