BRENTON POINT
WEALTH ADVISORS

February 17, 2021

Investing Environment Review and Outlook – Volume 45

There are anecdotal signs of speculation: Bitcoin's popularity, the surge in IPOs, the proliferation of SPACs, high call option volume, and the Gamestop short squeeze. These have drawn comparisons to 1999-- before the dotcom bubble burst. This month we discuss the implications of extreme investor positioning, the uptick in our inflation outlook indicators for the first time in 3 years, and the recent NYSE breadth thrust equity signal. Overall, indicators are bullish, giving us confidence that the bull market remains intact. However, we cut our U.S. equities rating from a max bullish 5 rating to a bullish 4 rating based on the extreme investor positioning. Foreign developed and emerging markets equities remain at a bullish 5 rating along with gold and commodities. Long-term bonds remain a cautious 1 rating, with the likelihood of higher interest rates hurting long-term bond prices.

Inflation Outlook Uptick: Negative for Long-Term Bonds/Positive for Equities

Inflation indicators ticked up to 77.8 this month, indicating higher inflation ahead for only the fifth time in the last 30 years. These indicators are designed to predict the direction, rather than the level, of inflation. Pressure is coming from the monthly ISM Manufacturing Prices Paid Index in the 96th percentile for January, the Dollar Index down 10% from its high, and strong coincident economic indicators like the Philadelphia Fed Index. Crude oil and agricultural commodity prices are up as well. Higher inflation outlooks in 1955 and 1966 might be comparable to this year, since inflation was below 2% in each case, before rising to 3-5%. The ultimate inflation peak depends on how long the indicators remain elevated and whether the Fed allows higher inflation, as they have promised. The post-vaccine demand surge could be transitory. Investors have learned to expect this pattern, as we saw in the 2010 and 2018 cases, when CPI rose, but only briefly, before rolling over.

More important than predicting the inflation peak is determining the implications for investors today. Tests show a higher inflation outlook combined with a strong economic outlook was negative for long-term bonds, as you would expect, with a -14.1% return annualized while conditions held. However, S&P 500 returns were strong, at +27.8% annualized, almost 3x the norm, when the inflation outlook was up and the Fed was loose. This compares to just a +5.2% return when the Fed was hiking interest rates. The level of inflation was also significant. The S&P 500 returned 18.6% when the inflation outlook was up and CPI was under 2% as it is today vs. just 0.7% return for the S&P 500 when CPI was over 4%. Historically, bond prices moved in anticipation of inflation, while stock returns remained positive, at least until inflation showed up and a Fed policy change was anticipated.

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Chart 1: Inflation Outlook Higher: 1950 - 2021

