On Our Radar – January 2021

As we close the chapter on calendar year 2020, it is one that will not soon be forgotten. 2020 was unprecedented in so many ways due to the global pandemic that will likely impact the way we work, learn, socialize, and entertain for quite some time.

The year began with President Trump ordering a drone strike on an Iranian security commander, which was then followed by the onslaught of COVID-19, government-mandated shutdowns, a recession, market turmoil, unprecedented monetary and fiscal responses, a recovery, an election, new vaccines, and an S&P 500 index that gained 16.25 percent for the year.

At one point during the year oil futures traded in negative territory, and the yield on the 10-year U.S Treasury Note fell from 1.92 percent at the beginning of 2020 to a low of 0.52 percent in August before ending the year at 0.93 percent.

Drastic times called for drastic measures, and the White House, Congress, and the Federal Reserve stepped up in ways never before seen. And given the ongoing uncertainty regarding the so-called second wave of COVID, they are not done. President Trump signed a $900 billion COVID-relief package, which included funding the government through September 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.

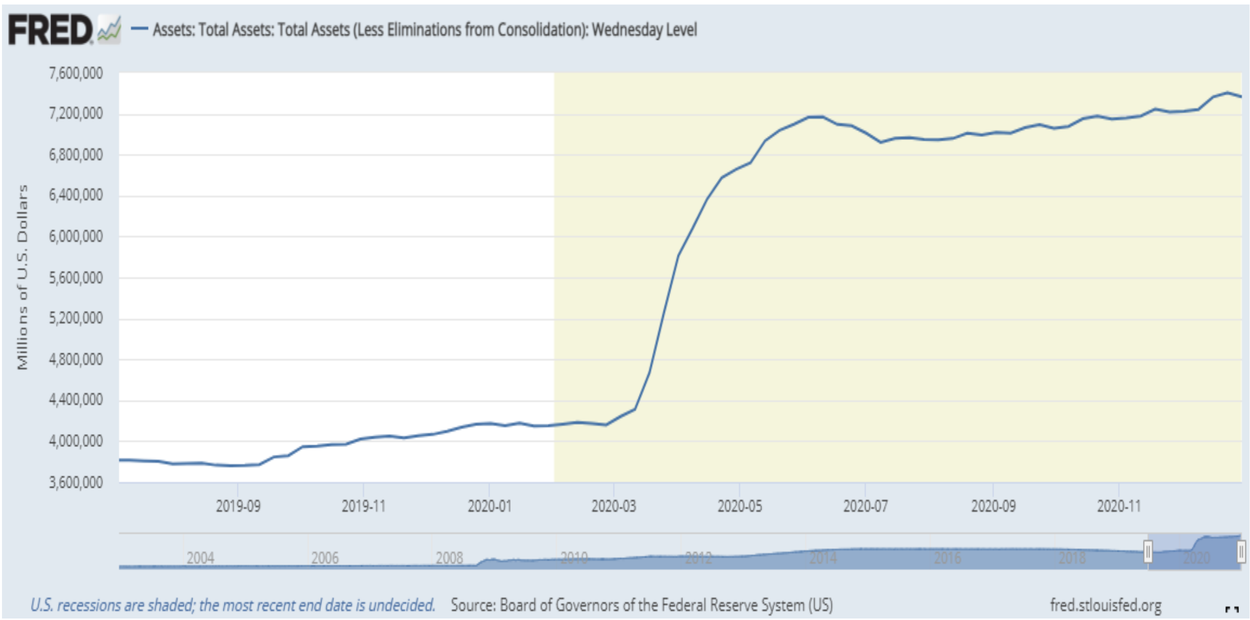
Interest Rates (Monetary Policy)

The Federal Open Market Committee (FOMC) met in mid-December and kept the federal funds target range of 0.00 percent to 0.25 percent. While the target range did not change, the Fed suggested it will expand its asset purchase program by stating that it will increase Treasury security holdings by **at least** $80 billion per month, and agency mortgage-backed securities by **at least** $40 billion per month. (Emphasis added)

Furthermore, Fed Chairman Jerome Powell said that the Fed believes its "enhanced balance sheet guidance will ensure that the stance of monetary policy remains highly accommodative as the recovery progresses." He then went on to say "we think the asset purchase guidance is very important" and that "by increasing our asset holdings, we see ourselves as adding policy accommodation."

Clearly the Fed is concerned about the potential effects of a second wave of COVID-19 and is keenly aware of increased restrictions in some states and the impact that will likely have on the economy. As such, Chairman Powell indicated that if the economy were to slow, the Fed would increase policy accommodation even further.

The Fed's balance sheet at year-end stood at a massive $7.36 trillion, up more than $3.19 trillion, or 76 percent higher than at the end of 2019 as seen in the following chart.



Valuation

The calendar year 2020 earnings estimate for the S&P 500 index is roughly $120. This would translate into about a 24 percent decline in earnings on a year-over-year basis.

Clearly, earnings only tell one part of the story. As a reminder, earnings in 2018 rose by more than 21 percent year-over year, yet the S&P 500 index declined by 6.2 percent.

That is why we wrote in a piece titled ***The Stock Market and the Federal Reserve***, (if you have not seen that piece, email info@tjtcapital.com to request a copy) "If you want to improve your returns in the stock market, we believe you should pay close attention to what the Federal Reserve is doing because liquidity moves markets. Doing so will do wonders for your wealth."

