BRENTON POINT
WEALTH ADVISORS

January 13, 2022

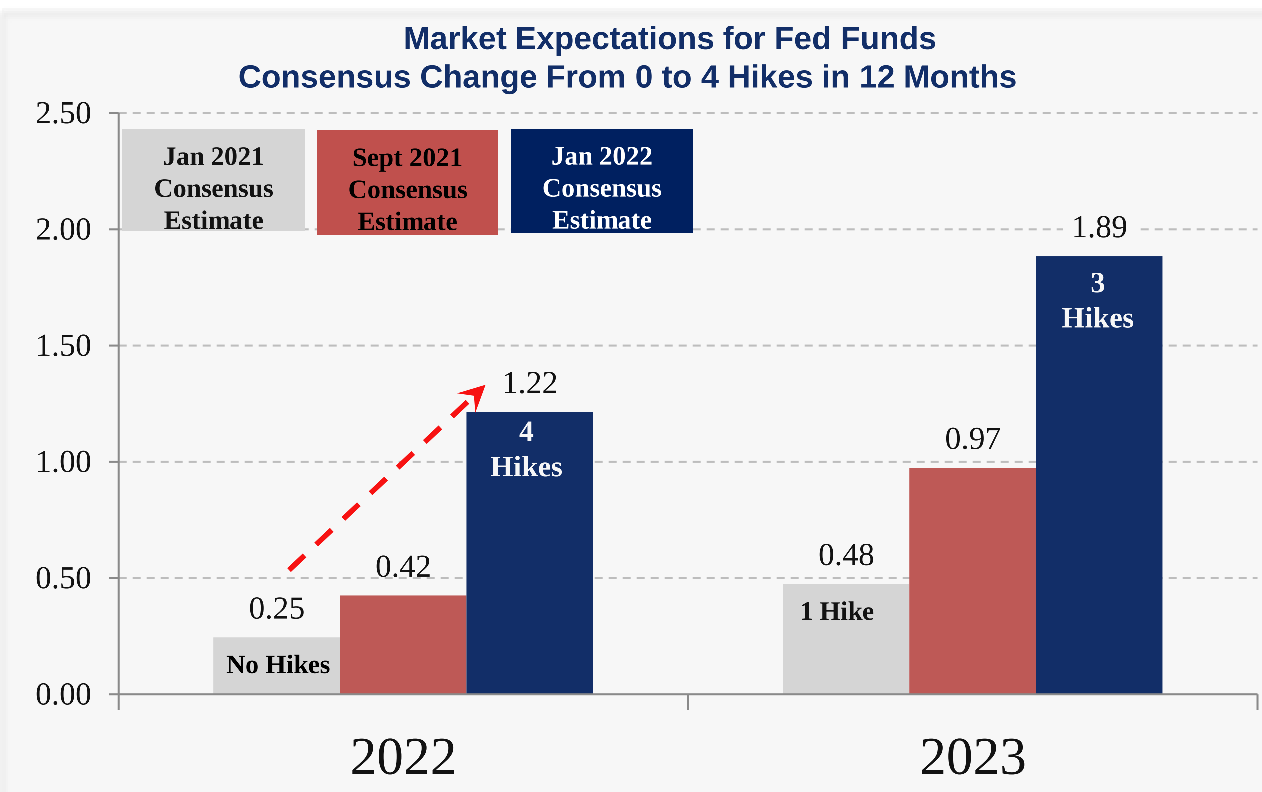
Investing Environment Review and Outlook – Volume 56

Fed Shift

The dominant economic story of the last 6 months has been inflation and the Federal Reserve. It is hard to imagine just a year ago CPI inflation was 1.4% and market consensus was for NO Fed interest rate hikes in 2022. What a contrast to today with inflation at 7.0% and the focus is whether 3 or 4 hikes in 2022, and at least another 3 hikes to follow in 2023.

