BRENTON POINT
WEALTH ADVISORS

January 10, 2019

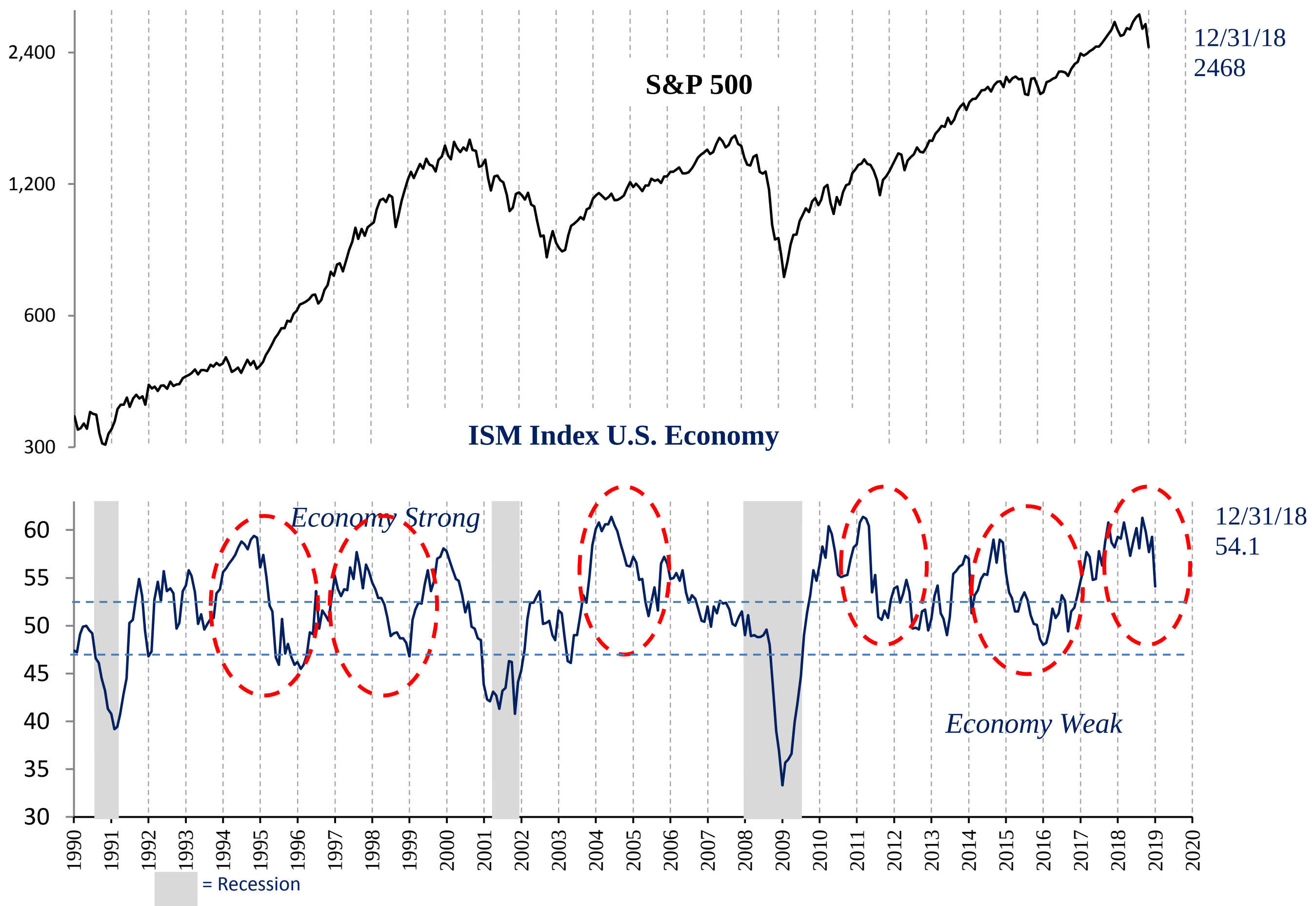
Investing Environment Review and Outlook – Volume 22

The investment environment has been difficult, but our research indicates a recession is unlikely despite the trade war, slowing economies in the U.S. and China, and the U.S. Government shut down. This month we look at the investment implications of the slowing economy, extreme investor sentiment, and similar stock market declines.

