BRENTON POINT WEALTH ADVISORS

December 16, 2020

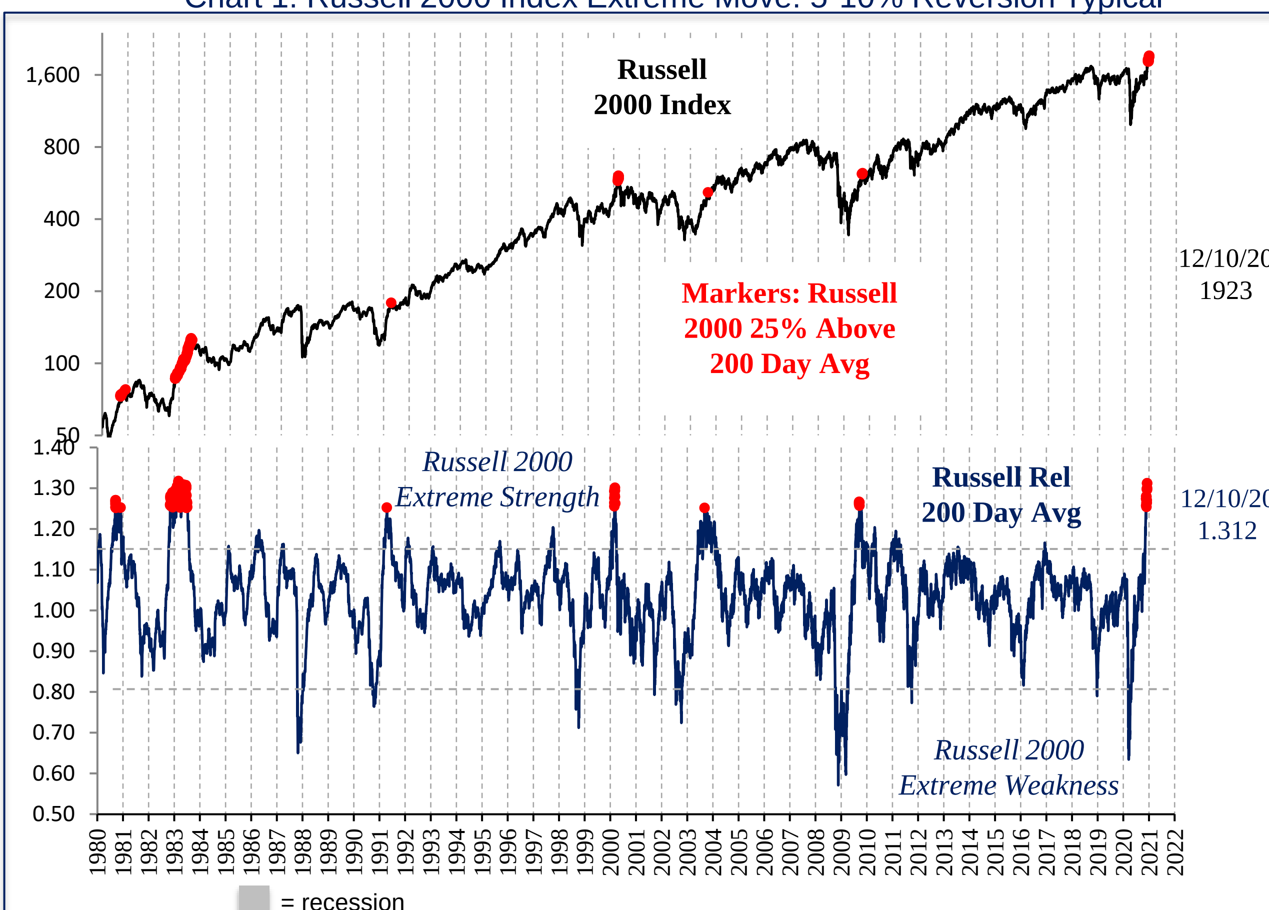
Investing Environment Review and Outlook – Volume 43

This month we discuss the extreme move in the Russell 2000 index of small cap stocks, investor positioning, China's central bank policy and the gold price decline. We remain focused on our economic and monetary indicators for investment allocation guidance. Despite some early warning signs from investor positioning and China's central bank policy, the continued strong economic outlook combined with a committed Federal Reserve and benign inflation readings, our equity ratings remain bullish along with commodities and gold. Long-term bonds remain at a cautious 1 rating, due to the asymmetrical risk presented by low interest rates.

Russell 2000 Index Extreme Trend for Small Cap Stocks

The Russell 2000 index of smaller cap stocks is up 14.6% YTD, not far ahead of the 13.4% gain for the S&P 500. However, from the March low, the Russell 2000 rallied 93% to December 10th, putting it close to a record 31% over its 200-day average. Following the 7 prior extreme Russell 2000 Index moves, returns were mixed 3 months out. However, 6 months out, 6 of 7 cases were higher an average of 9.8%, and the next 10% move was higher in 6 of 7 cases too. With economic and monetary indicators still positive, a 5-10% reversion to the downside within 3 months would be typical, but 6 months out the Russell 2000 historically has been higher.

