On Our Radar June 2022

The S&P 500 index eked out a gain of 0.22 points in May following a brutal 7-week selloff primarily due to the massive mistake by the Federal Reserve that let the inflation genie out of the bottle. As a result, the Fed has done enormous damage to its credibility and reputation, and markets reacted accordingly.

While we have written extensively about Federal Reserve mistakes in the past, the Fed compounded its mistake by increasing interest rates only 25 basis points (0.25%) in March, and continued to purchase bonds despite inflation running at a 40-year high. Moreover, less than one week following the March Federal Open Market Committee (FOMC) meeting, Fed Chairman Jerome Powell emphasized the need to raise interest rates “expeditiously,” seemingly unaware of the fact that the Fed could have done so the previous week, not to mention months earlier.

The significant gap between what the Fed said they would do and what they did has caused confidence to evaporate.

To be clear, the Russia war with Ukraine has added to price pressures including substantially higher oil and gas, wheat, and fertilizer prices. And U.S. policy regarding domestic fossil fuel production has essentially created a self-inflicted oil embargo. Nevertheless, the Consumer Price Index was 7 percent in December, before the Russia/Ukraine war, and roughly 8 percent before the Fed raised interest rates.

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 Federal Open Market Committee (FOMC) increased the federal funds rate by one-half of a percentage point to a range of 0.75 percent to 1.00 percent in May. In addition, Chairman Powell “guided” to additional half-percentage point (0.50%) increases in both June and July.

Over the past year Jerome Powell began most of his press conferences with “At the Federal Reserve, we are strongly committed to achieving the monetary policy goals that Congress has given us,” one of which is “price stability” (inflation). In early May, Mr. Powell began his press conference with “Inflation is much too high and we understand the hardship it is causing.” Markets dropped over the following weeks.

With inflation weighing heavily on the markets, we think it’s important to understand how we got here. Several years ago, the Federal Reserve was concerned about the threat of deflation because of what Japan had experienced for many years. For that reason, economists developed an argument that by adopting inflation “makeup strategies,” which would temporarily push inflation modestly above 2 percent, central banks could avoid deflation.

When COVID policies shutdown much of the economy in early 2020, the Fed began to think deflation was a real possibility. The Fed believed that inflation was too low, so they needed a “makeup strategy” and introduced a new monetary framework called “flexible average inflation targeting” (FAIT), with an aim to achieve higher inflation.

When Powell introduced this new framework in August 2020, he said “of course, if excessive inflationary pressures were to rachet up above levels consistent with our goal, we would not hesitate to act.” He attempted to assure market participants because he knew this theoretical framework had never been implemented. When Powell was asked what a “moderate” overshoot was, he responded “it means not very high above 2 percent.”

It would appear that the Fed never had any intention of acting, which is why they let inflation spike to 40- year highs before beginning to raise rates. Consider this: in October 2020, Fed Vice Chair Lael Brainard said “to support the inflation makeup strategy…it will be important for the [FOMC] Committee to stay the course resolutely,” and “eliminate the rationale for removing accommodation preemptively.”

It seems as though the Fed began with a dangerously incorrect assumption - that inflation was too low and would likely stay low – and therefore, higher inflation was needed. In fact, when the Fed changed policy in 2020, they did not expect inflation to hit 2 percent until 2023. We would note that in September 2020, Jerome Powell said the Fed is “strongly committed to achieving our goals and the [inflation] overshoot.”

That commitment has been on display for the past year as inflation continued to go well beyond the Fed’s “moderate” inflation overshoot. In January 2022 when inflation was at a 40-year high, Powell said “the Committee decided to keep the target range for the federal funds rate at zero to one-quarter percent.” And despite Powell saying “the balance sheet is, is substantially larger than it needs to be,” the Fed purchased more than $100 billion worth of bonds over the following eight weeks.

Valuation

The Price/Earnings (P/E) ratio on the S&P 500 index has fallen to roughly 18.4-times 2022 earnings estimates. This is down from over 21.7-times earlier this year as higher inflation and higher interest rates put downward pressure on earnings multiples.

With inflation still running at a 40-year high and the Fed determined to raise interest rates at least over the next two meetings in an attempt to slow demand, it remains to be seen what the market is willing to pay for earnings.

