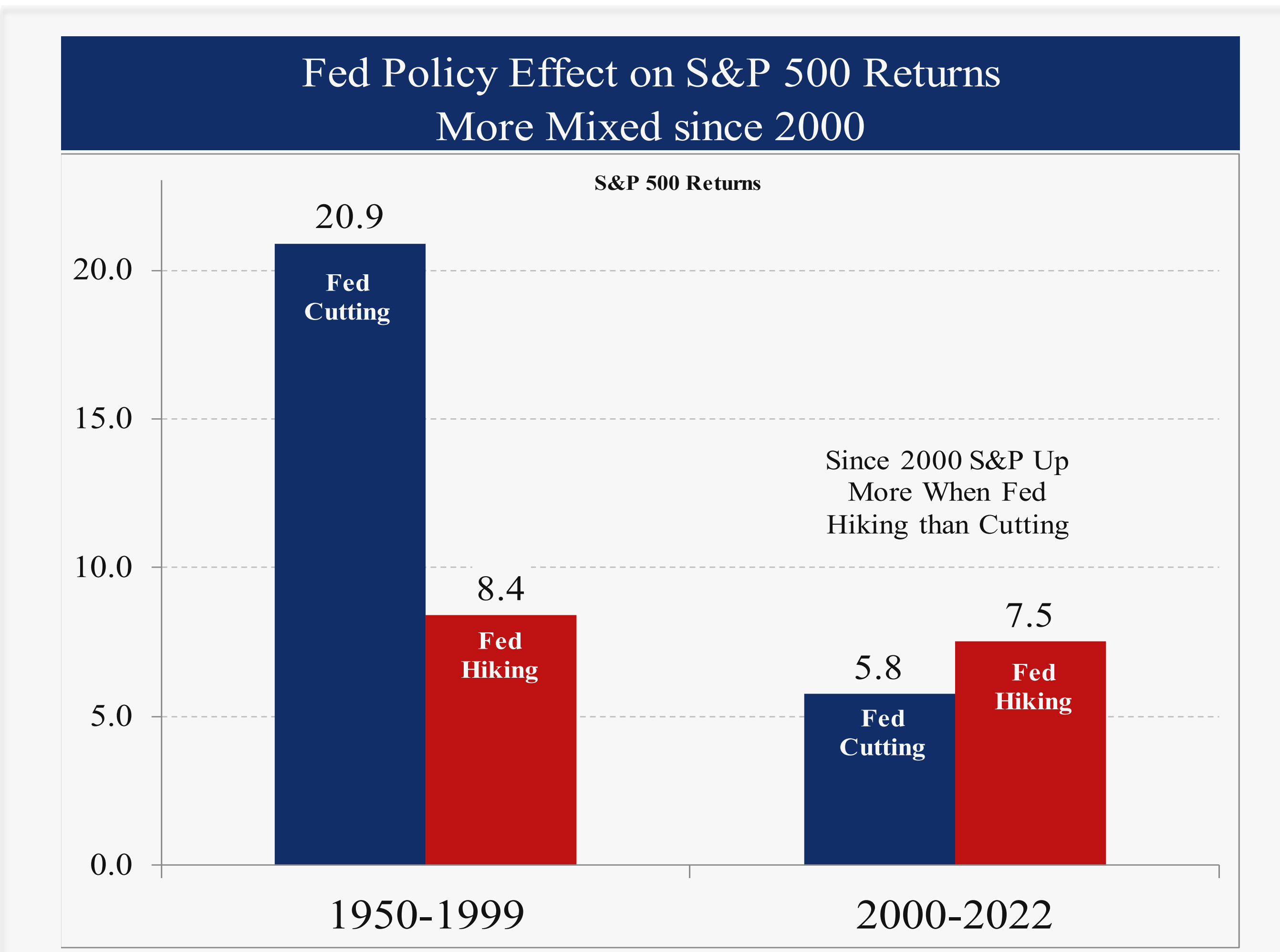
July 20, 2022

Investing Environment Review and Outlook – Volume 61

Fight the Fed

Last month we discussed the potential turning point for equities at the June Fed meeting when they hiked 0.75% in one of the most anticipated Fed moves ever. Perhaps surprising given the cascade of bearish headlines since then, a month later the S&P 500 was 1.8% higher. Conditions for equities were negative most of the year with high and rising inflation, the Fed hiking rates and the 10-year yield rising, a toxic combination for equities historically back to 1970. Since that Fed meeting, media headlines have repeated the high inflation, hawkish Fed and recession stories, missing how conditions actually shifted dramatically for the better. This month we discuss what changed and why we are indeed fighting the Fed.

