BRENTON POINT
WEALTH ADVISORS

May 17, 2022

Investing Environment Review and Outlook – Volume 59

Month of Extremes

Amid the extreme equity market volatility, war and inflation headlines, Fed interest rate hikes and recession predictions, investors might be missing the emergence of a normal mid-cycle economic slowdown and the counter intuitive implications for forward asset returns. This month we discuss this inflection point, the S&P 500 valuation relative to interest rates, extreme investor positioning, and the gold decline in historical context.

We raised the U.S. and foreign-developed equities ratings to a neutral 3. Emerging markets remain a neutral 3. We also raised long-term bonds to a neutral 3 rating. Gold remains a bullish 5 and commodities are a neutral 3.

Mid Cycle Economic Slow Down: Bullish for Bonds and Equities

While potential causes of a slower economy are numerous, like higher interest rates, the China COVID lockdown, or the decline in government spending, the evidence of a slowdown is pretty clear. For instance, the ISM manufacturing index declined again in April to 55.4 from 58.7 at year end and from the post COVID peak of 64.7 in March 2021. The 10-year Treasury yield also reversed lower by 0.4% from a peak of 3.2% to 2.8%, on 5/12. Copper is down 15% in the last month along with other base metals like Nickel and Zinc, all used in manufacturing. The CRB Industrials index is also down over 5% from the recent peak, the biggest decline since the COVID low in April 2020. After a neutral reading since June 2021, our economic outlook indicators downticked to a weak 39 reading on 5/13, indicating the ISM may slow further in the next 3 months.

Although there is always a risk of a recession at some point, so far, this economic move is quite normal for an economic recovery. For instance, in the last expansion from 2009 to 2020 there were 3 separate mid cycle slowdowns before the 2020 recession. During the 1990-2000 cycle there were 4 separate slowdowns before the 2001 recession.

When the Fed is cutting rates, a strong economy and strong economic outlook are bullish for equities. That is intuitive, since most investors equate a strong economy with higher stock prices. However, when the Fed is hiking rates to reverse inflation, a slowing economy and weaker economic outlook are bullish for equities historically, for instance like 2005, 1994 or 1984. Lower commodity prices like copper are accompanied by lower long-term interest rates as economic demand slows. Empirical evidence bears this out. Since 1970 when the Fed was hiking rates, the S&P 500 returned -7.2% annualized when the ISM was strong over 58 compared to a 13.3% return when the ISM was neutral, the conditions we have today.

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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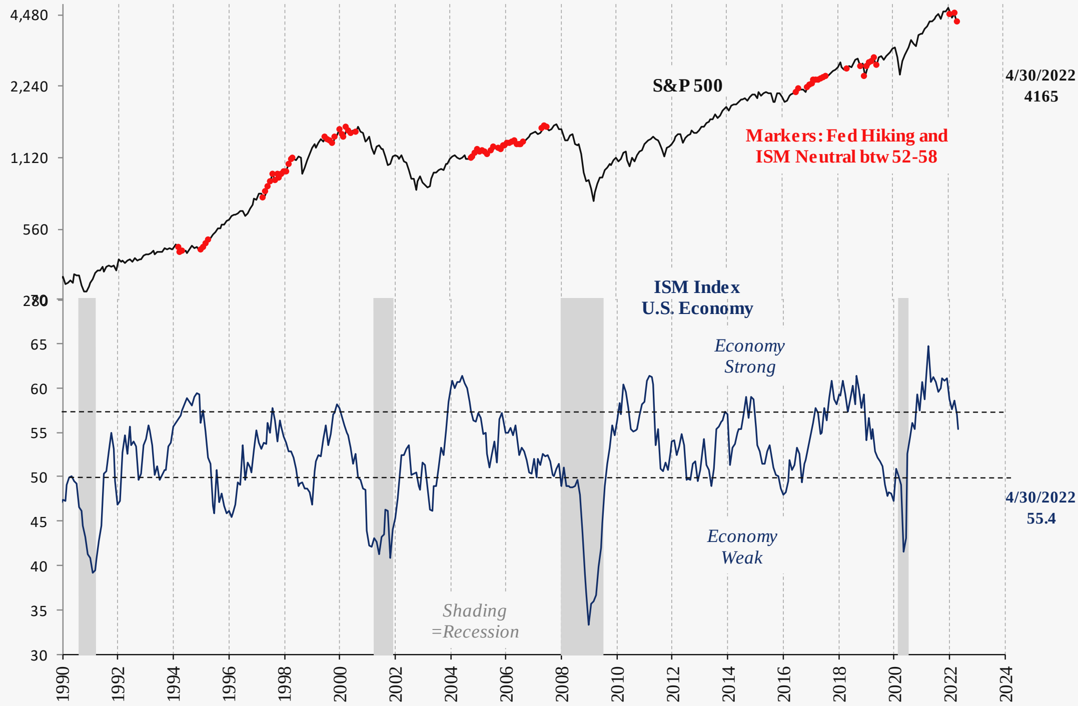
Reversal in ISM Manufacturing Index Signals Mid Cycle Slow Down: Bullish for Equities



