BRENTON POINT
WEALTH ADVISORS

April 18, 2022

Investing Environment Review and Outlook – Volume 58

Bond Fire

The perfect storm of inflation, war in Europe and the Fed hiking rates continues this month. To that, we can add what I call the 2022 Bond Fire to the mix – the extraordinary move higher in Treasury yields which has so far caused an 8% decline in Barclay's aggregate bond index and a 16% decline in long-term Treasury prices. For perspective, long-term bonds have lost over 5 times their annual yield in less than four months. We have also witnessed daily headlines of the inverted yield curve and recession predictions. This month we discuss the implications of these quickly changing economic and monetary conditions in a longer-term historical context, inflation outlook indicators, investor positioning, seasonality, and S&P 500 valuation.

In early April after an 11% rally from the low, we cut equity exposure in accounts and cut the U.S. equity rating to a bearish 1. We also cut foreign- developed equities to a 2 rating and emerging markets to a neutral 3 rating. Long term bonds remain a cautious 1, gold a bullish 5 and commodities are a neutral 3.

Treasury Yields Up: Negative for Equities

The move in the 10-year yield this year has been extraordinary, moving from 1.5% at year end to 2.8% on April 11th, as inflation rose and the Fed promised more aggressive tightening. Since 2000 extreme yield moves like this, in 2021, 2016, 2013 and 2009, marked yield peaks and consequently were no issue for equities, which continued higher as yields reversed lower. This pattern in the last 20 years has led many to expect yields to peak and equities to resume their rally. There is good reason why Powell expected inflation to reverse lower last year and why many investors expect inflation and bond yields to reverse lower today. These are the patterns they know from experience.

Looking further back to extreme bond yield moves prior to 2000, two things become clear. Bond yields not only tended to persist higher for longer, but these moves also led to S&P 500 bear markets in many cases (1987, 1984, 1981, 1980, 1973 and 1969). It is easy to say the world was very different then, which is true. No internet, no iPhones and a less diversified economy based more on manufacturing. However, inflation at 8.5% today makes the cases prior to 2000 more comparable. Since 2000, inflation was mostly under 4% while prior to 2000 inflation was mostly over 4%. Inflation, combined with the Fed hiking rates, was negative for stocks historically because the Fed has no option to pause or even reverse and cut rates until inflation reverses.

