TJT CAPITAL GROUP
REGISTERED INVESTMENT ADVISOR

On Our Radar – December 2021

The S&P 500 index dropped 2.2 percent and 1.9 percent in two of the last three days of November on concerns about a new COVID variant (Omicron), rising inflation, and renewed tension over the federal debt ceiling. In November, the S&P 500 fell 0.8 percent, the yield on the 10-year Treasury Note declined from 1.55 percent to 1.43 percent, and a barrel of West Texas Intermediate oil dropped more than 20 percent to roughly $66.50.

At this point not much is known about the Omicron variant, but we do know that viruses generally mutate, and although they become more transmissible, they generally become less severe. Nevertheless, some countries have already issued travel restrictions. The initial knee-jerk reaction was “here we go again,” however, the Delta variant did not result in a shutdown and it remains to be seen what happens with Omicron.

Of greater concern is whether the Fed is making another mistake. We have been critical of the Fed because both the 2000 and 2008 bear markets in stocks had the Fed’s fingerprints all over them. Moreover, the Fed tends to deny responsibility and accountability, so there seems to be few lessons learned. For example, in 2007, former Federal Reserve Governor Edward Gramlich wrote a book titled Subprime Mortgages: America’s Latest Boom and Bust. A few years later former Fed Chairman Alan Greenspan wrote an article titled “Never Saw it Coming.”

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.

In**terest Rates** (Monetary Policy)

As expected, the Federal Open Market Committee (FOMC) announced that it will reduce the monthly pace of Treasury securities purchases by $10 billion and agency mortgage-backed securities purchases by $5 billion. The Fed plans on reducing the amount of purchases each month, known as “tapering,” but reserves the right to adjust the amount as conditions warrant.

In our April piece we documented how for more than 8 years (2012-2020) the Fed repeatedly said that inflation below its 2 percent target was “transitory.” As the economy began to re-open following the 2020 COVID shutdown, Chairman Powell repeatedly said that higher levels of inflation were “transitory.” So, according to the Fed, when inflation is below its 2 percent target for eight years it’s “transitory,” and when it’s above its 2 percent target inflation is “transitory.”

However, in his FOMC press conference on November 3, 2021, Chairman Powell was forced to acknowledge that transitory “sounds a little out of touch with what’s going on.” Moreover, Mr. Powell tried to justify the Fed’s position by attempting to change the definition of “transitory” saying “it means different things to different people.”

This is not at all comforting and suggests that the Fed’s view of the world is somewhat delusional. The Fed’s favorite inflation gauge, core Personal Consumption Expenditures (PCE) – meaning excluding food and energy costs – rose 4.1 percent year-over-year. If you include food and energy, PCE rose 5 percent year-over-year. It did not help matters, in our opinion, that

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the FOMC minutes referred to “an increase in perceived inflation,” as if higher food and gas prices are paid with perceived dollars.

To give another example, in September 2017 at The Economic Club of New York, Fed Governor Lael Brainard admitted that “inflation has come in stubbornly below target for five years.” Yet two months later, Fed Chair Janet Yellen told the Congressional Joint Economic Committee “the recent lower reading on inflation likely reflect transitory factors.”

In some circles this is referred to as theory induced blindness.

When John Maynard Keynes, the great economist and legendary money manager, was asked about changing his view, he notably answered “When the facts change, I change my mind. What do you do, Sir?” Well, over the past two decades, when the facts change, it seems as if the Fed continues to stick to its theories rather than examining if their assumptions are correct.

In 2007 and 2008, the Fed sided with academic theory that subprime mortgage risks were small. They were wrong. Rather than admit to policy mistakes, the Fed often defaults to views that were “widely held” or that “studies showed.” The issue is not that the Fed is reducing its monthly bond purchases, something we have written about for months, it’s that the Fed has been denying that inflation was becoming a problem by disregarding evidence to the contrary. That goes directly to their credibility.

Consider this: The U.S. economy experienced a COVID-forced shutdown followed by unprecedented monetary and fiscal support, which produced the shortest U.S. recession on record. There was no historical precedent for that occurring. Similarly, there is no historical precedent for 4.4 million people quitting their job in one month as was the case in September. Yet when it comes to inflation, the Fed seems to have ignored facts and data and relied on theory which has little relevance to COVID-related issues.

On November 30, 2021, after denying reality for months, Chair Powell told a U.S. Senate Committee that the Fed might have to reduce its bond buying program more quickly. For someone who often said that they would provide advanced notice of policy actions so the market would not be surprised, the market seemed to be surprised.

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Valuation

The S&P 500 index ended November at 4567.00. Current earnings estimate for 2021 are about $202, while 2022’s estimates are roughly $219. Therefore, the P/E ratio (Price/Earnings) for the S&P 500 index is roughly 22.6-times 2021 earnings, and 20.8-times 2022 estimates.