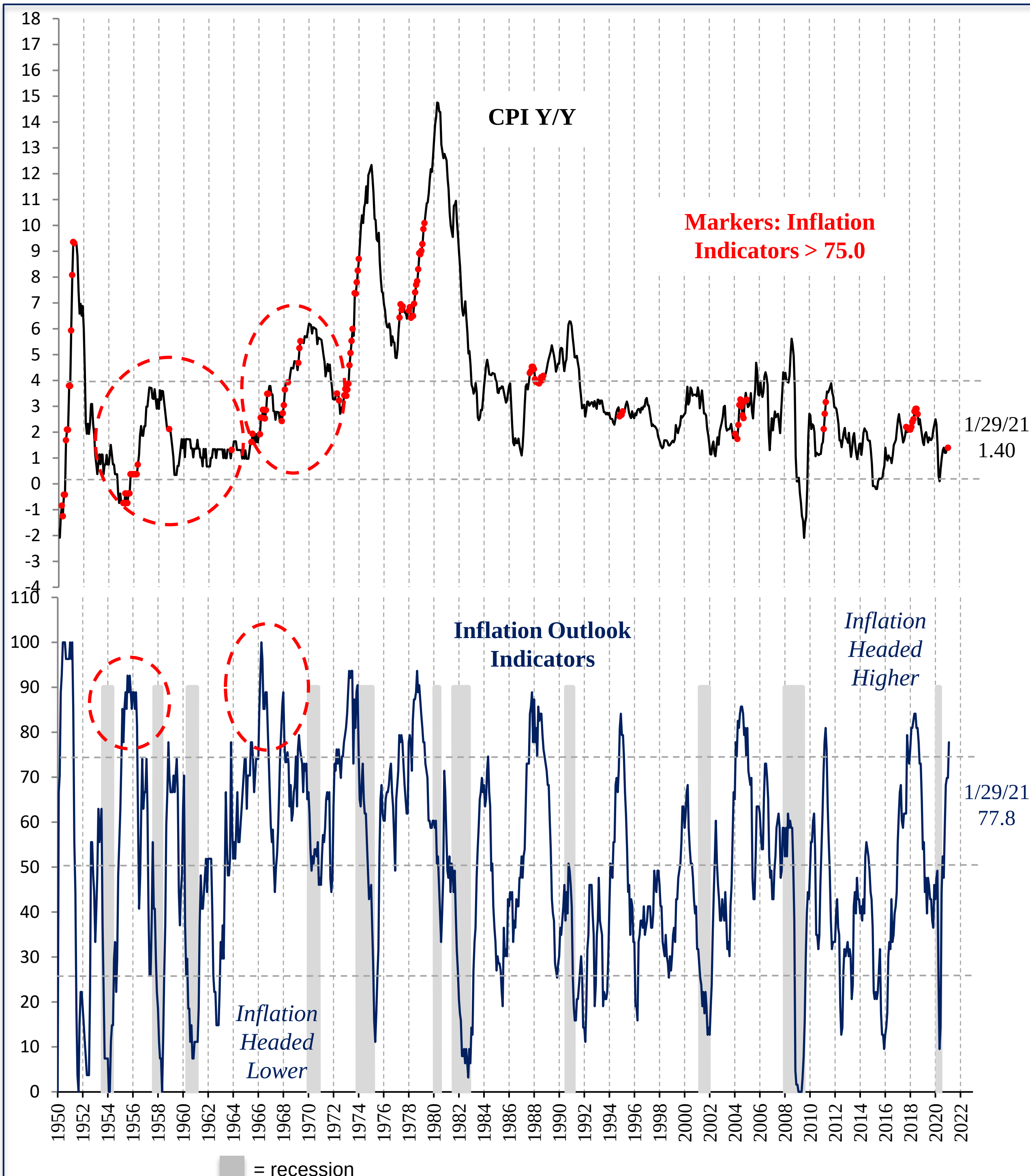

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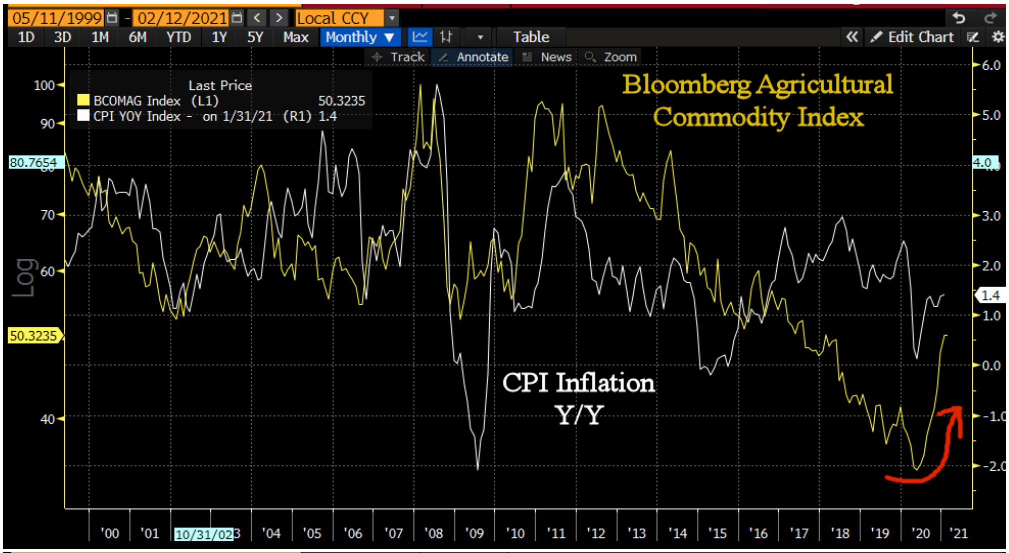
