

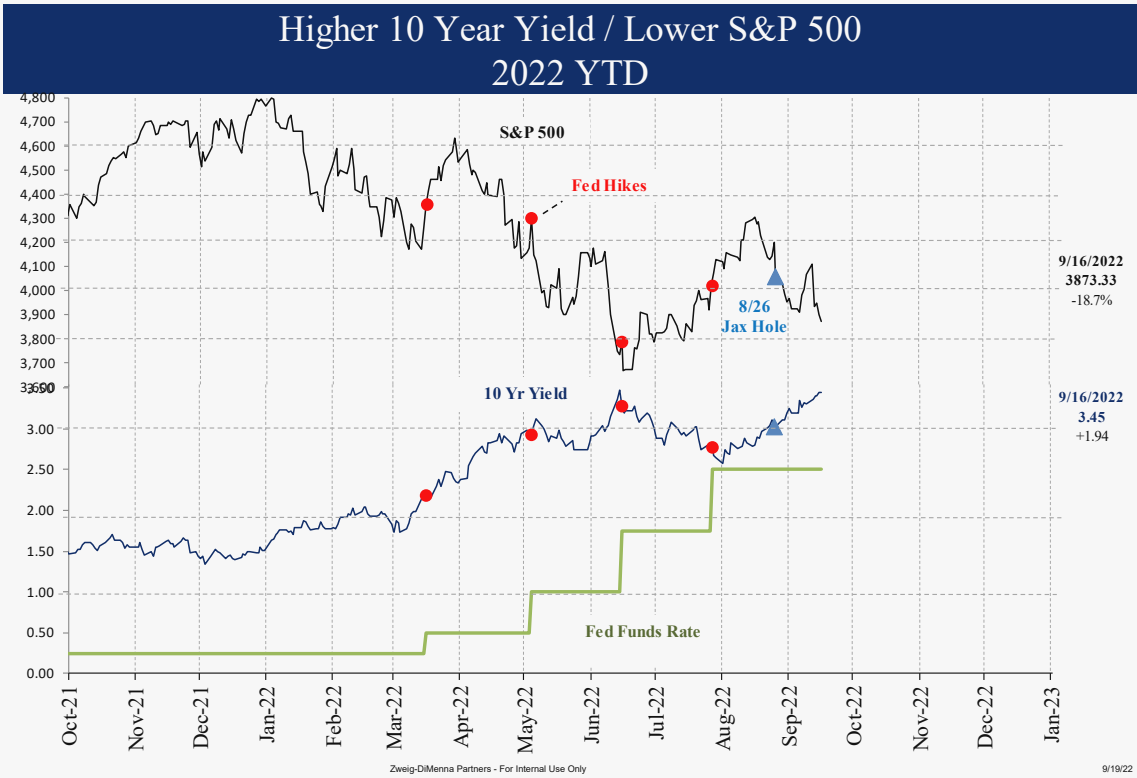
Investing Environment Review and Outlook – Volume 63

Doom and Gloom Consensus is an Opportunity

Last month we discussed the likely consolidation for equities after such a strong upside move and overbought market. Since the 8/17/22 peak the S&P 500 did more than consolidate, declining sharply by 10% and reversing 2/3s of the rally since June. The 9/13/22 upside CPI inflation surprise reversed the “peak inflation” consensus from July. Now most see a doom loop where the U.S. has a substantial underlying inflation problem which will require much higher interest rates, which, in turn, will lead to a more severe equity bear market and an imminent recession. As this new view was factored in, yields moved higher across the curve, and equities responded to the downside as they did in the first half. Higher interest rates compress multiples.

This month we discuss an alternative view of the facts starting with inflation, and more importantly, the significant implications for equities through year end. Conditions such as commodity prices, the economy, investor positioning, and seasonality today are quite different from the first half.