Economic Cycle

The U.S. economy contracted 1.5 percent in the first quarter due to a widening trade deficit as exports fell sharply and imports soared. Meanwhile, the Consumer Price Index (CPI) rose 8.3 percent year-over-year in May, keeping inflation levels at 40-year highs. As a result, the yield on the 10-year U.S. Treasury Note hit 3.12 percent in early May, more than double the yield at year-end, before ending the month at 2.85 percent.

Oil prices rose in the month as a barrel of West Texas Intermediate crude hit $115, up from about $103 at the end of April. Consequently, the national average for a gallon of gas is around $4.62, with some areas in California well over $6 a gallon. While that is going on food prices continue to soar as consumer prices for food rose 9.4 percent year-over-year in April. As a result, consumer sentiment has declined by more than 30 percent from a year ago.

The impact of higher interest rates is being felt in credit cards, auto leases, and mortgage rates, to name a few, which will create economic headwinds as consumers are forced to adjust. New Home sales in April fell by more than 16 percent month-over-month, the fourth consecutive monthly decline as mortgage rates have soared.

The Institute for Supply Management (ISM) Manufacturing Index did rise to 56.1 percent in May, up 0.7 percent from April. However, the employment index was 49.6 percent, with levels below 50 indicating contraction.

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Sentiment

Bearish investors sentiment has exceeded Bullish investor sentiment for the past five weeks. In general, we view extremes in Bullish or Bearish sentiment as a contrary indicator. Therefore, with more Bears than Bulls, it suggests many investors have likely already reduced positions.

Nevertheless, sentiment is only one data point, and is overshadowed by Fed monetary policy and inflation. That said, it is clear that a number of stocks are on sale, but the negative sentiment seems to be concerned about another mistake by the Federal Reserve.

Technical Factors

The markets have experienced extreme downward pressure with the S&P 500 index falling for 7-weeks in a row. As such, it should be no surprise that the percent of stocks trading below their 50-day moving average dropped to around 13.5 percent in late May. That is an extreme level, and often suggests a bounce at some point is likely.

Nevertheless, the technical damage has been significant. For instance, in mid-May more than 1750 companies in the NASDAQ Composite made a new 52-week low. That will likely take some time to heal.

Outlook

In March 2021, former Fed Chair and current U.S. Treasury Secretary Janet Yellen said Congress needed to “go big” and pass President Biden’s $1.9 trillion American Rescue Plan Act, which was another COVID stimulus package. At the time, Ms. Yellen dismissed any notion that inflation could get out of hand.

In April 2021, Fed Chairman Jerome Powell said “it seems unlikely, frankly, that we would see inflation moving up in a persistent way that would actually move inflation expectations up while there was significant slack in the labor market.” The Fed seemed to be looking at inflation only through the lens of unemployment, while ignoring basic economics 101: supply and demand.

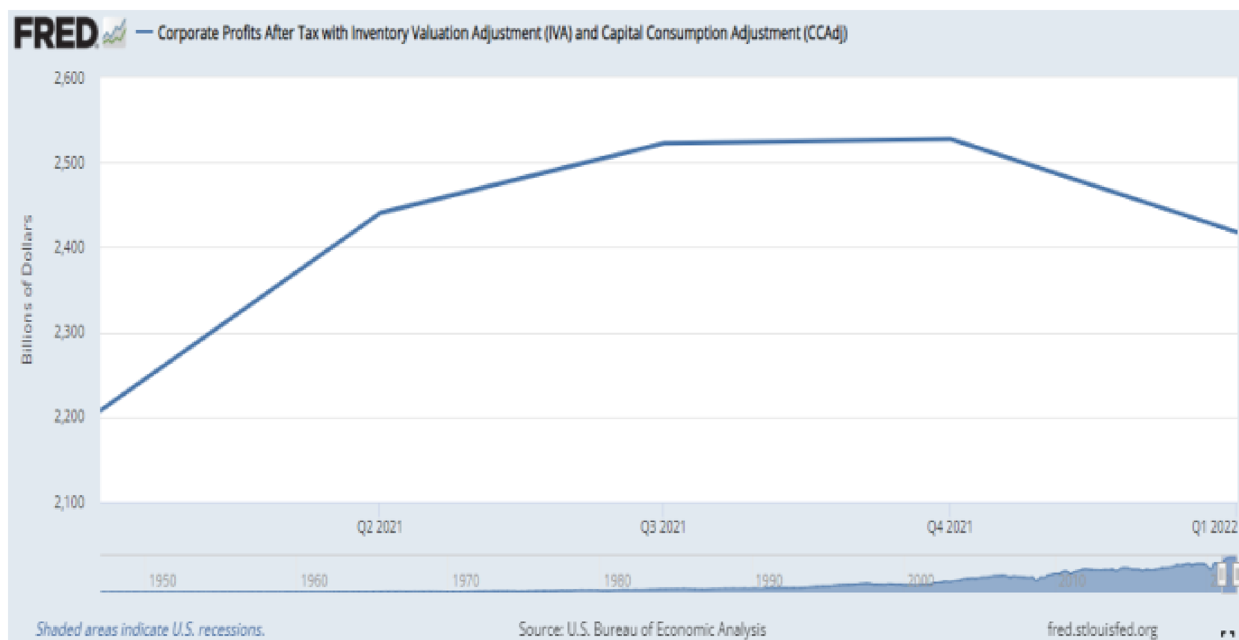
In July 2021, President Biden said “There’s nobody suggesting there’s unchecked inflation on the way – no serious economist.”

