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On Our Radar – March 2021

The S&P 500 index gained 2.6 percent in February even though the markets became increasingly volatile over the last week of the month as interest rates on the 10-year U.S. Treasury Note rose to the highest level in more than a year. As vaccine rollouts have increased, the equity markets have seen a rotation out of a number of COVID-lockdown "winners" into those areas hardest hit such as energy, travel, and leisure companies that stand to benefit from the re-opening of the economy.

The 10-year Treasury yield rose to 1.44 percent at the end of February from 0.93 percent at year-end and a low of 0.52 percent in August 2020 as seen in the following chart. While interest rates are still quite low on a relative basis, the rate of change has been significant as the yield has nearly tripled in about 6 months. To put that move into context, the price decline on the 10-year Treasury is equivalent to roughly seven years' worth of interest income.

The House of Representatives approved a $1.9 trillion COVID-relief bill that includes $1400 payments to millions and extends unemployment benefits through August, among other things. U.S. Treasury Secretary Janet Yellen said "We need to make sure that we provide a bridge so that people aren't scarred indefinitely by this crisis." However, as we saw in the CARES Act of March 2020, quite a bit of that money seems unrelated to the pandemic.

Johnson & Johnson was the latest company to receive Emergency Use Authorization (EUA) for its COVID-19 vaccine, which along with Pfizer and Moderna should have hundreds of millions of doses available in short order. Following the unprecedented lockdowns and disruption caused by the pandemic, there may be light at the end of the tunnel.

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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.

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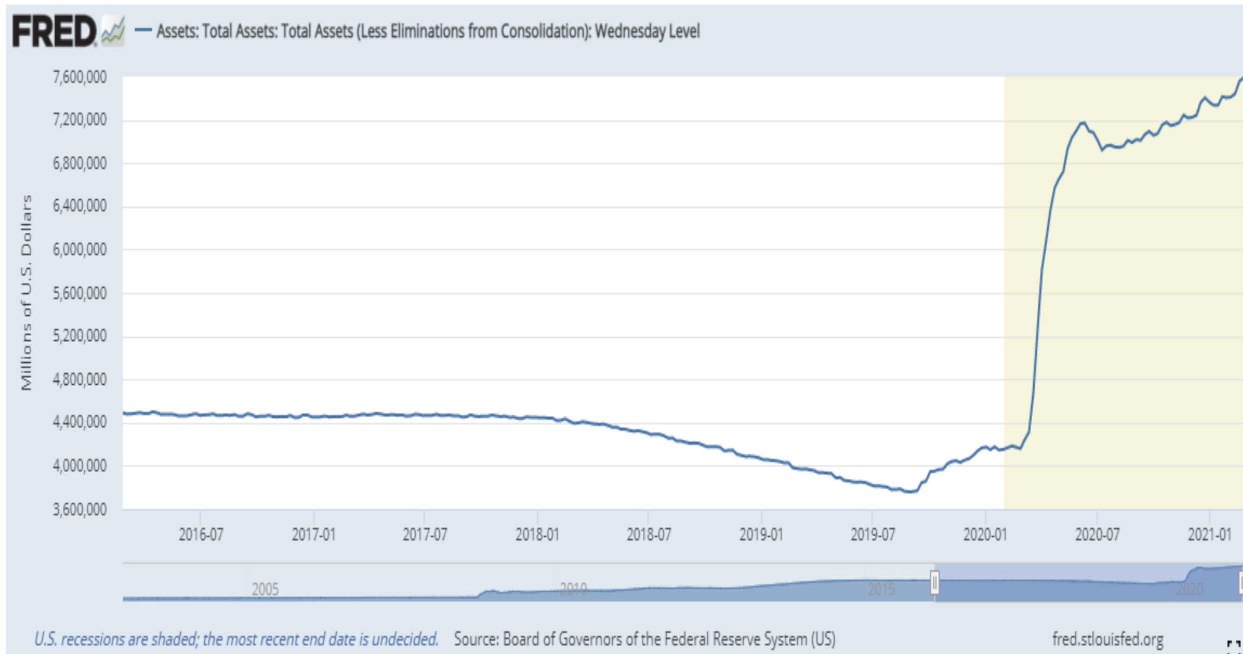
Interest Rates (Monetary Policy)

At a presentation to the Economic Club of New York in early February, Fed Chair Jerome Powell reiterated that employment levels were roughly 10 million below the pre-pandemic levels of a year ago. He also said that COVID led to the largest 12-month decline in labor force participation since at least 1948, and that the actual unemployment rate was closer to 10 percent rather than the Bureau of Labor Statistics' 6.3 percent due to a "misclassification." As such, the U.S economy is "a long way" from a strong labor market according to the Fed's definition.

