On Our Radar May 2022

The markets were under a great deal of pressure in April as high inflation, a significant rise in interest rates, continued geopolitical turmoil between Russia and Ukraine, and a Federal Reserve with a credibility problem weighed on stocks and bonds.

The S&P 500 index fell 8.79 percent in April and the yield on the 10-year Treasury security rose from 2.32 percent to 2.89 percent as the Consumer Price Index (CPI) increased 8.5 percent year-over-year. Moreover, the high yield bond index saw interest rates rise from 5.46 percent to 6.84 percent over a four-week period. The rate of change and lack of confidence in the Fed is causing leverage to be unwound, and investor sentiment has turned decidedly more bearish.

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)

The markets believe that the Fed has a credibility problem as they have totally mismanaged one of its two mandates: stable prices (low inflation).

What's become obvious is that when Jerome Powell changed monetary policy in August 2020, he was disingenuous when he said, "Of course, if excessive inflationary pressures were to rachet up above levels consistent with our [2 percent] goal, we would not hesitate to act."

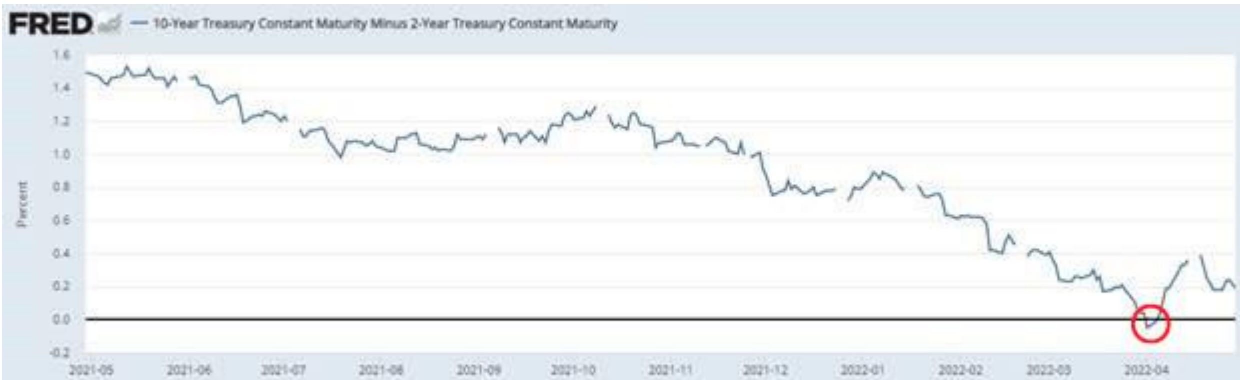
The reality is that the Fed had no intention of acting to ward off inflation because they wrongly believed that low inflation was a greater risk than high inflation. As we have quoted previously, soon to be Fed Vice-Chair Lael Brainard said in October 2020 the Fed needed to "stay the course" and let inflation run and "eliminate the rationale for removing accommodation preemptively."

On January 26, 2022, Chairman Powell admitted that "for a long time, we'd been tightening on expectations of high inflation which never appeared." Therefore, the Fed incorrectly assumed that the future inflation picture was going to be just like previous periods, even though there were no similar periods that resembled a global pandemic shutdown followed by the greatest fiscal and monetary infusion in history.

In 2008, the Fed relied on academic theory about housing and were wrong. The markets are concerned that the Fed has relied on inflation theory at the expense of market reality. Now, inflation is at a 40-year high, and the Fed seems intent on "slowing demand," something that is not part of their mandate.

Not only did the Fed fail to act, they threw gasoline on the proverbial fire when in December 2021, a time when inflation was at a 30-year high, Chairman Powell said the "[FOMC] Committee reaffirmed the zero to one-quarter percent range for the federal funds rate" and committed to buying additional bonds into March. The Fed bought additional bonds until the week-ending March 25, 2022.

In early April as seen below, the yield on the 2-year U.S. Treasury security rose above the 10-year Treasury yield for a brief period. This is a sign of stress in the markets, which has often preceded a recession. As such, markets are selling off, leverage is being unwound, and confidence is eroding.



