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WEALTH ADVISORS

June 10, 2021

# Investing Environment Review and Outlook – Volume 49

After the unprecedented COVID market crash in 2020, by mid-year conditions (including a strong economic outlook, low inflation, a loose Fed, and skeptical investors) were ideal for U.S. stocks. However, the subsequent economic rebound and 40% S&P 500 rally since last June has cut the future expected return. The most obvious changes are investor positioning (short to long) and inflation (low to high). While most investors debate the case for cyclical vs. technology stocks, the bigger opportunity may be in mostly overlooked foreign equities. This month we discuss the inflection point for foreign equities, the elevated inflation data, and the extreme investor positioning. Asset ratings are unchanged this month. U.S. equities remain a bullish 4. Foreign-developed and emerging markets remain a bullish 5, along with gold and commodities. Long-term bonds remain a cautious 1 rating.

## Inflection Point for Foreign Equities

For 13 years, the S&P 500 has dominated world equity returns. However, we believe foreign equity markets are likely entering a period of outperformance. Consider that since January 2008, the S&P 500 Index is up 186% vs. just 3.6% for the EAFE Index (which measures developed equity markets in Europe, Asia and the Far East). Even emerging markets stocks are just coming out of a 12-year period of underperformance. There are certainly good reasons for the divergence, including superior fundamentals in the U.S. like sales and earnings growth. However, the strong dollar, up 42% over that period, also played an important role. Dollar moves are inversely correlated to foreign equity's relative performance. Today we have an inflection point catalyst in a weak dollar. From the 2020 peak, the Dollar Index is down over 10%, a move logical and consistent with prior quantitative easing periods when the supply of dollars was also increased. In addition, the Eurozone economy is surging, challenging the consensus narrative that Europe is perennially weak. With more dollars in circulation, higher U.S. inflation, and no indication yet of tighter monetary policy, a big downside move in the dollar could be one of the biggest risks for investors. Between 2002 and 2008 the dollar declined 40%, a move few could contemplate today, and one that would likely coincide with a resurgence in foreign equities relative to the U.S.

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## After 13 Years Dollar Turn Catalyst for Foreign Equities

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## Fed Quantitative Easing Bearish for Dollar

