BRENTON POINT
WEALTH ADVISORS

September 12, 2019

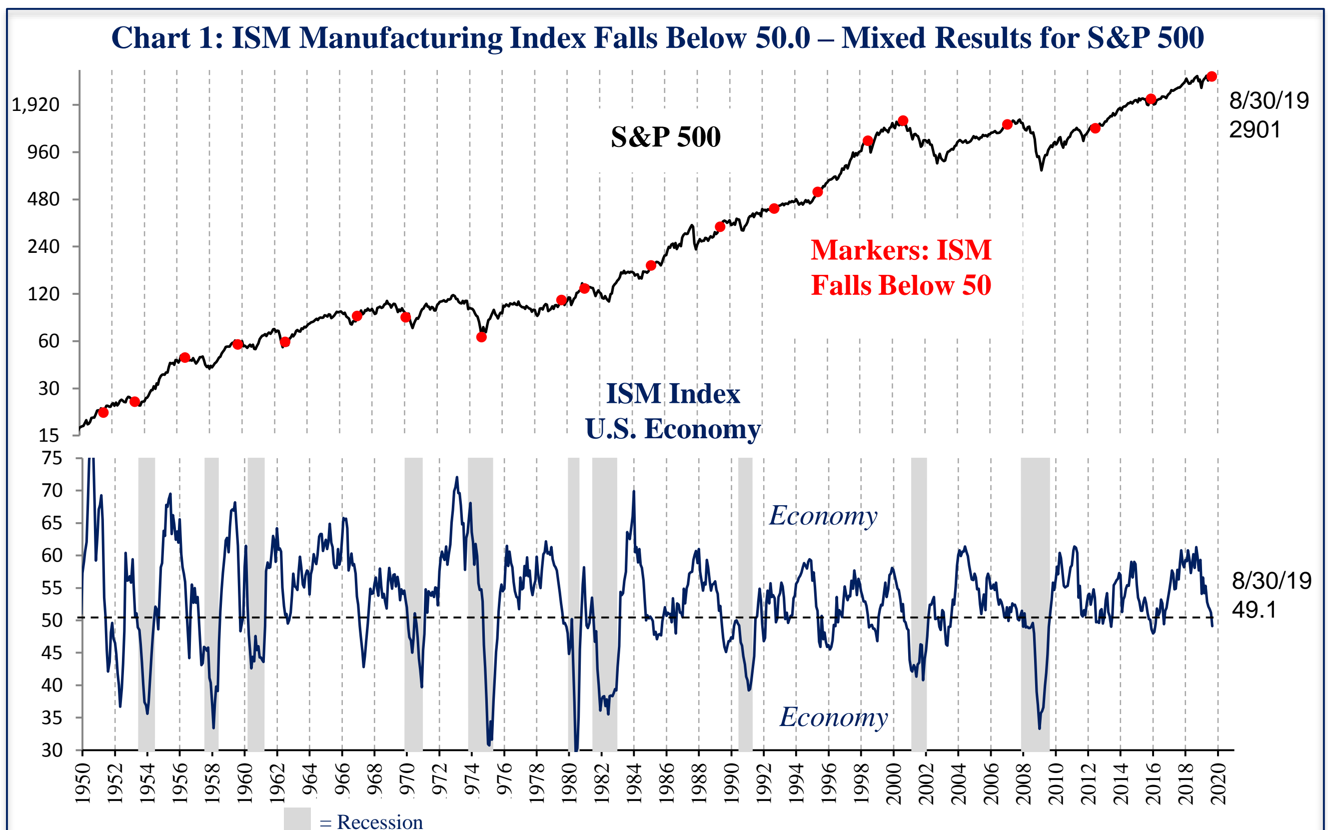
Investing Environment Review and Outlook – Volume 30

We are initiating coverage of emerging markets stocks with a bullish 5 ranking. This is based on improving economic conditions and low valuations, as well as the normal benefits of diversification. Emerging markets include stocks from China, South Korea, Taiwan, India and Brazil among other countries. These are countries in the process of industrializing, developing their currency, banking systems and stock markets. Returns can be more volatile than developed markets like the U.S. or Europe, but these investments offer the potential of greater returns due to periods of rapid growth, and diversification from other developed countries. Expectations are extremely low for emerging markets stocks while our data shows a positive turn in recent economic activity.

