BRENTON POINT
WEALTH ADVISORS

January 13, 2020

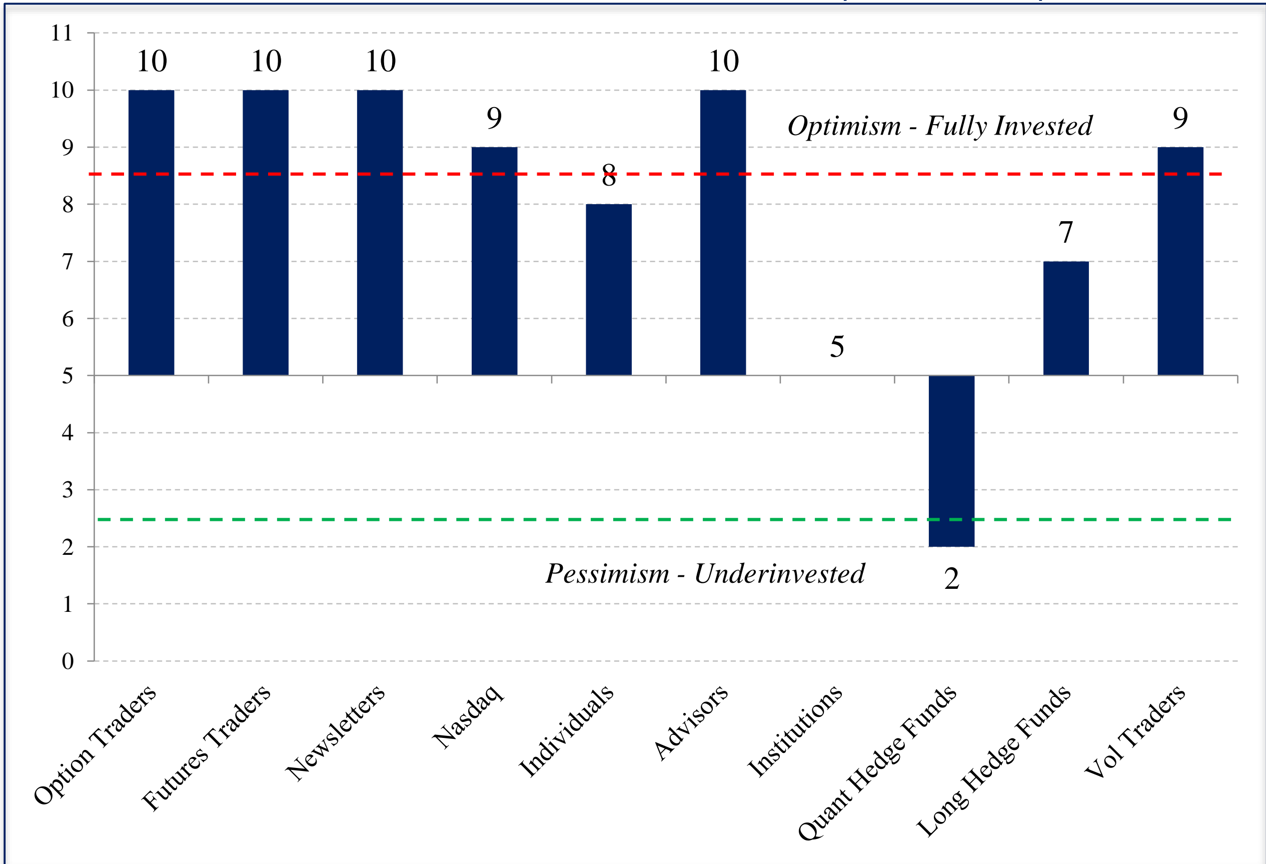
Investing Environment Review and Outlook – Volume 34

Equity Sentiment Extreme: Reduced U.S. Equities Rating

We cut our U.S. equity ranking to a neutral 3 from a bullish 5 due to extreme sentiment readings. Although economic conditions, marked by moderate growth, a loose Fed, and low inflation remain positive for equities, investor sentiment reached a 2-year extreme following the steady 13% S&P 500 advance since October 3rd. 6 of 10 investor groups are extremely optimistic, our best indication investors as a group have less cash to drive stocks higher. In prior cases, with such optimism at year-end, the S&P 500 declined 5-10% in January or February. For instance, when sentiment was this extreme in late 2017, the S&P 500 peaked on 1/26/18 and declined 10% in February. Other cases were followed by smaller declines of 5-6% in January 2011 and January 2014. For comparison, on October 8th this past fall, before the 13% move in the S&P 500, equity sentiment was the mirror image of today, with 6 of 10 groups showing extreme pessimism.