Last month we wrote about the potential Fed inflection point on 11/30/21 when Fed Chair Powell testified that inflation was no longer transitory. Since then, Fed meeting minutes and the sharp rise in interest rates confirmed that day was indeed the point the Fed belatedly shifted to a hawkish stance, entering what we call the "intention to hike zone."

This month we discuss more implications of that shift in Fed Policy, the possible end to supply bottlenecks and the surprising relative performance of the Nasdaq 100. U.S., foreign-developed, and emerging markets equities remain a bullish 5 rating along with gold. Commodities remain a neutral 3 and we lowered long-term bonds to a cautious 1 rating.



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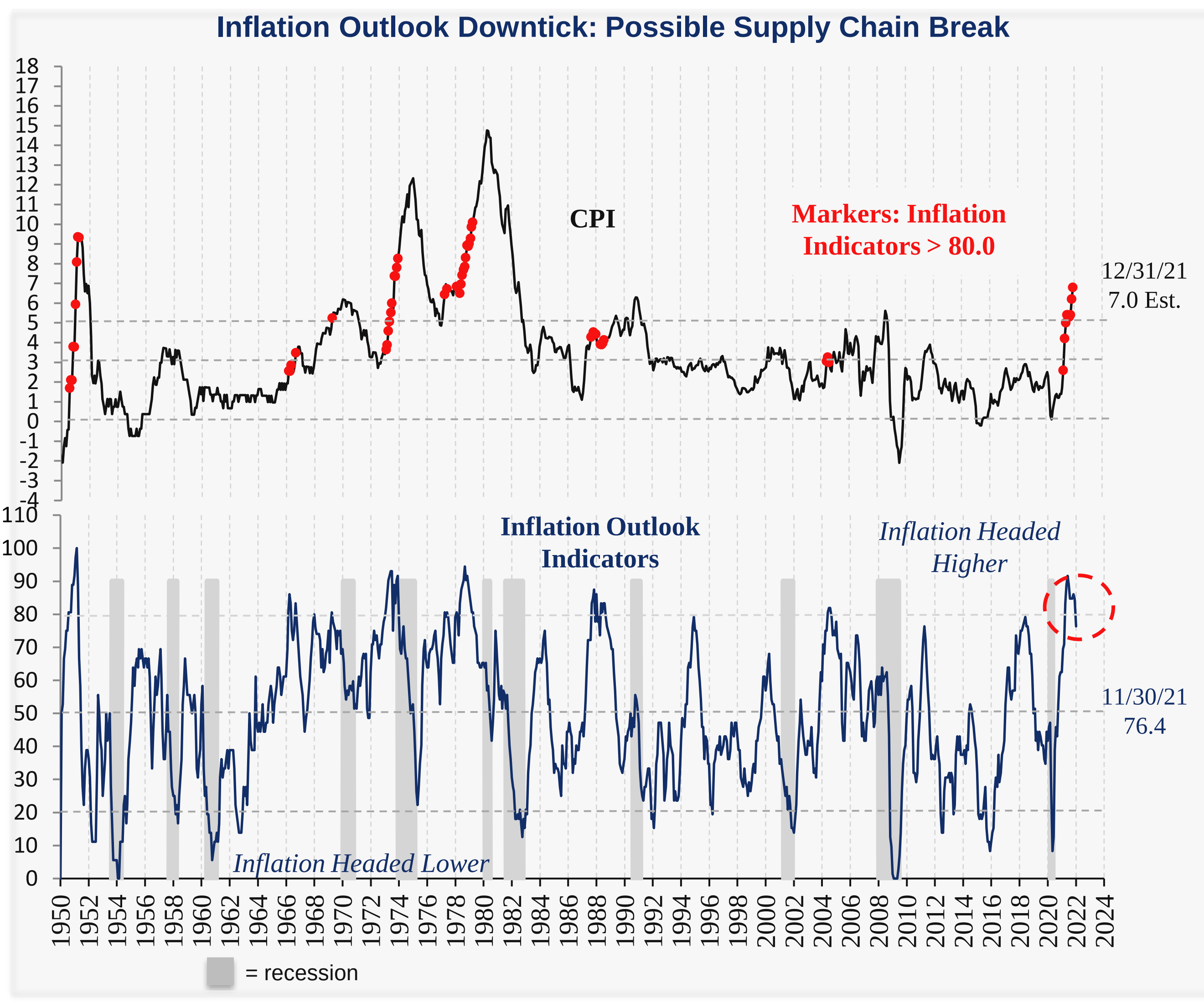
Inflation Outlook Indicators Down: Possible End of Supply Bottlenecks

