BRENTON POINT
WEALTH ADVISORS

February 17, 2022

Investing Environment Review and Outlook – Volume 56

Fed Regime Shift

Last month we discussed the developing Fed Pivot from dovish to hawkish beginning with Powell's comments in November. As of January 1, conditions were positive for U.S. equities since, in prior cases, the S&P 500 rallied in the three months prior to initial hikes, particularly when the economy was strong. In retrospect, the unprecedented magnitude of inflation and the unprecedented Fed advance communication of intentions changed the dynamics this year.

Financial news and commentary is distracting as usual, filled with predictions of the number of Fed hikes ahead. Understanding the implications for asset prices when the Fed hikes rates, and particularly in the context of high inflation and valuation is this month's focus. We also discuss the shift in investor positioning.

Please note we cut the U.S. Equity rating to a cautious 2. Foreign-developed and emerging markets remain a bullish 5 rating. Long Term bonds remain a cautious 1 rating. Commodities remain a neutral 3 rating and gold remains a bullish 5 rating.

Don't Fight the Fed and Inflation Together

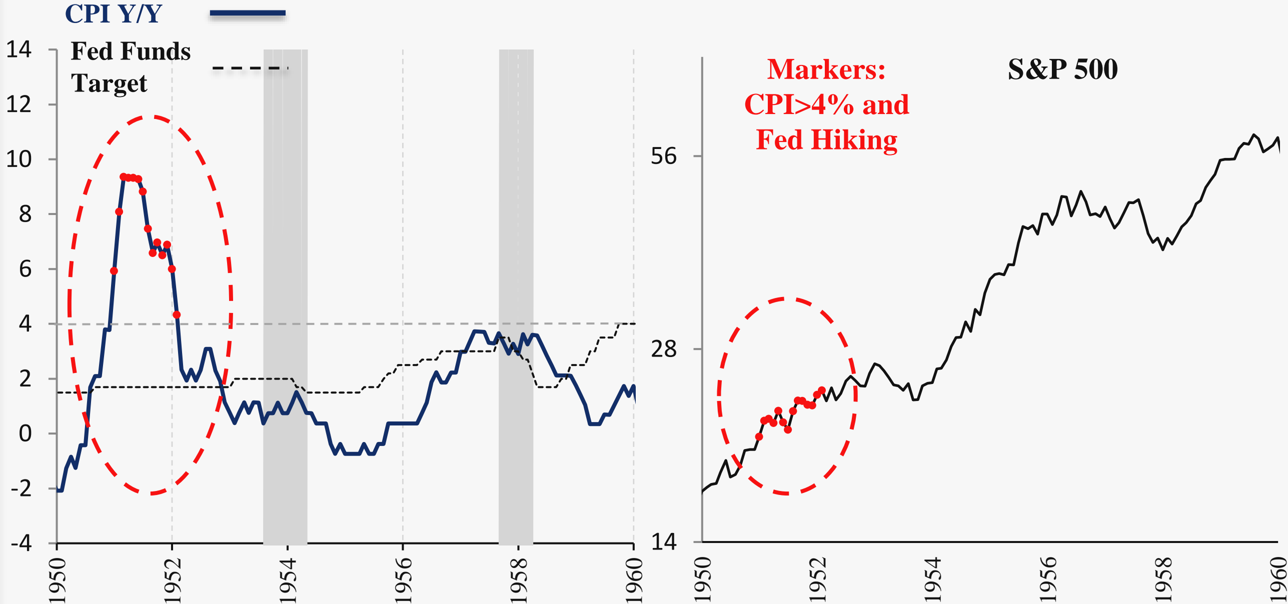
Historical S&P 500 returns when the Fed was hiking rates offer no reason for panic, averaging 7.7% since 1928 vs. the norm of 10.4%. In addition, the 6 months after initial hikes were even better at 13.9%. The difference this year is much higher inflation than usual at the initial hike. Returns were much worse at -3.7% when the Fed was hiking while inflation was up and rising as it is now. The most recent case in late 2005 was benign since inflation crossed above 4% but quickly reversed lower. Expected equity returns shift positive when inflation turns down, even when the Fed is hiking, and that was true in 2005. Falling inflation and still above 4% is good at 11.2% return, but inflation falling and below 4% is even better at 16.6%.

The most comparable cases when the Fed was hiking with inflation were 1987, 1973 and 1969, all involving S&P 500 bear markets. This doesn't mean a bear market today, but it is certainly a possibility we are considering. Prior to 1969, the 1950 Korean War inflation spike was the exception that proves the rule. Inflation spiked to 9% over 5 months but then quickly reversed back to 2% over 7 months, with no reaction from the Fed or the S&P 500.

