BRENTON POINT
WEALTH ADVISORS

October 13, 2021

Investing Environment Review and Outlook – Volume 53

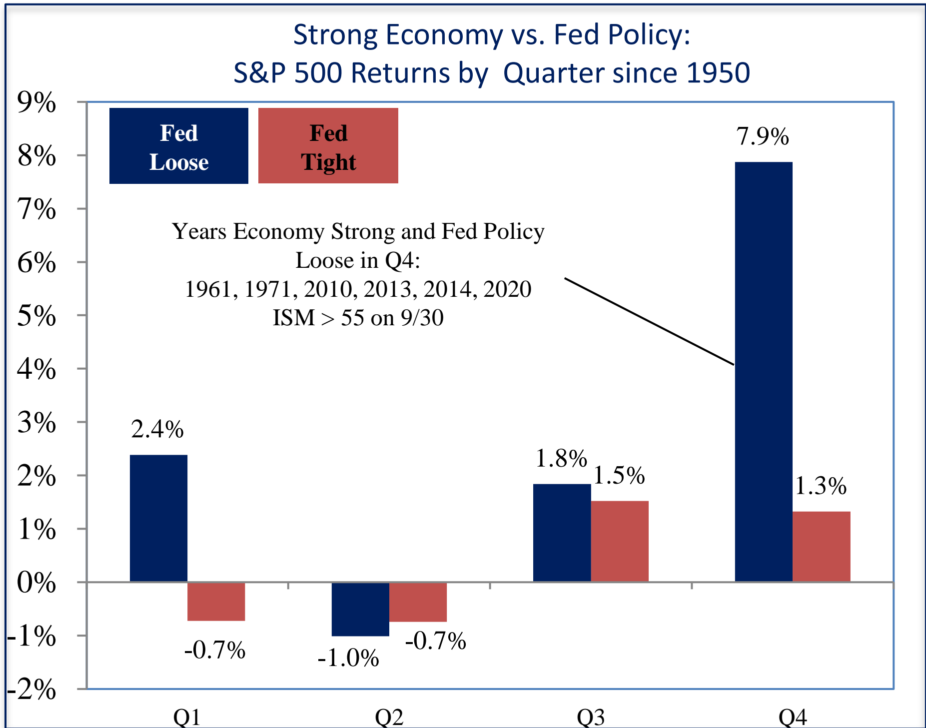
Equities Ratings Uptick

Last month we discussed the synchronized global economic slowdown, and the mixed implications for equities in particular, with a 5-10% potential decline before November. In September, the S&P 500 declined 5.1% from the peak. Today the world economy remains mixed with 67% of foreign economies weaker in September than August. This month we discuss the economy, the Federal Reserve, seasonality, inflation and market action to explain why we shifted equities and bond ratings.

This month we raised U.S. equities to a bullish 5 rating from a moderate 3 rating since July. Additionally, we raised Foreign Developed equities to a bullish 5 rating. Emerging Markets remain a bullish 4. We cut bonds to a cautious 2 rating. Commodities remain a neutral 3 and gold remains a bullish 5.

Strong Economy + Loose Fed + Q4: Bullish

Despite the mixed world economy, the uptick in the September ISM release showed the U.S. economy is quite strong at 61.1, in the 99th percentile of readings since 1990. Historically, stocks returned 21% when the economy was this strong and the Federal Reserve was loose, one of the most fundamental and consistently bullish set of conditions for stocks back to 1950.



Today we have an additional strong tendency of positive equity returns during the fourth quarter from October to December. Since 1950 there were 6 comparable years (1961, 1971, 2010, 2013, 2014 and 2020). Q4 was up in all 6 of those years an average of 7.9%. Cases of Q3 with similar conditions were positive but returned a lower 1.8% on average.

This review and outlook report by Brenton Point Wealth Advisors LLC represents our views and beliefs regarding the current market outlook. Please also read the important disclosures at the end of this report.

