February 21, 2024

Investing Environment Review and Outlook – Volume 80

- CPI Inflation Panic: Missing the Big Picture
- Economic Outlook Indicators Up: Bonds Rating Downtick to 1
- Natural Gas Meltdown: Inflection Point
- Dollar up 4%: Risk for Emerging Market Equities

Last month we discussed the mixed evidence for bonds, the myth of cash on the sidelines, and the opportunity in the Hang Seng Index collapse. Since then, bond indicators downticked with strong economic releases like the Philly Fed, higher commodity prices like copper, and generally stronger economic outlook indicators. This month we discuss the CPI inflation panic, the stronger economic outlook, a possible natural gas inflection point, and the risk to emerging market equities from the dollar strength. U.S. equities, foreign-developed and emerging markets equities remain bullish 5 ratings. Gold remains a bullish 5 rating and industrial commodities remain a bullish 4 rating. Long-term bonds downticked to a max bearish 1 rating.

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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CPI Panic: Missing the Big Picture

The stronger than expected CPI inflation released last week for January at 3.1% Y/Y down from 3.4% in December certainly cut back on expectations for Fed easing this year. Stronger than expected housing shelter costs are one reason CPI stalled in the last 6 months between 3.0 and 3.5%. The Cleveland Fed publishes a series called New Tenants Rent, which is currently down 4.7% Y/Y. This means the large shelter component of CPI will likely put downward pressure on CPI going forward. Combined with our inflation outlook model at a low reading of 37.5, it is likely CPI headline inflation will break below 3%.

What the Fed will do or whether inflation will hit the Fed's 2% target are the wrong questions. What matters for the health and life expectancy of this economic cycle is the declining trend of inflation, down from the 9.1% 2022 peak and in line with prior inflation spike cases. Historically, the sequence is typically first, higher equities and long-term interest rates (which lead), economic acceleration, higher inflation (which lags), Fed hiking (also lagging), then eventually the equity bear market (which leads the economy), lower long-term interest rates, and finally, Fed easing once a recession is obvious. For now, goldilocks conditions of moderate growth and falling inflation are bullish for equities.