Mid-Cycle Slowdown: Goldilocks Returns

The ISM manufacturing index fell 5 points in December, widely reported as the biggest drop since 2008. It marks the first significant evidence of an economic slowdown, consistent with the weak economic outlook indicators we reported in December. This actually marks the third slowdown of this cycle, the first being in 2011 during the European crisis, and the second in 2014-15 when oil crashed. You can see they were common in prior cycles and highlighted by red circles below (chart 1). Although stocks declined 2.5% after the January 3rd ISM report, the key takeaway is slowdowns serve to extend the cycle by postponing economic overheating, the usual cause of recessions and bear markets. Our outlook of no recession comes from indicators like the level of the ISM index, the yield curve, inflation, high yield spreads, and Fed policy which are showing low risk of recession. Instead, today's fundamental conditions of moderate economic growth, slowing inflation, a neutral Fed and extreme investor pessimism (chart 2) are historically bullish for stocks, more often seen in the early goldilocks stage of economic recoveries when stocks deliver the most consistently positive returns.

Chart 1: Mid-Cycle Slowdowns Extend the Cycle: 1990-2018



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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Investor Sentiment Extreme: Bullish

The increase in volatility and 19% decline in the S&P 500 last quarter caused investors to cut back their equity exposure. While generally we cannot measure investor exposure directly, sentiment indicators like surveys and put/call ratios give us the best indication of positioning. On January 2nd, all 8 investor groups we track were negative on the direction of the stock market, a rare occurrence. Institutions and advisors cut back from neutral to negative after the December decline. After sentiment was this extreme in October 2011 and January 2016, the S&P 500 turned higher. (chart 3).