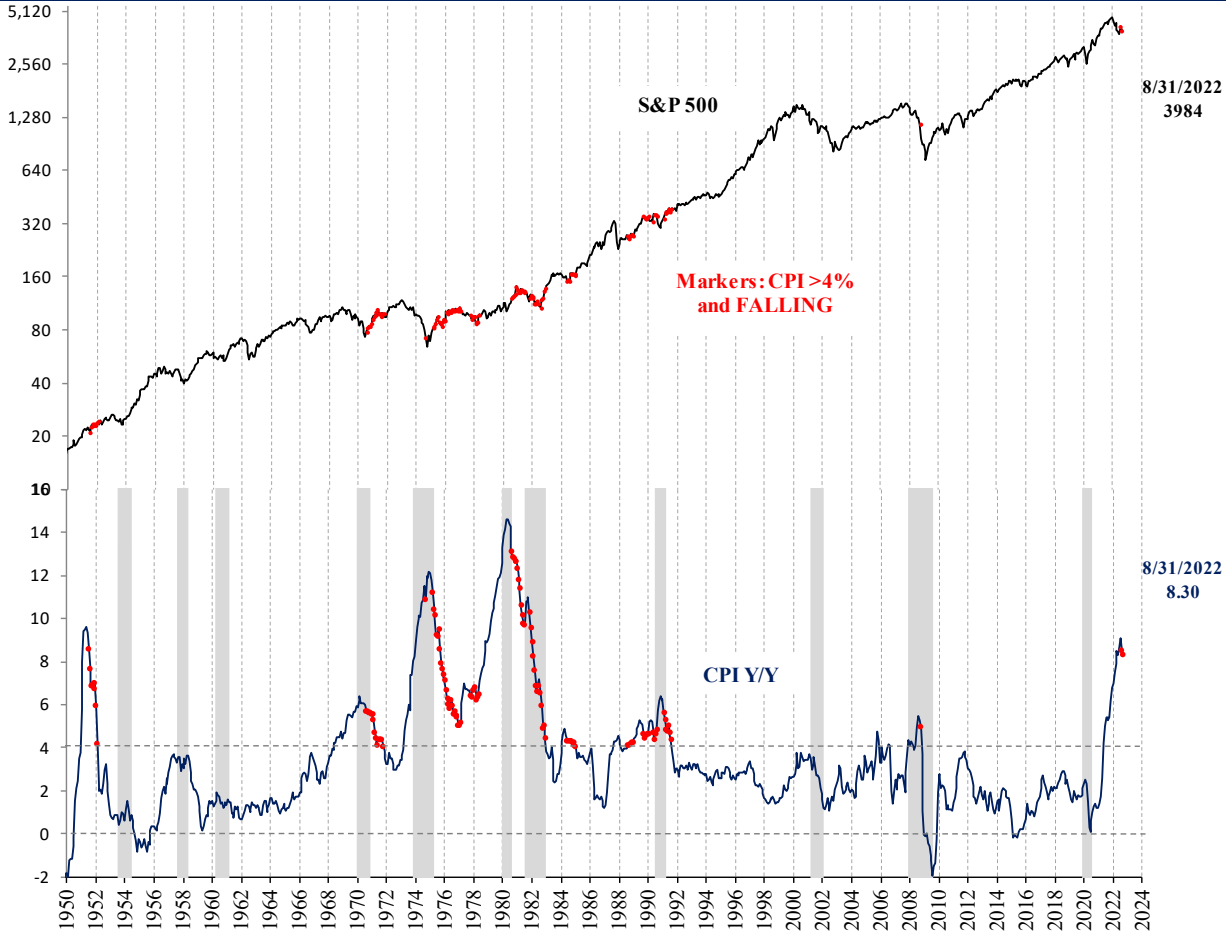
We reduced emerging markets to a 4 rating due to the persistently strong U.S. dollar. U.S. and foreign-developed equities remain a neutral 3. Long term bonds are a neutral 3. Gold remains a bullish 5 and commodities are a neutral 3.



