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TechnoMental Component Report Stocks & Bonds

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Stocks and Bonds

The stock market continued to digest the latest CPI report which showed that inflation in October reached a thirty-year high. Employment reports have been bullish for the economy; meaning rate hikes are on the horizon. While higher interest rates are typically bearish for the stock market, inflationary pressures that weigh on money's purchasing power are pushing all asset prices higher, and stocks are no exception. Earnings remain robust, but corporate tax hikes could cause some weakness in the equity markets over the coming months.

Over the past week, the S&P 500 rose 0.90%. The NASDAQ moved 1.91% higher, while the DJIA posted a 0.41% loss. The VIX was at the 17.02 level, 9.13% below the level on November 10, as stocks mostly rose over the past week.

The bond market declined over the past week, correcting after the recent gains. The Fed began tapering QE at a rate of $15 billion per month in November, but rate hikes are not likely on the horizon until late 2022, at the earliest. Tapering is not tightening, but rising inflation could cause the central bank to accelerate tapering and increase the Fed Funds rate earlier than they are currently projecting.

Each 25-basis point hike in interest rates would cost an additional $75 billion in debt servicing costs with the debt at the $30 trillion level. The Fed is caught between a rock and a hard place when it comes to increasing the Funds rate as inflation rises. Progressives are pushing the President to put a more dovish economist in the Chairman's seat. Perhaps the most significant factor against a reappointment is that former President Trump put Jerome Powell in his current role. I expect that another Fed chief, Lael Brainard, will cause the market to expect higher inflationary pressures, which could be bullish for stocks and commodity prices. Senator Elizabeth Warren called Chairman Powell "dangerous," increasing the pressure on the administration to replace him with the more progressive economist. Another term for the current Chairman would likely lead to a more hawkish approach to monetary policy. While QE tapering began this month, the markets would likely interpret replacing Chairman Powell as dovish for future monetary policy decisions. Former Larry Summers and Jack Dorsey have voiced concerns that inflation is getting out of control. At the same time, Chairman Powell and Treasury Secretary Yellen continue to blame it on "transitory" factors, including supply chain bottlenecks and other pandemic impacts. However, they seem to be realizing the data may be more inflationary than they previously believed.

Meanwhile, the Fed and Treasury have not addressed the role that monetary and fiscal policies have played in creating the current environment where prices are rising at the fastest rate in three decades. As of November 17, there is a 50-50 chance the President will reappoint Chairman Powell for another term. The odds for the sitting Chairman improved after the recent election results, but Lael Brainard is waiting in the wings to replace him. The latest word is that we will hear President Biden's decision by the end of this week.

Chinese stocks rose and outperformed US stocks over the past week in a reversal of the trend that had been in place for the better part of 2021. DIDI reached a high of $18.01 on June 30 and was trading at the $8.64 level on Wednesday. DIDI declined 31.0 cents from the level on November 10. DIDI has made higher lows at $7.16 on July 26, $7.18 on August 19, $7.26 on October 4, and $7.95 on November 5. The FXI rallied since November 10.

Source: BarChart

The China Large-Cap ETF product (FXI) settled at the $41.16 level on Wednesday, as it rose 3.37% since November 10. Technical support is at the October 4 $37.45 low, the lowest level since May 2020. The FXI product remains far below the all-time peak at $73.19 back in 2007, while US stocks have made a string of record highs. The high in 2021 came on February 17 at $54.52, the technical resistance level that continues to fade into the distance. China is the demand side of the equation for commodities as it is the world's second wealthiest and most populous nation.

As I have been writing:

"Chinese stocks carry significant political risk given the government's heavy hand and role in business and international investments."

Charlie Munger's Alibaba (BABA) purchase was a signal that value investors are now accumulating Chinese shares at bargain prices compared to US shares. The rally that took the FXI from the October 4 $37.45 low to the October 22 $42.70 high ran out of steam, but the ETF made a comeback over the past week, in a sign that investors are buying the dip. President Biden and President Xi had a summit this week, which may open the path towards more cooperation. Any easing of tensions could cause the FXI and Chinese stocks to rebound as they offer compelling value compared to US stocks.

December US 30-Year bonds moved lower since November 10. The bond market faces opposing forces as inflation increases, and the Fed continues to purchase debt securities each month despite the tapering. The Fed Funds rate remains between 0% and 0.25%, but the central bank only determines short-term rates. Medium and long-term interest rates are a function of the supply and demand for bonds. The quantitative easing program attempts to push bond prices higher, but rising inflationary pressures have had more effect, pushing bonds lower and interest rates higher. The trend in the bond market and technical break on the downside was a sign that the Fed was losing control of the market on longer-term interest rates. The bonds broke lower over the past weeks after rising since March, running out of upside steam in July and August, consolidating in September, and making lower lows since late last month. However, they rallied sharply on October 22 and 27 and have followed through in early November before pulling back.