What's more, after the Fed's official policy was to let inflation run, members of the Federal Reserve now seem incapable of independent thought. The Fed started with the conclusion that inflation was too low and was going to stay low for too long, hence Lael Brainard stating she thought inflation would remain below 2 percent until 2023. Now, it seems that the Fed learned a new word. Consider the following:

- The Fed "must move **expeditiously**" Jerome Powell

- What we need to do right now is get **expeditiously** to neutral and then go from there." James Bullard, President St Louis Fed

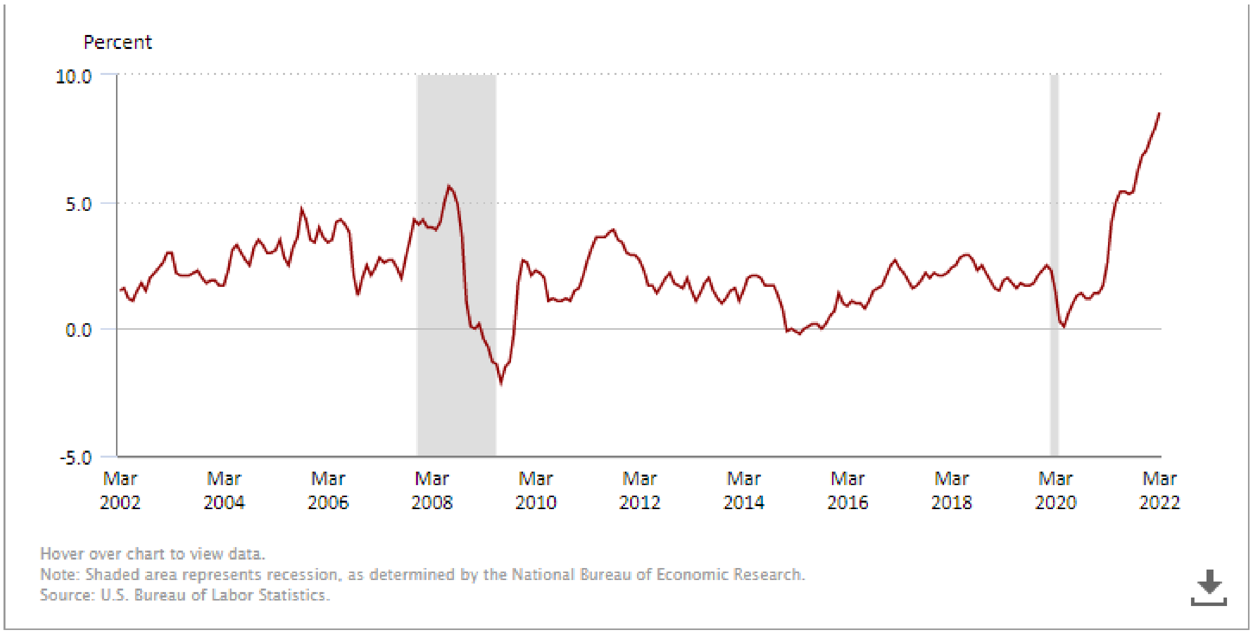
- "It's really important that we get to neutral and do that in an **expeditious** way." Raphael Bostic, President Atlanta Fed

- "I like to think of it as **expeditiously** marching towards neutral." Mary Daly, President San Francisco Fed

It would seem that members of the Fed are unaware that they could have moved expeditiously at any time considering that the CPI has been above 5 percent for 11 consecutive months. Moreover, we find it shocking that Fed Vice-Chair Lael Brainard quoted former Fed Chairman Paul Volker – the one who tamed inflation in the early 1980s - when she stated that Volker said runaway inflation "would be the greatest threat to the continuing growth of the economy…and ultimately, to employment."

What Ms. Brainard left out was that Paul Volker took issue with the Fed's belief that a little inflation is good for employment when he said the current Fed's belief "lingers on even though Nobel Prize-winning research and experience over decades suggests otherwise." Mr. Volker also took issue with the false precision of the Fed's 2 percent inflation target saying "No price index can capture, down to a tenth or a quarter of a percent, the real change in consumer prices...as they are too complex to calculate precisely month-to-month."

