BRENTON POINT
WEALTH ADVISORS

August 15, 2023

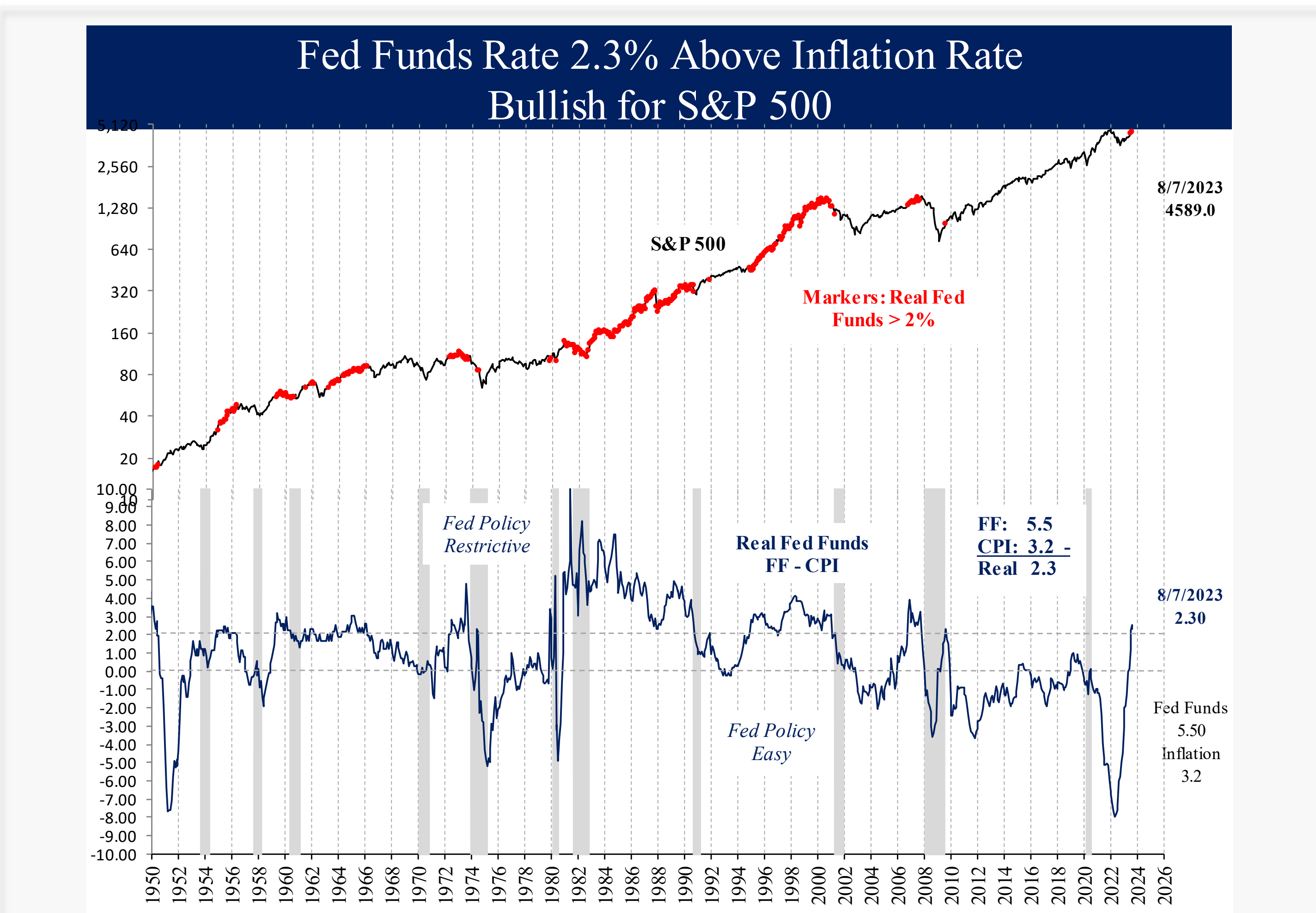
Investing Environment Review and Outlook – Volume 74

Restrictive Fed Policy

- High real Fed Funds rate bullish for S&P 500, mixed for economy
- S&P 500 up 16% in first half - positive for second half
- 1965-79 period unexpected risk for equities

Last month we discussed the cut in the U.S. equity rating to neutral, the potential narrative shift from recession timing to possible economic acceleration, and the positive implications of the near record inflation rate decline. Since then, economic outlook indicators remained strong and our best coincident economic indicator, the ISM Index, upticked slightly for July. This month we discuss the surprising implications of what Fed chair Powell now calls **restrictive Fed policy**. Investor positioning indicators reversed to neutral with the 2% S&P 500 decline.

