TJT CAPITAL GROUP
REGISTERED INVESTMENT ADVISOR

On Our Radar September 2022

Following a 9.1 percent gain in the month of July, the S&P 500 index fell 5.8 percent in the last four days of August following Federal Reserve Chairman Jerome Powell's speech at Jackson Hole, WY. For the month of August, the S&P declined 4.2 percent.

While we have been especially critical of the Powell-led Fed previously stating that "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," apparently, we were not harsh enough. To be blunt, the Powell-Fed has embarrassed itself.

The same people who ignored rising inflation and kept interest rates at zero until inflation hit nearly 8 percent are now lecturing us about the importance of low inflation. Powell, who four weeks ago said "now that [interest rates] are at neutral" – the theoretical level that is neither accommodative nor restrictive – recently did a 180-degree turn saying "another unusually large increase [in rates] could be appropriate at our next meeting."

After the 1008 point decline in the Dow Jones Industrial Average on August 26, 2022, the day Powell gave his speech, Minneapolis Fed President Neel Kashkari said he was "happy."

The yield on the 10-year Treasury Note rose from 2.60 percent in early August to nearly 3.25 percent at month end. Oil, meanwhile, was trading at roughly $87 a barrel, down from the mid-$90s in July.

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)

It has become abundantly clear that Fed Chairman Jerome Powell does not know what he is doing, and the markets have lost confidence in the Fed.

In his recent Jackson Hole speech, Jerome Powell referenced the "low and stable inflation of the past quarter-century." What Powell has yet to do is explain why he changed a "low and stable" inflation policy for a radical, untested policy based on a theory that was designed to **increase** inflation.

In his August 2020 Jackson Hole speech, Fed Chairman Jerome Powell introduced a new monetary policy framework to increase inflation. He said:

- "The persistent undershoot of inflation from our 2 percent longer-run objective is a cause for concern."
- "Inflation that is persistently too low can pose serious risks to the economy."
- Flexible average inflation targeting will aim "to achieve inflation moderately above 2 percent for some time."

- "Of course, if excessive inflationary pressures were to build or inflation expectations were to rachet above levels consistent with our goal, we would not hesitate to act."

This was totally misguided. Indeed, back in a 2018 speech, Powell said between 1995 and 2018 "inflation has been relatively tame, averaging 1.7 percent." So, after decades of low and stable inflation, in 2020, Powell changed policy to an "inflation makeup" strategy because inflation averaged 0.3 percent less that the Fed's arbitrary 2 percent objective.

This is a stunning example of arrogance and hubris!

Moreover, the facts show that not only did the Fed "hesitate to act," they had no intention of acting as they let inflation run to more than 3-times its official 2 percent target before they raised interest rates.

In late 2020, Fed Governor Lael Brainard stated that the Fed needed to "support the inflation makeup strategy [and] stay the course." Said another way, the Fed was determined not to respond to higher inflation.

The Fed misled the markets, and continue to do so.

About a month ago Fed Governor Christopher Waller admitted that the Fed "bet the farm" that inflation would come down. That statement hardly squares with Powell's repeated assurances that the Fed would not hesitate to act and that they were "guided by our mandate."

The Fed was never given the mandate to "bet the farm" on inflation.

In his August 2021, speech at Jackson Hole, Jerome Powell acknowledged that PCE inflation was more than double the Fed's 2 percent target, but went on to say, "these elevated readings are likely to prove temporary." Powell's basis for that prediction seemed to be the 1950s, a time that has zero resemblance to a post-pandemic economy.

Nevertheless, Powell assured markets that the Fed was "carefully monitoring incoming data" and that "if sustained inflation were to become a serious concern, the Federal Open Market Committee (FOMC) would certainly respond."

The Fed waited until inflation hit nearly 8 percent before it raised interest rates by 25 basis points (0.25%), and continued to purchase billions of dollars-worth of bonds.

In his August 26, 2022 Jackson Hole speech, Powell demonstrated once again that he is divorced from reality. He said, "Without price stability, the economy does not work for anyone," seemingly unaware that was the primary reason why Congress gave the Fed a mandate of low, stable inflation in 1977 – 45 years ago!

Valuation

S&P 500 operating profit estimates for calendar year 2022 continue to be reduced due to slower sales and rising input costs. About 90 days ago, estimates were in the range of $224. Now they are below $210.
The current P/E (price/earnings) ratio is roughly 18.6-times earnings. With higher interest rates on the horizon and a Fed determined to slow "aggregate demand," the P/E ratio could be under pressure.

High inflation and rising interest rates have usually meant lower P/E ratios in the past. That said, central bank policies around the globe are anything but usual.

Calendar year 2023 earnings estimates are around $240, but given the volatility in prices for goods and services as well as end demand, that seems highly suspect at this point.

