On Our Radar – July 2021

The S&P 500 index recorded another all-time high as the accommodative monetary policy from the Federal Reserve helps the post-pandemic economic recovery gain traction. Although stocks have been one of the primary beneficiaries, the combination of Fed liquidity and the economic re-opening is causing inflation to rise. For example, crude oil prices were roughly $75.50 a barrel at the end of June, up from around $48.50 at year-end. As a result, interest rates on 10-year U.S. Treasury securities, which were trading at a yield of 0.93 percent at the end of December, were recently yielding 1.45 percent.

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.

<u>In</u>terest Rates (Monetary Policy)

The Federal Open Market Committee (FOMC) met in mid-June and decided to keep the target range for the federal funds rate at zero to one-quarter percent and continue to purchase at least $80 billion worth of Treasury securities and $40 billion worth of mortgage-backed securities per month.

Although the Fed raised its inflation expectations to 3.4 percent, a full percentage point higher than its March estimate, the Fed declared that higher inflation is due to "transitory" factors and will stabilize at lower levels in the future. As such, the FOMC intends to continue this policy until "substantial further progress" is made toward its maximum employment and price stability goals.

According to the Bureau of Labor Statistics, the unemployment rate was 5.9 percent compared to the pre-pandemic low of 3.5 percent, and 9.5 million people remain unemployed. Ironically, there are a record 9.28 million job openings as seen in the chart below. Critics argue that the unemployment situation is being distorted by generous government programs, which in certain cases provides a higher level of income than if one were working. In essence, some people are being paid to take the summer off as the extra unemployment benefits are scheduled to be paid until the end of September.

So, the Fed's monetary policy is designed to support the labor market, and the labor market is being distorted by unprecedented COVID-related relief programs. This fact was recently acknowledged by Fed Chair Jerome Powell when he stated "unemployment insurance benefits appear to be weighing on employment growth." Nevertheless, the Fed's monetary policy is "outcome based," according to Mr. Powell, and so the accommodative policy is likely to continue until the unemployment rate falls below 4 percent.

The Fed now sees at least two interest rate hikes in 2023, an adjustment from their previous forecast of no interest rate hikes until at least 2024. That said, interest rate hikes deal with the "cost" of money, not the availability of money. By purchasing $120 billion bonds a month – which is essentially "QE 4" (the fourth round of quantitative easing) the Fed is increasing its balance sheet by a massive $1.44 trillion a year. The Fed's balance sheet recently rose to more than $8 trillion for the first time ever, nearly double the early 2020 level.

It seems as though central bank policy is also weaving social elements into its policy actions. For example, Chairman Powell has mentioned several times that joblessness has fallen disproportionately on African Americans and Hispanics. When asked specifically what the Fed can do to address these issues, the Fed responded "By keeping interest rates low, we are trying to make homes more affordable and revive the housing market. We are trying to make it cheaper for businesses to build, expand, and hire. We are trying to lower the costs of buying a car that can carry a worker to a new job and kids to school. **We are trying to help families afford things they need so that greater spending can drive job creation and even more spending, thereby strengthening the recovery**" (emphasis added).

In essence, the Fed is trying to use monetary policy to inflate the economy out of the crisis, and financial assets are an important transmission mechanism.

Valuation

Corporate earnings continue to rebound as the economy re-opens. The calendar year 2021 operating profit estimates for 2021 are roughly $187, which puts the S&P 500 P/E ratio (Price/Earnings) at about 21.7-times earnings. As we enter the second half of the year, investors will gradually look ahead to 2022 profit estimates.

The current earnings estimate for the S&P 500 index for calendar year 2022 is in the neighborhood of $210, which puts the forward P/E ratio at 20.5-times earnings.

