## On Our Radar – February 2022

In our early December piece, we wrote "Of greater concern is whether the Fed is making another mistake." And specifically, "any perceived mistake could result in a significant reduction in risk assets" as "hedge funds are exceptionally good at crowding the exits." That is exactly how the year began.

A rough start to the year got even worse following a press conference by President Joe Biden whereby the S&P 500 index dropped 6.8 percent over the following three days. That is not a political statement – it is a fact. It is quite clear that the markets did not like his comments that suggested a "minor incursion" by Russia into Ukraine would be tolerated, and that the 2022 elections might not be legitimate.

The S&P 500 index declined 5.25 percent in January having been down more than 11 percent only a week before. The bond market sensing a major mistake by the Federal Reserve regarding inflation saw the 10-year U.S. Treasury yield rise from 1.35 percent on December 3, 2021, to 1.87 percent on January 18, 2022. The nearly 40 percent increase in interest rates over a seven-week period was a catalyst for a selloff in the U.S. equity markets, with the NASDAQ Composite falling more than 15 percent at one point in January.

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)

In August 2020, the Federal Reserve changed its monetary policy framework based on the assumption that inflation would remain too low. It seems that the Fed totally ignored the more than $5 trillion of government stimulus – also known as "helicopter money" per former Fed Chair Ben Bernanke - and the effect that could have on the supply chain. The Fed was determined to increase aggregate demand and believed that pumping the economy would be good for large segments of the population.

However, at the time of the August 2020 policy change, Fed Chairman Jerome Powell said "of course, if excessive inflationary pressures were to rachet up above levels consistent with our goal, we would not hesitate to act." The Fed's inflation target for the past ten years has been 2 percent.

A couple of months following the 2020 policy change, Fed Governor Lael Brainard gave some further insight into the Fed's plan in a speech titled "Achieving a Broad-Based and Inclusive Recovery." In that speech Ms. Brainard revealed that the new strategy would eliminate "the rationale for removing [monetary] accommodation preemptively," and that it was important for the Federal Open Market Committee (FOMC) to "stay the course resolutely" and let inflation run.

Also regarding policy, in a recent speech to the World Economic Forum (Davos), U.S. Treasury Secretary and former Fed Chair Janet Yellen spoke of "modern supply side economics," which

seeks to reduce “inequality and environmental change.” To our knowledge this is the first time that Ms. Yellen articulated the U.S. Treasury’s “new approach” with the focus being on inequality.

When you combine what Lael Brainard said along with Janet Yellen’s “new approach,” it would seem that the Fed and the U.S. Treasury were essentially conducting a social experiment that may have backfired, causing pain and hardship through substantially higher inflation for those at the lower end of the income spectrum while putting the economy and the stock and bond markets at risk.

The violent move up in interest rates and the sharp decline in stock prices can be attributed to the Fed’s failure to recognize inflation which was right in front of their eyes. Once again, the Fed appears to have voted for theory rather than reality as 40-year highs in inflation is not consistent with “price stability,” which is one of the Fed’s core mandates.

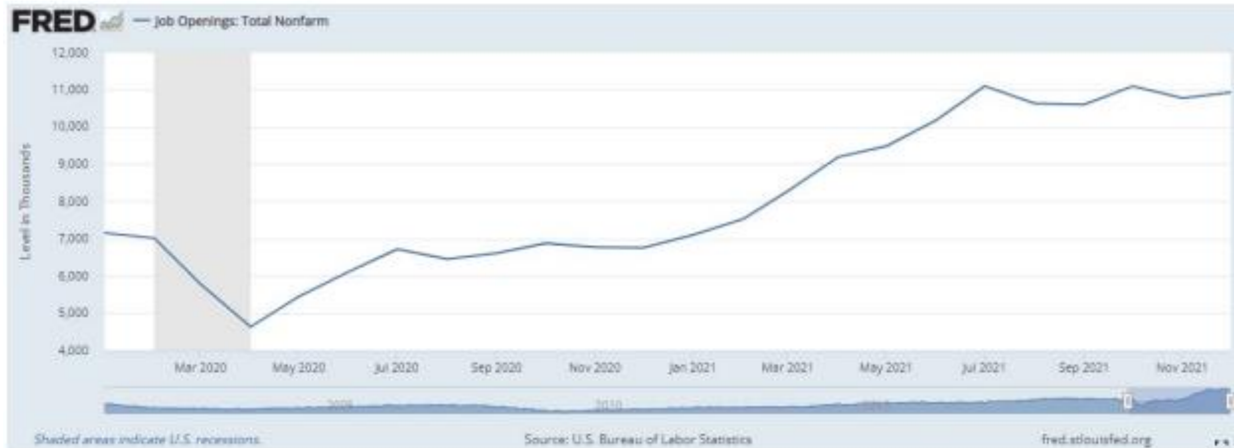
In reality, the Federal Reserve is way behind the inflation curve, and having inflation at 40-year highs and the federal funds policy rate at a target of zero to 0.25 percent is insane. The market is saying that the Fed’s credibility has taken a hit.