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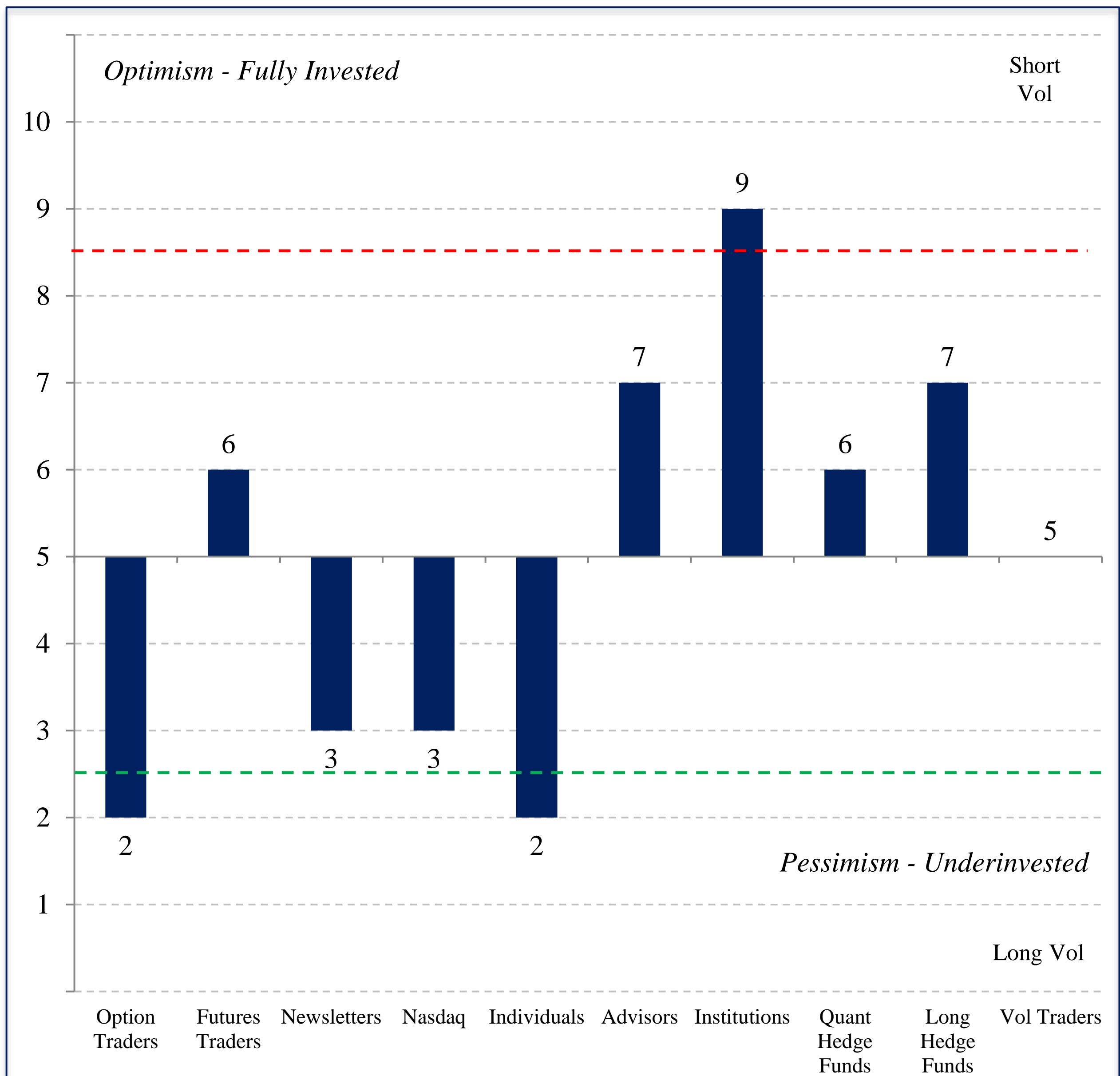
September Decline Reversed Investor Positioning: Bullish for Equities

The 4.7% decline in the month of September was effective in dampening the extreme investor positioning from July and August that made us more cautious. For instance half of the 10 investor groups we follow are now below their norm, indicating cash available on the sidelines to drive equities higher. There was no shortage of negative headlines recently to make investors nervous, but September's decline was bullish historically. In the 10 prior years since 1970 when September was down and the Fed was loose, the S&P was up 3 months out an average of 7.7%, 3x the norm.