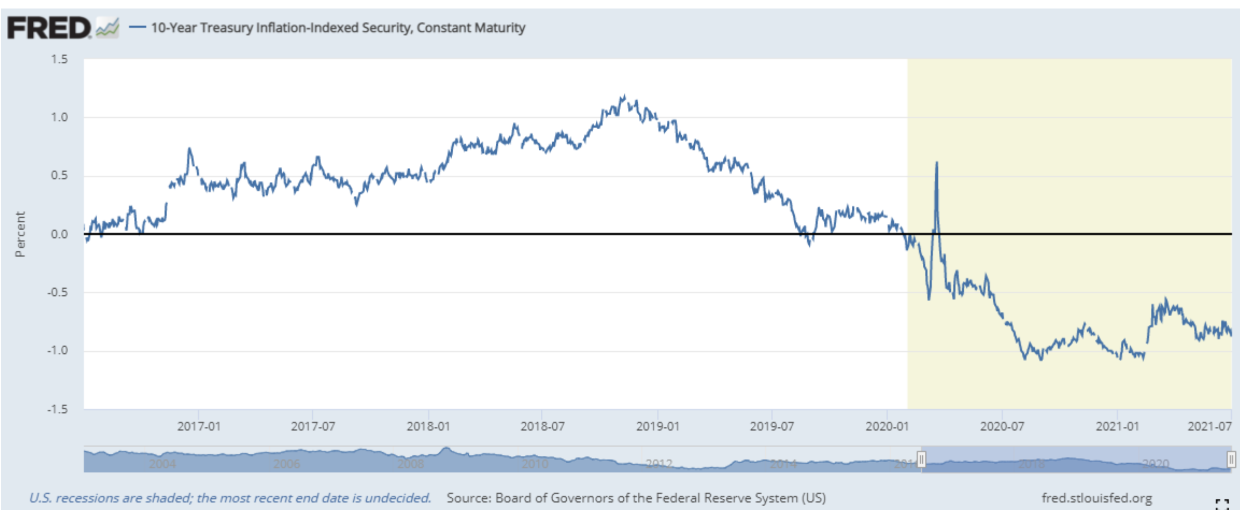
Obviously, the current level of interest rates and Fed policy will have a major influence on valuation measures.

Economic Cycle

The U.S. economy added 850,000 jobs in June and the unemployment rate was unchanged at 5.9 percent. The Institute for Supply Management (ISM) Manufacturing Index slipped to a still-solid 60.6 from the previous 61.2, and Consumer Confidence hit a fresh post-pandemic high of 127.3. The Leading Economic Index increased 1.3 percent last month and has also exceeded its January 2020 peak.

Inflation is on the rise as the Core PCE price index (Personal Consumption Expenditures) - excluding food and energy costs - rose 3.4 percent, the fastest increase since 1992, and the ISM Manufacturing prices paid index for raw materials increased to 92.1, the highest since 1979. While interest rates are generally higher than at year-end, they are mostly lower than the peak seen in March. For example, the yield on the 10-year Treasury Note was 1.74 percent at the end of the first quarter versus 1.45 percent at the end of the second quarter.

Higher inflation and lower interest rates are causing the “real” or “inflation-adjusted” interest rates to remain well-below zero as seen below. This is highly unusual, especially when the U.S. economy is projected to grow by about 7 percent this year.



Sentiment

According to Investors Intelligence, bullish sentiment has been in the range of about 52 on the low end and 64 on the high end over the past three months. Bullish sentiment is about 60. We view investor sentiment as a contrary indicator because higher levels tend to indicate that money has already been invested and there is less money on the sidelines.

A high reading of bullish sentiment can also be an indication of complacency, or it can mirror up and down moves in the overall markets. We prefer to see lower bullish numbers as the market has a tendency to “climb the wall of worry.” However, since the Federal Reserve began their COVID-inspired bond buying, investor sentiment has remained on the high side.

Technical Factors

The market has seen a rotation over the past seven months as money has shifted from growth companies/sectors to value sectors, especially as interest rates rose. However, with interest rates falling on longer-term U.S. Treasury securities since mid-February, money has moved back into growth companies/sectors as some industries that were hurt by the pandemic shutdown, especially airlines and the cruise industry, will take time to fully recover.