Ratings are unchanged this month with U.S. and foreign developed equities at a neutral 3 and emerging markets a bullish 5. Long term bonds are a neutral 3. Gold remains a bullish 5 and commodities are a neutral 3.



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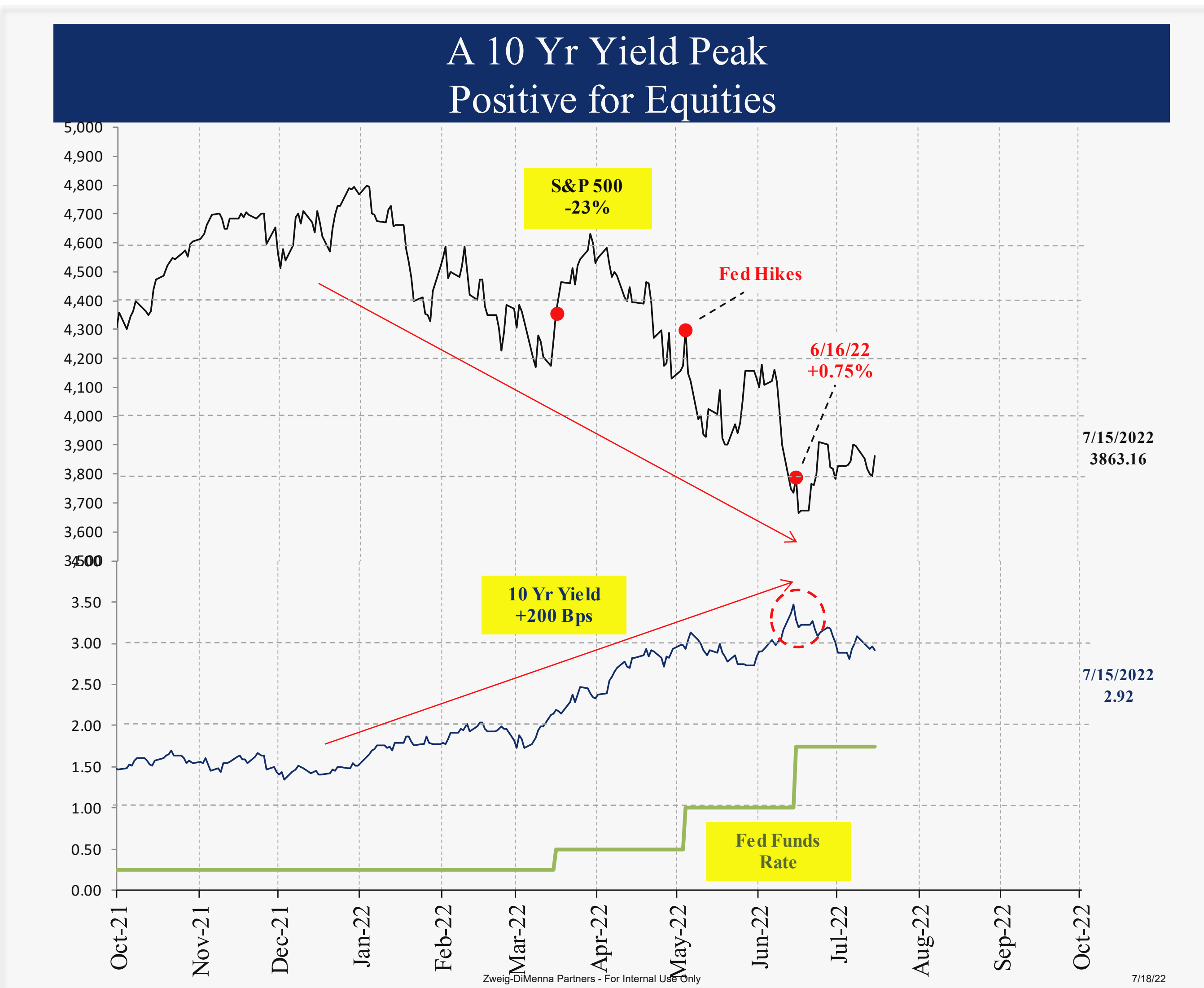
Treasury Yields Down: Positive

