TJT CAPITAL GROUP
REGISTERED INVESTMENT ADVISOR

On Our Radar – January 2022

The month of December ended a volatile six-week period with the S&P 500 index and NASDAQ Composite experiencing several weekly losses and gains exceeding 2 percent and 3 percent, respectively. Concerns about Federal Reserve policy, inflation, the Omicron variant, and the future of the Biden administration's Build Back Better, among other things, were responsible.

Nevertheless, the S&P 500 index gained 4.3 percent in December and was up 26.8 percent for the year as inflation spiked to multi-decade highs led by oil prices, which rose roughly 55 percent. Meanwhile, interest rates on the 10-year Treasury Note rose from 0.93 percent at the end of 2020 to 1.52 percent at year-end 2021.

The headline numbers by themselves were deceiving as there was quite a bit going on underneath the surface. The median S&P 500 stock has corrected 15 percent from its 52-week high, and as many as 208 stocks trading on the New York Stock Exchange and 738 stocks trading on the NASDAQ hit new 52-week lows on the week-ending December 3, 2021.

In addition, the Initial Public Offering (IPO) exchange traded fund was down more than 10 percent in 2021 despite the hype of the new issue market. It seems that a number of companies that had immature business models went public because money was available and interest was high.

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)

Fed Chairman Jerome Powell opened his December 2021 press conference following the Federal Open Market Committee (FOMC) meeting by stating that the Fed is strongly committed to achieving its monetary policy goals of "maximum employment and price stability." When you consider that inflation is running at more than twice the Fed's target, prices seem to be anything but stable.

As you can see from the following chart of the monthly 12-month percent change on final demand prices, as of May 2021 inflation was up 7.0 percent while core prices (less food and energy) were up 5.3 percent year-over-year. As of the November figures, inflation was up 9.6 percent year-over-year while the core PCE was up 6.9 percent.

Month	Change in final demand from 12 months ago (unadj.)	Change in final demand less foods, energy, and trade from 12 mo. ago (unadj.)
2020		
Nov.	0.8	1.0
Dec.	0.8	1.3
2021		
Jan.	1.6	1.9
Feb.	3.0	2.3
Mar.	4.1	3.1
Apr.	6.5	4.8
May	7.0	5.3
June	7.6	5.6
July(1)	8.0	6.0
Aug.(1)	8.4	6.2
Sept.(1)	8.8	6.0
Oct.(1)	8.8	6.3
Nov.	9.6	6.9

Footnotes: (1) Some of the figures shown above and elsewhere in this release may differ from those previously reported because data for July 2021 through October 2021 have been revised to reflect the availability of late reports and corrections by respondents.

In mid-December the Federal Open Market Committee (FOMC) announced a plan to accelerate the reduction in monthly bond purchases as they admitted that "overall inflation is running well-above our 2 percent longer-run goal." The Fed's new guidance is to reduce U.S. Treasury security purchases by $20 billion and agency mortgage-backed securities by $10 billion per month thereby ending the bond purchases by mid-March.

The FOMC decided to keep the federal funds rate at a range of zero to one-quarter percent.