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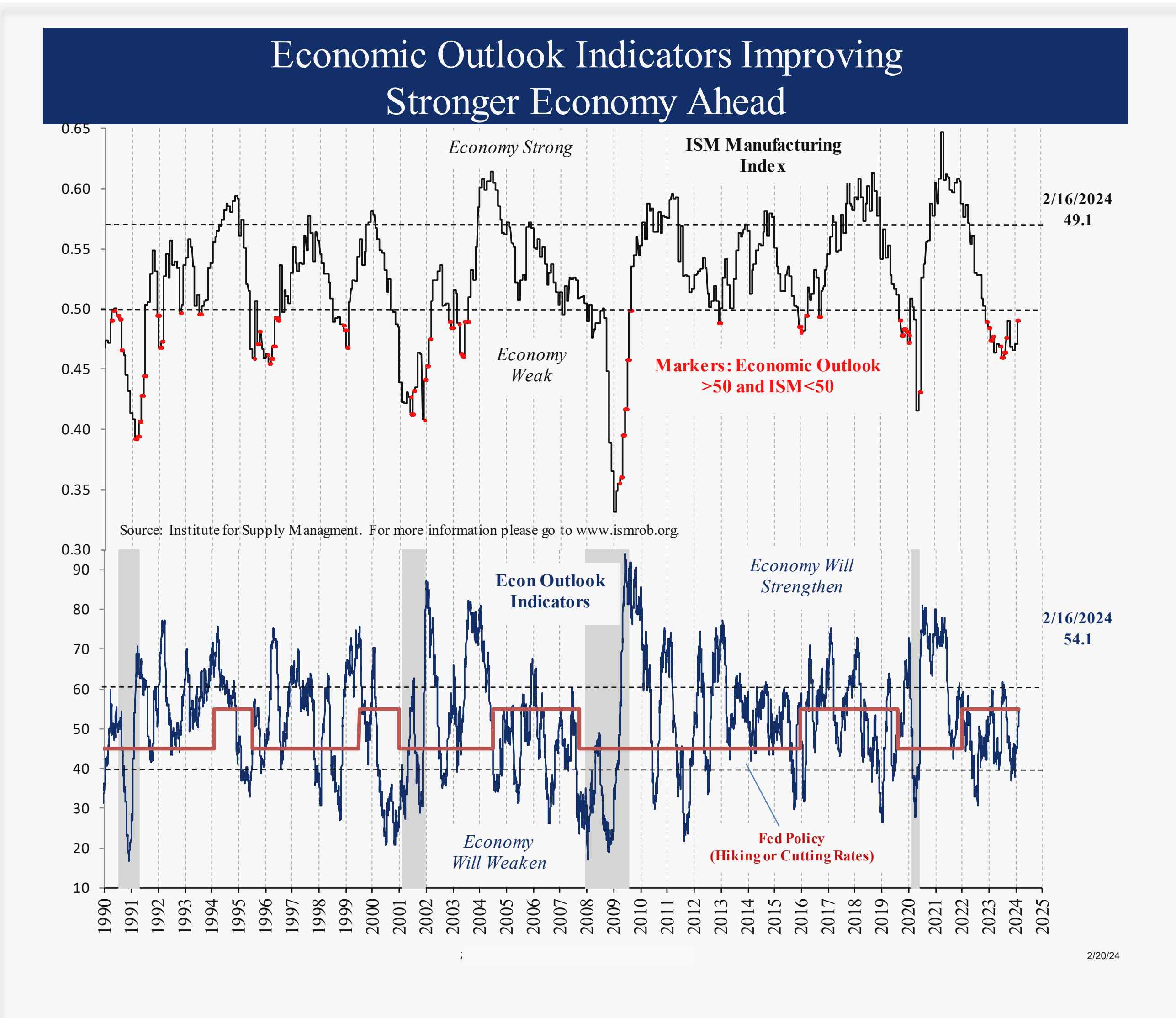
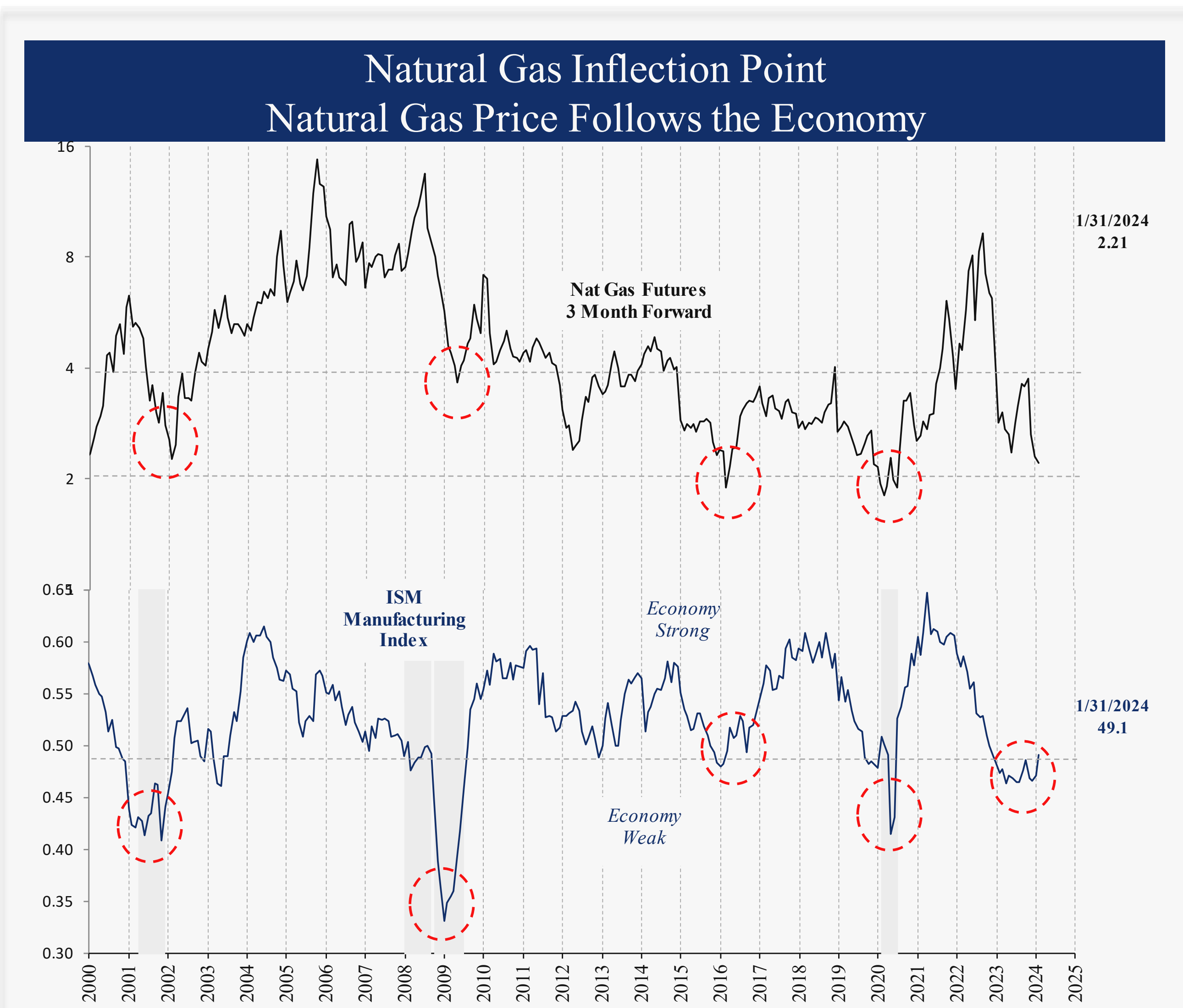
Economic Outlook Indicators 54.1: Stronger Economy Ahead