We also reduced developed foreign equities to a bullish 4 rating from 5 due to the risk they could be pulled lower if the S&P 500 declined. Emerging markets equities remain a max bullish 5 rating with sentiment less of an issue in our opinion, and due to the compelling 28% valuation discount to the S&P 500.

Chart 1: Stock Market Sentiment: 6 of 10 Groups Extreme Optimism



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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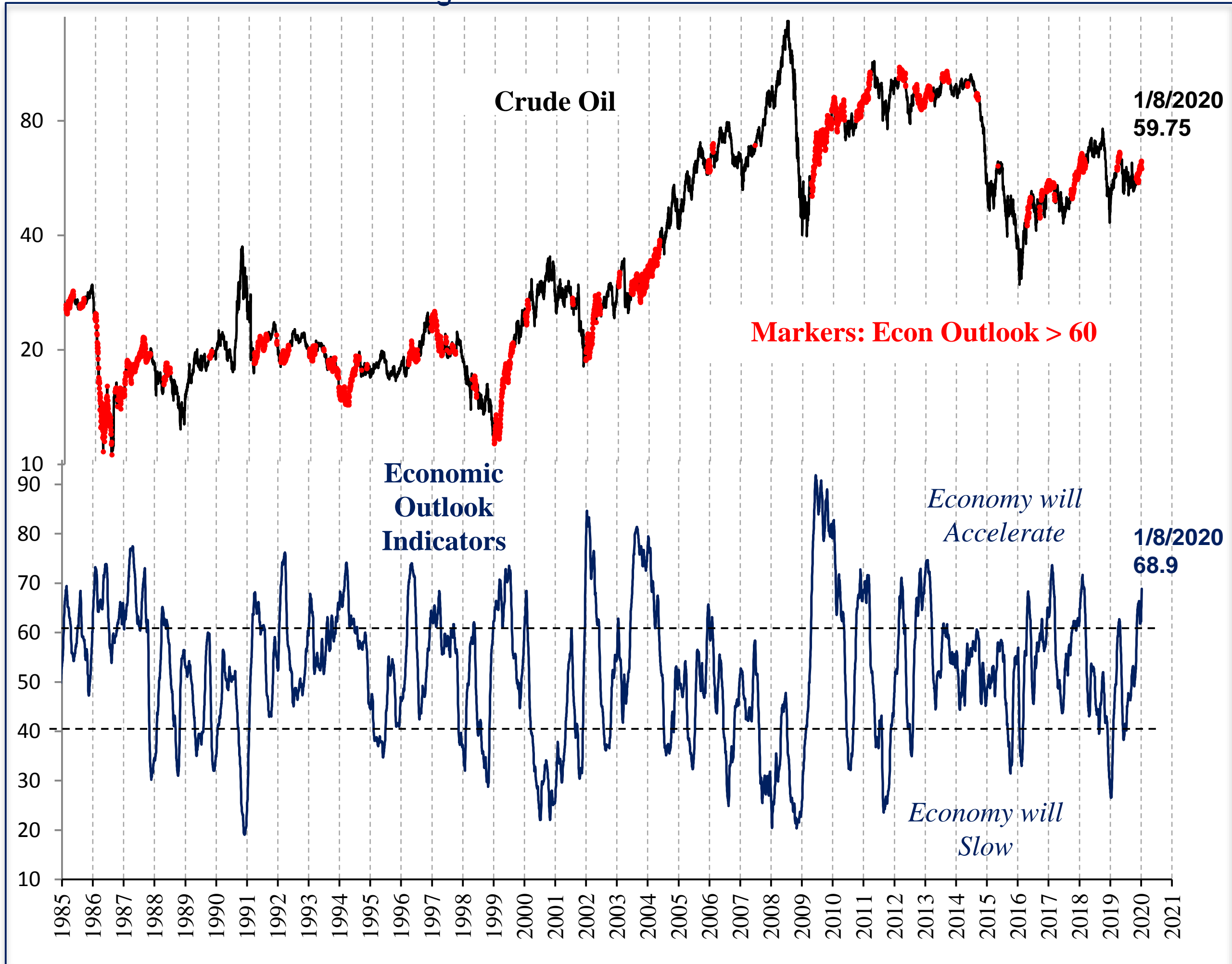
Increased Commodity Rating

We increased the commodity rating to a bullish 5 from a neutral 3 due to strong economic outlook indicators and a weak dollar. Our economic outlook model improved to 71, which historically indicates the likelihood that the U.S. economy will accelerate in the next 3-6 months. It is also a good indication of potential commodity strength ahead, in particular crude oil. For instance, as you can see on chart 2, when readings were over 60, crude oil returned 34% annualized since 1990, 8x the norm. Economic strength may have an even bigger effect on prices this year since expectations are so low. For instance, consensus for 2020 GDP is just 1.8%, down from 2.3% expected for 2019. After rallying through September, the dollar declined 3% in Q4. Since 1990 when the dollar was declining, crude oil returned 17% vs. a -7% return when the dollar was rising. Since crude oil and many other commodities are priced in dollars, when the dollar declines, commodity prices typically go higher.