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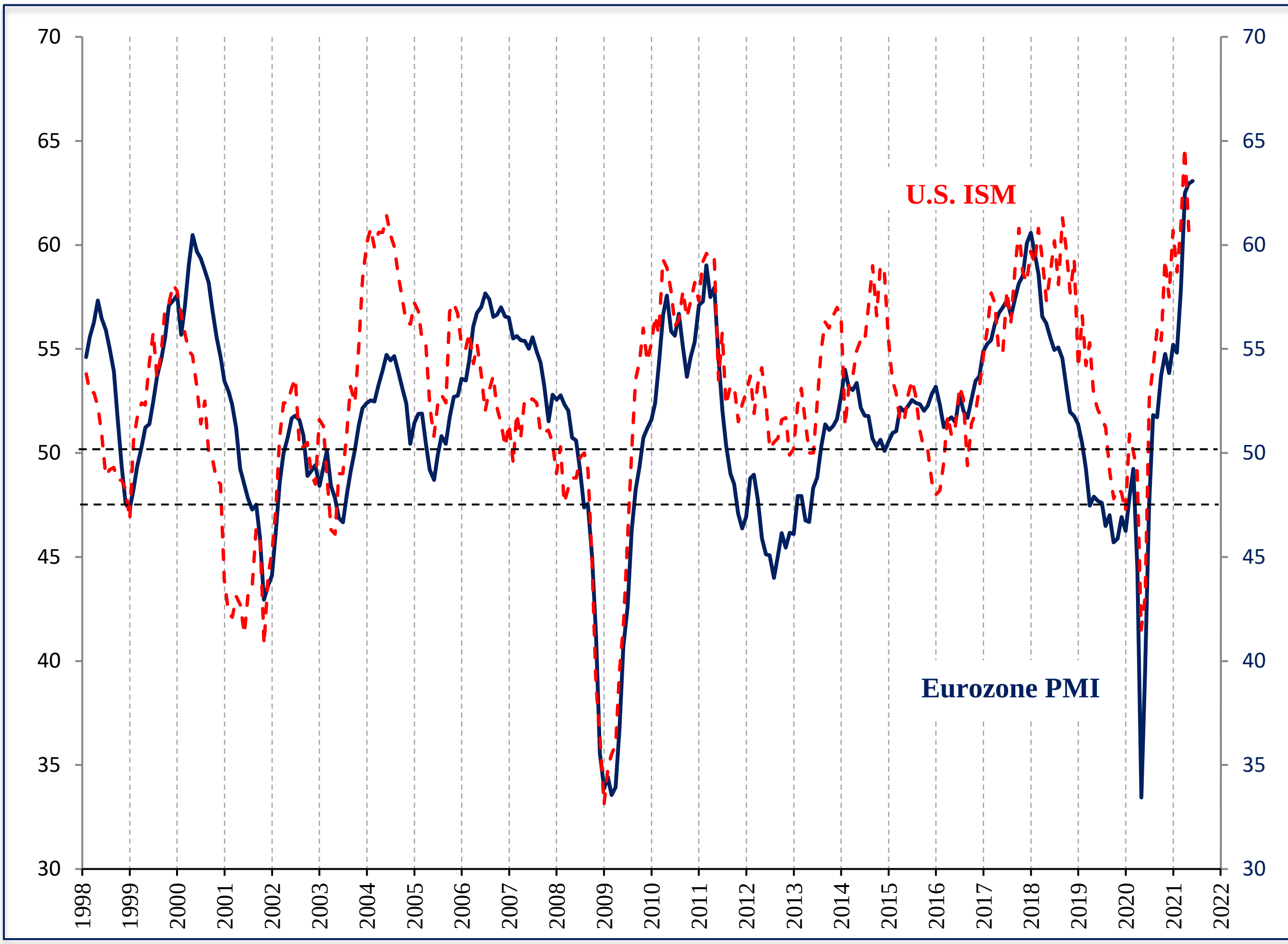
Eurozone PMI Record High
Stronger than U.S.



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## Emerging Markets Stocks Consolidated for 12 Years