Nevertheless, this Fed believed otherwise and the 12-month percentage change in the Consumer Price Index (CPI) as seen in the adjacent chart, was 8.5 percent. Now, San Francisco Fed President Mary Daly said that inflation may get to 2 percent in **five years**. (Emphasis added)



What is scary is Mary Daly said "Once accommodation is removed, we need to evaluate the effects" as if to imply that the Fed will not be evaluating the effects in real time. Once again, that reasoning is what allowed inflation to hit a 40-year high before the Fed changed policy.

It would appear as though the bond market has seen enough and investors don't have confidence that the Powell Fed - the one that did not see high inflation as a problem and, in fact, referred to it as a "high class problem" in January 2022 when inflation hit a 40-year high – are going to reduce demand just enough so as to engineer a "soft landing" rather than a recession.

When inflation was screaming higher, the Fed's reliance on their own assumptions and theory prevented them from seeing what was obvious to everyone else. Although the Federal Open Market Committee (FOMC) meets this week, the market does not seem interested in more lectures from the academically anointed that are completely divorced from reality.

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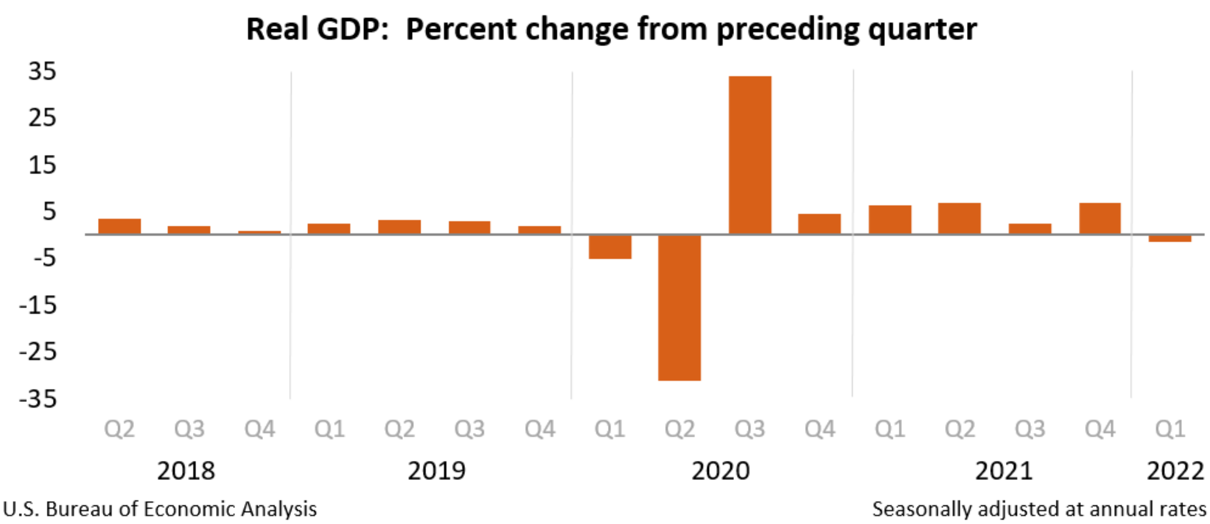
Valuation

Consensus S&P 500 operating profits for calendar year 2022 are expected to be around $227, putting the P/E (price/earnings) ratio at roughly 18.1-times earnings. The P/E ratio has come down quite a bit due to higher inflation and interest rates. Higher interest rates and inflation have historically put downward pressure on P/E ratios as the discount rate applied to future earnings increases.

With inflation running at a 40-year high and the Fed determined to raise interest rates in order to slow demand, it's no longer just about the level of earnings but what the market is willing to pay for those earnings.

Economic Cycle

The U.S. economy contracted by 1.4 percent in the first quarter with Gross Domestic Product (GDP) falling for the first time since the onset of the pandemic. While many are pointing to exports as the main culprit – exports did fall sharply - this is happening at a time of high inflation, a plunge in personal savings, and falling consumer confidence.



New single family home sales fell 12.6 percent year-over-year as rising mortgage rates are having an impact. The 30-year mortgage rate hit 5.4 percent, up from about 3.2 percent at year-end and the highest in a decade.

