On Our Radar – September 2020

The S&P 500 index closed at 3500.31 as of August 31, 2020, up 7 percent in the month of August and up 8.3 percent year-to-date. The yield on a 10-year U.S. Treasury Note was 0.72 percent, an ounce of gold closed out the month at $1973.90 after topping $2000, and a barrel of West Texas Intermediate oil was $42.82. The U.S. dollar fell a little over 1 percent in August and is at the lowest level since April 2018 relative to a basket of foreign currencies.

Despite the ongoing challenges related to COVID-19, the new high in the S&P 500 is due to the unprecedented monetary and fiscal support by the Federal Reserve and Congress. Moreover, the Federal Reserve literally changed its monetary policy rules last week, which will have a meaningful impact on markets for years to come.

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.

Interest Rates (Monetary Policy)

On August 27, 2020, Fed Chair Jerome Powell gave a speech outlining a new framework for monetary policy, the first update since 2012. Officially titled, Statement on Longer-Run Goals and Monetary Policy Strategy, the updated policy is designed to keep up with an evolving economy. Simply put, the Fed believes that the economic landscape has changed since 2012, therefore, monetary policy needed to evolve as well.

Although the reason given for the new Fed policy was due to the evolution of the economy since 2012, in reality it has to do with the fact that, for the past 8 years, the Fed ignored inflation evidence in defense of a theory.

In fact, the Fed adopted an inflation target of 2 percent on an annual basis in January 2012. Since then, the official PCE (personal consumption expenditures) inflation has averaged about 1.6 percent. However, over the years when the Fed Chairs were asked specifically about the below-target inflation, Ben Bernanke, Janet Yellen, and Jerome Powell often said the same thing: low inflation readings were "transitory," that is, they were temporary.

The Fed's official message after 8 years of below-target inflation is now, "The persistent undershoot of inflation from our 2 percent longer-run objective is a cause for concern." And this is because "Inflation that is too low can pose serious risks to the economy."

As of August 31, 2020, the yield on the 30-year U.S. Treasury bond was 1.49 percent. If the market believed the Fed, there is no way the yield would be that low. Clearly, this is the Fed's response to head off what could be the biggest risk: the threat of deflation.

The Fed's credibility also took a hit as it seemingly is abandoning the reliance on the Phillips curve, a 60-year old economic concept implying that inflation and unemployment have an inverse relationship. For example, in 2012 the Fed thought inflation would rise if the

unemployment rate fell below 5 ½ percent. In early 2020 the unemployment rate hit 3.5 percent – a 50-year low – and PCE inflation was still below the Fed's 2 percent target.

Valuation

The markets have rallied due to the Federal Reserve while S&P 500 operating profits estimates have declined by almost 30 percent. Current earnings for calendar year 2020 are roughly $113. The markets, however, are looking ahead to 2021 as estimates hover around $164. Therefore, the P/E ratio (Price/Earnings) on the market is roughly 21-times 2021 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 about 0.72 percent, the elevated P/E ratio can be justified.

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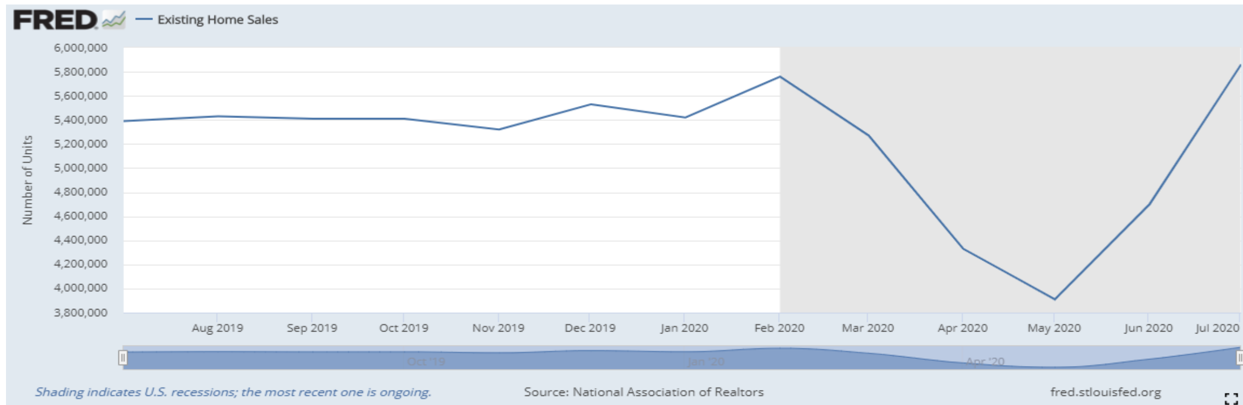
Economic Cycle

