On Our Radar –March 2020

The U.S. markets fell sharply over the past seven trading days as fears about the spread of the coronavirus (COVID-19) consumed markets. From February 19, 2020 to February 28, 2020, the S&P 500 index declined by 12.75 percent.

In our February issue we wrote the following: "While the liquidity backdrop is favorable and the economy is growing, investors should brace for more volatility due to these ongoing developments and the proliferation of trading algorithms, which can cause wide swings in prices." So, while we were not surprised by the increase in volatility, we clearly did not expect the magnitude to be as great.

Nevertheless, while algorithms will continue to dominate trading, it is critical for investors to distinguish between fact and fiction. In this age of social media, and the general lack of trust in government institutions, the narrative can get ahead of objective facts and cause markets to "shoot first and ask questions later."

While there is still a lot about COVID-19 that we do not know, according to Bill Gates, who has committed substantial resources in recent years to studying these matters, "The data so far suggest that the virus has a case fatality risk around 1%; this rate would make it many times more severe than typical seasonal influenza, putting it somewhere between the 1957 influenza pandemic (0.6%) and the 1918 influenza pandemic (2%)."

Of equal to greater concern is the possible effects to the supply chain. For example, Apple, Inc. said the quarantines in China would result in a drop in iPhone production. Therefore, they do not expect to meet the previous revenue guidance as supply is constrained and demand will be impacted as stores were closed for a period of time.

In addition, the Food and Drug Administration (FDA) announced that they were monitoring 150 prescription drugs made in China that could face shortages. Clearly these issues are going to affect corporate revenues and earnings in the short-term, in addition to escalating uncertainty.

Another issue is the Federal Reserve. After a decline of roughly 6 percent in May 2019 based upon a tweet by President Trump threating to increase tariffs on Mexico, Fed Chairman Jerome Powell in early June said “We are closely monitoring the implications of these developments for the U.S. economic outlook and, as always, we will act as appropriate to sustain the expansion.” So a 6 percent decline on a “tweet” caused the Fed to respond, yet a double-digit decline in a matter of days on an actual outbreak of a virus that was affecting the global economy was met with silence until late Friday, February 28, 2020.

TJT Capital Group’s InVEST Risk Model ® has helped our clients participate in bull markets and protect capital from the devastation of bear markets by focusing on 5 indicators that really matter when it comes to determining the health and direction of markets. The following is the most recent update.

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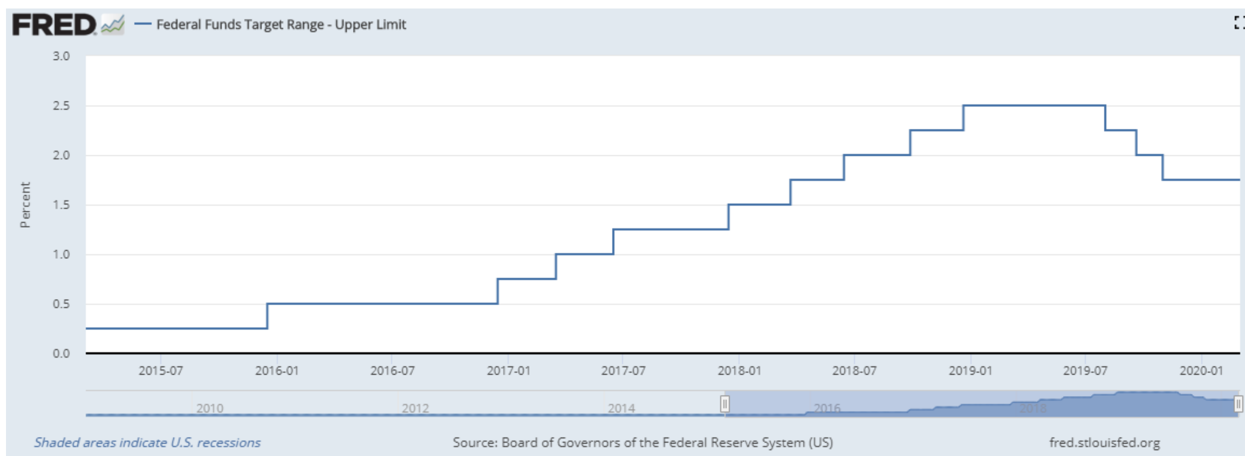
Interest Rates (Monetary Policy)

In early February Fed Chair Jerome Powell testified before Congress and said “the U.S. economy is in a very good place.” This helped the U.S. stock market achieve record highs by mid-month. Soon after, concerns about the virus changed things pretty dramatically. Interest rates on U.S. Treasury securities collapsed, with the yield on the 10-year note hitting 1.13 percent.