Inflation at 7.0% for December was big news, but the implications are more interesting. A year ago, inflation outlook indicators were indeed predictive. The model was elevated at 69 in January when CPI was just 1.4% and rose to an extreme of 83 by March when inflation was still 2.6%. Today we have somewhat opposite conditions. Expectations are for higher inflation while the inflation outlook indicators reversed down to 76.4 this month, the lowest reading since February. This could be the first sign supply chain bottlenecks are easing, perhaps partly due to the end of the Christmas retail rush.

Last year's combination of 7.0% inflation and a 28% return for the S&P 500 demonstrated inflation itself is not necessarily an issue for equity returns. It is the Fed's reaction that matters. Since 1950, the S&P 500 returned 11.1% when inflation was rising, and the Fed was loose vs. -6.6% return when inflation was rising, and the Fed was tightening policy. For now, conditions for equities remain bullish despite the high inflation. Once the Fed begins hiking, we will certainly reassess the situation.



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ISM Deliveries Index Down: Bottlenecks Clearing

Source: Institute for Supply Management®. For more information, please go to www. ismrob.org

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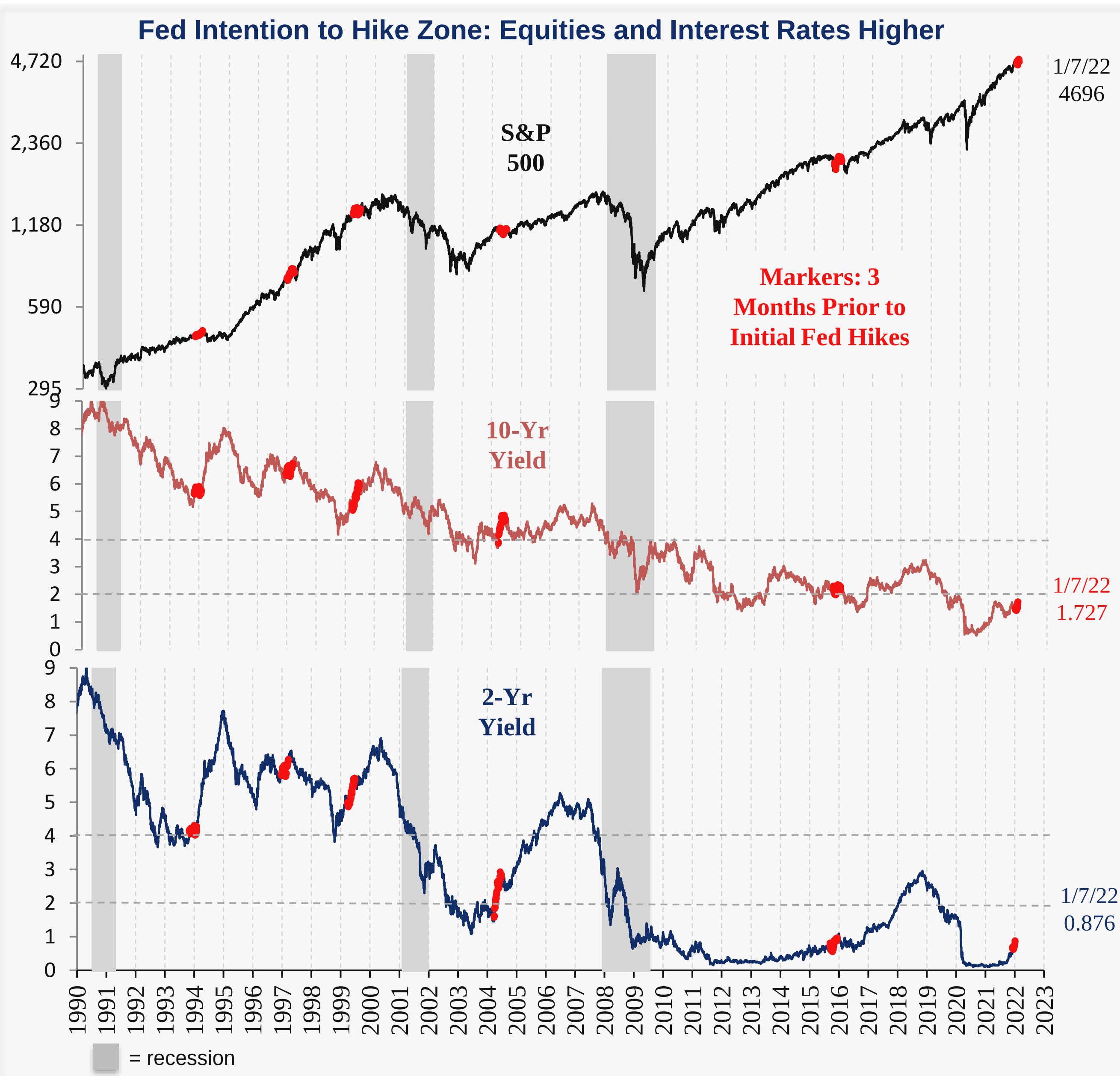
Long-Term Bonds Rating Downtick to 1

