On Our Radar – May 2021

Stocks, bonds, and commodities rallied in April as the U.S. economy continues to recover from the COVID-19 shutdown as more people are getting vaccinated every day. Pent-up demand along with additional stimulus checks and increased optimism about a post-pandemic world are causing numerous records to be broken. Of course, much of this is just the mirror image of records that were broken to the downside one-year ago.

The S&P 500 index rallied 5.2 percent in April as a majority of corporate earnings have come in better than expected. The yield on the 10-year U. S. Treasury Note dropped to 1.65 percent at the end of April from 1.74 percent at the end of the first quarter, and a barrel of West Texas Intermediate oil rose to roughly $63.65 from almost $59 a month ago.

Not everything was rosy, however, as losses from the massively-leveraged bets-gone-wrong by family office Archegos became public. In total, a few of the biggest global banks lost more than $10 billion as those trades were unwound. While the industry initially touted that this type of behavior was not widespread, some honest reports referred to the losses as a "surprise." The good news is that this event happened in a healthy market with plenty of liquidity. The bad news is that this is an example of late-cycle behavior comprised of massive leverage in complex and opaque instruments.

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)

"Significant further progress." That phrase was uttered 13-times by Fed Chair Jerome Powell at his April 28, 2021 press conference. Unlike his predecessors Ben Bernanke and Janet Yellen, Jerome Powell is known for reading answers so that he does not go off script. When you listen to Jay Powell, you will know what he wants to get across as he tends to repeat the key takeaways several times.

The Federal Open Market Committee (FOMC) kept the target range for the federal funds rate at zero-to ¼ percent and said they will continue to increase their holding of Treasury securities and mortgage-backed securities by at least $120 billion a month until the recovery is complete.

According to Powell, payroll employment is 8.4 million below the pre-pandemic level – a long way from full employment. In addition, he acknowledged that the economy is different as many companies were forced to adapt, often using technology to replace people who could not be physically present due to restrictions. As a result, some of those former jobs may no longer be available. An example of a COVID-related change was the remote office, which caused new home sales to increase more than 66 percent year-over-year.

The Fed's balance sheet stood at $7.78 trillion, up 87 percent from the pre-pandemic level, and up 5.6 percent year-to-date.

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Valuation

The massive liquidity that hit the economy a year ago along with the number of vaccinated on the rise has caused a majority of companies to report better than expected earnings. The current earnings estimate for the S&P 500 for calendar year 2021 is roughly $178. Therefore, the P/E ratio (Price/Earnings) for the S&P 500 index is roughly 23.4-times 2021 earnings.

Looking ahead to calendar year 2022, earnings estimates are roughly $202, which would indicate that the S&P 500 is trading at about 20.6-times 2022 earnings. We consider valuation to be fair given the current level of interest rates and inflation. However, we will be watching these closely.

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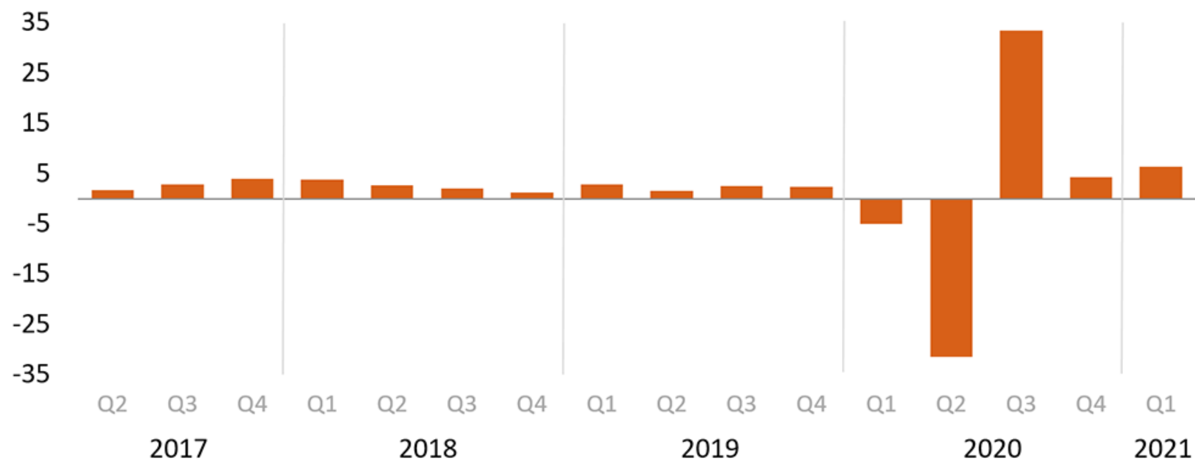
Economic Cycle