From January 1st to June 16th when the Fed hiked the third time by 0.75%, the 10-year yield rose 200 bps from 1.5% to 3.5% while the S&P 500 declined 23%. Since that hike, however, the 10-year Treasury yield declined 0.70% from 3.50 to 2.80 on 7/6/22. 2-year yields had a similar move. The turn in the 10 year confirms the inflection point we discussed last month. While this peak in rates holds, the pattern of higher yields and lower stock prices has reversed with lower yields and higher stock prices instead. Notice the sharp decline in the S&P 500 and run-up of the 10-year yield prior to the June meeting. So far, the 10-year yield has not shown the same tendency ahead of next week's Fed meeting despite the consensus for another 0.75% hike. The leveling of the 10-year yield likely marks a coming pause in Fed hikes by year-end despite their hawkish rhetoric. This is a big change and a bullish shift for equities.



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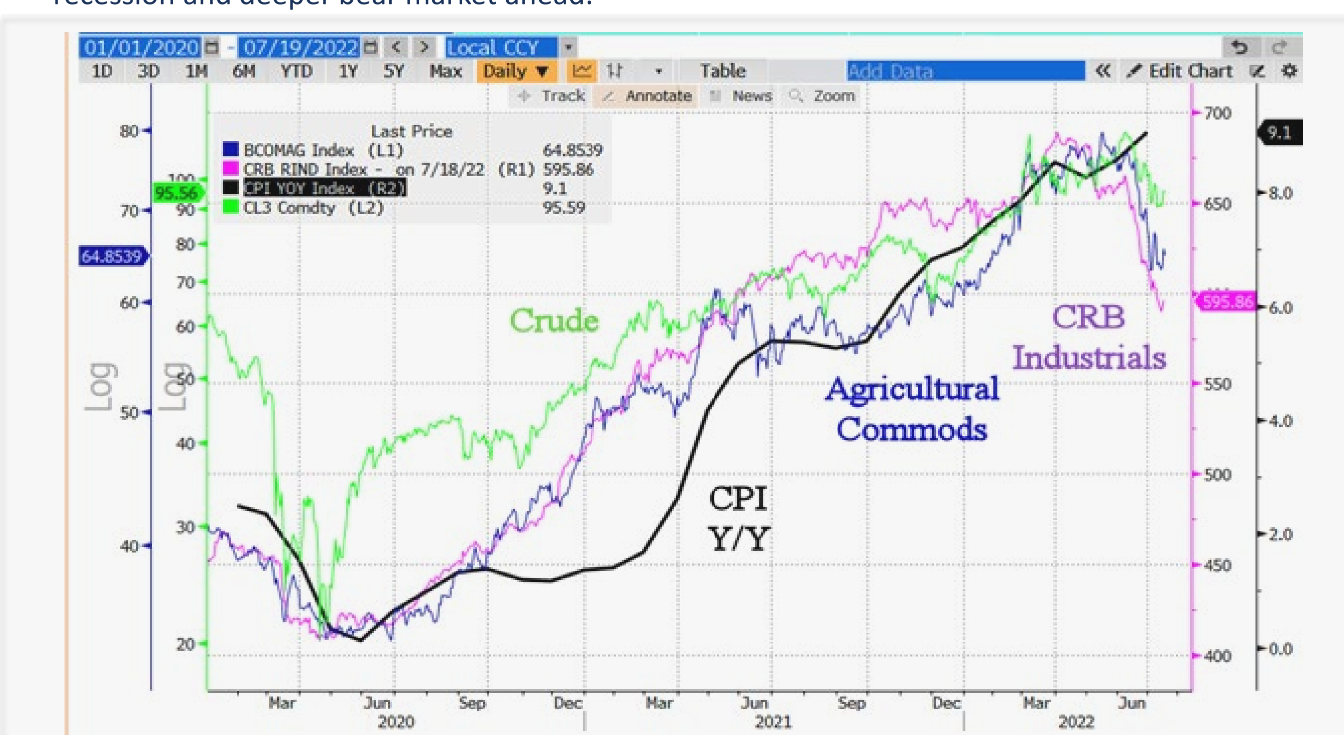
Inflation Peak: Positive

The 9.1% print for the June Consumer Price Index inflation last week made headlines as it should have, it was the highest reading in 40 years back to November 1981. This was certainly news, yet it was telling neither bonds nor stocks reacted to the downside, probably because there is now strong evidence that the inflation peak is at hand. Industrial commodities as a group are down 14% from the April peak, reversing 1/3 of the post COVID 2020 rally. Agricultural commodities as measured by the Bloomberg Agricultural index are down 20% from the May peak, now even below the pre Ukraine invasion level that sent food prices higher. Finally crude oil is down 23% from the June peak, also matching the pre Ukraine invasion level.

