On Our Radar October 2022

The only thing worse than a hostile monetary policy is a Federal Reserve that does not know what it is doing. The markets are dealing with both.

As inflation hit a 40-year high in January 2022, Federal Reserve Chairman Jerome Powell said the Fed “decided to keep the target range for federal funds rate at 0 to ¼ percent.” In that same press conference Mr. Powell referred to inflation as a “high class” problem. Now, after high inflation has caused a rout in the currency, commodity, stock, and bond markets, Mr. Powell has found religion and wants everyone to know that low, stable inflation is the “bedrock” of the economy.

For well over a year, Chairman Powell has repeatedly said that the Fed is “guided by our mandate,” one of which is stable prices. As the Fed ignored inflation and did not begin to raise interest rates until the Consumer Price Index (CPI) was 7.5 percent - a 40-year high - markets are sending a message to the Powell-Fed that those type of statements are not credible.

Consequently, markets have lost confidence in the Fed and are acting accordingly.

September saw the S&P 500 index fell 9.3 percent, the yield on the 10-year U.S. Treasury Note rose 68 basis points (0.68%) to 3.83 percent (it was 2.60 percent on August 1, 2022), and a barrel of oil fell from just over $88 to roughly $79.70.

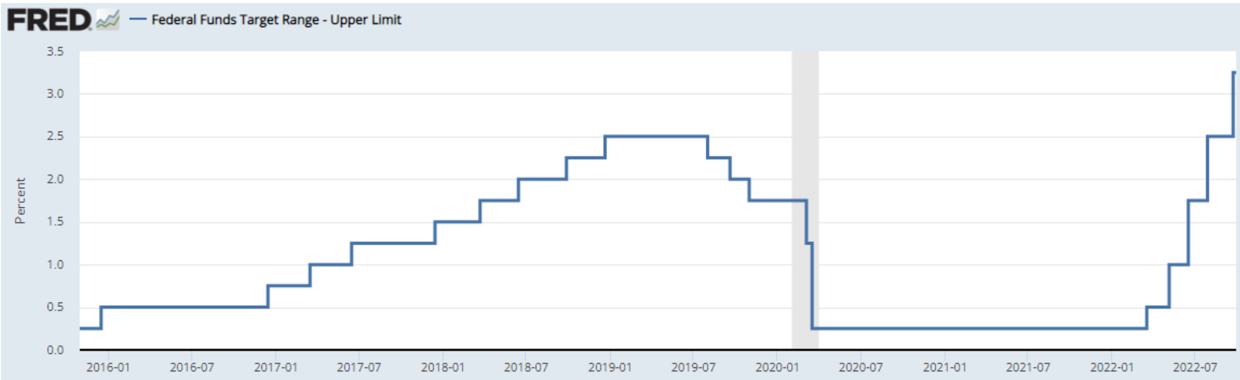
TJT Capital Group’s InVEST Risk Model ® has helped our clients participate in bull markets and protect capital from the devastation of bear markets by focusing on 5 indicators that really matter when it comes to determining the health and direction of markets. The following is the most recent update.

Interest Rates (Monetary Policy)

The Federal Open Market Committee (FOMC) increased interest rates on federal funds by another 75 basis points (0.75%) to a range of 3.00 to 3.25 percent, and is expected to continue to reduce the size of its $8.79 trillion balance sheet.

However, as you can see in the adjacent chart, the Fed has increased interest rates more in 6 months than it previously did over a three-year period in the last tightening cycle. The rate of change in interest rates is causing havoc around the globe as seen in currency, bond, and stock markets.

The upper range of the Fed’s target has increased 13-fold since March and bond markets around the world are seizing up. Leveraged positions on securities have experienced significant price drops and have forced significant collateral calls for additional capital to make up for losses. If more money is not deposited, positions are sold into a market with scarce liquidity.



Chairman Powell said the Fed was "taking forceful and rapid steps to moderate demand" in an effort to restore price stability, but has yet to say how that policy will address food inflation which rose 12.4 percent over the past year.

Of greater significance is the fact that Mr. Powell has yet to address the root cause of the problem that let the inflation genie out of the bottle: a radical, untested theory that the Powell-Fed implemented in August 2020 called flexible average inflation targeting (FAIT).

For background, the Fed believed that inflation was too low even though it averaged 1.7 percent rather than the Fed's arbitrary 2 percent goal. Several people were sounding the "alarm." For instance, in February 2020, Janet Yellen said the Fed is really worried that inflation is too low. In April 2021, Jerome Powell wrote a letter to a U.S. Senator stating "inflation that is too low harms American families and businesses."