The target range for federal funds, which is the interest rate at which depository institutions lend reserve balances to other depository institutions overnight on an uncollateralized basis, is 1.50 percent to 1.75 percent. As of February 28, 2020, the upper limit of the federal funds target range was above every U.S. Treasury security from 1-month to 30-years. Clearly the Fed needs to cut interest rates.



In his January 29, 2020 press conference, Chairman Powell addressed the Fed's decision to extend the overnight repurchase agreement operations at least through April 2020. While he stated that the Fed learned a lot and are "prepared to adjust the details of the plan as necessary," he did not provide any details of what the Fed actually learned. The Fed has conditioned the market that "when in doubt" they will adjust liquidity.

Valuation

Operating earnings for the S&P 500 for calendar year 2020 are estimated to be roughly $173, which puts the forward P/E ratio at about 17-times earnings. Year-over-year earnings growth is expected to be roughly 10 percent. Given the current level of interest rates and inflation, we believe the U.S. equity market is trading at fair value.

That said, the coronavirus is expected to have an impact on supply chains as well as demand. The economic and business impact remains fluid, so earnings estimates are likely to be revised lower.

Economic Cycle

The U.S. economy grew at 2.1 percent in the fourth quarter according to the second estimate, unchanged from the previous estimate. Consumer spending rose 0.2 percent month-over-month, and new home sales surged to 764,000, the highest level in more than a decade as interest rates plummeted. Moreover, the Conference Board Leading Economic Index rose 0.8 percent in January following a 0.3 percent decline in December.

The Institute for Supply Management (ISM) Manufacturing Index rose above 50 for the second time since August 2019, with the 50-level being an indication between growth and contraction.

In contrast, Durable Goods Orders fell 0.2 percent month-over-month and have declined 2.3 percent year-over-year, while Industrial Production has contracted year-over-year for 5 straight months. In addition, despite U.S. economic growth, the number of job openings has declined meaningfully over the past 12 months. This needs to be watched closely.

Sentiment

According to Investors Intelligence, bullish sentiment fell below 50 percent from almost 60 percent last month. We noted last month that “bullish sentiment levels above 60 percent have previously corresponded with an increase in short-term volatility,” which is exactly what happened.

Technical Factors

The recent selloff in the stock market has done some serious technical damage. The number of new lows on the New York Stock Exchange and NASDAQ suggest some time will be need to repair the breakdowns. It is typical to see a series of rallies and selloffs – tests and retests – before a “bottom” can be made.

Outlook

The global economy expanded by just 2.9 percent in 2019, the slowest pace since the financial crisis. Clearly the ongoing trade war and “Brexit” uncertainty had a lot to do with that. With both of those issues de-escalated to some degree, outbreak of fears surrounding the coronavirus and the impact it will have on the global economy has taken center stage.

We have been highlighting the impact of algorithms on daily trading for some time, something the financial media seems to downplay. Wall Street has a tendency to develop new products - like credit default swaps in the last crisis – that they do not truly understand. It is not a stretch to say that the largest two-day point decline in the history of the Dow Jones Industrial Average had a lot to do with relatively new algorithm-based products.

Price tends to move before psychology, and there is no doubt that we witnessed panic selling in the last week of February. In the short-term the narrative tends to dictate behavior. The concern about the spread of the virus, reports of inadequate testing kits, and the general lack of

specific virus-related information led some to conclude a worst-case scenario. As is often said, perception is reality.

The U.S. consumer is at the heart of the global economy, and the equity market has been the transmission mechanism that has fueled spending. The impact of COVID-19 on corporate profits is a negative as companies in the S&P 500 index get roughly 35 percent of sales from abroad. A lot will depend on the duration and extent of the outbreak, and whether it tips the U.S. economy into recession.

While the volatility has been massive, it also presents opportunity. At a minimum we expect a healthy bounce. When stocks trading below their 50-day moving average fall below 15 percent, it has generally been a good opportunity for additional commitments. As of Friday February 28th, that reading was 3.1 percent. Moreover, Chairman Powell recently reiterated that the Fed will use tools aggressively if they are needed.

While volatility is likely to remain high, so are the opportunities. That said, financial markets rely on confidence, and when confidence erodes accidents can happen. For that reason, it is critical that all politicians work together to focus on a solution for all rather than score political points. (3.2.20)

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