View from the North Country
by Steve Leuthold

- ***February's market action forces our use of the fail-safe mechanism, resulting in our equity allocation being cut to 50% at month's end.***

- ***Buy 'em when they hate 'em: that means NOW! Ten years of terrible performance present opportunities for those who have the courage and discipline to act.***

- ***The Fear Factor is rising again, as contrary opinion and sentiment measures have been of no value the past seven months. But two other fear-driven markets saw comparable declines in far more dangerous risk environments.***

EQUITY EXPOSURE 50%

First, let me say I'm sorry I'm late this month. February was both a very short and very busy month with two Board meetings, three days at the Mayo Clinic for some Mayo magic on my aching back, a CNBC interview with the "Money Honey" and topped off with a great seven day winter adventure at the Old Faithful Winter Snow Lodge in Yellowstone Park. No TV, no newspapers, no crowds, but lots of snow, animals and spectacular geothermal displays (a mere two people were there to witness one of Old Faithful's eruption). Highly recommended trip, but winter season ends March 15th. Try for next year. Info on request.

But back to business: on February 23rd, asset allocation equity exposure was reduced to 50% as the previous November 20th low was broken (fail-safe mechanism). Subsequently, the Index fell another 9%. Per our valuation benchmarks, using normalized earnings the market is very cheap. With a decline of 56% and a normalized PE ratio of 10.6x, **we won't be making any additional reductions in equity exposure**.

We continue to calculate our Major Trend Index (which is still Positive), but as previously noted, it is inoperative in market environments so driven by current levels of investor fear. Comments on the "fear factor" and the MTI elsewhere in this issue.

- I am, on a judgment basis, very bullish on the stock market even though the fail-safe required us to reduce equity exposure on February 23rd. The 2009 target for the S&P 500 is 1100, up 50% from today.

Tracking The Bear

The slide through the November lows elevates the current S&P bear market to second place all-time, behind only the 1929-32 collapse of 86% (the Dow's decline in that bear market was 89%).

- Though bear market blame has been pinned on overleveraged U.S. banks and consumers, market declines have been even larger in foreign markets, and especially horrific among foreign small caps, with losses approaching two-thirds from their 2007 peaks.

- Next to Financials (obviously), Industrials have been the poorest performing sector since the interim November 20th market low, with a loss of -17%.

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Performance Of Key Indexes In 2007-09 Bear Market

U.S. Stocks	Date of Bull Market High	Date Of Current Bear Market Low	Pct. Decline
Dow Jones Industrials	October 9, 2007	March 9, 2009	-53.8 %
S&P 500	October 9, 2007	March 9, 2009	-56.8
S&P MidCap 400	July 13, 2007	March 9, 2009	-56.3
S&P SmallCap 600	July 19, 2007	March 9, 2009	-59.2
Russell 2000	July 13, 2007	March 9, 2009	-59.9
NASDAQ Composite	October 31, 2007	March 9, 2009	-55.6
Value Line Arithmetic Composite	July 13, 2007	March 9, 2009	-60.1
Value Line Geometric Composite	July 13, 2007	March 9, 2009	-70.0
Global & Foreign Stocks (USD)			
MSCI World Index	October 31, 2007	March 9, 2009	-59.1 %
MSCI World Small Caps	July 13, 2007	March 9, 2009	-62.3
MSCI EAFE	October 31, 2007	March 9, 2009	-61.8
MSCI EAFE Small Caps	July 20, 2007	March 9, 2009	-64.2
MSCI Emerging Markets	October 29, 2007	November 20, 2008	-66.1
U.S. Sectors (S&P 1500)	**Bull Market High**	**Bear Market Low**	**Decline**
Consumer Discretionary	June 4, 2007	March 9, 2009	-61.1 %
Consumer Staples	December 10, 2007	March 9, 2009	-34.9
Energy	May 20, 2008	March 5, 2009	-55.8
Financials	February 20, 2007	March 6, 2009	-82.2
Health Care	December 10, 2007	March 5, 2009	-41.2
Industrials	October 9, 2007	March 6, 2009	-64.1
Information Technology	October 31, 2007	November 20, 2008	-55.1
Materials	May 16, 2008	March 9, 2009	-60.5
Telecom Services	May 31, 2007	March 9, 2009	-51.6
Utilities	December 10, 2007	March 9, 2009	-47.6

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- Impressive relative strength. The bottom has been made in China, my favorite foreign market.
- By 2010, I expect half of our equity exposure will be in foreign markets, mostly in Asia (fewer banking problems and higher GDP growth).
- U.S. markets are very cheap, but some foreign markets are cheaper and growing faster.

