BRENTON POINT
WEALTH ADVISORS

November 12, 2021

Investing Environment Review and Outlook – Volume 54

Last month we discussed the historical bullish implications of a strong economy combined with a loose Fed in the fourth quarter. Since then, the October ISM Manufacturing index release above 60.0 demonstrated the economy remains strong. At the 11/3/21 FOMC meeting, the Fed announced the QE Taper as expected, and more importantly saw no imminent interest rate hike, thus remaining loose. Finally, the 7% S&P 500 October rally validated conditions were indeed positive for equities. This month we discuss prior cases when equities were this strong, the upside CPI inflation surprise, emerging markets' outlook, and the surprising market expectations for Fed actions 4 years out.

We raised emerging markets to a bullish 5 rating. U.S. equities, foreign developed equities and gold remain a bullish 5 rating. Long-term bonds remain a cautious 2 rating and commodities remain a neutral 3.

Strong Stock Market: Bullish through March

The S&P 500 was up 7.0% in October and 24.0% YTD, in the 89th percentile of prior years since 1945. It would be logical to conclude it was overbought and due for a correction, but prior cases demonstrate the opposite. Only 8 prior years since 1945 were up more than 24% by October. And there were only 7 prior years that were up at least 5% in October and over 10% YTD. On average those years were up an additional 3.9% through December, very close to the positive norm for the last two months and nothing unusual. However, in the November to January period, the average return was 8.5%, almost twice the average for all other years. And in the November to March period, including the whole first quarter, the average return was 12.2%, also twice the average of 6.2% for all other years, and 29.2% annualized. The worst case and only down year was 1948, declining 6% from November to March. There are always downside risks, but in addition to a strong economy and loose Fed, we can now add strong equity market momentum to the bullish case.

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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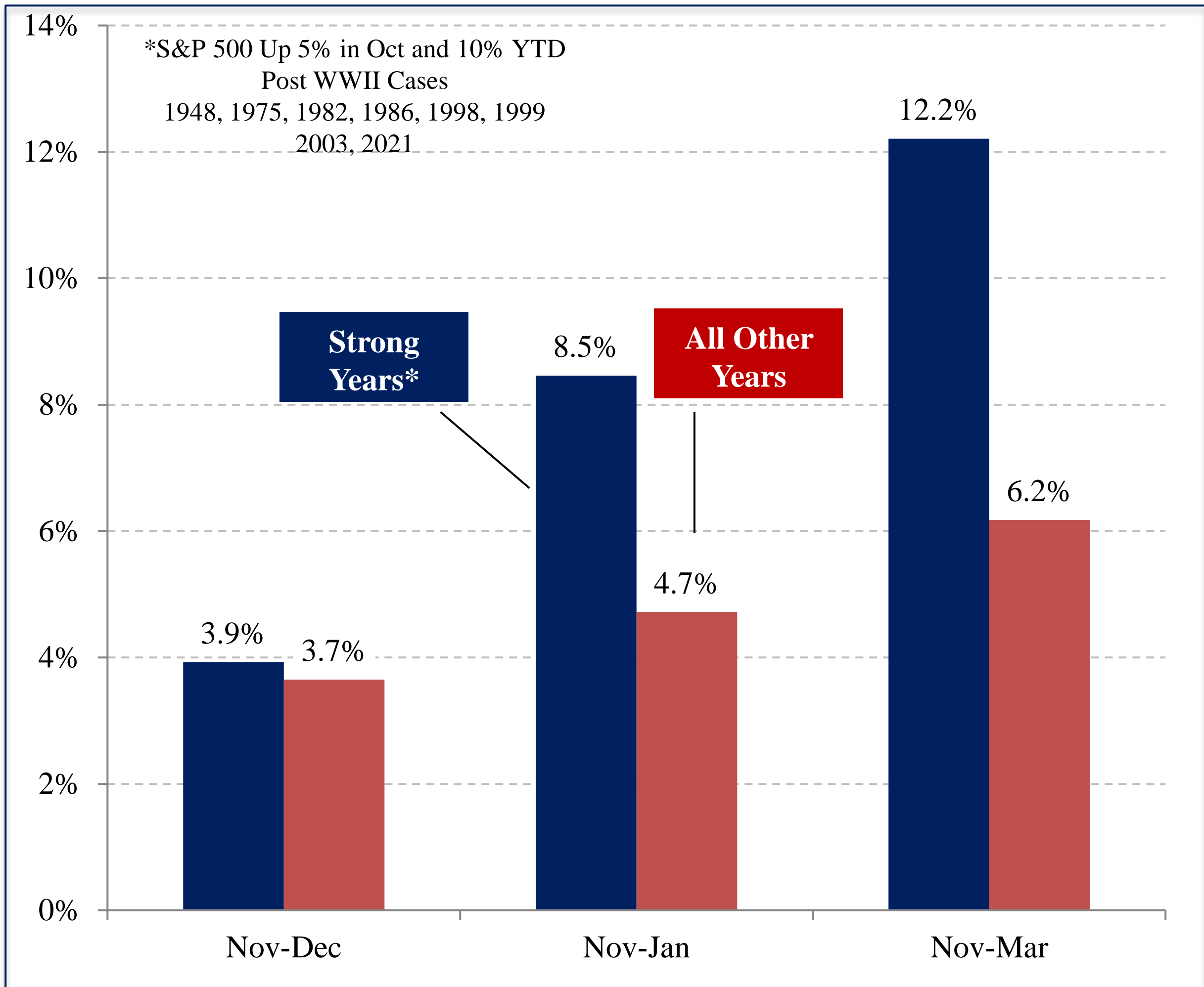
Strong Equity Market Bullish through March



