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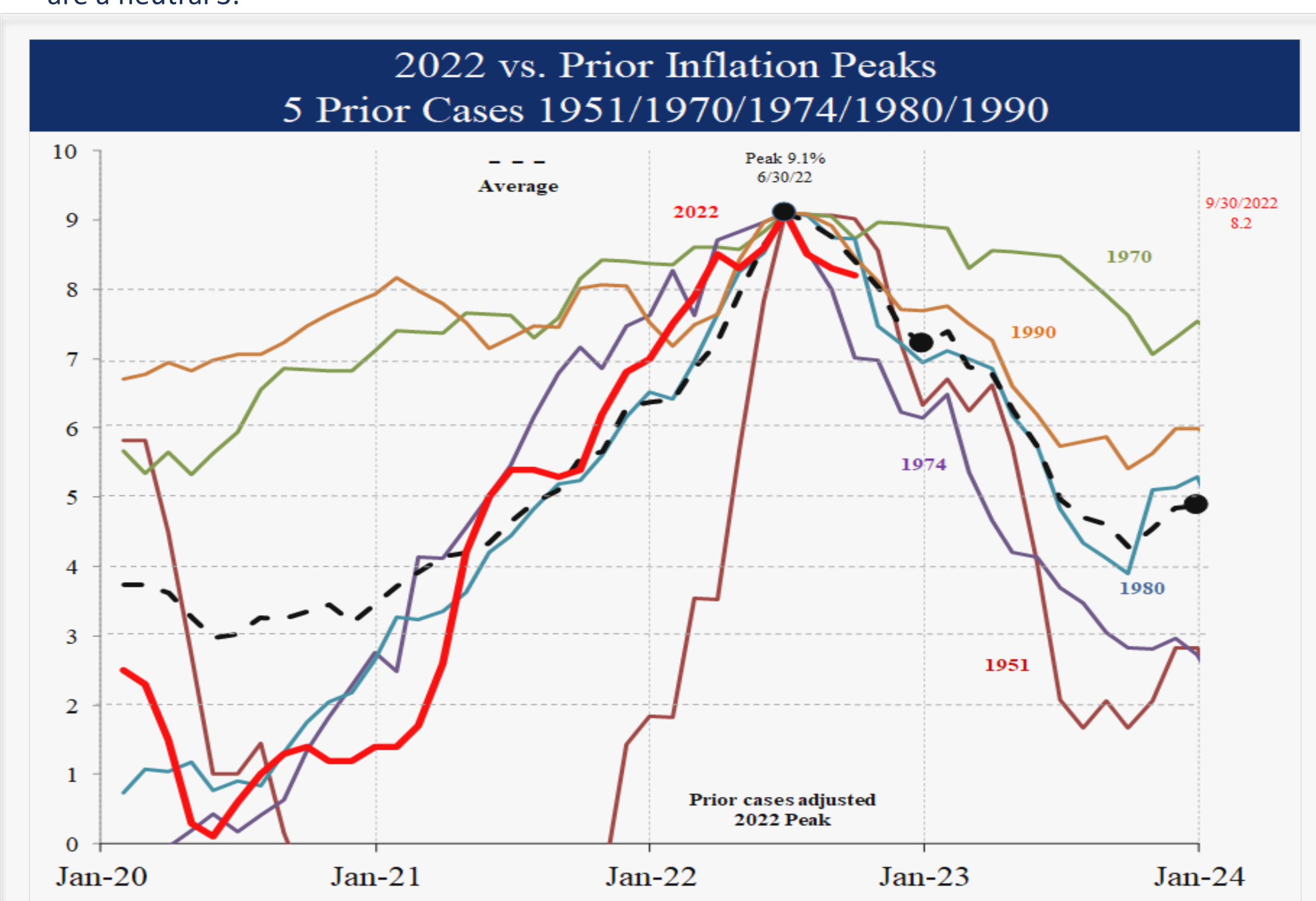
Investing Environment Review and Outlook – Volume 64

Q4 Turning Point

Last month we discussed the positive implications of the non-Fed related drivers of lower inflation and the opportunity in equities amid the pervasive investor gloom. Despite the upside inflation surprise in the core inflation reading last week (6.6% vs. 6.3%), headline inflation continued lower in line with prior peaks (8.2% down from the 9.1% June peak). The norm for prior cases after inflation peaks reaches 7% by December and 5% by June 2023. The implications of still high but falling inflation, record low investor positioning and the positive fourth quarter seasonality remain significantly positive for equities.

This month we shift our focus to the positive implications of the likely peak in Treasury yields despite further Fed hikes ahead. We also look at the consensus GDP forecast pattern showing a trough in Q1 then higher by year-end 2023.

We increased U.S. and foreign-developed equities to a bullish 4 rating. Emerging markets remain a bullish 4. We increased long-term bonds to a bullish 4. Gold remains a bullish 5 and commodities are a neutral 3.