Chart 2: Extreme Investor Sentiment 1/2/19: All Investor Groups Negative

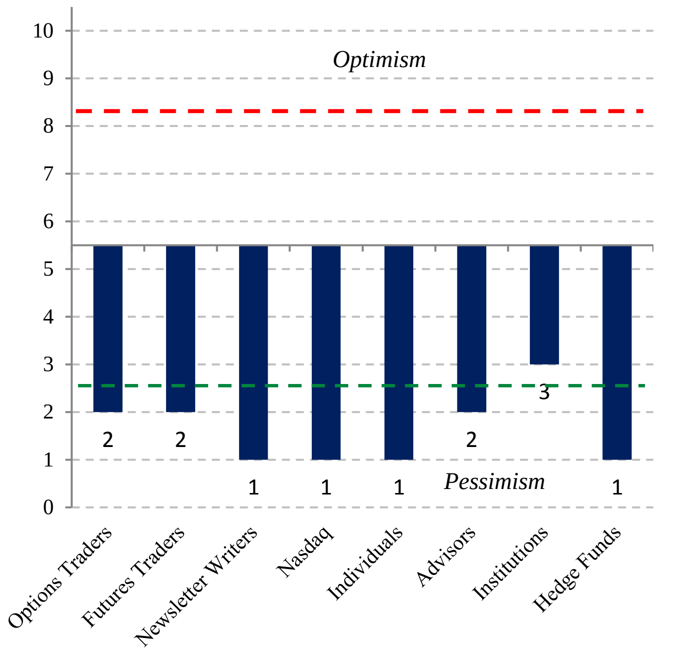
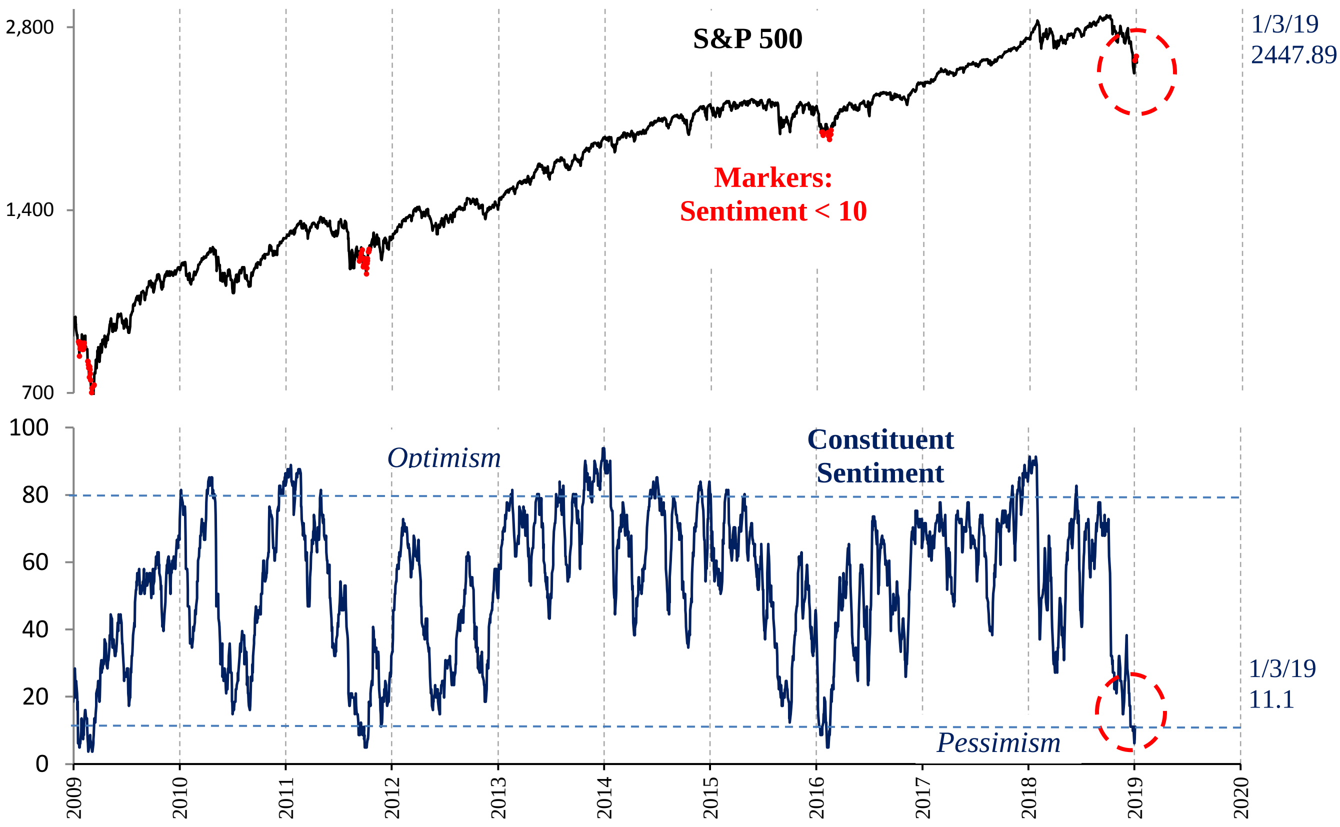


Chart 3: Extreme Pessimism at Stock Market Lows: Constituent Sentiment 2009-2019



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S&P 500 18% Declines: Limited Downside in No Recession Cases

On December 24 the S&P 500 was down 19.6% from the September peak. Since 1950 there were 12 prior declines over 18%. Of those, 7 resulted in a recession, when the S&P ultimately declined an average of 36%. However, in the 5 cases without a recession, the average worst decline from peak to trough was 24%, and the last two (2011 and 1998) were also down 19% at their worst, matching the current case. In other words, since we do not expect a recession at this time, much further decline from here is, from a historical perspective, likely to be limited.