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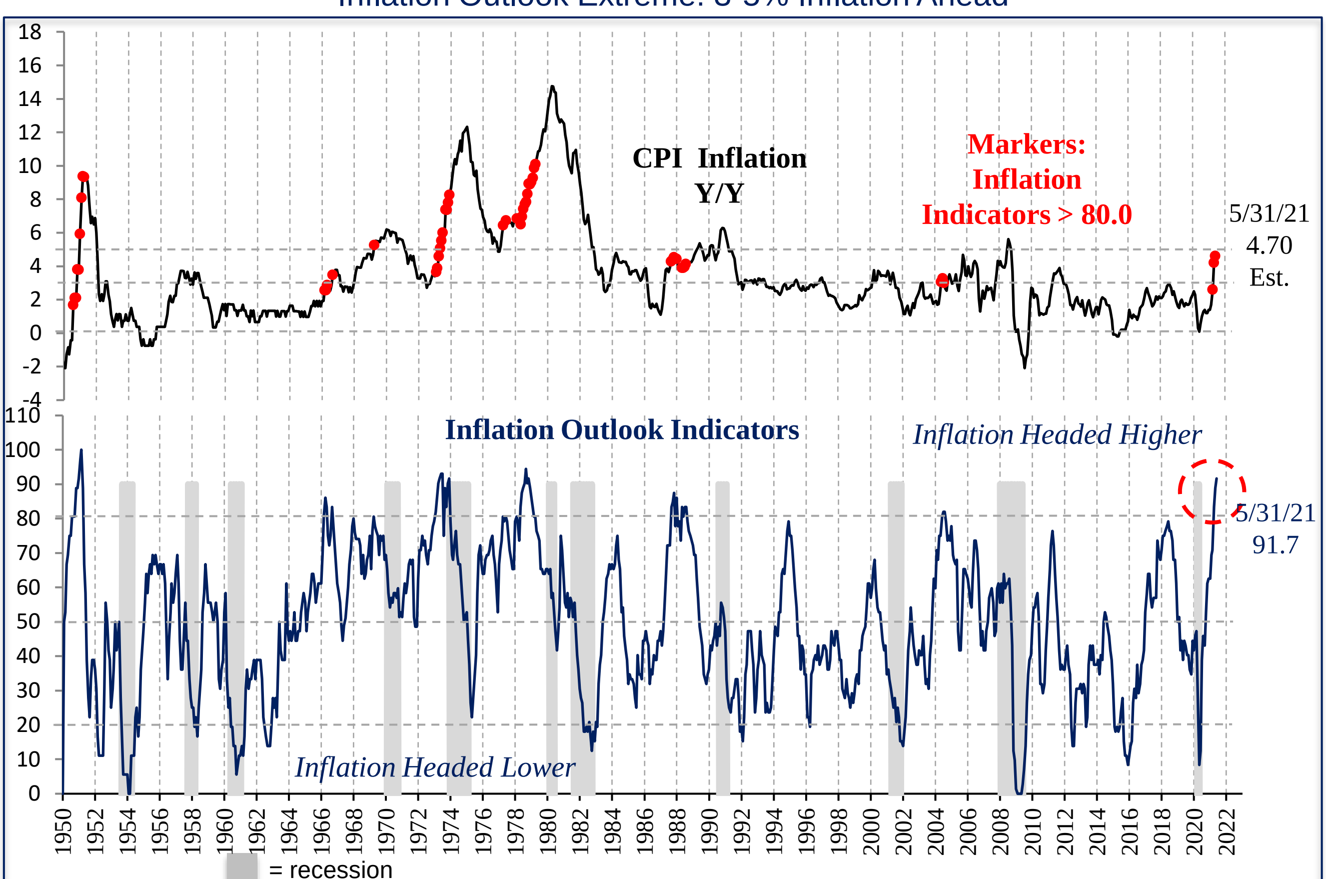
## Inflation Outlook Indicators Extreme

Inflation outlook indicators reached 91.7 for May, the highest reading since 1979. This is a simple, yet effective model designed to predict the next move in CPI inflation using leading indicators like economic activity, commodities, price indices, and the dollar. In the 6 prior readings over 80 since 1950, CPI continued higher in every case. There is no prediction on magnitude, but while these indicators are up, CPI is likely to continue higher. This has been the case since we wrote about it in February when CPI was just 1.7% vs. 4.2% in April and 4.7% expected for May. The Fed and most investors expect a reversion lower after the COVID economy reopening. Last week, Treasury Secretary (and former Fed Chairman) Janet Yellen conceded that inflation readings would likely stay elevated at least through the end of this year, which begs the question of when we will know which path is correct – reversion back to 2% or sustained higher readings. The Citi Inflation Surprise Index reached a record 70.7 in May, indicating data is surprising analysts to the upside despite the constant media attention on inflation. Food prices are up 40% Y/Y, adding to the upside pressure (although both of these are just coincident, not leading, indicators). The implications of further upside in inflation are bullish for commodities and equities, but negative for long-term bonds. Higher inflation without the Fed hiking rates means real rates (rates less inflation) are more negative and stimulative for the economy. Inflation outlook indicators will be our best guide, but either way the Fed will hike rates eventually--it is just a matter of time.