CPI Inflation Trend: Bullish for Equities

Despite the lower August headline CPI inflation released on 9/13/22 (8.3% vs. 8.5%), the higher core figure, not including food or energy (6.3% vs. 5.9%) was seen as evidence of further upside ahead for inflation. Aside from the fact that the core figure is a lagging number, due to the housing component, there is significant evidence that overall inflation by any measure will continue lower. This trend lower is meaningful, since historically the direction of inflation was predictive of equity returns. Perhaps surprising, since 1970, the S&P 500 returned 12.8% annualized while CPI inflation was high (over 4%) and falling as it is now, even when the Fed was hiking rates. Whether inflation will settle back to 2% is certainly unknowable, but more importantly, not relevant for investors today. It is the trend that matters.

**CPI High and Falling
S&P 500 Returns 12.8%**

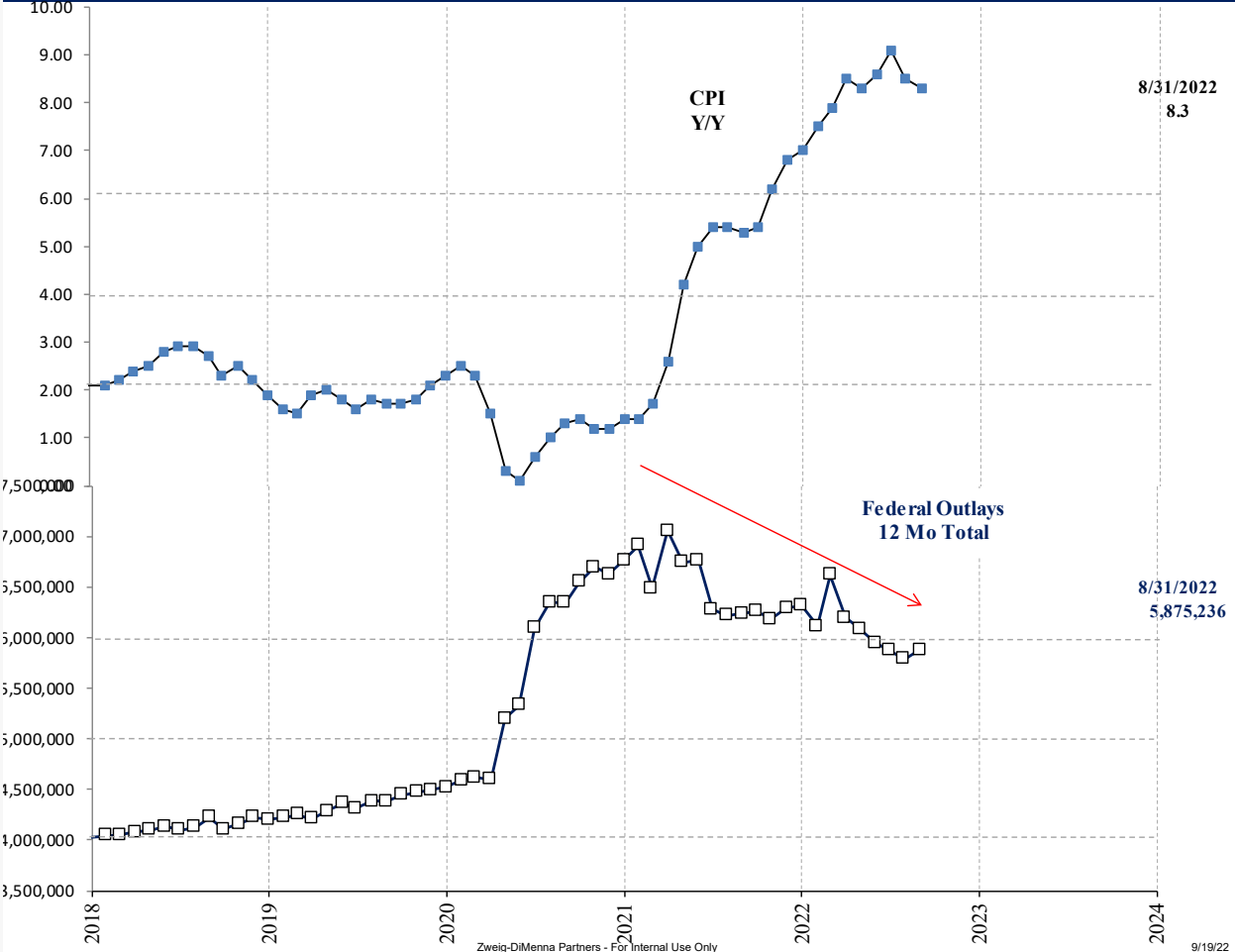


Lower Inflation Ahead: Supply and Demand