Copper Down 15% from Peak Economy No Longer Overheating

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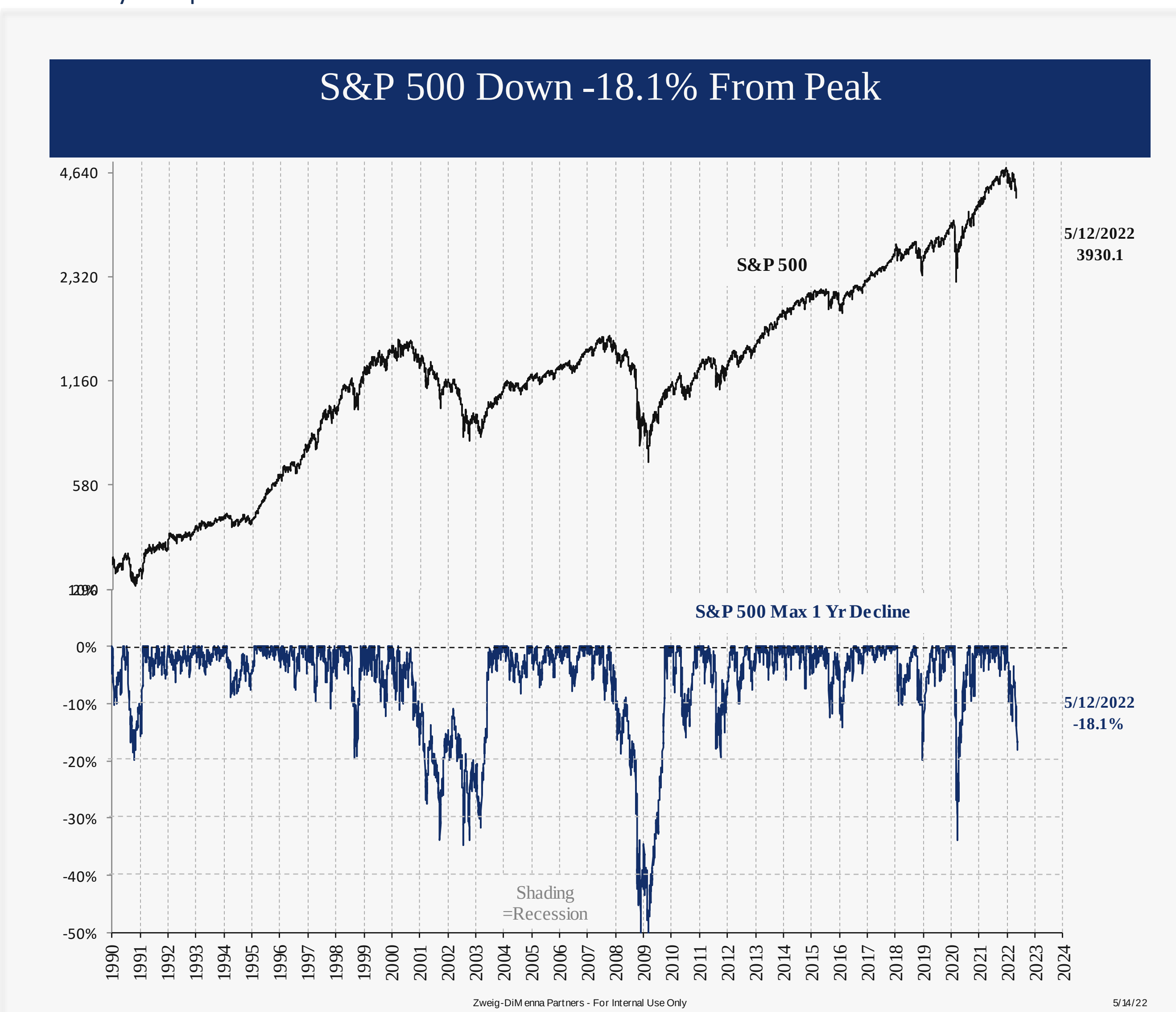
Intense Selling: Positive

