On Our Radar October 2021

The stock and bond markets came under increasing pressure in September as higher inflation, slowing economic growth, drama over raising the debt ceiling, and a possible default by China's largest property developer weighed on markets. More importantly, the Federal Open Market Committee (FOMC) suggested that the Federal Reserve could begin to "taper" the pace of bond purchases beginning in November.

The S&P 500 index fell 4.75 percent in September with much of that coming in the last few days of quarter-end. The yield on the 10-year Treasury Note rose 0.22 percentage points to 1.52 percent in four weeks, and a barrel of West Texas Intermediate oil rose from about $68.50 to $75.

Political brinksmanship over the debt ceiling was front and center as Treasury Secretary Janet Yellen warned of "catastrophic consequences" should the U.S. default on its debt. She went on to say it could cause "a steep drop in stock prices" and put the economy into recession.

If you say things like that near the end of a quarter when liquidity is light, it is going to cause a reaction. Despite the rhetoric, however, the reality is that the democrats can raise the debt ceiling by themselves. This is about politics. But if you are going to play with matches, people can get burnt.

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) met in September and kept monetary policy unchanged. The federal funds rate remains near zero and monthly bond purchases of $120 billion will continue for now. However, Chairman Jerome Powell said a gradual tapering of the monthly bond purchases "may soon be warranted," and could conclude "around the middle of next year."

The Fed's policy normalization principles call for reducing securities purchases in a gradual and predictable manner. Therefore, if the Fed plans on concluding the process around the middle of next year, they could start to reduce their U.S. Treasury and mortgage-backed security purchases by $10 billion and $5 billion a month, respectively, in November. If that were to happen, the Fed's bond buying would be over by June 2022.

Of greater concern is inflation. For the past year the Fed has said that higher inflation is "transitory" due to base effects, that is, comparing today's prices to the artificially low ones of one year ago that were impacted by the shutdown. However, the maximum impact of the base effects should have been seen in the second quarter. As such, Chair Powell has been forced to acknowledge that "Inflation is elevated and will likely remain so in coming months."

Nevertheless, Mr. Powell assures us that high inflation readings will "abate." Unfortunately, the Fed's track record on inflation is - to be candid - horrible. As we have stated previously, for eight years (2012- 2020) the Fed assured the public that the low inflation readings were "transitory." After eight years, the Fed came to grips with reality.

The fact is the Fed is terrified of deflation, especially with the mountain of debt the U.S. has accumulated. As a reminder, the deflation in house prices caused the subprime mortgage market to collapse in 2008. Therefore, near the low of the COVID-restricted economy when interest rates on the 10-year U.S. Treasury Note were trading around 0.6 percent, the Fed changed monetary policy. The new monetary policy framework that was adopted in August 2020 can be viewed as a form of inflation targeting.

Back in 1997, former Fed Chairman Ben Bernanke and Frederic Mishkin published a paper on inflation targeting and addressed the issue of supply shocks. The paper suggested the procedure if one were to occur: "convincing the public that the consequences of a supply shock are only a **one-time** rise in the price level, rather than a permanent increase in inflation." (Emphasis added)

Interestingly, in March 2021, Jerome Powell said "these **one-time** increase in prices are likely to have only transient effects on inflation." As such, the Fed expected inflation to be 2.4 percent this year. (Emphasis added)

Well, the market is starting to question Jerome Powell's forecast. The CFO of a major retailer that recently reported quarterly revenues of $61 billion said "we would estimate overall price inflation of the products we're selling to be in the 3.5% to 4.5% range." What's more, he went on to describe where inflation is coming from: "higher labor costs, higher freight costs, higher transportation demand, along with container shortages and port delays, increased demand in certain product categories, various shortages of everything from computer chips to oils and chemicals, higher commodities prices."

These things do not seem to be transitory, and it does not even consider healthcare, where some premiums are reportedly up 40 percent or more.

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Valuation

S&P 500 operating profits for calendar year 2021 are expected to be around $198, putting the P/E (price/earnings) ratio at roughly 21.7-times earnings. While earnings estimates have been steadily rising this year, the rate of change has been slowing of late.

While we believe the market is fairly valued, this is just one more of the tailwinds becoming headwinds as the pace of growth slows along with interest rates trending higher.

Economic Cycle

The U.S. economy grew at a revised 6.7 percent rate in the second quarter, up from the previous estimate of 6.6 percent. The Leading Economic Index (LEI) rose 0.9 percent in August, up from 0.8 percent in July, and the Institute for Supply Management Manufacturing Index rose to 61.1 percent from the prior reading of 59.9 percent.

That said, growth concerns are starting to mount as retail sales have stalled over the past few months, consumer confidence has been declining, and industrial production slowed from the previous month's 0.8 percent increase to 0.4 percent recently. In addition, the $300 federal unemployment subsidy that had been added to the CARES Act ended in early September.

Furthermore, there are increasing concerns about the possible shortage of goods as the global supply chain is under enormous pressure. At one point in September there were more than 70 cargo ships outside of the Port of Los Angeles waiting to unload. If each ship averaged 800 containers, it would equate to 56,000 tractor-trailers worth of goods.