The U.S. economy declined by 31.7 percent on a seasonally adjusted annual rate in the second quarter according to the first revision from the U.S. Bureau of Economic Analysis. The previous estimate was minus-32.9 percent. This statistic could have been much worse if not for the $2.2 trillion CARES Act, which provided direct payments to the unemployed and billions of dollars in loans.

While estimates for economic growth in the third quarter range from about 15 percent to 29 percent on an annual basis, the Trump administration and Congress continue to negotiate on another round of stimulus to support the economy.

The protocols related to coronavirus have had a profound effect on the economy, businesses, and families depending on local executive orders. For example, while most national restaurant chains remained opened and thrived from the shutdown, many smaller restaurants have endured great financial hardship as in-restaurant dining has been restricted.

One area that has seen a big rebound is existing home sales, which were up more than 49 percent off the May low as more and more renters leave the big cities as working remotely seemingly becomes more permanent for many companies.



In stark contrast, however, a study reported that an estimated 25 percent of adults missed their rent or mortgage payments for July. As a result, the Centers for Disease Control and Prevention (CDC) announced a temporary eviction moratorium to prevent the further spread of COVID-19. Under the order, landlords and property owners are prohibited from evicting certain tenants for non-payment of rent due to COVID-19. The Order, however, does not forgive rent or prohibit landlords or property owners from charging late fees.

Sentiment

According to Investors Intelligence, bullish sentiment rose to 60 percent recently, which is the highest reading since October 2018. Investors may recall that was just prior to a double-digit decline in the market averages.

Investor sentiment is a contrary indicator. At extremes, it can be very valuable. For example, there were more “Bears” than “Bulls” at the low in March 2020, signaling it was a good entry point on a risk/reward basis. The last time that occurred was late in the fourth quarter of 2018, right before the 2019 rally.

In contrast, a bullish reading of 60 or more, especially when the Bull/Bear difference exceeds 40, has indicated that more caution is advised.

Technical Factors

From a technical viewpoint, the rally off of the March lows has been the proverbial rising tide that floated all boats. That said, the number of stocks making new highs has narrowed a bit. Moreover, it has been a tale of two markets with the NASDAQ 100 index outperforming the S&P 500 by about 28 percentage points.

Recently, we have seen signs of excesses due to announcements of stock splits, which is indicative of a more mature phase.

The substantial outperformance of one sector relative to the rest of the market suggests a pause or a pullback could be in order.

Outlook

What does the Fed's new policy mean? Simply put, it means the Fed is terrified of deflation and is willing to do almost anything to prevent it from occurring. When you have a leveraged economy, should prices fall there would be a real struggle to service the debt (think 2008 house price declines and the impact on mortgage debt).

Notwithstanding the new policy announcement by Jerome Powell, we have always believed the architect of Fed policy is former Fed Chairman Ben Bernanke. In a speech back in 2002 on the subject of deflation, Mr. Bernanke said "sustained deflation can be highly destructive to a modern economy and should be strongly resisted." He went on to say that "a central bank, either alone or with other parts of the government, retains considerable power to expand aggregate demand and economic activity."

The "considerable power" is known as quantitative easing (QE). The Fed has said that QE is designed to raise asset prices, which boosts consumer wealth, which leads to economic growth and job creation.