The equity index declines have been intense by any measure. The S&P 500 was down 19.5% YTD at the intraday low on 5/12/22 and down 16.7% in just 6 weeks since 4/1/22. This put the S&P 500 10% below the 50-day average, in the 1st percentile of readings since 1990. This means the market was, by this measure, weaker just 1% of the time since 1990, or more importantly, it was stronger 99% of the time. In the 8 prior cases that occurred since 1950 when the Fed was hiking rates, the S&P 500 was higher 3 months later an average of 7.8%, 3x the norm. A year later the average was 25% higher, 2.3x the norm. One significant offset is that in four of those cases the Fed reversed course and cut interest rates within a month, which is unlikely this year. But intense selling and oversold markets are often followed by reversions to the mean even during bear markets, so flexibility is important.



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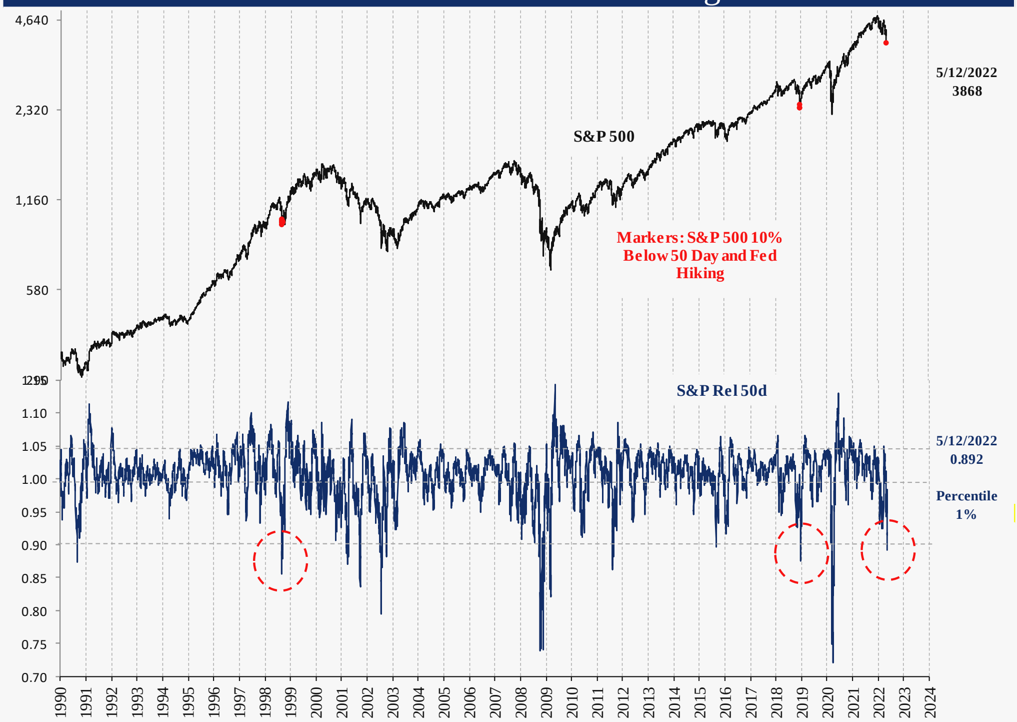
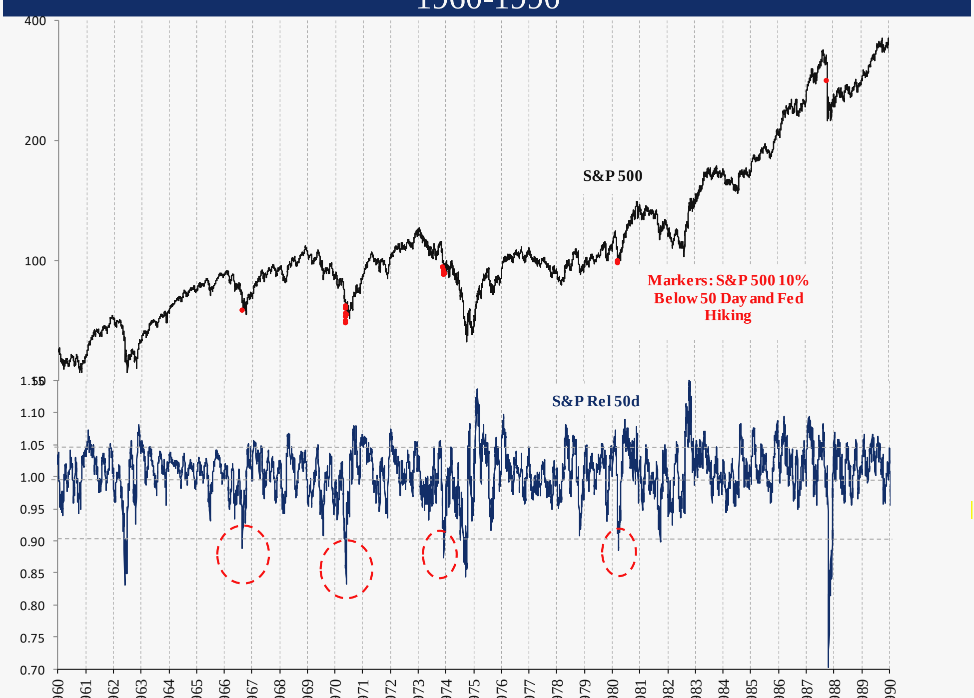
Intense Selling Pressure: Positive
S&P 500 10% Below 50d and Fed Hiking 1990-2022