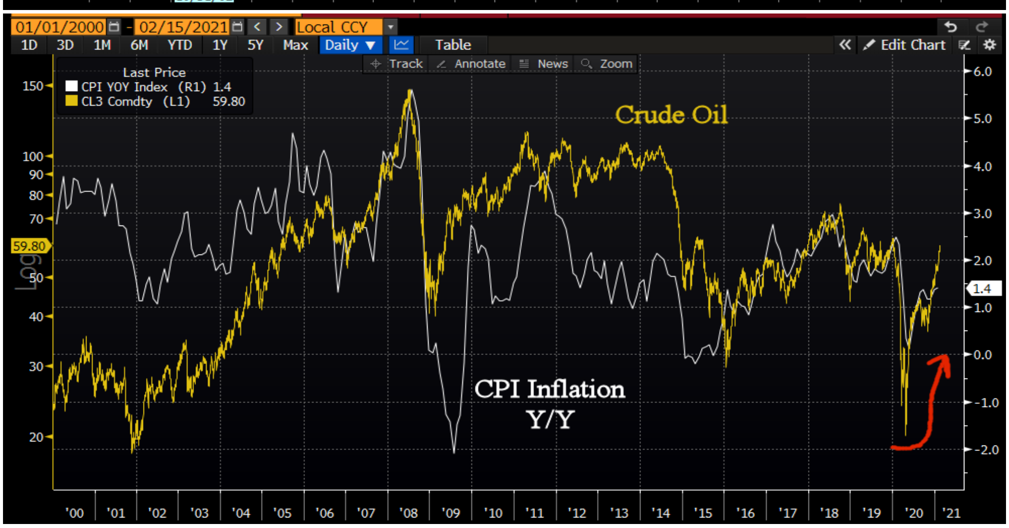
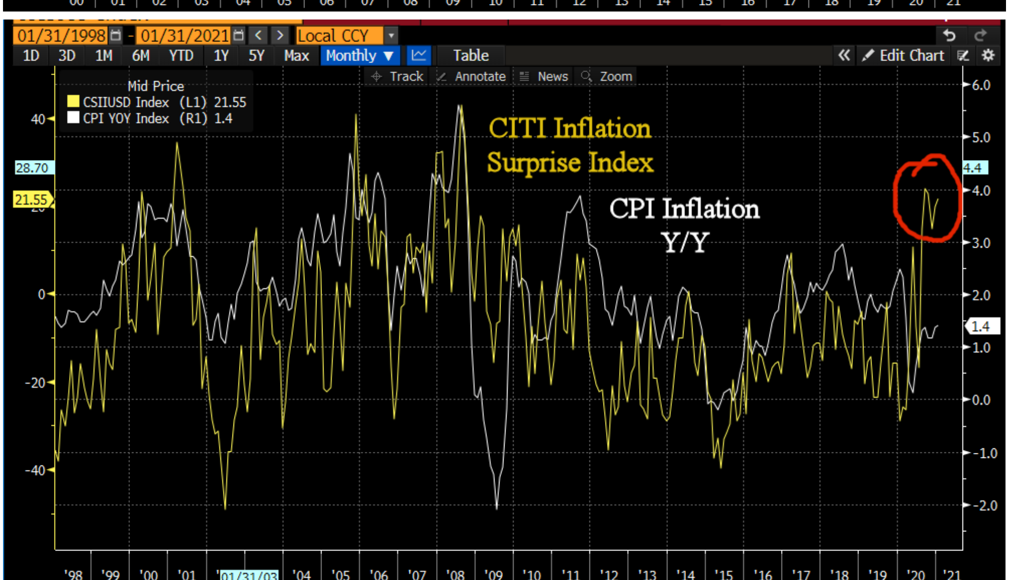
Chart 2: Inflation Indicators