This rotation was seen in the percentage of stocks that were trading above their 50-day moving average. In late May and early June, the percentage of stocks trading above their 50-day moving average was over 75. By the third week of June that number declined to about 30. The rotation into and out of stocks/sectors has been a correction of sorts.

When conditions are constructive, we view corrections as healthy. However, given how much money is trading on momentum, should selling pressure re-appear, a deeper correction could follow.

Outlook

The European Central Bank (ECB) confirmed its “very accommodative monetary policy stance” in June as they kept interest rates unchanged and will continue to purchase about $23.6 billion of assets a month until at least March 2022. The ECB noted that they will continue “as long as necessary” and make purchases “across asset classes” to support monetary policy.

Volatility has picked up in the markets as money has rotated in and out of more cyclical components. For instance, the Dow Jones Transportation Average (DJTA) fell by nearly 10 percent between early May and mid-June as investors realized that industries most acutely affected by the pandemic - such as airlines - are going to take some time before business “gets back to normal” and may have gotten ahead of themselves.

The Dow Jones Industrial Average fell by around 5 percent over a five-week period between mid-May and mid-June, and the NASDAQ Composite declined by more than 10 percent between mid-February and early March. Money also seems to be moving in and out of sectors that may benefit/may be hurt by the latest program out of Congress. For example, we are still awaiting details about the infrastructure bill that was reportedly to be in the trillions of dollars.

As the Fed pushes ahead with its flexible average inflation targeting (FAIT), second and third order effects are going to occur. After a massive increase in cryptocurrencies, such as Bitcoin, prices have dropped by 50 percent or more over the past three months as the Federal Reserve and Security and Exchange Commission (SEC) take a closer look. Bitcoin has been the “ransom” of choice for computer hackers over the past few years, including the recent Colonial Pipeline and JBS (meat processing) attacks.

Speculation in certain stocks and sectors has also been on the rise, which in the past was considered a late market-cycle phenomenon. On a given day a “tweet” by an individual or traders on a group chat on a website can cause prices to move 100 percent or more in a day. The Fed seems to be ok with that, as higher prices tend to support its macroeconomic goals.

Over the years we have reminded investors that the Fed had its fingerprints on the last two financial crises – 2000 and 2008. We believe the root causes had to do with the Fed putting more weight on theory than what was actually going on in the real world. For example, in 2007 – before the financial crisis - former Fed Governor Edward Gramlich published a book titled Subprime Mortgages: America's Latest Boom and Bust. Following the subprime crisis, former Fed Chairman Alan Greenspan wrote a piece titled "Never Saw It Coming."

It is quite possible that the Fed is running a version of Modern Monetary Theory whereby government policies are not constrained by government revenues. Regardless, the Fed is saying that they are not going to change policy until their goals are achieved, and even then "whenever liftoff [of interest rates] comes, policy will remain highly accommodative."

So, with the economy growing, corporate profits on the rise, and the Fed pumping liquidity until "substantial further progress has been made towards its employment and inflation goals," a majority of conditions are constructive. That said, we know that any advance from here is unlikely to be in a straight line.

Inflation is on the rise, and should it not turn out to be "transitory," the financial markets are going to see volatility increase. Bullish sentiment is also on the rise and a lot of money has come into the markets over the past few months. Markets have a way of testing investors' resolve, especially after a big rally. We view selloffs as opportunities to add to positions.

Regarding theory, the Fed is haunted by the pre-mature tightening that occurred in 1937 (yes, 1937 – during the Great Depression), and believe that interest rate hikes caused the economy to contract before it achieved a full recovery. Today, the Fed believes that the recovery from COVID is incomplete and has vowed not to pre-emptively withdraw support.

While that may sound good in theory, the markets – and reality – may have a different view as this type of monetary and fiscal stimulus has never been done before. (7.6.21)