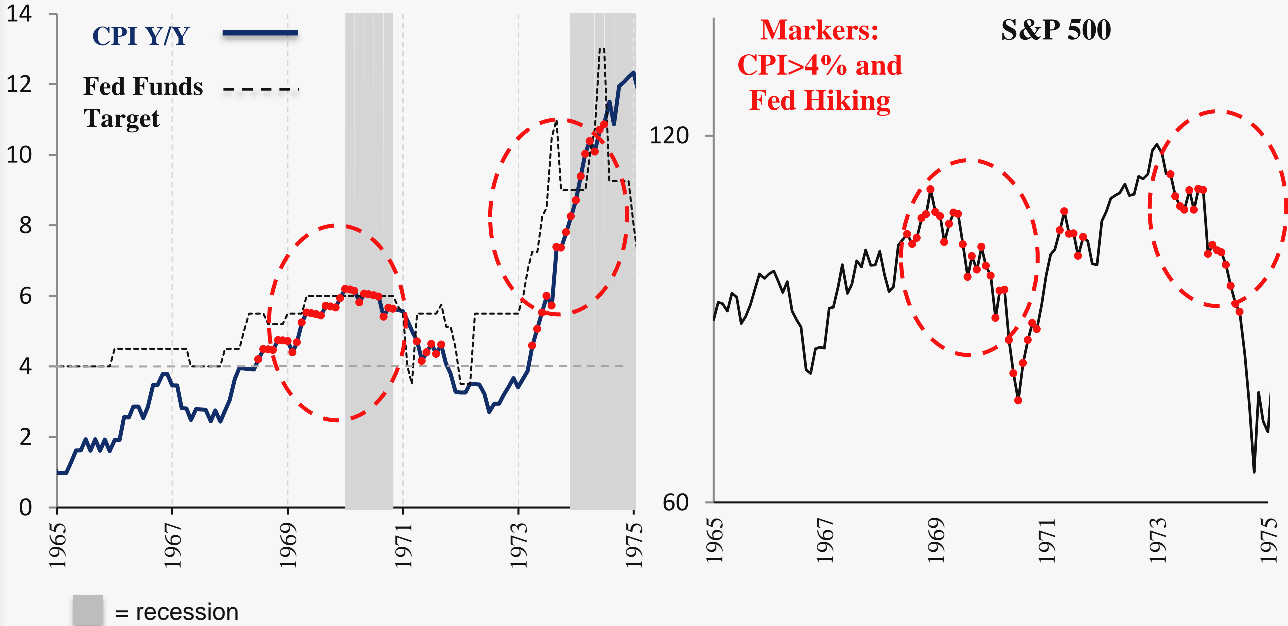
This review and outlook report by Brenton Point Wealth Advisors LLC represents our views and beliefs regarding the current market outlook. Please also read the important disclosures at the end of this report.