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NYSE Breadth Thrust: Bullish for Equities

On February 12th, the 10-day NYSE Advance/Decline ratio reached 65%. This means that on average, NYSE advancing stocks were stronger than declining ones for 2 weeks, reaching the 99th percentile of historical readings, with just 27 prior cases in the last 60 years. This is a version of what Marty Zweig called a breadth thrust, and the implications are bullish for equities. For instance, 1 month out the S&P 500 returned an average of +3.9%, with 89% of cases higher, over 4x the norm. 3 months out the average return was +7.2% and 6 months out it was +14.6%. Finally, the next 10% move was higher in all but one case, giving us confidence the bull market remains intact.

S&P 500 Returns after Breath Thrust Signal

		S&P 500	Returns		
	Date	1M Later	3M Later	6M Later	Next 10%
1	07/10/62	0.78	0.99	14.97	UP
2	08/22/62	-3.21	2.65	12.06	UP
3	11/07/62	7.73	14.06	21.24	UP
4	01/16/67	5.00	8.93	11.83	UP
5	08/31/70	3.64	7.99	21.15	UP
6	12/03/70	2.84	12.27	15.83	UP
7	12/08/71	7.04	13.28	12.72	UP
8	09/27/73	2.16	-9.83	-12.32	DOWN
9	01/08/75	12.74	19.67	38.38	UP
10	01/06/76	7.69	10.33	13.14	UP
11	08/23/82	7.32	17.24	30.88	UP
12	10/13/82	2.53	8.70	17.54	UP
13	01/21/85	3.79	4.26	13.34	UP
14	01/14/87	6.78	9.13	19.98	UP
15	02/04/91	8.40	9.99	12.33	UP
16	01/06/92	-0.80	-2.26	0.51	UP
17	06/05/03	1.57	3.61	8.17	UP
18	03/23/09	2.68	9.18	30.85	UP
19	07/22/09	7.80	13.93	20.52	UP
20	09/16/09	1.91	4.31	10.24	UP
21	11/30/12	0.91	7.83	16.43	UP
22	02/18/14	1.88	3.12	9.04	UP
23	10/12/15	3.04	-4.12	2.36	UP
24	02/26/16	4.73	8.35	12.53	UP
25	07/12/16	1.74	-0.07	6.86	UP
26	01/09/19	4.91	12.32	16.97	UP
27	06/05/20	-0.31	7.76	16.80	UP
28	02/12/21				
	Average	3.90	7.17	14.61	
	% UP	88.9	85.2	96.3	96.3
	Norm	0.88	2.64	5.28	

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Investor Positioning More Extreme: Negative

Since January, equity investor positioning extended further, with 7 of 10 investor groups extremely long.   Positioning by itself is rarely a catalyst for a market turn, but it does raise the risk of a reversal, and more so in Q1 than Q4. For instance, since 2010 the S&P 500 returned just +1.2% annualized in Q1 with this kind of optimism vs. +18.9% in Q4.   In the three prior cases with positioning this long in Q1, the S&P 500 declined between 5-10% (2011, 2014 and 2018). Those peaks occurred between January 15th and February 21st, around this time of the year. To recognize the risk of lower returns and a possible reversal, we cut the U.S. equity rating to a bullish 4 rating from a max bullish 5 rating.

