TJT CAPITAL GROUP

On Our Radar – September 2021

The month of August saw an increase in the number of COVID-Delta variant cases, a botched withdrawal from Afghanistan with legitimate questions about the competence of leadership in a number of areas, several hurricanes, and further record highs in the S&P 500 index.

To be clear, this is not a political statement. Too often investors get hurt when they ignore reality and do not confront "what is." For the record, over the years we have been equally critical of both sides of the aisle when the facts dictate.

Despite the headlines, the S&P 500 gained 2.8 percent in August to close above 4500 for the first time in history. The yield on the 10-year U.S. Treasury inched up to 1.30 percent, while the price of a barrel of West Texas Intermediate oil fell roughly 6.5 percent for the month after being down more than 15 percent mid-month.

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)

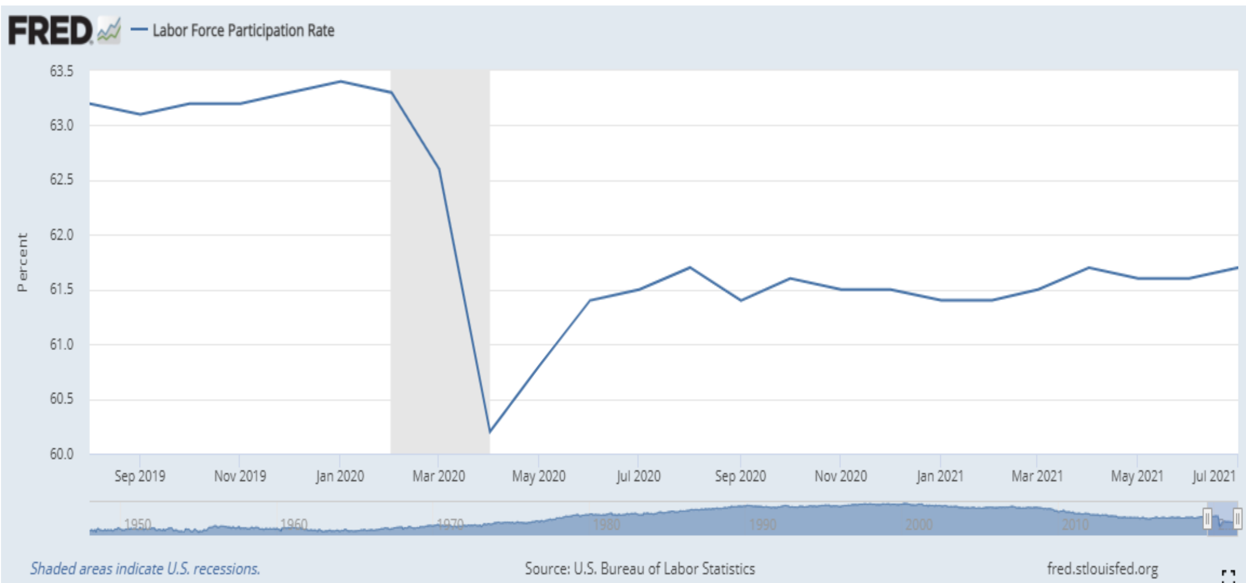
The markets anxiously awaited Jerome Powell's speech at the economic policy symposium in Jackson Hole, WY. Historically, Fed Chairs have used this forum to provide insight into changes to monetary policy. For example, in August 2010, Ben Bernanke hinted at the second round of quantitative easing (QE2), or as the Fed prefers, large-scale asset purchases. In August 2012, Mr. Bernanke all but guaranteed QE3, which officially began in September 2012, and increased the Fed's bond holdings by about $85 billion a month.

In August 2020, Jerome Powell introduced the Fed's new policy framework called flexible average inflation targeting, which states that when inflation has been running below the Fed's goal of 2 percent, monetary policy will aim to achieve inflation moderately above 2 percent for some time, thereby averaging 2 percent over time.

Last week, Fed Chair Powell focused on the pandemic, which produced the deepest recession and quickest recovery in history. He said the COVID Delta variant "continues to threaten not only health and life, but also economic activity." As such, the Fed will continue to purchase $120 billion worth of Treasury securities and agency mortgage-backed securities per month until they see "substantial further progress."