Don't Fight the Fed and Inflation Together

1950 CPI 10% No Fed Hike S&P 500 Higher



1969 & 1973 CPI 6%/12% Fed Hiked S&P 500 Bear Markets



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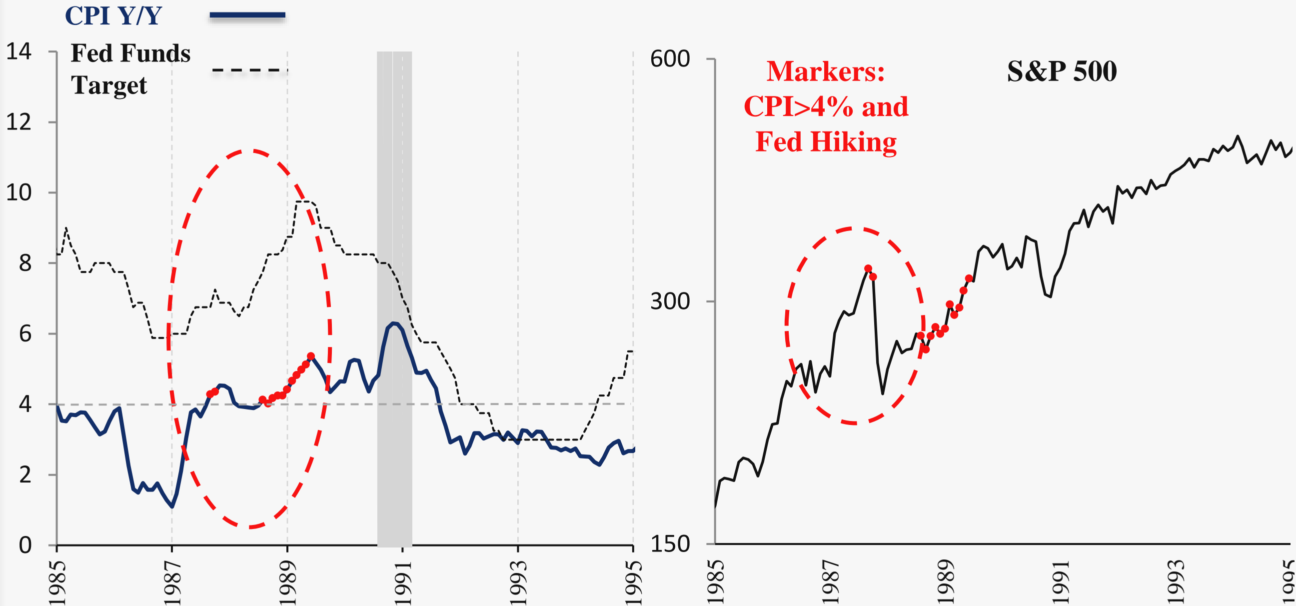
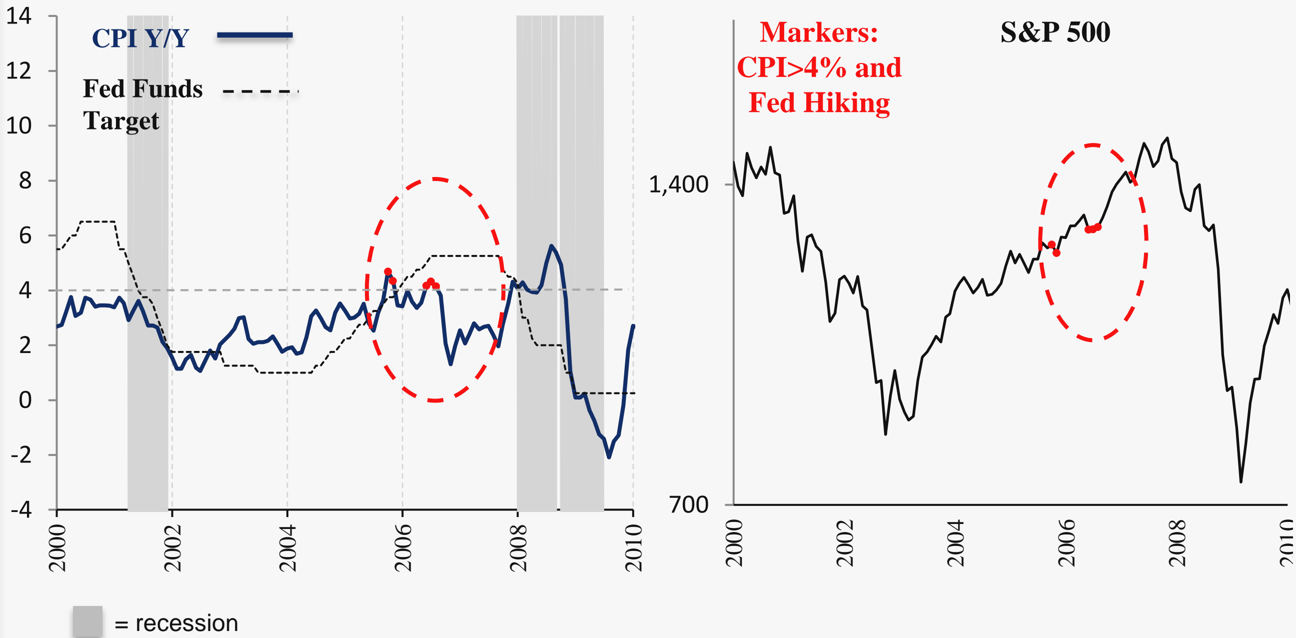
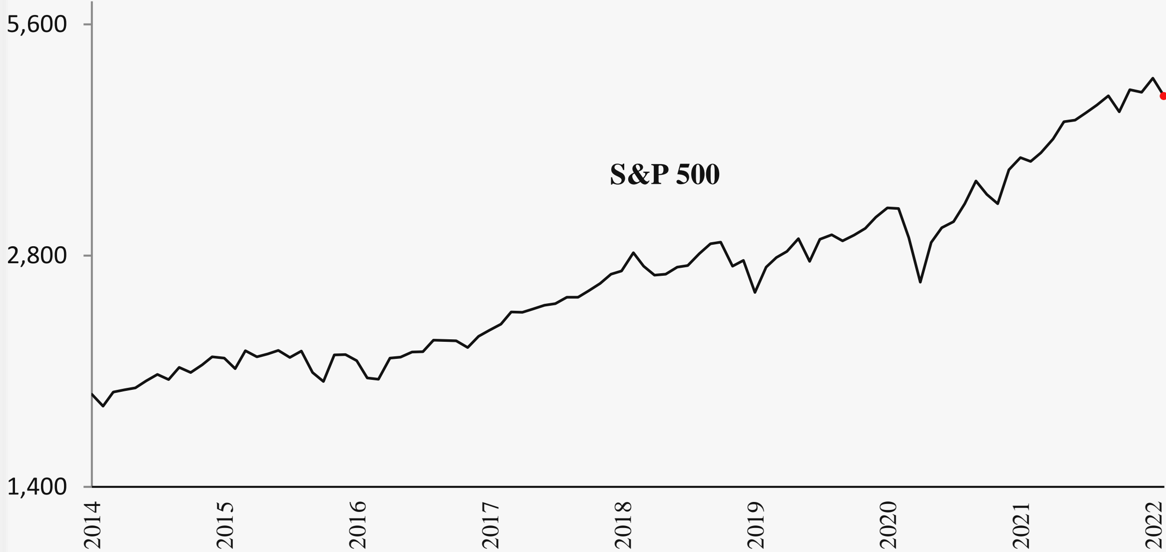
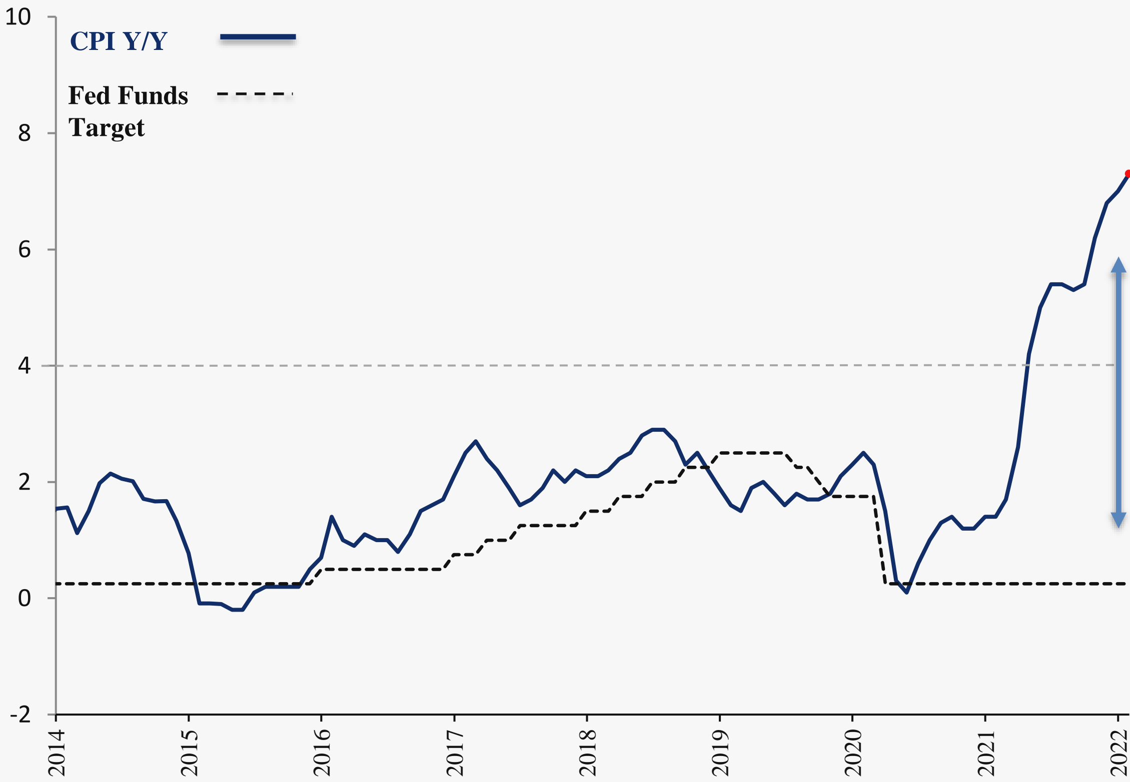




