On Our Radar – April 2021

It was one year ago that the global economy and financial markets were devastated by the onset of the COVID-19 pandemic. Coordinated responses by global central banks and governments flooded the markets with numerous liquidity programs in an attempt to offset the impact of forced lockdowns. Meanwhile, researchers and pharmaceutical companies went to work to develop a vaccine, which they did in record time.

While economies around the globe continue to gradually reopen, the markets have seen a tug-of-war of late as money has shifted from COVID beneficiaries – work from home, school from home, e-commerce, etc. – to those industries hit hardest from the shutdown, primarily the travel and leisure sectors due to social distancing.

The first quarter saw materially higher interest rates on the 10-year U.S. Treasury Note, higher oil prices, a blow-up in at least 2 hedge funds (1 a 'family office"), and a ten percent correction in the NASDAQ Composite. Nevertheless, the S&P 500 index went on to record another record high.

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 financial conditions. The following is the most recent update.

Interest Rates (Monetary Policy)

The Federal Open Market Committee (FOMC) met in March and maintained the federal funds target range at zero to ¼ percent, and said it will continue to purchase at least $80 billion worth of U.S. Treasury securities and $40 billion worth of mortgage-backed securities. Fed Chairman Jerome Powell said the economy is "a long way from our employment and inflation goals," so the Fed "will continue to provide the economy the support that it needs for as long as it takes."

In his press conference Mr. Powell said "inflation remains below our 2 percent longer-run objective," however, he acknowledged that we could see upward pressure on prices if the economy reopens quickly and more bottlenecks occur in the supply chain. He emphasized that a temporary rise in inflation would not cause the Fed to change policy.

The Fed's theory regarding inflation could be a potential problem. Over the years, when the Fed made a mistake, investors often felt the pain. In March 2000, literally days away from the top in the NASDAQ Composite, Fed Chairman Alan Greenspan said he saw nothing to suggest that "[technology] opportunities will peter out anytime soon." Over the next eighteen months, the NASDAQ Composite fell by more than 75 percent.

In 2007, Fed Chairman Ben Bernanke said "the problems in the subprime market seems likely to be contained" and that it "will not affect the economy overall." We know how that turned out.

In December 2018, Fed Chair Powell said that the Fed did not believe reducing the size of its balance sheet would have much of an impact and, if it did, it would be "a pretty small impact."

As such, according to Powell, the shrinking of the balance sheet was "on automatic pilot." The S&P 500 index dropped 9.1 percent in December 2018, and the Fed quickly reversed course. We highlight these not to be critical of the Fed as they have a very difficult job, but to point out that an unwavering belief in a theory can be harmful when taken to extremes.

For more than eight years (2012 – 2020) inflation was running below the Fed's target of 2 percent. When asked about below-target inflation, the Fed's response was the same; it was "transitory." Consider the following:

"Inflation has been running below the Committee's longer-run objective of 2 percent for some time and has been a bit softer recently. The Committee believes that the recent softness partly reflects **transitory** factors." Chair Ben Bernanke June 19, 2013.