ISM Index Below 50: Not A Leading Indicator

The widely followed ISM manufacturing index declined 2 points in August to 49.1, below expectations and below the 50.0 level that technically indicates contraction. The move from over 60 in September 2018 does show a significant weakening of the economy. However, the cross below 50 should not be significant for S&P 500 returns going forward.

Consider that there were 22 prior cases since 1950, but only 8 recessions. Of those 22 cases, S&P 500 returns 3 months and 6 months later were, in fact, positive, up 68% and 77% of the time. However, average returns of 2.8% and 6.2% were very close to the norm over that period, so it does not qualify as a significant signal.



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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China Cuts Reserve Requirements: Bullish

China cut their Reserve Requirement Ratio (RRR) 0.5% to 13% on 9/6/19, the 5th cut since they started this series at 17% in April 2018, also the beginning of the trade war. The RRR was down to 7% in 2006 so they have room to cut further as needed. Also, their Base Lending rate (equivalent to our Fed Funds target) is still 4.3% vs. just 1.25% for U.S. Fed Funds, so they still have room to reduce rates and further stimulate the economy.

In prior cycles (2008, 2012 and 2015), Bank of China cuts led their loan growth to the upside as banks were directly or indirectly signaled to lend more. Stronger loan growth was then followed by stronger Chinese and U.S. economies, and eventually a sustained rally in the S&P 500. The pattern of Bank of China rate cuts, stronger lending, and an improved economy.

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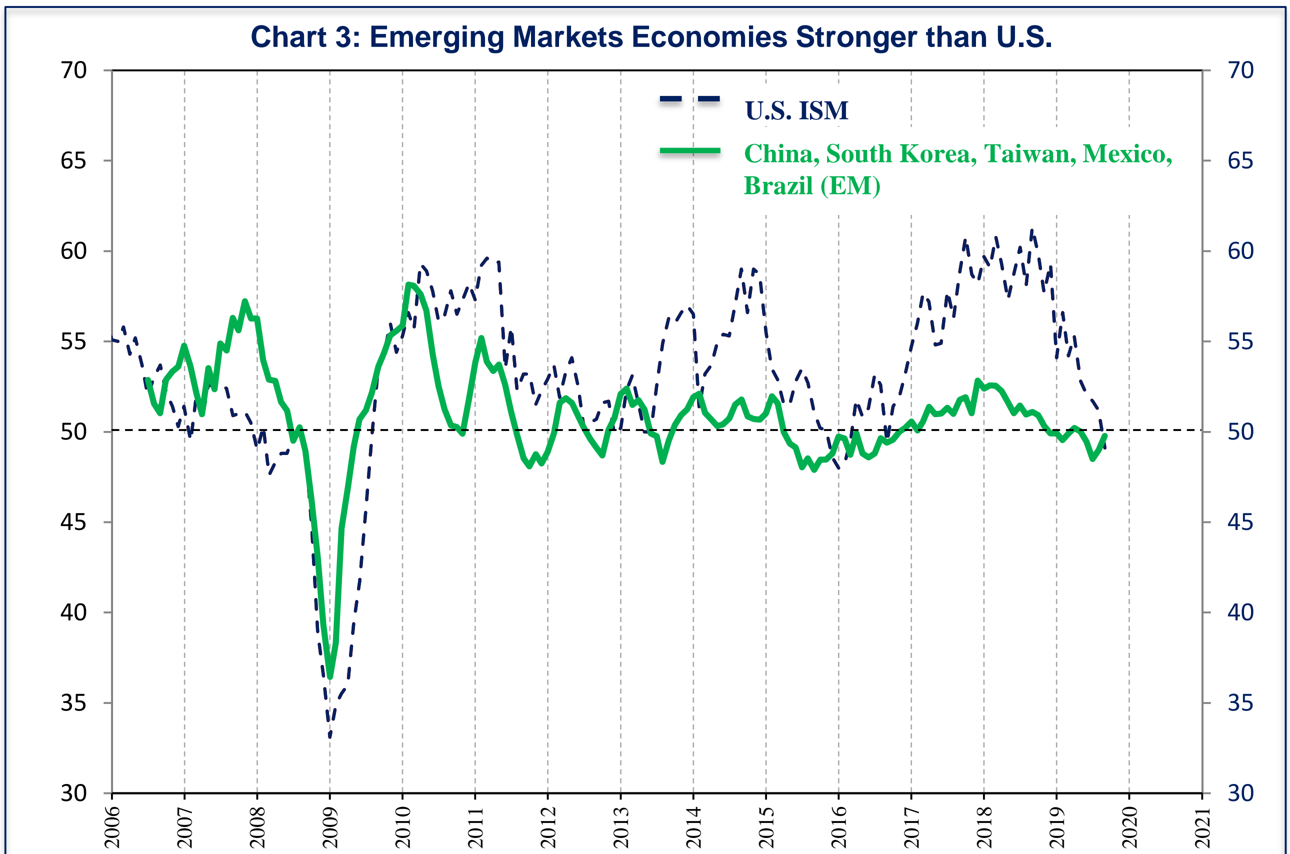
Emerging Market Indicators: Initiating Bullish 5 Ranking