Don't Fight the Fed and Inflation Together

Today





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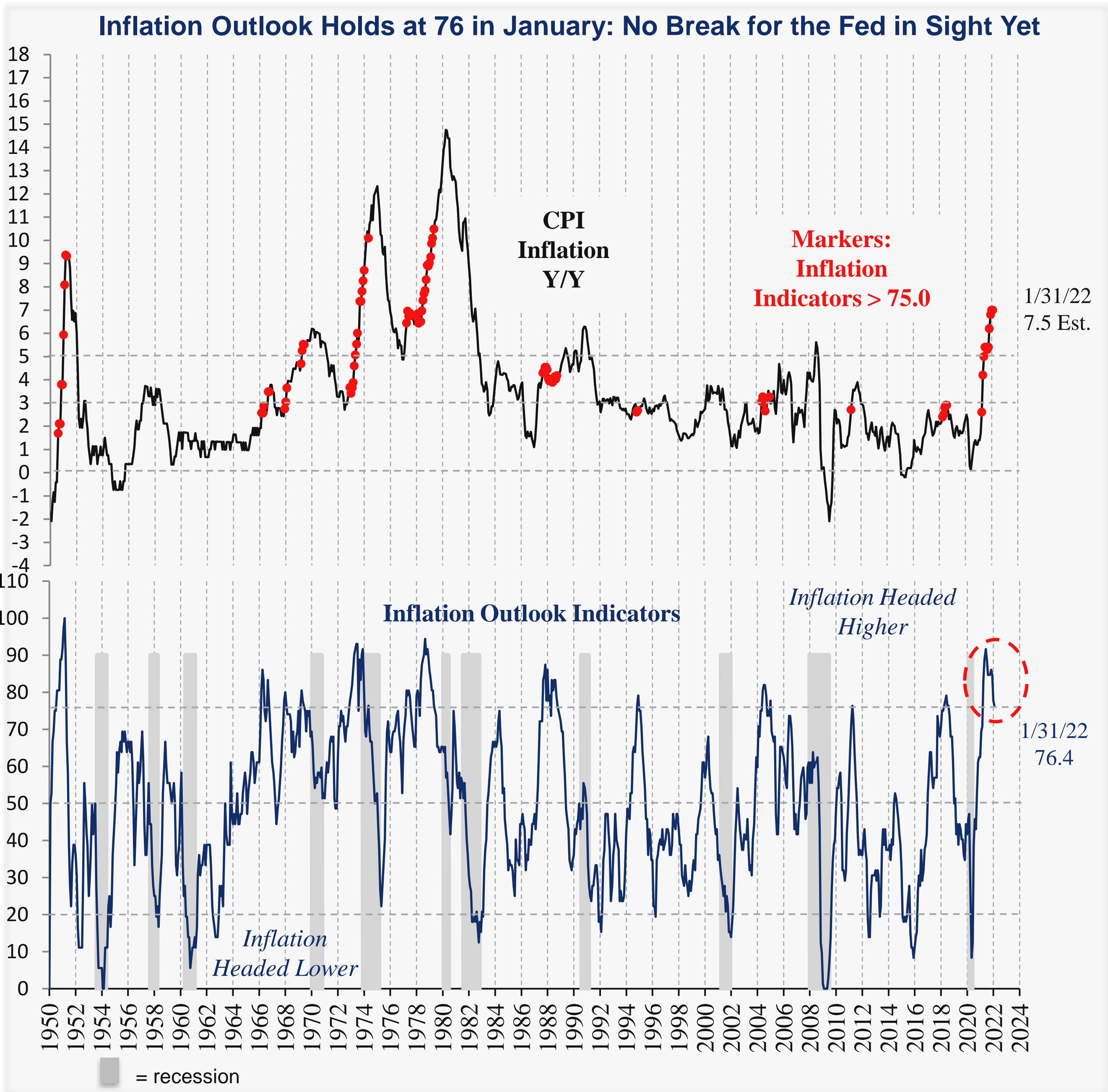
No Break for the Fed in Sight Yet