Chart 3: Investor Positioning Long Equities
7 of 10 Extreme Optimism

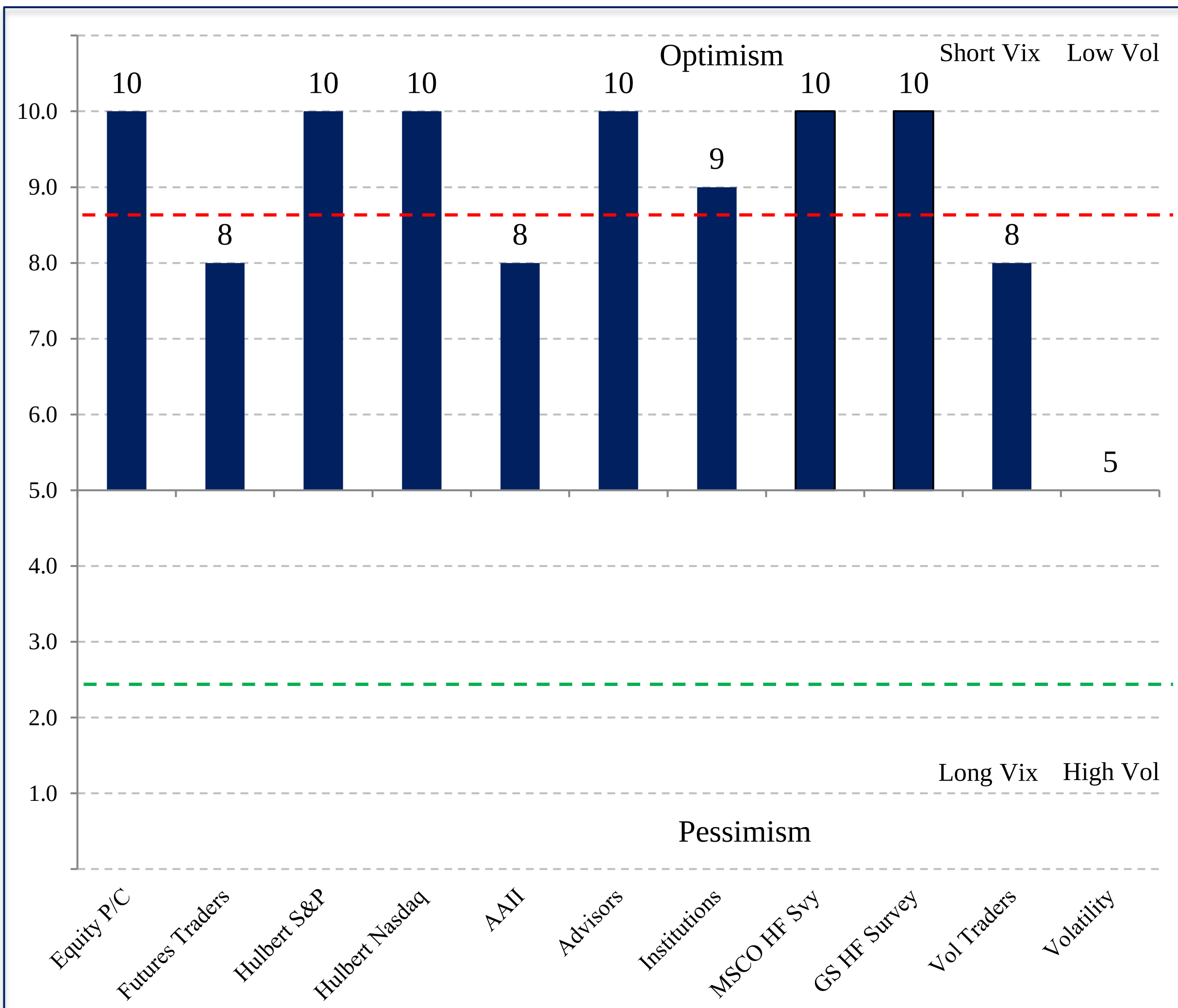

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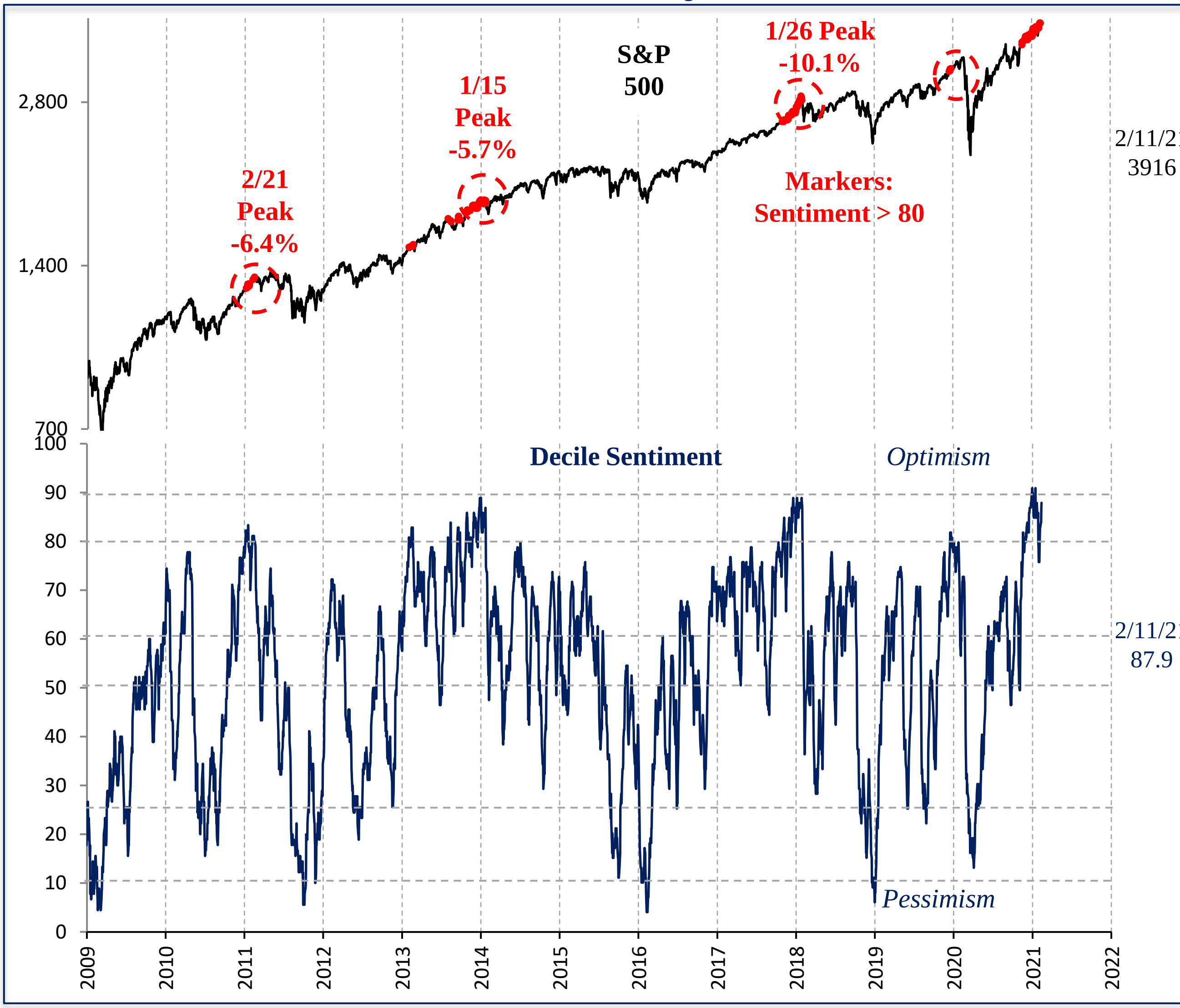
Chart 4: Investor Positioning Extremes: 2009 -



Summary

Despite anecdotal signs of speculation with comparisons to 1999, conditions remain bullish for equities--particularly the strong economic outlook, positive tape signals, and the loose Federal Reserve. The uptick in the inflation outlook indicators is a natural part of the economic cycle, which for now is negative for bonds and still positive for stocks. The extreme investor positioning is a rough tool, but a good reminder to expect a 3-8% decline at any time. We will continue monitoring and testing economic and market conditions daily. Thank you for your support, and please contact your advisor with any questions.

Michael Schaus
Director of Market Research

February 17, 2021

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