TJT CAPITAL GROUP

On Our Radar – August 2020

The S&P 500 index gained 5.5 percent in July, adding to the second quarter rebound of 19.9 percent despite the fact that Gross Domestic Product (GDP) fell at an annualized pace of 32.9 percent in the second quarter. This stark contrast between the underlying economy and the markets is due to the seismic shift in Federal Reserve policy.

The Eurozone economy contracted by 12.1 percent in the second quarter, which ultimately led to the European Union approving a $2.06 trillion spending package. The German economy, Europe's largest, fell by more than ten percent in the second quarter.

China's GDP reportedly rose at an unlikely 3.2 percent from a year ago following the 6.8 percent decline year-over-year in the first quarter. We say "reportedly" as a good portion of the global economy was shut down in the second quarter, making that number suspect.

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.

Want to have *On Our Radar* automatically sent to your email every month?

Click Here to Sign Up

Interest Rates (Monetary Policy)

The Federal Open Market Committee (FOMC) maintained the federal funds interest rate near zero and suggested it could stay there until late 2022. Fed Chair Jerome Powell said the central bank "is committed to using its full range of tools to support the U.S. economy…thereby promoting its maximum employment and price stability goals."

Mr. Powell said the Fed remains "committed to using our tools to do what we can, and for as long as it takes" to ensure that the economic recovery will be as strong as possible. He shared the Fed's goal: to "create an environment in the financial markets and in the economy where [the unemployed] have the best chance they can have to go back to work to their old job or to a new job."

The unemployment rate was 3.5 percent in January, and stood at 11.1 percent as of last month. The Fed is trying to engineer a tight labor market as quickly as they can. "A tight labor market really does a lot of good things" said Powell. But waiting "eight, nine, ten years to get there" as happened following the financial crisis is "not a good strategy."

Hence, we have monetary policy on steroids as the Fed's balance sheet stood at $6.949 trillion as of last week, up roughly $2.9 trillion – or 70 percent - from February's pre-COVID 19 levels.

Valuation

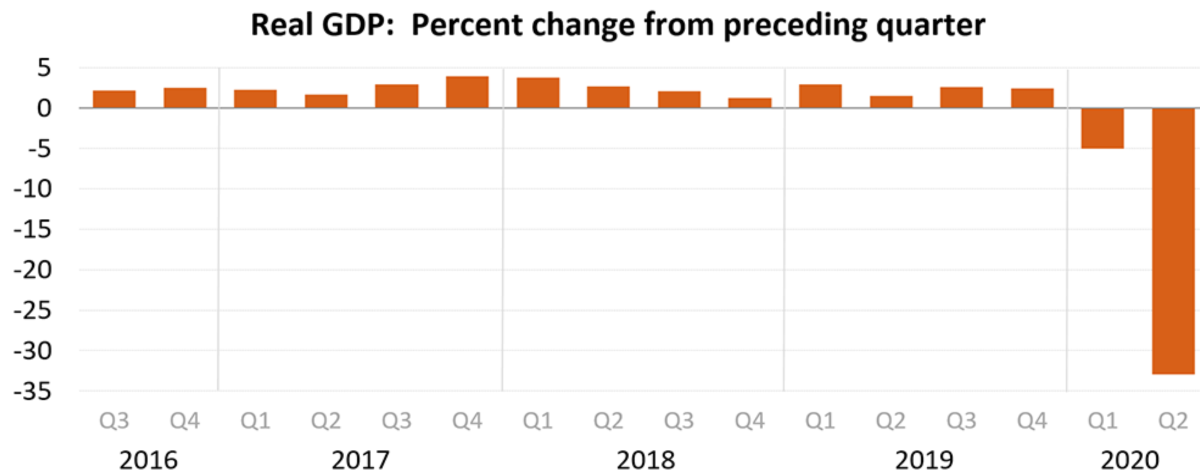
The markets have rallied due to the Federal Reserve while S&P operating profits estimates have declined by almost 30 percent. Therefore, with the S&P 500 trading around the 3300 level, the P/E ratio (Price/Earnings) is roughly 30-times earnings.

Under normal considerations that would seem to be very expensive, however, when you consider that the yield on the 10-year U.S. Treasury Note is approaching 0.50 percent – or one-half of 1 percent – 30-times earnings can be justified.

Moreover, the market seems to be looking past the 2020 COVID-19 impact and focusing on calendar year 2021, where estimates are as high as $165. That would bring the forward P/E down to about 20.

Economic Cycle

The U.S. economy decreased 5 percent in the first quarter of 2020 followed by the biggest contraction ever in the April to June period. The economic shutdown has cost the U.S. economy trillions of dollars and corporate profits are expected to decline by roughly 30 percent in 2020. Unemployment at 11.1 percent is higher than the worst levels seen during the financial crisis.



Retail sales rose 7.5 percent in June following an 18.2 percent increase in May as the CARES relief package designed to cushion the blow of the unemployed helped consumer spending. The Institute for Supply Management (ISM) Manufacturing index rose to 54.2 percent, the third consecutive monthly advance. The Leading Economic Index (LEI) increased 2 percent in June, while Industrial production rose 5.4 percent, although it remained 10.9 percent below the pre-pandemic February level.

In contrast, the Conference Board Consumer Confidence Index decreased to 92.6 in July from 98.3 in June, and weekly initial unemployment claims increased for the second straight week.

Sentiment

According to Investors Intelligence, bullish sentiment rose about 58 percent recently, essentially rising in lock-step with the stock market rally since late March. Over the past six months, bullish levels above 55 have corresponded with an increase in volatility, at least on a short-term basis.