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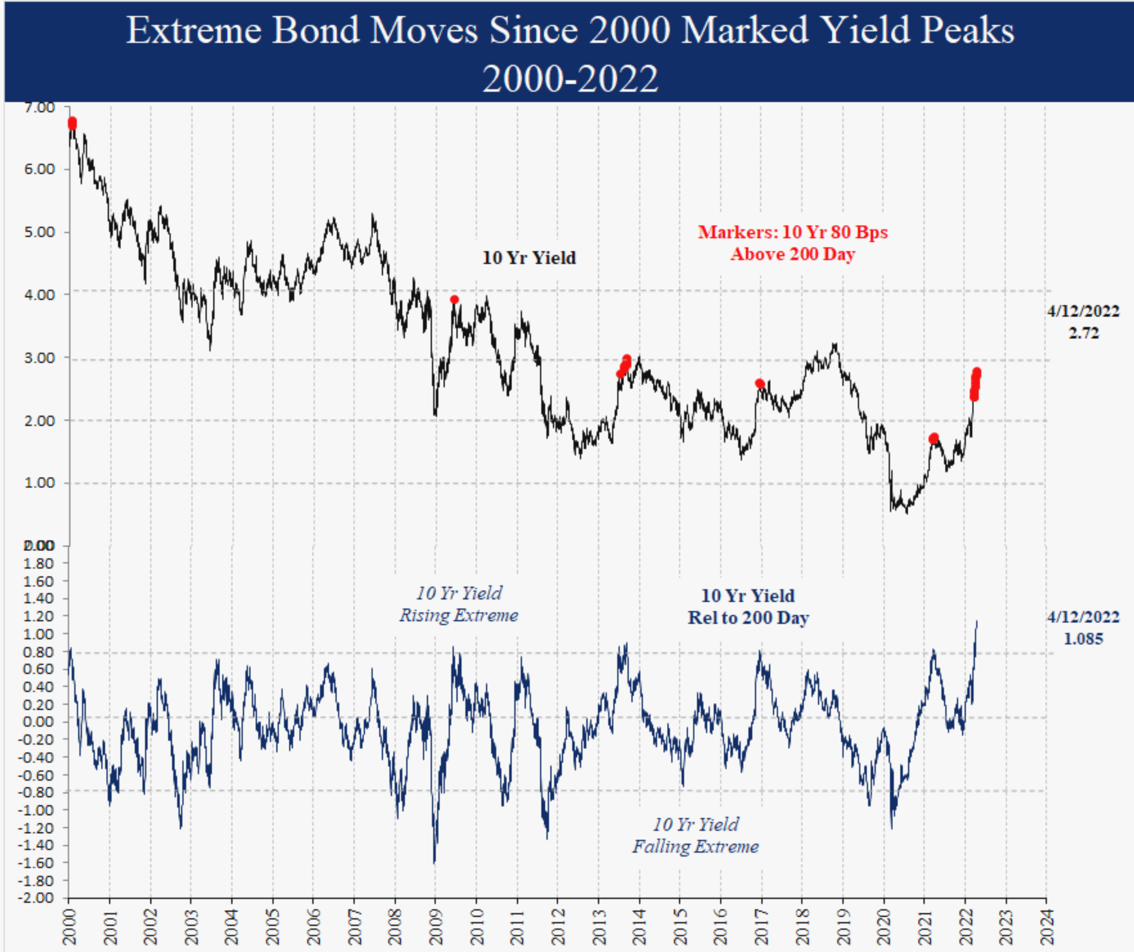
Consider the widely cited 1994 case. The Greenspan Fed hiked the Fed Funds target aggressively from 3% to 6% and the 10-year yield also rose with short rates. After an initial 9% decline in March, the S&P 500 ended flat on the year, up 1.3%, then rallied higher the next 3 years. However, the key difference that year was an absence of inflation. CPI ended the year at 2.7%, exactly where it started. One reason equities rose in 1995 was because rates were 300 bps over inflation, allowing equities to rally as rates unwound to the downside.

Today is the opposite with negative implications for equities. The Fed Funds target is 800 bps BELOW the inflation rate, and consequently unlike 1994, the Fed does not have the option to pause or cut rates. Historically, equity prices declined with this combination, anticipating further interest rate increases ahead.