The Leading Economic Index (LEI) did increase 0.3 percent in March despite the headwinds, but the global economy remains under pressure. Consumer credit increased by $41.8 billion, up from $8.9 billion the prior month and the highest since 2001. That is not something one would expect if consumer balance sheets were as healthy as the narrative states. In fact, U.S. inflation-adjusted average weekly earnings were down 2.3 percent year-over-year.

Consumer sentiment was 65.2 well-below the 71.8 low as a result of the 2020 COVID-shutdown.

Corporate earnings season is upon us and there have been some well-publicized misses that have resulted in severe declines. For example, former market favorite Netflix (symbol NFLX) saw its shares tumble roughly 46 percent over a six-day period as the number of subscribers fell for the first time in a decade.

As market confidence erodes, everything seems to get amplified just as liquidity is in short supply.

Sentiment

Bullish investor sentiment has dropped dramatically, in fact, we saw investor bearishness move higher than investor bullishness in late April. From a contrary standpoint, we view that as a positive indicator as it suggests that the market has already experienced a great deal of selling.

Although bullish sentiment is down, it does not mean it won't stay down for a period of time. Much of it is likely to rely on the level of inflation and the path of interest rate hikes by the Fed.

Technical Factors

The markets have experienced a significant pick-up in volatility - in both directions - which reflects the level of uncertainty at this time. In addition, the number of stocks making new 52-week lows continues to be elevated.

For example, the week ending April 22, 2022, saw 415 stocks making a new 52-week low on the New York Stock Exchange while the number on the NASDAQ Composite was 646. Those are not numbers associated with a healthy market.

Outlook

As a result of NASA's Challenger space shuttle disaster there is a sign in a meeting room that says "None of us is as dumb as all of us," a reminder that unexamined groupthink can have significant consequences. Indeed, what got the Fed so far behind the inflation curve was a lack of independent thought.

Chairman Powell begins most of his press conferences stating that the Fed is strongly committed to achieving "price stability" - meaning low inflation, yet it is obvious given the rate of change in interest rates over the past few months that fewer and fewer believe him. When the Fed's credibility erodes, investors often feel pain.

Now that the Fed policy has allowed inflation to hit 40-year highs, their policy is to slow demand. With first quarter Gross Domestic Product (GDP) down 1.4 percent, they got their wish. Unfortunately, the Fed's last policy move was to increase inflation, and sometimes the Fed gets the outcome they desire. Regrettably, there are second and third-order effects that the Fed does not take into consideration.

Jerome Powell recently said "Our goal is to use our tools to get demand and supply back in sync and do so without a slowdown that amounts to a recession." The Fed has no experience doing that, and since they were so misguided on one of their 2 mandates, some money has been moving to the sidelines.

As a reminder of how misguided Fed policy can be regarding inflation, in August 2007, after two Bear Stearns mortgage-backed security hedge funds were essentially worthless and just prior to Countrywide Financial requiring a bailout, the Federal Reserve believed high inflation was the biggest risk. They seemed to be ignorant of what was happening in the subprime market, and the potential second and third-order effects.

Jerome Powell also recently quoted Paul Volker praising the former Fed Chairman for “staying the course” in the face of a slowing economy in order to get the early 1980s inflation under control. Considering that the Powell Fed’s policy in August 2020 is the one that allowed inflation to hit a 40-year high, this is rich. What’s more, since that phrase was used by Lael Brainard to get the Fed to let inflation run, perhaps the Fed should pay a little more attention.

While the markets have seen a tremendous amount of pressure due to the economy, high inflation, a war that is affecting food and energy supplies, and a Fed that is challenged, today’s prices reflect a lot of those uncertainties. The question remains where we go from here.

Milton Friedman once said that “Inflation is a policy,” and he was right. The Fed made a disastrous policy mistake, and the markets are experiencing a negative feedback loop. The Fed made a policy change designed to generate higher inflation based on false assumptions. Now they are determined to slow demand, which has led to one of the worst starts to the year in some time.

Complex geopolitical situations are both a challenge and opportunity. If the Fed stops relying on theory and focuses on reality, the markets could experience a significant rally from these depressed levels. Nevertheless, we expect a wider range of outcomes as the year progresses. (5.2.22)