BUY 'EM WHEN THEY HATE 'EM: THAT MEANS NOW!

The 10 year annual compound return for the S&P 500 from the end of 1998 to the end of 2008 (including re-investment of dividends) was –1.38%, a cumulative loss of 13.00%. A pretty dismal return. Excluding dividends, the annual compound loss is –3.03%, a cumulative loss of 26.5%. This is very bad… but today the results are even worse. And that is bullish!

- **Measured to the recent March 6th, 2009 close, the ten year total return performance is a negative 4.41% per year, a cumulative loss of 36.33% over this period. Excluding dividends, the annual compound loss is 6.05% per year, a cumulative loss of 46.42%**.

- **The total return loss for the ten years ended March 6th is the worst 10 year performance in U.S. stock market history, including the great depression**.

The most meaningful investment lesson to be learned from this exercise is the investment opportunities that ten years of terrible performance present for those with the courage and discipline to then act.

What follows is the performance over the **next ten years** when the past ten years of performance has fallen to the bottom 5% of our performance distribution.

- ***When ten year annual total returns fall to 1% or less, the next ten years produce an average cumulative return of +183%***.

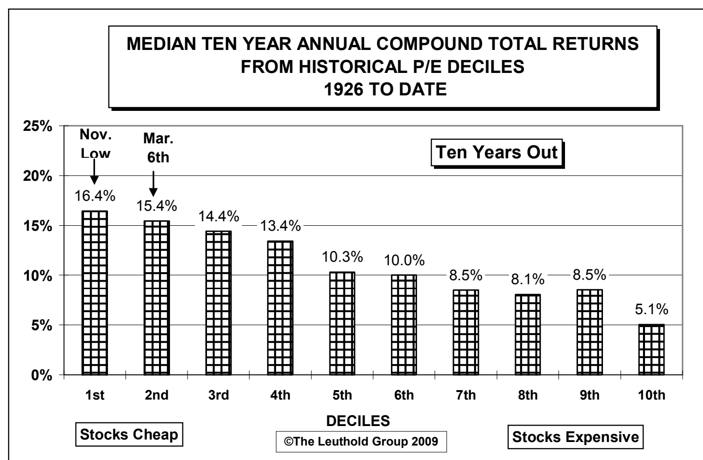
- ***The worst subsequent ten year return was +101% (Q4 1938—Q4 1948), with the best being +325% (Q3 1974—Q3 1984)***.

Past Ten Years			10 Year ACR	Next Ten Years			Annual Compound Return	Total Return	
Q2 1929	to	Q2 1939	-3.65	Q2 1939	to	Q2 1949	8.62	128.54	
Q1 1929	to	Q1 1939	-2.79	Q1 1939	to	Q1 1949	9.12	139.36	
Q3 1929	to	Q3 1939	-2.74	Q3 1939	to	Q3 1949	7.74	110.79	
Q1 1928	to	Q1 1938	-2.54	Q1 1938	to	Q1 1948	11.76	203.87	
Q1 1930	to	Q1 1940	-1.42	Q1 1940	to	Q1 1950	9.65	151.31	
Q2 1930	to	Q2 1940	-1.42	Q2 1940	to	Q2 1950	12.19	215.88	
Q4 1928	to	Q4 1938	-0.65	Q4 1938	to	Q4 1948	7.21	100.63	← WORST
Q3 1928	to	Q3 1938	-0.10	Q3 1938	to	Q3 1948	8.12	118.31	
Q3 1930	to	Q3 1940	0.18	Q3 1940	to	Q3 1950	12.57	226.85	
Q4 1927	to	Q4 1937	0.20	Q4 1937	to	Q4 1947	9.61	150.39	
Q4 1929	to	Q4 1939	0.23	Q4 1939	to	Q4 1949	9.09	138.67	
Q2 1928	to	Q2 1938	0.44	Q2 1938	to	Q2 1948	9.52	148.39	
Q3 1964	to	Q3 1974	0.49	Q3 1974	to	Q3 1984	15.58	325.30	← BEST
Q1 1931	to	Q1 1941	0.71	Q1 1941	to	Q1 1951	14.47	286.14	
Q4 1964	to	Q4 1974	1.24	Q4 1974	to	Q4 1984	14.76	296.23	
						Average	**10.67**	**182.71**	