Intense Selling Pressure
1960-1990



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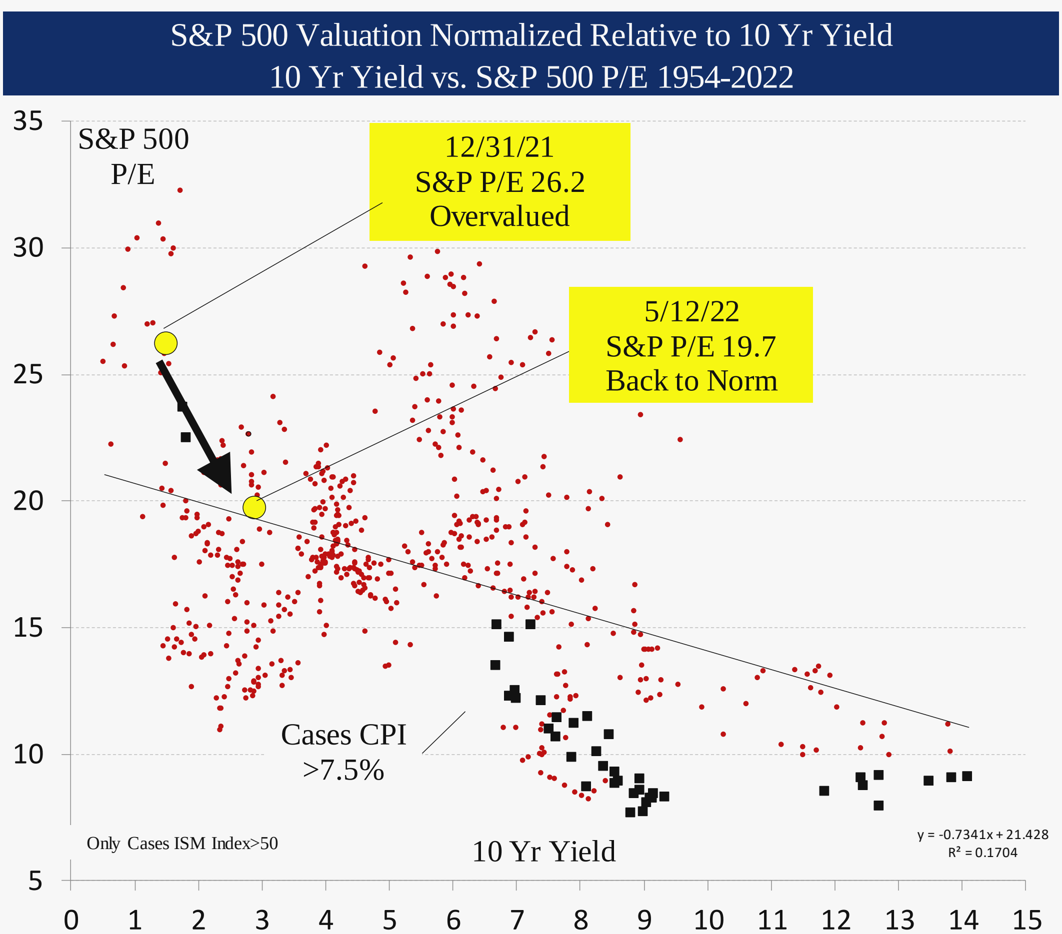
Higher Interest Rates = Lower Equities

Finance 101 teaches that a higher interest rate means a lower present value of future cash flows. Reality is more complicated as usual, since historical S&P 500 valuations compared to interest rates are certainly not a perfect fit. However, the concept is valid. The historical S&P 500 price earnings ratio norm is 21 when the 10-year Treasury yield is 1% and declines to a P/E of 10 when the 10-year yield is much higher at 15%. At year end the S&P 500 trailing price earnings ratio was 26.2, 5 points above the historical norm. By 5/12/22 the 10-year yield had doubled to 2.9% while the S&P 500 declined 18% and reduced the P/E to 19.7, close to the norm for a 3% 10-year yield. This historical relationship demonstrates why higher interest rates are a risk to equity prices and why the recent reversal in the 10-year yield, if it holds, is so important for the direction of equities. There is significant variation, but all else equal, if the 10-year Treasury yield continues higher, we should expect the S&P 500 to go lower. For now, the 10-year Treasury yield has been flat for a month, which may be enough for equities to rally.