As we have pointed out in previous reports, the Powell-Fed "printed" (electronically) more money in 12 weeks than the Bernanke-Fed did in five years. Moreover, for the first time ever the Fed purchased corporate bonds in March, including junk-rated bonds, in an effort to support the economy.

So, while economic growth will rebound over the next few quarters and corporate profits are estimated to decline by about 25 percent in 2020, the stock market is being supported by the Fed's purchases. As Ben Bernanke has said, "sufficient injections of money will ultimately always reverse a deflation."

The Fed is essentially using the bond market and stock market as the transition mechanism to generate a wealth effect in order to increase aggregate demand (consumer spending).

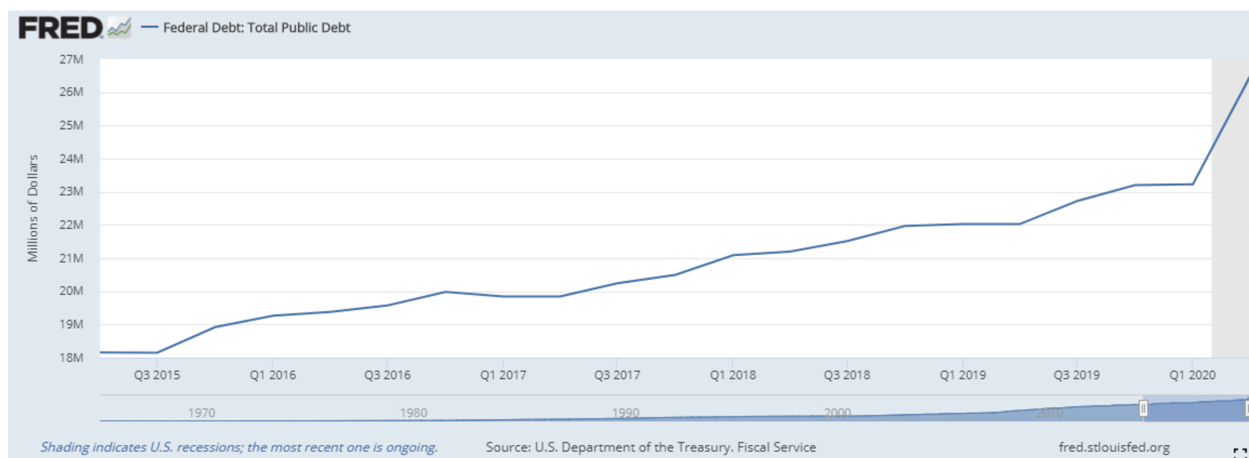
However, in what could be interpreted as a sign of desperation, a number of Fed Governors have suggested they need to do even more than what has been done to date so that the COVID-induced contraction does not morph into something more serious. In fact, Fed Governor Lael Brainard suggested just yesterday that monetary policy "pivot from stabilization to accommodation."

The bottom line is this: The Fed is prepared to use its "full range of tools" to offset the adverse effects from COVID, and do so until the unemployment rate gets back to near pre-COVID levels. With the last reading of unemployment more than 10 percent, the Fed's bond purchases are likely to continue for some time. What's more, Fed Vice-Chairman Richard Clarida said monetary policy should "seek to offset [unemployment] throughout the business cycle and not just in downturns."

If that is truly the Fed's position, it is not that the stock market cannot go down, it is that it is unlikely to stay down as long as the market has confidence in the Fed to deliver.

That said, confidence in the Fed is not a given as the Fed is prone to mistakes. For example, on March 6, 2000, just as the tech bubble was near its peak, former Fed Chairman Alan Greenspan said to a Congressional committee, "and I see nothing to suggest these [technology] opportunities will peter out anytime soon."

As the level of debt has skyrocketed to more than $26 trillion, the Fed cannot afford to make a mistake. And given the impressive advance in the markets over the past few months, volatility could increase as we get closer to the election. Moreover, the number of bullish advisers has risen to 61.5 percent, the highest level since October 2018, which was just prior to a double-digit decline in the indices.



Nevertheless, with the Fed's recent announcement of a major shift in strategy, that would present a buying opportunity. (9.2.20)

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