CPI Inflation Surprise: Bullish for Equities

The October CPI inflation was 6.2% Y/Y, the highest since 1990 at the stock market low after oil doubled to $40 during Kuwait invasion (Gulf War I). Prior to that it was the highest since 1982. There was a base effect this month since CPI increased just 0.1% M/M a year ago. The bad news is high comps (making it easier for Y/Y to decline) don't start until March. The prior 4 cases of inflation this high didn't turn lower until we saw a recession (1990, 1980, 1974, 1970). However, in 1950 the Korean War inflation spike to 9% reversed quickly back to 2% without a recession, which is a possible scenario. Historically high inflation was bullish for equities while the Fed was loose as they are today. In fact, with higher inflation and no change from the Fed in October, the Fed effectively eased monetary conditions. Our inflation outlook indicators remain elevated at 86.1 and indicators like ISM deliveries index show that supply bottlenecks continue putting upward pressure on prices. In theory bottlenecks will clear and prices will come down quickly, particularly if companies have ordered more than they actually need.

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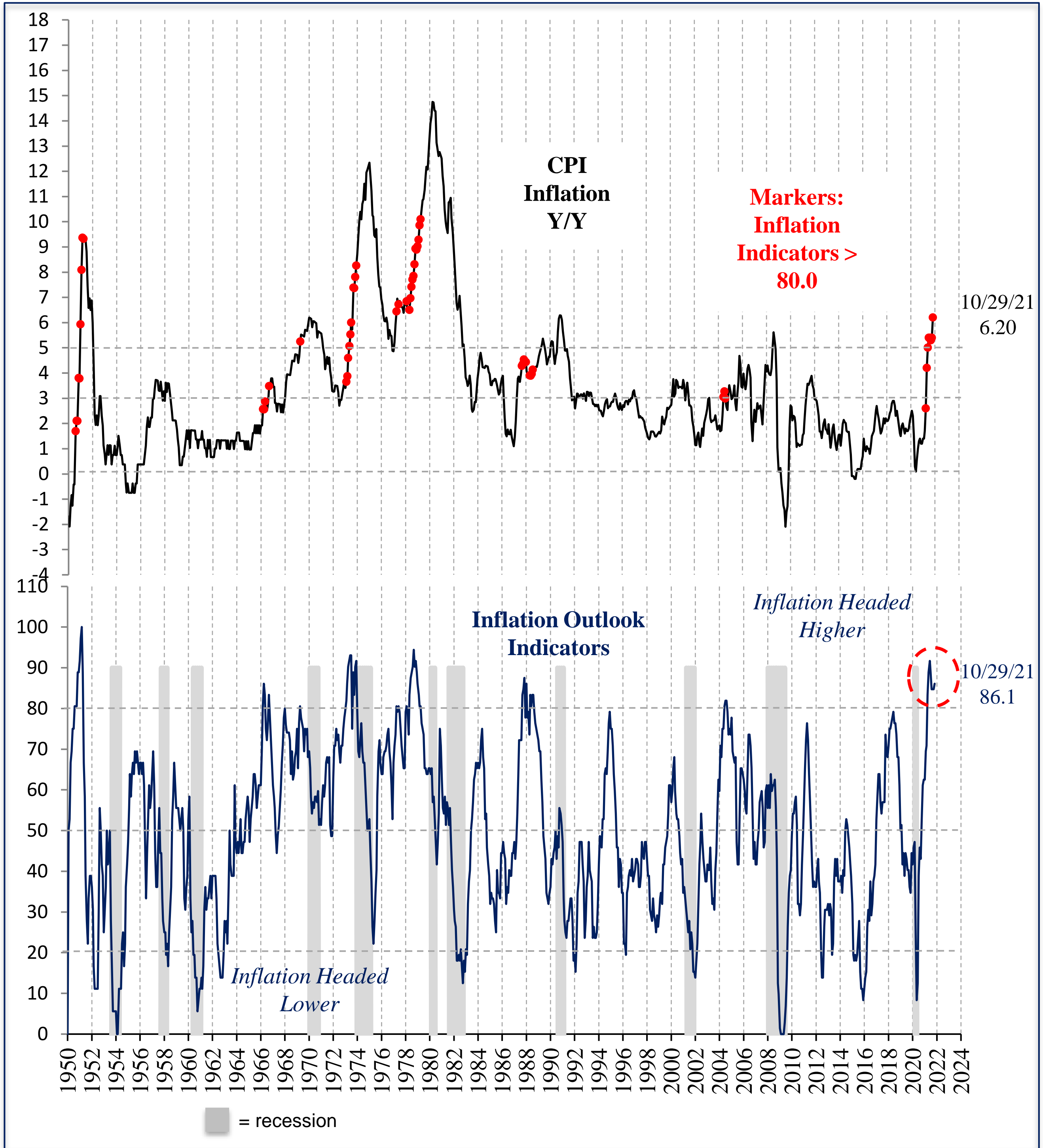
CPI Inflation Over 6% Highest Since 1990/1982
Inflation Outlook Remains Elevated