Mr. Powell acknowledged that inflation was running "well above" the Fed's 2 percent target, but still believes that high inflation readings will prove to be temporary. On the employment front, the unemployment rate of 5.4 percent was “still much too high, and the reported rate understated the amount of labor market slack.”

Chairman Powell has focused on the labor force participation rate, which is 61.7 percent, down from the pre-pandemic readings in the 63 percent range as seen below. Total employment is 6 million below its February 2020 level yet there are over 10 million job openings. Nowhere in his Jackson Hole speech did he mention the impact that generous unemployment benefits may be having on employment.



It is a fact that many people have been making more money by not working than they would if they were employed, yet the Fed is using the distorted unemployment statistics as a reason to justify purchasing $120 billion bonds per month even though gross domestic product (GDP) averaged 6.4 percent growth in the first half of the year.

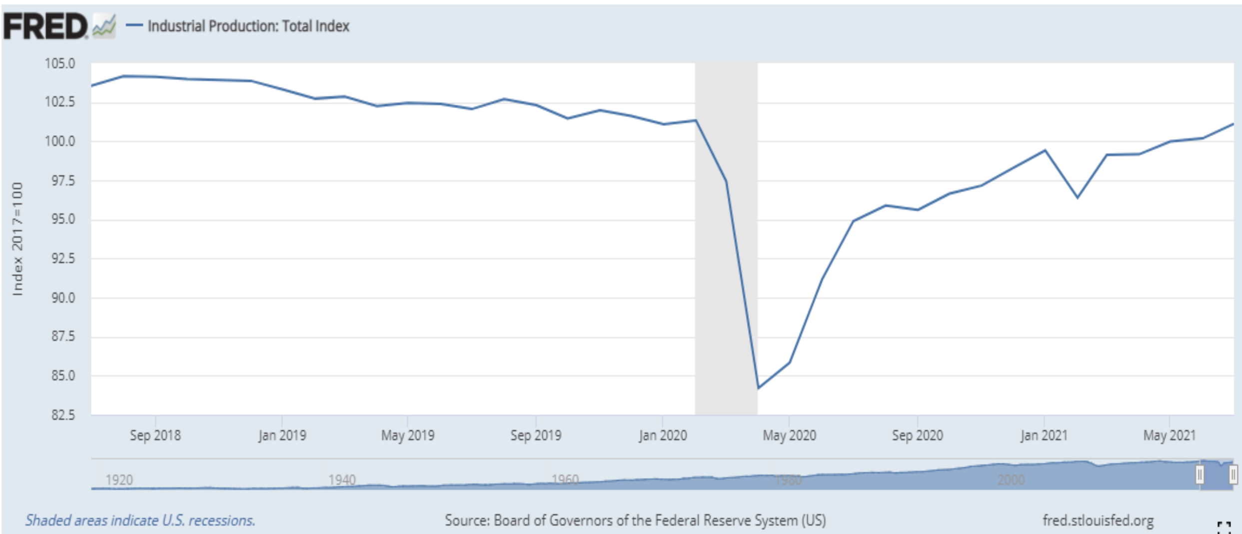
Valuation

S&P 500 profit estimates following the second quarter earnings season took a relatively big jump from about $189 this calendar year to roughly $198. For 2022, profit estimates rose from $211 to nearly $218.

The markets are being supported by the growing economy, the continued rise in corporate profits, and the accommodative policy from the Federal Reserve,

Economic Cycle

The U.S. economy grew at a revised 6.6 percent in the second quarter, up from the previous 6.5 percent estimate and the 6.3 percent increase in the first quarter. The Leading Economic Index (LEI) increased 0.9 percent, and industrial production rose 0.9 percent, although it is still lower than it was in 2018 as seen in the chart below. The Institute for Supply Management (ISM) Manufacturing index was a solid 59.9 in August.



The University of Michigan Consumer Sentiment index, however, dropped roughly 11 points in August to the lowest reading since 2011. That is remarkable given it is even lower than the pandemic readings of a year ago. The Federal Reserve's favorite inflation gauge - the core (meaning excluding food and energy prices) personal consumption expenditures (PCE) - rose 3.9 percent year-over-year, a thirty-year high.