The fact of the matter is the global supply chain – even at full strength – was not capable of meeting the trillions of dollars in artificial demand as a result of the money that was pumped into the economy. In reality, only recently has the Fed and others been acknowledging the demand side of the equation as opposed to being solely focused on supply bottlenecks.

After meeting with President Biden on May 31, 2022, Janet Yellen admitted that she was wrong on inflation as this is becoming as much of a political issue with upcoming elections in November as it is an economic issue.

Regarding the Fed, the markets have lost confidence in Jerome Powell with stocks and bonds selling off sharply. In January, Mr. Powell referred to inflation as a “relatively high-class” problem yet in early May said the Fed understands the pain and “hardship it is causing.”

Unfortunately, the Fed does not know that they are the problem. After failing to adjust its policy to rising inflation, the Fed’s new goal is to slow demand at a time when many are already struggling with higher food and energy bills on top of global growth headwinds. Moreover, corporate profits declined by 2.3 percent in the first quarter as seen in the chart below.



As of June 1, 2022, the Fed is beginning to reduce the size of its balance sheet by $47.5 billion a month from June through August, then intends to increase that to $95 billion starting in

September. In addition, the Fed is "guiding" to an additional 50 basis point (0.50%) increase at each of the next two meetings.

Stocks and bonds have sold off hard because of a lack of confidence in the people running monetary policy. The Fed has two mandates: maximum employment and stable prices (inflation), and they failed miserably on stable prices with an experimental theory that blew up. The Fed began with a dangerously incorrect assumption (inflation was too low), adopted a new monetary policy framework that had never been implemented, assured everyone that they would adjust policy if needed, yet waited until inflation hit a 40-year high before acting.

In our view the Fed ignored many of its safeguards to get to this place. For instance, the Fed ignored the Brainard Principle – named after William Brainard, no relation to current Fed Vice Chair Lael Brainard – which says when you are uncertain about the effects of your actions, you should move slowly. In contrast, the Fed went all-in and ignored rising inflation for more than a year.

As a result, interest rates on bonds have increased substantially, with the high yield index going from 4.35 percent at year-end to 7.00 percent at the end of May. This has caused some forced selling as leverage has been unwound along with signs of panic selling in areas such as cryptocurrencies and special purpose acquisition companies (SPACs).

Moreover, if you can't sell what you want to – for example, an illiquid high yield bond – you sell or hedge what you can, which is often U.S. stocks.

While market corrections often clear out excesses, this market is dealing with a major Fed policy mistake, an ongoing war between Russia and Ukraine, higher food and energy prices with seemingly few solutions, and the possibility of a Fed-induced recession.

The question is how much of that is currently baked into today's prices given the recent declines. We know that heightened volatility provides opportunities, and there are some outstanding values at present. What we do not know is whether there are second and third-order effects such as an accident in the hedge fund world that could cause a problem.

As such, we expect a wider range of outcomes and volatility in both directions. (6.2.22)

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