Unfortunately, there is a shortage of truck drivers, school bus drivers, and other workers that are essential, many of which have been taken for granted. At one point during the height of the pandemic, 400,000 crewmembers were unable to leave their ships. Indeed, the global supply chain is starting to buckle as a result of the COVID-induced strain, and it is starting to show up in prices. The Personal Consumption Expenditures (PCE) price index rose 3.6 percent year-over-year, the highest in decades. While the official unemployment rate was 5.2 percent in August, total employment remains about 5 million below pre-COVID levels. The Federal Reserve believes the actual employment rate is higher due to the low labor force participation rate, which has yet to recover from the pandemic. Yet there were more than 10.9 million job openings according to the Bureau of Labor Statistics.

Sentiment

The political infighting has been weighing on bullish investor sentiment for a number of weeks. In fact, bullish sentiment has dropped into the low 40-percent area from over 60 percent back in July.

As a reminder, we view investor sentiment as a contrary indicator, especially at extremes. When "everyone" is bullish, often it suggests that vast sums of money have already been invested. On the other hand, when bullish sentiment declines, it often suggests what investors have already done, which implies that some selling has already occurred and investors are less enthusiastic.

Technical Factors

From a technical viewpoint, the markets have been going through an internal correction of sorts that has not yet affected the major market averages. For example, at the end of August, the number of stocks that were above their 50-day moving average was over 68 percent. At the end of September that number had fallen to roughly 23 percent.

While the S&P 500 was up double-digits year-to-date at the end of September, there have been corrections along the way. For example, higher interest rates in February caused the NASDAQ Composite to fall more than ten percent over a few weeks. The Dow Jones Transportation Average as well as the energy sector experienced double-digit declines during the summer months.

Selloffs can and do happen all at once, but they can also take place sector by sector. In fact, a majority of S&P 500 constituents have experienced a peak-to-trough decline of 10 percent this year.

Outlook

Politics, the Fed, and inflation have caused a spike in volatility, a 5 percent decline in the market averages, and the ripple effect may have more to go due to one thing: confidence.

Confidence can be very fragile, and confidence in our leaders, the Fed, and the markets is crucial to sustaining a healthy stock and bond market. When confidence wanes, money starts to leave. That's how bank runs happen.

Regarding politics, the threats and pressure regarding the debt ceiling is a high stakes game of chicken. As mentioned, the democrats can raise the debt ceiling without any republican votes. President Biden signed a bill extending government funding through December 3, 2021, averting a partial shutdown, but that is separate from the debt ceiling. A default on U.S. debt could occur by October 18, 2021, according to Janet Yellen.

Lawmakers are also battling over a $1.2 trillion infrastructure bill and a $3.5 trillion reconciliation bill. Regardless of whether they pass or the ultimate amount of money they involve, the Biden

administration has said that the cost of those programs would be "zero dollars." While semantics may play well in political circles, investors likely have a different view.

Politicians may be way too complacent as competence in leadership at all levels of government is increasingly being questioned. Markets are dynamic, and there are second and third-order effects that can have significant consequences. Higher tax rates are not a cost? Higher corporate tax rates will result in lower earnings, which would likely impact the markets.

Confidence in the Fed is being questioned. The Federal Reserve talks about transparency, saying that it is fundamental to their credibility and the public's trust, yet it was recently reported that two Federal Reserve regional bank presidents were trading stocks during the financial crisis. They have the ultimate inside information, as the Fed is the "market maker of last resort," according to Ben Bernanke and Janet Yellen.

What is even more egregious, an insider at a corporation has to file stock transactions within two business days of a trade. In these cases, the Fed presidents reported the transactions roughly 18 months after the fact. Imagine being the firm that executed those trades.

When the Fed makes policy mistakes, investors usually feel the pain. The Fed agreed with the theory that subprime housing risks were small in 2008; they were wrong. Is the Fed making another mistake regarding inflation?

The new monetary policy framework that the Fed is implementing is really a back-door way of targeting economic growth. Back to the 1997 paper by Bernanke and Mishkin, they wrote "the concept of inflation is better understood by the public than is the concept of nominal GDP…if this is so, the objectives of communication and transparency would be better served by the use of an inflation target."

But a global supply chain disruption caused by a pandemic may not turn out to be a "one-time" increase in prices. And if confidence in the Fed starts to erode, the markets may be tested.

On the bright side, the political game of chicken is likely to get resolved at some point, and even when the Fed begins to taper, their balance sheet would still be growing, but by a much smaller amount.

There is no shortage of concern as we have highlighted, and the political rhetoric is likely to grow louder in the days and weeks ahead. The Fed announced that they plan on tapering bond purchases, and by definition, monetary policy is less accommodative. Therefore, the reduction of liquidity will likely turn what has been a powerful tailwind into a headwind as financial conditions become less favorable.

And politics has gotten in the way of progress. For example, many have heard about semiconductor shortages affecting production of everything from cars to game consoles, yet the Senate approved $52 billion in June – known as the CHIPS for America Act – to rebuild our semiconductor capability, yet it has not been taken up by the House.

The economy is still growing as are corporate profits, but the level of uncertainty has clearly risen. As long as the level of uncertainty is elevated, markets will be volatile. Yet in the middle of difficulty lies opportunities. (10.4.21)

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