

Steve Leuthold: The Market will Rally This Year

By Robert Huebscher

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If you saw Steve Leuthold in a hotel lobby and didn't know who he was, you would probably think he was just returning from an ice fishing trip on a lake in frigid northern Minnesota. His laid-back and untailed demeanor and thick beard, though, belie his investment acumen. Leuthold is chairman of the \$4.5 billion Minnesota-based Leuthold Group, where his funds have consistently outpaced their peers over long time horizons.

Leuthold was the keynote speaker at the Fortigent conference in San Diego last week, where he presented an upbeat short-term forecast for the US markets. For a summary of other, less rosy, presentations at that conference, see [here](#).

Upside for the next six months

Leuthold prefers to forecast the economy, which he said he was dead right about for the last three years. The US economy bottomed in the fourth quarter of last year, he said, and is in a mild expansion. He expects 3.5% growth for 2010, which will lag the rest of the world with the exception of Europe.

“We are a mature economy,” he said, “having lost a great deal of our manufacturing base.” The US global companies he follows may compensate for that decline, he said; they derive more than half their revenue from outside the US.

Consumer spending will increase 1.5-2% over last year, although consumers remain over-leveraged, Leuthold said. “If you have a product that people like, they will find the money to buy it,” he said, which is why he expects this modest expansion in consumer spending to lead to growth in revenue and profits among companies.

“This market as we see it is about 16.5 or 17.5 times normalized earnings – not richly valued but somewhat overvalued.” He expects retail investors to continue to be net sellers of stocks, but institutions will build their equity exposure.

Relative good news from earnings announcements will lead to growing enthusiasm and a 16-20% gain in the stock market in the first six months of this year, and the S&P 500 will reach 1,300-1350 and a normalized PE of 19-21, at



which point it will be “clearly overvalued,” he said. Those advances, Leuthold said, will be powered by “momentum, breadth, and divergence” – and not by fundamental undervaluation.

The second half of 2010

Leuthold’s enthusiasm wanes as he looks beyond the first six months of this year, primarily because he is wary of federal deficits. He does not expect Congress to act in a fiscally responsible manner. The pending November elections will result in ill-conceived spending measures designed to generate votes and not economic growth, he said.

“The deficit isn’t coming down,” he said, which points to a “pretty big market correction” sometime in the second half of the year.” That “could be a decline of 15-20% from the peak,” he said.

In his asset allocation fund, Leuthold has half of his equities in foreign companies, and about 60% of that half is in emerging markets. Over the last 15 years, the biggest change in his business is expanding his research into non-US markets.

Leuthold has been very successful with his investments in China, but he is trimming those back now and turning to other Asian countries, including Singapore, Thailand, Korea and Vietnam. He expects 5-7% appreciation in Asian currencies “unless there is a run on the dollar.”

Leuthold said the euro does not offer strength or stability against the dollar and is exposed to political risk, such as the recent unrest in Greece. He noted that no multi-country currency has ever survived. The diverging economies of the 16 countries that use the euro and societal problems, he said, will ultimately lead to the demise of the euro over the next five to six years. “The seeds of the destruction have been planted,” he said.

Leuthold was short the euro against the dollar until about 10 days before he spoke, and he said he would short it again if its price rose to 1.48 or 1.49.

“A major run on the dollar could bring some sanity to our politicians in Washington,” he said. He defends against this are gold and his foreign equity exposure.

“I can’t find anything I like in the bond markets,” Leuthold said. Normally, his asset allocation fund has at least 30% in bonds, but now, according to his latest newsletter, he holds only 11% in fixed income. “Yields are going to rise due to inflation or fears about our currency,” he said. He is short long-term Treasury



bonds, and recommended this position either through direct shorts or ETFs. His only significant long fixed income position is some Brazilian bonds yielding 10.5%.

“Municipals are different, though,” he said, because he is confident taxes will go up, and their taxable-equivalent yields will be attractive to investors.

He has added high-yield stocks to his portfolio to substitute for his fixed income allocation, including positions in Altria and Reynolds, which offer 6-7% yields with “less risk than the bond market offers,” he said.

Among commodities, Leuthold does not like industrial metals, because recent price increases in this sector have led to the development of new extraction and production capabilities that will lower prices.

“I think gold is going higher,” Leuthold said, and he believes it is undervalued relative to its inflation-adjusted 1980 price of \$2,250. He expects gold to trade between \$985 and \$1,600 in 2010, and “it could go higher than that.” Problems with the federal deficit will be the driver of higher gold prices.

Leuthold has been a remarkably accurate forecaster, and his research is widely read by institutional investors. One area, though, to which his accuracy does not extend is picking a Super Bowl winner. His have been correct a mere 11% of the time.

Vikings fans take note – this year he called for a Minnesota-San Diego Super Bowl and a Viking victory. The Chargers have already lost since.

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