The 8.3% inflation today can be traced to three demand and supply shocks. First, the unexpectedly strong Covid rebound demand due to catch up purchases accelerated by record government stimulus spending. Second, the supply chain issues from labor shortages and overwhelming demand. And third, the Ukraine War cutting critical supplies of food and energy.

This year all three of these forces reversed. First, the COVID economic rebound is best illustrated by the ISM index reaching the 99th percentile at 64.7 in March 2021. Since then, the index declined to a neutral 52.8 as the economy slowed, easing the overheated demand on goods and services in a typical mid-cycle slowdown. There have been 10 similar mid-cycle slowdowns since 1950 that eased pressure on inflation and were not followed by a recession. Federal outlays are also down 16% from their 2021 peak, cutting macro demand.

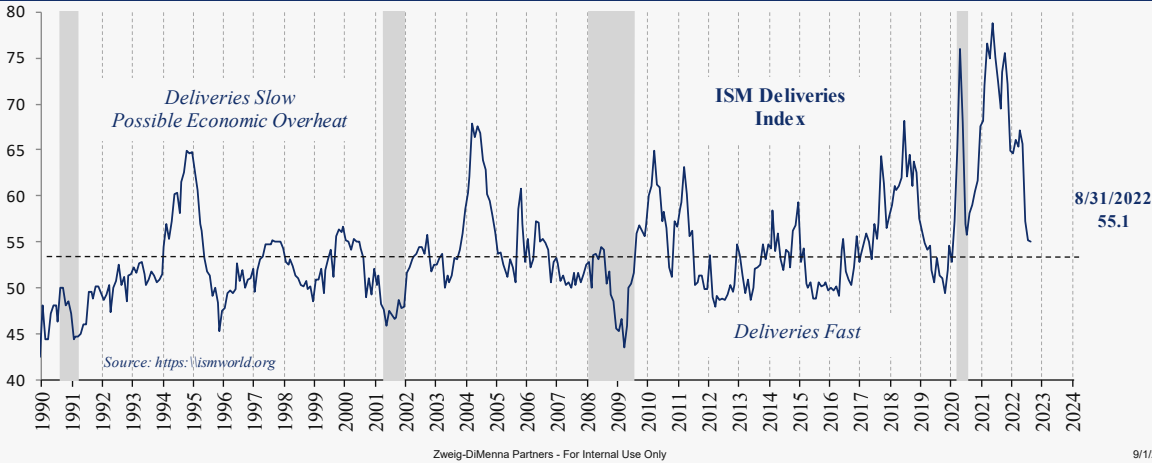
**Federal Outlays Lead Inflation
Down 16% from 2021 Peak**