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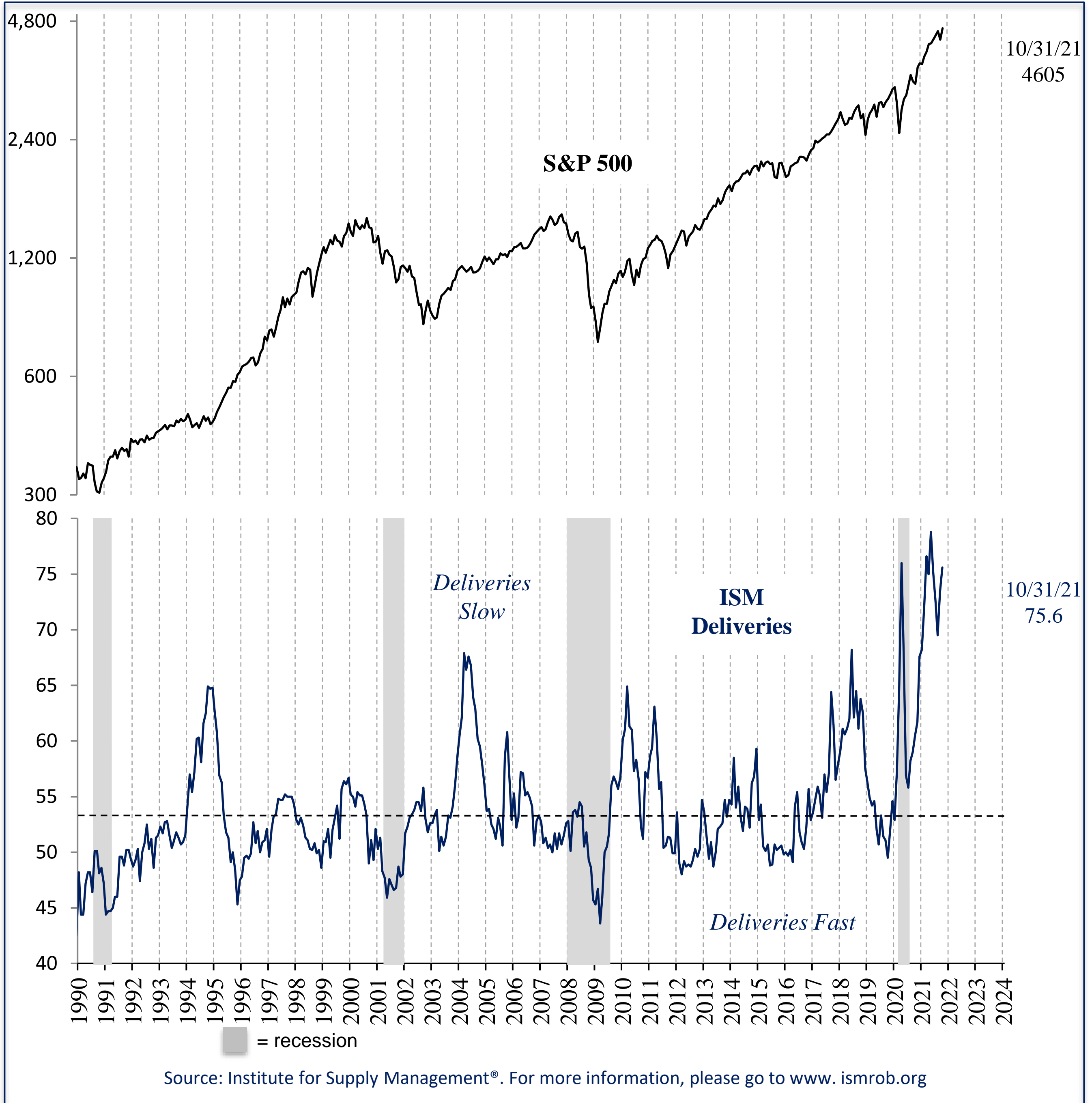
ISM Deliveries Index Up: Bottlenecks Remain