ANOTHER APPROACH

1926 To Date

	P/E Decile	P/E Range For Decile	Subsequent Avg. 12 Month Return	Subsequent Median 12 Month Return
	1	Below 10.1x	+36.2%	+30.4%
Mar 6th➔	2	10.1x to 11.3x	+10.8	+11.9
	3	11.3x to 13.0x	+13.9	+16.3
	4	13.0x to 14.7x	+12.7	+16.3
	5	14.7x to 16.4x	+15.1	+17.7
	6	16.4x to 17.8x	+12.7	+10.1
	7	17.8x to 19.3x	+ 5.3	+ 7.2
	8	19.3x to 20.5x	+ 9.0	+10.8
	9	20.5x to 22.4x	+ 8.1	+ 6.8
	10	22.4x and above	+ 1.2	+ 6.3



As of the November 20th low, the S&P 500 was selling at 10.4x normalized earnings, ranking in the 2nd decile of the 1926 to date distribution and just edging into the 1st decile of the 1957 to date history. The median 10 year annualized return from the 2nd decile of the 1926 to date study has been +15.4% (or 318.8% on a cumulative basis).

QUESTION OUR MARKET JUDGMENT… BUT NOT OUR INTEGRITY!

As I write this, the S&P 500 is trading at 679 and drifting lower. Until about a month ago, I thought the S&P 500 had bottomed at 750 back on November 20, 2008… but as of now the S&P 500 is 9.5% lower. Six months ago, the disciplines of the Leuthold Major Trend Index produced a major defensive failure for the first time in 35 years, tracking back to the fall of 1973 (back then the stock market continued to fall an additional 25%-30% after the weight of the evidence shifted to positive).

In recent months a few critics have implied and more than implied that our firm and myself had "sold out," compromising our work, objectivity, and integrity, citing the growth in our asset management business as producing a bullish bias to our work. This is not only an insult to our integrity, but patently absurd.

Today, our short book is about $800 million considering hedges and the Grizzly Short mutual fund (up 73% in 2008 and 18% year to date). In fact, less than 8% of our firm's asset base operate under mandates to be at or close to 100% in equities, whereas 75% of our asset base is invested in flexible asset allocation portfolios that can include long and short equity positions as well as fixed income securities.

So where is our "vested interest" in being bullish? There is no conflict of interest. But we have been flat out wrong about the market for six months.

My definition of success in this business is being right as well as leading a firm that produces innovative and insightful investment research. In terms of being right in the last six months, I have not, as I see it, been successful. But our seven senior analysts and the support staff have continued to produce innovative and insightful research. I'm proud of that.

THE FEAR FACTOR

February was another terrible market month with most major U.S. market measures down another 11%-13%. In early March the decline has continued. The current S&P 500 bear market decline (-56%) is now the largest decline since the 1930s. Normally contrary opinion and sentiment measures have been quite reliable in identifying market bottoms, but in the last seven months they have essentially been of no value.

With the exception of 1974, I have never before seen the U.S. stock market so completely dominated by the "Fear Factor." The current financial and related economic crisis have all but driven the bulls from the field of play. CNBC's stable of usually upbeat cheerleading commentators seem to have recently become, for the most part, bearish worry warts (except Kudlow). A few CNBC guests profess to be "bullish, but not yet." Wait until we see signs of the economy improving before buying stocks, seems to be their advice. (History shows us the stock market will already be up 40%-50% by the time these "signs of improvement" are observed.)

Usually the administration in Washington makes some attempt at optimistic leadership, but certainly not the Obama administration. Normally I am not a big fan of government cheerleaders, but today, with most Americans fearing the worst, we seem to need optimistic leadership ala FDR, Ronald Reagan, and Winston Churchill.

No doubt Americans are afraid, including Americans on Main Street, Wall Street, and in Washington. Deleveraging the U.S. (and world) economy is a painful new experience for most of us. Increasing personal and financial leverage was lots of fun on the way up, but hell to pay on the way down.

With this deleverage transformation, higher personal saving may come to be viewed as a positive. Paying off a mortgage will no longer be viewed as dumb. Banks may once again make their profits by borrowing from depositors at 4% and lending to good credit risks at 7%. Insurance companies may once again insure mostly conventional individual and corporate risk and maintain adequate non-toxic reserves. Does this sound like a step back to the 1950s? Maybe so, **but in this case stepping back means our economy can again move ahead**.

