TJT CAPITAL GROUP
REGISTERED INVESTMENT ADVISOR

On Our Radar – June 2021

The S&P 500 index rose just over 0.5 percent in May and recorded a new all-time high despite a pick-up in volatility due to rising tensions in the Middle East, a computer hack of a major oil pipeline, a meaningful jump in inflation figures, and a significant selloff in cryptocurrencies, including Bitcoin.

The Consumer Price Index (CPI), excluding food and energy prices, increased 4.2 percent year-over-year, the fastest increase since 2008. The Federal Reserve's preferred inflation gauge, Personal Consumption Expenditures (PCE) excluding food and energy, increased 3.1 percent year-over-year.

And while oil prices are excluded, they have risen from well below $40 a barrel one-year ago to more than $66 a barrel at the end of May. Regardless of any inflation index, higher food and energy prices act as a tax and are creating some headwinds.

While housing has been strong over the past year, it has cooled a bit as both new single-family houses sold and pending home sales have declined over the past one-month and three-month time frames. Moreover, consumer confidence has slipped over the past few weeks.

When the employment report was released on May 7, 2021, the consensus was for 950,000 to 1 million new jobs. The number of new jobs came in at 266,000 and the unemployment rate actually rose from 6.0 percent to 6.1 percent, a big disappointment. Moreover, the number of new jobs initially reported in April were reduced by 78,000. When asked if the exceptionally generous unemployment benefits had something to do with the low new jobs' figures, Treasury Secretary Janet Yellen said "I don't think that the addition to unemployment benefits is really the factor that's making a difference."

It seems as though Janet Yellen, whose specialty is labor economics, is at best being intellectually naive and at worst less than honest. We say that because the next business day President Joe Biden threatened to take away unemployment benefits when he said "We're going to make it clear that anyone collecting unemployment, who is offered a suitable job must take the job or lose their unemployment benefits."

Moreover, the Federal Open Market Committee minutes from the April 2021 meeting stated that businesses were having trouble hiring workers because of factors such as "expanded unemployment insurance benefits." The reality is that some states offer weekly unemployment benefits of as much as $855 before the additional $300 in Federal assistance, which equates to being paid more than $45,000 a year not to work.

However well-intentioned the relief programs have been, we are seeing second and third order effects. While Joe Biden has been very careful to follow the script - not a political comment but an observation – occasionally he improvises. Following the employment report, he said "I know there has been a lot of discussion since Friday's since Friday's report (SIC) that people are being paid to stay home rather than go to work. Well, we don't see much evidence of that. **That is a major factor.**" (Emphasis added)

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) minutes stated that the U.S. "economy remained far from the Committee's maximum employment and price stability goals" and, as such, expected "to maintain an accommodative stance of monetary policy until [those goals] were achieved." And while GDP growth was projected to increase this year, the staff continued to view that the risks to the economy "were skewed to the downside."

The Fed has emphasized that monetary policy is "outcome based," which is driven by their mandates of maximum employment, stable prices, and financial stability. Ironically, the Fed has been mostly silent for years about cryptocurrencies, including Bitcoin, which according to its "founder" is "a purely peer-to-peer version of electronic cash."

It seems as if the Fed did not think much of it as a "currency" when the price was low, but seemed to become more vocal as the cryptocurrency traded north of $64,000 in April. Moreover, the ransom paid to the hacker of the oil pipeline was reportedly paid in Bitcoin, and since Bitcoin is often used by pseudonyms, it becomes harder to trace potential money-laundering schemes.

Over the past few weeks, the Federal Reserve Vice Chair of Supervision Randal Quarles told the Senate Banking Committee that a crackdown is coming. In addition, Fed Chair Jerome Powell told lawmakers that cryptocurrencies volatility poses risks to the stability of the financial system. Bitcoin was trading in the area of $36,000 at the end of May, down roughly 45 percent over the past two months.

Regarding inflation, while the Fed is saying that higher inflation is "transitory," the 5-year breakeven inflation rate – an indication of future inflation – is near a 10-year high as seen in the following chart. Although the Fed is unlikely to waiver in its assessment that higher inflation is temporary, that does not mean that they are right.

Valuation

Earnings estimates for the S&P 500 for calendar year 2021 have increased just over 9 percent over the past three months. Current earnings estimates are roughly $186, up from about $170 at the end of February. Therefore, the current Price/Earnings ratio (P/E) for the S&P 500 index is roughly 22.6-times earnings.