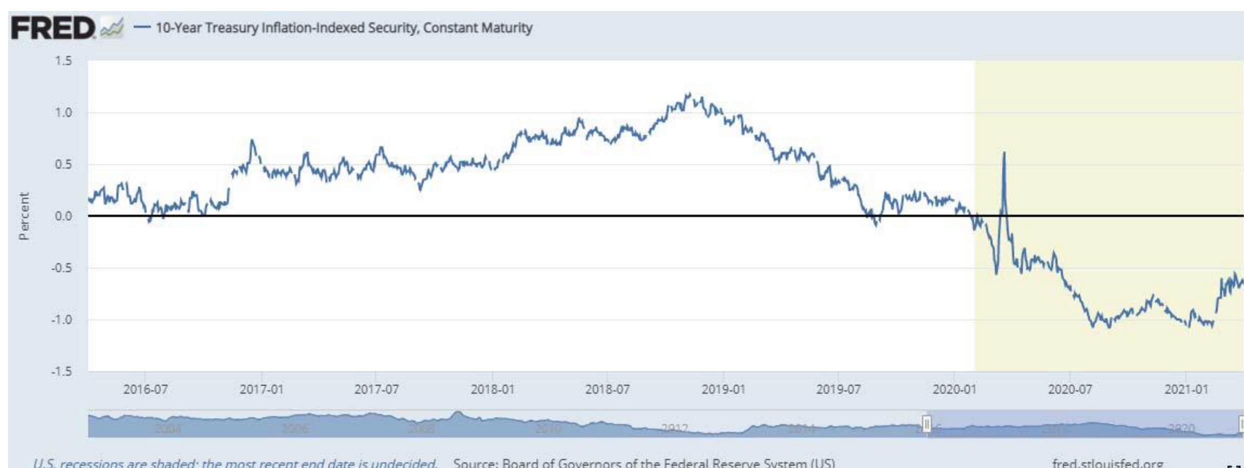
"As these **transitory** influences fade…the Committee expects inflation to rise to 2 percent over the medium term." Chair Janet Yellen December 16, 2016.

"Core inflation stood at 1.6 percent for the previous 12 months. We suspect some **transitory** factors." Chair Jerome Powell May 1, 2019.

However, after years of believing in their inflation theory and disregarding actual evidence, the Fed officially changed its monetary policy in September 2020 to address the below-target inflation. In fact, the Fed adopted flexible average inflation targeting. Since then, interest rates on the 10-year U.S. Treasury Note have more than tripled to approximately 1.7 percent.

What is interesting is that the median inflation projection of the FOMC participants is 2.4 percent in 2021, well above the current yield on longer-term U.S. Treasury securities. While it's possible that the Fed is right and any inflation above 2 percent will be temporary - the 10-year inflation indexed security is still negative as seen below - it is also possible that the bond and stock markets may be tested by the highest level of inflation in many years.

This is something we are watching closely.



Valuation

Although not final, calendar year 2020 profits for the S&P 500 are estimated to be roughly $122 per share, while current estimates for 2021 are about $175, a 43 percent jump. Therefore, the price/earnings (P/E) ratio of the S&P 500 based on 2021 estimates is 22.7.

With the economy growing and liquidity from central banks expected to continue, early estimates for calendar year 2022 are in the neighborhood of $200. While a lot can change and probably will, including a rise in corporate and individual taxes, the combination of relatively low interest rates and growing corporate profits has valuation in neutral territory.

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Economic Cycle

The U.S. economy grew 4.3 percent in the fourth quarter, a positive revision of 0.2 percent from the previous estimate from February. The Institute for Supply Management Manufacturing survey rose to 64.7 percent, a 38-year high. As we saw last year, a once-in-a-generation pandemic will likely generate record-breaking economic statistics for some time as we attempt to get back to “normal.”

The unemployment rate in March fell to 6 percent as the economy added 916,000. Moreover, the number of jobs created in both January and February were revised higher. That said, we are still millions of jobs short of where we were pre-COVID. For example, the U6 unemployment rate – referred to as the underemployment rate by the Federal Reserve – is roughly 4 percent above a year ago.

Consumer confidence has rebounded as the number of people vaccinated continues to rise.

Sentiment

According to Investors Intelligence, bullish sentiment was around 57 percent at the end of the quarter, down from the euphoric 63 percent level seen in mid-January. Rising interest rates and a double-digit decline in the NASDAQ Composite from mid-February to mid-March seemed to have had the effect of throttling expectations.

However, there is no doubt that confidence is on the upswing as the number of people vaccinated continues to rise and hope grows that the life gets back to “normal” soon.

Technical Factors

Market technicals have been mixed with the Dow Jones Industrial Average and S&P 500 index showing strength, while the statistics from the NASDAQ were much weaker for a few weeks. In fact, the number of stocks on the NASDAQ making new 52-week lows increased to 200 in early March.

