BRENTON POINT
WEALTH ADVISORS

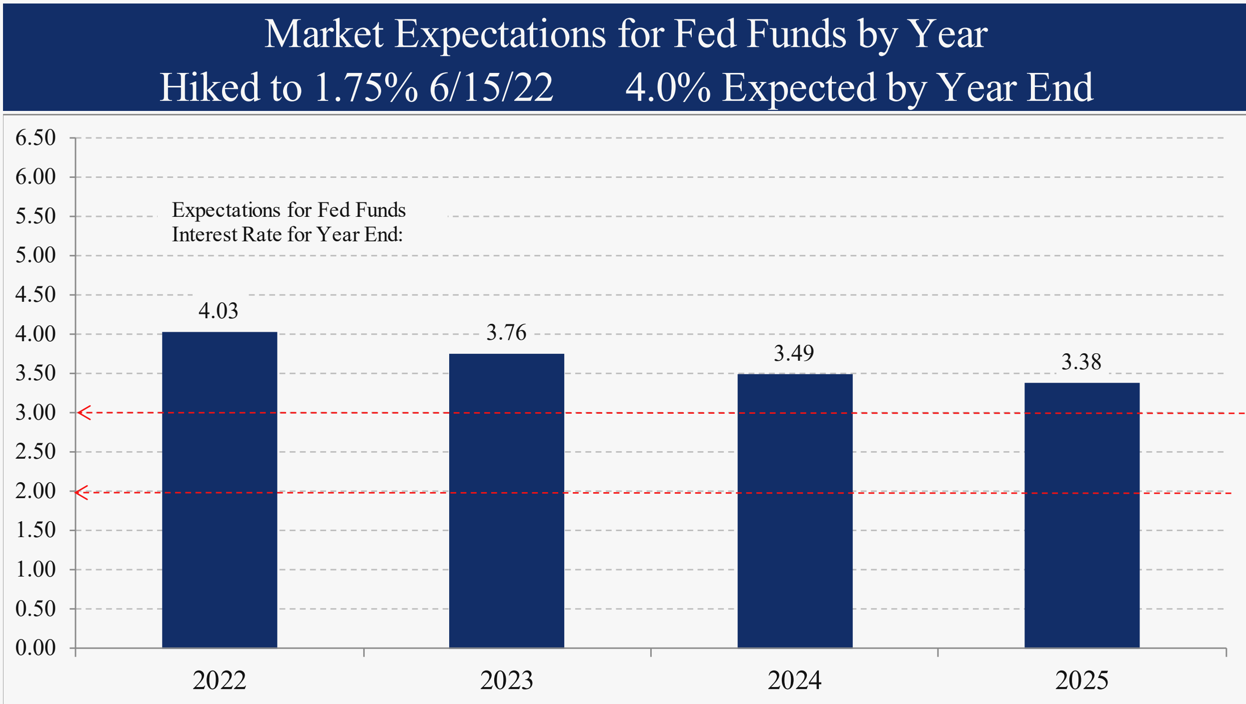
June 17, 2022

Investing Environment Review and Outlook – Volume 60

Déjà Vu

Last month we discussed the positive implications of the mid-cycle economic slowdown, intense selling, and the extreme investor positioning. Since then, it was a round trip for the S&P 500 up 10% into May's month-end followed by this week's sharp 3-day 9% decline prior to the widely anticipated June Fed meeting. Despite recent news, like the crypto crash and the Fed 0.75% hike on 6/15, the major economic, sentiment and technical conditions match one month ago, and remain positive for equities in the short term despite the negative headlines. This month we discuss the implications of the Fed's move and update some of last month's relevant charts.

We raised the emerging markets rating to a bullish 5. The U.S. and foreign developed equities remain a neutral 3 along with long term bonds. Gold remains a bullish 5 and commodities a neutral 3.



