On Our Radar June 2020

Optimism towards the economic re-opening and a pledge by Federal Reserve Chairman Jerome Powell "to use our tools to the fullest until the crisis has passed" helped the S&P 500 index gain 4.5 percent in May. Oil prices bounced back from severely oversold levels and the yield on the 10-year U.S. Treasury Note fell to 0.65 percent.

However, that optimism was replaced by shock and dismay over the senseless death of George Floyd in Minneapolis, which sparked protests and riots in a number of large U.S. cities. While the friction regarding the re-opening of the economy was likely to be anything but business as usual due to many new restrictions, numerous mass protests, curfews, and general unrest are likely to create additional challenges.

These are clearly unprecedented times.

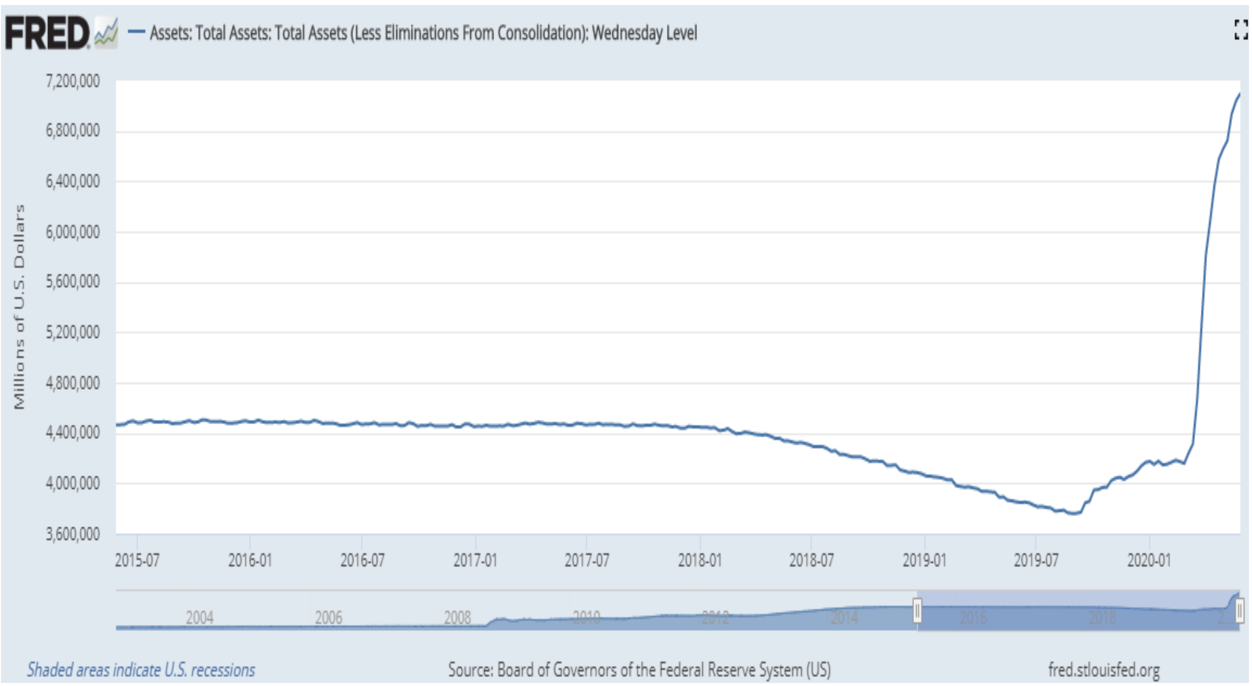
TJT Capital Group's **InVEST Risk Model ®** helps us evaluate conditions with the goal of growing our client's portfolios regardless of the headlines and narratives by focusing on 5 indicators that really matter when it comes to determining the health and direction of markets. The following is the most recent update.

Interest Rates (Monetary Policy)

Fed Chairman Jerome Powell went on *60 Minutes* to address the intervention in various markets. In essence he said we simply flooded the system with money. That is an understatement as the Fed increased the size of its balance sheet from roughly $4.2 trillion in mid-March to almost $7.1 trillion as of last week. A $2.9 trillion expansion – roughly 67 percent increase - in less than three months.

