On Our Radar – February 2021

January 2021 had a lot of drama, both politically and in the financial markets, with events that may have repercussions for some time. On January 5th, the state of Georgia had two Senate runoff elections which gave the Democrats and Republicans a 50-50 split, with the tiebreaker going to Vice-President Kamala Harris. The next day there was a clash at the Capitol Building as the Electoral College was in the process of certifying the Presidential election. As a result, the House of Representatives issued an Article of Impeachment against former President Donald Trump.

Later in the month the markets came under pressure due to intense "short squeezes" in a number of heavily "shorted" stocks – issues that were sold in the hope of buying them back at a lower price. As you will see later, the substantial movement in a few stocks caused leverage in some hedge funds to be reduced, thereby putting pressure on the major averages. As a result, the S&P 500 index fell 1.1 percent for the month after registering another record high.

TJT Capital Group's InVEST Risk Model ® is designed to help identify market conditions (favorable/unfavorable), which allows us to 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)

In mid-January Federal Reserve Chairman Jerome Powell was interviewed by a Princeton University professor and said that COVID-19 was essentially a natural disaster that created "a shortage of demand." He then went on to say that "[the Fed] can stimulate aggregate demand, particularly with monetary policy."

In his late-January press conference Chairman Powell admitted that the "real unemployment rate is close to 10 percent if you include people that have left the labor force," rather than the official 6.7 percent. To put that higher number in perspective, according to Chairman Powell, "that's as many people as lost their jobs at the peak of the global financial crisis in the Great Recession."

Jerome Powell spoke about the lessons learned from the Great Recession. He said, "We learned, come in early, come in hard, and don't leave until the job is done." Therefore, the Fed is going to remain accommodative until they see improvement in the economy, and specifically, an unemployment rate that approaches the pre-pandemic level of about 3.5 percent.

Valuation

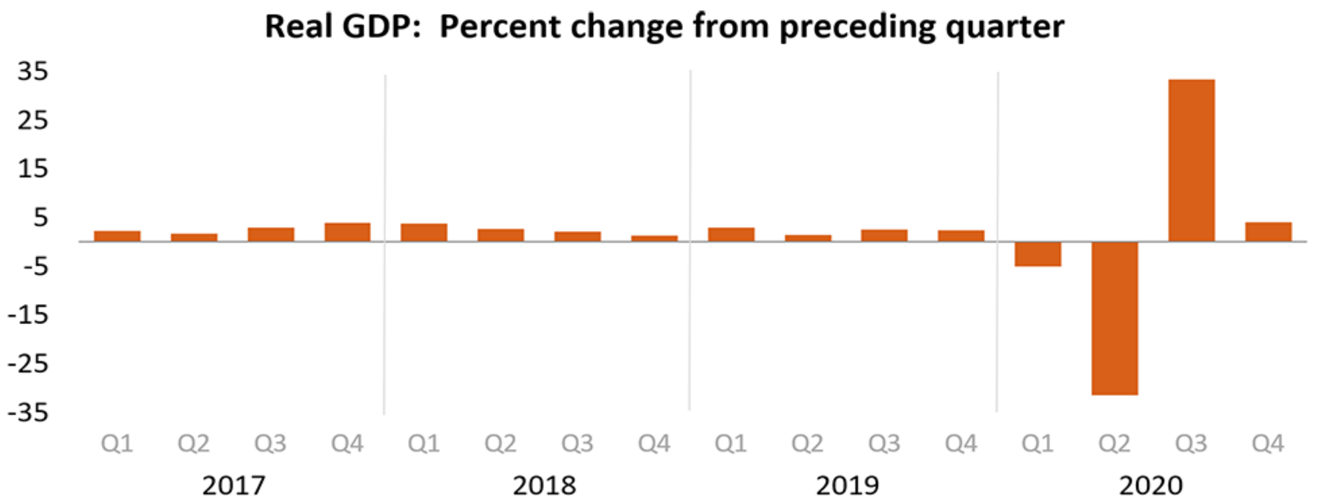
S&P earnings estimates for calendar year 2020 are roughly $121. Over the past 12 months they have seen a range from about $175 pre-COVID to $109 at the end of the second quarter. Moreover, 2021 calendar year estimates are near $170, still well-below the pre-pandemic levels but up substantially as the economy continues to rebound.

Clearly, the markets have rallied due to the Fed embarking on another round of quantitative easing – unofficially QE 4.

The P/E ratio (Price/Earnings) on the market is roughly 21.8-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 1.11 percent and the Fed has indicated that rates are likely to stay low for some time, the elevated P/E ratio can be justified.

Economic Cycle

The U.S. economy grew at an annual rate of 4 percent in the fourth quarter following the 33.4 percent snapback seen in the third quarter. While partial lockdowns, a slow rollout of vaccines, and a delay in additional COVID-relief are creating some headwinds, the economic recovery from the sharp decline in the first half of 2020 continues.



The Leading Economic Index (LEI) rose 0.3 percent in December, following a 0.7 percent and 0.9 percent increase in November and October, respectively. The Institute for Supply Management (ISM) Manufacturing index was 58.7 percent in January, down slightly from December's reading of 60.5 percent, and industrial production rose at an annual rate of 8.4 percent in the fourth quarter.

Consumer confidence improved moderately in January after falling in December, however, at a level of 89.3 it is still well-below the readings of more than 130 a year ago. Nevertheless, U.S. existing home sales rose to their highest level in 14 years.