Sentiment

Similar to consumer confidence, bullish investor sentiment has moderated from over 60 percent in July to the low 50 percent range. Likewise, bearish sentiment has increased from about 15 percent in early August to over 21 percent recently.

Clearly, this change in sentiment has not prevented the market from recording new highs, but investors seem to be getting concerned about the Delta variant as well as the end of the enhanced unemployment benefits.

Technical Factors

The equity market has been rising almost in lockstep with the continued expansion of the Fed's balance sheet. However, along the way there have been several corrections, either in specific industry groups or in sectors of the market, including the NASDAQ Composite earlier this year.

This can be seen looking at the percentage of stocks trading above their 50-day moving average. In late May/early June, more than 75 percent of stocks were trading above their 50-day moving average. By mid-July, that number fell to around 45 percent before moving back to the high 60s percent range.

New highs in the major equity indices confirm the bullish uptrend that has been going on since October, precisely with the Fed expanding their balance sheet. When asked about the correlation, Fed Chairman Powell responded that it is "very hard to say with any precision" what is affecting the stock market.

Outlook

The withdrawal from Afghanistan dominated the news and possibly set the stage for problems down the road. While the administration can attempt to spin and deflect blame, none of what took place was lost on our adversaries. The world was watching. Following the debacle in Afghanistan, the China Global Times tweeted "From what happened in Afghanistan, those in Taiwan should perceive that once a war breaks out in the Straits, the island's defense will collapse in hours and US military won't come to help."

Once a war breaks out? The one thing that China needs but does not have is the capacity to manufacture leading-edge semiconductors, and roughly 90 percent of those leading-edge semiconductors come out of Taiwan.

Taiwan Semiconductor Manufacturing Company (TSMC) is by far the world's leading semiconductor producer. In many cases, there are no second sources for the chips. Taiwan believes it's an independent country. China believes Taiwan is part of its territory. Simply put, if China were to invade Taiwan, Apple would not have chips for their iPhones. And that goes for many other companies. Taiwan is the ultimate chess piece.

Russia took over Crimea and, for the most part, nothing happened. China essentially bypassed the Hong Kong legislature to effectively take control and eliminate the "one country two systems" structure.

In July, President Biden said a takeover of Afghanistan by the Taliban was unlikely to happen. It happened. Now the narrative from the White House is essentially everybody knew that it was going to happen. This is not inspiring. Moreover, when Secretary of State Antony Blinken was interviewed about this on a Sunday national TV show, he said "I was on the phone with President Karzai the day before." President Karzai left office in 2014.

While this may seem minor to some, it goes to a bigger issue that the administration is not on top of things and some of what they have told the public has been wrong or untrue. For example, the administration denied knowing about criticism regarding our departure from Afghanistan while Armin Laschet, who replaced Angela Merkel as the leader of Germany's ruling Christian Democratic Union, referred to the American withdrawal as "the biggest debacle that NATO has suffered since its founding."

Hopefully we are going to get it together, but many of our allies seem to believe we are vulnerable. China's tweet may just be propaganda, but it's a fact that China fighter jets have been buzzing the island of Taiwan almost daily.

Regarding the Fed, its balance sheet has ballooned to more than $8.3 trillion and they seem to have hitched monetary policy to the level of employment when it is being distorted by government payments. Part of Powell's August speech seemed to be revisionist history when he spoke of the lag that monetary policy can have on the economy.

Apparently, Mr. Powell forgot about the "lag" in 2018 when the Fed was not only hiking interest rates at a time when the U.S. economy was already decelerating and global trade was down about 30 percent year-over-year, but also reducing the size of its balance sheet. In fact, in December 2018, Mr. Powell said "if you run the quantitative easing models in reverse, you would get a pretty small adjustment in economic growth and real outcomes." As such, he said the Fed's balance sheet reduction was on "automatic pilot."