Chart 4: S&P 500 Declines since 1950: Recession Cases Much Worse

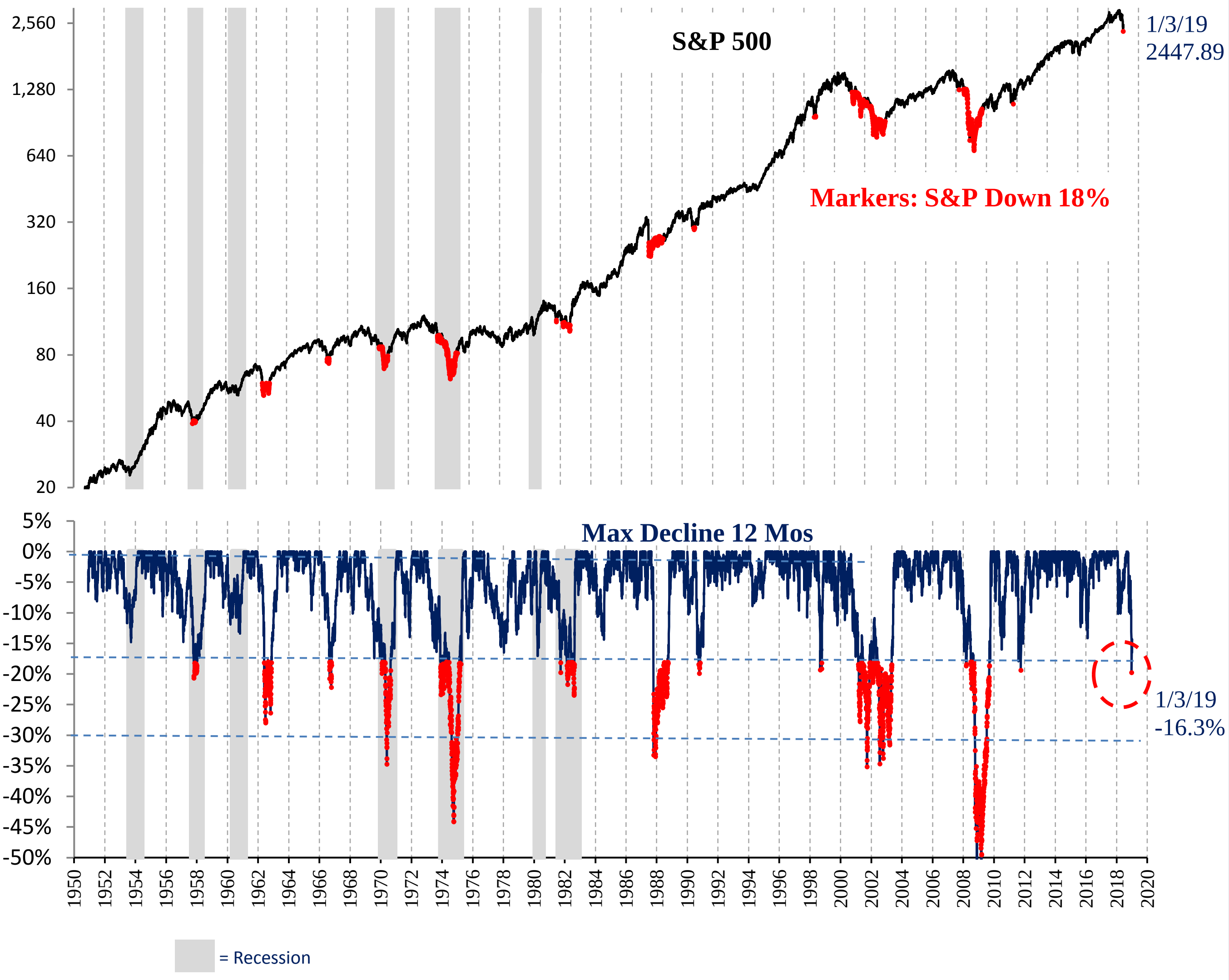
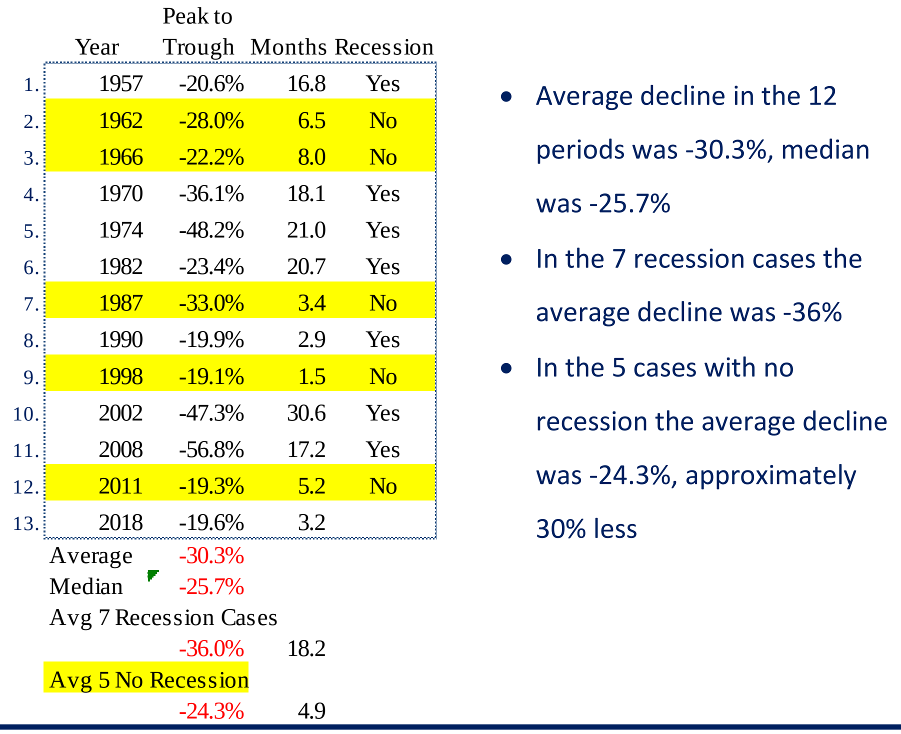


