TJT CAPITAL GROUP
REGISTERED INVESTMENT ADVISOR

On Our Radar August 2022

After falling more than 20 percent in the first half of the year due to a massive policy mistake by the Federal Reserve and exacerbated by questionable domestic energy policy and the Russia/Ukraine war, the S&P 500 index rallied more than 9 percent in July following months of persistent weakness.

The interest rate on 10-year U.S. Treasury Notes fell to 2.67 percent from roughly 3.50 percent in mid-June, and a barrel of oil fell almost $10 in the past four weeks

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) raised interest rates on federal funds by 75 basis points (0.75%) for the second month in a row in July to a range of 2.25 percent to 2.50 percent. After ignoring inflation for more than a year, the Federal Reserve is frantically trying to hike rates in an effort to catch up with inflation that is currently running at a 40-year high.

Unfortunately, Fed Chairman Jerome Powell has yet to take responsibility for the policy blunder, and his July 27, 2022 press conference was an exercise in misdirection. While Powell continued to parrot the line that the Fed is "guided by our mandate" – one of which is low, stable inflation, Powell acknowledged that "price stability is really the bedrock of the economy. And nothing works in the economy without price stability."

If the Fed really believes "price stability is the bedrock," then why did they wait until inflation hit nearly 8 percent before raising interest rates?

According to Fed Governor Christopher Waller, the Powell-Fed was not "guided by its mandate" but **"bet the farm,"** (Emphasis added) that inflation would come down, as Mr. Waller recently admitted in a moment of candor. Nevertheless, people who speculate on a radical, untested theory that has a damaging effect on the markets and the economy should not be in charge of monetary policy.

What's more, Jerome Powell wants you to believe that he understands the hardship that inflation is causing, especially for those on the lower income scale. However, this is a lesson that did not need to be re-learned. In fact, it's one of the main reasons why Congress gave the Fed a "price stability" mandate in 1977.

In an April 2021 letter to Senator Rick Scott, Chairman Powell wrote "We understand well the lessons of the high inflation experience in the 1960s and 1970s, and the burdens that experience created for all Americans." However, just a few weeks ago, Jerome Powell tried to use ignorance as a defense when he said "We now understand better how little we understand about inflation."

No one has done more damage to the Fed's credibility than Jerome Powell. The biggest question is why did the Powell-Fed disregard decades of established monetary principles?

In 2018, Powell said between 1995 and 2018 "inflation has been relatively tame, averaging 1.7 percent and never declining below 1 percent or rising above 2.5 percent. Even during the financial crisis, core inflation barely budged."

Yet, after 23 years of inflation averaging three-tenths of 1 percent below its arbitrary two-percent target – which the Fed adopted from New Zealand – the high priests of monetary theory determined that the U.S. needed a new inflation "make-up strategy."

According to the FOMC minutes from September 2019, "policymakers would promise to make-up for past inflation shortfalls with a sustained accommodative stance of policy that is **intended to generate higher future inflation.**" (Emphasis added)

In August 2020, Chairman Powell officially introduced a new flexible average inflation targeting framework that was designed to increase inflation. The Fed got their wish.

If that was not bad enough, in January 2022 the FOMC compounded that mistake and unanimously reaffirmed the policy strategy without revision.

Valuation

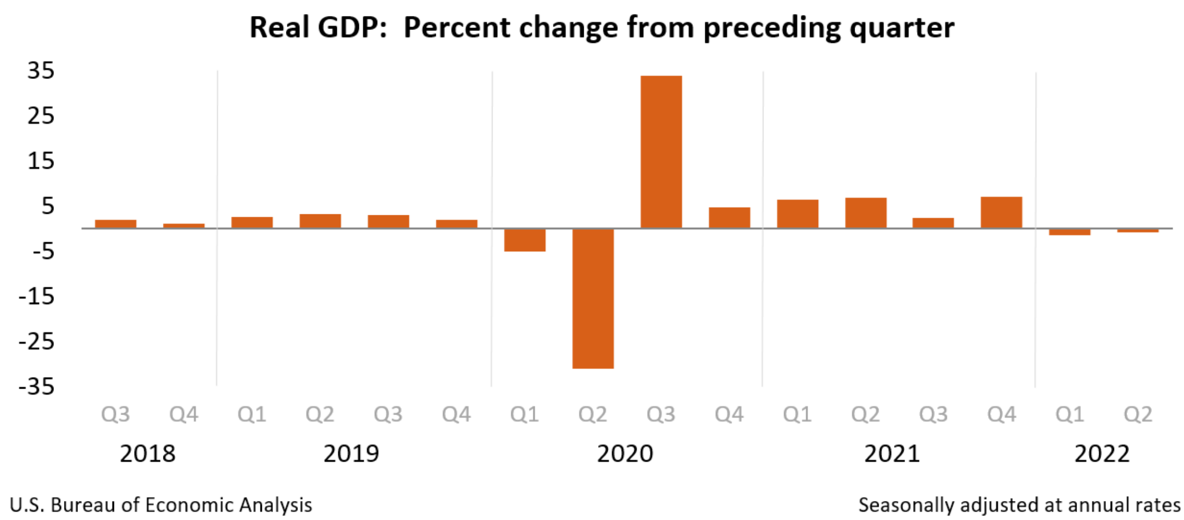
Over the past 90 days, earnings estimates for the S&P 500 have declined from roughly $226 for calendar year 2022 to about $218. When Fed policy includes raising interest rates and reducing the size of its balance sheet (quantitative tightening), Price/Earnings (P/E) ratios tend to decline.