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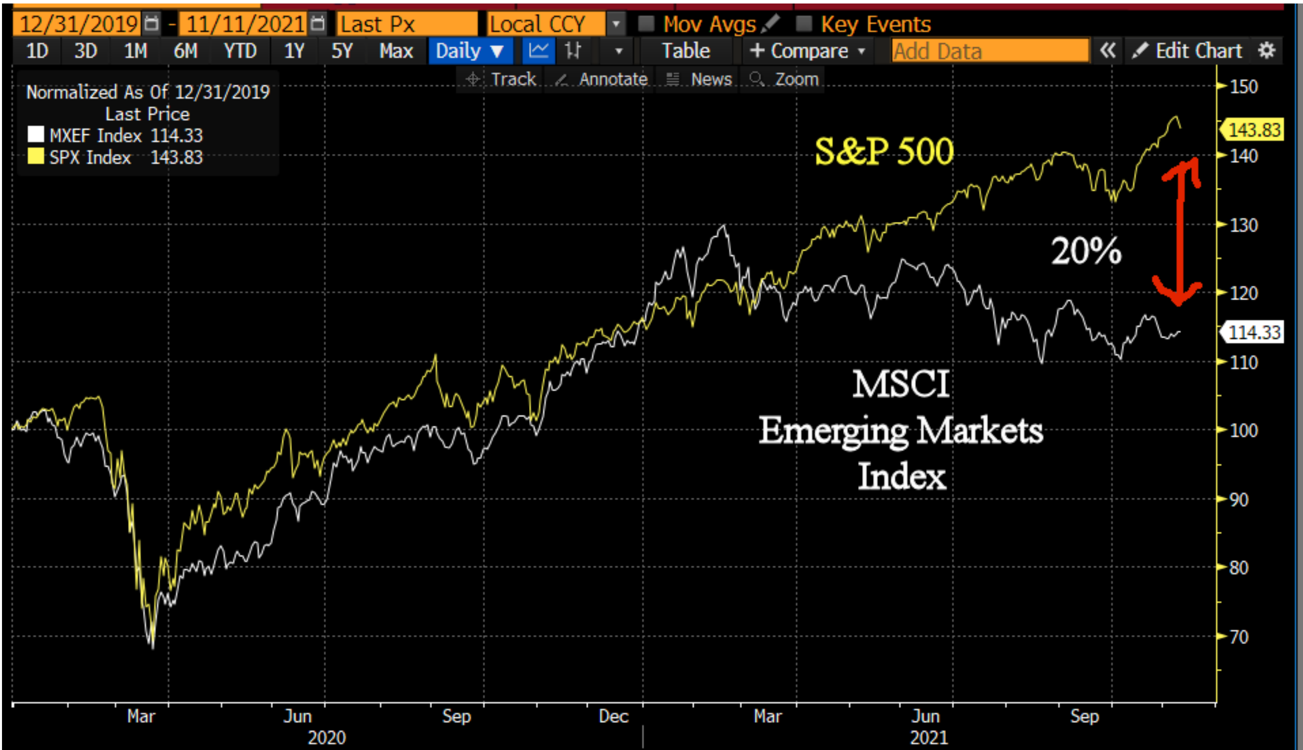
Emerging Markets Ratings Uptick

We increased the emerging markets rating to a bullish 5, based on various bullish leading indicators like strong industrial commodities, extreme investor positioning, seasonality and strong gold stocks. The combination was followed by strong emerging market returns historically, despite the strong dollar offset. The MSCI Emerging Markets Index is down 2% this year, vastly underperforming the S&P 500 by over 20%. This reflects the extreme investor positioning into U.S. stocks and the dollar strength. At some point we expect this will reverse as investors shift out of the U.S. into the undervalued emerging markets, leading to a reversion in performance.