Rising rates could eventually ignite selling in stocks and create another crisis for the central bank, which is between a rock and a harder place. However, short-term rates are not likely rising until late 2022, which has propelled the stock and bond markets higher. The government stimulus under the Biden administration will continue to flow. Even if the Fed moves towards a slightly more hawkish stand on monetary policy, fiscal initiatives remain unprecedently dovish. A more dovish Fed chief could cause a battle between the bonds and the central bank. The market remains in the dark as the President has given no indication of his intentions for who will be the Fed chief in 2022. There is likely lots of horse-trading going on behind the scenes between progressive and moderate Democrats. Chairman Powell could be on the trading block in exchange for support for the lower budget. Meanwhile, the poor showing by Democrats in the recent election could favor Chairman Powell as he appeals to moderates and Republicans and would be the optimal bipartisan choice.

Consumers are not exempt from rising food and energy prices, so the core CPI measure is a bit of a fantasy. Higher prices continue to take a significant bite out of consumers' paychecks. Time will tell how quickly and decisively the Fed is willing to act. Last year the central bank changed its inflation target from 2% to an average of 2% in August. They got more than they bargained for with the CPI data in 2021. The central bank began tapering, but a new Fed Chief could shift monetary policy over the coming months. Chairman Powell's term will end in early 2022. Even the most aggressive tax hikes in history will not pay for the trillions in stimulus and other initiatives over the past year and those now before Congress. The US Treasury Secretary worked with other nations to establish a 15% minimum corporate tax structure. The initiative pushes the US towards economic globalism.

On Wednesday, November 17, the December long bond futures contract was at the 160-20 level as it fell 0.89% lower over the past week. The December 30-Year Treasury bonds futures made a low at 157-03 on October 11. The bonds broke below the first level of support, but reversed, and technical support is now at the October 29 159-18 and the October 11 157-03 level. Short-term technical resistance is at 164-01, the November 9 high on the December futures contract. Upward pressure on rates further out on the yield curve over the past year had been an inflationary signal for markets. The October jobs report propelled stocks and bonds higher. October CPI sent them lower.

With Chairman Jerome Powell at the head of the central bank and former Chair Janet Yellen, the Treasury Secretary, the doves have their hands firmly on the wheel of the US financial system. However, the situation could get even more dovish if progressive Democrats get their way and push the President to replace Chairman Powell. The Fed was encouraging inflation, but up until recently, it ignored the evidence in raw material markets and other asset markets that could lead to a far larger dose of the economic condition than it is bargaining for over the coming months. Once a ball begins rolling, it could pick up momentum and becomes more challenging to stop. The current concerns are over inflation or stagflation, which could be even worse for the economy.

Energy, agricultural, metal, and mineral prices have been trending higher over the past months. Bull markets rarely move in a straight line. Commodities can be highly volatile; they rise higher than most believe possible, and corrections can take prices far lower than logical levels. However, the trends since the 2020 lows remain very bullish despite the recent corrections over the past weeks. The most recent commodities to take the bullish torch have been coffee, wheat, and ethanol.

The tidal wave of liquidity and tsunami of stimulus comes with a price tag that will not be satisfied with a gradual shift towards tightening monetary policy. The stock market's rise over the past year could be a mirage as it may reflect a decline in money's purchasing power instead of bullish fundamentals for many companies.

Meanwhile, even the most aggressive bull markets rarely move in a straight line. Periodic severe selloffs are the norm, not the exception. Bull market corrections can be sudden and brutal, as witnessed in more than a few markets. The overall trend in raw materials and other asset prices, including stocks and cryptocurrencies, remains higher, a clear sign of inflationary or stagflationary pressures. A capital gains tax hike could eventually cause selling in the stock market as investors cash in on significant profits and need to sell more shares to pay the government more at tax time. Moreover, higher corporate taxes trickle down to the consumer, so all Americans from rich to poor will be paying more to the government either directly or indirectly. Higher inheritance taxes could increase selling.

Over the past years, retirement accounts have provided the stock market with consistent and natural buying, making the path of least resistance for stocks higher. Rising taxes could interfere with the phenomenon and balance buying and selling or even create periods where selling overwhelms buying, adding to stock market volatility and creating more significant downdrafts.

