On Our Radar – August 2021

The S&P 500 index rose 2.2 percent and recorded another all-time high in July notwithstanding a significant uptick in volatility as the COVID-Delta variant has caused the number of new cases to rise. Uncertainty about the government's response, including whether we will be subject to new restrictions, weighed on the markets.

The S&P 500 experienced its worst and best one-day performance since March on back-to-back days in July. Although the number of COVID cases are on the rise, the number of fatalities has remained relatively low compared to last year.

The yield of the 10-year U.S. Treasury Note fell to 1.24 percent at the end of July, down from 1.45 percent at the end of June and 1.74 percent at the end of the first quarter. This action seems to be counterintuitive given that inflation, according to the core personal consumption expenditures (PCE), rose 3.5 percent year-over-year, the highest since 1991.

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) kept the federal funds rate near zero and maintained the monthly bond buying program at $120 billion per month. The Fed's balance sheet now stands at $8.2 trillion, roughly double what it was pre-pandemic.

There seems to be a big discrepancy in some of the messaging by the Federal Reserve that requires close attention. Federal Open Market Committee (FOMC) minutes are released roughly three weeks after a meeting, while the transcript is released five-years later.

The minutes from the June 2021 FOMC meeting stated that "market participants appeared to remain confident that the economic recovery was broadly on track." However, two days after those minutes were released the Fed submitted its Monetary Policy Report to Congress, which stated "the Committee judges that downward risks to employment and inflation have increased," of which the employment comment seems inconsistent with a growing economy.

According to the Bureau of Labor Statistics, the U.S. has more than 9.2 million job openings while the Fed estimates that there are 9.5 million unemployed. Reluctantly, the Fed has acknowledged that "very generous unemployment benefits" may have something to do with that discrepancy.

Nevertheless, the Fed seems to have tied monetary policy to the unemployment rate, which is clearly being distorted due to a variety of issues. At his recent press conference, Fed Chairman Jerome Powell said "the labor market has a ways to go. The unemployment rate in June was 5.9 percent, and this figure underscores the shortfall in employment."

The Fed has highlighted employment for African Americans and Hispanics as examples that there is more to do, but has yet to indicate how the blunt instrument of monetary policy can surgically alleviate high unemployment in certain segments of the population. Regardless, the Fed now views maximum employment "as a broad-based and inclusive goal" and no longer considers "a single number that we can target."

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Valuation

As the U.S. and global economies continue to recover from the COVID-lockdowns of a year ago, and as governments and central banks around the world continue to flood the system with liquidity, corporate earnings on a year-over-year basis have skyrocketed.

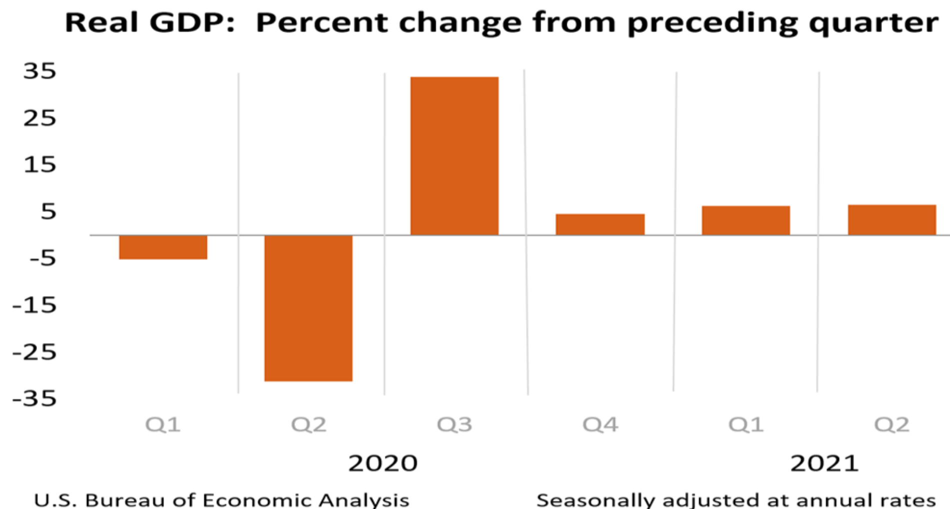
For example, S&P 500 earnings estimates for the second quarter of 2021 are expected to be roughly $46, that compares to the $26.79 actually reported in the second quarter of 2020, which would be a 71 percent increase.

For all of 2021, estimates call for companies in the S&P 500 index to earn about $189, up from $122.37 in 2020, a 54 percent increase. For calendar year 2022, current earnings estimates are just over $211, which puts the forward P/E (price/earnings) ratio near 21-times earnings. With the federal funds rate hovering around zero and the yield on the 10-year U.S. Treasury Note at 1.24 percent, we view the market as fairly valued.

Economic Cycle

The National Bureau of Economic Research (NBER) Business Cycle Dating Committee announced that the COVID-19 recession officially began in February 2020 and ended in April 2020, thereby producing the shortest economic downturn in U.S. history. May 2020 was the month that NBER said the new economic expansion began, however, the recovery is far from complete.