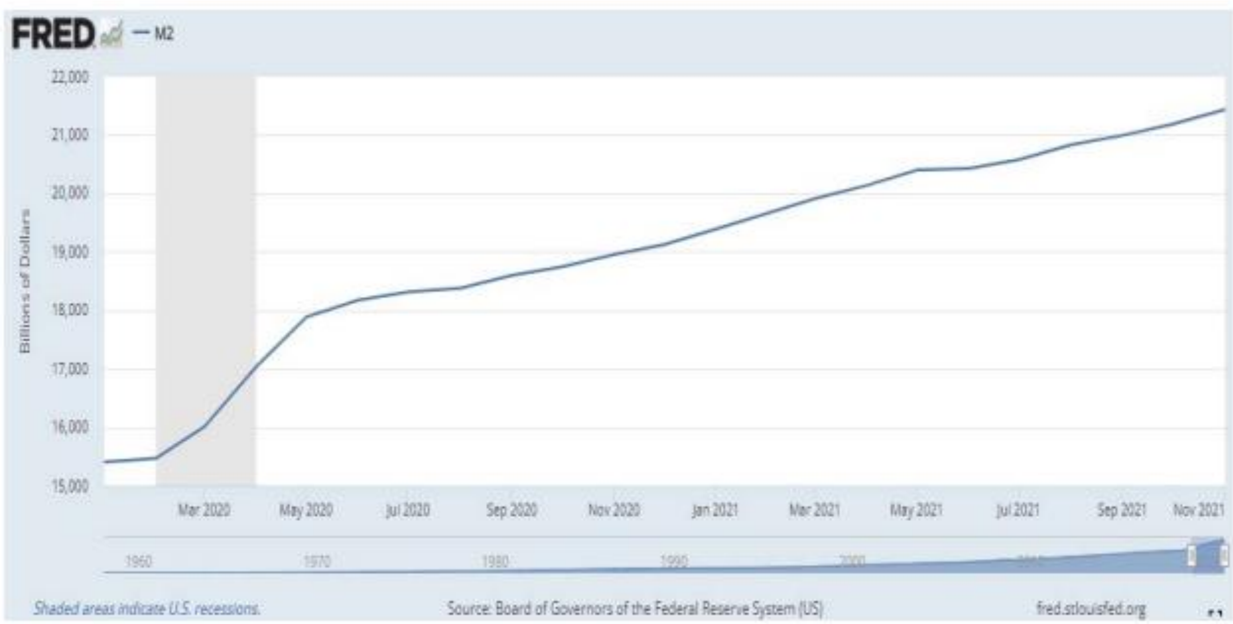
Chairman Powell attempted to deflect criticism by using phrases such as "Like most forecasters" and a "very, very widely held view in the forecasting community." Perhaps someone should remind Mr. Powell that 50 out of 50 professional forecasters in February 2008 were not predicting an economic contraction when the recession associated with the subprime crisis began in December 2007 – two months earlier.

Even more curious is that Chair Powell said that the inflation we are seeing is "not the type of inflation that we were expecting," which is irrelevant because when people have to pay more, higher prices act like a tax on consumers regardless of the "type" of inflation. Unfortunately, the

Fed seems to be focusing on the Phillips Curve (a change in inflation in relation to the change in the unemployment rate) instead of recognizing that the pandemic has affected the economy in ways never contemplated by the Phillips Curve theory.

When the Fed changed its monetary framework in August 2020, its median projection for inflation in 2021 was 1.7 percent based on a study of "recent decades." However, none of those recent decades included a pandemic-forced economic shutdown at the same time the U.S. government was handing out trillions of dollars in COVID-relief assistance. In fact, the FOMC did not expect inflation to hit 2 percent until 2023.

The Fed along with the federal government tried to stimulate demand by pumping an unprecedented amount of money into the system. As seen in the following chart, M2, a broad measure of the money supply, was up more than 38 percent since the beginning of the pandemic.



Valuation

The S&P 500 index ended 2021 at 4766, with S&P 500 earnings for calendar year 2021 expected to be roughly $201. That would put the P/E (Price/Earnings) ratio at 23.7-times earnings.

Current earnings estimate for calendar year 2022 are roughly $220. Therefore, the S&P 500 is trading at roughly 21.6-times 2022 earnings.

That said, higher interest rates often impact the P/E ratio that the market is willing to pay for earnings as persistent higher interest rates generally leads to lower P/E ratios.

Economic Cycle

The U.S. economy grew at a revised 2.3 percent pace in the third quarter, up 0.2 percent from the previous estimate, due primarily to higher levels of inventory. Economic growth decelerated from the second quarter's 6.7 percent pace as many government assistance programs came to an end in the third quarter.

Nevertheless, the Leading Economic Index (LEI) increased 1.1 percent in November, suggesting the economy is positioned to grow into the first half of 2022. The Consumer Confidence index also increased in December but is still well-below levels reached over the summer months.

Despite the unemployment rate falling to 4.2 percent in November, there were more than 11 million job openings at year-end. Wages are rising at their fastest pace in years, which along with higher food, energy, healthcare, and housing costs are causing inflation to surge.

Sentiment

According to Investors Intelligence, bullish sentiment ended the year in the low 40-percent range after having been in the high 50-percent range in November. It is worth noting that bearish sentiment rose above 25 percent in early December, the highest reading since May 2020.

As with the overall market, we expect sentiment to be volatile as investors adjust to the new realities.