However, third quarter earnings estimates are roughly flat with the second quarter as supply chain issues, higher transportation costs, and higher wages are impacting profit margins. This

needs to be watched closely as earnings growth has been one of the pillars to the stock market's advance.

Economic Cycle

The U.S. economy grew at a revised 2.1 percent pace in the third quarter, down from 6.7 percent in the second quarter. The Conference Board Leading Economic Index (LEI) increased by 0.9 percent, and the Institute for Supply Management (ISM) Manufacturing index was 61.1 in November versus 60.8 in October, which indicates continued growth.

Every economic cycle is different in some respects as the economy continues to evolve, but the fact that 4.4 million people, or 3 percent of workers, quit their job in September suggests something very strange is happening. Perhaps that is why the University of Michigan consumer sentiment index was 67.4, the lowest since November 2011.

Sentiment

According to Investors Intelligence, bullish sentiment rose from about 40 percent following the late September selloff due to the possibility of a U.S. government debt default to more than 56 percent at the end of November. However, as we noted previously, a number of issues that caused volatility to spike in late September and early October remain unresolved.

As we get into the last month of the year, liquidity could be pulled back causing relatively big changes in sentiment.

Technical Factors

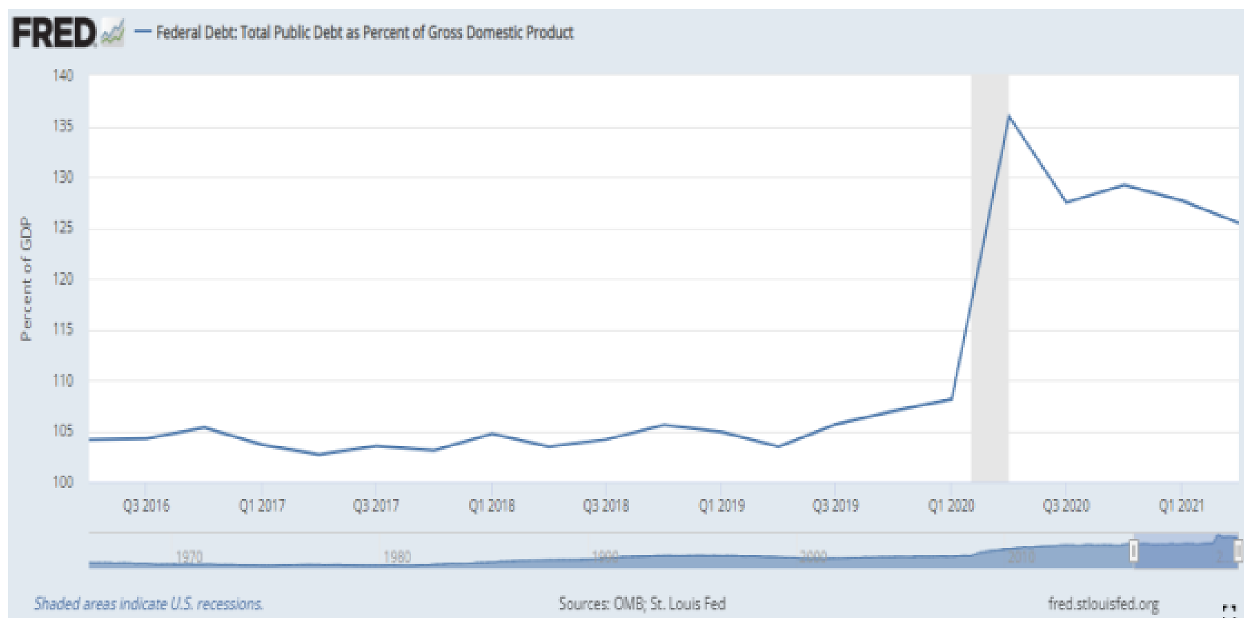
Volatility has picked up and there has been a significant change in some areas of the market. For example, a number of companies with little to no earnings have come under some severe selling pressure. A number of these fall under the “meme” category that were internet chat-room favorites.

Interest rates on high yield bonds have risen by more than 80 basis points (0.80%) since mid-September, and the percentage of stocks trading above their 50-day moving average has gone from about 23 in late September to roughly 73 in mid-November to 50 percent at month end.

There have been some massive moves in some stocks of late. The number of stocks making new 52-week highs have been dwarfed by the expansion of new 52-week lows. The reality is the U.S. stock market has already experienced some fairly significant price corrections underneath the surface of the indices.