At his Semiannual Monetary Policy Report to Congress, Jay Powell took the opportunity to reinforce the Fed's updated monetary policy referred to as Flexible Average Inflation Targeting (FAIT), which seeks "to achieve inflation that averages 2 percent over time." Therefore, when inflation has been running below 2 percent for some time - as it has since 2012 – the "appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time" so as to average 2 percent over the longer-run.

Recall that the 10-year Treasury yield bottomed around the time that the Federal Reserve introduced its new monetary strategy. Moreover, Chair Powell told the Senate Banking Committee that the Fed would keep its foot on the gas pedal as the recovery path remains "highly uncertain." However, when asked about rising interest rates, Mr. Powell said they were "a statement of confidence," which seems to contradict his claim about uncertainty. Nevertheless, higher rates could be a reflection of the Fed's new policy, which will allow inflation to run higher without a pre-emptive move to tighten policy.

The Fed's balance sheet currently stands at an unprecedented $7.59 trillion as seen in the adjacent chart. With inflation and unemployment running well below target, the Fed expects to maintain its accommodative monetary policy.



Valuation

The markets have rallied due to the Federal Reserve liquidity, hope for the vaccines opening up the economy, and the potential for another COVID-relief bill out of Congress. Estimates for S&P 500 operating profits in 2021 are roughly $170, up from about $118 in calendar year 2020.

Therefore, the forward P/E ratio (Price/Earnings) on the market is roughly 22.4-times 2021 earnings. As long as interest rates and inflation behave, that would seem reasonable. However, with interest rates on some bonds on the rise, the markets will be watching the Fed closely for guidance.

Economic Cycle

The U.S. economy grew at a revised 4.1 percent in the fourth quarter of 2020, an increase of 0.1 percent from the "advanced" estimate released in January. Gross Domestic Product (GDP) for the full year was negative 3.5 percent, the worst year in over six decades.

The recovery is continuing as the Leading Economic Index (LEI) increased 0.5 percent in January, up for the ninth consecutive month, while Consumer Confidence rose to 91.3 from 88.9 in January. Consumer Confidence is still well below the readings of a year ago.

The Institute for Supply Management said its manufacturing index climbed to a two-year high of 60.8 percent in February compared to 58.7 percent in January, and housing data continues to be strong. The proverbial "fly in the ointment" is the real unemployment rate.

Sentiment

According to Investors Intelligence, bullish sentiment fell to about 56 percent recently, down from a high of 64 percent in December. We remind people that investor sentiment is a contrary indicator. At extremes, it can be very valuable.

Obviously, with stocks like GameStop running like they did in January, sentiment should also be viewed from the actions of investors since many times what people say is quite different than what they do.

What "they" have been doing is chasing some Special Purpose Acquisition Companies (SPACs) as well as some high-flying exchange traded funds (ETFS). Clearly, bullishness is running high.

Technical Factors

The Dow Jones Industrial Average, S&P 500, and NASDAQ Composite made all-time highs in February. However, all three indices spiked higher only to close down on the day. In the "old" days – before social media – that would have been considered a possible "buying climax," which, at a minimum, would signal the markets may see more volatility ahead.

Outlook

Volatility has picked up in the markets due to a combination of factors that is causing adjustments in many portfolios. Although the Fed's favorite inflation gauge is still well below 2 percent, a number of commodity prices are on the rise. For example, a barrel of West Texas Intermediate oil, which was trading around $37 on election day in November, is now above $60.

Higher interest rates have put pressure on "growth" stocks as their Price/Earnings (P/E) ratios contract because higher yields make future cash flows less attractive. In addition, money has been rotating into more economically sensitive sectors as a result of pent-up demand.

The reality is the economy may be at an inflection point. Dr. Marty Makary of Johns Hopkins cited the fact that the number of COVID cases are down materially over the past few months while the number of people getting vaccinated are up substantially – with another major drug company's vaccine available – suggesting that herd immunity may not be too far off.

If that is directionally true, with central banks around the world continuing to pump liquidity into the system, the global economy could surprise on the upside. Moreover, the Fed has said it is in no rush to raise interest rates or trim its holdings of bonds. In fact, the Fed is committed to doing everything in its power to "ensure that the recovery will be as strong as possible."

As these factors converge, volatility could remain elevated as the markets vacillate between characteristics such as growth vs. cyclical, domestic vs. international, small vs. large, etc. In addition, the proliferation of trading algorithms can cause wide price swings in short periods of time as we have seen over the past few weeks.

While the economic backdrop and liquidity factors are favorable, we are seeing several signs of excess that may need to be corrected. Specifically, a few Special Purpose Acquisition Company (SPAC) stocks - essentially “blank check” companies - have increased substantially based on speculation of a future acquisition even though the majority of assets are in cash.

Bullish sentiment has risen as have the number of initial public offerings (IPOs) of companies with no earnings. Given the run that we have seen following the election, we would not be surprised to see a little air taken out of the markets. That said, we still view volatility as an opportunity to add to exposure. (3.1.21)

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