Inflation Outlook Extreme: 3-5% Inflation Ahead



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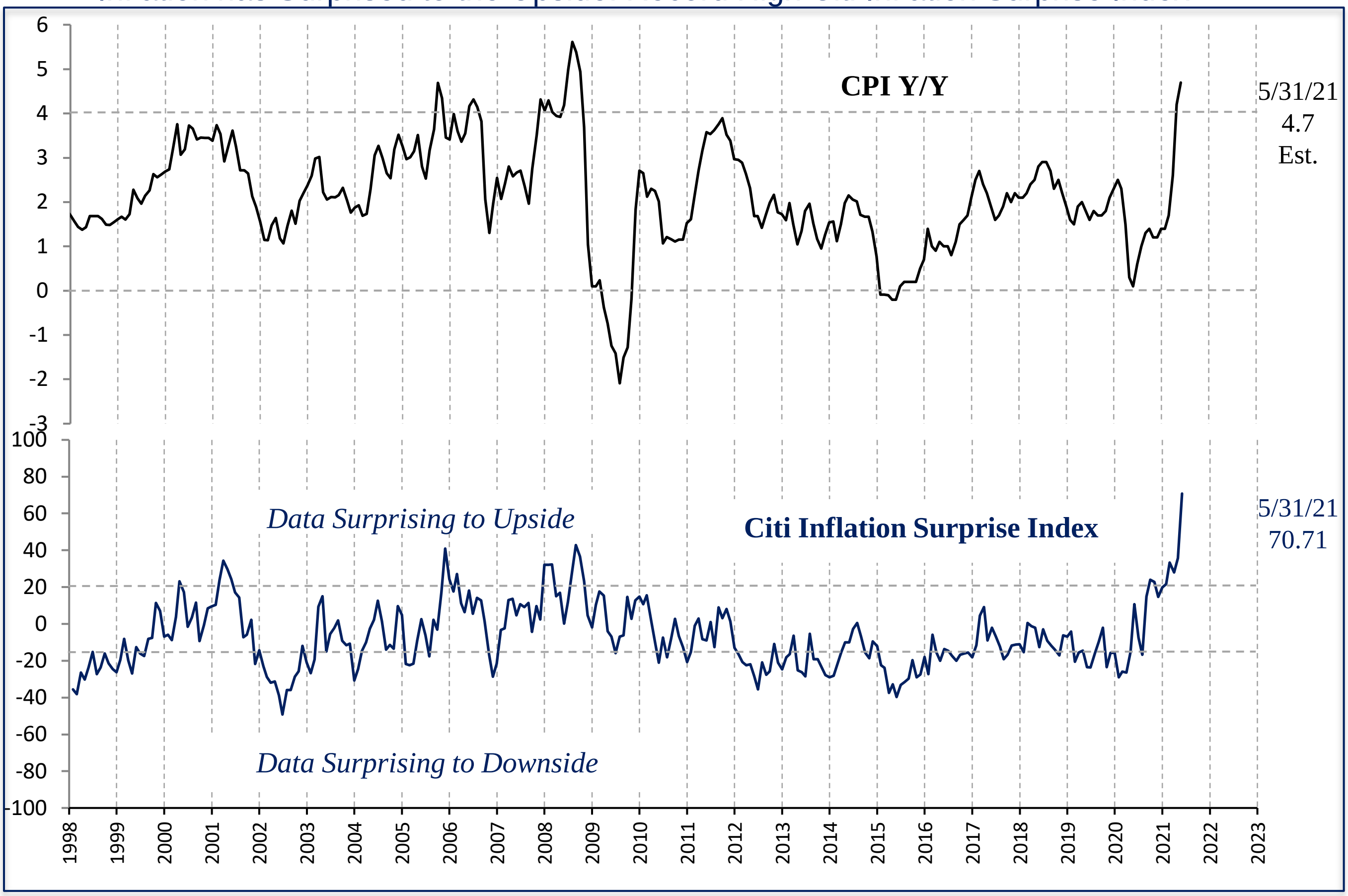