The addition of crude oil to a traditional equity portfolio might sound risky, but with a correlation of just 0.36 with the S&P 500, crude oil can actually cut the volatility and risk of a portfolio since moves in each may offset each other. And given the biggest risk to equities is inflation, a combination of gold and crude oil generally serve as an effective inflation hedge.

Chart 2: Strong Economic Outlook: Bullish for Crude Oil



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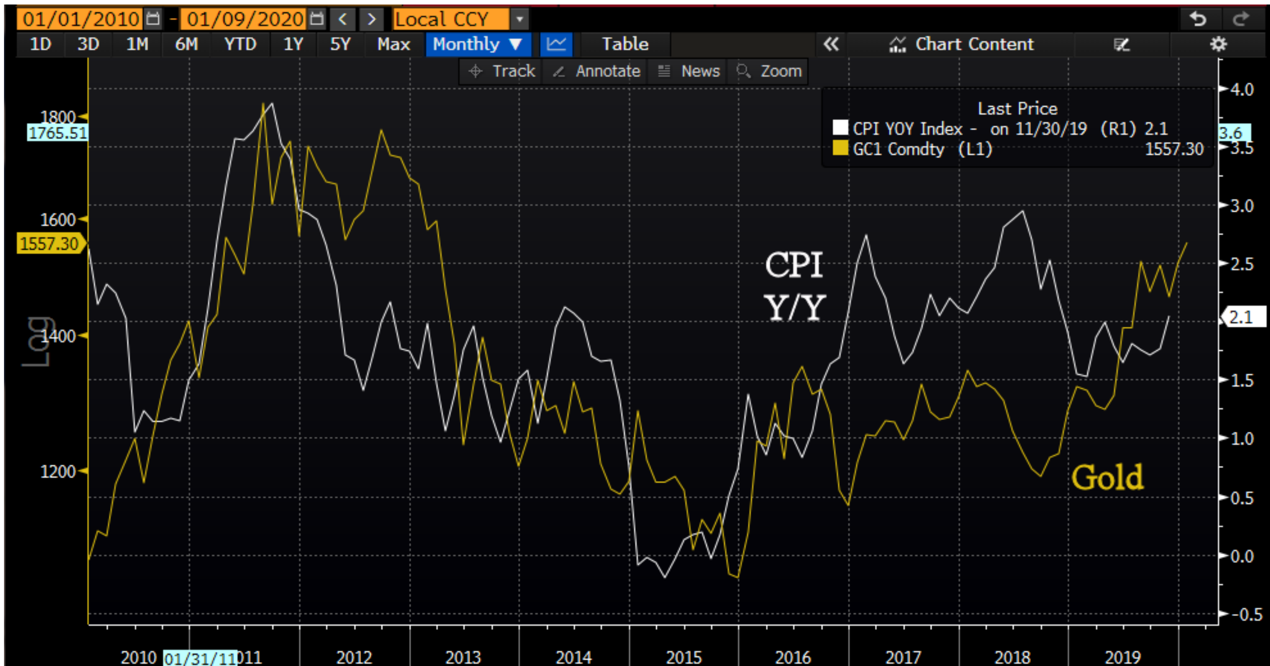
Increased Gold Rating

We also increased the gold rating to a bullish 4 from a neutral 3, based on inflation and the Federal Reserve. Since 2000, gold returned 14% annualized when the Federal Reserve was easing rates and CPI inflation was rising, conditions we have today. This is significantly better than the norm of just 8.7% over the same period. CPI inflation was 0% in 2014 after the price of oil collapsed and has since risen to 2.1%, and likely 2.3% through December. At their December meeting, the Fed said they would allow inflation more leeway to the upside before tightening policy, an extremely bullish development for gold. With a strong economic outlook and commodities like crude oil and copper rising already, a risk for this bull market is unexpected inflation. Investors will likely continue buying gold to hedge this risk, particularly with the Fed signaling they will not tighten anytime soon.

Chart 3: CPI Inflation vs. Gold



In summary, background conditions remain bullish for stocks with moderate growth and strong Fed support through 3 cuts and $50 billion per month of T-Bill purchases. However, the higher expected volatility in January combined with extreme sentiment readings were enough to cut our U.S. equity and developed equity ratings until conditions improve. We also raised commodity ratings based on the improving economic outlook and rising trend of inflation, ultimately the biggest risk to any bull market. Thank you for your support and please contact your advisor with any questions or to discuss if changes are warranted in your portfolio.

Michael Schaus
Director of Market Research