Given the importance of the inflation level and trend for S&P 500 returns in the new regime when the Fed is hiking rates, we are watching it very carefully from all angles. Despite the break in some supply chain indicators like delivery times, overall inflation outlook indicators were unchanged at an elevated 76 in January, and energy prices continued higher into February. In addition, we will not see low comps for two months until April when the March CPI numbers are released. The take away: although 3-5% inflation ahead is plausible, for now there is no break for the Fed in sight yet.



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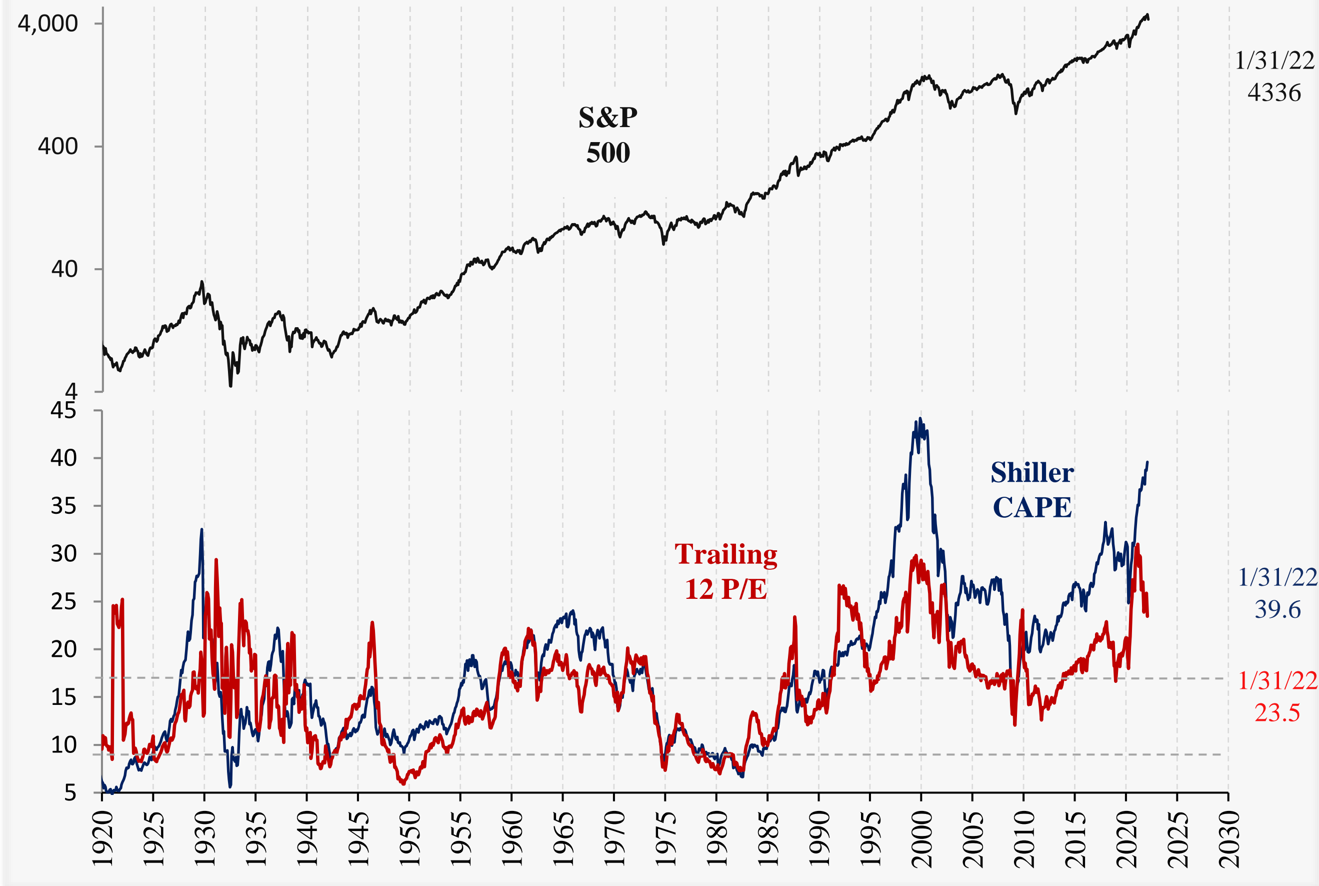
Valuation Risk for Equities