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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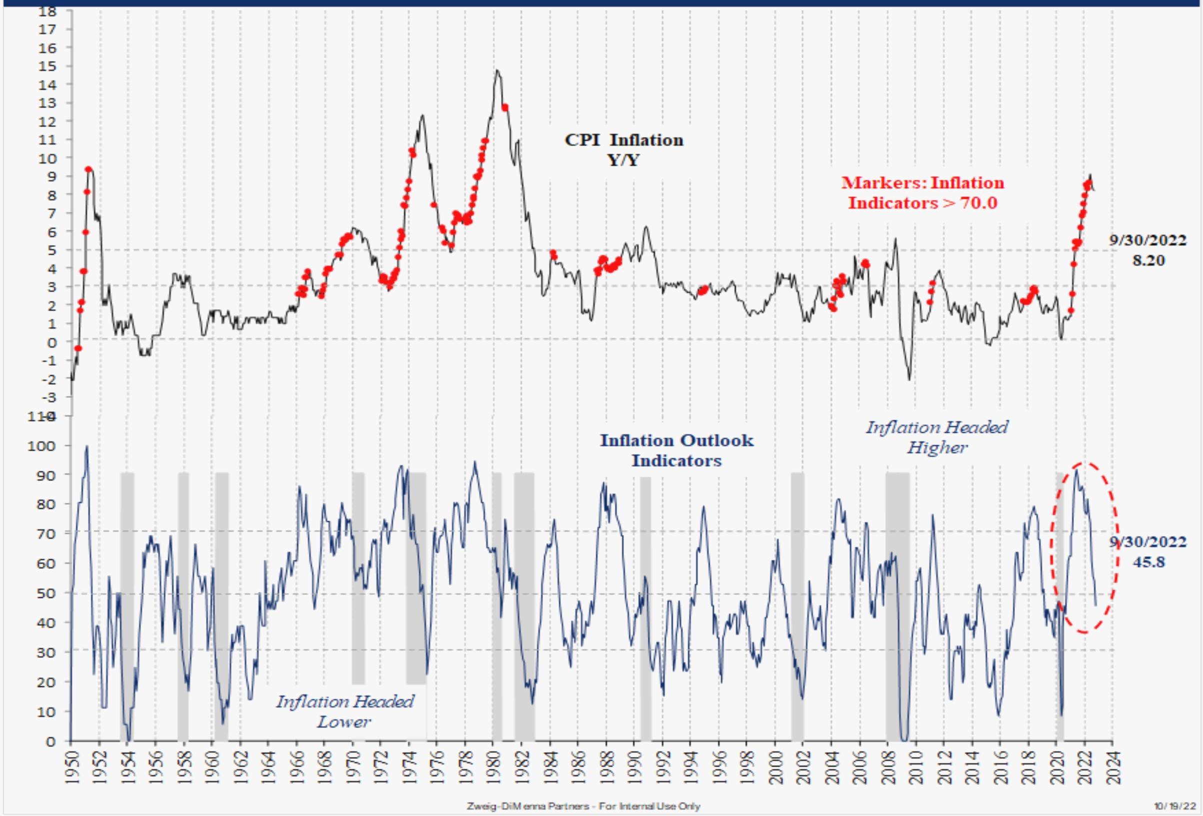
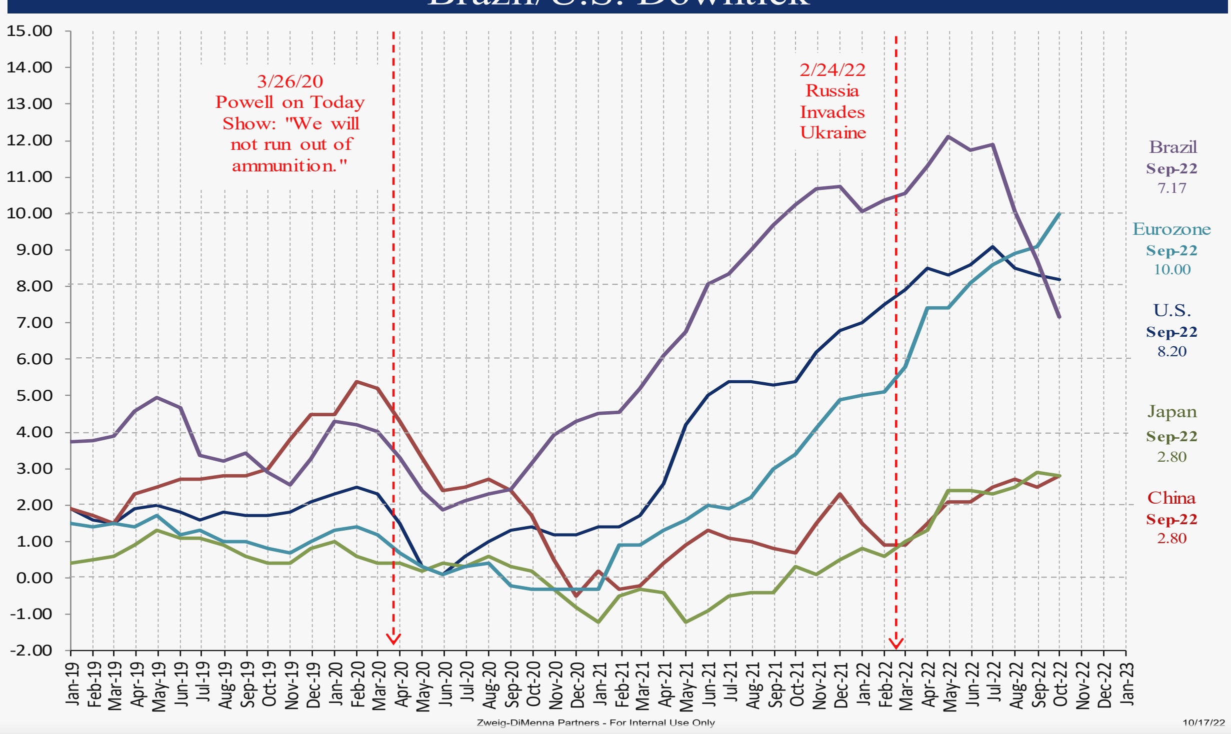
Inflation Outlook Indicators Reversed
45.8 down from 2021 Peak of 91.6