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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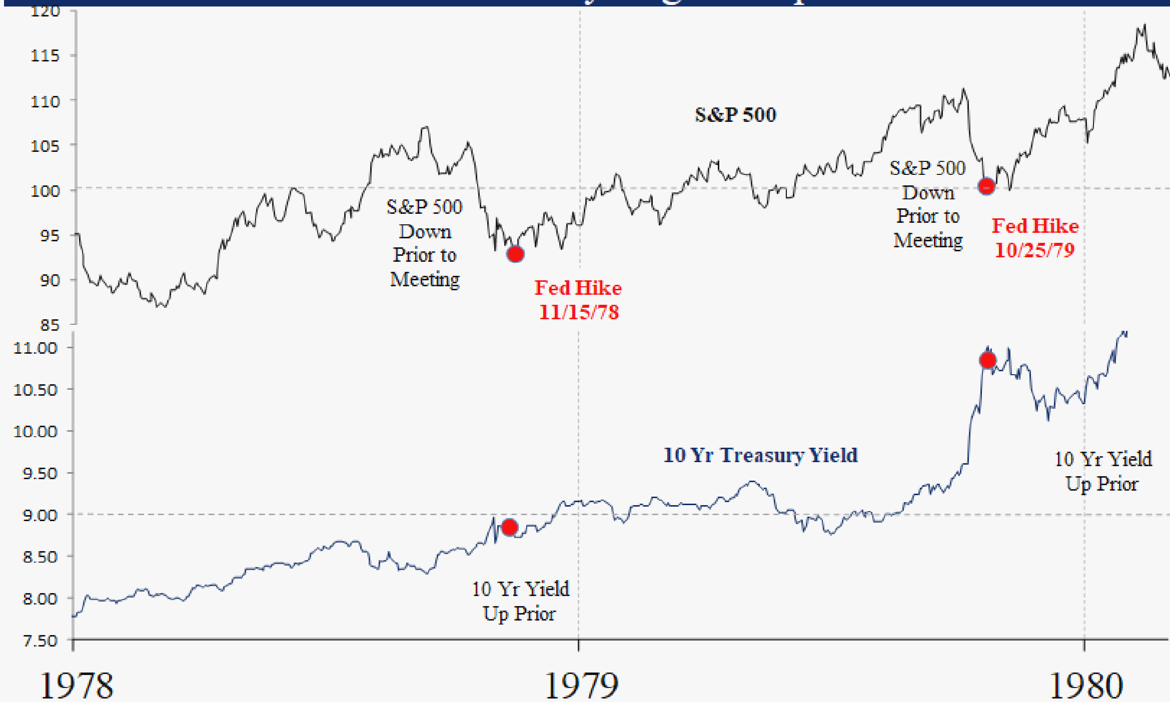
June Fed Hike: Potential Equity Turning Point

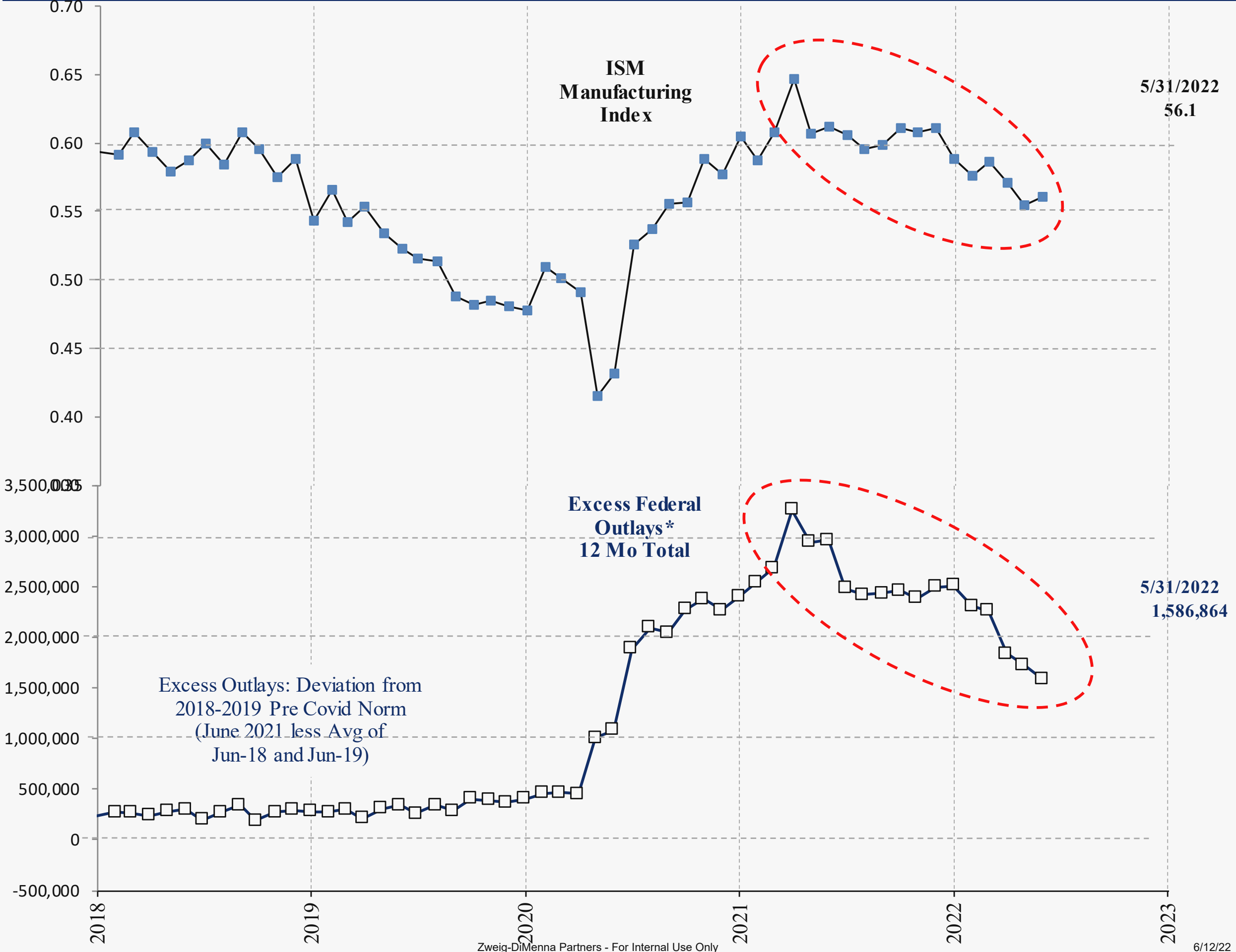
After the extreme selling in the last two weeks and near record low investor positioning, the 0.75% 6/15/22 Fed interest rate hike may mark a turning point for equities. We know the Fed hiking rates combined with inflation is a negative combination historically, which is why we cut ratings and exposure in April. However, we also know markets anticipate future events. The S&P 500 declining 23% over 5 months has certainly anticipated bad news, in particular pricing in Fed Funds at 4.0% by year end. If that occurs, 2022 will rank 3rd for Fed hikes in the 108 years since the Fed began in 1914, just behind Volcker in 1979 and 1980. The important point is a lot of bad news is already expected and priced into markets.