TODAY'S INVESTORS' FEARS AN OVERREACTION

In terms of rational and justifiable investor fears, how does the current market compare to previous fear driven markets? Some of you may recall the real fears of global nuclear war, back when bomb shelters were being built in backyards and school children were practicing "duck and cover." More recent was the Cuban Missile Crisis, when JFK faced off with Khrushchev forcing the abandonment of a nuclear missile attack base in Cuba. Even more recent was the 9/11 terrorist attacks and the high perceived risk that additional attacks would certainly soon follow.

Herein I will present in greater detail, as I have done before, two other fear driven markets; each occurring during comparable 53%-60% declines, and each in a far more dangerous risk environment where investor fears were justified and far greater than in today's financial and economic crisis environment.

1974… The Market Collapse

- In 1974 U.S. interest rates had soared above and beyond 12%, with Fed Funds hitting 13%. These were, up to that time, the highest rates in U.S. economic history (about 500 basis points above previous bond yield peaks).

- CPI inflation was at a panic high of 12%+ and rising.

- Washington and the Nixon administration dithered and did nothing, being consumed and side tracked by the Watergate Crisis and impeachment considerations. In August 1974, for the first time in U.S. history, a President resigned. But Nixon's resignation was no help, with the stock market falling 28% in less than two months.

- The dollar was scorned, gold doubled in price, and global currency trading was frequently shut down.

- An oil embargo skyrocketed gasoline prices, producing shortages, long gas lines and even public panic.

At the time many really believed the end of Western Civilization was near. The OPEC nations seemed destined to control most of the world's wealth.

- ***From the third quarter of 1974 (the depths of the 1974 "this time it's different crisis"), the S&P 500 produced a ten year total return of 325%.***

1937-1942… Losing WWII And The Fear Of A U.S. Invasion

In the summer of 1937, Japan invaded China and later that year Japanese bombers sunk a U.S. gun-boat in Chinese waters. In the spring of 1938, Hitler invaded Austria. By the fall of 1939, World War II was underway and by June 1940, the Nazis had conquered all of Western Europe, with the U.S. still not declaring war against Germany, Japan, and Italy until December 1941 (Pearl Harbor).

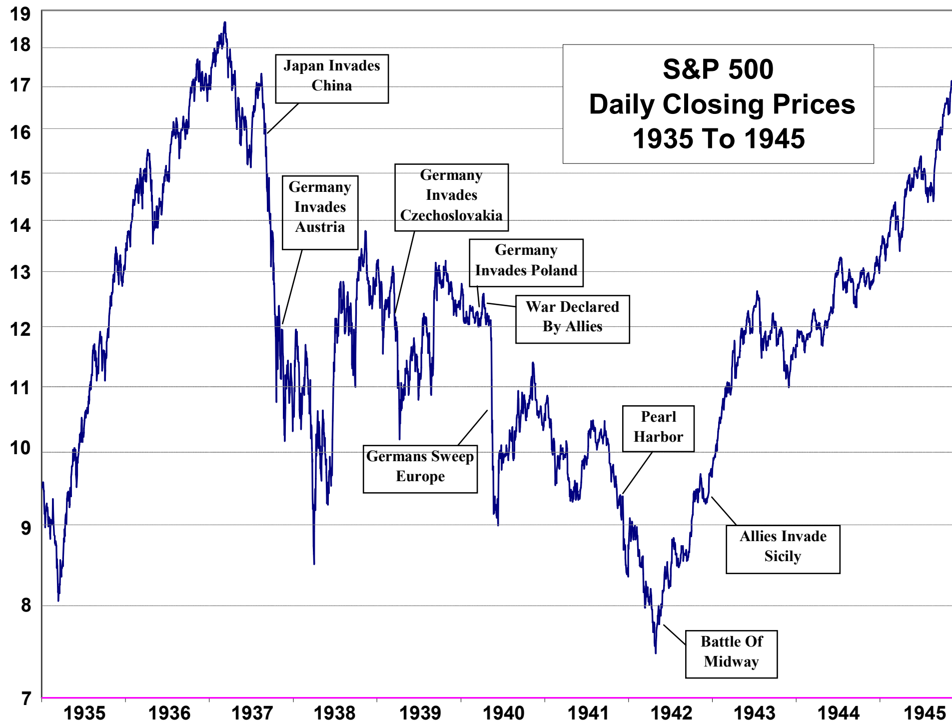
By the spring of 1942, Japanese and German victories seemed unending with their war machines viewed by most of the world as invincible. With stock markets in New York and London pounded, U.S. rail stocks sold at 1 times earnings. In the European theater, only England and parts of the Soviet Union remained unoccupied by the Axis. In the Pacific, Japan controlled and occupied Singapore, Malaysia, Burma, Hong Kong, the Philippines, Guam, and New Guinea and seemed virtually unstoppable.

