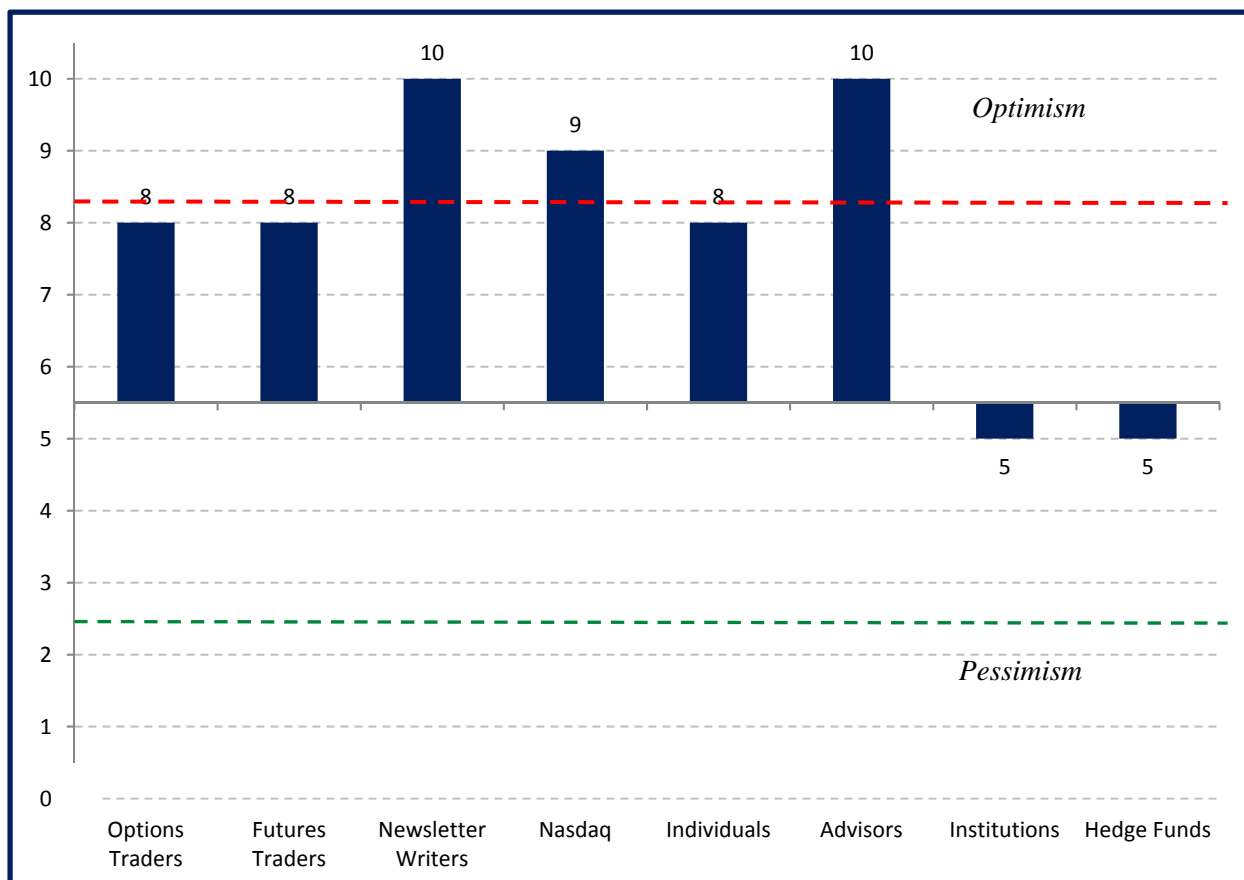


## Investing Environment Review and Outlook – Volume 18

### Sentiment vs. the Economy

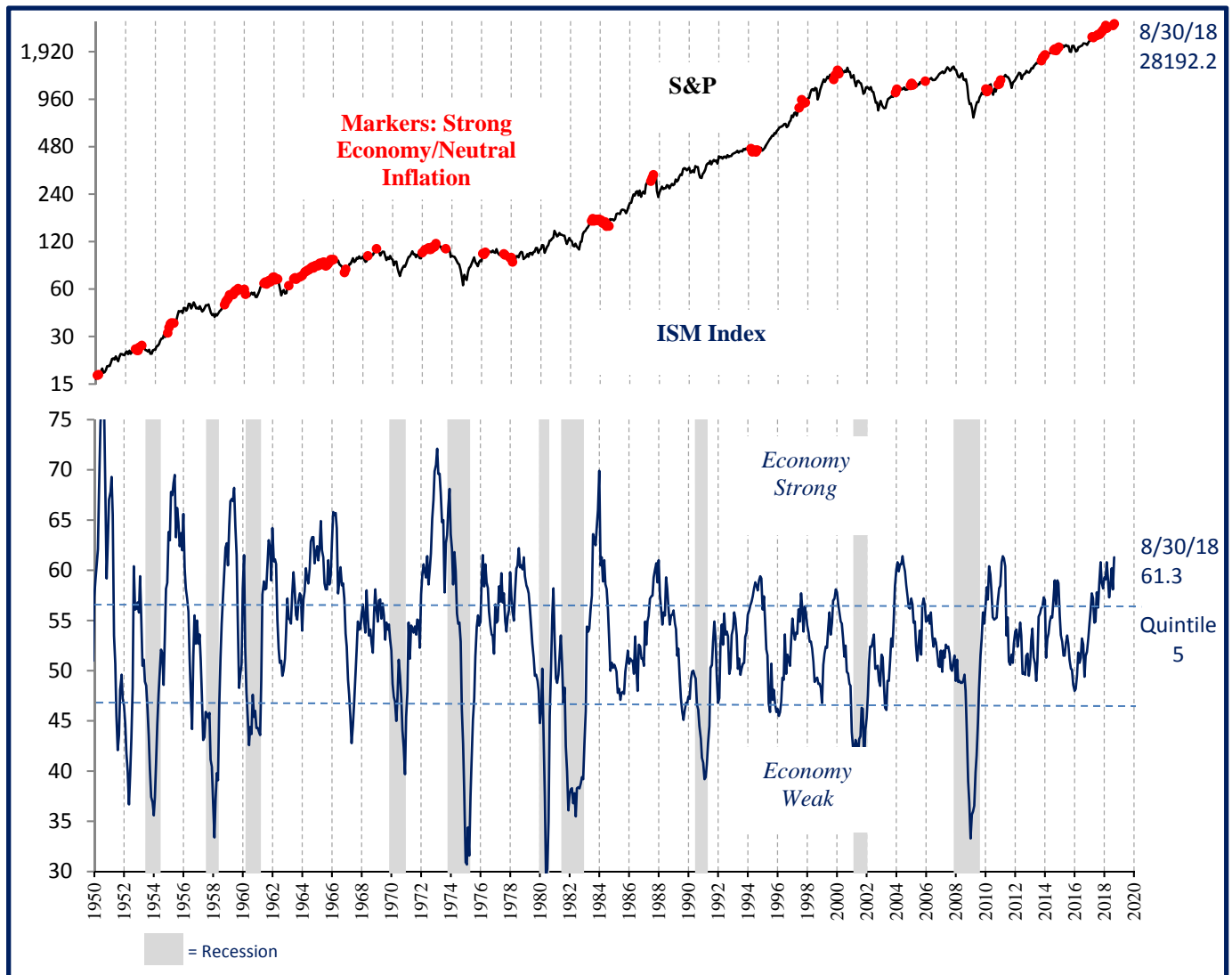
The equity rating remains a bullish 5. The biggest worry is lopsided investor positioning on the long side. Our sentiment indicators show strong optimism, to be expected after the 15% S&P 500 rally and 22% Nasdaq rally from the February low. Six of eight investor groups are optimistic (chart 1). The hold outs are hedge funds and institutions, who remain still neutral. Overall sentiment is less extreme than it was in January, but the bar is lower in August and September when seasonality is negative. For instance, in the 3 prior cases when sentiment was this strong in August or September, the S&P declined between 4-7% in each case.

**Chart 1: S&P 500 Constituent Sentiment: 6/8 Groups Optimistic on 9/5/18**



Although that may mean a short-term downturn is likely, more fundamental longer-term indicators are positive for equities. The ISM manufacturing index is the best coincident economic indicator, and for August it was quite strong at 61.3, in the top 1% since 1990 (chart 2). In addition, the prices paid component, a proxy for inflationary pressures, was down to a neutral reading. This is significant because since 1950, the S&P 500 returned a consistent 16.9% annualized with the current combination of strong economy and neutral ISM inflation component.

**Chart 2: ISM Manufacturing Index: Strong Economy + Neutral Inflation = Bullish**



We watch inflation very closely, because it is the biggest threat to this bull market. The recent decline in emerging market stocks and currencies has led to worries over contagion, but may, in fact, extend the economic cycle by delaying inflation. Commodities like copper are already down 20%, and in the two comparable cases (Mexico devaluation in 1994 and the Asian Currency Crisis in 1997), the U.S. economy slowed and bond yields fell in the following year, in 1995 and 1998.

Our ratings on long-term bonds, commodities and gold also remain unchanged. We are watching for a reversal in the strong dollar which could signal a resumption of the commodity bull market and higher inflation.



**Michael Schaus**  
Director of Market Research



September 10, 2018

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