Should bullish sentiment approach 60 percent, it could signal that the market is due for an increase in volatility.

Technical Factors

From a technical viewpoint, the rally off of the March lows has been the proverbial rising tide that floated all boats. New highs have been comfortably above new lows, and stocks trading above their 50-day moving average were recently over 63 percent.

That said, there have been signs of extremes as a number of technology names have seen some substantial increases. Although the medium and long-term outlooks appear healthy, the substantial outperformance of this sector relative to the rest of the market suggests a pause or a pullback may be in order.

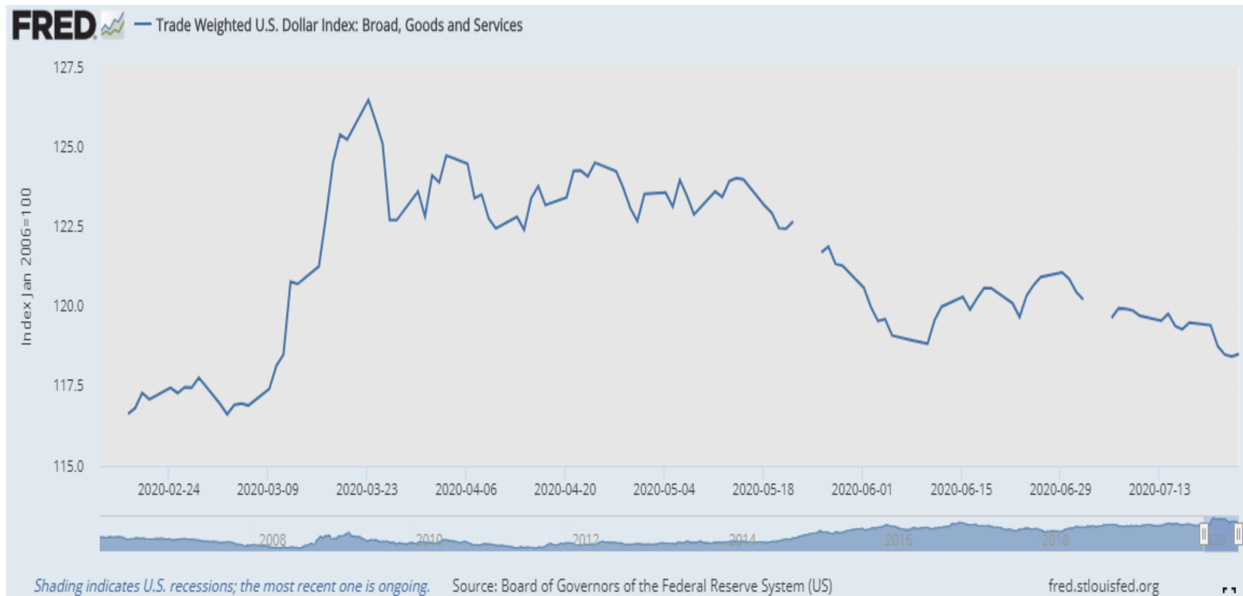
Outlook

In testimony before the House of Representatives regarding the Coronavirus crisis, former Fed Chairs Ben Bernanke and Janet Yellen said the Federal Reserve “has served as **market maker of last resort** by acting to stabilize critical financial markets.” For the better part of the last 50 years, the Fed always referred to themselves as the “lender of last resort.” This is a profound change in monetary policy. It is clear that the Fed has been intervening in the financial markets like never before.

While the tide of liquidity has lifted almost all assets – the price of gold rose above $1900 an ounce for the first time in nine years – we do not know the longer-range ramifications of an explosion of debt. For example, the U.S budget deficit soared to a record $864 billion in June, which was higher than all of last year.

One of the risks is the U.S. dollar could eventually lose its reserve currency status. The trade weighted dollar has fallen by more than 6 percent since March as seen in the following chart. Should this continue, it could pressure international trade.

TJT CAPITAL GROUP



The $600 extra weekly unemployment payment under the CARES Act expired on July 31, 2020. As we get closer to the November elections, investors should expect gridlock in Washington to continue and the rhetoric to increase. Nevertheless, congressional leaders are negotiating another CARES relief package, but they currently seem to be very far apart.

For now, the Fed seems to be on a mission to almost single-handedly prop up the economy. In fact, Philadelphia Fed President Patrick Harker said he would support monetary policy that would allow the economy to run “hot” before raising interest rates. As a result, markets are responding to the Fed’s unprecedented stimulus.

Clearly economic growth will improve as more and more states re-open, nevertheless, a number of industries have endured some longer-term disruptions that will take some time to repair. With uncertainty around coronavirus, the massive build-up of debt, escalation between the U.S. and China on the rise, and an upcoming election, volatility is likely to resume at some point. However, if the Fed is going to continue to intervene in markets, selloffs will present buying opportunities.

If, on the other hand, the Fed’s credibility is questioned, or an event takes place that is out of the Fed’s control, a deeper selloff could emerge. (8.3.20)

Disclaimer: This is for informational purposes only and does not constitute an offer to buy or sell any securities. Past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the investment, investment strategy, or product made reference to directly or indirectly in this article will be profitable or suitable for your portfolio. Nothing mentioned herein is a substitute for personalized investment advice from TJT Capital Group, LLC. Please request a copy of our disclosure statement for further information. Copyright © 2020 TJT Capital Group, LLC. All rights reserved.

TJT Capital Group, LLC • 9 W. Broad Street • Stamford, CT 06902 • 877.282.4609 tel • 203.504.8849 fax • tjtcapital.com