Supply Chain Running Again

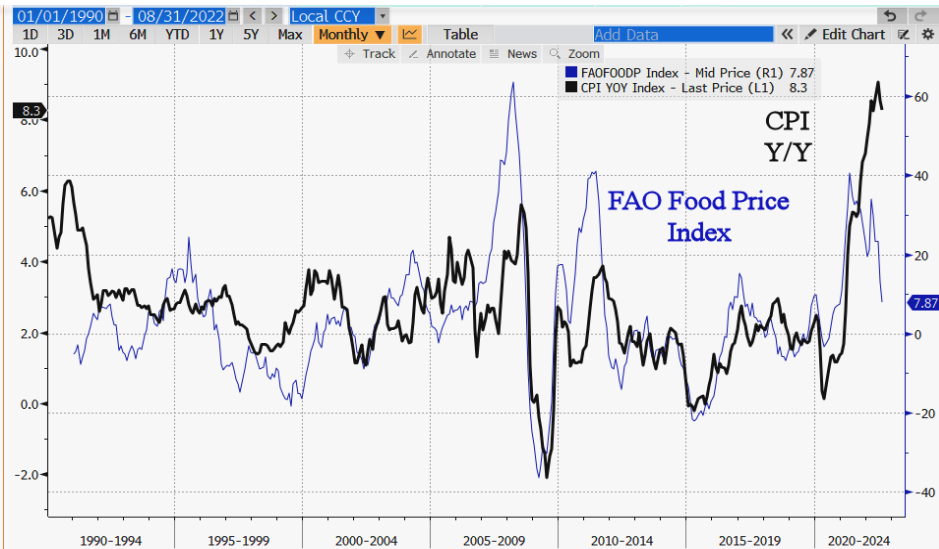
Second was the supply chain issues, best illustrated by the ISM Deliveries index which hit a peak of 78 in 2021 and has since also declined to a neutral 55.1 today. This is one piece of evidence showing that supply chains are returning to normal, also easing pressure on prices.

ISM Deliveries Index Down: Supply Chains Running Again



Ukraine Inflation Effects: Reversing

The third piece of high inflation was the Ukraine War. Partly as a result, U.S gasoline prices rose sharply to a peak of \$5 per gallon in July, pushing the CPI inflation index to 9.1% Y/Y. Gasoline prices have since reversed 26% lower to \$3.68, putting downward pressure on inflation. In addition, food prices as measured by the FAO Food Price Index rose to a peak of 40.0 in May 2021 but have since reversed to just 7.9 as of August. This is also a good leading indicator of inflation-like prior peaks in 2007 and 2010.