Under normal considerations that would seem to be expensive, however, when you consider that the Fed plans to continue what is essentially "QE 4," the higher valuation can be justified.

Current operating earnings estimates for 2022 are around $208.

Economic Cycle

The second estimate of Gross Domestic Product (GDP) for the first quarter of 2021 was unchanged at 6.4 percent. This compares to GDP growth of 4.3 percent in the fourth quarter of 2020.

The Institute for Supply Management (ISM) Manufacturing Index rose to 61.2 percent in May, and the Leading Economic Index (LEI) rose 1.6 percent last month to exceed its pre-pandemic peek recorded in January 2020, which indicates that the economic expansion should continue.

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Sentiment

According to Investors Intelligence, bullish sentiment on the equity market rose to almost 64 percent in late April, only to pull back to a more reasonable 51 percent recently.

We view investor sentiment is a contrary indicator, which can be valuable at extremes. 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 as most of the selling already took place.

In contrast, bullish readings in the mid-60 range, especially when the Bull/Bear difference exceeds 40, has often indicated that more caution is advised.

Technical Factors

The Advance/Decline Line (AD Line) is a breadth indicator that gives a sense of the number of stocks participating in an advance – or decline. A healthy market advance is going to have

broad participation with more stocks advancing than declining. The A/D line recently hit a new high, which is often a leading indicator for the overall market.

The S&P 500 index has been choppy since early May as a number of technology stocks have been correcting over the past few months as money has rotated out of growth stocks into value sectors.

Outlook

Last spring the Fed purchased more U.S. Treasury securities than it did through the entire 2009 – 2018 time period. We have seen an exceptional amount of monetary and fiscal stimulus, and as we stated previously, there are second and third order effects that are starting to appear in ways that could impact the markets.

For example, the Fed used to say that monetary policy was a blunt instrument. Now, however, they seem to believe that their policies can be used with such precision that it can affect the unemployment rate of certain segments of the economy. Policies intended to rescue certain sectors tend to inflate others that are in better shape.

As a result, the Fed has increased the size of its balance sheet to more than $7.9 trillion. And even though some statistics are at pre-pandemic levels, the Fed intends to continue to purchase at least $120 billion worth of U.S. Treasury securities and mortgage-backed securities a month.

This has put pressure on the value of the U.S. dollar as seen below. Moreover, it has been reported that the Biden administration is proposing a $6 trillion budget with a substantial increase in infrastructure spending as well as additional spending on social services. In some circles people are now saying that deficits don't matter as the Fed is essentially monetizing both government and private debt. This policy was totally understandable during an unprecedented pandemic-related shutdown of the economy. How it works in a post-vaccinated world remains to be seen.

We have stated in the past that investors have been hurt when the Fed has made a mistake. We point this out not to criticize them – they have a very tough job – but to highlight the fact that the last two significant declines had the Fed's fingerprints on them.
In 2013 former Fed Chairman Alan Greenspan wrote an article titled "Never saw it coming" regarding the subprime crisis, which morphed into a global financial crisis. What Mr. Greenspan neglected to point out in that article is that former Fed Governor Edward Gramlich published a book in 2007 – before the financial crisis - titled Subprime Mortgages: America's Latest Boom and Bust.

Too often the Fed has chosen to be guided by theory and models while ignoring the realities of the marketplace. It's similar to those who preach that the market is efficient based on outdated assumptions from a paper written more than 50-years ago and ignore the reality that a cryptocurrency reportedly started as a "joke" had a market value in excess of $75 billion just a few months ago. Or that a "tweet" can send a stock up several hundred percent in a week or so.

With the U.S. economy growing, corporate profits on the rise, and an accommodative Federal Reserve policy, market conditions are constructive. That said, we are late in a cycle, and the later you are in a cycle the more reliant the market is on Fed liquidity. In the most recent FOMC minutes it said "A number of participants suggested that if the economy continued to make rapid progress toward the Committee's goals, it might be appropriate at some point in upcoming meetings to begin discussing a plan for adjusting the pace of asset purchases."

With the rate of change slowing - from an economy that was shut down to one that is continuing to open - at some point the Fed is going to consider reducing the amount of its bond purchases. As the market assesses the likelihood of that we expect volatility to rise. In addition, volatility could rise due to geopolitical tensions, a drop in the dollar, or higher inflation to name a few. As such, we would not be surprised to see choppy markets over the next few months. (6.2.21)

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