On Our Radar – December 2020

Following a 5.6 percent decline in the last week of October, the S&P 500 index rallied by an impressive 10.75 percent in November as some "worst case scenarios" regarding the election did not materialize. For example, fears of a contested presidential election reportedly caused some cities to board up windows as concerns about possible riots mounted. Given how contentious the atmosphere was heading into the election, a number of investors raised cash or "hedged" portfolios. Clearly, some of those hedges have been unwound over the past few weeks.

Some of the biggest rallies were seen in laggards such as energy and financial sectors.

In addition to the election, there were also worries about the rise in the number of COVID-19 cases as well as further restrictions on activity by some states. Moreover, Congress and the White House could not agree on the next round of coronavirus stimulus.

Adding to the post-election rally was positive COVID-vaccine news from Pfizer (BioNTech) and Moderna citing efficacy rates above 90 percent. While it will take several quarters to ramp production of the vaccines, if approved, investors are looking ahead to a better 2021.

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 early November and Chairman Powell said they "expect to maintain an accommodative stance of monetary policy until [maximum employment and price stability] outcomes are achieved." The Fed continues to purchase $120 billion of U.S. Treasury securities and mortgage-backed securities per month, which has taken its balance sheet to more than $7.2 trillion, up from $4.1 trillion at the end of February.

In his press conference Chairman Powell seemed to have a "Freudian slip" when he said "today we had full discussions around quantitative ease…not quantitative easing, the asset purchase program." While Jerome Powell is playing semantics, the reality is "QE" is and was originally designed to raise asset prices, and regardless of what they call it, the effects are similar. As former Fed Chairman Ben Bernanke wrote about QE, "**higher stock prices** will boost consumer wealth…that will further support economic expansion." (emphasis added)

The Fed is trying to support the economy by supporting aggregate demand. Chairman Powell acknowledged that when he said the Fed "can support demand through interest rates and asset purchases." Thus, the Fed is supporting both the financial markets and economic activity.

Moreover, since the Fed believes that they are a long way from their goals, Powell said "we are strongly committed to using these powerful tools…for as long as needed."

Valuation

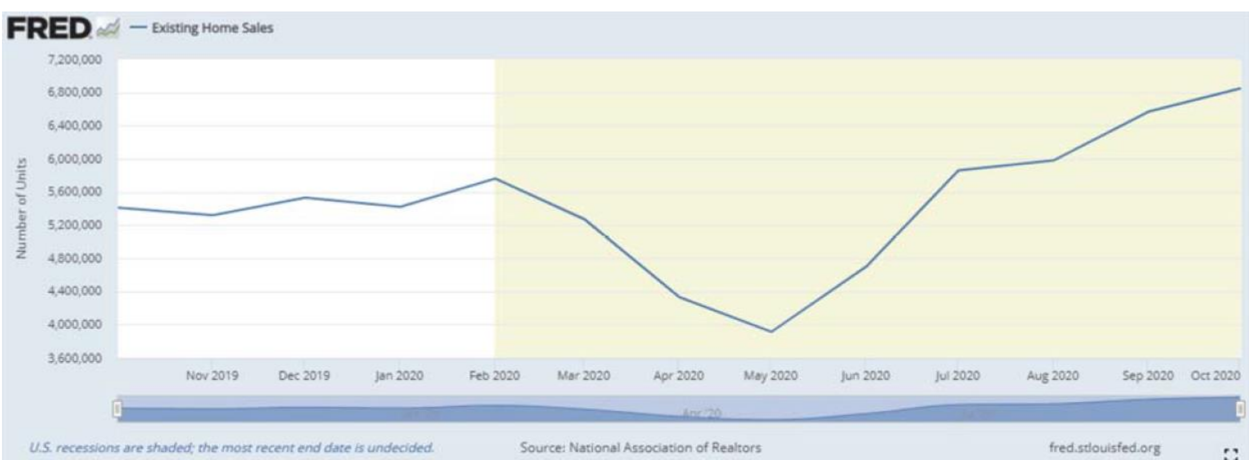
The markets have rallied due to the Federal Reserve, stimulus from the CARES, or Coronavirus Act – with more likely on the way, while S&P 500 operating profits estimates have declined by almost 25 percent. Current earnings for calendar year 2020 are roughly $120, up from around $110 in the summer. The markets, however, are looking ahead to 2021 as estimates are moving up to about $166. 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 0.84 percent, the elevated P/E ratio can be justified.