Chart 5: S&P 500 Declines over 18%



	Year	Peak to Trough	Months	Recession
1.	1957	-20.6%	16.8	Yes
2.	1962	-28.0%	6.5	No
3.	1966	-22.2%	8.0	No
4.	1970	-36.1%	18.1	Yes
5.	1974	-48.2%	21.0	Yes
6.	1982	-23.4%	20.7	Yes
7.	1987	-33.0%	3.4	No
8.	1990	-19.9%	2.9	Yes
9.	1998	-19.1%	1.5	No
10.	2002	-47.3%	30.6	Yes
11.	2008	-56.8%	17.2	Yes
12.	2011	-19.3%	5.2	No
13.	2018	-19.6%	3.2	
	Average	-30.3%		
	Median	-25.7%		
	Avg 7 Recession Cases			
		-36.0%	18.2	
	Avg 5 No Recession			
		-24.3%	4.9	

- Average decline in the 12 periods was -30.3%, median was -25.7%
- In the 7 recession cases the average decline was -36%
- In the 5 cases with no recession the average decline was -24.3%, approximately 30% less

The volatility has been difficult for everyone the last 3 months. Although the decline was deeper than historical norms in this cycle, our daily tests of market conditions and assumptions showed a positive outcome for equities throughout, so we held our bullish 5 rating. As of this writing the S&P was up 9.9% from the low, recouping 40% of the peak to trough decline in just two weeks. It is times like these that investors benefit from a data-driven research process rather than emotion to direct decision making, which has served investors well over many market cycles. The high volatility and extreme sentiment has an upside – it may serve to extend the cycle and equity bull market by pushing off the overheating and exuberance - elements which often set the stage for the next recession.

Commodities Rating +1 to Bullish 4

We are raising our commodities rating to a bullish 4 from a neutral 3 last month. The Bloomberg commodity index, a mix of industrial, precious, and agricultural commodities, is down 65% from the 2008 peak and down 54% from the April 2011 peak. After such a long period of negative returns, investor sentiment and portfolio allocations to commodities are low with room to increase and drive prices higher. For instance, according to the Bank of America survey, institutions have been negative on commodities for 6 years.

Typically, commodities do well in the boom phase of the economic cycle as industrial demand accelerates. However, the strong Dollar has been negative for commodities this cycle, since it makes them more expensive outside the U.S. and particularly in emerging market economies where commodity demand is higher than in developed countries. Recently the Dollar was down 2.4% from the December peak and our dollar indicators are negative. The weaker U.S. economy should result in further Dollar declines, which might serve as a catalyst to turn commodity prices higher. In chart 6 below you can see the strong relationship between the dollar index and the Bloomberg Commodity Index. At appropriate times commodities' low correlation with equities can add return and cut portfolio volatility.