U.S. equities remain a neutral 3 rating. Foreign-developed and emerging markets equities remain bullish 5 ratings. Long-term bonds remain a neutral 3 rating. Gold and industrial commodities remain bullish 5 ratings.



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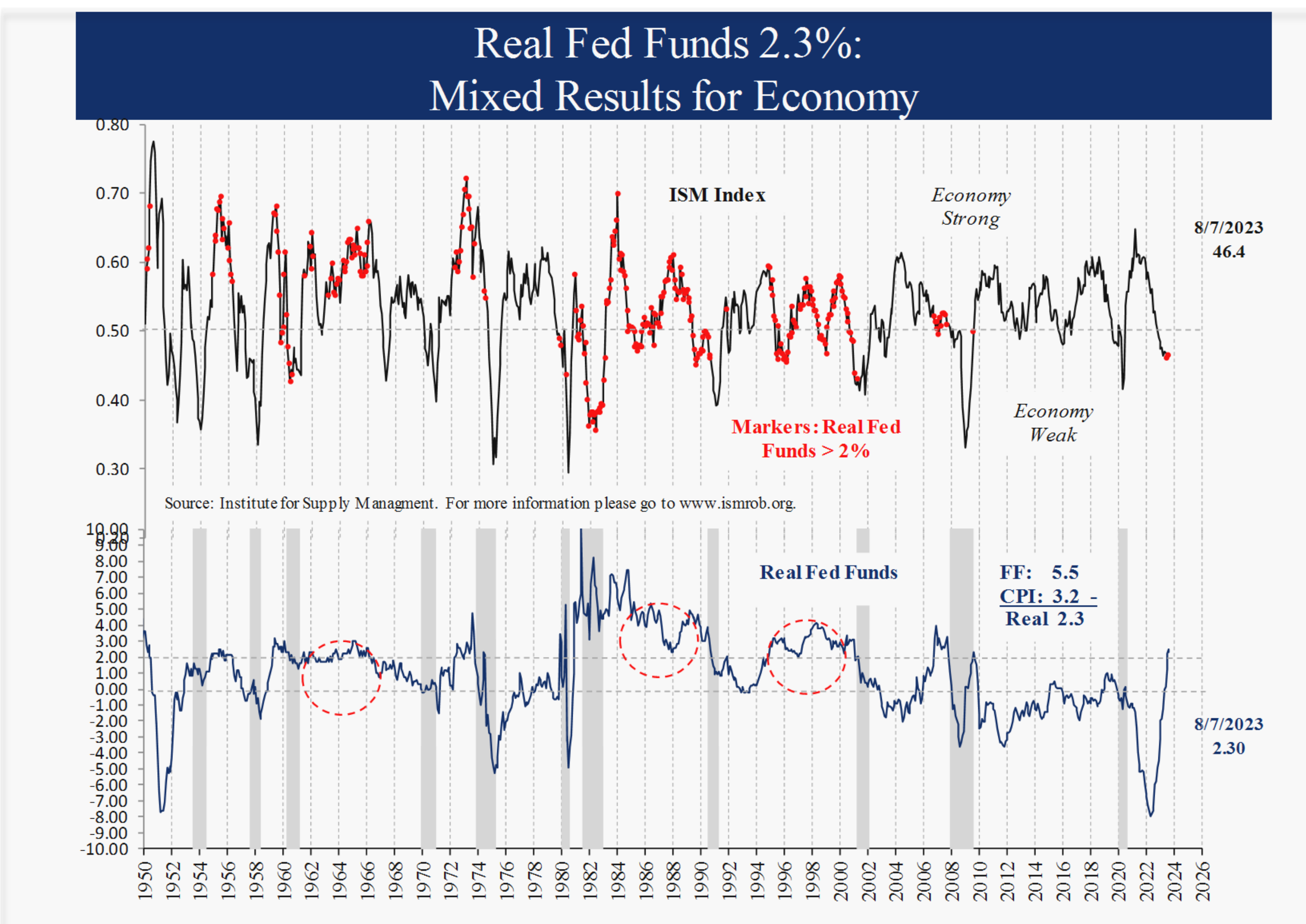
Real Fed Funds Rate 2.3%: Bullish for S&P 500

One of the most widely used gauges of Fed policy is the Fed Funds target relative to the inflation rate, or the "real" Fed Funds rate. Today the Fed Funds target is 5.5% and headline CPI inflation is 3.2%, or a real Fed Funds rate of positive 2.3%. In the July 26th Fed press conference, Chairman Powell called the current Fed Funds target "well above" the neutral rate, also calling it "restrictive" and likely to put downward pressure on economic activity and inflation. 2.3% is in fact high historically, in the 72nd percentile since 1950. It has been as high as 8% in 1982, and as low as -8% in 2022 when the Fed Funds target was 0.5% and inflation was 8.5%.

