TJT CAPITAL GROUP
REGISTERED INVESTMENT ADVISOR

On Our Radar July 2022

The Federal Reserve has made an enormous mistake and the stock, bond, currency, and commodity markets are paying the price. Moreover, the Fed is the problem, and they do not know it.

In August 2020, the Fed reached a conclusion centered on the assumption that inflation was too low. The Fed then changed monetary policy based on an untested theory – flexible average inflation targeting – with a goal of increasing inflation "moderately above 2 percent."

The Consumer Price Index (CPI) hit nearly 8 percent before that Fed actually raised interest rates - its "primary tool for adjusting monetary policy."

As former Federal Reserve Chairman Ben Bernanke wrote, "the Federal Reserve's objectives – its dual mandate, set by Congress – are to promote a high level of employment, and **low, stable inflation"** (Emphasis added). The Fed failed catastrophically in one-half of its two mandates.

In June, Fed Chair Jerome Powell told the Senate Banking Committee that the Fed needs "compelling evidence" that inflation is falling before interest rate hikes slow after ignoring "compelling evidence" that inflation was well-above its 2 percent target.

The markets have lost confidence in the Fed. As a result, the S&P 500 index lost 8.3 percent in June and has had its worst start to the year in decades.

Few markets have been spared. The yield on 10-year Treasury securities have risen from 1.52 percent at year-end to roughly 3 percent after hitting nearly 3.5 percent in mid-June. High yield ("junk") bonds have soared to 8.88 percent from 4.35 percent at year-end. These massive rates of change suggest that the people in charge of monetary policy should no longer be making decisions.

A barrel of oil was trading around $105 at month-end from roughly $125 four weeks ago, however, oil is still up more than 40 percent year-over-year. Copper is down more than 20 percent, cotton dropped nearly 30 percent, and natural gas fell 16 percent in a matter of weeks as the global economy slowed.

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 interest rate by 75 basis points (0.75%) to a range of 1.50 to 1.75 percent. It was the largest rate increase since 1994. Since the Fed is so far behind the inflation curve, many on the Committee are talking about several more relatively significant rate hikes over the next year or so.

After ignoring factual evidence and history to implement an untested theory, which has led to a 40-year high in inflation, Jerome Powell told the Senate Banking Committee "we have to restore price stability…it's the bedrock of the economy." According to Powell, bringing down inflation is now "essential," seemingly unaware that his policy ignored the "low, stable inflation" Congressional mandate for more than a year.

The Fed essentially conducted a monetary policy experiment that failed miserably. Moreover, a case can be made that when Powell changed policy in August 2020, he was shockingly dishonest.

As we have previously pointed out, when Powell introduced the new monetary framework, he said, "of course, if excessive inflationary pressures were to rachet up above levels consistent with our goal, we would not hesitate to act." Clearly, the Fed did not raise interest rates when they should have, and are now aggressively raising rates because they have to at a time when the economy is slowing.

As a reminder, the CPI was 1.3 percent in 2020, a year when the economy was partially shut down due to COVID. And in August 2020, the month that Powell changed monetary policy, the Fed's favorite inflation gauge - core personal consumption expenditures (PCE) - was 1.5 percent. Those numbers hardly qualify as deflation, which was one of the fears the Fed used to justify the change.

It seems to us that the policy change was based on a 1997 paper authored by Bernanke and Mishkin about a new strategy for monetary policy known as "inflation targeting." It is important to note that the paper said the framework "should give the central bank a better chance of convincing the public that the consequences of the supply shock are only a **one-time rise in the price level**, rather than a permanent increase in inflation" (emphasis added).

Eerily, that is the argument the Fed used to justify not changing policy even though inflation was advancing toward a 4-decade high.

Valuation

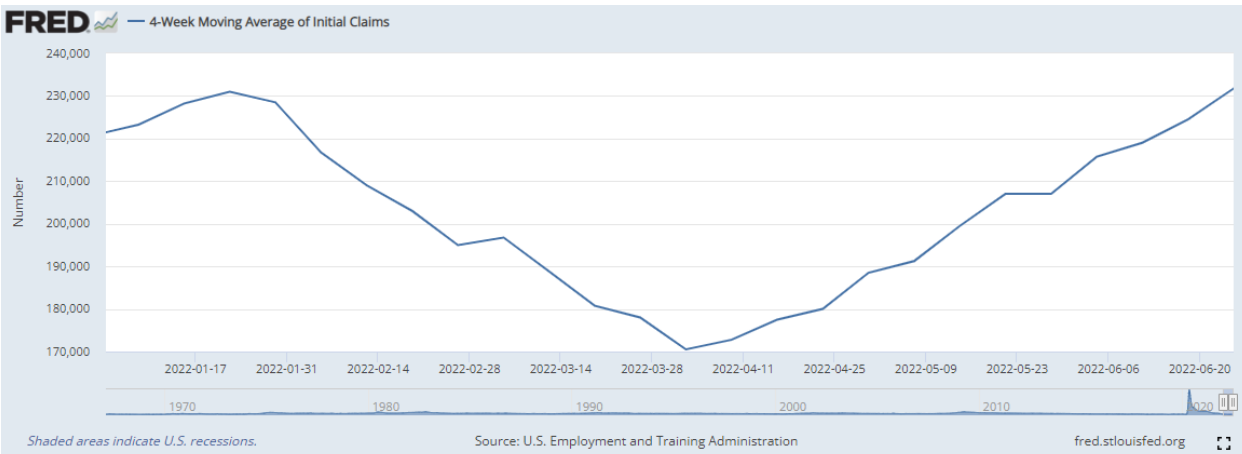
S&P 500 operating profits for calendar year 2022 are expected to be around $224, putting the P/E (price/earnings) ratio at roughly 17-times earnings. Calendar year 2023 earnings estimates are $249, but given the volatility in prices for goods and services, that seems highly suspect at this point.