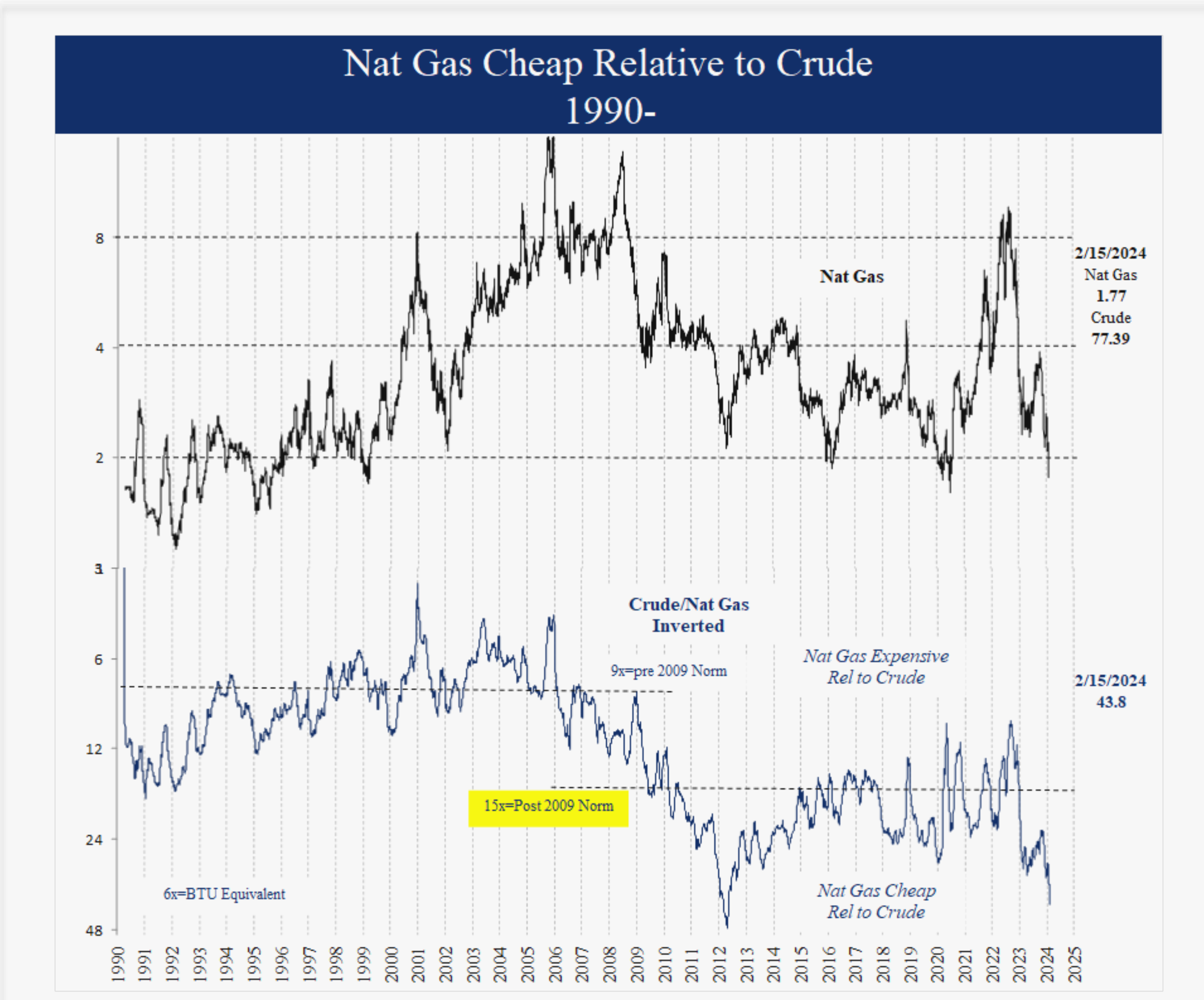
Our economic outlook indicators have improved from the recent low of 37 on 11/1/23 to 54 on 2/16/24 as leading indicators like equities, bond yields, and commodity prices have risen. The ISM Index is one of the best coincident economic indicators due to its long history, a timely release at the end of each month, and no major revisions like GDP or retail sales. In prior cases when our economic outlook indicators were above 50 and the ISM Index was below 50, the economy accelerated. The ISM Index is already up 3 points to 49.1 from the recent low of 46.0 in June. It is likely to continue higher. This is the primary reason we are cutting the long-term bond rating to a max cautious 1. Higher long-term rates mean lower bond prices.