Equity Investor Positioning Neutral After September Decline



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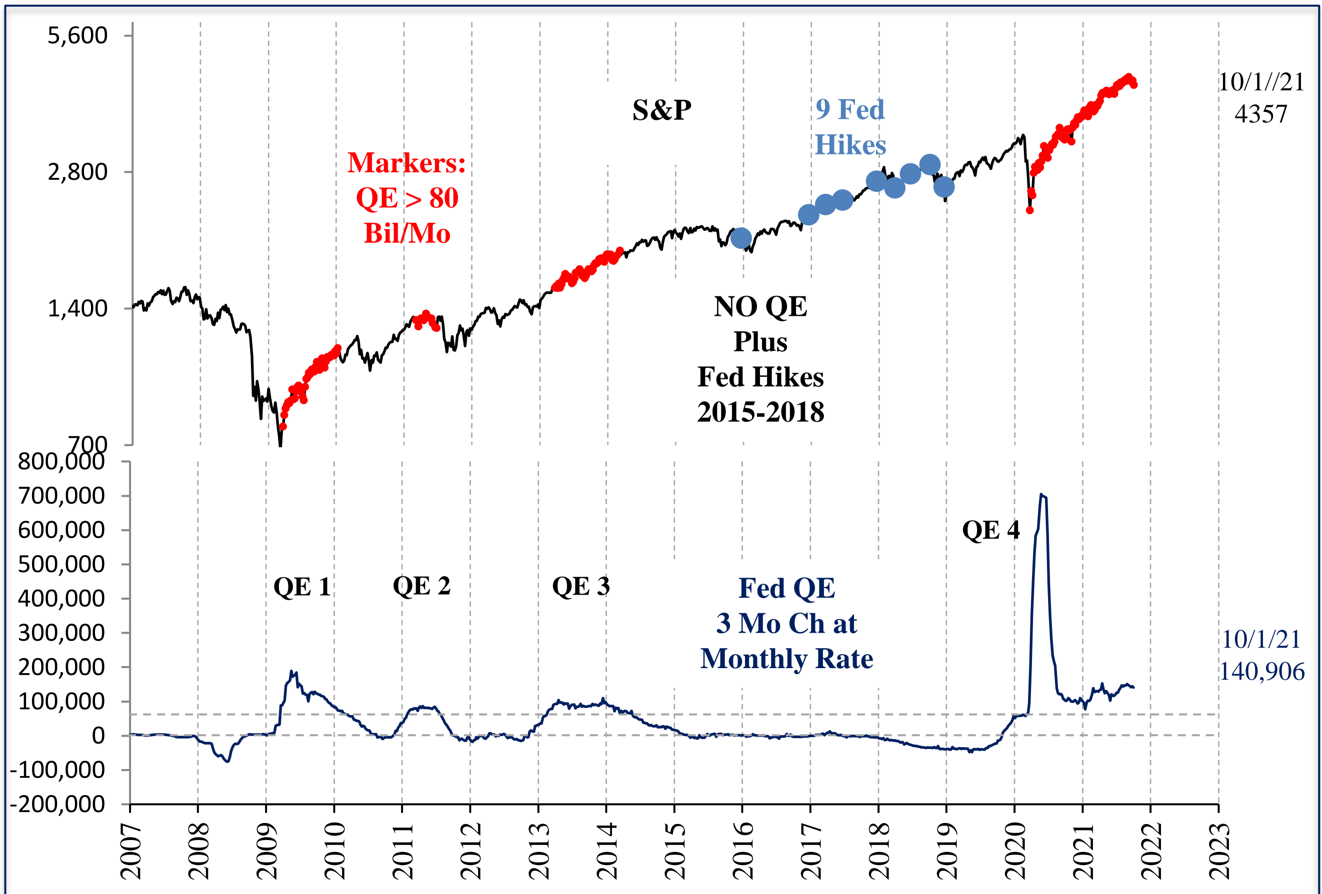
Tapering is NOT Tightening

After months of speculation, at last month's FOMC meeting the Fed signaled they will begin tapering QE in November, meaning they will decrease the amount of bonds they purchase each month from the current rate of $120 billion. The September equity decline resulted in more negative predictions in the media as usual, with some concluding that tapering is in fact tightening and, therefore, bearish for equities.

However, the record shows quite the opposite. Since 2010 the S&P 500 returned 44% annualized, or 3x the norm, when the QE rate was over 80 billion per month and falling. The fact is we already saw a tapering of the initial COVID QE in May 2020 from $800 billion a month to $120 billion since then with no downside effect on equity returns.

Even if we assume it is, in fact, a Fed tightening, the implications are more positive for equities than investors might expect. People forget not only that the Fed hiked 9 times to 2.5% from 2015 to 2018, but the S&P 500 rallied 29.7% between the first and last hike. The pattern is surprisingly similar in prior cycles as well. The S&P 500 rallied an average of 7.4% 3 months prior to the 15 initial hikes since 1946 and another 3.9% 3 months later. All but one was higher a year later, an average of 11.5%.