The S&P 500 P/E today is 23.5, in the 93rd percentile of readings since 1910. Certainly "high" by historical standards but impossible to say "overvalued" except in retrospect. Historical comparisons are never entirely accurate since today's higher weight in growth stocks skews the index P/E to the upside. In other periods like 1982, cyclical stocks with lower P/Es had a bigger weight in the index, skewing the index P/E to the downside.

Despite the measurement issues, a look at historical cases shows high valuation in today's high inflation context adds an additional downside risk for equities. Years like 1987, 1969, 1973, and 1946 saw high valuation combined with inflation and Fed interest rate hikes, and were all followed by bear markets. The 2000 peak had the highest P/E and was accompanied by the Fed hiking rates but no inflation above 4%. A bear market followed nonetheless. Compare those cases to 1979 when inflation rose from 9% to 13% and the Fed hiked the Fed Funds target from 10% to 15.5%, yet the S&P 500 was up 12% that year. After a decade of bear markets, the S&P 500 P/E began 1979 at 8.2x, in just the 7th percentile of historical readings and low by any standard. The low valuation offered downside protection to an otherwise hostile macro environment.



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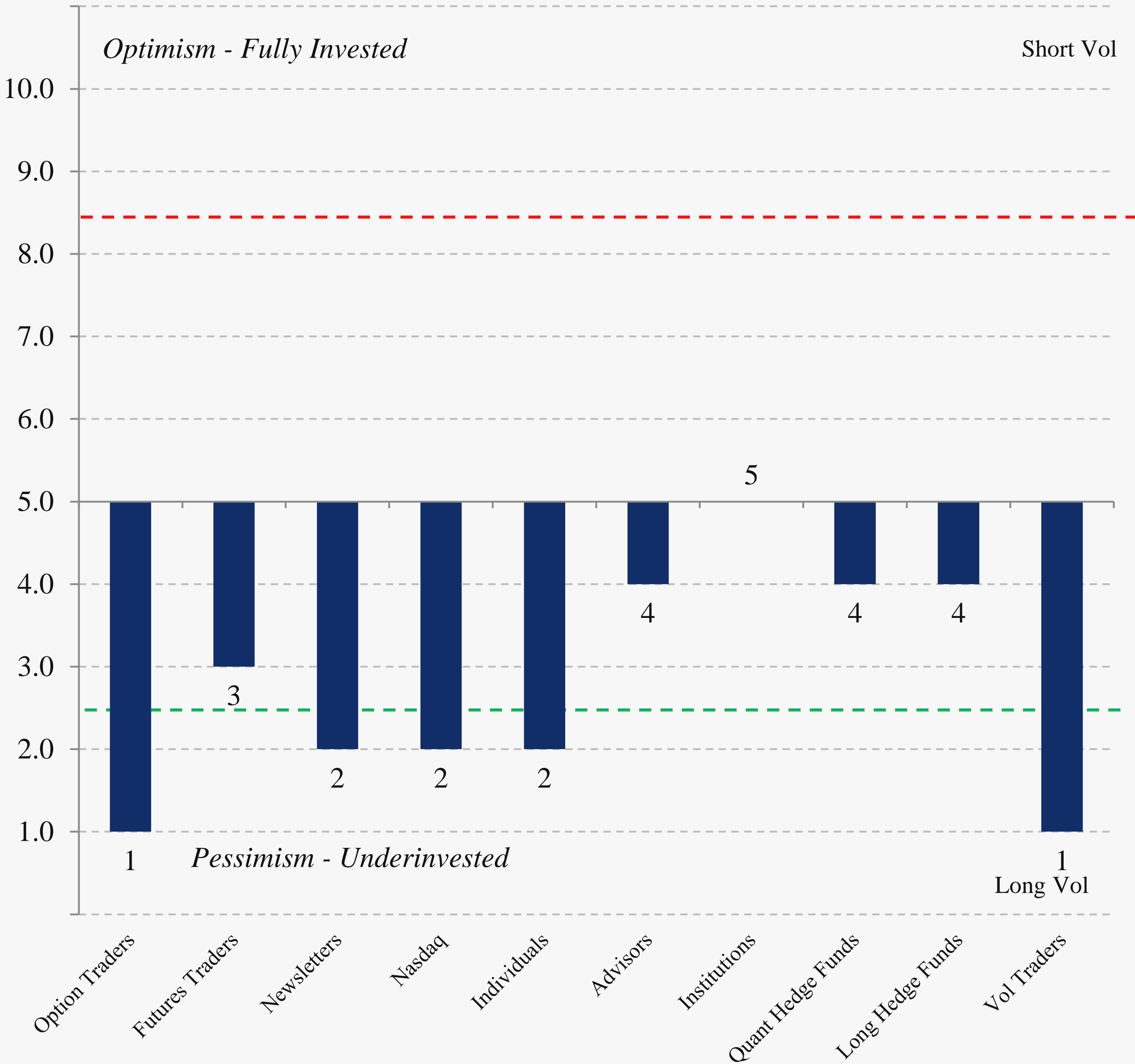
Investors are Nervous and Short

Higher equity volatility this year combined with inflation surprises, Fed hike speculation, and the Ukraine invasion headlines have caused investors to cut back equity exposure to the lowest since the March 2020 COVID crash low. Although long-term expected returns for the S&P 500 are lower as a result of the Fed regime shift to hiking rates, this extreme in positioning shows a lot of bad news is expected and makes a positive surprise and equity upside more likely in the short term.