Low unemployment is a legitimate inflation risk for inflation higher for longer, yet even average hourly earnings are down from a recent peak of 5.6% to 5.1% Y/Y in June. There are numerous signs among realtors that housing (31% of CPI) has peaked as well with less demand and more supply. Finally, our inflation outlook indicators reversed significantly lower to 61 from a 2021 peak of 89. This model was a good leading indicator last year, rising from a low of 10 in 2020 to 70 in February 2021 when CPI inflation was just 1.7%.

Combining the reversal in the 10-year yield with a likely peak in CPI inflation, the historical return for the S&P 500 was a counter intuitive 30% since 1970, 3x the norm even when inflation was high over 4% and the Fed was hiking. Equities discount the future, and monetary conditions have improved significantly. The slowing economy and reversal in commodity prices are positive for equities when the Fed is hiking, at odds with the consensus view these are signaling an imminent recession and deeper bear market ahead.



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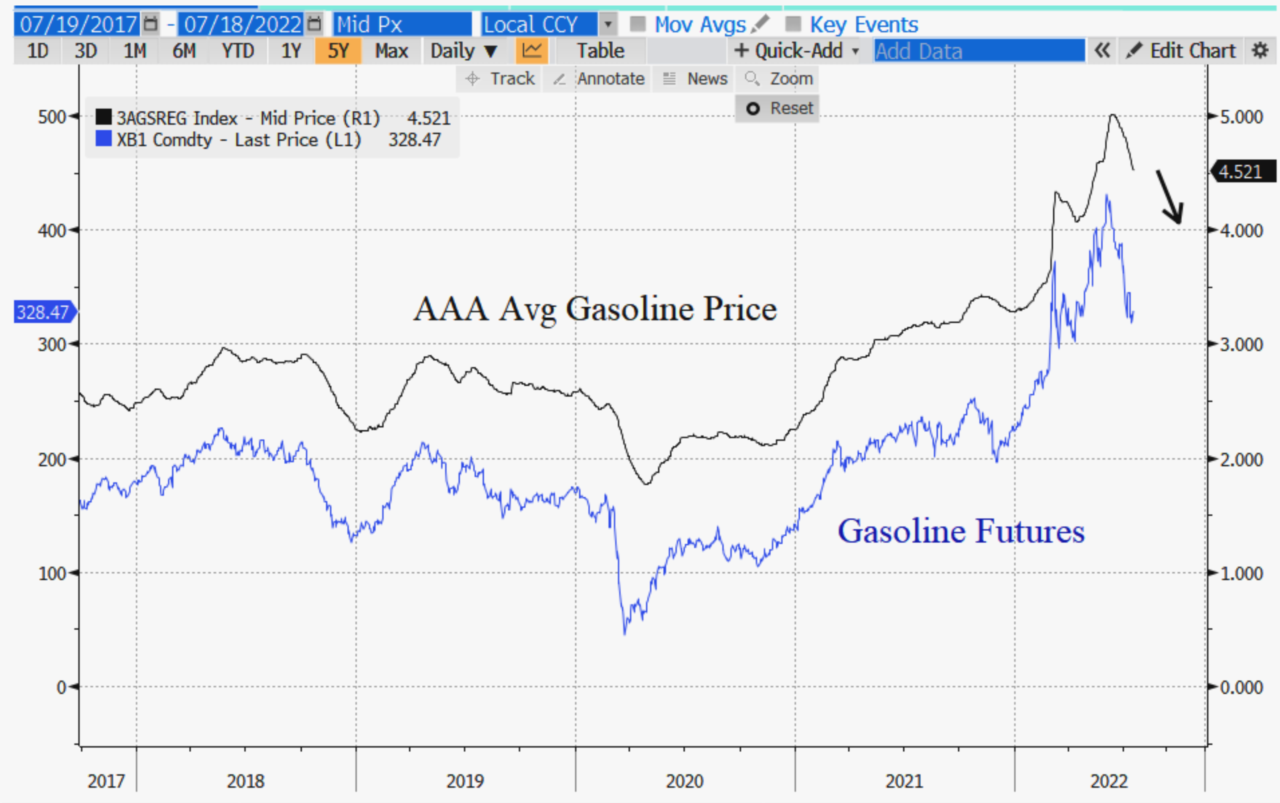