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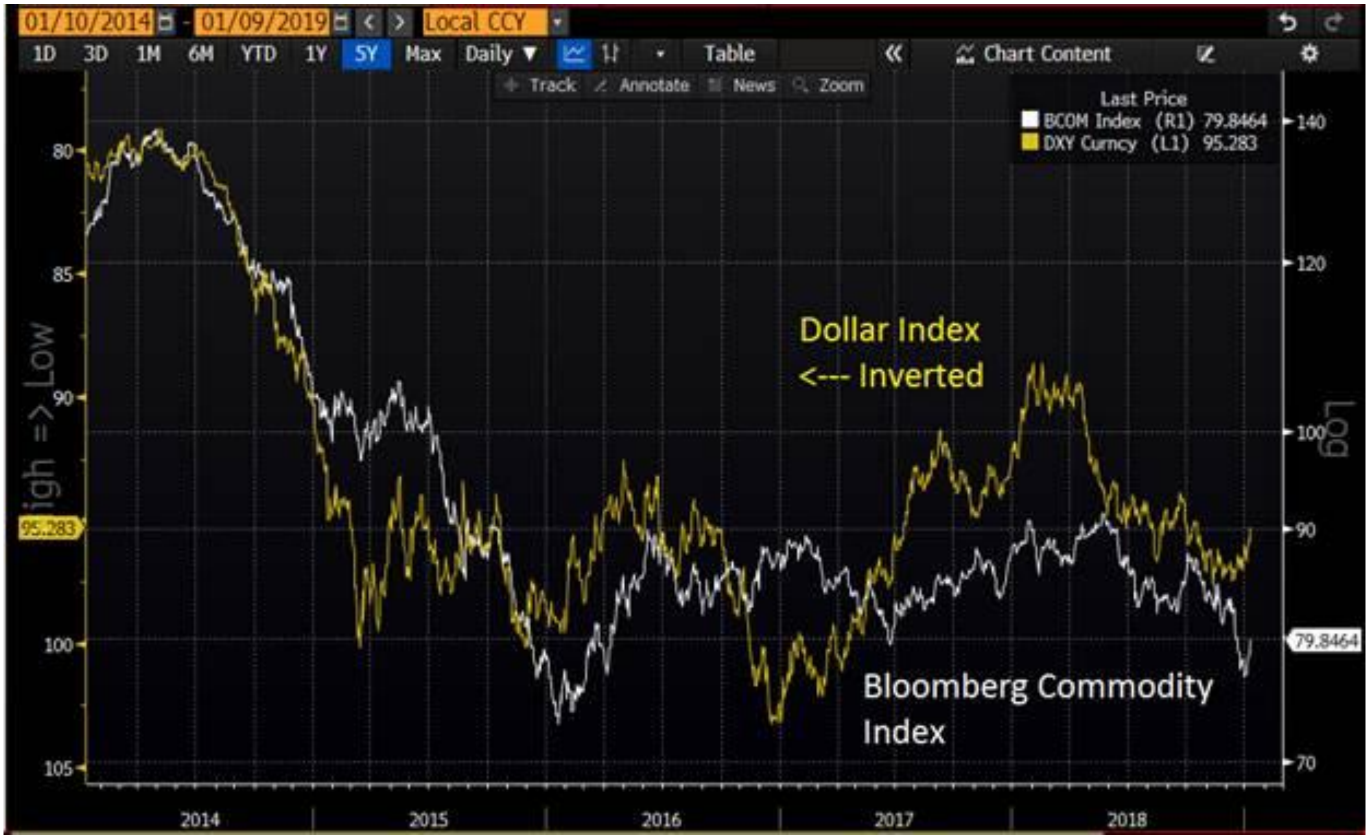

We are maintaining our 3 (neutral) rating on long-term bonds until the economic outlook improves, which we expect. We are maintaining our 5 (bullish) rating on gold since a slowing economy should push the dollar lower and gold higher. Commodities increased to a 4 rating as a weaker economy could lead to dollar declines, signaling the resumption of the commodity bull market. However unlikely, we are watching indicators closely for the chance this mid-cycle slowdown will deteriorate into a recession. In that case we would reassess our asset exposures and adjust our ratings. Thank you for your confidence and please call with any questions.

Michael Schaus
Director of Market Research