The U.S economy grew 6.4 percent in the first quarter according to the advanced estimate, up from 4.3 percent growth seen in the fourth quarter. Inflation also increased to 2.3 percent, a big rise from 1.3 percent seen in the fourth quarter based on the personal consumption expenditures (PCE), excluding food and energy. But the reality is that the price of many commodities is on the rise, including food, energy, lumber, and copper, which recently hit an all-time high.



While the Federal Reserve is convinced that higher prices are “transitory” due to COVID-related supply channel disruptions and bottlenecks, the Fed’s track record on inflation over the past decade has not been good. As a reminder, after three Fed Chairs – Bernanke, Yellen and Powell - over more than 8 years repeatedly said lower-than-2 percent inflation was “transitory,” in September 2020 – near the bottom of the COVID-related shutdown – the Fed announced a new policy framework called Flexible Average Inflation Targeting.

The Conference Board Consumer Confidence Index rose to 121.7, the highest level since February 2020 when it hit 132.6, and the Leading Economic Index (LEI) increased 1.3 percent in March. The Institute for Supply Management (ISM) Manufacturing report was 60.7 percent in April, down from 64.7 percent in March.

While the economic numbers are very good, we may be approaching the peak in the rate of change as the year-over-year comparisons are against the COVID-shutdown time period.

Sentiment

According to Investors Intelligence, bullish sentiment got as high as 63.7 percent in mid-April, the highest level since just after the November presidential election, before closing out around 59. We consider investor sentiment to be a contrary indicator, therefore, we prefer lower levels of bullishness to higher levels as optimism often brings with it elevated prices.

High levels of bullish sentiment by itself is not necessarily a negative. However, it usually indicates where we are in the cycle. Levels above 60 usually indicate that a lot of good news is priced in. Therefore, investors need to be alert to any changes that might dampen investors’ enthusiasm.

Technical Factors

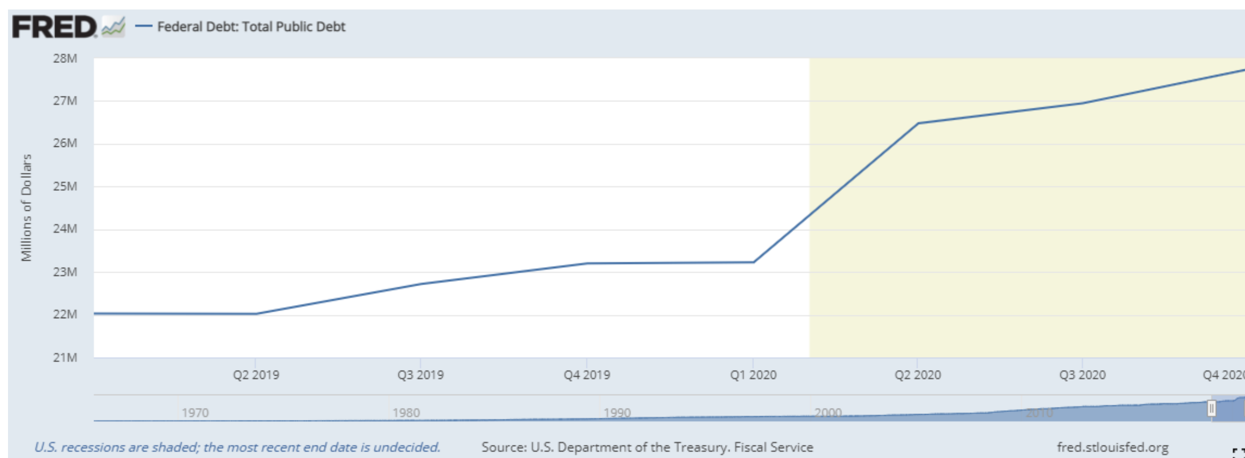
Volatility has picked up over the past few months as money has rotated out of COVID-winners to COVID-laggards. Said another way, there has been some pressure recently in a number of high-flying growth companies as money has shifted to energy, financial, and industrial companies, among others.

