TJT CAPITAL GROUP
REGISTERED INVESTMENT ADVISOR

On Our Radar – November 2020

The S&P 500 index fell 2.7 percent in October on mounting tensions around the election outcome, a rise in the number of COVID-19 cases, and a complete stall in the next round of Congressional stimulus (CARES Act II). Clearly, politics is front and center, and likely will be until a clear winner emerges.

Interest rates on the 10-year U.S. Treasury Note rose from 0.69 percent at the end of September to 0.88 on October 30, 2020. Meanwhile, the price of a barrel of oil (West Texas Intermediate) fell from over $40 to about $35 in a month due to the continued decline in demand.

The initial CARES Act provided much needed support to households and businesses as a result of forced shutdowns, which included expanded unemployment insurance benefits. The enhanced federal unemployment payment of $600 a week ended on July 31, 2020, although some state benefits extend until year-end.

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.

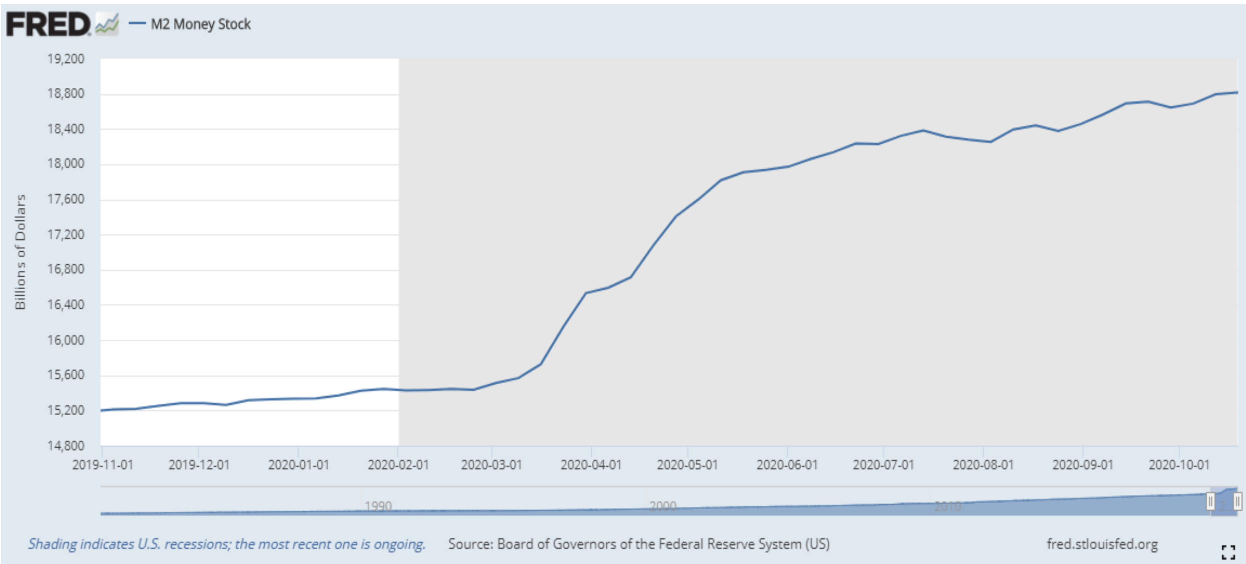
Interest Rates (Monetary Policy)

The post 2008 financial crisis ushered in the Dodd-Frank Act, which gave the Federal Reserve new powers to respond to possible risks to the financial system. When COVID-19 arrived, the Fed viewed the pandemic as a natural disaster, a medical emergency, that required the most forceful response in recent memory.

As a result, it unleashed an unprecedented amount of asset purchases, established a number of emergency lending facilities, and adopted a new policy framework called flexible average inflation-targeting.

While the recovery is obviously far from complete, the Fed has vowed ongoing policy support until it achieves its Congressional mandate of maximum employment and price stability. An unemployment rate of 7.9 percent is a long way from any definition of maximum employment, and with Federal Open Market Committee (FOMC) participants expecting unemployment to remain above 4 percent until the end of 2023, the Fed intends to keep interest rates low for years to come.

The new Fed policy of "flexible average inflation targeting" will likely require a higher level of the money supply. A broad range of the money supply - known as M2 – is up more than 24 percent on a year-over-year basis as seen in the following chart. So, in addition to lower interest rates, the Fed intends to continue to pump more money into the system in order to achieve its 2 percent average inflation target.



Since the Fed's preferred inflation measure – personal consumption expenditures (PCE) excluding food and energy prices - was up 1.5 percent on a year-over-year basis, the Fed believes they have more work to do to achieve its statutory goals.