Therefore, the markets have been adjusting to both a lower level of earnings as well as a lower P/E ratio. This is likely to be the case until the Fed signals that they are done with interest rate hikes.

Clearly, year-over-year inflation figures running at a 40-year high have not been kind to companies with well-above market P/E ratios.

Economic Cycle

The U.S. economy contracted by 0.9 percent in the second quarter after shrinking by 1.6 percent in the first quarter. While the Biden administration seems focused on the technical definition of a recession, the fact of the matter is the last ten times the economy declined for 2 consecutive quarters it resulted in an official recession every time. The Leading Economic Index (LEI) fell for the fourth consecutive month. Every time that has happened the U.S. economy was in recession.



The consumer price index (CPI) rose 9.1 percent in June on a year-over-year basis, well above the Federal Reserve's 2 percent target. Even the Fed's preferred personal consumption expenditures (PCE) inflation gauge rose 6.8 percent on a 12-month basis, the biggest increase since 1982. As the cost of essentials such as food and gas increase, there is less disposable income to spend on other goods and services.

As inflation has raged and interest rates have risen, consumer confidence has been under pressure, falling for a third straight month in July. Higher mortgage rates have impacted the U.S. housing market as new and pending home sales plummeted in June to their lowest levels since April 2020.

The Institute for Supply Management (ISM) Manufacturing index fell to 52.8. While a number above 50 indicates expansion, this is the lowest figure since July 2020.

Sentiment

Bearish investor sentiment exceeded Bullish investor sentiment for 11 consecutive weeks, and the Bear to Bull spread exceeded 17 percent just as the S&P 500 index was making its mid-June low. Specifically, the Investors Intelligence bullish percent fell to roughly 26, while the bears exceeded 44.

Often times, extreme readings one way or another are suggestive of a counter-trend move. Given the July advance in the markets, the extreme negative readings were a "heads up" that a long-awaited uptick was possibly developing.

Technical Factors

In just seven trading days in June the S&P 500 index declined by 12.5 percent. It went from a close of 4160 on June 7th to an intraday low of 3636 on June 17th. While that was occurring, the percent of stocks trading above their 50-day moving average fell to roughly 2 percent.

It certainly appears that some large funds dumped stocks ahead of the second quarter close. In fact, according to some reports, equity allocation on the parts of funds fell to the lowest level since October 2008, and cash rose to the highest level since 2001.

Indeed, both of those periods provided some very attractive entry points despite the fact that there was more volatility ahead.

Outlook

In the 2021 letter Jerome Powell sent to Senator Rick Scott, Powell said "inflation that is too low harms American families and businesses." Yet, we know that Powell acknowledged that even during the 2008 financial crisis "core inflation barely budged." So why did the Powell-Fed adopt a radical and untested inflation policy when in fact it's high inflation that actually harms families and businesses? We may never know the true answer.

One possibility, however, is what Treasury Secretary Janet Yellen told an audience at the World Economic Forum about "our new approach," which seeks to reduce "inequality and environmental damage." Perhaps the Powell-Fed believed that higher inflation could help in that endeavor.

Nevertheless, the high priests of finance decided to experiment with a new, untested theory. In fact, Jerome Powell boasted that the Fed was "the first major central bank to adopt this framework."

Unfortunately, along the way it appears that Mr. Powell has been disingenuous and, at times, intentionally deceptive about the policy. For example, in September 2020, shortly after the introduction of the new framework, Mr. Powell was asked what inflation moderately above 2 percent meant. Powell responded, "it means not large. It means not very high above 2 percent."

As we know, the Fed did not raise interest rates until inflation hit nearly 8 percent. Even with Washington's tendency to change definitions, you will not find many people who believe that something nearly 4-times the target would be considered to be "not very high above 2 percent."

We believe the Fed experimented with a new policy that was laid out in a 1997 academic paper by Ben Bernanke and Frederic Mishkin titled: *Inflation Targeting: A New Framework for Monetary Policy?*

Unfortunately, it seems that Mr. Powell and the crew at the Fed ignored one of the main points from that paper: "accurate inflation targeting could be extremely difficult."

When the Fed makes mistakes, investors pay the price. Now the Fed is trying to mop up their mess at a time when the economy is slowing and geopolitical tensions are on the rise.

Moreover, it seems like Mr. Powell is just winging it when he speaks. For instance, at his press conference he said “households are generally in about as strong as financial shape as they’ve been in a very long time or perhaps ever” followed by “their paycheck doesn’t cover the food that they are accustomed to buying.”

Needless to say, this does not instill confidence, and the erosion has been a major headwind this year. However, after the damage has been done, the Fed wants you to know that now they are “acutely aware that high inflation imposes significant hardship” and now they are “strongly committed” to stable prices.

Following months of weakness, in late June and early July markets experienced some extreme selling pressure that by some measures have not been seen since the 2008 financial crisis. One report showed that fund managers cut equity exposure to the lowest levels since 2008.

There is no doubt that many good companies are on sale. What is in doubt is the competency of people in Washington, D.C. (8.2.22)