TJT CAPITAL GROUP

On Our Radar – May 2020

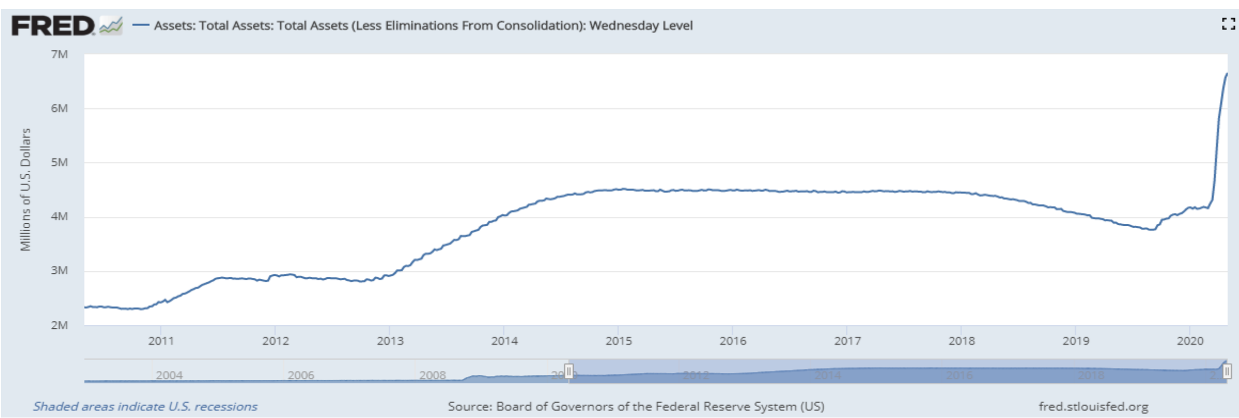
The waterfall decline in March as a result of the COVID-19 and subsequent shelter-in-place orders was offset to some degree in April by the colossal support from the Federal Reserve and a series of Congressional relief programs totaling trillions of dollars. The S&P 500 index rallied 12.6 percent in April.

It was not without pain, however, as the price of a barrel of oil in the futures market traded at ***minus*** $38 for the first time in history as the collapse in demand caused storage facilities to operate near capacity.

As a reminder, the unprecedented government-mandated shutdowns in many states were due to virus models that estimated as many as 2.2 million deaths in the U.S. alone. Therefore, in order to prevent the healthcare system from being overwhelmed, according to the experts, drastic measures were needed. The goal was to "flatten the curve," which has caused devastating collateral damage to the economy and untold personal and financial hardships.

<u>In</u>terest Rates (Monetary Policy)

The Federal Reserve balance sheet has expanded to roughly $6.6 trillion as seen below, up by about $2.5 trillion since mid-February, as the Fed continues to pump liquidity into the system in an attempt to cushion the blow. The Fed has vowed to use its "full range of tools...forcefully, proactively, and aggressively" until they are confident that the economy is on the road to recovery.



In the Federal Open Market Committee (FOMC) minutes released three weeks after its unscheduled March 15, 2020 meeting, the Fed admitted that there was an "acute decline in market liquidity" including "off-the-run Treasury securities." The Fed revealed that the "Issuance of commercial paper (CP) maturing beyond one week reportedly almost dried up."

As we stated at the time, when liquidity dries up, especially in the U.S. Treasury market – widely considered the most liquid market in the world - and you cannot sell what you want to, you sell what you can, especially when it involves leverage. That is exactly what happened at the end of March.

In any case, in addition to purchasing U.S. Treasury securities and mortgage-backed securities, the Fed, along with the U.S. Treasury, announced plans to lend to and/or purchase money market securities, municipal securities, asset-backed securities, and corporate bond securities, including some exchange-traded funds (ETFs). Furthermore, the Fed's Main Street Lending Program is now open to businesses with up to 15,000 employees or $5 billion in annual revenue. Needless to say, this has never been done before.

Jerome Powell held a press conference on April 29, 2020 and said "our credit policies are not subject to a specific dollar limit." Simply put, the Fed is telling the markets they will not run out of money and that its credit facilities are "wide open."

While that may be true, there are a lot of unknowns about the longer-run ripple effects of the shutdown. For example, what percent of businesses will pay rent when they have been forced to shut down? What is the long-term effect on commercial real estate in hot-spot cities such as New York? Will the Fed bail-out every independent oil producer when their break-even price level is about $40 a barrel? Consequently, there is a much wider range of outcomes that the Fed cannot control.

Valuation

Due to the forced shutdown of numerous non-essential businesses in a number of states, as well as social-distancing practices that are being enforced in other countries, earnings and revenue guidance are being suspended in many cases. Those that are guiding have been providing a much wider range of outcomes for obvious reasons.

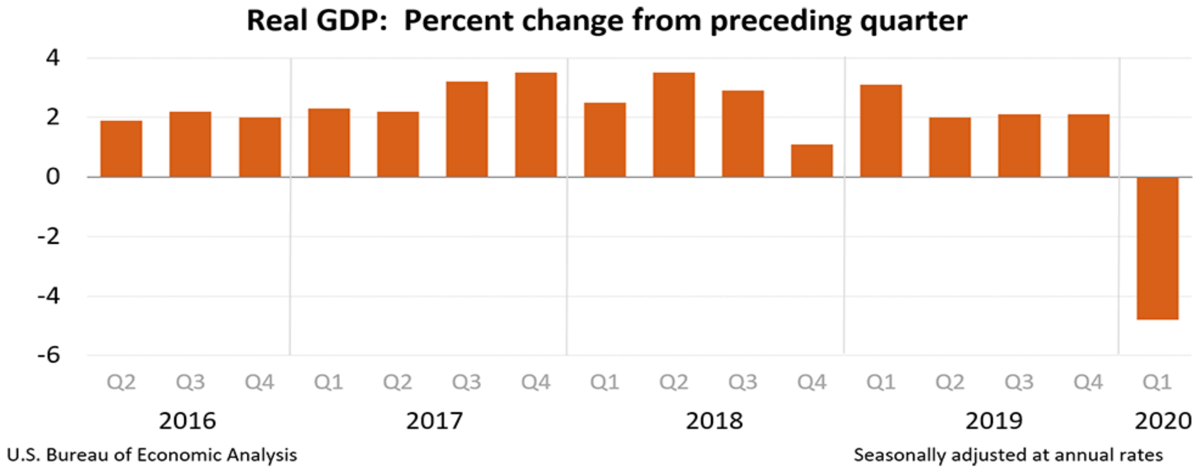
Nevertheless, the current S&P 500 earnings estimates are roughly $120 for calendar year 2020, down from roughly $157 in 2019.

