TJT CAPITAL GROUP
REGISTERED INVESTMENT ADVISOR

On Our Radar – November 2021

Following a 4.75 percent decline in September on concerns over the U.S. government debt ceiling, higher inflation, and a slowing economy, the S&P 500 index rallied 6.9 percent in October to a new all-time high. Meanwhile, a barrel of West Texas Intermediate crude oil rose 11 percent in October to more than $83, up more than 71 percent year-to-date and the highest level in 7 years.

The interest rate on the 10-year Treasury Note was 1.55 percent at the end of October, up from 0.93 percent at year-end. Moreover, the Federal Reserve is expected to announce a reduction in the amount of monthly bond purchases, which currently is running at $120 billion per month.

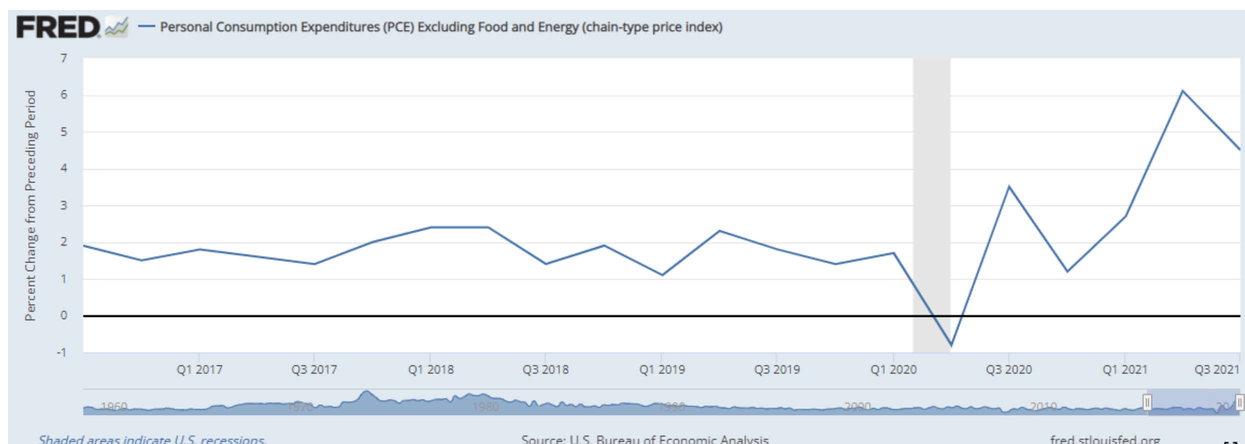
TJT Capital Group's InVEST Risk Model ® has helped our clients participate in bull markets and protect capital from the devastation of bear markets by focusing on 5 indicators that really matter when it comes to determining financial conditions. The following is the most recent update.

Interest Rates (Monetary Policy)

The Federal Open Market Committee (FOMC) meets on November 2-3, 2021, and will likely make an announcement about reducing the amount of monthly bond purchases, which have been running at $120 billion a month. The Fed's balance sheet has grown to a record $8.55 trillion, more than double the pre-COVID level.

Back in December 2020, Fed Chair Jerome Powell said the bond purchases would continue until "substantial further progress" was made on employment and inflation. The unemployment rate, which was 6.7 percent to start the year, now stands at 4.8 percent, while inflation is exceeding the Fed's target by a wide amount.

The Fed's preferred inflation gauge - the core Personal Consumption Expenditures (PCE) index -, meaning inflation less food and energy costs, increased 3.6 percent year-over-year. This is well above the Fed's 2 percent target as seen in the following chart. Moreover, it does not appear that supply chain disruptions, higher commodity costs, or higher wages are going away anytime soon.



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Valuation

As the U.S. economy continues to recover from the COVID-shutdowns, corporate profits have been on the rise. Estimates for 2021 S&P 500 operating profits rose from roughly $187 to about $199 following recent third quarter earnings reports, which helped fuel the rally.

Although some of the tax considerations are still fluid pending decisions in Washington, D.C., calendar year 2022 profits for the S&P 500 are estimated to be roughly $218 per share, up from approximately $210 three months ago.

With the economy growing and liquidity from central banks expected to continue despite an eventual Fed "taper," we consider valuation to be in neutral territory.

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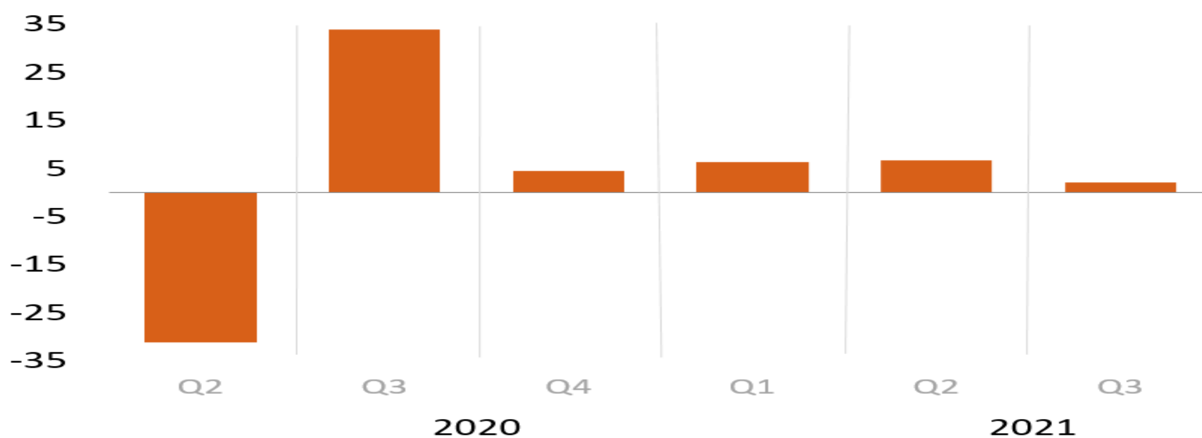
Economic Cycle