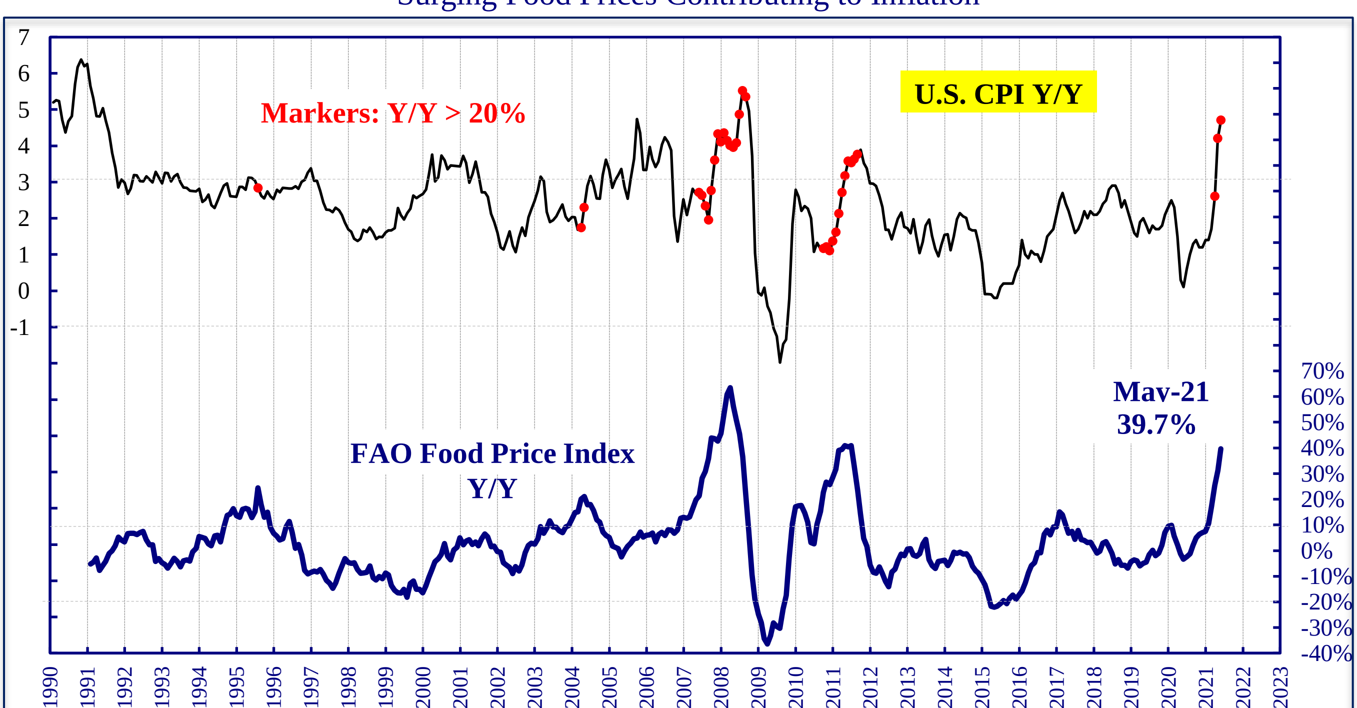
## Inflation has Surprised to the Upside: Record High Citi Inflation Surprise Index