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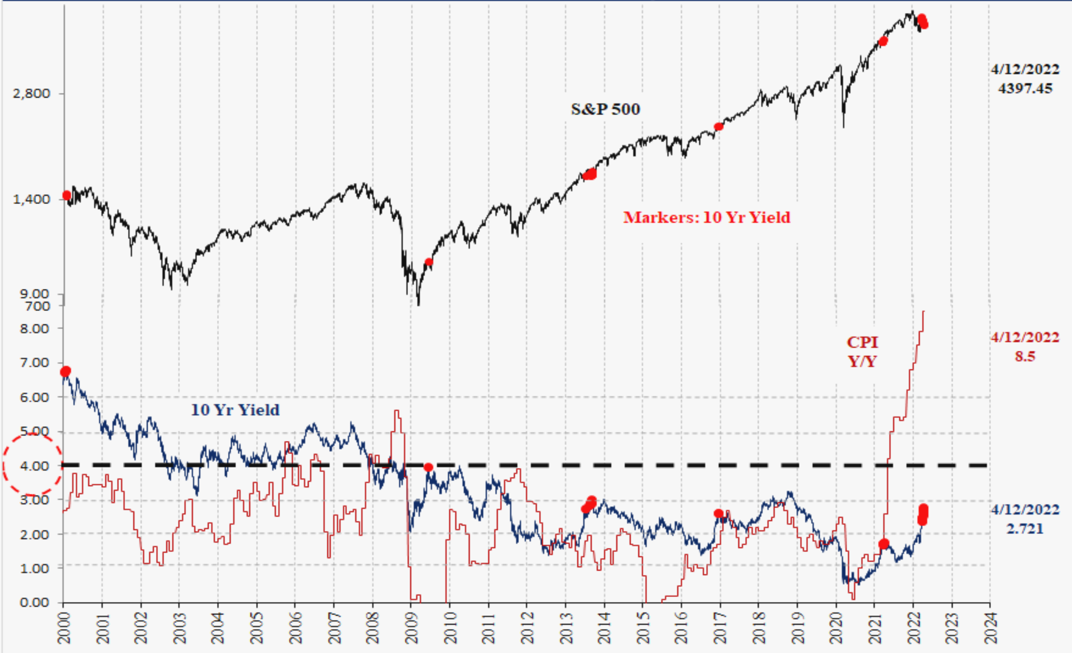
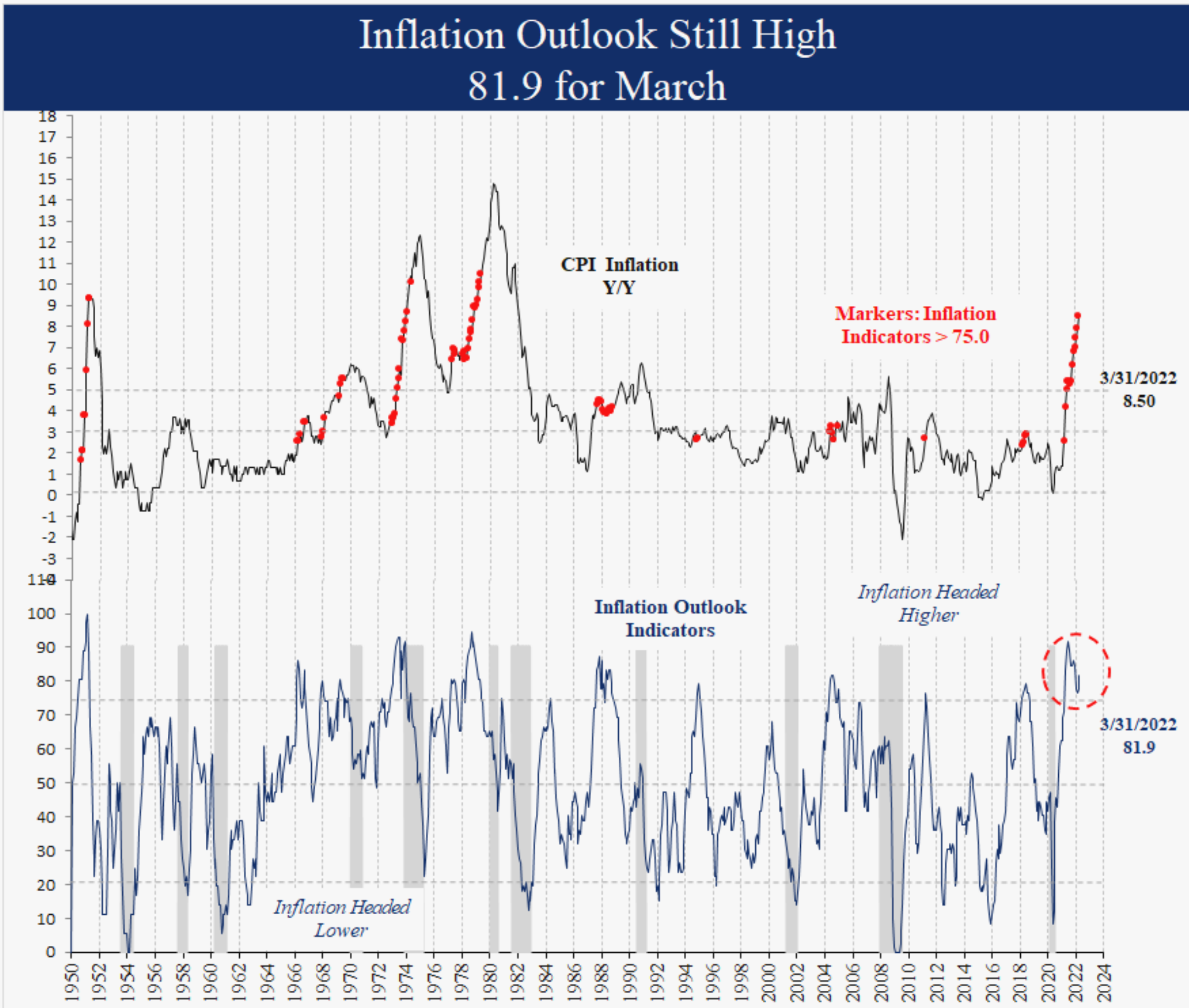
Extreme Bond Moves Since 2000 Were No Issue for S&P 500
Inflation and Yields Mostly Under 4%