In his January 11, 2022 renomination hearing to continue as Federal Reserve Chairman, Jerome Powell admitted that “Both the initial shutdown and the subsequent reopening of the economy were without precedent,” yet the Fed used precedent to guide its inflation outlook. In fact, in her October 2020 speech, Lael Brainard said “my baseline forecast for inflation over the medium term is for it to remain short of 2 percent over the next few years.”

As prices rose, the Fed seemed to be focused on the supply chain disruptions and ignored the demand side, demand that they helped create with trillions of dollars in unprecedented amounts of bond purchases (“QE”). When you inject trillions of dollars into the economy, in addition to several rounds of fiscal stimulus, which in some cases paid people more not to work than to work, you are helping to overwhelm the supply chain. To be clear, the supply chain even at full strength could not have handled that amount of stimulus-created demand.

In March 2021, even as the COVID vaccines were being distributed and the economy was opening, Treasury Secretary Yellen championed Joe Biden’s additional $1.9 trillion relief package stating that we needed to “go big.”

In his December 2021, press conference Jerome Powell stated that the Fed was phasing out bond purchases more rapidly due to elevated inflation pressures and a rapidly strengthening labor market. Mr. Powell cited a “record level of job openings” for the coming change in monetary policy, however, the number of job openings as seen in the following chart was over 11 million back in July. This is further evidence that the Fed was focused on something other than the facts to determine policy.




## Valuation

As interest rates rise, the present value of future earnings is generally worth less. Therefore, although S&P earnings estimates are expected to rise from about $203 in 2021 to roughly $221 in 2022, higher interest rates may reduce the overall P/E (Price/Earnings) ratio of the market.

At the end of January, the S&P 500 was trading around 22-times 2021 earnings and 20.5-times 2022 earnings. However, higher inflation and tighter Fed policy could pressure the P/E ratio even more.

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## Economic Cycle

The U.S. economy grew at a 6.9 percent pace in the fourth quarter, up from 2.3 percent in the third quarter. Inflation, using the Fed's favorite statistic – the core personal consumption expenditures (PCE), which excludes food and energy costs – increased 4.9 percent in 2021, the highest annual level since 1982, while the consumer price index (CPI) increased 7 percent in 2021. Oil prices ended January near $88 a barrel, up from roughly $75 at year-end.

The Leading Economic Index (LEI) increased 0.8 percent in December suggesting continued economic growth, however, consumer sentiment fell to 67.2, down from over 100 pre-COVID, retail sales declined 1.9 percent in December, and industrial production slid 0.1 percent. The Institute for Supply Management (ISM) Manufacturing Index was 57.6 in January, down from over 61 in November.

## Sentiment

Bullish sentiment has dropped considerably since the start of the year. According to Investors Intelligence, recent bullish sentiment was in the mid-30 range compared to over 50 at the end of 2021.

As expected, bearish sentiment has been on the rise and is up to levels last seen in May 2020 as the original COVID-variant was causing a partial shutdown of the U.S. economy.

As volatility increases in the markets, these numbers will likely bounce around in concert.

## Technical Factors

The markets have experienced some significant technical damage over the past few weeks as higher interest rates impacted a number of highly valued companies. The percentage of stocks in the S&P 500 trading above their 50-day moving average fell into the 33-range, down from over 67 percent at year end.

Moreover, the number of stocks hitting new 52-week lows expanded dramatically with over 525 on the New York Stock Exchange and more than 1300 on the NASDAQ at the end of January. By definition, many companies have experienced a correction or are in bear-market territory.

## Outlook

Famed economist Milton Friedman said "one of the great mistakes is to judge policies and programs by their intentions rather than their results." Prior to the 2008 financial crisis, it could be argued that subprime mortgages for many in the lower income quadrant made sense. However noble the intent, the Fed and other government agencies completely ignored the massive leverage buildup, which almost took down the entire financial system.