Chart 1: Russell 2000 Index Extreme Move: 5-10% Reversion Typical



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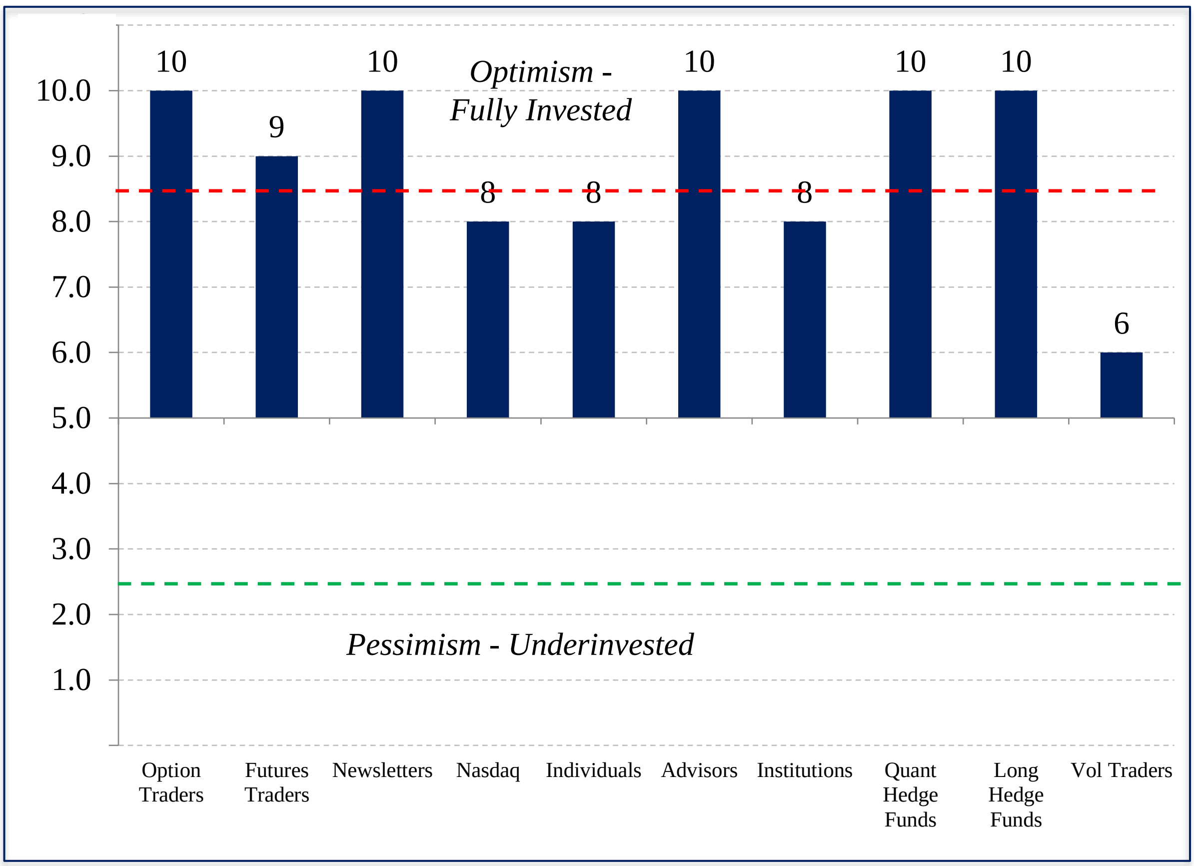
Investor Positioning is Long

Equity markets rallied in November after the U.S. election process was better than expected and following 90% vaccine efficacy announcements. Equity investor positioning moved higher in response. All 10 investor groups we follow are now long, and 6 of those are extreme. However, tests show overall positioning is not significant for equity returns in the fourth quarter. However, if positioning continues higher, we will reassess the implications in the first quarter of 2021.

Chart 2: Equity Investor Positioning is Long
6 of 10 Groups Extreme



China's Monetary Stimulus Slowing

Foreign central banks like China's PBoC joined the U.S. Federal Reserve in easing monetary policy since March to stimulate their economies. For instance, China loan demand increased rapidly to 85% Y/Y in August. However, it has since slowed to 59% in November. In prior cases the growth rate rolled over, China's economy slowed in response. It could be meaningful for industrial commodity prices like copper, which benefit from China's economic strength. We are maintaining our bullish 5 rating on commodities, but this apparent shift is a reminder that the unprecedented pace of global central bank easing is unsustainable, and that central banks will not maintain easy monetary conditions indefinitely.