Extreme Bond Moves Prior to 2000 Negative for S&P 500
Inflation and Yields Mostly Over 4%

Inflation Outlook 81.9: Still High

The inflation outlook upticked in March to 81.9. Inflation pressure remains despite the consensus expecting March as the peak for the year. We will be watching these indicators closely for a reversal, since lower inflation would be extremely significant for the investment environment. For now the high readings mean no relief in sight although the lower ISM index and higher CPI comps in the months ahead will help. For a lower CPI reading by year end, the M/M readings must drop below 0.6% vs. recent readings 1.2% in March and 0.8% in February.



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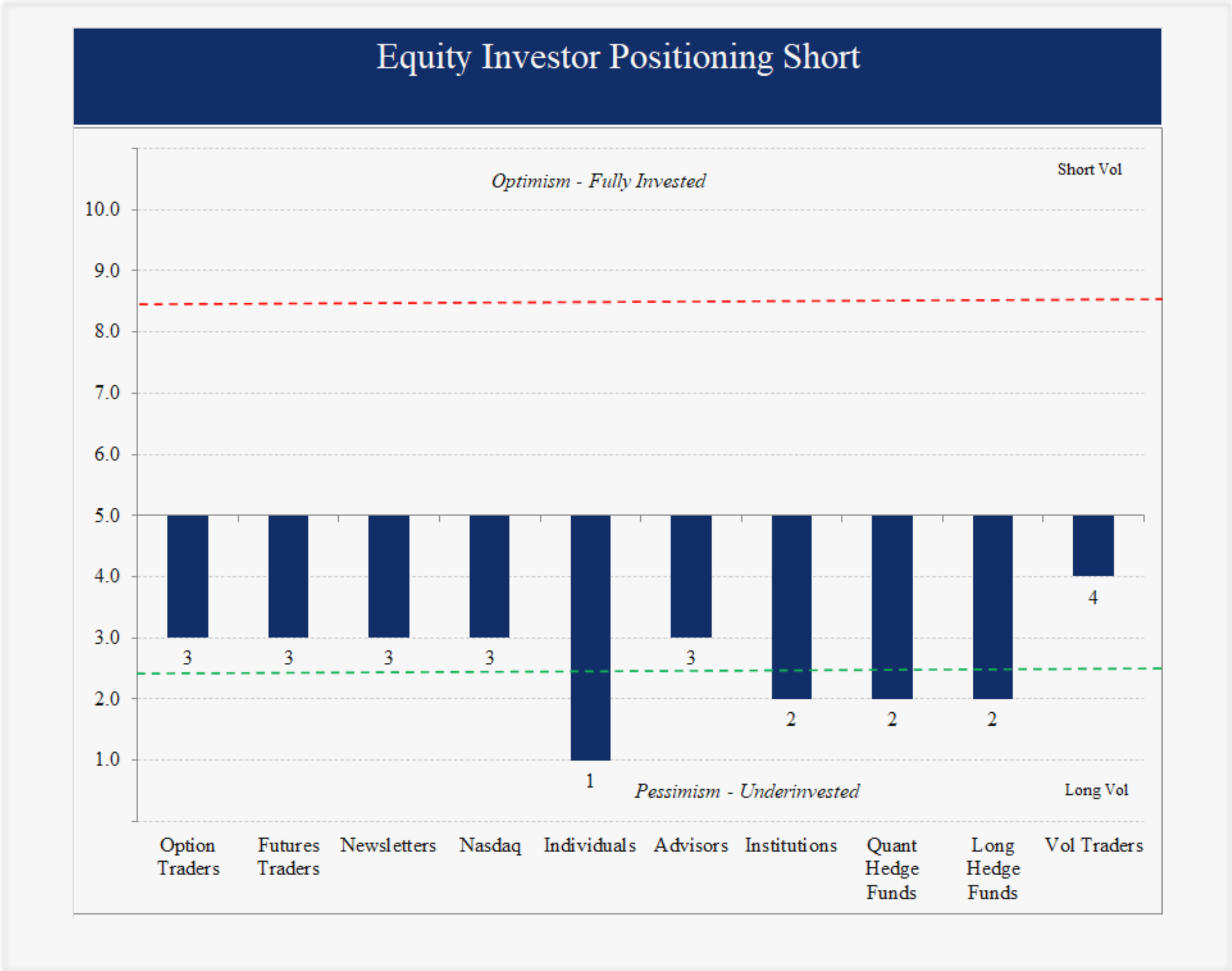
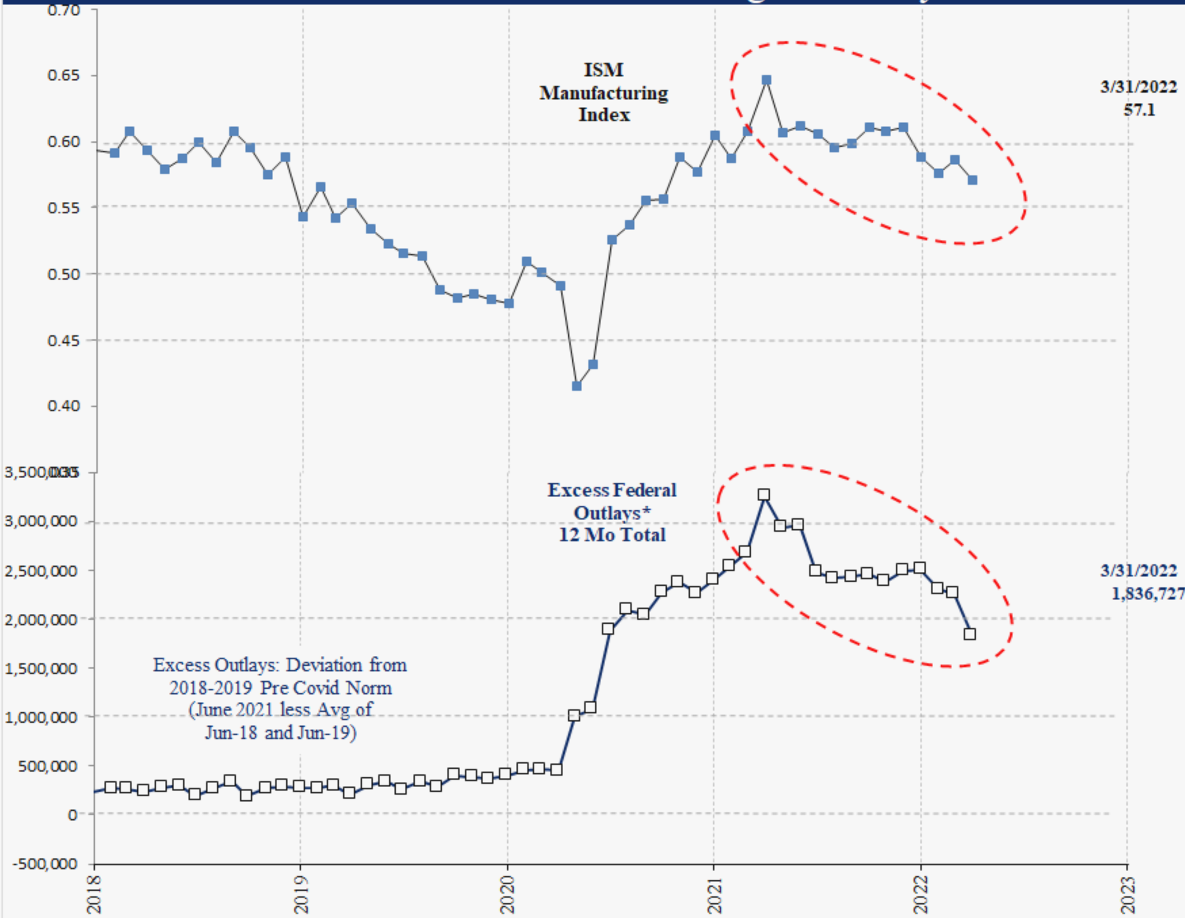
Equity Investors Short

All ten equity investor groups we follow are negative on equities, suggesting excess short-term cash on the sidelines and a potential rally ahead at some point. Positioning is still not as extreme as the March 8th low when the S&P 500 was down 13% from the peak.