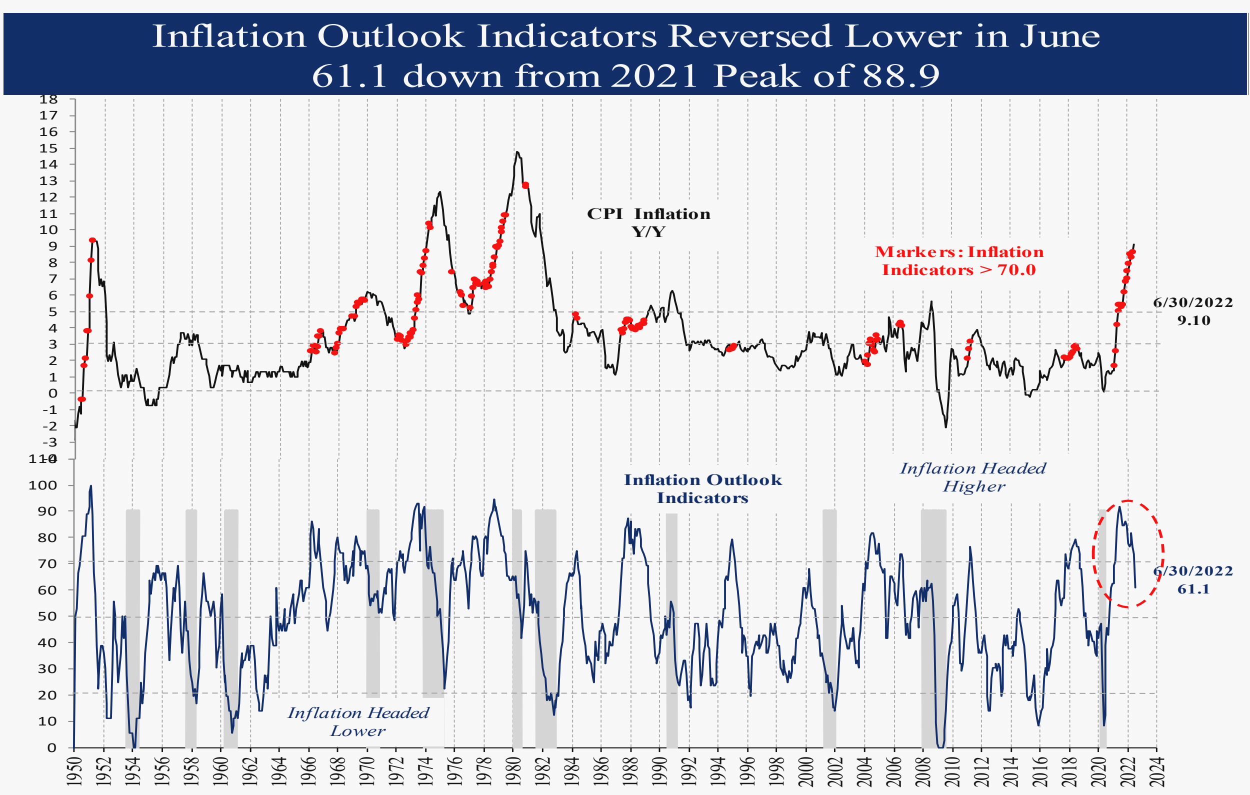

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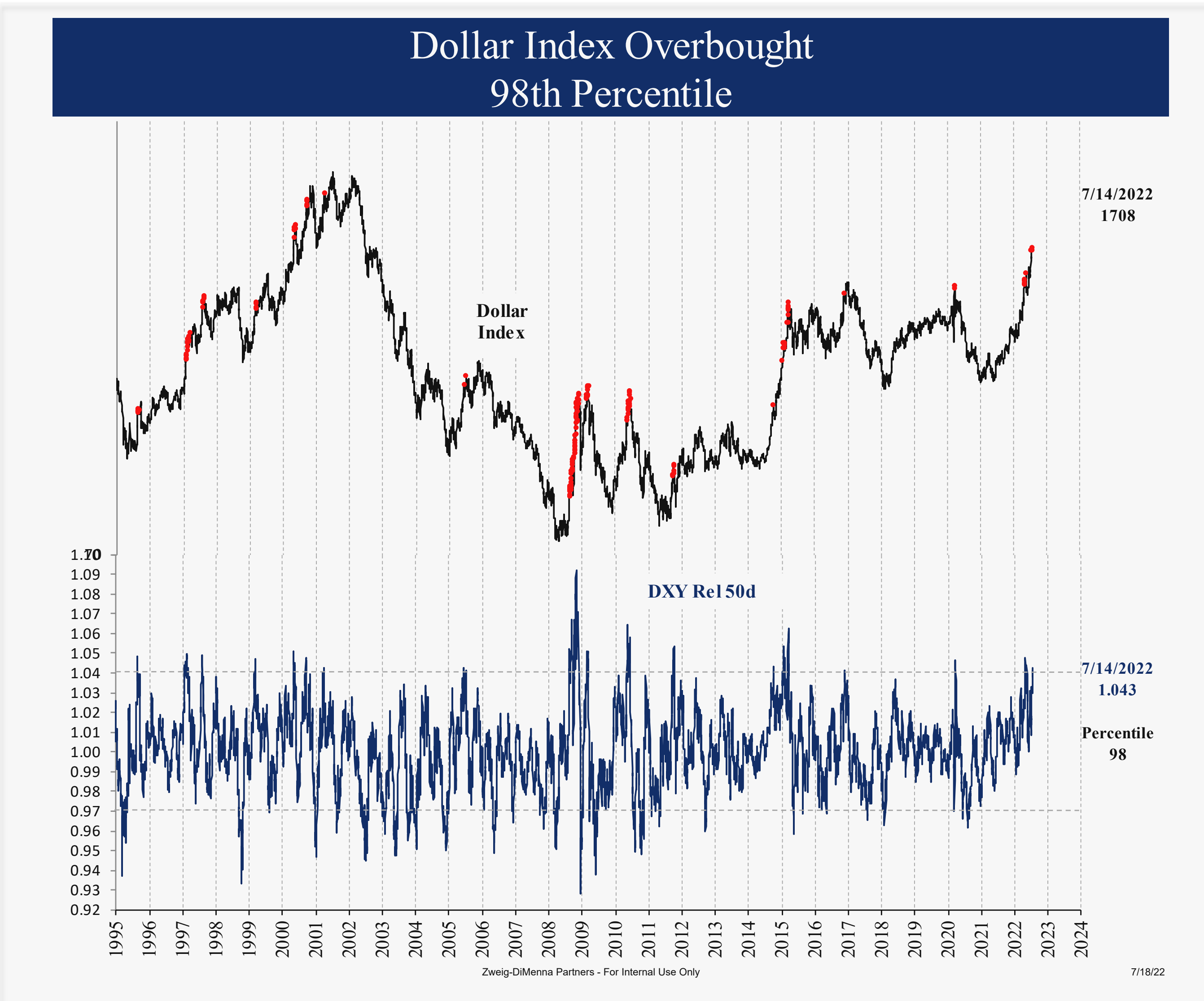
Dollar Extreme: Reversal Positive for Emerging Markets and Gold

Since the May 2021 low the dollar index is up 21%, the biggest rally since 2015. At the peak on 7/14 it was overbought in the 98th percentile relative to the 50-day average. In other words, the dollar was only stronger 2% of the time, with a high probability of a reversal lower. Sentiment has reached an extreme as well. The DSI survey of futures traders showed 95% bulls and only 5% bears. Last week an analyst called the Euro “uninvestable.” Gold and emerging markets have been disappointing investments this year, but historically a weak dollar was one of the most bullish indicators. For instance, emerging markets returned 21% and gold returned 15% annualized when the Fed was hiking rates and the dollar index was falling. The price earnings ratio of the MSCI emerging markets index is just 9.6, half that of the S&P 500 at 19.7. The emerging markets index and gold ratings both remain a bullish 5.



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Summary

The evident slowing in the economy this year is misunderstood to mean an imminent recession and deeper bear market ahead, but our historical analysis shows the opposite. While there is always a recession ahead at some point, the current conditions of a slowing economy, weaker commodities and a reversal in Treasury bond yields were bullish for equities even when the Fed was hiking and inflation was high over 4%. If the extreme move in the dollar is followed by a reversal like most prior cases, historically that translated into strong returns ahead for foreign equities like emerging markets and gold. It is certainly too soon to say the equity bear market is over, but what we do know is that conditions are positive for now. We will continue to monitor our diverse indicator database and keep you posted. Thank you for your support and please contact us with any questions.

Michael Schaus
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