Global Inflation
Brazil/U.S. Downtick



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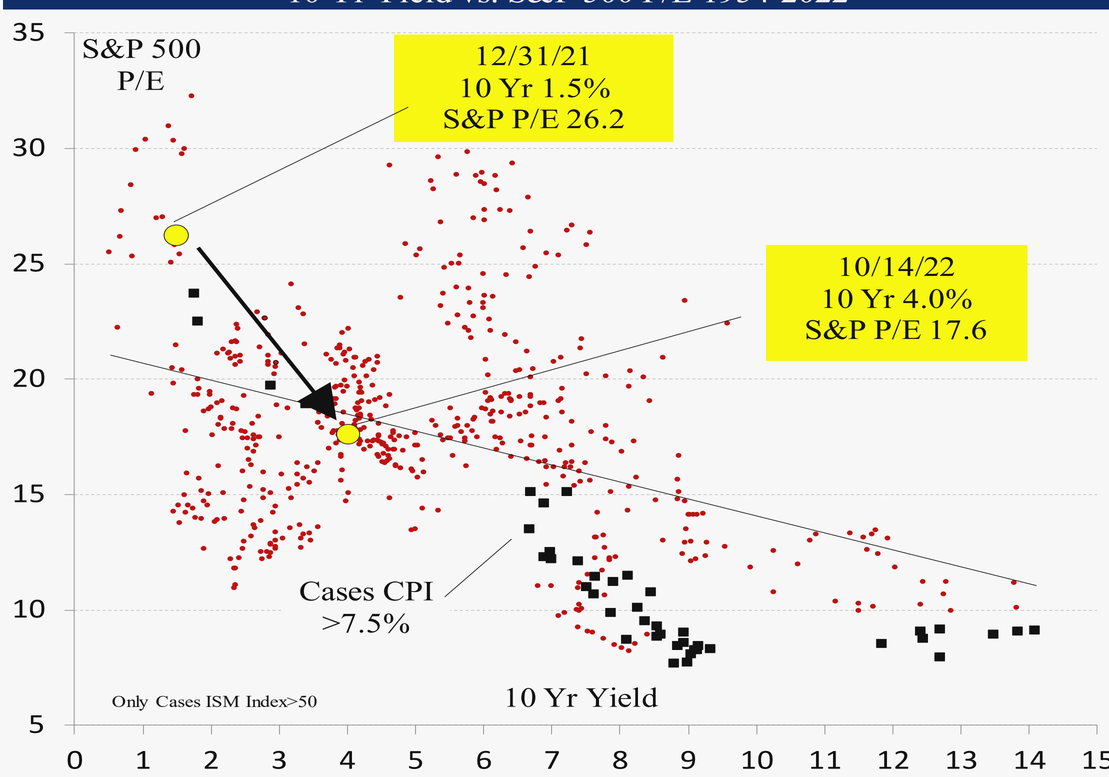
2022 Doom Loop
Fed/Inflation/Rates/Bear Market/Recession