Fiscal Cliff Arrived: Economy Slowing

The much-anticipated reversal in federal expenditures, also known as the fiscal cliff, finally arrived this year. After surging to over $3 trillion, excess federal outlays are down over a trillion to under $2 trillion as of March 31. Excess outlays are defined as the excess over the 2018-2019 norm. The high correlation to the economy demonstrates how important this fiscal impulse can be when this extreme. With fiscal programs deadlocked in Washington, D.C., the economy has already slowed on its own with minimal Fed input. Our economic outlook indicators remain neutral and a recession in the next 12 months remains a low probability for now.



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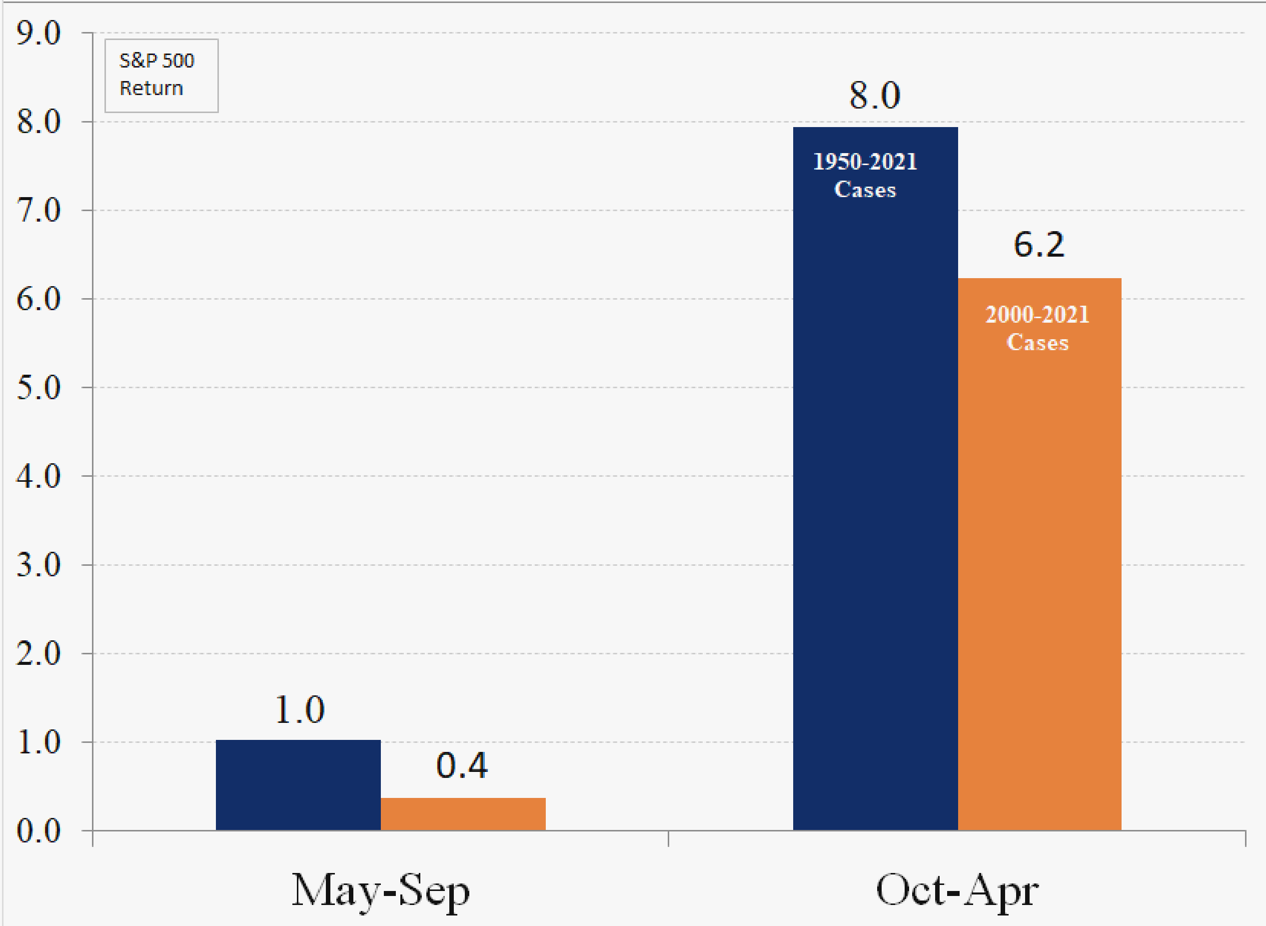
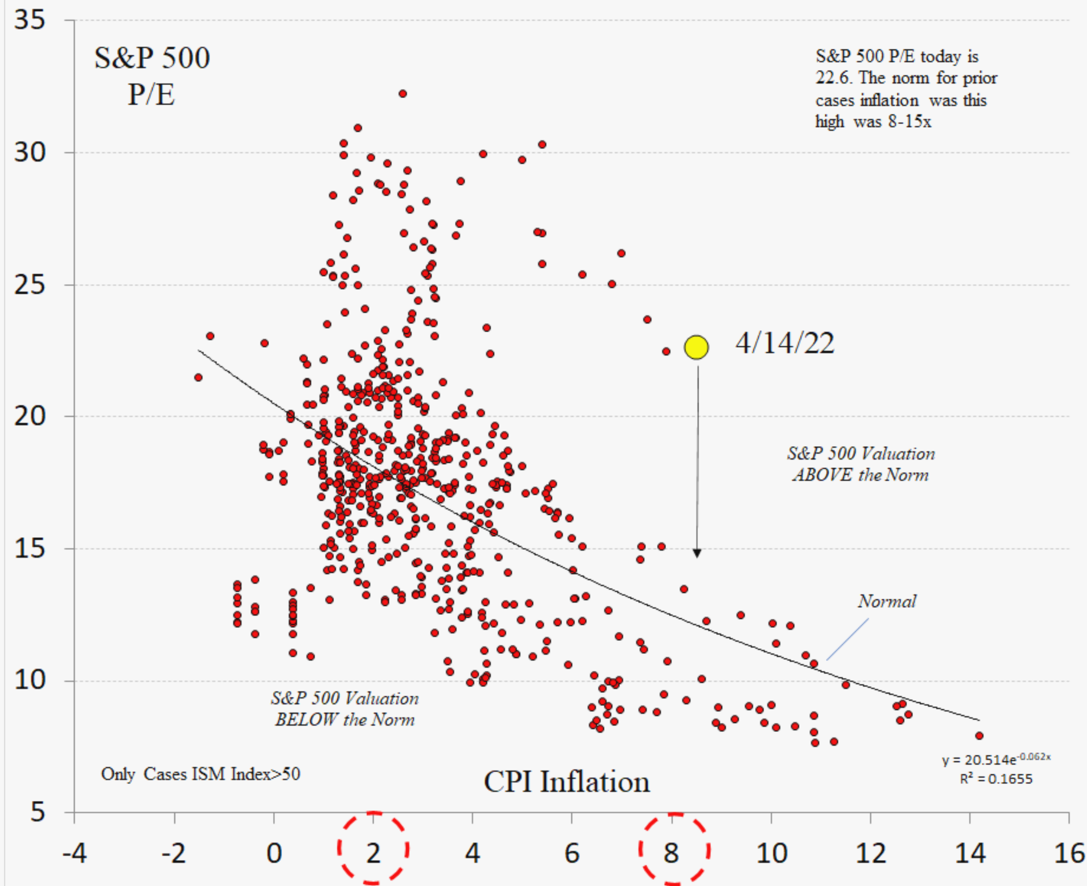
S&P 500 is Weak in the May to September Period

May 1st begins the weakest seasonal period of the year through September. Since 1950 the S&P 500 averaged just 1.0% during these 5 months vs. 8.0% for the 7 months between October and April. Despite the well-known saying "sell in May," the pattern has persisted consistently since 1950 and holds more recently as well. Since 2000 the May to September period was up 68% of the time vs. 81% for the October to April period. It is one more reason to be cautious on equities.