With downward pressure expected on economic activity, it would be logical to expect negative equity returns as many have this year. What is counter intuitive to that expectation is that, since 1950, the S&P 500 returned 15.6% when the real Fed Funds rate was over 2% compared to the norm of 11.4%. The reason is clearer when we consider the inflation trend. When the real Fed Funds rate was between 2% and 3% while inflation was falling like we have today, the S&P 500 return was even higher at 25.7%, compared to just 7.1% when inflation was rising. In other words, the trend of inflation dominates the level of interest rates for equity returns. In the same way, the -8% real rate was not bullish for equities in March 2022 as the bear market was getting under way, since inflation was still rising.



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While consensus believes record Fed tightening will cause a recession, the results against the economy are mixed historically. For instance, there were at least 3 periods of sustained real Fed Funds rate above 2% in 1963, 1986 and 1996 which did not cause a recession. In addition, there were several periods when the economy accelerated from a weak position like 1964 and 1996.

First Half of 2023 up 16%: Positive for 2nd Half

The first half of 2023 the S&P 500 was up 15.9%. In the 22 other years since 1950 when the S&P 500 was up over 10%, the second half was up an average of an additional 7.7%, with just 4 years down. The worst was 1987 when the market crashed in October, but there were none down since. This compares to an average of just 2.1% for the 23 years when the S&P 500 was down in the first half. Just 57% of those were higher in the second half. Q3 (July-Sept) was not great in either case, but odds were better in up years at 68% vs. just 48% in the down years.

Positive First Half of the Year Bullish for 2nd Half

Years S&P 500 UP 10% in First Half

	Year	Jan-Jun	Jul-Dec	Q3
1.	1954	17.7%	23.2%	10.6%
2.	1955	14.0%	10.8%	6.4%
3.	1958	13.1%	22.0%	10.7%
4.	1961	11.2%	10.7%	3.2%
5.	1967	12.8%	6.4%	6.7%
6.	1975	38.8%	-5.3%	-11.9%
7.	1976	15.6%	3.0%	0.9%
8.	1983	19.5%	-1.9%	-1.2%
9.	1985	14.7%	10.1%	-5.1%
10.	1986	18.7%	-3.5%	-7.8%
11.	1987	25.5%	-18.7%	5.9%
12.	1988	10.7%	1.5%	-0.6%
13.	1989	14.5%	11.1%	9.8%
14.	1991	12.4%	12.4%	4.5%
15.	1995	18.6%	13.1%	7.3%
16.	1997	19.5%	9.6%	7.0%
17.	1998	16.8%	8.4%	-10.3%
18.	1999	11.7%	7.0%	-6.6%
19.	2003	10.8%	14.1%	2.2%
20.	2013	12.6%	15.1%	4.7%
21.	2019	17.3%	9.8%	1.2%
22.	2021	14.4%	10.9%	0.2%
23.	2023	15.9%		
	Average		7.7%	1.7%
	% Up		82%	68%

Years S&P 500 DOWN in First Half

	Year	Jan-Jun	Jul-Dec	Q3
1.	1953	-9.1%	2.8%	-3.3%
2.	1960	-5.0%	2.1%	-6.0%
3.	1962	-23.5%	15.3%	2.8%
4.	1965	-0.7%	9.9%	6.9%
5.	1966	-8.3%	-5.2%	-9.7%
6.	1969	-5.9%	-5.8%	-4.7%
7.	1970	-21.0%	26.7%	15.8%
8.	1973	-11.7%	-6.4%	4.0%
9.	1974	-11.8%	-20.3%	-26.1%
10.	1977	-6.5%	-5.4%	-3.9%
11.	1981	-3.3%	-6.6%	-11.5%
12.	1982	-10.6%	28.3%	9.9%
13.	1984	-7.1%	9.2%	8.4%
14.	1992	-2.1%	6.8%	2.4%
15.	1994	-4.8%	3.4%	4.1%
16.	2000	-1.0%	-9.2%	-1.2%
17.	2001	-7.3%	-6.2%	-15.0%
18.	2002	-13.8%	-11.1%	-17.6%
19.	2005	-1.7%	4.8%	3.1%
20.	2008	-12.8%	-29.4%	-8.9%
21.	2010	-7.6%	22.0%	10.7%
22.	2020	-4.0%	21.2%	8.5%
23.	2022	-20.6%	1.4%	-5.3%
	Average		2.1%	-1.6%
	% Up		57%	48%