S&P 500 vs. MSCI Emerging Markets Index



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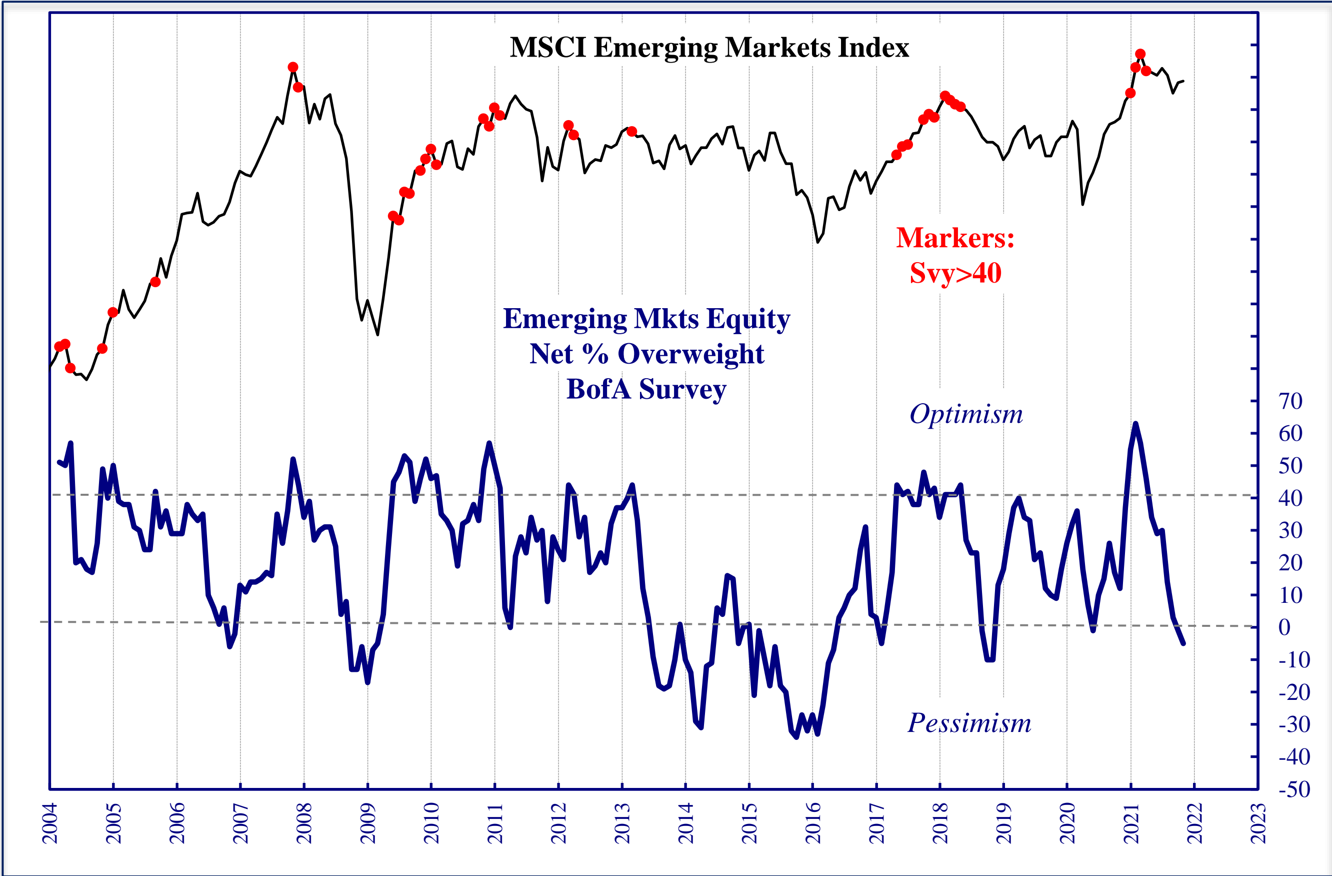
Institutions Out Of Emerging Markets



Bond Investors: Inflation will Return to 2%

The bond futures market expects a peak Fed Funds rate of just 1.8% over the next 4 years. That is highly unusual considering inflation today at 6.2%, and even the Fed's own long run projection of the Fed Funds rate is higher at 2-3%. What is more incredible is that in all 15 hiking cycles since 1950, the Fed hiked rates above the inflation rate. For instance, in the last cycle starting in 2015, the Fed hiked the Fed Funds rate from 0% to 2.5% by the last move in December 2018, hiking above the inflation rate of 2.2% as they always did. It was the same pattern for every cycle back to 1950. It appears that bond investors believe inflation will indeed be transitory and return to 2%, or if not, the Fed will not hike like they did in prior cycles. We will be watching leading inflation indicators and bond market expectations for clues on the Fed's future actions. In the meantime, the Fed remains loose by any measure.