S&P 500 Valuation is High Relative to CPI Inflation

Today CPI inflation is 8.5% and the S&P 500 price earnings ratio is 22.6x. Historically, when inflation was at 8%, price/earnings ratios ranged from 8 -15, 50% lower. The 10-year Treasury yield relationship to valuation is not as tight, but at 2.8%, the current P/E of 22.6 is in the normal historical range. However, in prior cases the CPI was over 7.5%, the 10-year yield was much higher above 6% and the S&P 500 P/E was also much lower in the same 8-15 range. The risk for equity markets is a consensus expecting lower inflation. If instead inflation holds or surprises to the upside, the 10-year yield may continue higher and equity valuations may adjust to the downside. Historical P/Es are a very rough guide since the composition of the index has changed dramatically towards more growth stocks with higher valuations. For this study only cases when the ISM was over 50 were used to omit recession earnings which distort the P/E ratio.



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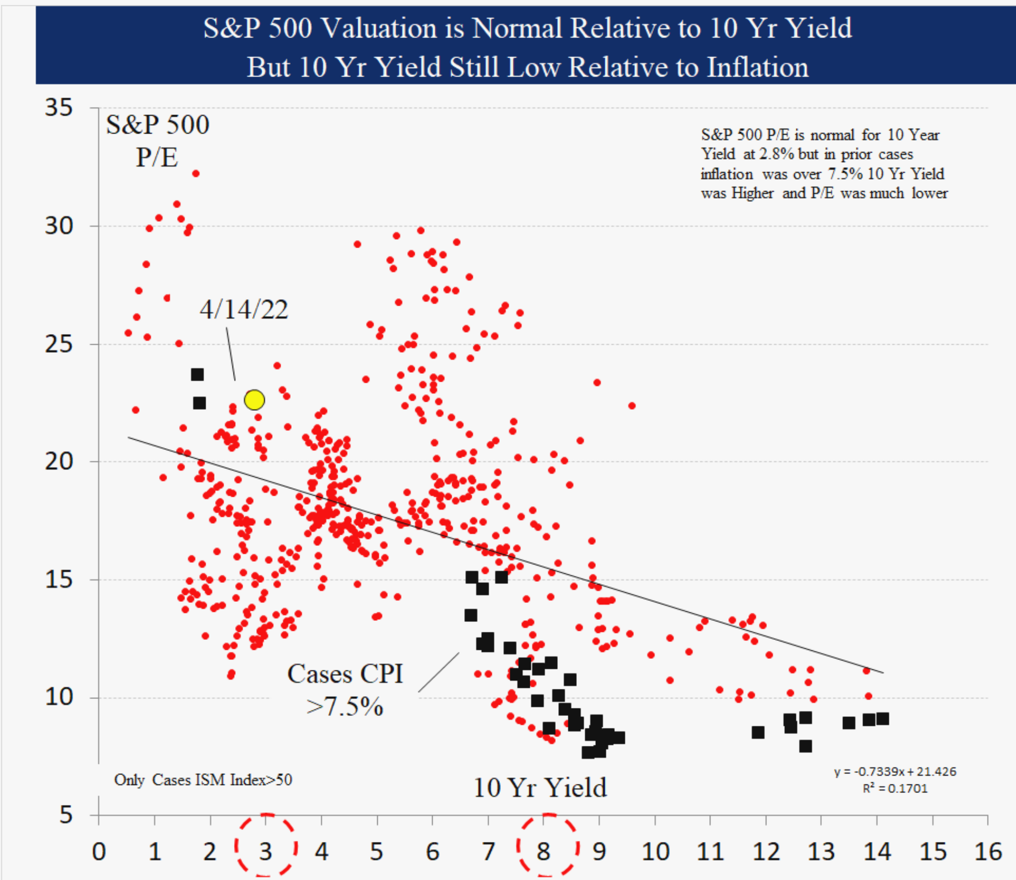

Summary

In early April after an 11% rally off the March low, we cut equity exposure in accounts and all our equity ratings. The combination of high and rising inflation, the Fed hiking rates and a rising 10-year yield is negative for equities historically, with a good possibility that a bear market began in January. The upcoming negative seasonal period combined with the valuation divergences are added risks particularly for U.S. equities. In this environment we have reduced risk to preserve capital until conditions improve. Gold remains a better option than cash to maintain purchasing power. We are testing conditions on a daily basis for any significant changes to our outlook. Thank you for your support and please contact us with any questions.

Michael Schaus
Director of Market Research