In two similar prior cases in Nov 1978 and Oct 1979 when stocks declined sharply and the 10-year yield rose sharply before the Volcker Fed hiked interest rates, stocks rallied, and the 10-year yield declined afterwards. In both cases the S&P 500 was up 10% within 3 months.



Falling Federal Spending Slowing Economy, Helping the Fed

Federal outlays peaked with the economy in March 2021 and have led lower since then. This is no coincidence since Federal outlays were 30% of GDP in 2021. The slowing economy is consistent with prior mid-cycle slow downs, positive for equities, particularly when the Fed is hiking rates as they are today. The slowing takes the pressure off inflation and the Fed eventually.



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Equity Extreme Selling…Again

After a 10% 2 week rally off the May 20th extreme selling low, the S&P 500 reversed sharply lower in June in a second round of extreme selling. On 6/13 the S&P 500 was over 10% below the 50-day average, in the first percentile of historical oversold readings. That means in prior cases stocks were stronger 99% of the time, and today more likely to reverse to the upside than decline further. In addition, the media widely reported the S&P 500 was down over 20% from the high, marking a bear market. It sounds ominous but of the 13 prior cases since 1950, all but one was higher 2 months out an average of 6.2%, over 3x the historical norm.

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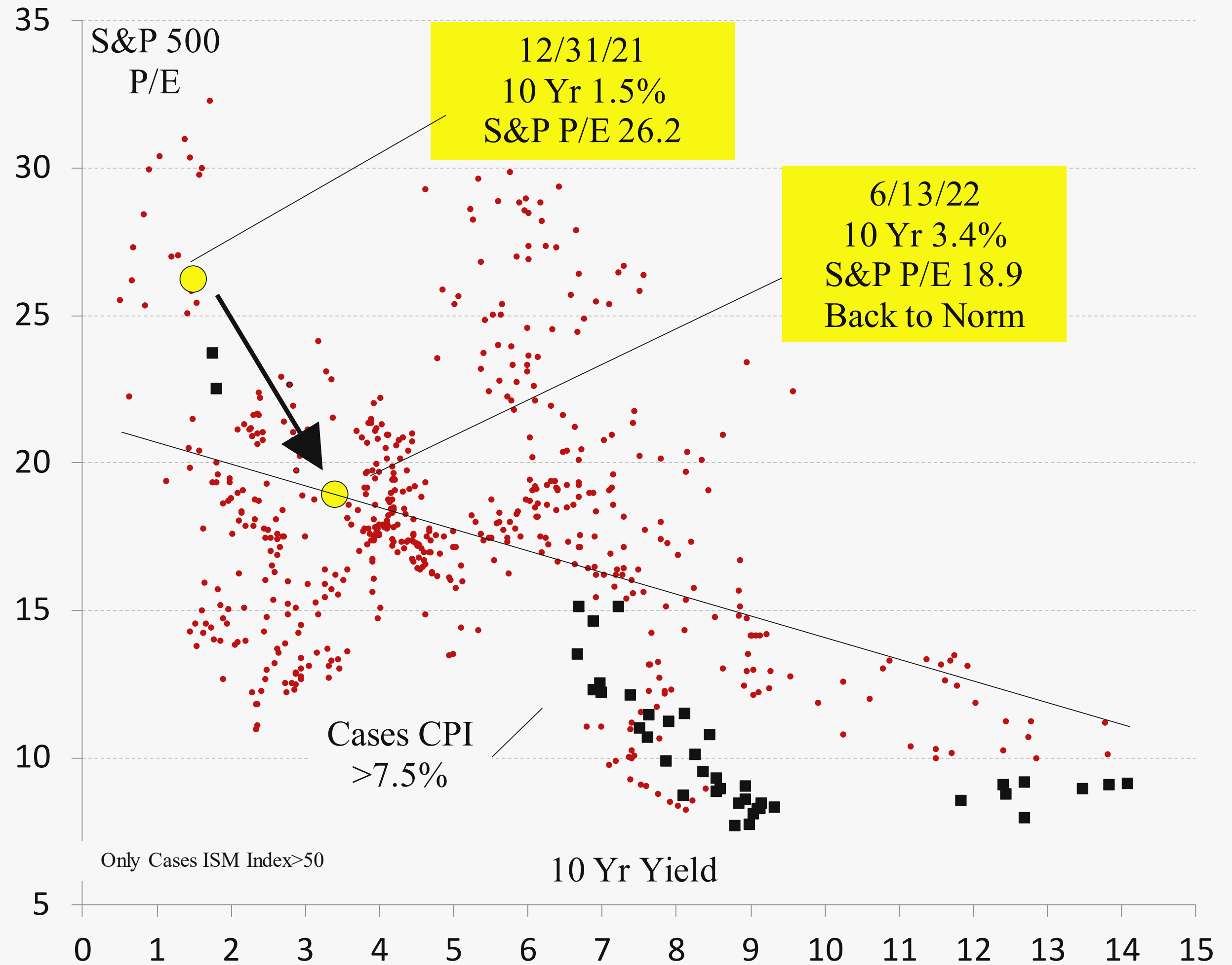
How the 10 Year Treasury Yield Matters for Equities

The decline in the S&P 500 price earnings ratio this year from 26.2 at year end to 18.9 on 6/13 as the 10-year yield climbed from 1.5% to 3.4% demonstrates what we discussed last month – that a higher interest rate translates into a lower present value. While not predictive, it shows why interest rates are so important to the stock market, and why we watch them closely. The current P/E and 10-year yield combination is now in line with historical readings. The second chart shows relative to inflation of 8.6%, the valuation is still above prior cases. This will likely resolve with a higher 10 year yield and lower valuation, or inflation declining back to the norm.

The trend of the 10-year yield is also significant as we witnessed this year. The perfect storm conditions this year of the Fed hiking, the high and rising CPI, and rising 10-year yield historically led to -13.3% S&P 500 annualized returns since 1950. However, historical returns jump to a positive 4.1% when the 10-year yield reverses down like we saw after the 6/15 Fed hike, even with high and rising inflation and the Fed hiking.