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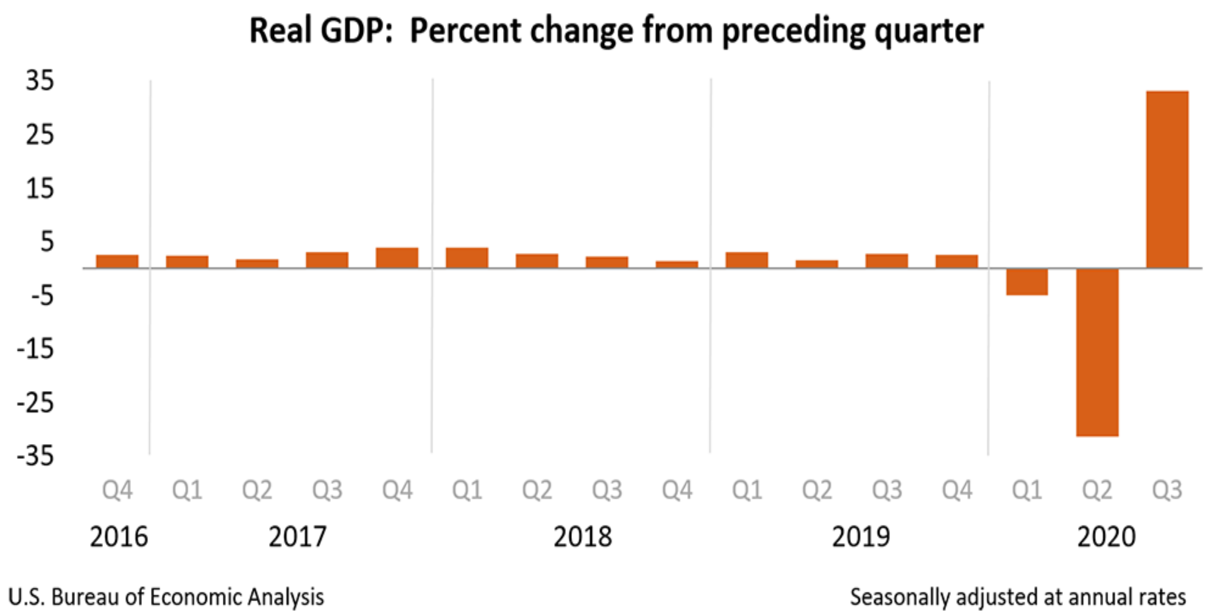
Valuation

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.

Economic Cycle

Gross Domestic Product (GDP) rebounded at an annual rate of 33.1 percent in the third quarter, bouncing back from the 31.4 percent decline in the April to June period primarily due to the stimulus.



The unemployment rate has improved from 14.7 percent at the height of the COVID-lockdowns in April to 7.9 percent as of September. The Institute for Supply Management (ISM) Manufacturing Survey increased to 59.3 percent in October from 55.4 percent in September. In addition, the housing market remains strong as mortgage rates are low and the work-from-home trend has created an additional incentive.

While the snap-back has been impressive to date, the rate of change is declining. For example, the Leading Economic Index increased 0.7 percent in September, down from 1.4 percent in August and 2.0 percent in July. Moreover, consumer sentiment remains well-below pre-COVID-19 levels.

Sentiment

Bullish sentiment rose above 60 percent near the end of October. Over the past few years, bullish sentiment above 60 have corresponded with high levels of volatility. We saw that scenario play out in early September when technology stocks experienced selling pressure ahead of many third quarter earnings reports.

Nevertheless, we still view corrections as “healthy” events as long as the Federal Reserve continues with its accommodative monetary policy and interest rates behave.

Technical Factors

We have repeatedly pointed out that the substantial outperformance of one sector relative to the rest of the market often suggests a pause or a pullback could be in order. In October we saw the percentage of stocks trading above their 50-day moving average fall from over 72 percent to roughly 30 percent in a matter of a few weeks.

Given the dominance of algorithm-based trading, investors could see wide swings over the next few weeks.

Outlook

Volatility has picked-up recently as election uncertainty, the continuing effects of the pandemic, and no progress on the next round of fiscal stimulus from Congress weighed on sentiment. No matter who wins the election, the likelihood of additional fiscal stimulus is almost certain. What is less certain is the ramifications for healthcare, energy policy and tax rates, among other things.

There is no doubt that some areas of the economy are under a great deal of pressure and a number of households are hurting. However, Congress and the White House could not agree on a second round of stimulus. We should not be surprised; politics is a nasty game. At this time of year, politicians are often thinking of themselves and their party rather than their constituents.

Fed Governor Lael Brainard recently stated that “the most significant downside risk to my outlook would be the failure of additional fiscal support to materialize” as too little support would lead to a slower and weaker recovery.

In the post-Dodd-Frank environment when Congress has been slow to act, the Fed has stepped in to support the economy. Former Fed Chair Ben Bernanke always viewed high unemployment as a national crisis. As such, the Fed has pledged to use its full range of tools to manage the downside risks to the economy.

As the outlook remains highly uncertain and a full recovery has a long way to go, both here in the U.S. and globally, financial conditions are highly accommodative. Moreover, the Fed expects to maintain an accommodative policy until it achieves its unemployment and inflation goals.

Fed Chair Jerome Powell said “forceful policy actions were also likely responsible for reducing risk aversion in financial markets.” However, excessive debt and chronic budget deficits can create instability at any time. Therefore, it is imperative that the markets maintain confidence in our leaders and institutions.

With the economy recovering, an accommodative monetary policy, the likelihood of more fiscal stimulus on the way, and the end of this election cycle, we would look at any excess volatility as an opportunity. (11.2.20)

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