While the U.S. economy has weakened significantly over the last year, surprisingly emerging market economies improved recently. Since June, the Purchasing Managers Index for emerging markets rose from 48.5 to 49.8. You can see in Chart 3 that emerging markets led the U.S. economy to the upside in both 2009 and 2015. Since 2004, emerging market stocks returned 18.7% when this index was rising vs. -5.2% when the index was falling.

The price earnings ratio of the emerging markets index is 13.5, a 30% discount to the S&P 500 at 19.5 (chart 4). At the peak in 2007, emerging markets traded at the same valuation as the U.S. The low valuation is evidence of the negative expectations for emerging markets in the trade war, and more importantly, the under weighting by portfolio managers. Once this economic turn becomes more evident, the allocation could be potent for emerging markets stock prices. For these reasons and diversification, we are initiating a bullish 5 ranking on emerging markets stocks.



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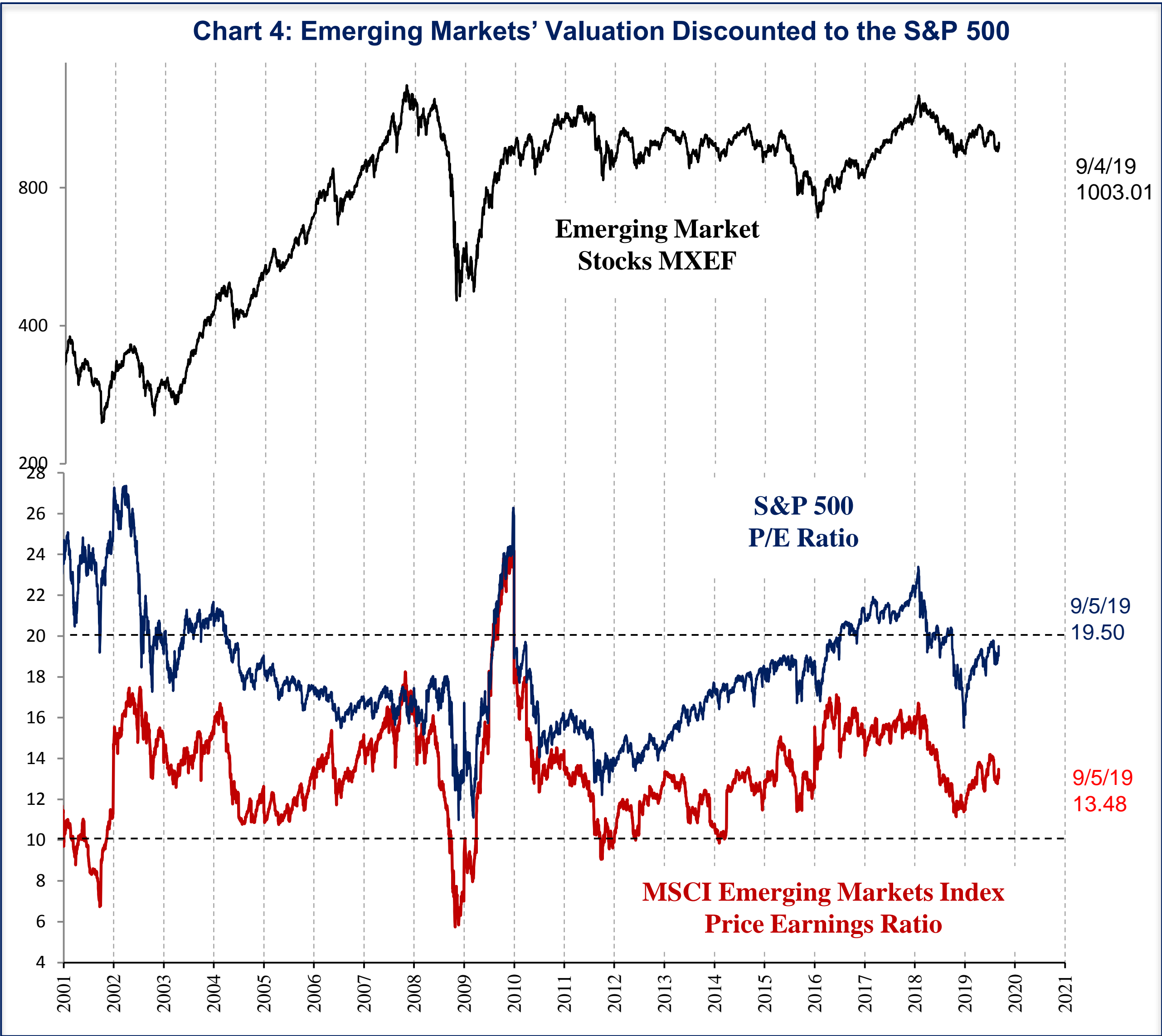

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Reducing Gold to a Neutral 3 Ranking

We are reducing Gold -2 to a neutral 3 rating. Year to date, gold is up 18.86% through the end of August and has provided good diversification for portfolios. The sharp decline in the 10-year Treasury yield has been a big positive. For instance, since 2000 gold returned 20.4% annualized when yields were down, as it is currently, over a 6-month period. This is 2.4x the norm of 8.4%. We are reducing exposure due to the risk of a reversal in the 10-year yield if economies rebound as we expect. In prior periods that the gold/bond correlation was this high with strong gold rallies, the gold price reversed sharply when yields reversed. Also, strong bullish sentiment in gold adds to the risk, since any reversal could be larger than usual.

Chart 5: Gold Price and 10-Year Price Correlation

Chart 6: Extreme Gold Sentiment

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Our U.S. and Developed Markets equity ranks remain a neutral 3 due to mixed signals. However it is likely the next change in ratings will be higher. The long-term bond rating remains a neutral 3 as well, although the extreme move in yields is a negative historically, particularly with signs the economy will rebound on the back of significant China stimulus. We will continue monitoring our indicators and adjust our outlook as conditions change. Please contact me or your advisor with any questions

Michael Schaus
Director of Market Research