BRENTON POINT
WEALTH ADVISORS

August 12, 2019

Investing Environment Review and Outlook – Volume 29

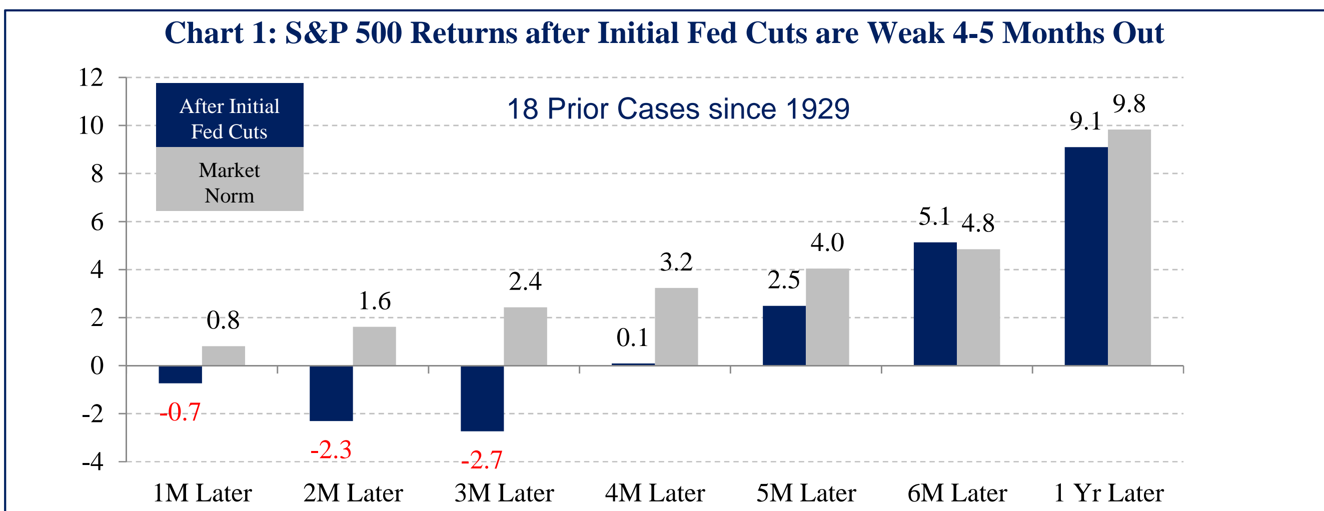
We lowered the equity rating from overweight to our baseline neutral 3 rating. As of late July, the bull case for equities was strong, supporting our most bullish 5 rating. Goldilocks conditions – moderate growth with falling inflation meant no pressure on the Fed to tighten further, and in fact a cut was likely. Sentiment was mixed despite the new high in the S&P 500, another positive. The 18.5% rally in the first half was also bullish, with an average 10% return in the 2nd half in prior cases. We knew the third quarter was weak historically (-0.2% since 2000 vs. 4.3% in Q4) but the Q3 return was 11% annualized when volatility remained as low as it was. The Goldilocks scenario is still relevant, but the sharp drop in the 10-year yield combined with the increased volatility in stocks gives us more mixed signals for stocks, therefore a neutral 3 rating.

Initial Fed Interest Rate Cuts: Mixed Returns 5 Months Out

The Federal Reserve cut the Fed Funds target rate to 2.25% on 7/31, their first cut since they began hiking rates in 2015. There have been 18 prior initial Fed cuts since 1929. The last two (9/18/07 and 1/3/01) were followed by bear markets and recessions and other cases like 1929, 1932, 1937 and 1974 were also followed by sharp equity declines. The S&P 500 was up strongly after several others like 1998, 1989 and 1987. The results are volatile, with the next 7% move in stocks up just 50% of the time.

The level of rates may matter as well. Of the 6 prior cases when the target rate was below 5% after the first cut (vs. 2.25% today), 5 months later the average return was -10.2% and just 2 were higher. The 4 post WW II cases were better, with the market close to unchanged 5 months out, with 2 higher and 2 lower (chart 1).

The S&P 500 was down 5% the first week after just 3 prior initial cuts like this year; Nov 1929, July 1974 and Sep 1998. The S&P 500 was down over 20% within 3 months after the first two, although in 1998 the S&P 500 rebounded strongly after the second bottom, excessive pessimism, and 3 Fed cuts. Historically, S&P 500 returns following an initial rate CUT were lower 4-5 months out, then normal beyond that time.



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.