Outlook

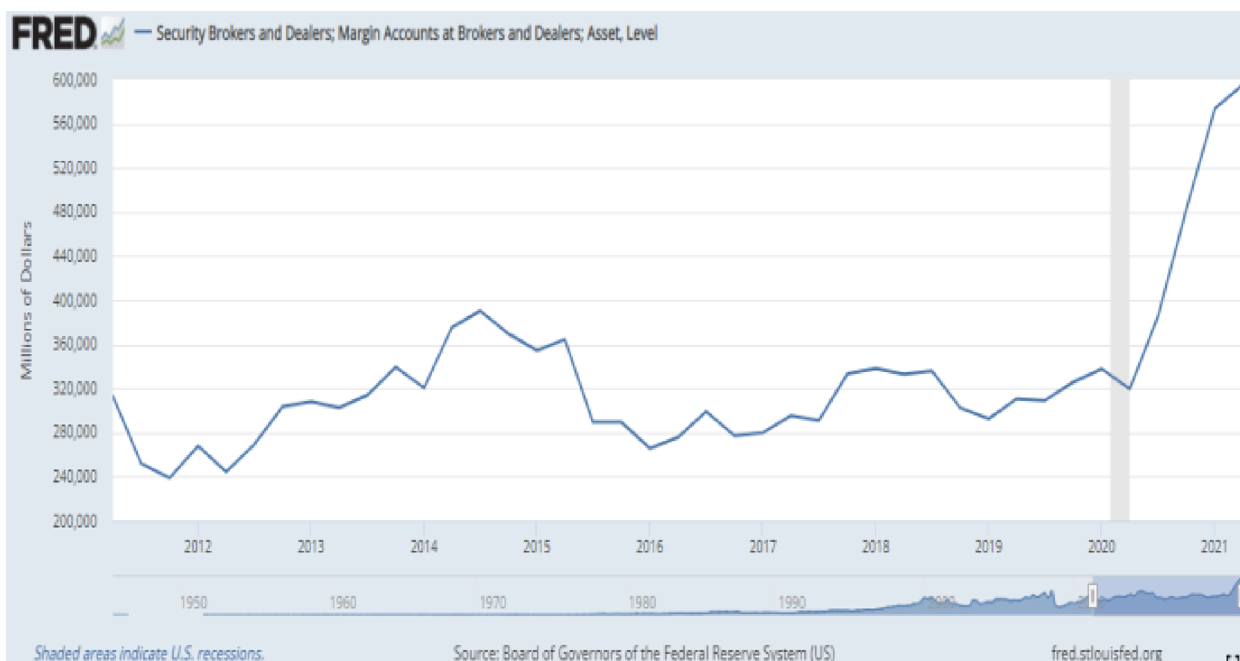
Credibility is important because when the markets and/or the economy is at a crossroad, confidence in leadership is essential. The U.S. economy is roughly $22 trillion and federal debt is about $28.5 trillion. Therefore, total public debt as a percent of Gross Domestic Product (GDP) is currently over 125 percent. Although down from the recent peak of nearly 136 percent, it is still the highest in decades.



It seems as though the Biden administration has gotten the memo that higher prices are not sitting well with voters. In just a few weeks the pendulum has swung from Biden’s Chief of Staff

retweeting that inflation is a "high class problem" to where the Federal Trade Commission (FTC) has ordered a number of large U.S. companies to shed light on disruptions that "are causing serious and ongoing hardships for consumers."

U.S. stock inflows in 2021 have been massive and as this was happening, margin debt exploded to an all-time high as seen in the following chart. Lower growth, higher inflation, less Fed support and potentially higher corporate taxes are not conducive to supporting that amount of leverage indefinitely. With computer generated trading making up a larger percentage of the daily stock exchange volume, any perceived mistake by the Fed could result in a significant reduction in risk assets.



The Fed, Congress, and the Biden administration need to understand that confidence is essential, especially late in a cycle as there are 2nd and 3rd order effects. While the Biden administration's $1.75 trillion Build Back Better plan is being debated, the Congressional Budget Office (CBO) said it will add $160 billion to the federal debt as Treasury Secretary Janet Yellen, President Joe Biden, and others claim "it is fully paid for and will reduce the deficit."

It's worth noting that President Biden said the original $3.5 trillion framework would "cost nothing." The "fully paid for" and "cost nothing" references mean that should it go through, corporate taxes will be higher, and there is a proposed tax on corporate share buybacks. That will almost certainly affect the stock market.

It remains to be seen whether the Build Back Better plan gets approved.

So, as we enter the last month of 2021, the market will be dealing with potentially another standoff regarding the debt ceiling, which was one of the reasons why the S&P 500 index

declined 4.5 percent in September. In addition, the Fed is clearly signaling that the historic liquidity that helped support the economy and the markets is coming to an end.

Moreover, tax-loss selling and potential “position unwinds” by hedge funds will likely cause volatility to remain high. While the Fed has been adamant that monetary policy will remain accommodative even after they stop buying bonds, the market is likely to experience an adjustment as the tailwind of liquidity changes.

As a result, investors need to recognize that the level of uncertainty is quite high, and will likely remain so until some of these important issues are resolved. (12.2.21)

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