2022: 10 Yr Yield Up Valuation Down
10 Yr Yield vs. S&P 500 P/E 1954-2022



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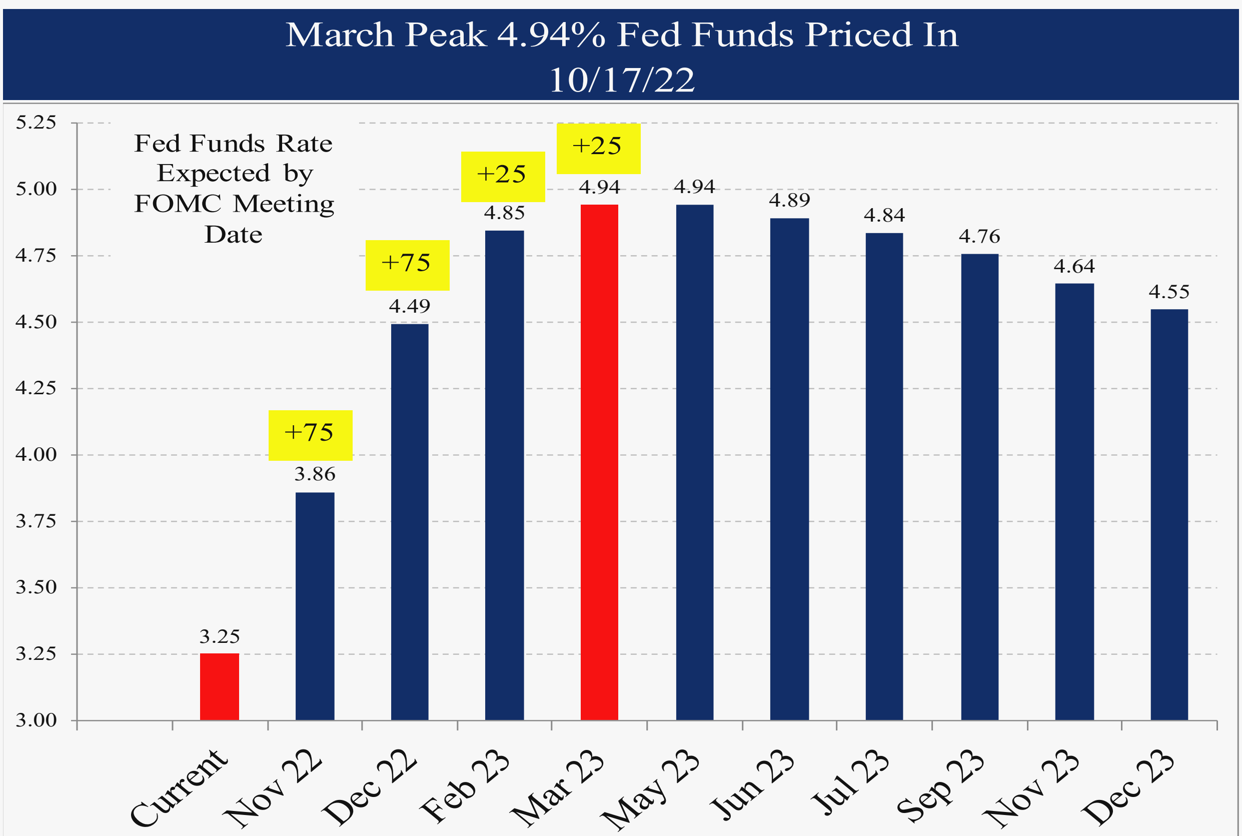
Fed Pause Starts in March: Positive for Equities

With Fed Funds at 3.25% and inflation at 8.2%, there is no question the Fed will hike further. In fact, the futures market has priced in rate hikes at the next four meetings with a March peak just under 5%. This appears negative for equities; however, it is the direction of market rates like the 2-year Treasury yield and the 10-year which have driven stock prices this year. Rising expectations for Fed hikes have driven these longer maturity market rates higher as well, despite indicators like weak industrial commodities and break-even inflation rates of just 2.3% which normally push interest rates lower.