Last month we discussed the positive return for equities in the period just prior to initial Fed hikes, finding that equity returns were surprisingly strong in this period historically, and that actions speak louder than words. This month we cut the rating on long-term bonds from a cautious 2 to a 1 due to several factors like the strong economic outlook and higher commodity prices, but also due to the consistent pattern of higher yields (and lower long-term bond prices) during this Fed “intention to hike” zone. In the 5 cases since 1990, long-term bond yields rose on average 0.39%. All cases were higher and ranged from 0.10% to 0.70%. Bonds remain an important piece of any portfolio to offset the higher volatility of equities, so short-duration bonds are still appropriate since interest rate movements have less effect on short-term bonds.



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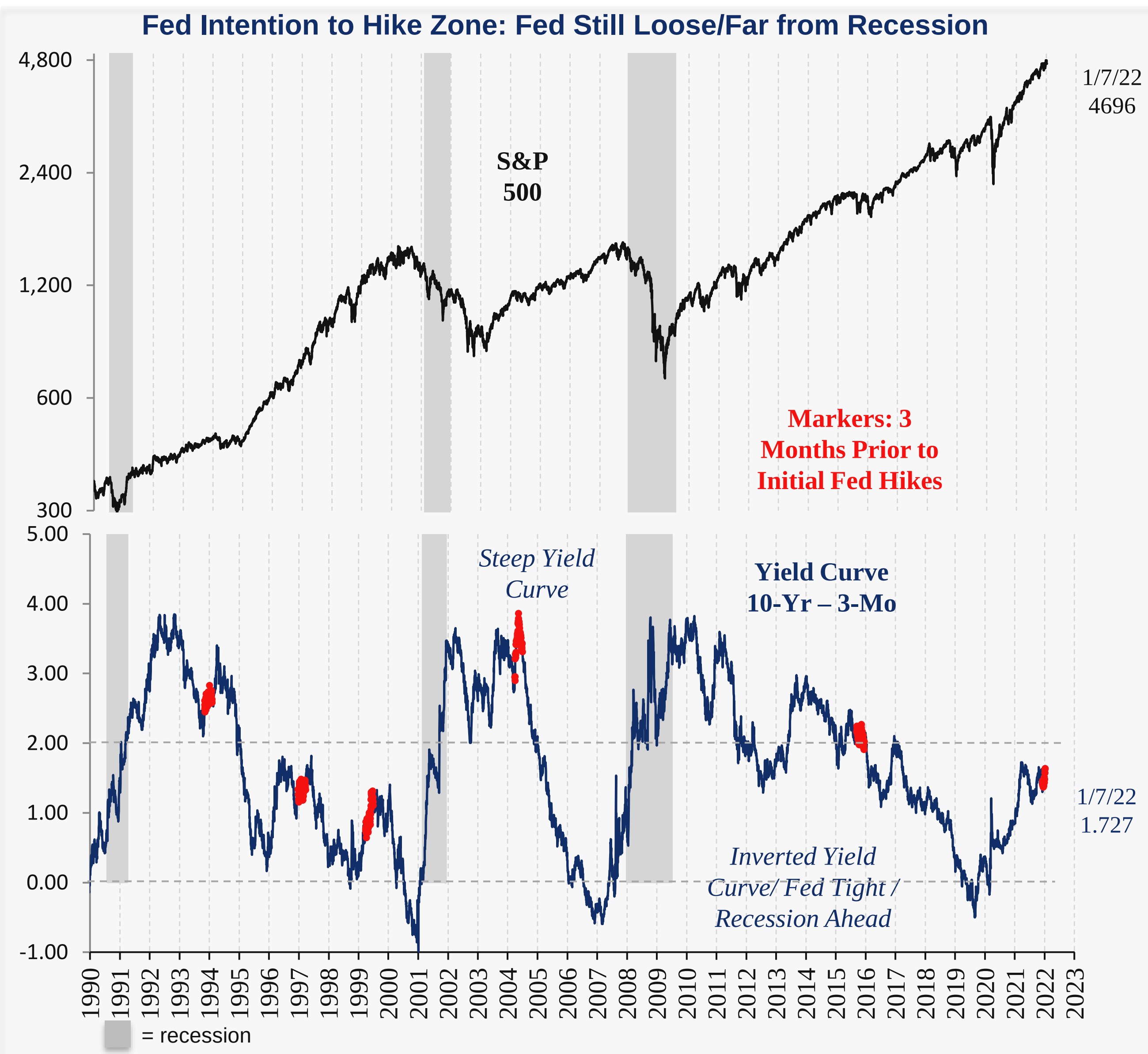
Steep Yield Curve: Fed Loose/Economy Healthy

Since 1950 the S&P 500 returned 21% annualized when the economy was strong and the Fed was loose, conditions we still have today. The December ISM manufacturing index was 58.7, down from November but still in the 90th percentile.

Bears point to tightening monetary policy. Aside from Fed actions, the 10-Year to 3-Month yield curve is a good objective measure of Fed policy. Excessively tight monetary policy precedes recessions and bear markets. Today at 1.7% this risk is not there yet, but typically over 6-18 months as the Fed hikes and long rates level off and even decline, the risk creeps in. For now, talk of Fed hikes followed by a higher 10-year yield is quite normal, and bullish for the economy and equities.



Nasdaq Positioning Down: Bullish

Selling in early October was concentrated in the big cap Nasdaq stocks. The NDX 100 index declined 5.8%, the biggest decline since October. Interestingly despite all the talk of big cap dominance in the market, the NDX has not outperformed the S&P 500 for 18 months since July 2020. The Hulbert Survey of Nasdaq Investors shows extreme levels of pessimism, the best sign that investors have cut back significantly. The current reading of -43 is in just the 4th percentile since 2010. In prior Fed "intention to hike" periods, the NDX was up 6 of 7 times an average of 4.8% and outperformed the S&P 500 in 5 of those 7 cases despite a higher 10-year yield in all cases but one.

