On Our Radar – October 2020

The S&P 500 index fell 3.9 percent in September and experienced the first ten percent correction - from the month's intraday high to the intraday low - since the rally began in late March. Despite the decline, the S&P 500 gained 8.4 percent in the third quarter as economic momentum picked up, the Federal Reserve flooded the markets with liquidity, and the CARES Act (Coronavirus Aid, Relief, and Economic Security Act) provided much needed stimulus.

However, the markets fell under pressure due to a host of issues including the slow progress on the second round of COVID relief, the looming presidential election, the death of Supreme Court Justice Ruth Bader Ginsburg and the expected political battle over filling her seat, and fear of a second wave of coronavirus shutdowns.

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)

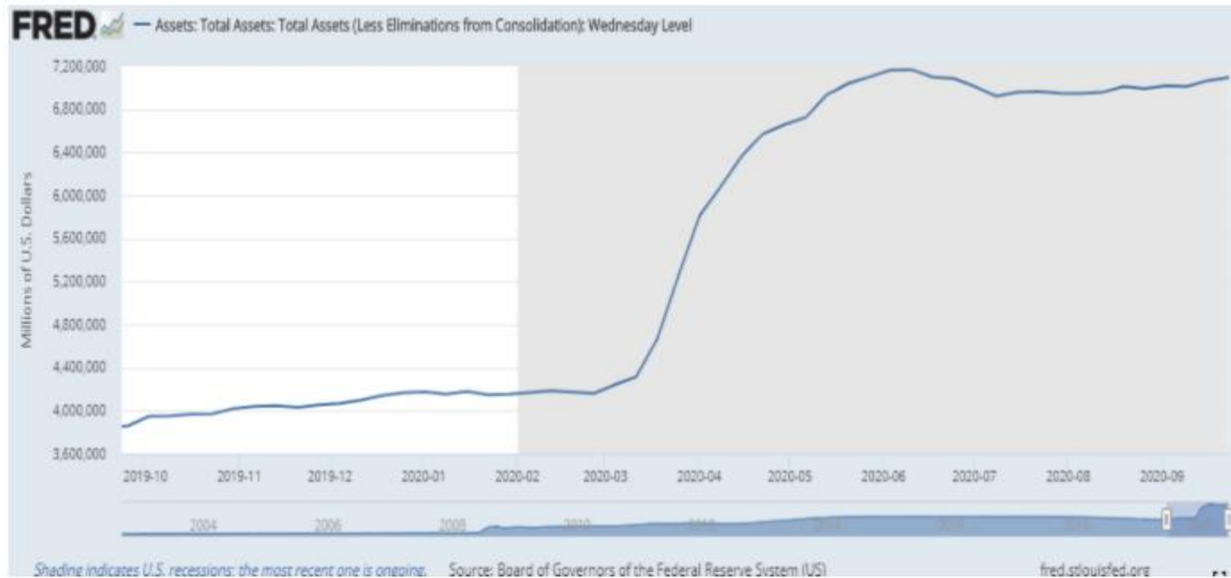
The Federal Open Market Committee (FOMC) met in mid-September and pledged to "support the recovery for as long as needed." Since one of the Fed's primary mandates from Congress is maximum employment, the Fed said they "expect to maintain an accommodative stance of monetary policy until" maximum employment is achieved.

Prior to the onset of COVID-19, the unemployment rate was at a 50-year low of 3.5 percent. Given the current unemployment rate of 7.9 percent, the Fed will likely be purchasing massive amounts of bonds for quite some time. As it stands today, the Fed is buying $120 billion worth of securities per month.

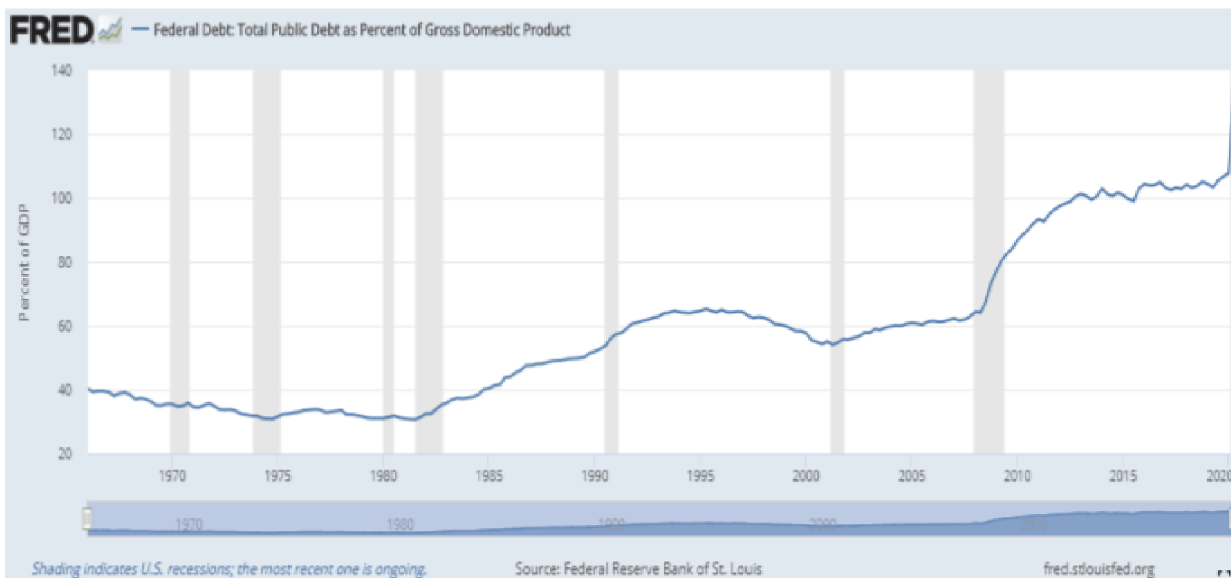
The Federal Reserve's balance sheet is currently $7.09 trillion, the first reading above $7 trillion in three months. It peaked at $7.16 trillion in June, fell to $6.92 trillion in July, and has now resumed its ascent as seen in the following chart. Since liquidity has been an important factor in the market's advance, any significant change in monetary policy could have a material impact.