Europe Natural Gas Price Down 45%: Bullish

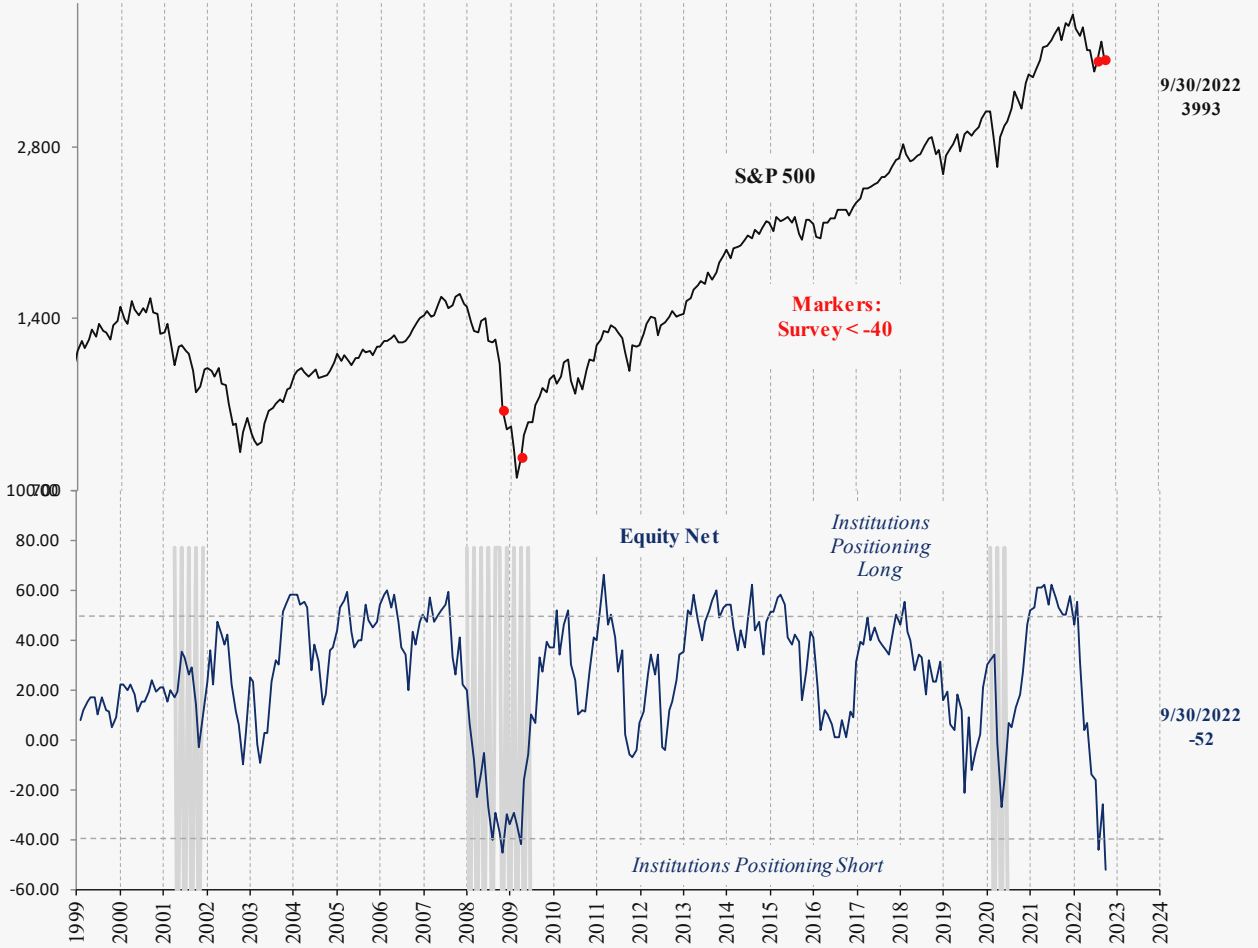
Finally, European natural gas prices more than tripled from June to August. The New York Times headline on 9/19/22 was “Crippling Energy Bills Force Europe’s Factories to Go Dark.” No question there is a devastating energy crisis in Europe. What is surprising and likely positive for inflation is the 45% decline in natural gas prices from the August peak. During the first Gulf War in 1990 the July Kuwait invasion also caused an oil price spike and an equity bear market. In that case the October oil peak at \$40 marked the low in equities and the end of the war to come. Obviously, the geopolitical issues are complex and seemingly intractable, but the 1990 pattern may be comparable.