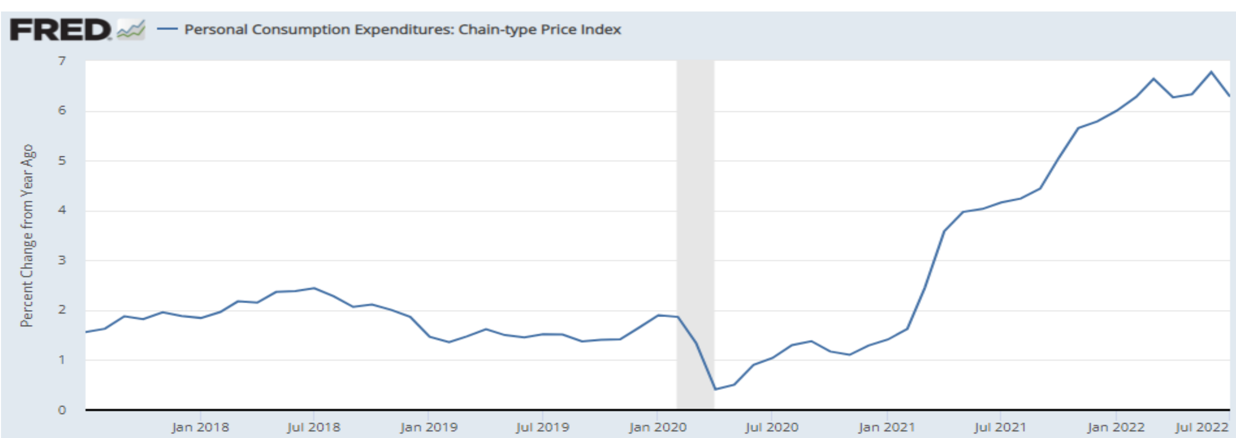
What is more important, however, is the uncertainty around what the "market" thinks the proper P/E ratio should be given the current high inflation, rising interest rates, and a Federal Reserve that has signaled that it will continue to hike interest rates in an effort to bring inflation down.

Economic Cycle

Second quarter Gross Domestic Product (GDP) was revised up to negative 0.6 percent from the initial estimate of a 0.9 percent decline. Industrial Production rose 0.6 percent, and the Institute for Supply Management (ISM) Manufacturing index was 52.8, with levels above 50 indicating growth.

On the other hand, the Leading Economic Index (LEI) decreased 0.4 percent in July, the fifth consecutive monthly decline. Rising interest rates have caused existing home sales to decline for 6-consecutive months, while retail sales were flat.

The Consumer Price index rose 8.5 percent year-over-year and the Fed's favorite inflation gauge, Personal Consumption Expenditures (PCE), increased 6.3 percent year-over-year.



Sentiment

Near the peak in the August rally, bullish investor sentiment was north of 45 percent, having rallied from below 30 percent. By the end of August, bullish sentiment dipped back down into the high 30s range.

Bearish sentiment was above 44 percent near the June market lows before dropping to roughly 27 percent during the August rally.

For perspective, bearish investor sentiment was above bullish sentiment for 13-consecutive weeks before the "bulls" finally outnumbered the "bears."

Technical Factors

The percent of stocks trading above their 50-day moving average has been a good indicator of oversold/overbought markets.

At the June 2022 lows, only 2 percent of stocks were trading above their 50-day moving average, an extremely oversold condition. As the markets rallied in August, that number rebounded to almost 90 percent before Jerome Powell's Jackson Hole speech.

These extreme moves are good for traders and momentum based computerized trading, however, many investors prefer a less volatile environment.

Outlook

It is ironic that when the Ben Bernanke-Fed first issued a Statement on Longer-Run Goals and Monetary Policy Strategy in 2012, Bernanke said it was not "a change in the underlying policy approach," something that was in effect for decades, but to "increase our transparency and accountability."

So far, there has been zero accountability for Jerome Powell and those on the Federal Open Market Committee (FOMC) who radically changed to a policy designed to increase inflation.

Clearly, the notion that inflation was "too low" was absurd as PCE inflation has been negative on a year-over-year basis in only 9 out of the last 750 months going back to 1960, all of which occurred following the 2008 financial crisis. Therefore, Jerome Powell made a disastrous decision to experiment with monetary policy because of the fear of an occurrence that happened 1.2 percent of the time over the last 62 years.

To add to the Fed's delusions, Jerome Powell referenced Paul Volker in his recent speech. This is insulting. Paul Volker tamed inflation, which led to decades of low, stable inflation while Powell reversed many of Volker's policies, which helped usher in the highest inflation in 4-decades.

Moreover, Powell is apparently unaware that Mr. Volker said, “no price index can capture down to a tenth or a quarter of a percent the real change in consumer prices,” yet that seems like a primary reason why Powell changed course.

The facts suggest that the Fed was not “guided by its mandate” of low, stable inflation, but was determined to carry out a radical monetary policy experiment based on a theory that had never been implemented by a central bank.

What’s more, in January 2022, the Powell-Fed reaffirmed the new monetary policy strategy without revision! According to this Fed, no changes or tweaks were necessary.

It is quite clear that the Fed does not know what it is doing, and now some Fed governors are “happy” with lower asset prices. As such, the markets have lost confidence in the Fed’s ability to manage monetary policy.

To have a Fed Chairman go from “now that we are at neutral” to the economy “will likely require maintaining a restrictive policy stance for some time” over a 4-week period does not seem like someone who is in command of the situation.

The Fed seems determined to slow economic growth even if it causes unemployment levels to rise. There is a real risk that the people that made massive policy mistakes may now overcompensate for their failure to maintain low, stable inflation by tightening policy too much.

As a result of Powell’s speech one week ago, commodities are down, interest rates are up, and stocks are down. It seems the Fed has yet to learn that there is a big difference between theory and reality.

To put it mildly, this is unsettling. The Fed seems to be flying blind, taking investors along for the ride. The Fed is a major problem, and they do not seem to know it. As such, we expect volatility to remain elevated and a wider range of outcomes. (9.2.22)