TJT CAPITAL GROUP
REGISTERED INVESTMENT ADVISOR

On Our Radar – July 2020

The S&P 500 index rebounded from a 5.9 percent drop mid-month to finish up 1.8 percent in June, continuing the rebound due to the massive injection of liquidity from the Federal Reserve since March. The rising tide of liquidity has levitated everything from oil and gold to penny stocks and even bankrupt companies.

The price of gold approached the $1800 level, which it has not reached since 2011. In May, Hertz rental car company filed for bankruptcy, hurt by ride-sharing businesses such as Uber and Lyft, as well as the virtual shutdown of business travel due to COVID-19. Nevertheless, demand for the bankrupt company's shares was so strong, a federal bankruptcy judge approved the sale of up to $500 million worth of stock before the Securities and Exchange Commission (SEC) weighed in.

Clearly, these are not normal times.

Interest Rates (Monetary Policy)

As seen in the following chart, between mid-March and early June, the Fed increased the size of its balance sheet from roughly $4.2 trillion to almost $7.1 trillion. A $2.9 trillion expansion – roughly a 67 percent increase - in less than three months.

To put that amount of money into perspective, the Powell Fed "printed" as much money in 12 weeks as it took Ben Bernanke-led Fed to "print" in five years following the 2008 financial crisis. Rather than several rounds of "quantitative easing" (QE), the Fed has seemingly gone "all-in."

This massive injection of liquidity along with unprecedented purchases of corporate bonds and exchange-traded funds (ETFs) – the Fed owns $6.8 billion worth of ETFs including junk bonds as of June 18, 2020 – has been the fuel behind the stock market advance. In his policy report before Congress, Chairman Jay Powell said, "We are committed to using our full range of tools to support the economy and to help assure that the recovery from this difficult period will be as robust as possible."

Moreover, the Fed made an adjustment to the language in its Secondary Market Corporate Credit Facility (SMCCF) that allows it to purchase "securities based on an index," which essentially gives it the green light to purchase the entire universe of nonfinancial corporate debt.

Minutes from the June Federal Open Market Committee (FOMC) meeting suggested the monetary policy-setting arm doesn't see the recovery in consumer spending being "particularly rapid beyond this year" and noted a need for "highly accommodative monetary policy for some time."

Valuation

Due to the forced shutdown of numerous non-essential businesses and schools in a number of states, as well as social-distancing practices that are being enforced in other countries, earnings and revenue guidance have been withdrawn in many cases. Nevertheless, S&P 500 earnings estimates for 2020 have fallen to about $109. With the S&P 500 around the 3100 level, the current price/earnings (P/E) ratio is more than 28-times earnings.

At this time, investors seem to be looking out to calendar year 2021, where earnings estimates anticipate a rebound back to the $160 level, bringing the P/E ratio below 20.

Economic Cycle

The U.S. economy continues to make progress as states slowly re-open. It was reported that the U.S. Treasury paid out over $108.5 billion in unemployment benefits in the month of June, which helped retail sales surge 17.7 percent due to pent-up demand. Nevertheless, sales have only partially retraced the March and April declines of 8.3 percent and 14.7 percent, respectively. While the Consumer Confidence Index rose to 98.1 in June, mortgage delinquencies rose to 7.7 percent up from 3.4 percent in March.

The labor situation improved as non-farm payrolls increased by 4.8 million in June, which brought the unemployment rate down by 2.2 percentage points to 11.1 percent. With the unemployed well-above the pre-COVID-19 level, Congress is looking to extend unemployment benefits into August.

The Institute for Supply Management (ISM) Manufacturing rose to 52.6 in June, up from 43.1 percent a month ago and the first print above the 50 percent growth level since the shutdown. Industrial Production rose 1.4 percent in May, yet it is still 15.4 percent below its pre-pandemic level in February.

Meanwhile, while some states are continuing to re-open, others are adding new restrictions due to a surge in new cases. For example, indoor dining in states such as New York and California have been banned, and some beaches have been closed ahead of the 4th of July weekend.

Sentiment

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

Since the bottom in March, bullish sentiment has rebounded from 30 percent to roughly 57 percent.

Technical Factors

The market technicals have rebounded from the extreme oversold conditions seen in late March. In April, we noted that the percentage of stocks trading below their respective 50-day moving averages fell to roughly 1 percent, which is about as extreme as it gets.

The number of stocks trading above their 50-day moving average was recently north of 70 percent, indicating a broad-based rally.

Outlook

The financial markets are being driven by the unprecedented actions of the Federal Reserve. At his June 10, 2020 press conference, Fed Chair Jay Powell said "we are strongly committed to using our tools to do whatever we can, and for as long as it takes, to provide some relief and stability, to ensure that the recovery will be as strong as possible, and to limit the lasting damage to the economy."

Yet the Fed recently ordered banks to suspend stock buyback programs and limit dividend payouts indicating concern about losses should the economy continue to languish. Perhaps that is why Powell urged Congress not to remove fiscal support too fast. Clearly the Fed is not anticipating a v-shaped recovery, yet the markets are priced for one.

Moreover, the Fed has recently talked about targeting interest rates and "yield curve control" as a way to "achieve their goals." Needless to say, this is unconventional at best, and radical at worst. Meanwhile, the U.S. Treasury infused $700 million into public trucking company YRC Worldwide, and took a 30 percent equity position.

At this point the market is more concerned with the direction of the data rather than the level, as S&P 500 profits are expected to decline by almost 30 percent this year before rebounding in 2021. However, much of that depends on COVID-19 being somewhat contained.

The blunt force of liquidity has caused one of the largest short-squeezes in history as hedged portfolios unwind negative bets. In addition, we have seen several signs of speculative excess, which usually depart in a painful manner.

Yet Fed Vice Chairman Richard Clarida said he did not see unintended consequences or bubbles stemming from the Fed's policy. Unfortunately, as well-intentioned as the Fed may be, they are prone to big mistakes. In January 2008, for instance, Fed Chair Ben Bernanke said the Fed was not forecasting a recession when the biggest one in a generation began the month before. Moreover, Bernanke told Congress in April 2007 that the "problems in the subprime market" seemed to be contained, and in June 2007 he said the subprime fallout "will not affect the overall economy."

Needless to say, those comments were way off base. So, while the Fed has an uneven track record, the reality is that its liquidity injections are driving asset prices. Still, we know that there will be a number of unintended consequences and second and third order effects. Debt levels are exploding, state and local budgets are underwater, and underfunded pensions are falling further behind.

As we saw in mid-June, violent selling can happen at any time, especially when markets get one-sided. Nevertheless, with talk of another round of coronavirus aid, along with continuing liquidity injections from the Fed, the trend is likely intact.

So, the Fed is driving the markets. Should confidence in the Fed deteriorate at any point in time, that would be a different matter entirely. (7.2.2020)