The Allies were losing the War. The Germans were sinking U.S. ships all along the U.S. coast, even in New York Harbor. The U.S. was fortifying both its east and west coast, preparing for invasion. Japan was making ready to invade Hawaii, with the next stop being the U.S. west coast. London was being heavily bombed with an invasion planned but only after Germany conquered Russia… Hitler's critical mistake.

But in June 1942, the tide began to turn at the Battle of Midway, as the Americans scored their first victory, followed by a second critical victory at Guadalcanal. In early 1943, the tide began to turn in Europe as the Nazis surrendered at Stalingrad and in July 1943, the Allied troops successfully invaded Sicily.

U.S. Stock Market In War Time

From a peak in 1937 when the first hostilities began, to the low in 1942 just prior to the critical Battle of Midway, the U.S. stock market fell 60%. From the fall of 1939 when the Allies (but not the U.S.) finally declared war on the Axis, the U.S. stock market fell 44% to the lows of 1942. From December 7, 1941, when the U.S. finally did declare war, the U.S. stock market fell an additional 21% to the 1942 lows.



- ***Today's political and economic negatives are quite different than back in 1974 and 1942, but to me today's negatives seem considerably less ominous than in either period. It is time to pay heed to yet another Bob Farrell truism:***

  "HISTORY DOES NOT REPEAT ITSELF EXACTLY BUT BEHAVIOR DOES."

POSTSCRIPT TO OUR INVESTORS

Good Relative Strength. So What? …..You Can't Spend It

In 2008, the two versions of our asset allocation portfolios lost 25.7% and 29.1%, compared to the S&P 500's 37.0% total return loss. While in terms of relative performance, this was better than most, **it fell far short of our firm's investment management objective of "making it and keeping it"**.

So far in 2009, through March 6, our two large asset allocation mutual funds are down 12.9% and 14.1%, much less than the 24.3% S&P 500 loss, but again good relative performance in a down market is not our objective.

- **In the real world, good relative performance in a down market won't even buy you a Big Mac and certainly not a more comfortable retirement**.

Suffice it to say, I am not proud of our asset allocation fund performance in the current bear market, which is now the most devastating bear market since the 1930s. However, over the past ten years, investors in our Leuthold Core Investment Fund have experienced a cumulative return of +103% in the ten years 1998 through 2008, a period when the S&P 500 lost 13% and the Lipper Flexible Fund Index was up only 6.9%. Over the last five years, our fund's 20% cumulative gain compares to the S&P 500's 10.5% loss and a 0.7% gain for the Lipper Index.

POSTSCRIPT TO OUR INVESTORS…..Continued

But That Was Yesterday, This Is Today

Still, virtually all investors who bought this fund in the last three years do now have a loss. Sure it is much less than the S&P 500; **nevertheless, a loss is a loss**. I know you expected better, and so did I. As the investment captain of the Leuthold ship, I sincerely apologize and sympathize. I also sincerely believe the stock market now provides the most attractive investment opportunity in the last quarter century… since 1982.

I certainly realize the distress and pain suffered by those within hailing distance of retirement, those who have seen 50% or more of their retirement assets washed away in a mere 14 months, those whose retirement dreams have now become nightmares. It is little solace that our asset allocation investors have lost 30%-35% compared to the 55% decline for the S&P 500. I had really believed we would have done better and so did you. In this context our superior long term record is close to meaningless. But speaking as a 47-year veteran of this rollercoaster business, I offer you this counsel:

- *If you are within hailing distance of retirement, this is a terrible time to check out of our fund or other reputable funds. Wait for about two years and I strongly believe you may recover 50% or more of your 2008-2009 losses.*

- *If you are ten years or more away from retirement, grit your teeth and increase your stock market exposure NOW! No, I am not allowed to guarantee it, but I am dead certain you will beat the heck out of the skimpy returns offered by money market funds and Treasury securities over the next two years.*

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