As many of you know, for years we have pointed out how we believe former Fed Chairman Ben Bernanke is the architect of current Fed policy. We believe that because much of what Mr. Bernanke has said or written over the years, both before he was Chairman and after he left the Fed, often shows up in official policy.

The Fed is terrified of deflation. Back in 2002 Ben Bernanke said "Sustained deflation can be highly destructive to a modern economy and should be strongly resisted." We saw a glimpse of deflation in 2008 when real estate prices fell, which threatened to take down the mortgage debt associated with that asset class and, by extension, the financial system as a whole.



Today, due to the 2008 financial crisis as well as the COVID response, federal debt as a percent of Gross Domestic Product (GDP) is higher than any time since World War II. As a result, the Fed is determined to do everything they can to maintain confidence in the system. One of the primary tools the Fed uses to maintain confidence is "forward guidance." That is why Chairman Powell said "this very strong, very powerful guidance shows both our confidence and our determination" in achieving their goals.



It was Ben Bernanke who said "a determined government can always generate higher spending and hence positive inflation."

Valuation

The markets have rallied due to the Federal Reserve while S&P 500 operating profits estimates have declined by roughly 28 percent. Current earnings for calendar year 2020 are about $114. 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 20.5-times calendar 2021 earnings.

Under normal considerations that would seem to be rich, however, when you consider that the yield on the 10-year U.S. Treasury Note is about 0.70 percent and, according to the Fed likely to be low for some time, the elevated P/E ratio can be justified.

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Economic Cycle

While the U.S. economy is rebounding, the pace of change is slowing. For example, the Institute for Supply Management (ISM) Manufacturing survey was 55.4 percent in September, down from 56 in August. The Conference Board Leading Economic Index rose 1.2 percent in August, down from 2 percent in July and 3.1 percent in June. And although consumer sentiment and confidence have rebounded, they remain below their pre-COVID levels.

The U.S. housing market remains robust due to low mortgage rates and the new work-from-home policies that have been a catalyst to move out of some cities. Nevertheless, the unemployment rate is at a still-elevated 7.9 percent, which could be a headwind for future growth.

Sentiment

Bullish sentiment dropped by roughly 10 percentage points as the markets got hit in September. As we wrote last month, “a bullish reading of 60 or more, especially when the Bull/Bear difference exceeds 40, has indicated that more caution is advised.” That proved to be prescient as the S&P 500 index fell by about ten percent.

Corrections can be a healthy event as excesses are purged to some degree. What’s more, volatility creates opportunities for companies and industries involved in powerful secular trends.

Technical Factors

Again, last month we pointed out that the “substantial outperformance of one sector relative to the rest of the market suggests a pause or a pullback could be in order.” Since then, the percentage of stocks trading above their 50-day moving average fell from over 80 percent to below 33 percent in a matter of a few weeks.

Outlook

The S&P 500 index fell for four consecutive weeks before rallying at month-end. Leaders in Washington have failed to agree on the next round of stimulus, which seems to be held hostage due to political considerations, and concerns about the upcoming election are starting to take center stage.

Gross Domestic Product in the second quarter was revised to minus 31.4 percent from the previous two estimates of minus 31.7 percent and minus 32.9 percent. Nevertheless, it is still the worst quarterly decline on record. Meanwhile, U.S. debt has increased from $23.25 trillion to $26.4 trillion in just the last five months, the fastest increase in history. Moreover, it is estimated that the budget deficit will triple to $3.3 trillion in fiscal year 2020. U.S. Treasury Secretary Steve Mnuchin said now is not the time to worry about the fiscal deficit or the Fed’s balance sheet.

The Federal Reserve estimates that the “real natural rate of interest“ (Fed theory) is minus 3.7 percent, which suggests interest rates will remain low for quite some time.

More important, we believe, is the Bernanke playbook, which is what we are seeing from the Federal Reserve. Ben Bernanke has said that “Deflation is in almost all cases a side effect of a collapse in aggregate demand.” What’s more, he said “sufficient injections of money will ultimately always reverse a deflation.”

In essence the Fed is injecting money and using the stock market as the transition mechanism to generate a wealth effect in order to increase aggregate demand – consumer spending. Remember, in explaining the first round of “quantitative easing“ (QE) when Bernanke was the Fed Chair, he wrote “And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits, this in a virtuous circle, will further support economic expansion.”

So, while volatility is likely to be high as we approach the election and the corresponding uncertainty about policy changes, the Supreme Court, and COVID-19, among other things, economic growth in the third quarter will likely be the best in U.S. history. Moreover, 2021 profit estimates for the S&P 500 are roughly $164, up from the COVID-impacted 2020 estimates of about $114, an increase of 43 percent.

Clearly, the range of outcomes is obviously wider than it has been in some time. Nevertheless, we still view corrections as opportunities and want to be on the same side as the Fed. If, however, confidence in the Fed is challenged, that would be a different dynamic entirely. (10.2.20)

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