US government remains divided even though Democrats have majorities in the House of Representatives and the Senate. However, the majorities are razor-thin, and the midterm elections are coming closer each day. An agreement on infrastructure rebuilding will create more stimulus and stoke inflationary flames. The 2022 midterm elections will increase the partisan divide. The administration's support has slipped in the polls because of the continuation of the pandemic, a hasty and problematic departure from Afghanistan, and other issues. The election results from Virginia, New Jersey, and Minnesota were a five-alarm warning for Democrats. Compromise on the budget initiative is likely to cause the spending to drop, which is dividing Democrats along moderate and progressive lines. We will likely see the reductions come from cutting the spending timeline, which would set upcoming elections in 2022 and 2024 as referendums for the initiatives. The economic and political landscapes remain reasons why a sudden downdraft in stocks would not be a surprise.

However, expectations for an October correction were likely elevated, leading to the recent rally and move to new highs in the S&P 500 and other stock market indices. As I pointed out over the past weeks, inflationary pressures pushing the stock market high could be a mirage if money's purchasing power is declining at a faster rate than stocks are appreciating. Two weeks ago, I posted a chart of the stock market in Bitcoin terms, which shows a bearish instead of a bullish trend in the equities. If Bitcoin has been an inflation indicator, the stock market is little more than a feel-good mirage for investors.

Open interest in the E-Mini S&P 500 futures contracts moved 0.70% higher since November 9. Open interest in the long bond futures moved 2.12% higher over the period. Over the long term, fighting the Fed has been a losing battle, but the last year remains an exception. The bond market lined up with the Fed's plans to tighten credit in late 2022, but the jury is still deliberating as it is unclear who will be running the central bank in 2022.

The VIX at 17.02 on November 17 was 9.13% lower since November 10. Taxes and regulations will increase, which is not bullish for the stock market. I continue to favor trading the VIX and related products from the long side on price weakness. However, VIX-related products are not for long term investments. They are instruments to buy on dips and take profits on rallies. I am using very tight stops on VIX-related products, buying on dips. Commodities, stocks, cryptocurrencies, and bonds have been significant barometers of inflationary pressures over the past year. In 2021, the bond market told us that the Fed policies have significant inflationary side effects. A correction in stocks could cause the bonds to turn higher.

Meanwhile, China is a substantial holder of US debt. As the tensions between Washington and Beijing remain elevated, any Chinese selling could push rates much higher further out along the yield curve.

However, the meeting between President Xi and President Biden represents a thaw in the tensions. Financing the US debt through the bond market could cause the Treasury to issue bonds with longer maturities to pay for the trillions in stimulus packages, but they better hurry. Even though yields have increased, they remain historically low.

Higher yields over the coming months and years could close a window of opportunity for fifty or one-hundred-year US debt securities to fund the deficit, which makes sense at today's rates. It boggles the mind that the Treasury is not issuing very long-dated debt securities in the current interest rate environment.

The administration is looking to raise tax rates and take advantage of the growing wealth. Markets remain more than bubblicious. We are either in a bubble, or fiat currencies are losing value at an accelerating pace. Higher interest rates and rising taxes are not a bullish cocktail for the stock market. However, TINA or there is no alternative to stocks for capital growth, and tax-advantaged retirement accounts continue to push money into the stock market.

As I wrote over the past weeks, hedging stock portfolios at or near all-time highs could be the optimal approach given the uncertain future of markets. Markets reflect the economic and political landscapes, creating high odds for lots of volatility over the coming months. I believe a very volatile period is on the horizon, and we will see lots of two-way price action in markets across all asset classes sooner rather than later. I remain concerned that as the bull moves the stock market higher, the complacency and comfort could give way to a sudden downdraft.
Be cautious in the stock and bond markets.

Over the past three weeks, I wrote:

"Substantial sell offs and corrections tend to arrive when the market least expects them."

Little changed since last week in the stock and bond markets. Be careful as bullish complacency returned to the stock market, which could be dangerous as significant moves tend to arrive when the market least expects them. Square's (SQ) Jack Dorsey has warned of "hyperinflation," which is a highly dangerous condition for stocks market markets across all asset classes. Even if stocks continue to rally, if they do not keep pace with losing purchasing power, they will lose value. I follow trends and remain long stocks, but my eyes are wide open to the potential for a sudden and dramatic reversal in the market when we least expect it to occur.

I will follow the herd at the risk of being chopped up in a directionless market. However, my goal is always to be long or short when a significant trend emerges.