What is more important, however, is the uncertainty around what the "market" thinks the proper P/E ratio should be given the current high inflation, rising interest rates, and a Federal Reserve that has signaled that it will continue to hike interest rates in an effort to bring inflation down.

Economic Cycle

The U.S. economy declined by 1.6 percent in the first quarter, the Institute for Supply Management (ISM) Manufacturing Index fell to 53 percent - the slowest pace in two years, and the Leading Economic Index (LEI) recently declined 0.4 percent. The ISM new orders index dropped to 49.2, with a level below 50 indicating contraction. There is a very high probability that a recession is here.

Consumer sentiment hit its lowest level in 50 years, retail sales in May fell 0.3 percent, and the 4-week moving average of initial unemployment claims have increased almost 36 percent since late March as seen in the following chart. Moreover, with the recent Consumer Price Index (CPI) up 8.6 percent yearover-year, inflation-adjusted weekly earnings fell a record 3.9 percent in May. As a result, credit card balances are rising seemingly to fund essentials such as food, gas, and rent.



Sentiment

Bullish investor sentiment dropped to a recent low of 26.5 percent, well-below the lowest level seen during the COVID shutdown. Moreover, the percentage of bearish advisors rose above the 44 level, thereby creating a negative spread of more than 17 percentage points. This is the widest Bull/Bear spread in years.

Regarding consumer sentiment, as previously mentioned, the University of Michigan sentiment numbers were the worst in 50 years, which is no doubt due to the high levels of inflation, rising interest rates, and falling stock and bond markets.

Technical Factors

Some extreme moves have been seen in the markets over the past few months. Recently, the percent of stocks trading above their 50-day moving average fell to about 2 percent, a level that exceeded the COVID-shutdown low.

The number of stocks on the New York Stock Exchange making new 52-week lows dropped from over 1000 a few weeks ago to “only” about 560. Clearly, the market is oversold, however, declines of this magnitude typically take time to heal.

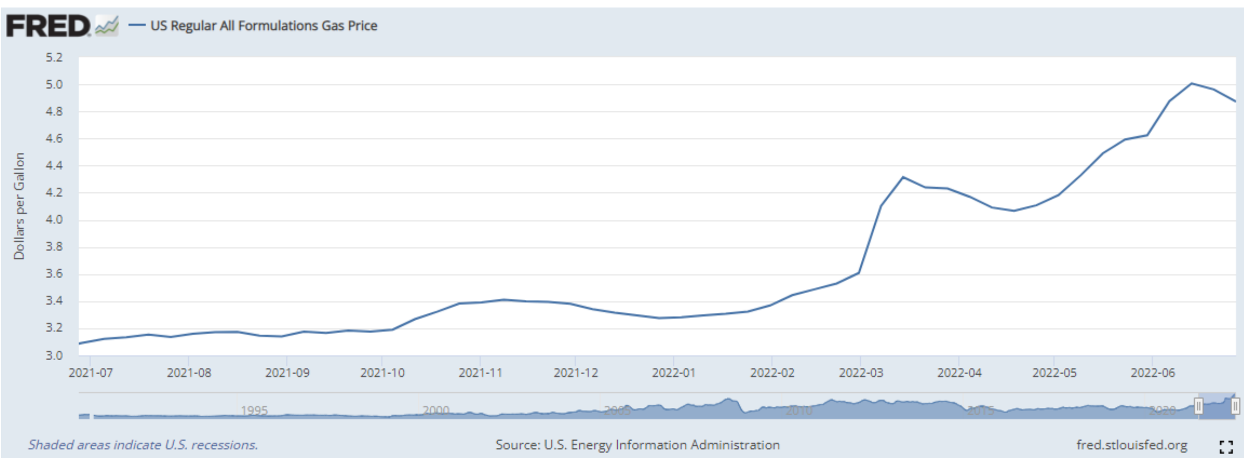
That said, it does not preclude a counter-trend rally at any time.