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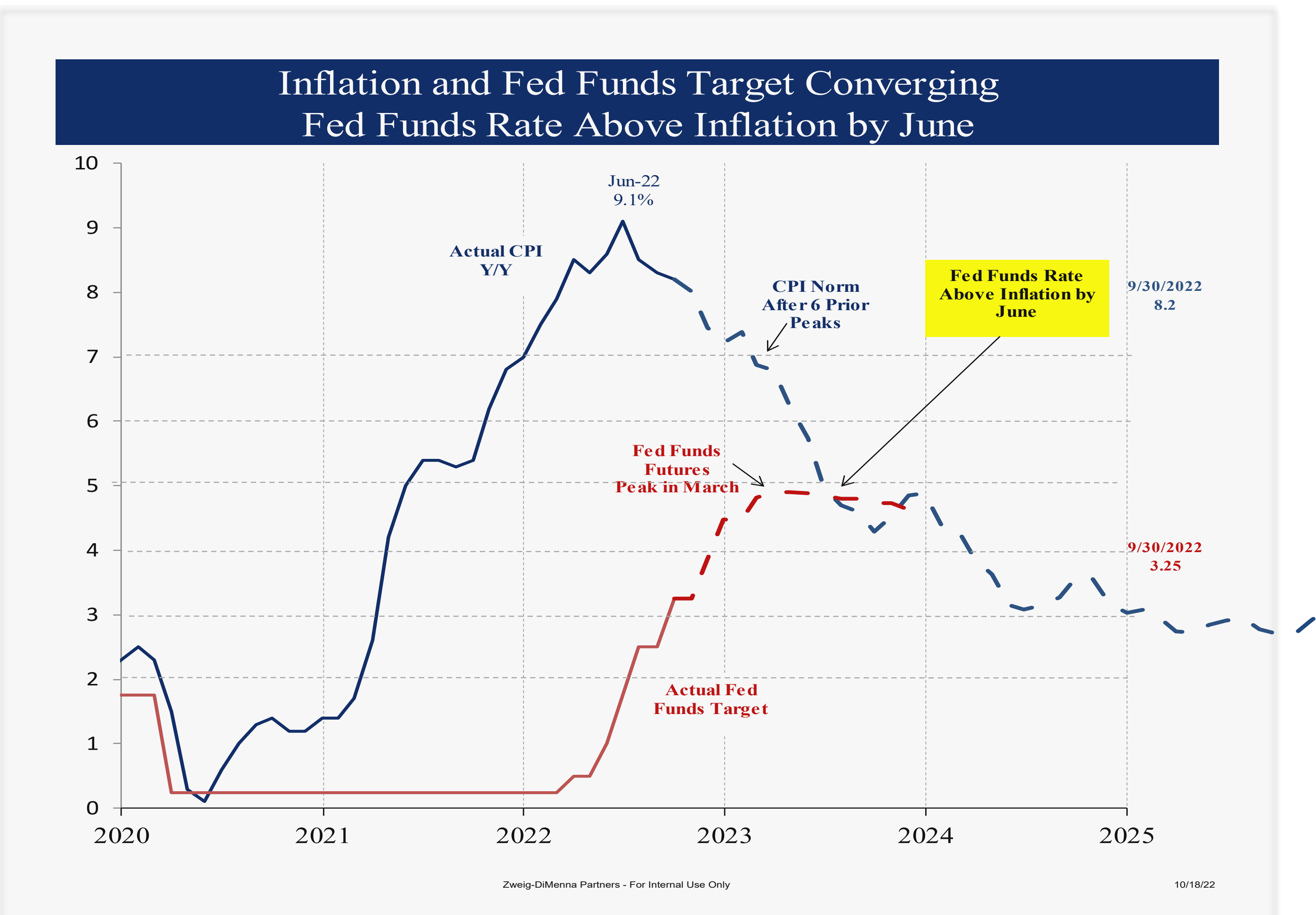
Consider the Fed has only raised rates over 5% within 12 months twice in 109 years of existence. Those were in 1980 and 1981 when inflation was not only higher, but also still rising. Second, in prior cycles, CPI and commodity peaks like today marked the end of hiking cycles and peak in rates. Finally, the falling CPI means the Fed Funds target rate and CPI inflation are converging rapidly. An average of prior inflation peak cases shows the CPI will be below the expected 5% Fed Funds level by June, allowing the Fed to pause, particularly because they will not yet know the lagged effect of all their hikes to date.

The bottom line is that, if as expected, with no further hikes to be priced in above 5%, market interest rates like the 2-year and 10-year yield, which have been powerful drivers against equities, have likely peaked for now. In prior cases when extreme upside moves in rates like this reversed, it marked a low in equities.