Economic Cycle

The U.S. economy continues to rebound from the mandated shutdowns seen in the second quarter when Gross Domestic Product (GDP) fell 31.4 percent. While the third quarter saw GDP rebound 33.1 percent, the last unemployment report was a still-elevated 6.9 percent, with over 11 million people unemployed. Nevertheless, the Leading Economic Index increased 0.7 percent in October, Industrial Production rose 1.1 percent, and November's Institute for Supply Management (ISM) Manufacturing Index was a still-positive 57.5 percent, down slightly from 59.3 percent in October.

Core inflation, as measured by Personal Consumptions Expenditures (PCE) was 1.4 percent, well below the Federal Reserve's target of 2 percent. Low inflation and low mortgage rates along with work-from-home initiatives has caused existing home sales to rise to an annual rate of 6.85 million, the highest since 2006.



Uncertainty remains, however, as the Conference Board Consumer Confidence Index fell to 96.1 in November from 101.4 in October, and household debt rose to a new record of $14.3 trillion.

Sentiment

According to Investors Intelligence, bullish sentiment rose above 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, which is where it is now, 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. Post-election momentum has seen the number of stocks making new 52-week highs broaden out. In addition, we have seen some powerful rotation from a number of COVID-leaders to COVID-laggards as hope that new vaccines will allow the economy to open up further.

Whether the recent rotation in the markets is short-term in nature or proves to be more sustainable, some powerful trends such as more people working remotely will likely to be with us for years.

Outlook

We often remind people that when it comes to successful investing, few things really matter, but those that do matter enormously. What should not matter is the continuous stream of irrelevant opinions from the media as they often embellish stories - particularly negative ones - because that’s what captures peoples’ attention and encourages them to “click.” We saw this heading into the 2016 election when several reports similar to Politico’s “A Trump win would tank the markets” caused a stir.

It seems as if certain segments of the media have abandoned all pretense of objectivity in order to create narratives. It is also important to recognize that many people in the investment arena have agendas, so when they make their public forecast, they are hoping to benefit themselves and their existing positions by influencing the crowd.

That is why we emphasize principles. One of our guiding principles is that liquidity moves markets. Therefore, one of the few things that really matters is the Fed's monetary policy. According to the Federal Reserve's playbook, stocks are an important "transition mechanism" used to generate a wealth effect that can increase aggregate demand, and this is the Fed's position regardless of what party is in control of the White House.

While the election is not yet certified, Joe Biden has announced that former Fed Chair Janet Yellen is his pick for Treasury Secretary. Janet Yellen followed Ben Bernanke as Chair of the Fed, so she knows how important financial markets are to a full economic recovery. What's more, she is a labor economist and is unlikely to agree with any radical policy changes that could negatively impact the employment picture.

That said, current U.S. Treasury Secretary Steve Mnuchin announced that some emergency pandemic programs will expire at year-end arguing that companies do not need more loans but "more grant money, which requires action from Congress." Therefore, at some point Congress and the administration will likely agree on new fiscal programs (CARES Act 2).

With news about promising vaccines, the markets experienced a significant rotation from COVID "winners" to COVID "laggards" as money flowed out of some technology names to more value-oriented companies in sectors such as financials, airlines, hotels, and energy.

We are also seeing volatility in the interest rate complex as the economy looks to re-open more broadly in 2021. The yield on the 10-year U.S. Treasury Note has gone from 1.88 percent at the beginning of the year, to a low of 0.52 percent in early August, to 0.92 percent as of December 1, 2020.

With the U.S. economy growing and the Federal Reserve's accommodative monetary policy, market conditions are generally positive. However, there is still a lot of uncertainty that could impact markets at any time. In addition, we have seen a spike in bullish advisor sentiment that is as extreme as anything since January 2018, right before the markets experienced a healthy pullback.

As we head into the last few weeks of 2020, volatility could make a comeback following the post-election rally due to portfolio rebalancing, rising tensions in the Middle East after an Iranian nuclear scientist was reportedly assassinated, and concern about control of the Senate as a result of the upcoming election runoffs in the state of Georgia in early 2021. Should that happen, we would view any weakness as an opportunity to add to positions. (12.1.20)

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