The NASDAQ Composite fell by more than 10 percent between mid-February and early March, but staged an impressive bounce into late April’s “earnings season” to record a new all-time high. Nevertheless, a number of tech companies with no earnings did not come close to achieving new 52-week highs, which is usually a warning signal.

Outlook

In his first address to Congress, President Biden unveiled a nearly $2 trillion American Families plan to be largely funded by tax reform. How much of that ultimately gets through Congress remains to be seen, but the Biden administration is proposing a sharp increase in the capital gains tax rate and higher corporate taxes to pay for it.

Since the outbreak of the pandemic, federal debt has increased by more than 25 percent as seen in the following chart. Of course, this does not include unfunded liabilities such as Medicare and Medicaid, which would make the debt levels substantially higher.



When the pandemic hit the Fed essentially began QE4 – the fourth round of quantitative easing. You may recall the first round of QE began in early 2009. At that time, we were told that QE was temporary, and that the "tools" would be put back in the toolbox when no longer needed. Essentially with QE 4, the Fed's goal was to reduce interest rates and inflate assets in order to support economic activity.

During his recent press conference Chair Powell said the Fed is strongly committed to doing everything they can for as long as it takes in order to have inflation average 2 percent and unemployment back near pre-pandemic levels. After that, "we will taper asset purchases" and withdraw the accommodation.

Fed Chair Powell told 60 Minutes "I think it's highly unlikely that we would raise rates anything (sic) like this year." However, based on the 10-year Treasury yield rising from 0.93 percent at year-end to 1.65 percent recently, some parts of the bond market are not waiting for the Fed to adjust policy.

When the Fed does decide to adjust policy, it will likely resemble the following:

1. Reduce the amount of monthly bond purchases
2. Eventually stop new bond purchases with the exception of reinvesting principal & interest
3. Stop reinvesting altogether
4. Raise interest rates

But the reality is that interest rates on federal funds never got close to pre-financial crisis levels. The federal funds rate was 5.25 percent in 2007. After the Fed began to taper bond purchases and shrink the size of its balance sheet by roughly 17 percent, the federal funds rate never got above 2.5 percent.

While Mr. Powell alluded to withdrawing accommodation in the past, it is quite clear that they have never done it to this degree. As a reminder, the Powell Fed put more money into the system in three months than the Bernanke-Fed did in five years. If and when the time comes, putting the “tools” away has never been attempted to this degree given the magnitude of the COVID-liquidity.

Until that time, however, financial conditions are likely to remain accommodative. While the liquidity background is favorable with record stimulus and a growing economy, financial conditions are also favorable. Corporate profits are on the rise, which should continue into 2022.

Nevertheless, much of that optimism is currently baked into today’s prices. In addition, there are more than a few signs of excesses in some markets, which Chairman Powell called “a bit frothy.” Therefore, we believe investors should brace for more volatility as the rate of change from the effects of the COVID-shutdowns to the economy re-opening is peaking. Moreover, the proliferation of trading algorithms can cause wide swings in prices as we saw between mid-February and early-March.

Another thing to keep an eye on is geopolitical tensions, which could cause market liquidity to change quickly. As seen with Archegos, highly leveraged bets can go sour when liquidity dries up. (5.3.21)

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