The U.S. economy grew 6.5 percent in the second quarter, up from the 6.3 percent pace in the first quarter, reflecting the continued economic recovery and the ongoing government support. While the headline number was solid, the median forecast by economists called for an 8.4 percent increase. Most of the difference was due to inventories, which were roughly $165 billion below estimates due to supply chain bottlenecks.



The Institute for Supply Management (ISM) Manufacturing index was 59.5 percent in July, down from 60.6 percent the previous month and 64.7 percent in March. While numbers above 50 indicate growth, the rate of change is clearly slowing. This is consistent with the Conference Board Leading Economic Index (LEI), which increased

by 0.7 percent in June following a 1.2 percent increase in May and a 1.3 percent increase in April.

Consumer sentiment has improved but remains below the pre-pandemic levels. Meanwhile, housing has begun to moderate as new home sales fell 6.6 percent in June and pending sales of existing homes dropped 1.9 percent.

Sentiment

According to Investors Intelligence, bullish sentiment declined from over 61 percent in mid-July to around 52 percent at month end.   As volatility picked up due to the increase in COVID-Delta cases, it seems like some investors headed to the sidelines.

As many investors are aware, notwithstanding the headlines about the market averages, there has been quite a bit of rotation of money switching between sectors.

Technical Factors

The U.S. equity market has come a long way as a result of the rebound from the COVID-shutdown and massive monetary and fiscal support from the U.S. government. That said, the uncertainty about the possibility of the COVID-Delta variant causing new restrictions has weighed on companies in different sectors. This can be seen in the number of stocks trading above their 50-day moving average, which fell from over 91 percent in April to a July low of about 35 percent.

As COVID vaccines were initially rolled out, the Dow Jones Transportation Average (DJTA) rallied more than 30 percent between February 2021 and mid-May. Since then, the DJTA has declined by roughly 10 percent as the market has seen a rotation out of COVID-laggards such as airlines back into growth sectors.

Outlook

We are watching the Fed closely as liquidity has been the overwhelming force driving this market. While the U.S. economy is growing and corporate profits are on the rise, that was also the case in 2018 when the S&P 500 index fell 6.2 percent. Despite S&P 500 profits rising by more than 21 percent in 2018, the Fed was raising interest rates and reducing the size of its balance sheet.

Today, we have relatively high unemployment and inflation. The Fed continues to suggest that the high inflation readings are temporary, but we remind readers that the last two severe declines – in 2000 and 2008 – had the Fed's fingerprints on them due to policy mistakes.

For background, in 2018, ten years after the Lehman bankruptcy, former Fed Chairman Ben Bernanke wrote an article stating that the "seeds of the panic were sown over decades as the American financial system outgrew the protections against panics that were put in place after the Great Depression."

Nowhere in the piece does it acknowledge that the Fed supported changing the leverage rules that allowed five major Wall Street banks to go from a net leverage ratio of 12-to-1 to as much as 40-to 1 or 50-to-1 as reported in the cases of Bear Stearns and Lehman.

Not so ironically the Dodd-Frank Act reestablished capital ratios. In fact, just last week Chairman Powell said the previous crisis was caused by "an undercapitalized banking system."

Is the Fed about to make another policy mistake? For more than eight years, from 2012 to 2020, the Fed repeatedly said that low inflation was "transitory." Similar to today, they would always point to one or two things that caused inflation to be lower than estimated. The Fed believed that once the price of the things that were weighing on inflation subsided, everything would be fine.

The mistake was the Fed assumed that the prices of other items would essentially stay the same. For more than eight years inflation was consistently below the Fed's target despite stating that low inflation was "transitory." In August 2020, Jerome Powell announced a new monetary policy framework that would "target a moderate overshoot of 2 percent inflation for some time."

That fact is when it comes to inflation, the Fed has a less than stellar track record. With inflation currently the highest in 30-years, we remind you that just last December Jerome Powell said "It is not going to be easy to have inflation move up."

That is right up there with Ben Bernanke saying the subprime fallout will not affect the economy overall.

As we have stated many times in the past, our issue is not that Fed officials got things wrong. Our issue is that Fed officials seemingly ignored reality for the sake of theory.

In 2021, officials originally said higher inflation was due to "base effects," that is, comparing prices today when the economy is "open" versus COVID-related shutdown prices. Then officials blamed supply chains for high inflation, some of which is true. Now, however, Treasury Secretary Janet Yellen seems to have moved the goal posts saying "I think over the medium term we'll see inflation decline back to normal levels."

The fact of the matter is the Fed is essentially conducting emergency monetary policy by purchasing $120 billion worth of U.S. Treasury and mortgage-backed securities a month when the U.S. economy just grew by 6.5 percent and the recession officially

ended in April 2020. Still, with unemployment well above the pre-pandemic level, Jerome Powell said the recovery is not complete and the Fed is “not going to preemptively raise rates.”

Therefore, with the economy growing, corporate profits on the rise, and highly accommodative monetary policy, the conditions are still constructive. However, with a balance sheet well over $8 trillion, the Fed cannot afford to make a mistake. We are watching the Fed closely for signs that they may begin to taper their bond purchases, which could cause volatility to pick up materially. (8.2.21)

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