Similarly, while the intentions of supporting the economy due to government-mandated shutdowns made sense, the amount of money pumped into the system was an order of magnitude larger than anything we have ever witnessed. In fact, the fraud from the Paycheck Protection Program (PPP) alone is estimated to be well over $100 billion dollars, where in one case a 29-year-old obtained approximately $3.9 million and spent $318,000 on a Lamborghini sports car.

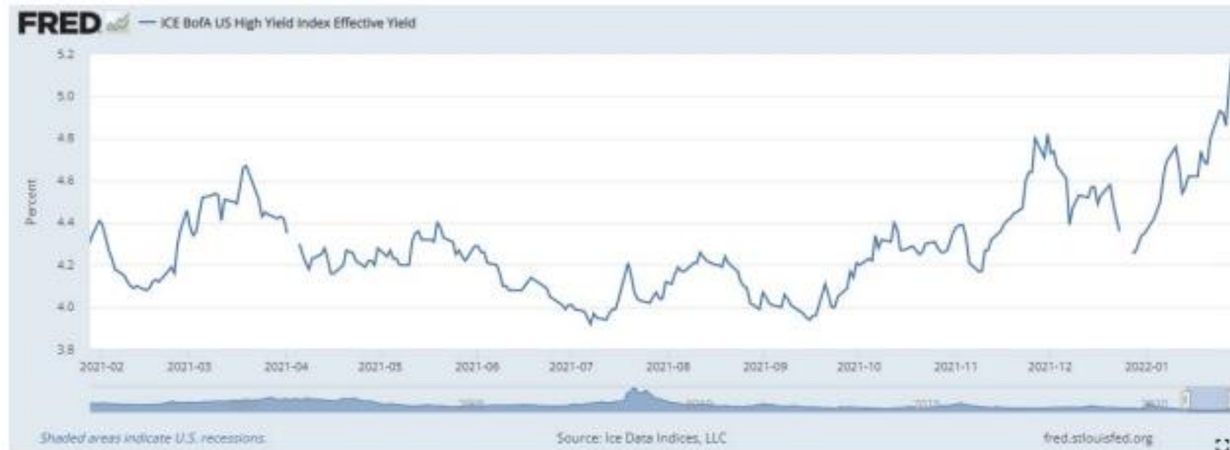
As a result, the federal debt has increased by about $7 trillion to more than $30 trillion.

Therefore, the Federal Reserve needs to adjust policy in order for interest rates and monetary policy to better reflect reality. The violent move in the markets reflects concerns about another Fed policy mistake.

If the Fed moved when they should have rather than when they had to - they seemed to be the last to know inflation was a concern – the violent move in the stock and bond markets would have likely been less intense over a seven-month period rather than a seven-week period.

When prices drop quickly, financial accidents can happen as leveraged hedge funds sell what they can, not necessarily sell what they want to. As a result, a good investment can suffer as some of the excesses that have built-up over the past 20 months are corrected.

As confidence in the Fed – and Washington, D.C. – erodes, the speed at which prices adjust is reduced considerably. Below is the chart of the high yield index, which has seen its yield climb from a July low of 3.92 percent to about 5.2 percent at the end of January.




The Fed needs to understand that the world is much more complex than the textbooks, and check the theoretical assumptions that do not reflect reality.

In 2012, Fed Chairman Ben Bernanke came up with a 2 percent inflation target. He adopted that from New Zealand. The last time inflation was this high, Paul Volker was the Chairman of the Federal Reserve. Mr. Volker was credited with tackling the record high inflationary policies of the late 1970s and early 1980s. Mr. Volker once wrote “I know of no theoretical justification” for a 2 percent inflation target.

Nevertheless, the Fed seems intent on continuing with this new policy “framework,” which makes it all the more critical for the markets to have confidence in their policies. Economics is also about behavior, and confidence plays a crucial role.

The markets do not like uncertainty, and concerns about the Fed, President Biden, and rising geopolitical tensions are likely to cause wider swings in both directions. The U.S. economy is growing and corporate earnings are expected to rise in 2022. However, it’s not just earnings but the P/E (Price/Earnings) ratio that matters, which is influenced by the level of interest rates.

Geopolitical tensions are front and center with the Russia/Ukraine situation very fluid. It was reported that President Biden was considering deploying troops to the region, although that had yet to be confirmed officially.

Therefore, we expect volatility to remain elevated and are closely monitoring the landscape. We know that corrections are inevitable and can provide opportunities to invest in dynamic companies with sustainable competitive advantages. (2.1.22)

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