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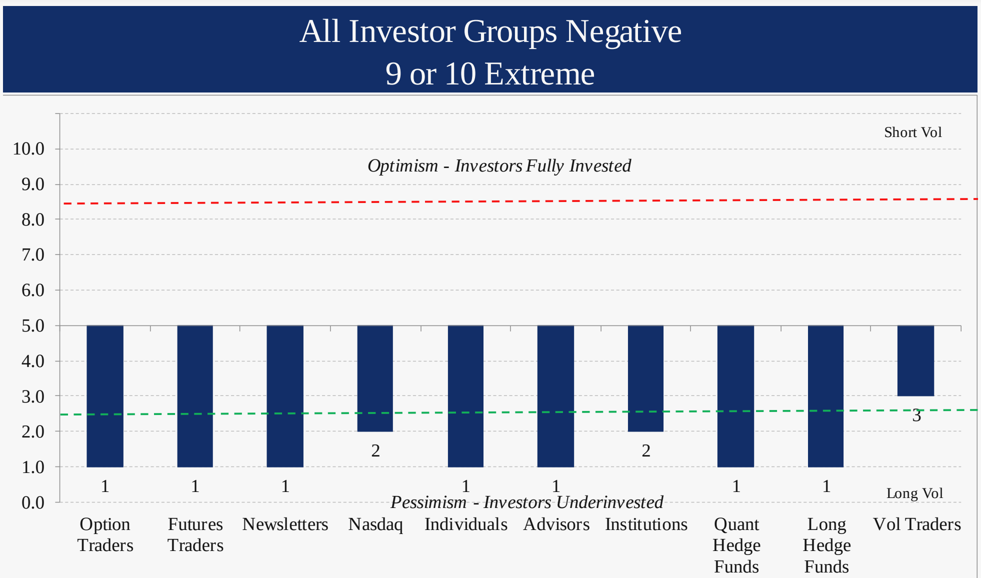
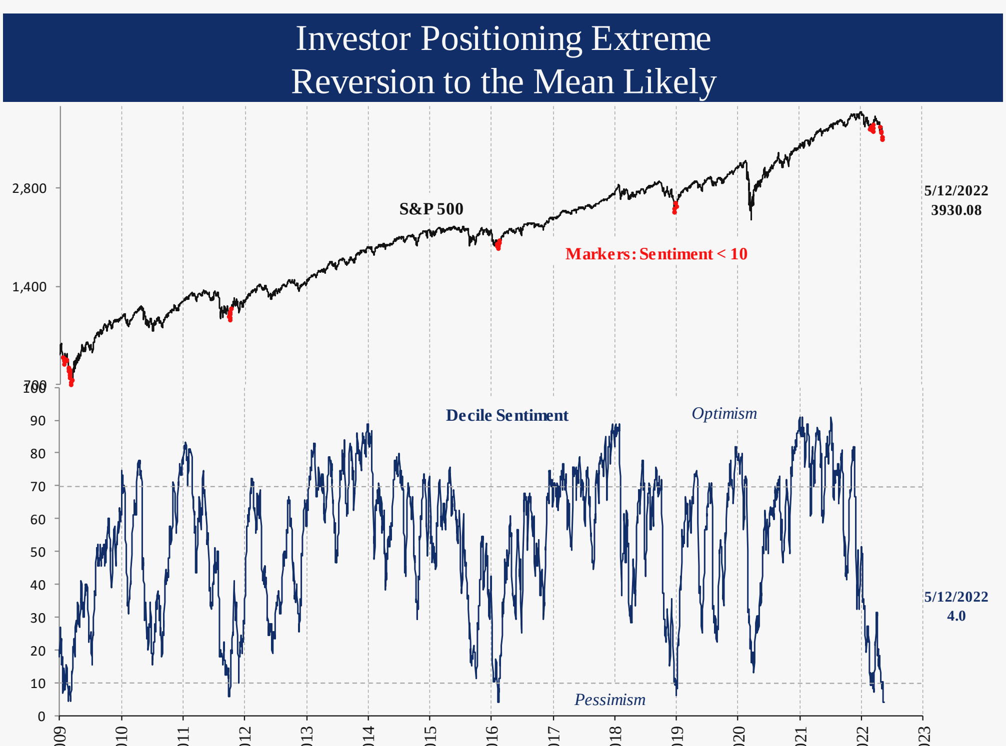
Investor Positioning Extreme

The 18% decline in the S&P 500 this year and bigger decline for other indices has resulted in extreme investor positioning as you might expect. 9 of 10 groups we follow are now in the bottom quintile of historical readings. While no one group is reliable as an indicator, when all groups reach a negative consensus like today, the low investor equity exposures and high cash levels mean a reversal in equities becomes more likely, even during bear markets.