The markets rallied due to unprecedented liquidity from the Fed along with substantial fiscal support from the CARES, or Coronavirus Act – with more likely on the way. Nevertheless, S&P 500 earnings estimates for calendar year 2021 are around $167, putting the Price/Earnings (P/E) ratio at about 22.5-times earnings.

While that level would be expensive under conventional measures, we believe valuation is neutral given the Fed has indicated that short-term interest rates will remain near zero for quite some time.

Economic Cycle

The U.S. economy rebounded at a revised 33.4 percent pace on an annual basis in the third quarter after it contracted by a record 31.4 percent pace in the second quarter. As we exit

2020, the unemployment rate stands at 6.7 percent, a substantial improvement from the 14.7 percent COVID-related shutdown high, but still elevated from February's 3.5 percent. In addition, the Conference Board Leading Economic Index (LEI) increased 0.6 percent in November, and has been up for the past seven months although decelerating of late.

Industrial production increased 0.4 percent in November, yet it remains 5.5 percent lower than a year ago. Inflation continued to run well-below the Fed's 2-percent plus target, and the Conference Board index of consumer confidence fell to 88.6 in December, down from 92.9 in November and 132.6 in February. Retail sales fell 1.1 percent in November, but were up over 4 percent on a year-over-year basis.

Sentiment

According to Investors Intelligence, bullish sentiment has been above the 60 percent level for five weeks in a row. Moreover, we have seen the highest bullish sentiment ratios since October 2018, which was just prior to a double-digit decline in the market averages. One major caveat, however, was that the Fed was raising interest rates back then and reducing the size of its balance sheet.

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. In contrast, a bullish reading of 60 or more, especially when monetary conditions are tight has indicated that more caution is advised.

Today, however, monetary conditions are highly accommodative.

Technical Factors

From a technical viewpoint, the rally since the November elections has been powerful and the number of new 52-week highs both on the New York Stock Exchange and NASDAQ have been expanding.

2020 saw some extreme divergences in some sectors with technology up more than 41 percent while the energy sector declined more than 36 percent. As a result of that divergence, the market may be susceptible to money rotating from the COVID-winners to the COVID-laggards. However, some powerful technology trends such as artificial intelligence, cloud computing, and 5G will likely be with us for some time.

Outlook

2020 was truly a remarkable year in many respects. We doubt that anyone would have believed that a government-mandated shutdown due to a global pandemic early in the year would result in a positive year for risk assets, but that is indeed what happened.

However, despite the advance we are not out of the woods. According to the Fed, the U.S. economy remains “extraordinarily uncertain” due to the lingering effects of COVID. While some areas of the economy clearly benefitted from COVID - such as eCommerce and technology – other areas such as restaurants, travel and leisure, among others, are still reeling from the ongoing restrictions.

Towards the end of the year, we saw a spike in the level of bullishness along with a near frenzy in the prices of new initial public offerings (IPOs). At a minimum, this suggests a pause in the market advance, if not something more meaningful, given the rally since the November elections.

2020 saw a significant increase in the number of Special-Purpose Acquisition Companies, or SPACs, which are publicly traded shell companies formed to merge or acquire another company. That is a tremendous amount of money going into “shell” companies, and seems to suggest that money is almost chasing potential returns. Nevertheless, with more than $70 billion raised in 2020, these SPACs need to complete an acquisition within two years or the capital raised needs to be returned to investors. As a result, more than $300 billion in mergers and acquisitions could take place in 2021-2022.

Although there has been much speculation about what a Biden administration would do, a lot of it depends on the make-up of the Senate. With all eyes focused on the Georgia runoff elections, volatility could pick-up. Moreover, January 6, 2021 is when the Electoral College count is certified.

What will not change is the Fed’s determination to “ensure that the recovery is as strong as possible.” By the Fed’s own admission, economic activity remains well below the pre-pandemic levels, and they seem particularly concerned about the next few months.

Joe Biden has picked former Federal Reserve Chair Janet Yellen to be U.S. Treasury Secretary. As such, we believe it is important to remember that at her Fed confirmation hearing in 2013 she said monetary policy is most effective when the public understands what they are trying to do and how it plans to do it. Since the Fed believes that COVID is a natural disaster that has created a demand shock, they are going to do their best to spur economic activity and create jobs regardless of who is in office.

Therefore, the Fed’s goal is to promote as robust a recovery as possible, and anticipates that its unprecedented support will continue until the unemployment level moves below 4 percent, which they estimate will not be achieved until about 2023.

However, since this massive increase in debt has never been done before, and since there is approximately $17 trillion in negative-yielding debt outstanding globally, no one knows the longterm effects. For example, the 30-year German government bond yield is minus 0.20 percent. Here in the U.S., the trade weighted value of the dollar relative to other currencies has fallen by more than 11 percent since March. Should this trend continue, it could have major implications.

With the economy growing and monetary policy highly accommodative, financial conditions are constructive. However, a good portion of that is reflected in current prices. With extreme readings in bullish sentiment on top of an impressive post-election rally, we would not be surprised to see a little air taken out of the markets. In fact, we would deem that to be healthy in the scheme of things.

That said, we would still look at volatility as an opportunity given the Fed has pledged “to continue to provide support to this economy.”

We hope that you continue to stay safe, and wish you a Happy and Healthy New Year. (1.5.21)

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