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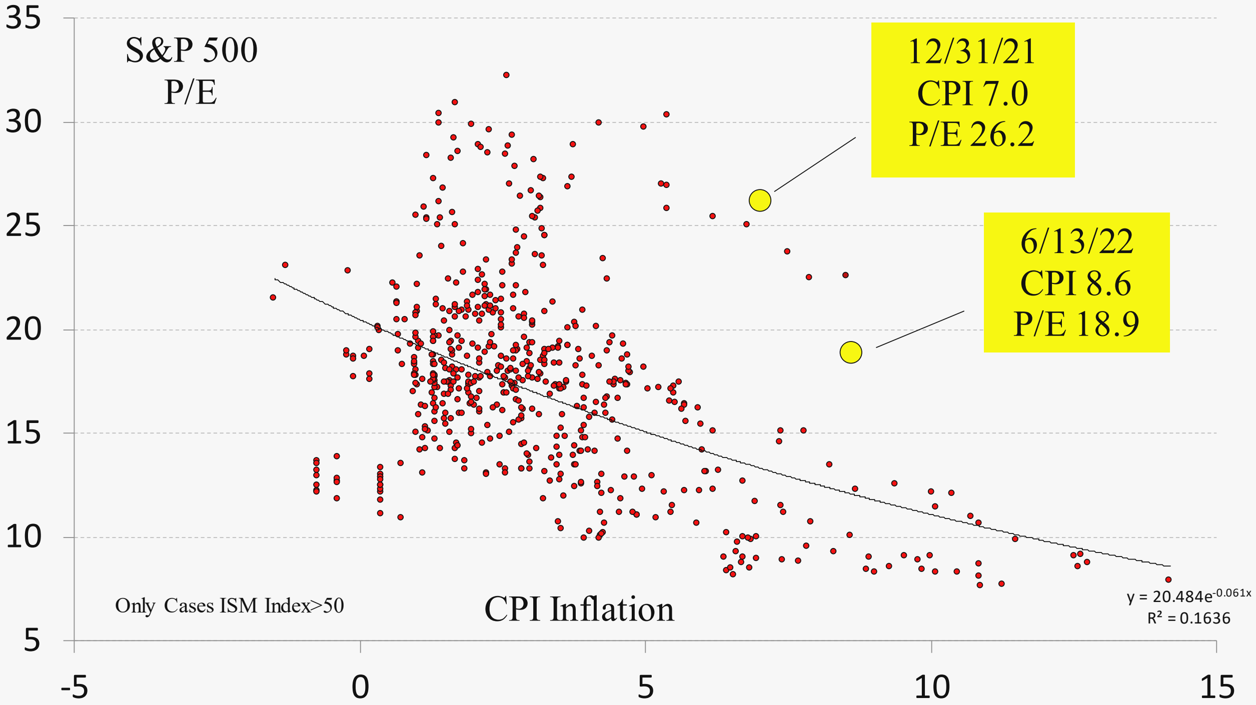
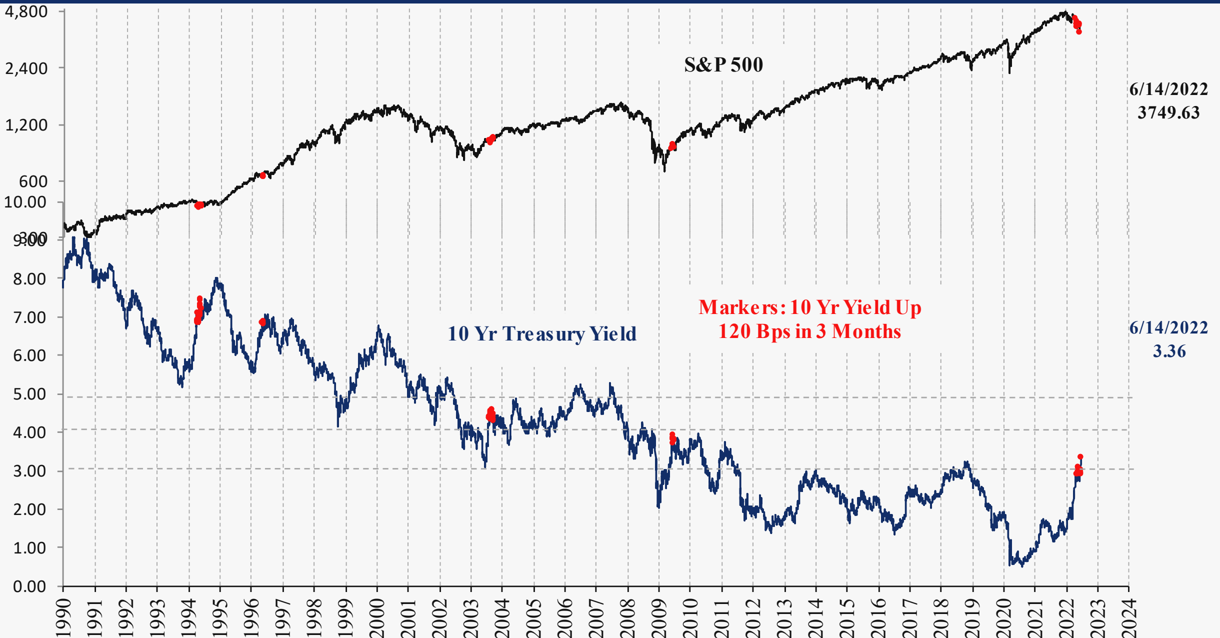
S&P 500 Valuation Still High Relative to CPI Inflation
CPI Inflation vs. S&P 500 P/E 1954-2022