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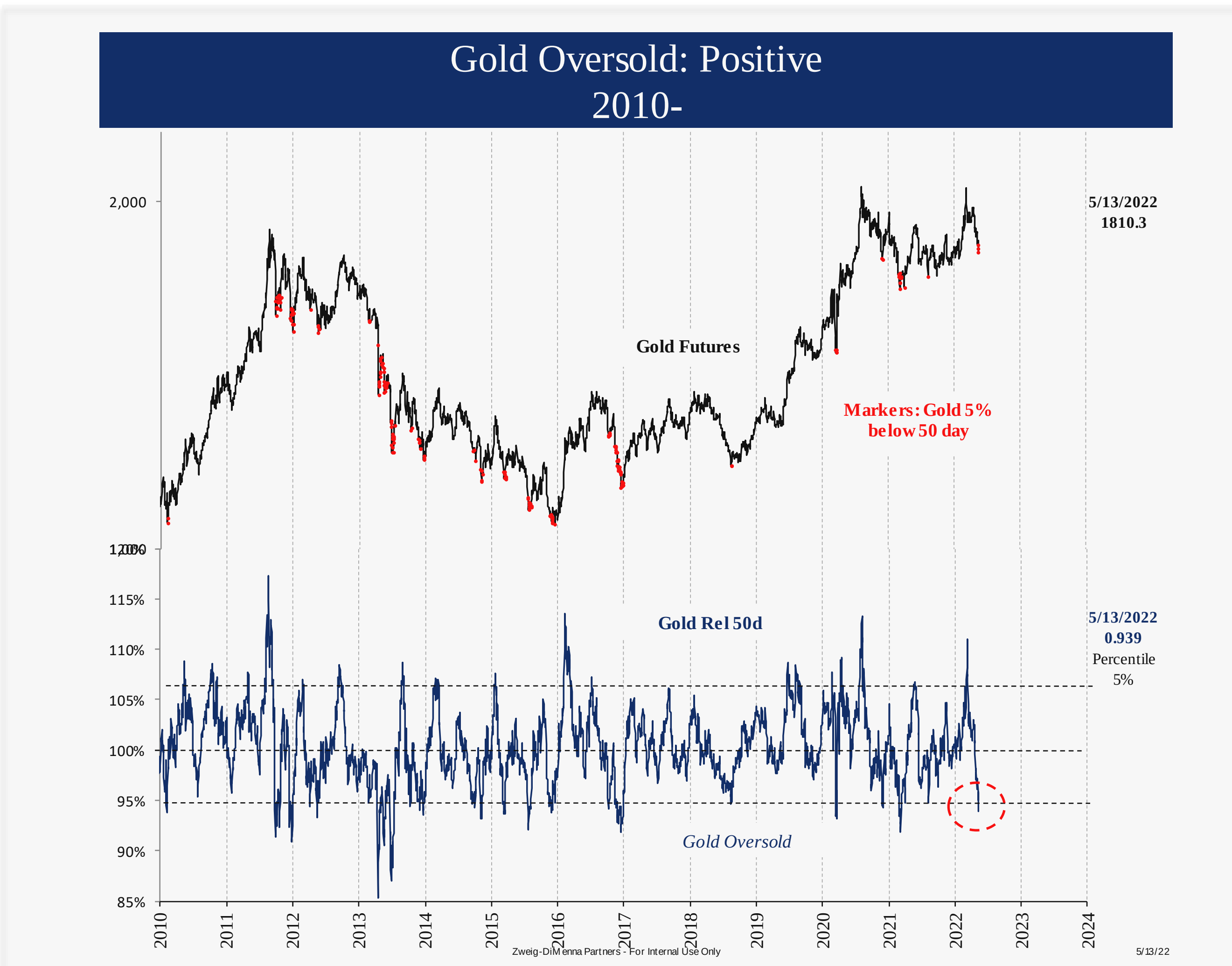
Gold Oversold: Positive

Gold has been a disappointment this year for investors, outperforming equities but seeing recent liquidation. After peaking at $2,058 up 12.4% YTD on 3/8 post the Ukraine invasion, Gold closed at $1809 on 5/13 down 1.2% YTD and down 8.5% in just one month. This puts it 6% below the 50-day average in the weakest 5% of readings since 1990. Prior cases since 2010 were typical of intermediate term lows which then reversed higher. There were also 4 cases which marked lows in the comparable 1977-79 period. These occurred early in the bull market with significant gains ahead. Today is similar to this gold bull market period when the Fed was hiking rates and inflation was above the 3-month T Bill yield, pushing investors into alternatives. Our gold rating remains a bullish 5.