Tapering is NOT Tightening: 4 Fed QE Cycles 2010-2021



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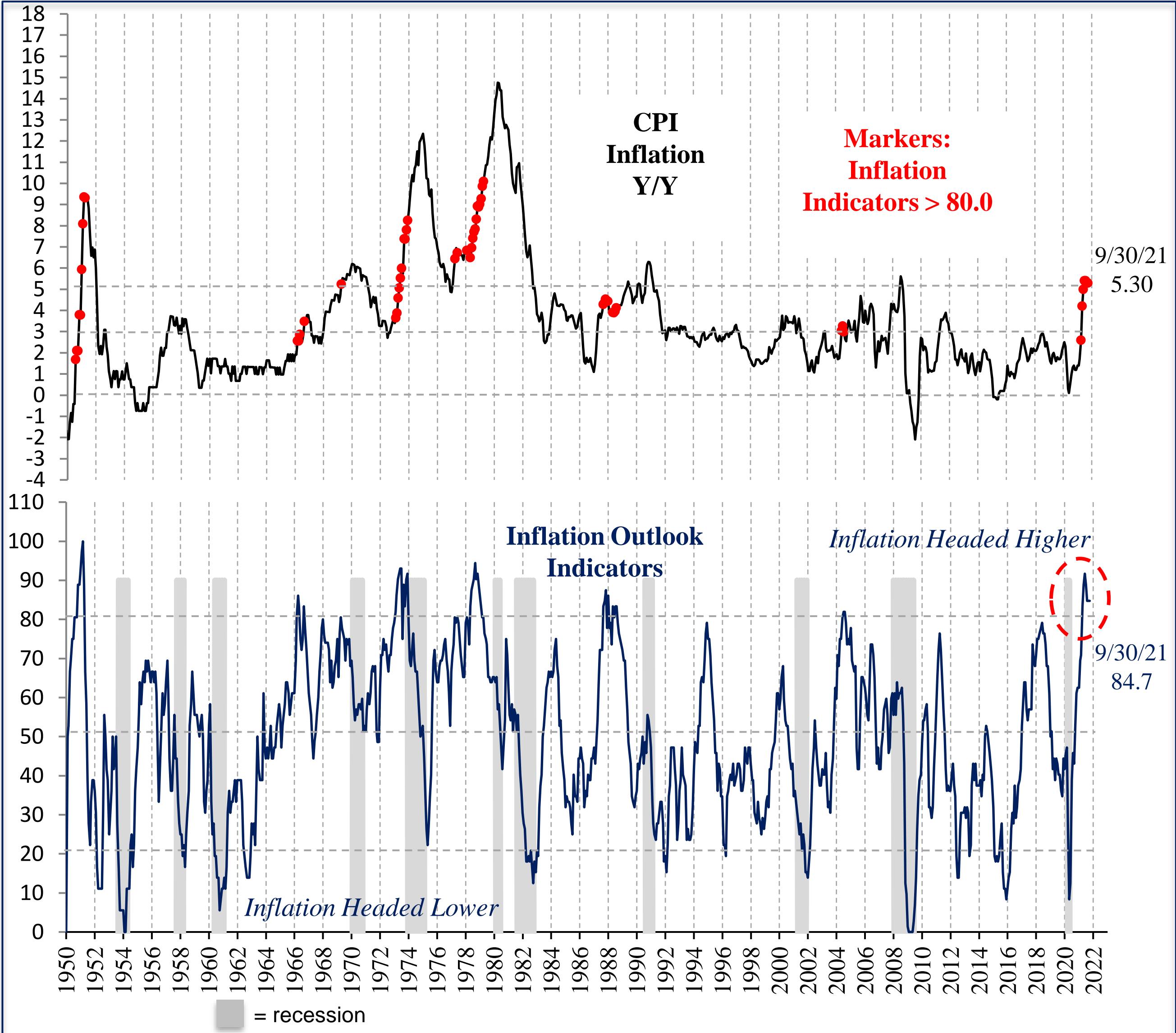
Inflation Outlook Remains Up: Higher Interest Rates Ahead

Inflation outlook indicators remained elevated in September, putting pressure on the Fed's "transitory" inflation narrative. After declining in August, delivery times reversed higher in September, suggesting supply bottlenecks are not clearing as expected. This year might be unique, but prior sharp inflation moves like 1974, 1979, 1990 and 2007 only reversed lower after a recession hit, usually caused by Fed hiking rates over the inflation rate. In contrast, today the Fed Funds rate is 5% BELOW inflation. Since August market expectations for Fed Funds are up, but still below 2%, even for 2025. We moved our bond rating to a bearish 2 because bond yields may have a long way to go on the upside, despite the neutral economic outlook. Surprisingly, a strong inflation outlook combined with a loose Fed is bullish for equities historically with a 40.6% annualized return, or 4x the norm. A tight Fed and rising inflation is a negative combination for equity returns as you might expect, and one we are watching closely.

Inflation Outlook Extreme: 3-5% Inflation Ahead



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Summary

Investment conditions today are as complex and noisy as ever. However, the combination of a strong U.S. economy, a loose Federal Reserve, and the fourth quarter of the year gives bulls the edge for upside at least through year end. The persistent inflation readings and the elevated inflation outlook mean there is more risk to the upside for interest rates, and downside for bond prices. If interest rates continue higher, eventually that will certainly present a downside risk for equities. Thank you for your support and please contact your advisor with any questions.

Michael Schaus
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