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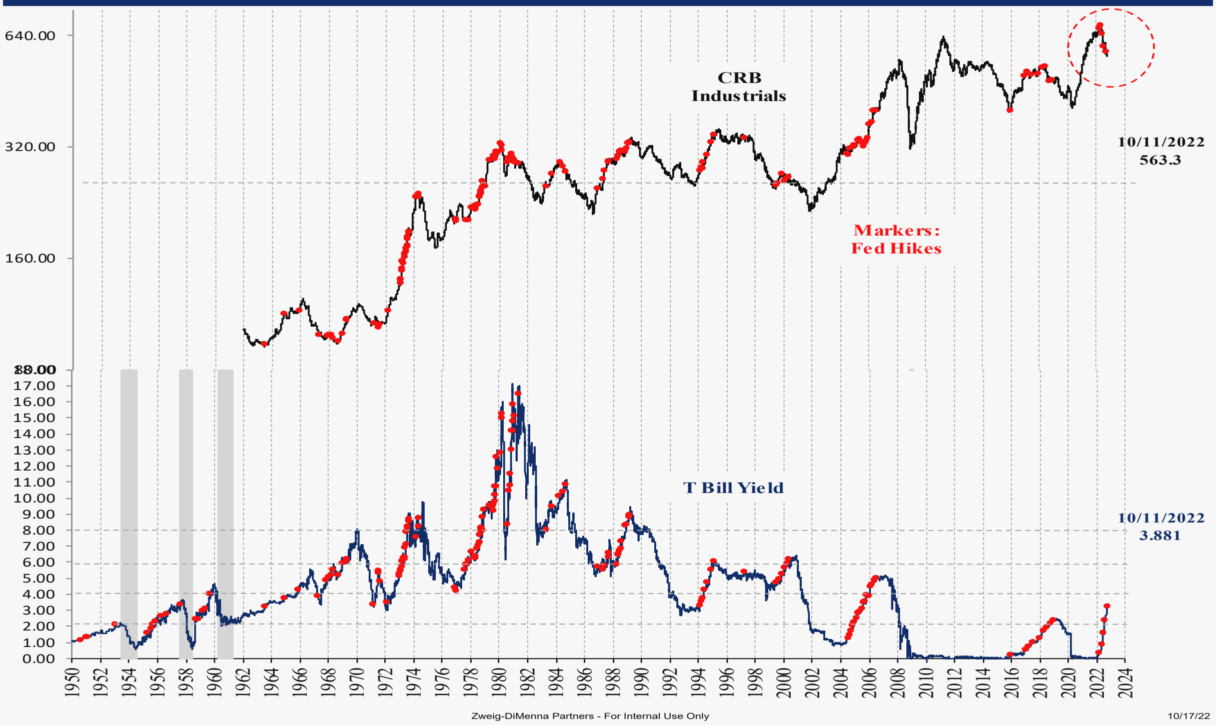
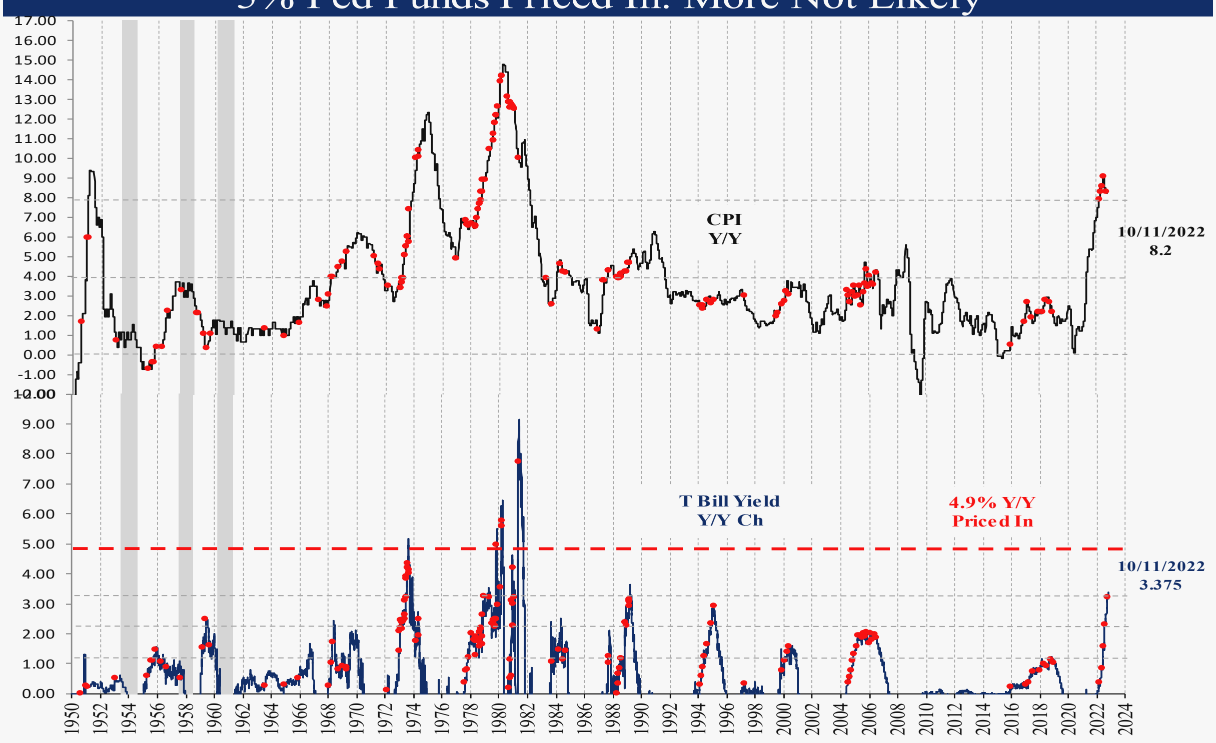
Industrial Commodity Peaks Marked the End of Fed Hikes