Technical Factors

Volatility has picked up over the past few months and weakness can be seen in the percentage of stocks trading above their 50-day moving average, which hit 40 percent in early December. To provide some context, this number was above 73 percent in November.

While some of that can be traced to year-end tax loss selling, it would appear that the change in Fed policy is causing quite a bit of rotation in and out of some sectors.

For example, more than 440 stocks in the NASDAQ Composite hit new 52-week lows for the week-ending December 17, 2021, and another 343 hit new 52-week lows for the week-ending December 31, 2021. Clearly there is a shift taking place underneath the index levels.

Outlook

We have written extensively over the years about how the Fed is prone to mistakes when they ignore reality for the sake of defending a theory. For example, in March 2000, literally days before the peak in the NASDAQ followed by a roughly 75 percent drop, Fed Chairman Alan Greenspan said regarding “lofty equity values…I see nothing to suggest that these opportunities will peter out anytime soon.”

In late March 2007 in front of Congress, Fed Chairman Ben Bernanke said “the problems in the subprime market seem likely to be contained.” This was literally days before New Century Financial, the largest subprime mortgage company in the U.S., filed for bankruptcy.

In late December 2018, Chairman Jerome Powell said “we don’t see…the balance sheet runoff as creating significant problems.” In December 2018, the S&P 500 fell more than 9 percent and the Fed soon reversed its thinking in early January 2019.

When the Fed adopted a new monetary policy framework in August 2020, Powell said “of course, if excessive inflationary pressures were to build or inflation expectations were to rachet up above levels consistent with our goal, we would not hesitate to act.” Well, the Fed hesitated to act, inflation is much higher than the Fed’s target, and now it has to play catch-up. The Fed has forecast three interest rate hikes in 2022.

To be clear, it’s not about the Fed being wrong as the U.S. economy and the global supply chain are enormously complex. Our concern is that many inside the Fed seem to live in a world of theory based on false assumptions that are unrelated to the real world.

Nevertheless, the markets are going to have to navigate slower economic growth and higher interest rates and inflation. For the Fed, the easy part is pumping money. The more challenging part is removing that accommodation without disrupting the economy or the markets.

We would also note that S&P operating profits for the third quarter (they still are not final) are expected to be $52.02, which would be flat with the second quarter. The estimates for S&P 500 fourth quarter earnings are currently $50.45, which would be a 3 percent quarter-over-quarter decline. Higher inflation and lower earnings tend to lead to lower price/earnings (P/E) ratios.

What’s more, net profit margins peaked at 13.1 percent in the second quarter. Higher inflation, including wages, are impacting corporate profitability.

Uncertainty in Washington, D.C. remains as the status of President Biden’s Build Back Better Act is still in doubt. To this day the true cost is unknown as estimates have ranged from President Biden’s “zero” dollars to some as high as $4.6 trillion if budget gimmicks are excluded. Even for objective observers the hypocrisy in Washington D.C. is stunning as some critics focus on the expiration of enhanced child tax credits - annual payments of up to $3600 for lower income families – while at the same time trying to push through $80,000 state and local tax (SALT) deductions for wealthy donors.

What investors should be aware of is that QE4 (4th round of quantitative easing) is ending regardless of how the Fed frames it and three interest rates hikes are forecast for 2022. This will be occurring at the same time the European Central Bank (ECB) and the Bank of England (BoE) are moving towards a tighter monetary policy.

While central banks are pulling back their accommodation, global economic growth is decelerating and inflation has been on the rise. As such, there is a wider range of outcomes and investors should brace for more volatility ahead.

Geopolitical tensions are also on the rise as Russia still has a large number of forces near the Ukraine border. The Group of Seven economic powers have called on Russia to de-escalate its military buildup. Meanwhile, China is still making military overtures towards Taiwan, prompting National Security Advisor Jake Sullivan to say the U.S. is going to take every action to make sure that the reunification of China with Taiwan by force “never happens.”

Complex economic and geopolitical conditions are both a challenge and an opportunity, and some sectors of the markets have already experienced healthy corrections. Nevertheless, with the reality that tailwinds are turning to headwinds, investors will need to stay vigilant as the volatility seen in the past few months is likely to be with us in 2022. (1.3.22)