10-Year Yield Decline

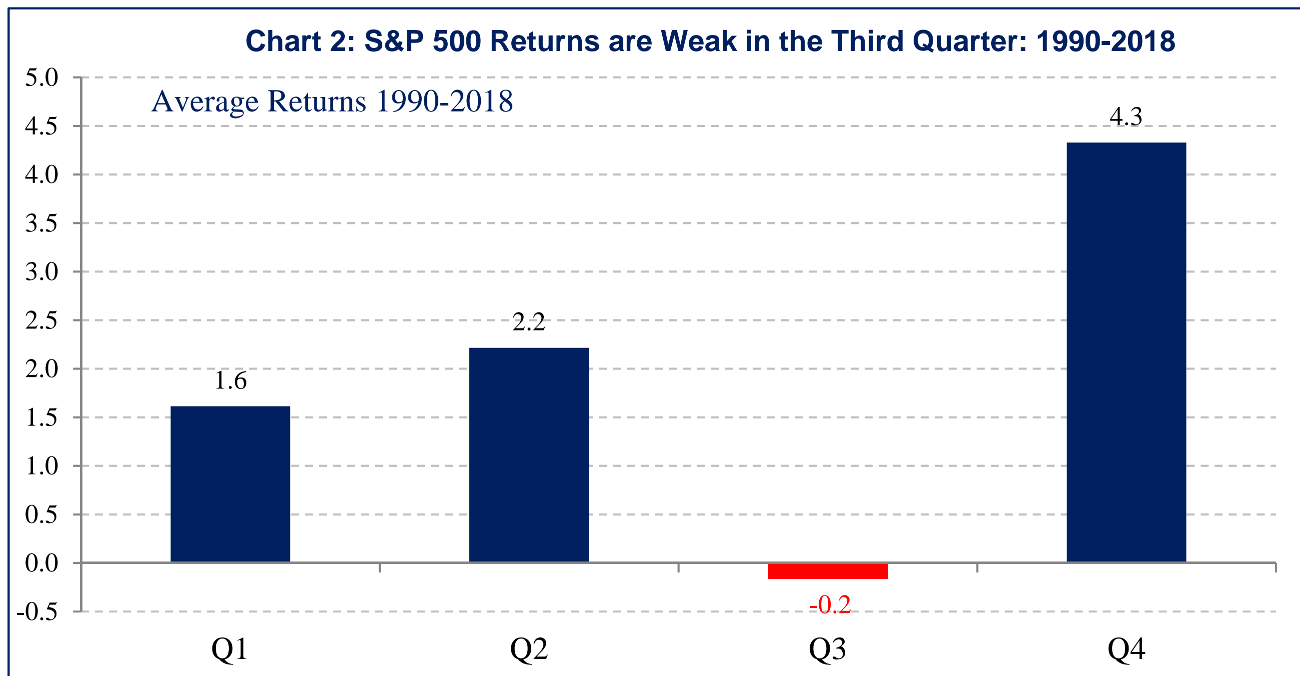
The China Trade War escalation on 8/1/19 (10% tariffs on another $300 billion of imports) might have been just politics and irrelevant to stocks, since as we have seen, the news can change in a day. However, since the news was followed by sharp declines in stocks, the 10-year yield and commodities like copper, the implications are more significant. For instance, the S&P 500 and 10-year have not declined this much together in a week (6% and 0.30%) since 2010-11, when the S&P declined 19%, a much bigger drop.