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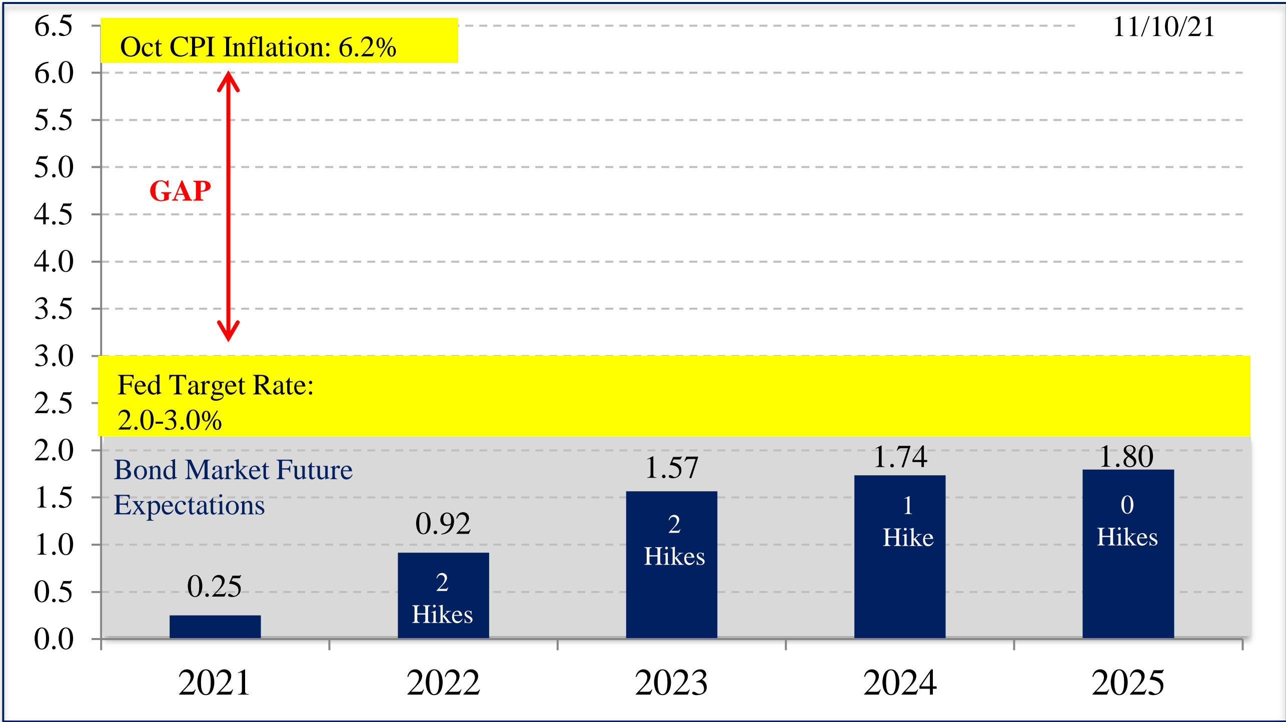
Bond Market Expectations For Fed Funds
Peak Under 2.0% 4 Years Out



The Fed Hiked Above The Inflation Rate In Every Business Cycle Since 1950

Real Fed Funds Rate
at Last Hike

Fed Funds Rate ABOVE Inflation
Fed Tight

Median:
3.0%

Jan-53	Aug-57	Sep-59	Apr-69	Aug-71	May-74	Mar-80	May-81	Aug-84	Sep-87	Feb-89	Feb-95	May-00	Jun-06	Dec-18
1.2	0.2	3.0	0.8	1.4	2.9	5.8	10.0	7.5	3.0	5.1	3.2	3.4	1.1	0.3

Fed Funds Rate BELOW Inflation
Fed Stimulative

12 11 10 9 8 7 6 5 4 3 2 1 0 -1 -2 -3 -4 -5

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Summary

Equity indicators improved further in November, with a particularly strong outlook through the first quarter in prior years with similar conditions. Emerging markets are seemingly poised for upside now that institutions have cut back. U.S. inflation was a big upside surprise in October as the headlines showed, and our inflation outlook indicators remain elevated. Investors are nervous about the Fed reaction, but until then it equates to a Fed easing. The biggest risks for equities appear to be extreme investor positioning and eventually the inevitable tight monetary policy. We will continue testing conditions as they change. Thank you for your support and please contact your advisor with any questions.

Michael Schaus
Director of Market Research