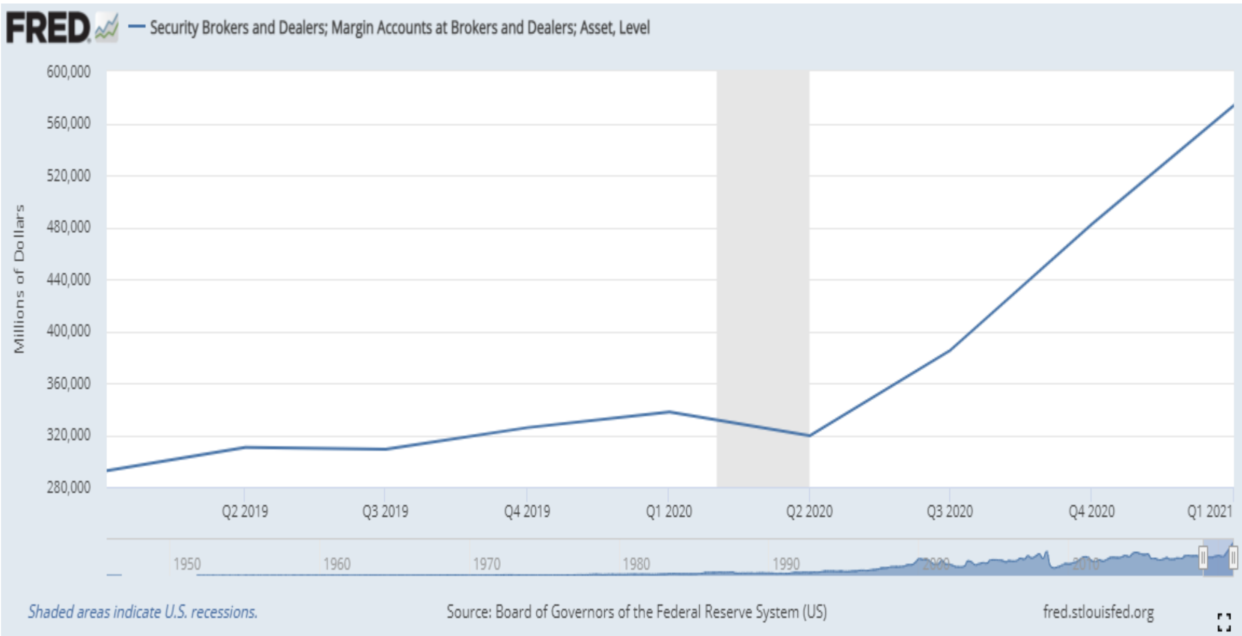
In December 2018, the Fed's assumed "pretty small" adjustment based on theory caused the S&P 500 index to decline more than 9 percent for the month and nearly 14 percent in the fourth quarter. Roughly two weeks later Mr. Powell, reading from a script, said "there is no preset path for policy."

From automatic pilot to no preset policy in two weeks!

Liquidity is an extremely important component when it comes to financial conditions, but psychology is a crucial element. Financial markets run on confidence, and when confidence erodes, markets can freeze up in a hurry.

The end of the first round of quantitative easing (QE1) saw the S&P 500 index decline by more than 16 percent, while the market dropped nearly 20 percent following the end of QE2. By QE3, the Fed learned to spread out the time between the gradual reduction in bond purchases and the increase in interest rates.

The sheer size of QE4 is likely to put more pressure on the Fed as they have injected an enormous amount of money into the system. There has been a surge in margin debt as seen below, and if confidence were to be shaken, institutions are likely to reduce risk exposure in a hurry.



The Fed has pledged to "support the economy for as long as needed to achieve a full recovery," but that it could be appropriate to start reducing the pace of asset purchases this year. They have tried to alleviate the concern about the eventual reduction in bond purchases by stating that after asset purchases end, they will continue to support accommodative financial conditions.

While that is likely true, it is also true that geopolitical risks are on the rise, inflation is at a 30-year high, and the Delta variant among other things has caused confidence to take a hit. While the economy is growing, corporate profits are on the rise, and financial conditions are still constructive, much of that is currently reflected in the markets.

The markets have come a long way since the initial COVID shutdown and investors need to be vigilant given the recent state of affairs. (9.2.21)

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