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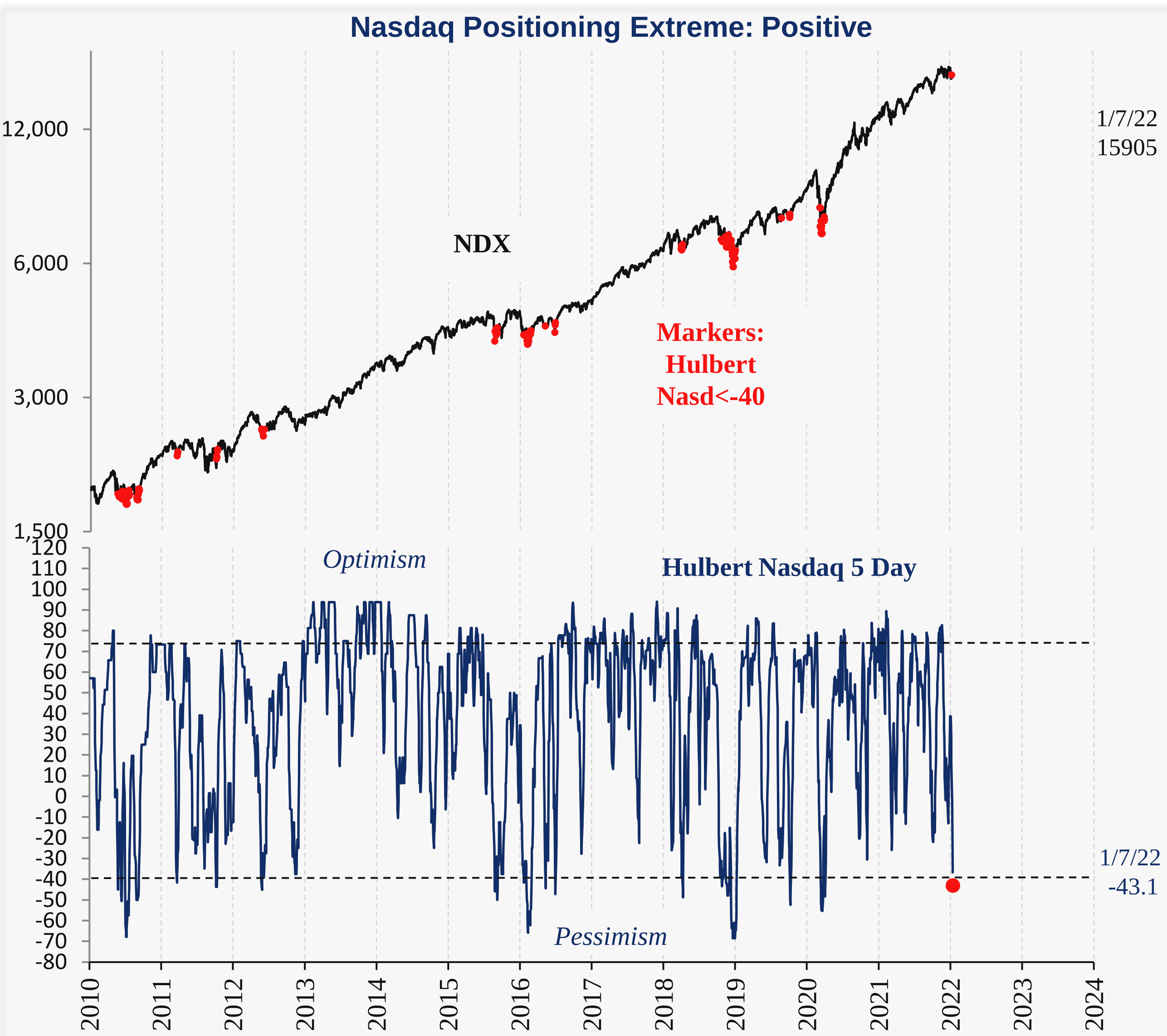

Summary

This month we discussed the Fed's inflection point in policy and implications for asset returns. Although expected equity returns will go lower at some point, for now the strong economy and loose Federal Reserve policy is a potent combination for equities, and negative for bonds as interest rates are likely to rise further. Although there is justified fear of tighter Fed policy ahead, historically the best equity returns were in fact before the initial hike. 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