10 Yr Yield Up Sharply in 2022



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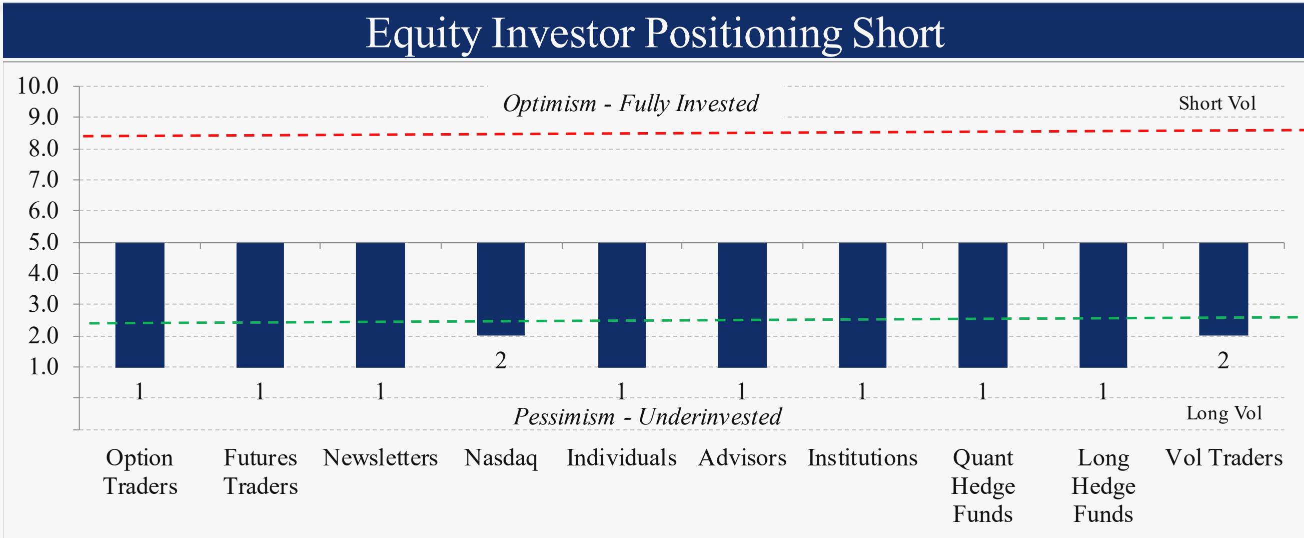
Investor Positioning Extreme…Again

The intense selling this month has led to a predictable move in investor positioning back to extreme levels. All 10 investor groups we measure are now in the 1st or 2nd decile of historical readings. Although pessimism can persist during market declines, as Marty Zweig used to say, "the rubber band is pulled back." As discussed, a prime catalyst for a turn to the upside is the 6/15/22 Fed hike meeting.