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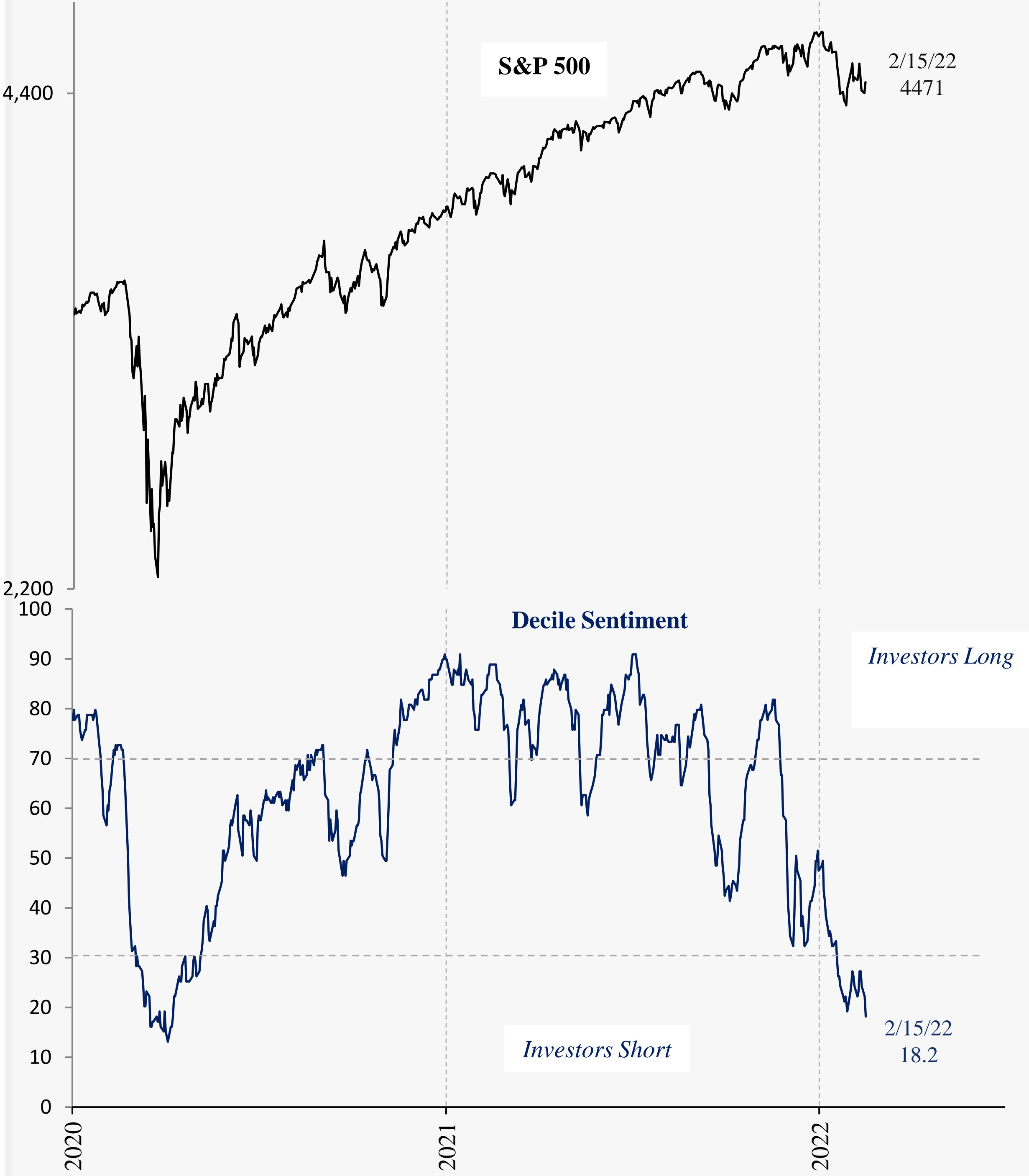