The U.S. economy grew by 2 percent on an annual basis in the third quarter, down from an increase of 6.7 percent in the second quarter and the slowest pace in more than a year. Much of the deceleration can be attributed to the delta variant and supply chain disruptions along with a slowdown in consumer spending, which rose by only 1.6 percent compared to the 12 percent increase in the second quarter as government assistance programs expired.



The slowdown in growth was confirmed by the Leading Economic Index (LEI), which increased by 0.2 percent following 0.8 percent and 0.9 percent increases the previous two months. The Institute for Supply management (ISM) manufacturing index dipped to 60.8 in October, down slightly from 61.2 in September.

The U.S. economy created 194,000 jobs in September, the fewest since January although the unemployment rate fell to 4.8 percent from 5.2 percent. Moreover, wages increased 4.6 percent year-over-year, yet consumer sentiment is lower than it was a few months ago.

Sentiment

According to Investors Intelligence, bullish sentiment rebounded following the market selloff in September. Bullish sentiment fell to roughly 42 percent from over 60 percent in July on concerns about a possible government default.

Since then, bullish sentiment is back near 50 percent and has rallied along with the markets.

We continue to look for extreme readings in either direction, which often are good contrary indicators.

Technical Factors

Market technicals have also improved following the September weakness. The percentage of stocks above their 50-day moving average fell to about 23 at the end of the third quarter, down from 68 in August, and have moved back to around 60.

In late September the markets experienced a potential shock in the form of China's Evergrande real estate development company possibly defaulting on its debt. Stocks across the board fell as the S&P 500 declined more than 3.5 percent over a 24-hour period. Since then, there has been a divergence in some sectors with healthcare generally underperforming while selective technology and small cap companies rallied.

Outlook

The sport of politics and some over-the-top rhetoric regarding the extension of the debt ceiling caused an increase in volatility in September. Treasury Secretary Janet Yellen warned of "catastrophic" consequences that would "likely precipitate a historic financial crisis…including a steep drop in stock prices" if the debt ceiling was not resolved by October 18, 2021.

As we wrote, politics aside, the Democrats could increase the debt ceiling on their own, so the probability of an actual default was low. However, when the markets have benefitted from a massive amount of liquidity and probably a good deal of leverage, anything that causes confidence to decline could potentially lead to bigger problems.

Nevertheless, as the market dodged a “catastrophic” outcome, hedge funds that made negative market bets ran to cover. Moreover, as the Biden administration infrastructure deal and the reportedly $3.5 trillion budget reconciliation package was downsized, the initial reports of higher corporate and individual tax hikes were adjusted accordingly.

Unfortunately, the debt ceiling extension was only temporary and a number of factors that led to September’s selloff remain unresolved at this time. For example, higher oil prices are likely to be with us for some time due to years of underinvestment following the financial crisis and the pressure to reduce our reliance on fossil fuels. However, that transition from fossil fuels to more green energy is going to take years.

For example, the U.S. produced about 13 million barrels a day pre-COVID. Today, we produce around 11 million barrels a day. Therefore, we are importing hundreds of thousands of barrels of oil a day to meet demand.

Back to politics, President Biden’s Chief of Staff retweeted a former Obama administration economist’s claim that “most of the economic problems we’re facing…are high class problems.” A year ago, the national average for a gallon of gas was roughly $2.20. At the end of October, it was $3.39. For many at the lower end of the income spectrum, they probably disagree as a 50 percent-plus increase in gas on top of higher food prices affects them the most.

The supply chain continues to be under a great deal of pressure from container ships trying to unload cargo at the docks, to the lack of truck drivers, to staffing issues at warehouses and distributors. In addition, companies can no longer rely solely on “just-in-time” inventory and are looking to stockpile inventory to ensure they have enough supplies on hand to satisfy demand. This is going to take time and there is no easy fix.

As such, the Fed’s “inflation is transitory” story is becoming less credible by the day. Higher energy, food, and labor costs do not appear to be transitory if the economy continues to grow. And while the Fed has been wrong on inflation for more than a decade, Chair Powell announced that the Fed “will also continue to identify the links between climate change and financial stability.”

The dynamics of the labor market have changed dramatically. Despite unemployment of 4.8 percent there are more than 10.4 million job openings. Companies are looking at higher labor costs to fill positions.

Despite all of the noise, we continue to focus on the things that really matter. On the positive side the economy is growing as are corporate profits. The Fed is expected to announce the tapering of monthly bond purchases, but its balance sheet is likely to grow for a couple more quarters.

On the negative front, inflation is likely going to be higher and more persistent than the Fed initially thought, and the debt ceiling resolution was delayed until early December. As such, we expect a higher level of volatility between now and year-end while keeping an eye out for opportunities. (11.2.21)

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