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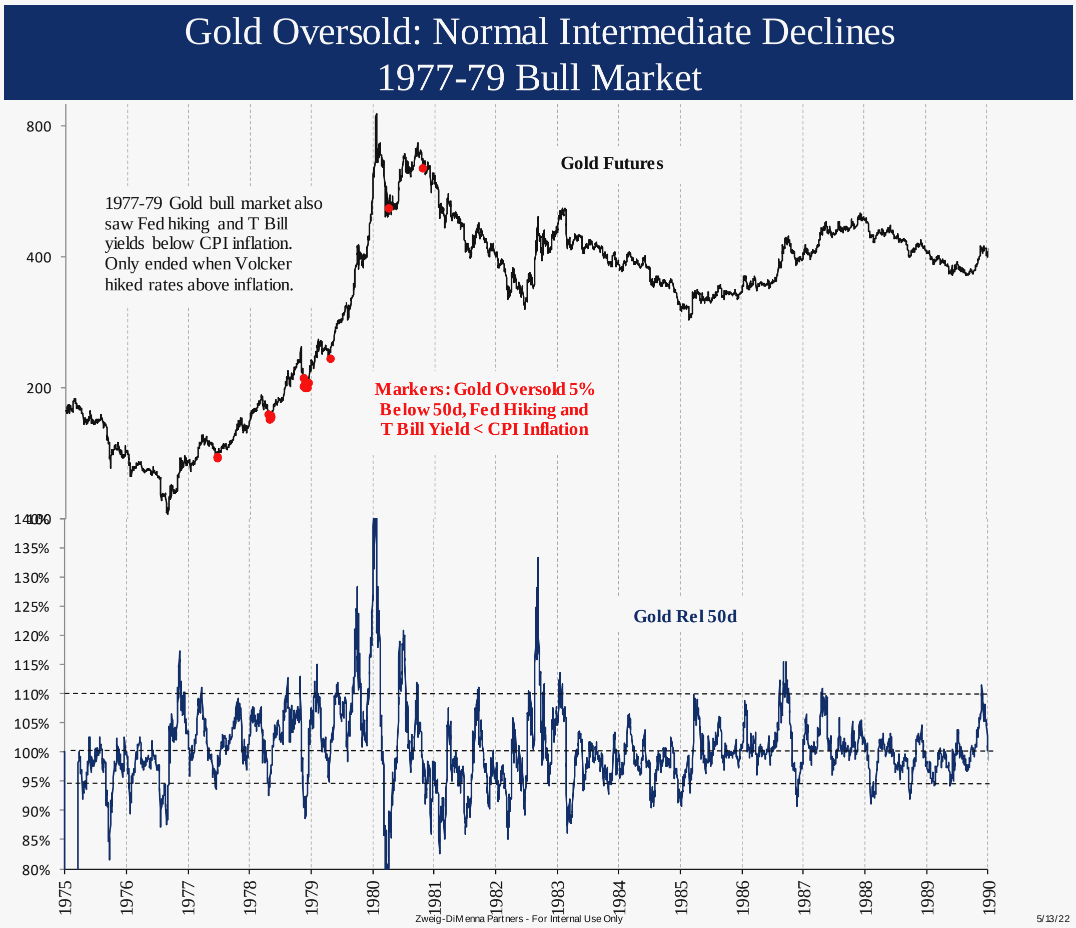

Summary

Last month equity indicators were negative based on high and rising inflation, the Fed hiking rates, the rising 10-year yield and negative seasonality. This month, after the S&P 500 declined 16% in just 6 weeks, conditions have changed significantly. While the Fed is still hiking rates and seasonality remains negative through September, the combination of an extreme decline in stocks, evidence of a normal mid-cycle slow down, and extreme investor positioning were positive for equities historically, even if we remain in a bear market. We will remain flexible and continue testing conditions as they change on a daily basis. Thank you for your support and please contact us with any questions.

Michael Schaus
Director of Market Research