Economic Cycle

As a result, the economic statistics for the near future are going to be downright ugly. Gross Domestic Product (GDP) in the first quarter was minus 4.8 percent led by a 7.6 percent decline in personal expenditures. Moreover, over the past six weeks more than 30 million people have filed for unemployment benefits, which has caused the Consumer Confidence Index to collapse to 86.9 from 118.8 in March.

The Institute for Supply Management (ISM) Manufacturing Survey fell to 41.5 percent, with readings below 50 indicating economic contraction, and the Leading Economic Index (LEI) declined 6.7 percent, the largest drop in its 60-year History.

As long as restrictions are placed on economic activity, investors should expect additional record-breaking data. That said, the Federal Reserve, Congress, and the Trump administration are working to prevent further damage.



Sentiment

Investor sentiment is a contrary indicator and has provided keen insight, particularly when signals are at extremes. Last month, for example, we said "given that there are more bears than bulls, we view that as a positive." We also pointed out that when the number of bearish advisors exceeds the number of bullish advisors, it has corresponded closely "in December 2018, February 2016, and December 2011 with lows in the U.S. equity market averages."

Since then, bullish sentiment has rebounded with the market averages.

Technical Factors

Last month we wrote that "technical market bounces from extreme oversold conditions are the rule, not the exception." We also noted that the "percentage of stocks trading below their respective 50-day moving averages fell to roughly 1 percent," which is about extreme as it gets.

The markets have rallied impressively with help from Congress and the Fed.

Outlook

The coronavirus epidemic has caused nearly 70,000 deaths in the U.S. While that number, so far, is well below the 2.2 million that was originally estimated, it is still a tragic, staggering loss of life.

With respect to the economy, more jobs have been lost in the past few weeks than were gained in the years following the financial crisis.

The good news is that the dire predictions about the U.S. running out of hospital beds did not happen. In New York City, for example, the U.S. Naval Ship Comfort left after a month as only 182 patients were treated on the 1000-bed floating hospital. The bad news is the economic numbers will get worse before they get better.

Unfortunately, due to the lingering effects of the trade war with China, many of the economic statistics were sluggish entering 2020. For example, the leading economic indicators were flat to down in six of the last eight readings, and similar trends were seen in industrial production. With Phase 1 of the trade deal signed in mid-January, expectations were for a pick-up in economic growth. Then came the coronavirus.

As a result, many companies are cutting or eliminating dividends, pulling guidance for the next few quarters, and reducing spending to focus on necessities. In fact, more companies have suspended or canceled their dividends so far this year than in the previous ten years combined. Additionally, 135 companies have cut their dividend, the most since 2009, and many are temporarily suspending their stock repurchase programs.

In an effort to fight the virus war, a number of unintended consequences have taken place. For example, many elective surgeries were postponed in order to prevent hospitals from being overwhelmed due to an expected surge. As a result, hospitals have taken a big financial hit. The Mayo Clinic announced plans to furlough or reduce pay of 30,000 employees as they are operating at about 35 to 40 percent of capacity.

Moreover, farmers have been dumping milk and plowing healthy produce as the supply chain for schools and restaurants collapsed. Yet, at the same time, food banks are struggling to keep up with a surge in demand.

Regarding the Paycheck Protection Program (PPP), it has been reported that about half of those eligible stand to earn more in unemployment benefits than they did while working. This perverse incentive may cause some to delay going back to work. Moreover, some suggest certain states are using COVID-19 lockdowns as an attempt for back-door pension bailouts.

Nevertheless, in the interest of time, the Fed, the Trump administration, and Congress chose a blunt response. As Treasury Secretary Steve Mnuchin said, “We need to spend what it takes to win the war.” As is always the case, when trillions of dollars are doled out in short order, there are some that stand to benefit from inappropriate behavior.

At the time the virus hit, many government officials were working with models based upon estimates. Since COVID-19 was new and we had so little real-time data, there was very little else for officials to go on. Now, however, we have actual data and know a lot more than we did just six weeks ago. As such, a number of states are beginning to re-open slowly.

The economic challenges are being met with unlimited and unprecedented amounts of liquidity. While some industries such as travel may be under pressure for a longer period of time, generally speaking, the trends that were already underway before the pandemic are highly likely to accelerate coming out of it.

On the other hand, the origin of the virus has escalated trade tensions between the U.S. and China with the possibility of additional tariffs being considered.

The financial stimulus, “flattening of the curve,” and plans for some states to re-open gradually have supported the market rally. While volatility is not going to go away, it should create opportunities. For example, supply chains, especially from China, will be brought back to North

America. It has been reported that 80 percent of Active Pharmaceutical Ingredients are produced abroad, the majority in China and India.

Our vulnerabilities as a country have been exposed and will be addressed. (5.4.20)