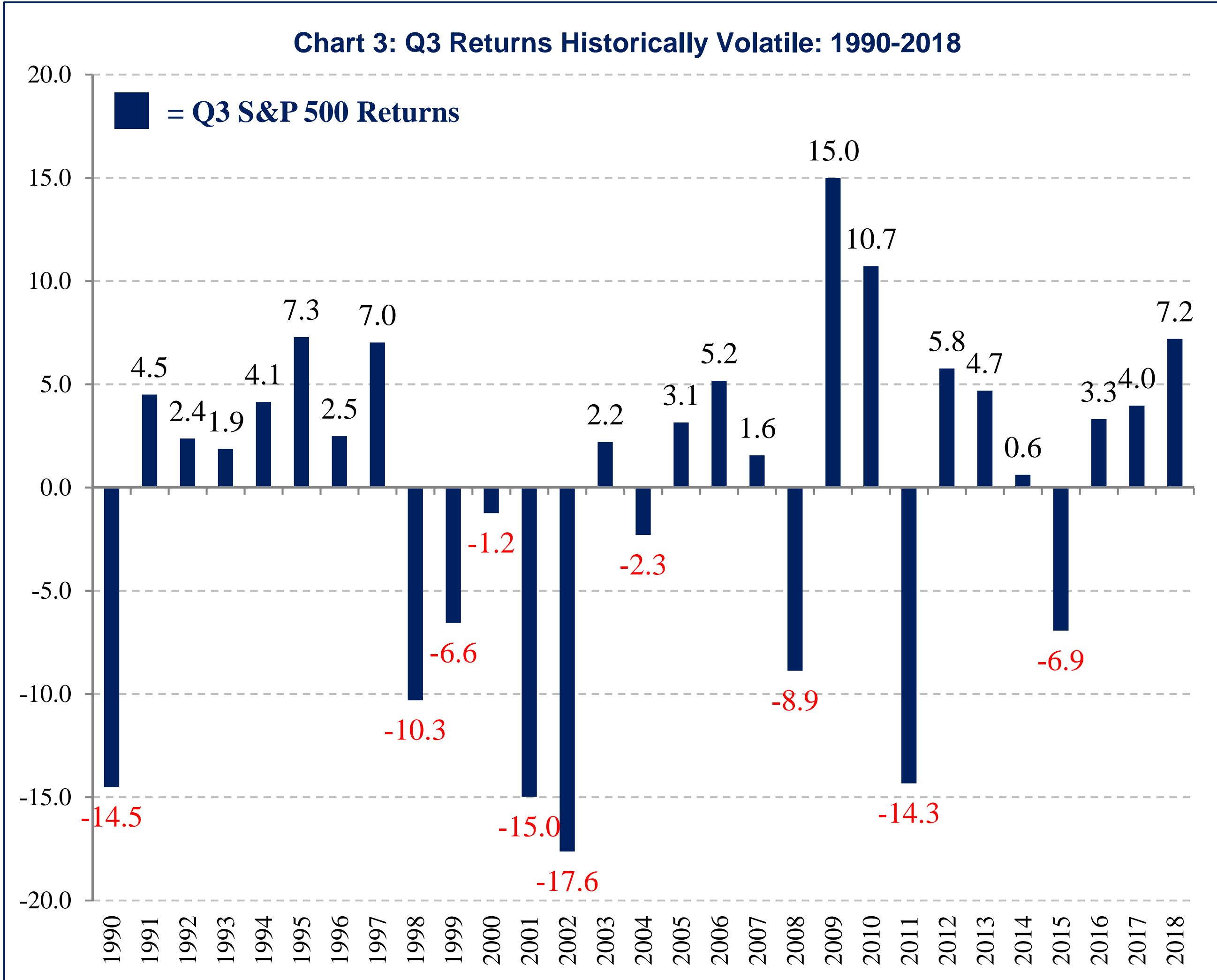
The sharp 10-year yield decline is generally bullish for stocks – taken alone the S&P 500 returned 17% annualized since 1990 when it was falling like this vs. 10% normally. However, the S&P500 returned -6.1% annualized in Q3 when the 10-year yield was falling, a big difference from the 66.6% annualized return in Q4. With the 10-year yield falling combined with higher volatility we have now, the S&P 500 returned just 5.2% (vs. 18.6% with the low volatility we had before last week).

Q3 Returns are Weak and Volatile

Third quarter returns are the lowest of any quarter at -0.2% since 1990 vs. 4.3% in Q4 (chart 2). For instance, 2015 was -6.9% and 2011 was -14.3%. However, 66% of prior Q3 returns were up and the median return at 2.4% is the 2nd best of the year. Much like initial Fed cuts, it just means the odds for stocks are more mixed, especially when volatility picks up as it has in early August (chart 3).

Prospects are still positive for stocks – goldilocks conditions are the most reliable for stocks, but the higher volatility combined with weak economic outlook signals this time of year are reasons to reduce our overweight position. A neutral exposure allows us the flexibility to add if indicators improve, or cut back further if conditions deteriorate.





End of Quantitative Tightening (QT): Positive

Aside from cutting the Fed Funds target on 7/31/19, the Federal Reserve also halted bond sales from their balance sheet, also known as quantitative tightening. This important move has mostly been ignored. This means the Federal Reserve will stop selling the bonds they purchased during quantitative easing (QE) to reduce their holdings as originally planned. In fact, they will buy bonds as current holdings mature. The important result is additional liquidity available for stocks.

Since it is the first case of QT, we cannot compare prior cases, but we can observe that the 3 cases of quantitative easing from 2009-2013 (the opposite of QT) were bullish for stocks, and somewhat negative when they ended (chart 4). Since January 2018, when QT started and liquidity was reduced for stocks, the S&P 500 failed to make a significant new high. From limited cases, it appears that the end of QT should be a net positive for stocks.

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Chart 4: Quantitative Tightening I (QT I) is over: Positive for S&P 500

S&P 500

3/31/10

7/20/11

-16.0%

-17.3%

-12.3%

-19.6%

Markers: Fed QE Above
$50 Bil/Mo

Fed Holdings of
All Securities
1 Month $ Ch

Fed Buying Securities

QE I

QE II

QE III

Taper

QT I

Fed Selling Securities

200,000
180,000
160,000
140,000
120,000
100,000
80,000
60,000
40,000
20,000
0
-20,000
-40,000
-60,000

2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020

We are maintaining our neutral 3 rating for bonds and commodities. The gold rating remains a bullish 5 rating. We will continue monitoring our indicators and adjust our outlook as conditions change. Please contact me or your advisor with any questions

Michael Schaus
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