At quarter end, the percentage of stocks above their 50-day moving average was 82, which indicates broad stock participation.

Outlook

The U.S. and China held tense meetings in Alaska as the markets attempt to get clear on the Biden administration's policy. To say the meetings were a little testy would be an understatement. Yang Jiechi, China's Director of Central Foreign Affairs Commission publicly said "the U.S. does not have the qualifications to say that it wants to speak with China from a position of strength."

It would appear that the ongoing tension between the U.S. and China is not going away anytime soon.

Again, the first quarter saw higher interest rates, higher oil prices, a blow-up in leveraged funds that will cause materially losses for some banks, a ten percent correction in the NASDAQ Composite, and a new high in the S&P 500 index.

Much of the market's gain has been due to what was essentially "QE 4" - the 4th round of quantitative easing by the Federal Reserve as well as several unprecedented COVID-relief bills produced by Congress. Recently Fed Chair Powell said the economy is "a long way from our employment and inflation goals," so [the Fed] will continue to support the economy "for as long as it takes."

The Fed's balance sheet stood at $7.68 trillion at quarter-end, up from about $4.2 trillion in early March 2020. The easy part is putting money in. QE was designed to drive interest rates down thereby pushing up the value of stocks, houses, and other financial assets in order to increase aggregate demand. The more challenging part will be when the Fed attempts to exit gracefully.

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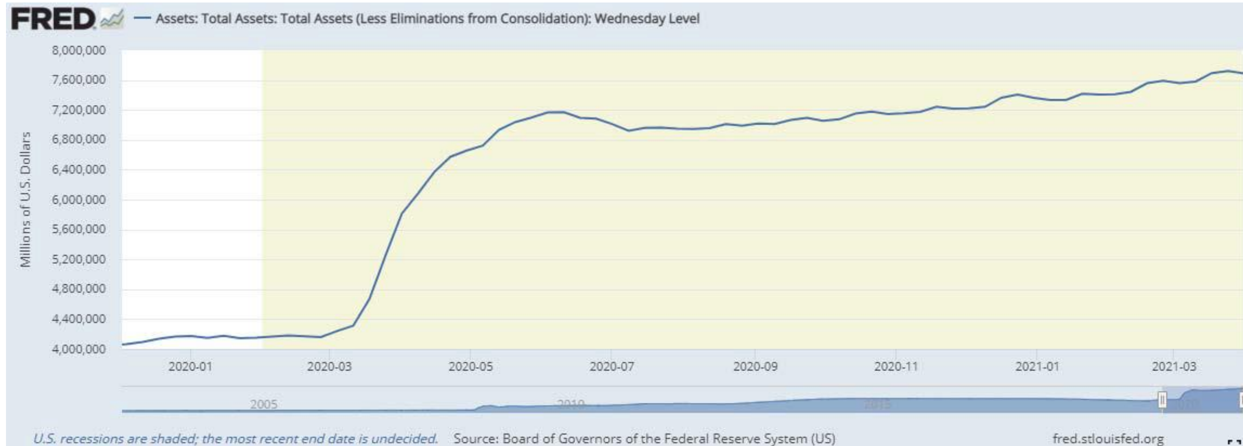

There has been a rotation over the past few months as higher interest rates, which are detrimental to growth stock price/earnings (P/E) ratios, has caused some money to shift into economically sensitive areas. However, a number of these “growth” stocks are in companies that are positioned to benefit from longer-term trends.

As the U.S. economy strengthens from the COVID-lockdown, the number of people vaccinated grows, corporate earnings on the rise, and an accommodative monetary policy, financial conditions are still constructive. However, as we have seen recently, higher interest rates can cause volatility to spike as capital shifts from sector to sector, and leveraged investors may be forced to sell regardless of the fundamentals.

The administration is talking up a multi-trillion-dollar infrastructure bill that reportedly will be paid for with higher individual and corporate taxes. How the markets deal with that remains to be seen. While volatility is not likely to go away, neither are the opportunities it presents. (4.2.21)

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