Positioning Since 2020

S&P 500

4,400

2,200

6/13/2022
3749.63

Decile Sentiment

Investors Long

Investors Short

100
90
80
70
60
50
40
30
20
10
0

6/13/2022
2.0

2020
2021
2022

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6/14/22

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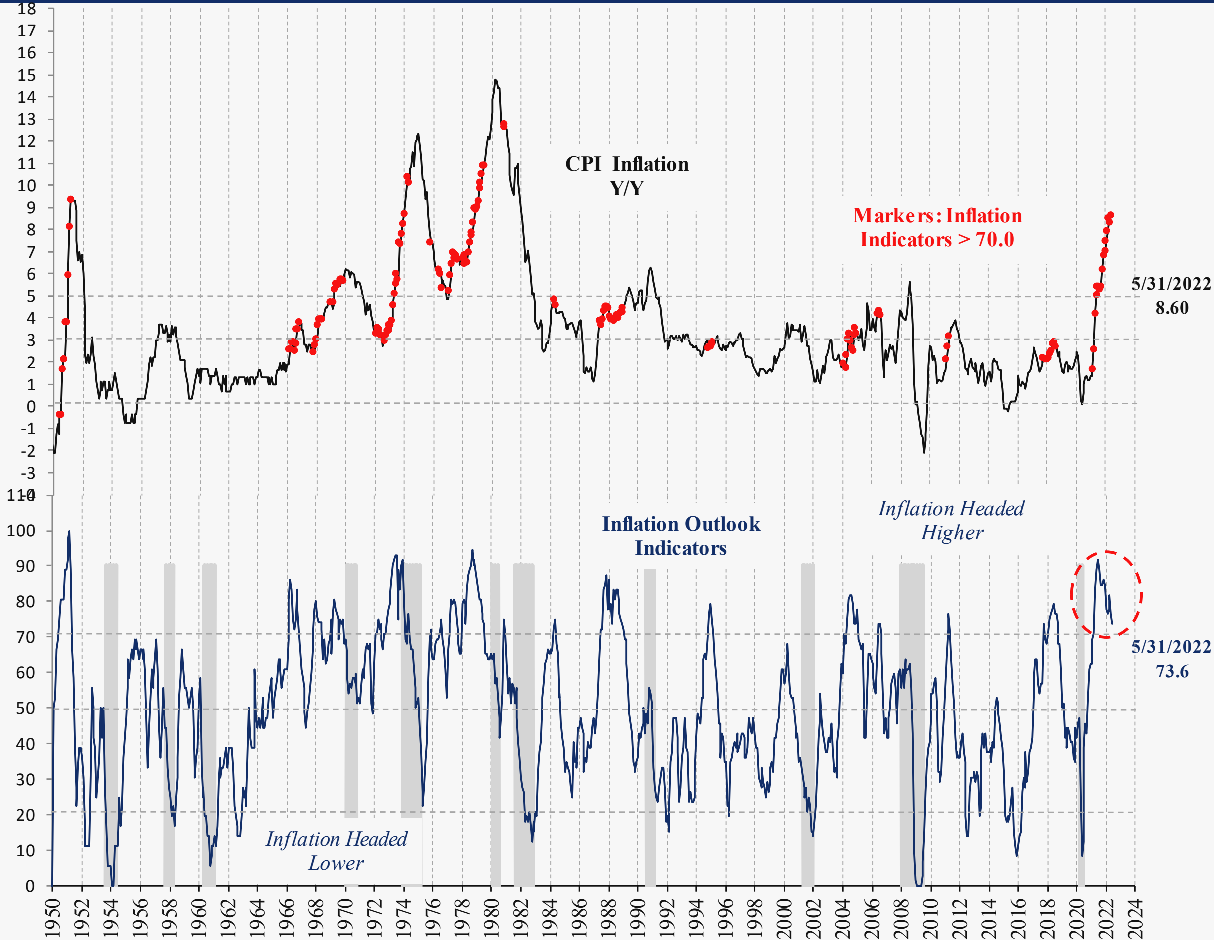
Inflation Outlook Indicators Improved but still Elevated

Inflation indicators improved to 73.6 in May but are still elevated. The pressure for higher inflation is still on but there are signs of a reversal. The most important is the slowing of the economy itself, since inflation typically lags economic moves. The ISM manufacturing index peaked in March 2021 and fell 6 points from November through April. Second is the 5% decline in the CRB Industrials index from the April peak, the lowest since February. Finally, the LME base metals index is down 22% from the March peak, the lowest since December. Although Natural Gas declined 15% on 6/14, crude oil remains up over 50% YTD.