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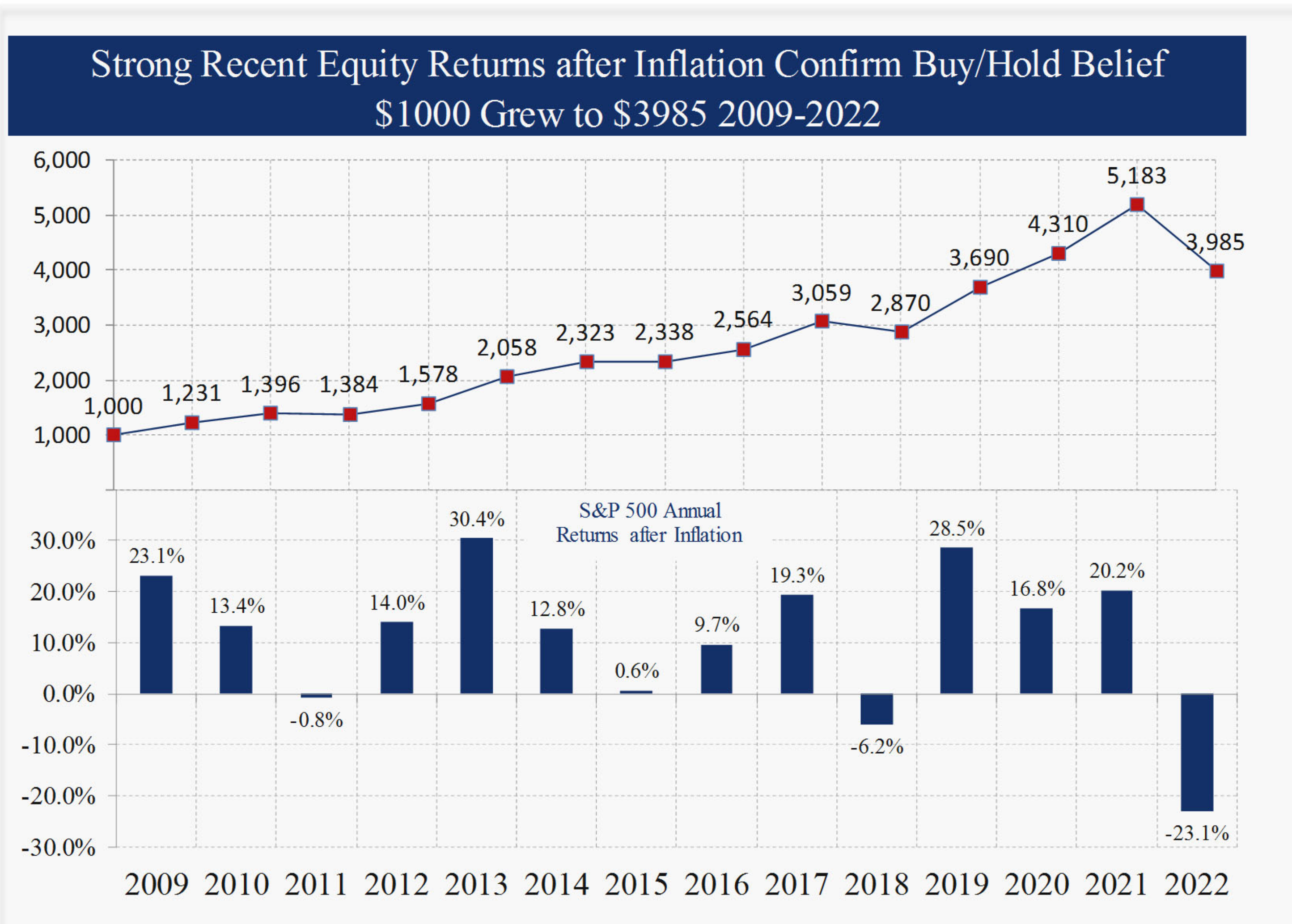
Hindsight Bias Risk

Last month we discussed the risk that the next 15 years may not resemble the last 15 years. Since 2009 the S&P 500 beat inflation in all but 3 years and $1000 compounded 4x to $3,985 **after inflation**. With 9 of those years up over 10% after inflation, investors cannot be blamed for having high expectations. One risk most investors are **not** expecting is a period like 1965-79, when $1000 compounded to just $916 after inflation. 5 of those years were down over 10% after inflation. The worst period was 1973-74 with 21% and 34% declines. We are not predicting such a period, but our process includes preparing for the worst by knowing history and remaining flexible.