CPI Peaks Marked End of Fed Hikes
5% Fed Funds Priced In: More Not Likely



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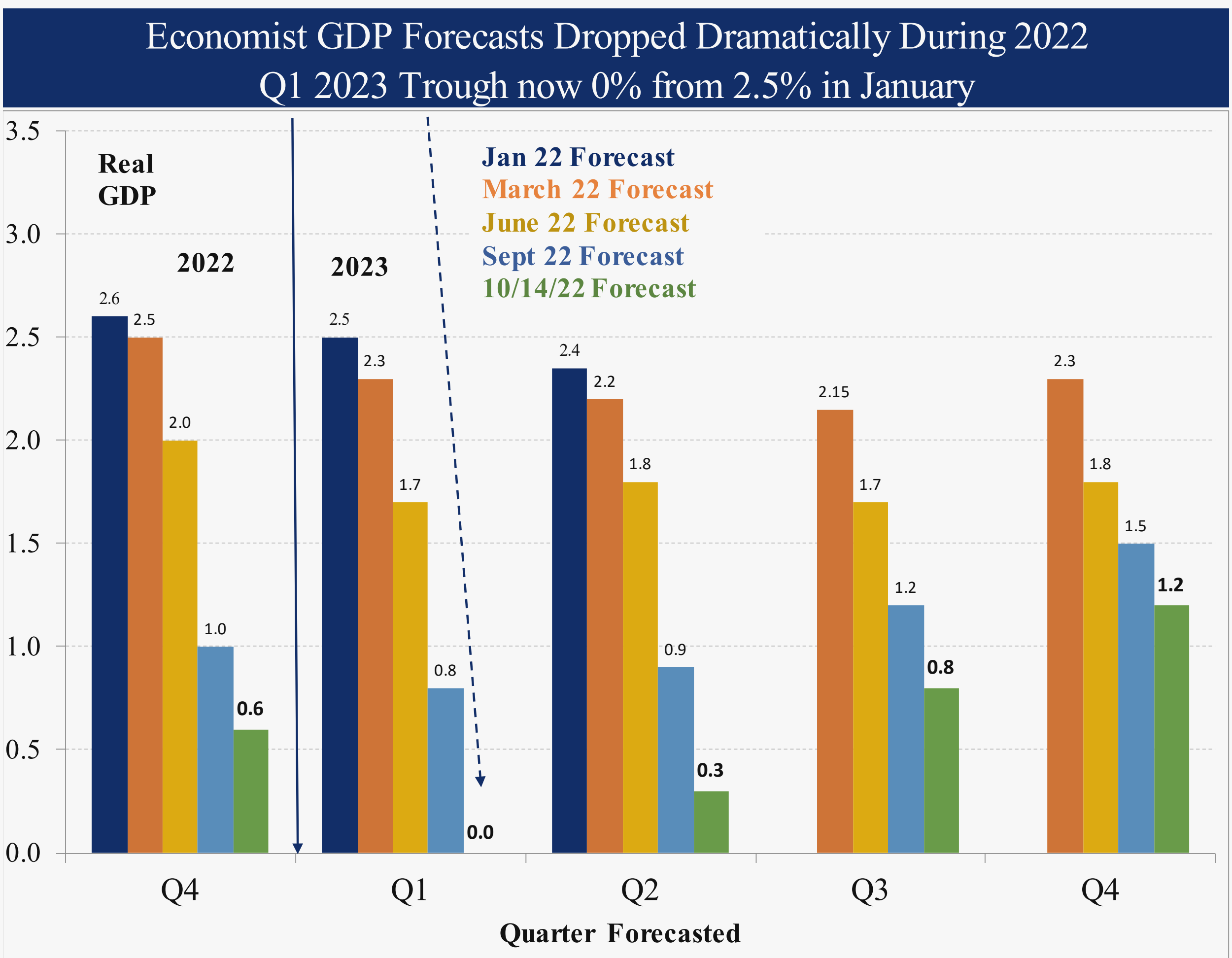
Consensus Economic Forecast Dropped this Week: Trough in Q1 Positive for Equities

The consensus economic forecast dropped dramatically this month to a trough of 0% in Q1, down from 2.5% expected last January. While this could certainly drop further, the Q1 trough is significant since equities bottom ahead of the economy. While prior cycles showed variable lead times, a Q1 trough in GDP would be consistent with a Q4 low for stocks.