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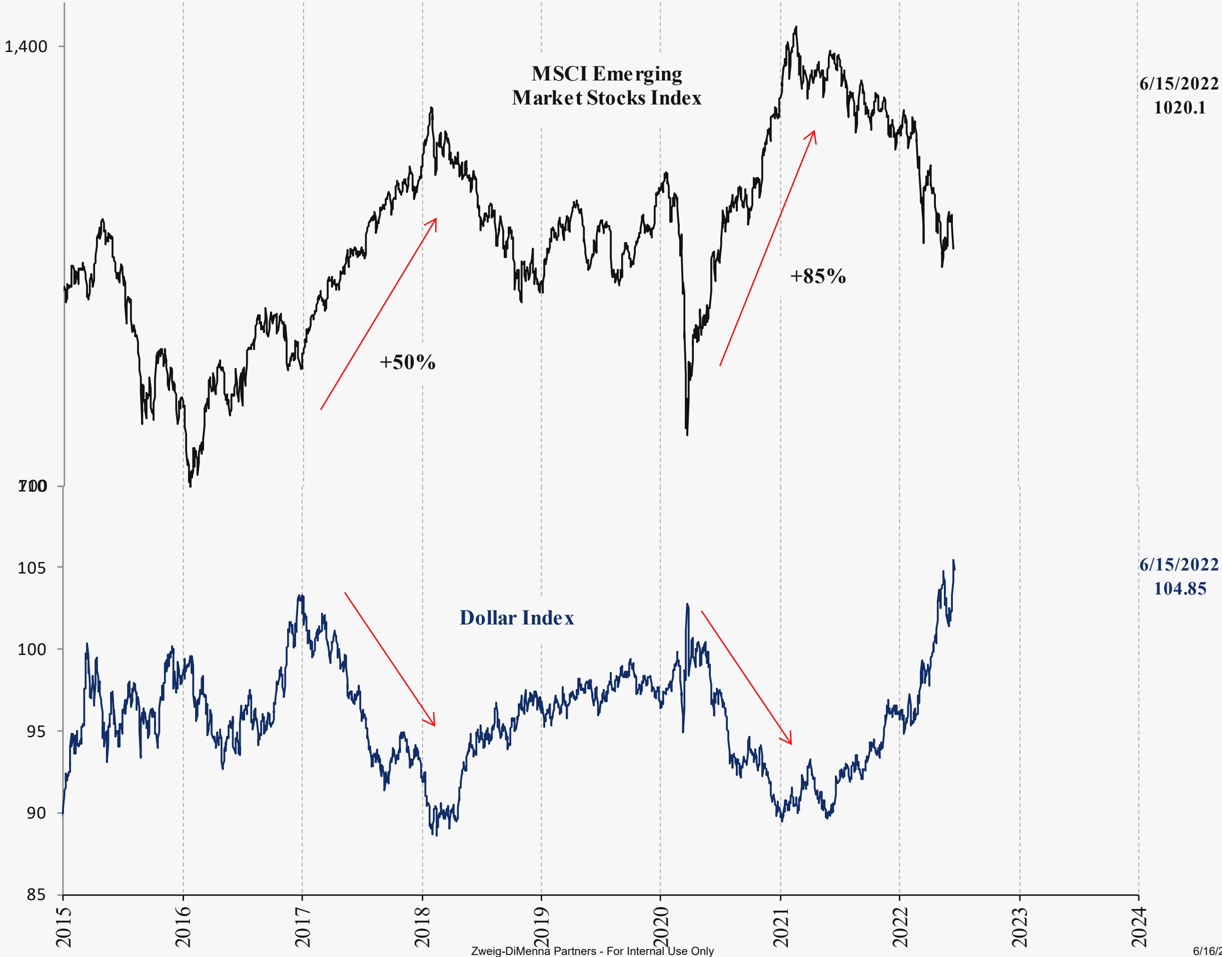
Emerging Markets Upticked to Bullish 5 Rating

We raised Emerging Markets from neutral to a Bullish 5 rating this month based on the weaker dollar, the reversal in the relative performance trend and the significant valuation discount. One of the biggest headwinds for emerging markets has been the strong dollar, up almost 10% YTD. Since 1990 the MSCI Emerging Markets index returned -5.2% when the Dollar Index was rising vs. 18.0% when it was falling. Through the end of May the Dollar Index declined 4%, the biggest decline since 2020, a significant buy signal and potential catalyst for a trend change in emerging markets. After underperforming for over two years, the emerging markets are outperforming the S&P 500 this year. Combined with the positive conditions developing for equities after the Fed rate hike, it may signal a turn for the group. Finally, the valuation is compelling at just 10.9x earnings vs. 18.0x for the S&P 500. Emerging markets offer great equity diversification, more potential upside, and a powerful hedge against a weak dollar.



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Summary

These are no doubt emotional times for investors with extreme moves in many asset classes. It is times like these when conviction is one of the most important tools in generating investor returns. For us it comes from constant research, and sometimes it leads us to some surprising conclusions. This month the extreme conditions lead us to a positive outlook at odds with the bearish consensus, in particular regarding emerging markets. We will stick with our process and continue analyzing conditions as they change. Thank you for your support and please contact us with any questions.

Michael Schaus
Director of Market Research