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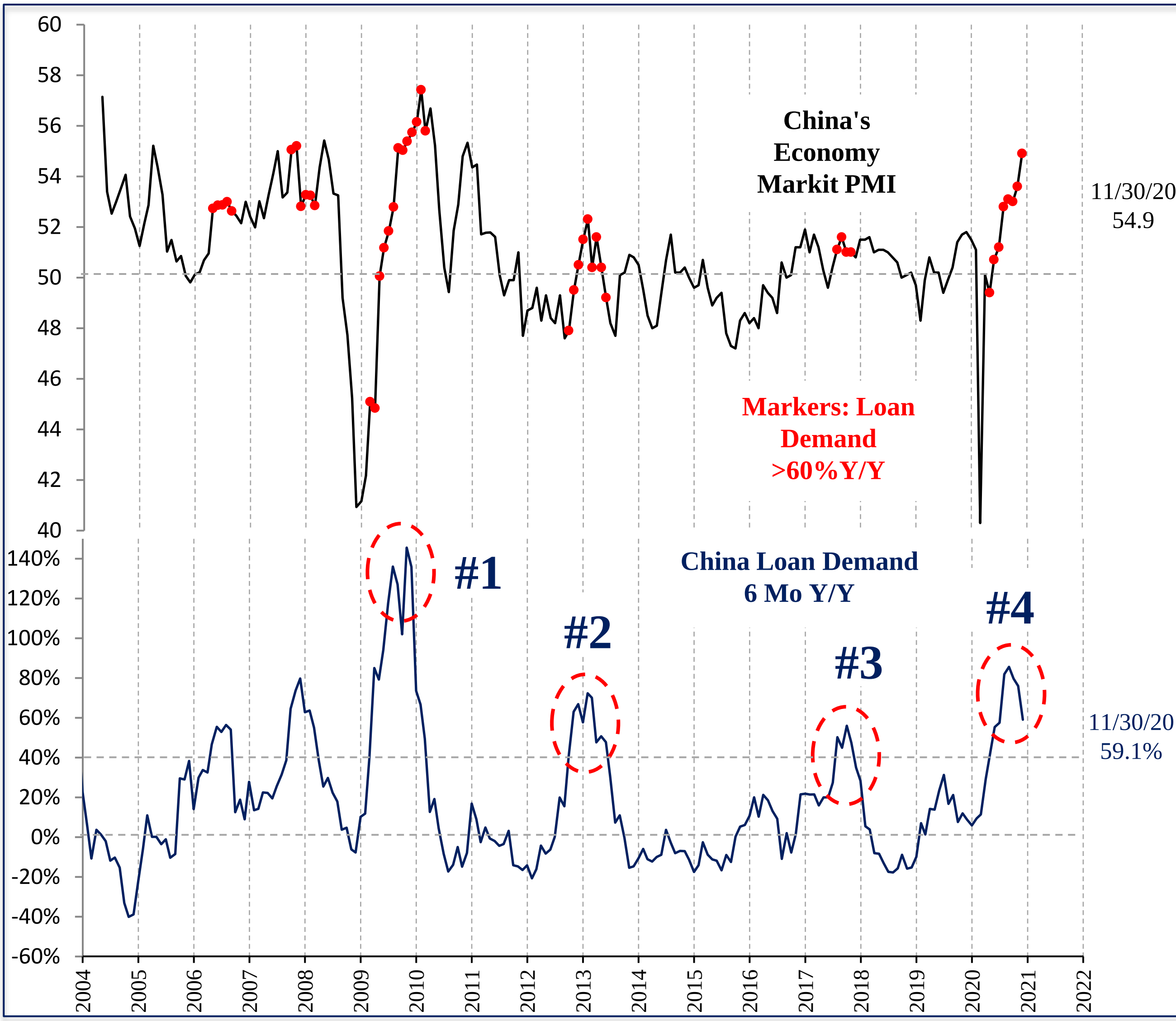
Chart 3: China's Monetary Stimulus Slowing



Gold Down 14%: Positive

Through the end of November, gold declined 14% to below $1,800 from the August peak of over $2,000, but was still up 16% YTD. This move was similar to prior bull market reversals after previous extremely overbought markets like we saw in August. Short term interest rates below the inflation rate (also called negative real interest rates), unprecedented money printing by the Federal Reserve, and a reversal in our leading inflation indicators are bullish for gold. The gold bull market will likely not end until the Fed hikes. Finally, since 2000, gold returned an average of 5.7% from December 15th through February, and it was higher 75% of the time. So there might be some structural buying that will take place this time of year. We are maintaining our bullish 5 rating on gold.

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Chart 4: Price of Gold

Summary

The extreme move in equities since the election may lead to consolidation in the strongest indices like the Russell 2000, like we saw in gold since August with a 14% 3-month decline. However, since the economic outlook remains positive and the Federal Reserve remains committed to easy monetary policy, we are maintaining our bullish 5 rating on equities. The dollar decline will benefit both commodities like crude oil and foreign equities like emerging markets and foreign developed indices. We will continue monitoring our array of indicators and testing our assumptions on a daily basis. Thank you for your support and we wish you good health this holiday season. Please contact your advisor with any questions.

Michael Schaus
Director of Market Research

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