Investors Positioned for Doom and Gloom: Positive for Equities

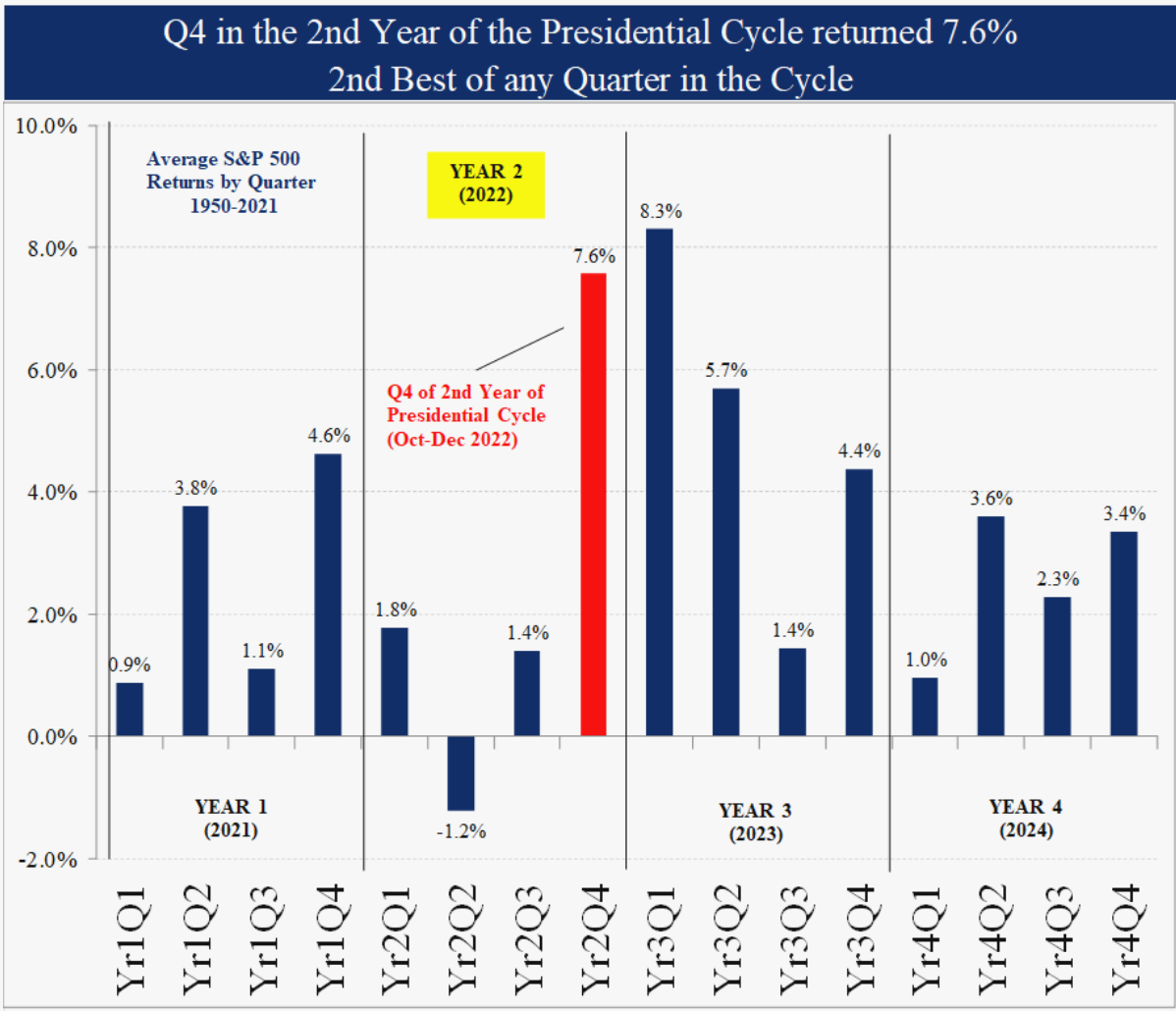
From the daily negative headlines it is obvious most investors are bearish. Similar to the June low before the S&P rallied 16%, all 10 investor groups we track are positioned short, and 7 of 10 are in extreme positions. The Bank of America monthly survey run by Michael Hartnett is a great example. Institutional investors were record bearish in their September survey, even more so than at any time in 2008 during the Global Financial Crisis when the S&P 500 declined over 50% from the peak. This means cash on the sidelines to drive stocks higher. Like a dry forest, it is just a matter of time before a fire ignites.

**Institutions Record Short Positioning
Sept BofA Survey -52**



Q4 Equity Returns are Best of the Year

It is widely known that Q4 returns (October-December) are historically the best of the year. However, this year is particularly positive in the 2nd year of the Presidential Cycle (and mid-term elections), with a 7.6% average return since 1950, almost 2x other presidential cycle years and over 30% annualized. The first quarter of the third year of the presidential cycle (corresponding to next year – 2023 in the current cycle) historically is even better at 8.3%, the strongest quarter of the whole presidential cycle.



Summary

Seasonality remains negative through the end of September, but the combination of falling inflation, extreme investor positioning and positive Q4 seasonality marks a potential upside opportunity for a year-end move into 2023. The 40% decline in European natural gas bears watching. If it marks some sort of war resolution ahead, the implications would be significant – likely a dollar reversal, stronger commodities and a European focus shift from assured recession to a much more positive outlook to rebuild Ukraine and all the stimulus that would entail. We will continue to monitor our indicators on a daily basis and keep you posted. Thank you for your support and please contact us with any questions.



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