Natural Gas Down 80%: Inflection Point

Natural gas is down 80% from the $9 August 2022 peak to a recent $1.56 on 2/16/24. The extreme decline reflects a succession of bearish news items including record U.S. well production, the slowing economy, the warmest winter since 2015, and strong rains out west boosting hydro power generation. While we have found weather beyond 10 days to be unpredictable, economic activity is predictive for natural gas prices since it boosts demand. For instance, since 1990, when the ISM Index was weak as it is now, below 50, natural gas futures returned -28% annualized. Compare that to a 14.9% return for natural gas when the ISM was strong above 57 (20% of the time). The ISM is already up 3 points to 49.1 from the recent low of 46.0 in June. Further economic improvement, reported production shutdowns due to the price decline, and finally steady electricity demand increases from data center growth may mark $2 as a turning point for natural gas prices. Soon investors will be seeing upside from electricity demand spiking during summer heat waves. The primary risk is unabated production, with supply overwhelming demand in the short term.





Dollar Index Up 4%: Risk for Emerging Markets

Since January, the Dollar Index is up 4%, putting pressure on commodities like copper and emerging markets equities. Since peaking at 114 in September 2022, the Dollar Index declined to 100 in 2023 but has since remained in a trading range including a recent rally to 104.3 as the U.S. 10-year Treasury yield moved higher. A further dollar rally is a risk for emerging markets, we are watching closely. For now, the positives for emerging markets dominate including extreme investor positioning after the Hang Seng Index collapse combined with China's central bank (the PBoC) responding rapidly with expanding stimulus and rate cuts. Central bank stimulus is proven as one of the most reliable leading economic indicators for any country over time. In prior China cases, China equities reversed higher and the dollar weakened.

Summary

This month we discussed how the lower CPI inflation trend is an important indicator for the health and longevity of this economic cycle. Current mid-cycle conditions are quite positive for equities, commodities and higher Treasury bond yields with the economic outlook improving and inflation still declining. Once the economy accelerates, late cycle signposts include excessive optimism from investors, CEO's and bank loan officers. That will be the time to cut back on equities for recession and bear market risk. We will continue to watch our indicators on a daily basis and shift exposure targets as needed. Thank you for your support and please contact us with any questions.

Michael Schaus
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