Sentiment

According to Investors Intelligence, bullish sentiment has been above 60 percent since November, which is an extremely high level. That said, it has also been correct as the Fed has indicated that it will continue to support the economy and, by extension, the markets.

Investor sentiment is a contrary indicator. At extremes, it can be very valuable. When bullish sentiment is high for a long period of time, it tends to lead to extreme behavior, similar to what we saw with GameStop.

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Technical Factors

From a technical viewpoint, the rally since the November election has been impressive. Recall that there were a number of stories about what a Democrat sweep would do to corporate taxes, individual taxes, and other issues that could negatively impact the economy. However, with over 10 million still unemployed due to COVID-19, the Biden administration is unlikely to take its foot off the accelerator, especially with Janet Yellen as Treasury Secretary.

Therefore, while there has been some rotation of money out of the winners to the laggards, the number of new 52-week highs to 52-week lows is still in positive territory.

Outlook

Global central banks are continuing with their unprecedented monetary policy. Bank of England (BoE) monetary policy member Silvana Tenreyro gave a positive speech on the virtues of negative interest rates. She said “we have all been brainwashed that you cannot go there” but sub-zero rates “should, with high likelihood, boost UK growth and inflation.” With about $17 trillion worth of negative yielding bonds globally, and German government bonds yielding negative interest rates all the way out to 30-years, eventually we are going to find out if that belief is true.

China reported that Gross Domestic Product (GDP) grew by 6.5 percent in the fourth quarter, and grew by 2.3 percent in calendar year 2020 despite Covid-19. If true, China would be the only major economy that saw economic growth in 2020. While many look at that number with a great deal of skepticism, China did report that exports picked up meaningfully as a result of the global pandemic.

Despite President Joe Biden's pledge, "My priority is to get, first and foremost, a stimulus bill passed," it has yet to materialize. Ultimately, we believe one will get done.

Regarding the need for additional stimulus, former Federal Reserve Chair and current Treasury Secretary Janet Yellen said that "more must be done…Without further action, we risk a longer, more painful recession now – and long-term scarring of the economy later." At her Senate confirmation hearing, Secretary Yellen said "the smartest thing we can do is act big."

It has been our belief that the architect of current monetary policy is former Fed Chairman Ben Bernanke who years ago said "a determined government can always generate higher spending and hence positive inflation." Mr. Bernanke understands that the stock market is the engine – the multiplier effect – that can boost consumer spending and help create jobs.

Regarding the "short squeeze" that occurred in a company called GameStop, in essence it was a case whereby the hunted became the hunter. While there has been a lot of misinformation, a lack of transparency, and finger-pointing, investors should know this: the heart of the matter is that at one point roughly 140 percent of the shares of GameStop were sold short. That is, about 40 percent more shares were sold – betting on a lower stock price - than existed to trade.

While it is true that a particular online discussion forum – WallStreetBets – with millions of followers were touting the shares of GameStop, it is also true that a good portion of that buying occurred after a hedge fund posted on the internet that "GameStop buyers at these levels are the suckers at this poker game. Stock back to $20 fast. We understand short interest better than you…"

At the time of that negative post, GameStop was trading around $40 a share. About a week later GameStop hit a high of $483 and some hedge funds were in financial trouble and needed a significant infusion of capital to survive.

Moreover, that event caused a number of leveraged hedge funds to have to reduce their exposure by buying-back stocks that they had bets against (their 'shorts") and, at the same time, selling stocks that they owned in order to raise cash for the share re-purchases. This activity caused the S&P 500 to decline by more than 4 percent in just four trading days.

We have always believed that the trillions of dollars invested in hedge funds are a direct result of the industry hijacking the impressive returns of about 15 to 20 investment legends. What the Wall Street marketers were able to do is get people to believe that the hedge fund "structure" was the key to impressive returns rather than the investment genius of some very special individuals.

Anybody who sells short a stock that has 40 percent more shares sold than exists…with leverage…is not a genius and is playing with dynamite. What's more, it exposes a dirty little secret that has existed with impunity for years. That is, all too often a hedge fund will take a position - pro or con – then go to the media and talk it up or down in an effort to influence the price for their benefit.

This time, however, the dynamite blew up in their face.

After many examples, especially over the past twenty years, perhaps it's time to dispense with quaint investment theories such as "rational" behavior and market "efficiency." When Wall Street continues to tout the "100-year flood" but investors know it actually happens every 10 years, one of them needs to make an adjustment.

While the rollout of COVID vaccines was less than efficient, the number of vaccinations continues to rise. And as the effects of the pandemic continue to recede, a number of sectors that have been negatively impacted, such as travel and leisure, should begin to recover. However, more people working remotely will likely be more permanent as the "digital transformation" of the economy accelerates.

So, while the economy continues to recover and corporate earnings are on the rise, a new stimulus package on the way should be a positive. Furthermore, with the Federal Reserve committed to keep monetary policy accommodative by purchasing over $120 billion worth of bonds per month, market conditions are constructive.

However, liquidity is key. As we saw with GameStop, anything that causes liquidity - or leverage - to be cut back, be it "short squeezes," higher margin requirements, or materially higher interest rates, likely will cause volatility to pick up.

Generally speaking, an increase in volatility should provide opportunities as the Fed said it will "not exit" from its accommodative monetary policy too early in order to "ensure that the recovery will be as strong as possible." (2.2.21)

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