## Surging Food Prices Contributing to Inflation



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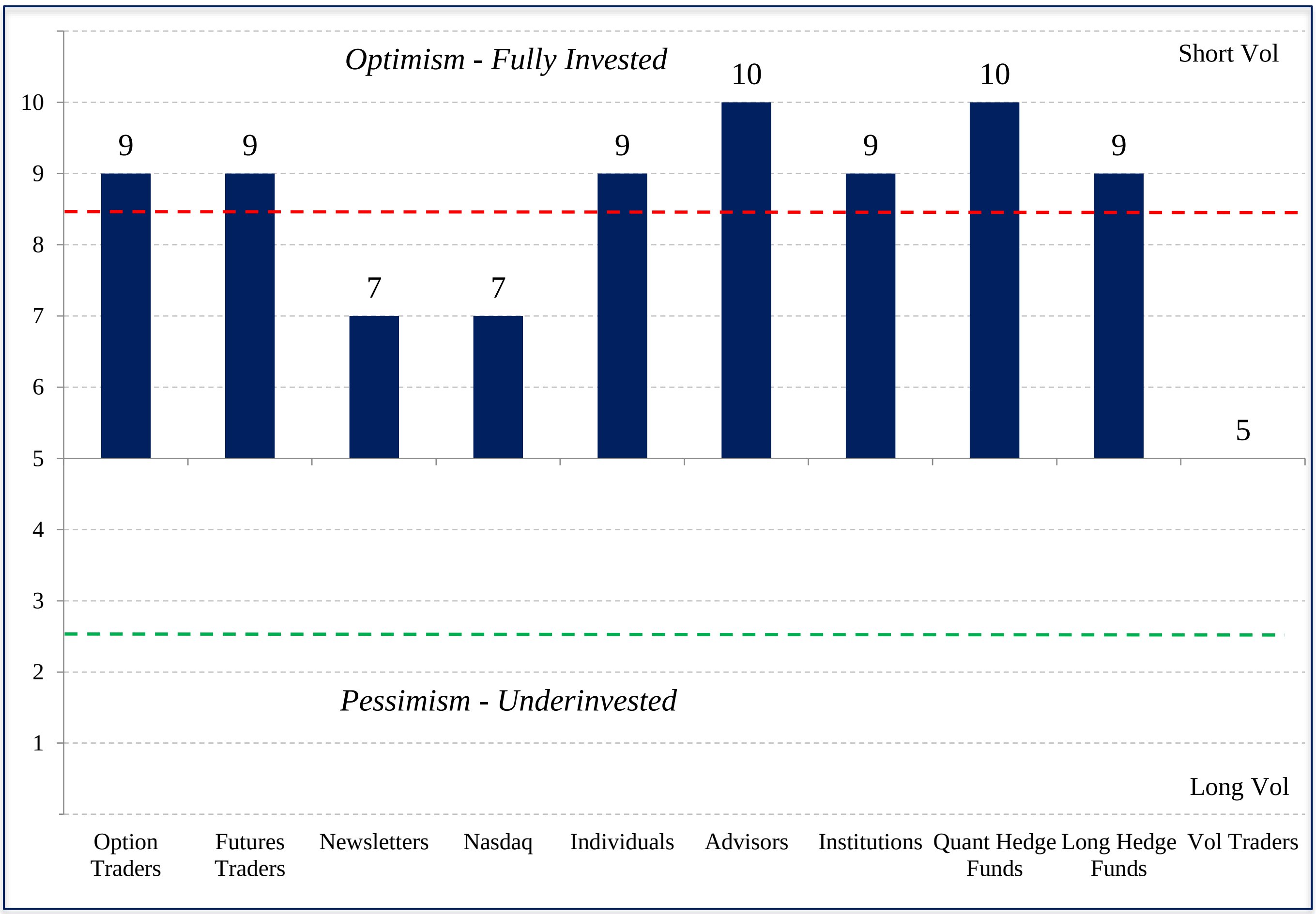
## Investor Positioning Extreme

Equity investor positioning remains extreme, with 7 of 10 groups in the top quintile. Historically, this level of investor enthusiasm translated into lower returns ahead during this period of the year, since it means less cash on the sidelines to fuel stocks higher. In the 3 prior cases since 2010, the S&P 500 declined 5-16% over the following 3 months, resulting in more neutral positioning before the next move higher.

Equity Investor Positioning Extreme
7 of 10 Groups Extreme



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## Investor Positioning Extreme: 3 Comps in April/May followed by 6-15% Declines

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**Summary**

Although the bullish U.S. equity conditions have deteriorated, foreign equities have reached a relative return inflection point. The Dollar Index is already down 10% from the 2020 peak and the outlook remains negative while the Fed is the most dovish central bank in the world. A further decline in the dollar will favor foreign equities over U.S. equities for the first time in 13 years, particularly as foreign economies gain momentum. The negative seasonal period of the year combined with extreme investor positioning is good reason to expect more mixed S&P 500 returns ahead as recent stock market gains are consolidated. We will continue questioning assumptions and watching our indicators every day. Thank you for your support and please contact your advisor with any questions.

**Michael Schaus**
Director of Market Research