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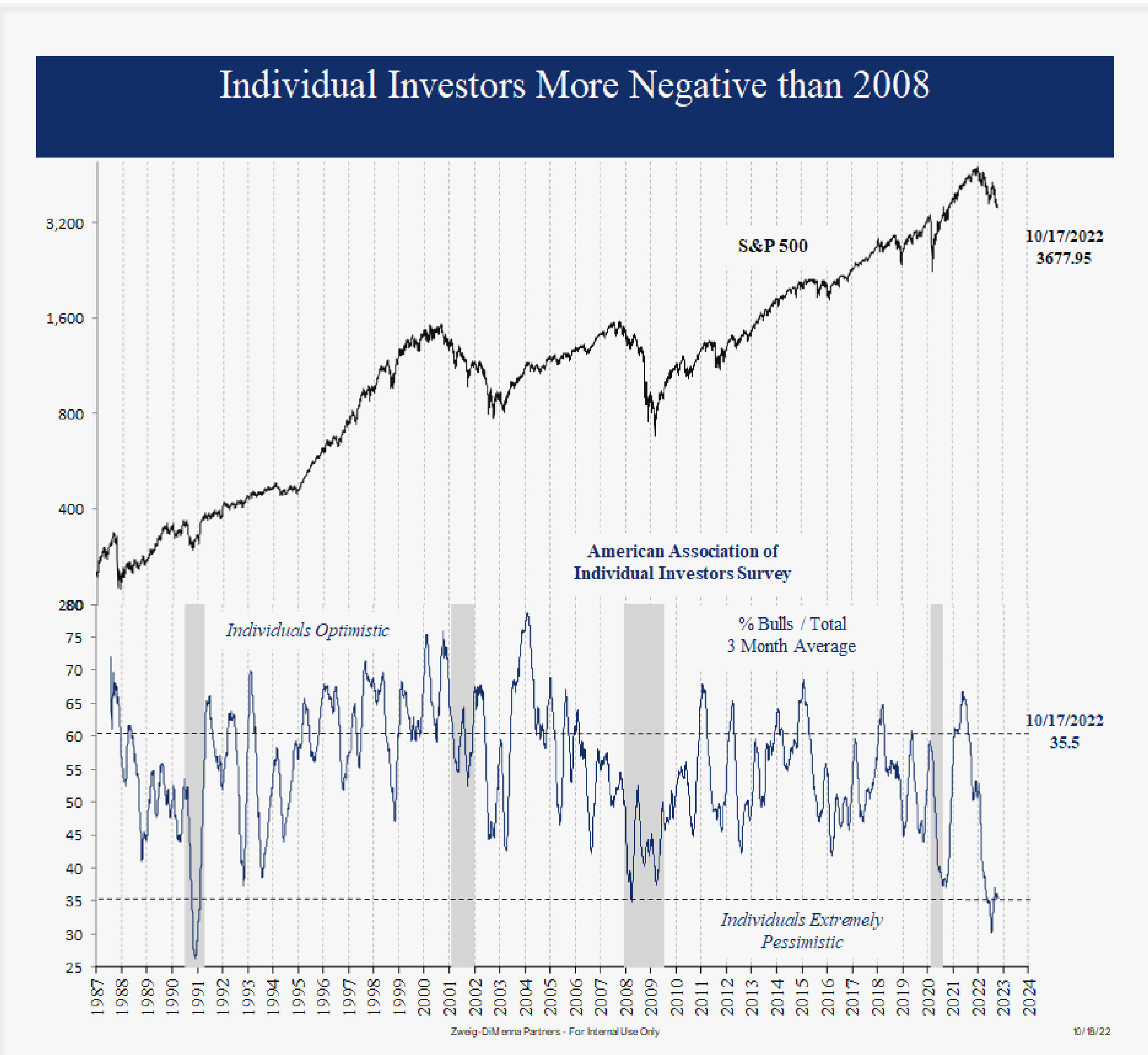
Individual Investor Positioning More Negative than 2008: Cash on the Sidelines

Last month we showed institutions were more negative than during the Global Financial Crisis in 2008 when the S&P 500 declined over 50%. Individual investors were also more negative this year than 2008, with an extreme low reading going back 32 years to 1990. Extreme investor positioning is never a catalyst for a turn in the opposite direction, but it does set the stage for a reversal much like a dry forest does not cause a forest fire but increases the risk. It represents extreme liquidity in portfolios available to drive stocks higher.



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Summary

Last month we outlined the positives of falling inflation, extreme investor positioning and Q4 seasonality, which remain today. This month we discussed why market yields like the 2 year and 10-year Treasuries are likely peaking, which will remove one of the biggest headwinds of the year for equities. While it may seem logical to wait for a Fed pivot, historical cases show equities will move to the upside ahead of the Fed just like they did to the downside this year ahead of the initial March hike. This was the case in the 1994 hiking cycle as well, when the S&P 500 bottomed in December soon after the 10-year yield peaked, both despite the final hike over a month later in 1995. The initial Fed cut was not until July when the S&P 500 was already up 22% from the low. Our research is clear about upside potential for equities, but it does not mean the bear market is over. We will continue to monitor our indicators on a daily basis for any significant changes to our outlook. Thank you for your support and please contact us with any questions.

Michael Schaus
Director of Market Research