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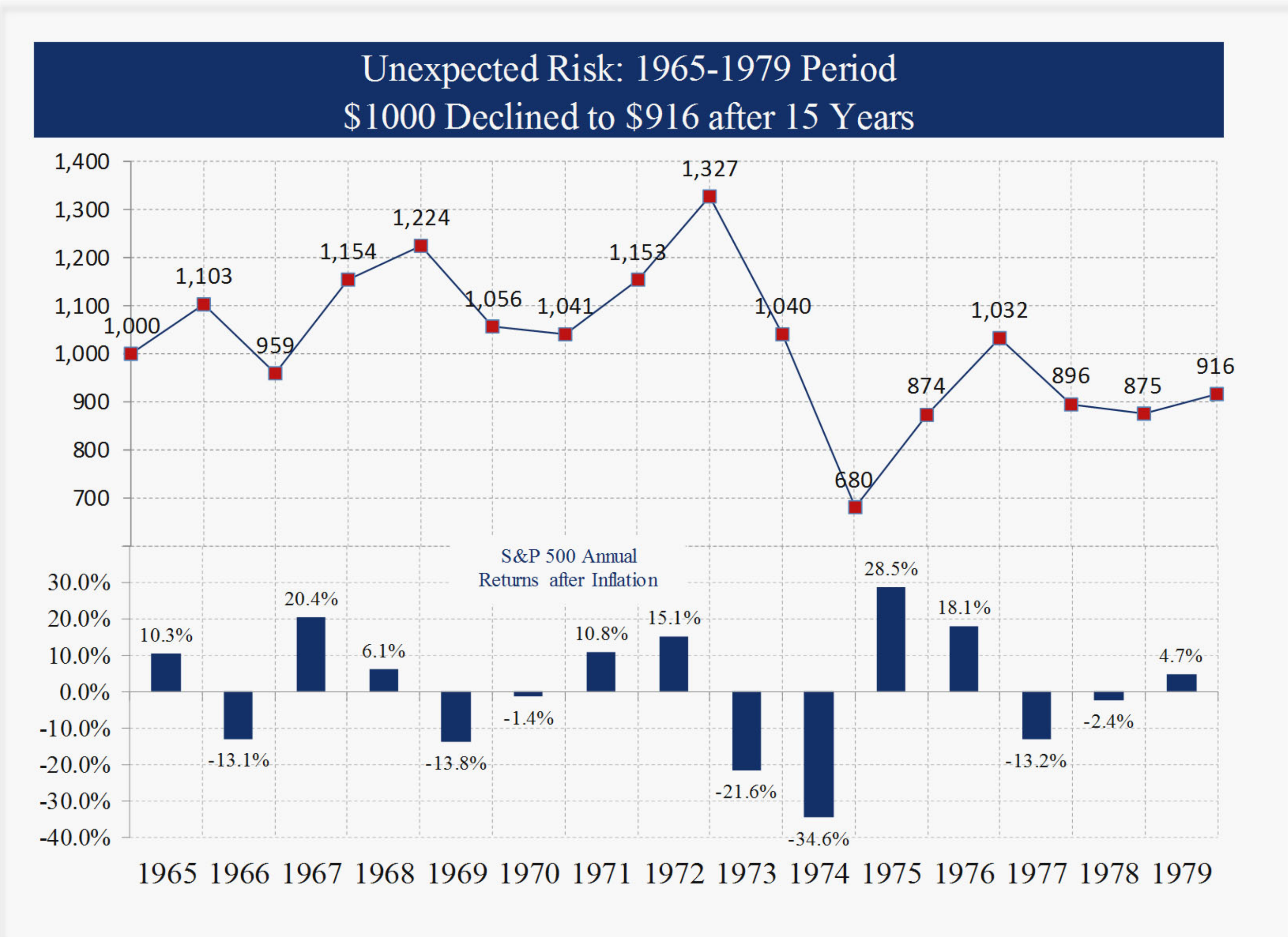

Summary

This month we discussed the surprising implications of restrictive Fed policy. Historically, a high real Fed Funds rate was bullish because it was usually associated with falling inflation, a bullish condition for equities and a sign the economy has slack to run with little risk of overheating. The strong first half equity return was positive historically for the second half, although Q3 remains a risk. After such a strong period since 2009, investors are not expecting a period like 1965-1979 when equities lagged inflation for over 15 years. We will continue to watch our indicators daily and shift exposures as needed. Thank you for your support and please contact us with any questions.

Michael Schaus
Director of Market Research