That is a massive amount of liquidity unlike anything we have seen done before. To put that increase in perspective, it took the Fed more than five years following the 2008 financial crisis to increase its balance sheet by $2.9 trillion.

The major direction of the stock market is dominated by monetary policy, which is why we put it at the beginning of our model.



Moreover, Chair Powell went on to say "there's really no limit to what we can do with these lending programs." Indeed, for the first time ever the Fed bought corporate debt through exchange-traded-funds (ETFs) and invented new programs to "assure that the markets are functioning."

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Valuation

Due to COVID-19 and the subsequent shutdowns by various states, S&P 500 earnings estimates are likely to decline by more than 20 percent year-over-year. The market, however, seems willing to look past that and focus on the economic recovery in the second half of 2020 or 2021.

Economic Cycle

With respect to the economy, Gross Domestic Product (GDP) fell at a revised 5 percent clip in the first quarter, according to the second estimate for U.S. Gross Domestic Product (GDP). The previous estimate was minus 4.8 percent. The U.S. economy lost 20.5 million jobs in April and the unemployment rate rose to 14.7 percent, with travel, leisure, and hospitality industries suffering the most.

Industrial production fell 11.2 percent in April, the largest drop in the 101-year history of the index, and fell 15 percent year-over-year. Retail sales fell 16.4 percent month-over-month, the largest monthly drop on record, mortgage delinquencies surged by 1.6 million in April, by far the biggest jump ever, and corporate profits fell 13.9 percent in the first quarter.

A research paper estimated that about 68 percent of those receiving unemployment benefits receive more money than they did while working as a result of the CARES Act. Those additional benefits are scheduled to expire at the end of July. Nevertheless, the next report on non-farm payrolls could see the unemployment rate spike to around 20 percent.

Core Consumer Price Index (CPI), which excluding food and energy, fell 0.4 percent, the largest monthly decline in history going back to 1957. On a positive note, the Conference Board Consumer Confidence Index rose to 86.6 from 85.7 in April.

Sentiment

According to Investors Intelligence, bullish sentiment rose about 50 percent recently, up from the low of 30 percent in late March. In the past bullish sentiment has risen above 60 percent before it signaled a problem for the markets.

Technical Factors

Due to the combination of fiscal stimulus (CARES Act) and unprecedented monetary expansion by the Federal Reserve, the markets have had an impressive bounce. As we stated back in late March and April, a bounce after a significant decline is the rule, not the exception.

The number of stocks trading above their 50-day moving average rose from about 1 percent in late March to more than 90 percent recently. Therefore, the rally has been broad based.

Outlook

The global economy is recovering from lockdowns that were enforced based on what appears to have been flawed models. Recent reports from the Centers for Disease Control and Prevention (CDC) suggest the mortality rate from COVID-19 was much less lethal than the "experts" thought.

COVID models are only as good as the underlying assumptions that go into them. Flawed inputs will produce flawed outcomes, and when drastic decisions are based on those incorrect models, the results can be devastating.

As more of this information comes out, frustration and anger are building. The physical, mental, emotional, and financial strains as a result of these decisions have been substantial. Add to that the recent vandalism, looting, and arson and the social unrest becomes a powder keg waiting for a match.

We are seeing stress not only in the economic statistics, but also in things like our supply chain. For example, the lack of adequate personal protective equipment (PPE) and our reliance on production of many goods from foreign sources has left us vulnerable. The same goes for pharmaceuticals, many of which have no second source. That needs to change, but it will take many years and billions of dollars to build new facilities in the U.S.

The lockdowns have crushed city and state budgets, and because of that Congress is likely to consider another coronavirus bill. Yet there remains much uncertainty. The California Senate recently advanced a bill that would allow small businesses to renegotiate or modify leases. However, if an agreement is not reached in 30 days, the tenant can break the lease with no penalty. This could have a great impact on the credit markets.

Nevertheless, in the short-term the economy is likely to benefit from pent up demand, which could result in one of the strongest statistical quarterly growth rates in history. However, as we stated previously, there will be friction such as social distancing and ongoing regulations that will cause disruptions for some time.

That is why the Federal Reserve has pledged to do "everything we can for as long as we need to." Therefore, while volatility is likely to remain high, so will the opportunities. (6.2.20)