Outlook

While the Fed is largely responsible for letting inflation get out of hand, the Biden administration’s energy policies have not helped.

As a reminder, any political comments are not motivated by political interest for or against a party, just candid observations of the facts. We view money as green, not “red” or “blue.”

Energy prices are up materially over the past few years, and the national average for a gallon of gas recently hit $5.00 for the first time ever. In states like California, the price of gas is even higher.



While the war between Russia and Ukraine has clearly had an impact, it seems like lessons from COVID regarding the importance of having secondary sources of essentials were disregarded.

The fact of the matter is U.S. oil production is still well-below the roughly 13 million barrels a day we saw prior to COVID, which makes us more reliant on imports. While there are likely many reasons, one certainly seems to be part of an ideological agenda considering that President Biden has said, “I guarantee you, we are going to end fossil fuel.”

Indeed, moving to a greener energy environment is a noble cause, yet it is imperative that we understand that the journey is likely to take decades. However, when you consider the following, it is almost as if the economic impact of a potential outside disruption of supply was not even contemplated. For instance:

- President Biden canceled the Keystone XL pipeline on his first day in office.

- Energy Secretary Granholm, when asked by a Bloomberg reporter what the plan was to increase oil production in America, laughed and said, “oh my god, that is hilarious.”

- Presidential Envoy for Climate John Kerry recently said the U.S. “absolutely” does not need to drill for more oil and gas.

- President Biden’s original nominee for Comptroller of the Currency said regarding oil companies, “we want them to go bankrupt if we want to tackle climate change.”

- President Biden’s original nominee for a Federal Reserve position said banks should deny credit to companies in the fossil fuel industry.

It seems like the message to U.S. energy companies is that the stated policy of the administration is to reduce domestic supply. Ironically, one of the greatest weapons against Russia would be to reduce the amount of money that they are receiving for exports of oil and gas. The Russian ruble is up more than 35 percent year-to-date versus the U.S. dollar despite the economic sanctions.

So, the markets are dealing with soaring inflation, a collapse in consumer sentiment, falling wages, a colossal error by the Federal Reserve, and a short-sighted energy policy that is affecting all markets.

Having completely failed at its “low, stable inflation” mandate as they blindly speculated on an untested theory, the question is now whether the Fed will compound their mistake by overtightening as the economy is already slowing. In an effort to correct their mistake, the Fed is determined to slow demand.

We have yet to see evidence where higher interest rates are the solution to food and oil shortages.

Nevertheless, the market tends to be forward looking, and a number of the aforementioned issues seem, in part, to be reflected in current prices. Many commodities that experienced some extreme moves, including energy, have seen prices decline of late as seen in the following chart. Given that, the markets could experience a cyclical rotation where money comes out of the recent commodity winners and moves back into more traditional stocks.

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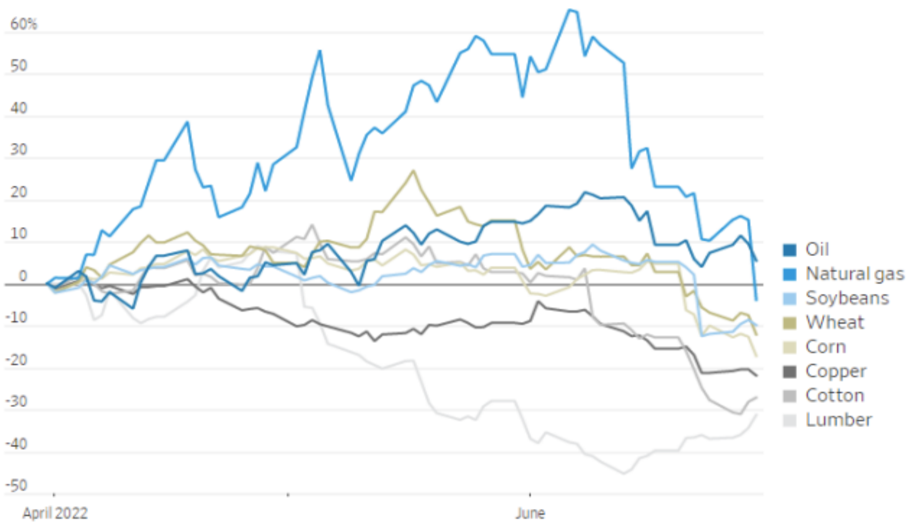
Second-quarter futures prices performance



Source: FactSet

The consumer appears to be continuing to spend, which could allow the U.S. economy to avoid a recession. However, as long as the Fed continues to tighten monetary policy, investors should expect a wider range of outcomes. (7.5.22)

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