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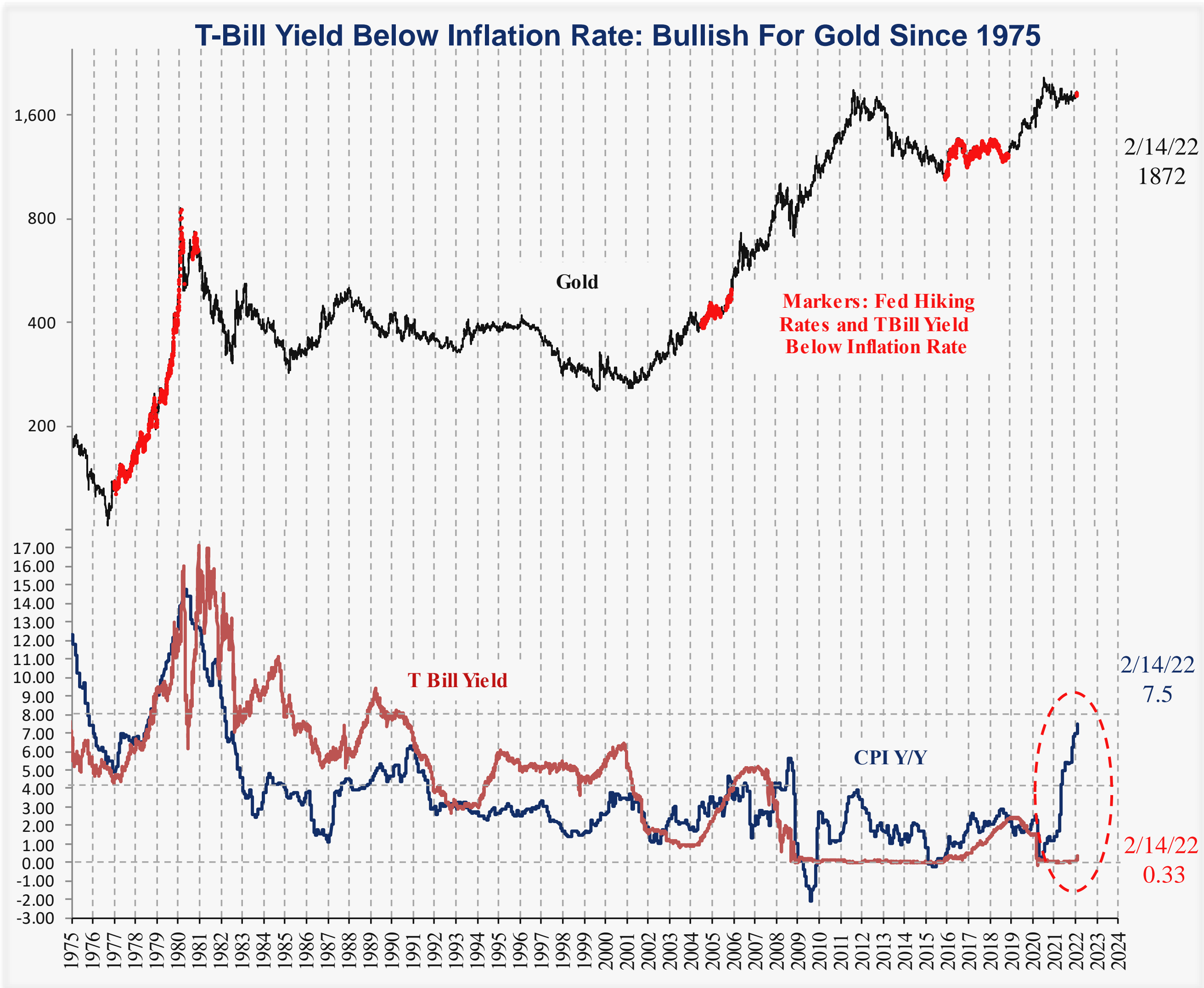
Fed Regime Shift: Bullish for Gold

Gold rates a maximum bullish 5 for many reasons, primarily as a long bond replacement to reduce portfolio volatility through its low correlation with equity returns. Last year was a good example, with the S&P 500 up 28% and gold down 4%. The same holds true this year with the S&P 500 down 7% and gold up 2%. More importantly, the regime shift this month to the Fed hiking rates is bullish for gold. Since 1975, gold returned 6x the norm at 31.2% annualized when the Fed was hiking rates while T-Bill yields were below the inflation rate. T-Bill yields below the inflation rate means cash balances are effectively depreciating at 7% a year, a catalyst for investors to seek alternatives. There were three periods historically when this was true, and gold rallied in all three. The first was from 1977 to 1980 when gold rallied from $130 to the peak of $850 as the Fed tried to slow inflation by hiking rates. Other periods were 2004 to 2006 and from 2015 to 2018. As last year demonstrated, gold is not always an inflation hedge as people assume, but with the Fed hiking rates and inflation destroying the purchasing power of cash, a significant exposure to gold is a rational alternative for any portfolio.



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Summary

This month we discussed the implications of the Fed hiking rates, one of the most significant points of any economic cycle, and why it is negative for U.S. equities. We cut our U.S. equity rating from a bullish 5 to a cautious 2 since the forward expected return for the S&P 500 is dramatically lower. Our inflation outlook model remains at 76, indicating pressure on the Fed will persist. Due to the equity volatility, inflation, and growing Fed hike expectations, investor positioning is now the lowest since the March 2020 COVID crash bottom. This investor positioning makes a positive surprise and equity upside more likely in the short term. Gold should be one of the primary beneficiaries of this stage of the cycle and remains the best cash alternative for any portfolio. We will continue testing conditions and will update you as they change. Thank you for your support and please contact us with any questions.

Michael Schaus
Director of Market Research