So, the academically anointed thought they should gamble with monetary policy and adopt an untested theory because of three-tenths of 1 percent. To illustrate the hubris and absurdity of that logic, a three-tenths of 1 percent price change over a period of ten years is the difference between a gallon of gas that costs $3.00 compared to $3.09.

Now, after inflation has ravaged through markets based on a colossal policy error by this Fed, Chairman Powell waxes poetically about yesteryear as price stability "delivers large benefits to society over a long period of time." Just last week Powell stated "for a long time, The United States had 2 percent inflation, didn't move around much, and that was enormously beneficial to the public that we serve."

It is as if Mr. Powell is oblivious to the fact that he was the one who changed decades worth of monetary policy principles that provided stable prices for a radical "inflation makeup strategy." The Fed played with fire and the markets have been scorched.

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Valuation

S&P 500 operating profits for calendar year 2022 are expected to be around $208, putting the P/E (price/earnings) ratio at roughly 17.2-times earnings. While earnings estimates have been coming down this year due to higher operating costs and inflation, so have Price/Earnings (P/E) ratios.

Higher interest rates have a serious impact on what the market is willing to pay for future earnings. The Fed's glaring policy mistake is having an enormous impact on valuation.

Economic Cycle

The U.S. economy has had two negative Gross Domestic product (GDP) prints in the first and second quarters of this year, and is teetering on a third. The Leading Economic Index (LEI) has declined for 6 consecutive months, a harbinger of a recession. The Institute for Supply Management (ISM) Manufacturing survey for September fell to 50.9, the lowest since May 2020. Moreover, new orders fell to 47.1, with levels below the 50 indicating contraction.

The Consumer Price Index (CPI) increased 8.3 percent year-over-year in August, while the Fed's favorite inflation gauge, Personal Consumption Expenditures (PCE), increased 6.2 percent over the past 12 months.

On the positive side, consumer confidence has ticked up off the lows seen in early July, and gasoline prices have dropped about 25 percent since the summer peak.

Sentiment

Higher inflation, weak stock and bond markets, a war, an economy that has contracted for 2 consecutive quarters, and a Federal Reserve that seems content to officially steer the economy into recession is weighing on investor sentiment. Bullish sentiment is in the mid-20 percent range, which does not happen often.

We normally view sentiment as a contrary indicator, especially at extremes. That said, there is a risk that the Fed over-tightens, which has been eroding confidence. The extreme volatility that we have seen to date is not healthy, and a number of investors have been reducing exposure.

Technical Factors

From a technical viewpoint, stocks and bonds are in a bear market. The key is where the market goes from here. The percent of stocks trading above their 50-day moving average fell to roughly 3 percent recently. That is pretty extreme. It is also indicative of a market that is broken and in need of repair.

The number of stocks making new 52-week lows on the New York Stock Exchange and the NASDAQ have exceeded 1000 on a number of days. Again, a lack of confidence and a lack of liquidity are showing up in the poor technical readings.

Outlook

The UK experienced a significant decline in its currency as a result of high inflation and reckless fiscal policy. In late September the British pound quickly fell to roughly 1.03 versus the U.S. dollar, down from 1.17 the previous week. Moreover, 10-year UK government bond yields surged from 1.75 percent at the beginning of August to 4.5 percent in September.

According to the Financial Times, this massive move caused “thousands of pension funds” to have to meet urgent margin calls on leveraged bond positions. As a result, the Bank of England (BOE) was forced to begin a new round of bond buying “on whatever scale is necessary” to help alleviate the “significant dysfunction” in the credit markets.

The Bank of England (BOE) said that UK asset prices suffered significant declines that could weaken the country’s financial system and economy if left unchecked.

In the U.S., the Fed wants everyone to know how courageous they are in going on the inflation attack. These are the same people who turned a blind eye to inflation and failed to act on a timely basis.

Last September, when inflation was more than double the Fed’s target, Fed Vice Chair Lael Brainard said “high inflation is likely to be transitory.” Previous to that she said the Fed should eliminate the rationale for removing monetary policy preemptively in “anticipation for high inflation that is unlikely to materialize.”

In November 2021, when inflation was almost three-times the Fed’s 2 percent target, Federal Reserve Bank of Minneapolis President Neel Kashkari said the Fed “need not overreact to some of these temporary [inflation] factors.”

The Fed that dismissed any notion that high inflation was a problem and ignored actual inflation for well over a year now can’t raise interest rates fast enough. They do not understand the consequences of their actions.

Furthermore, the Fed wants you to believe that they are now going to be “data dependent,” yet in the same speeches state that monetary policy needs to be “restrictive for some time” as if they know what the future is going to be. It seems as though the Fed is repeating the same mistake they made a year ago except in the opposite direction. Specifically, whereas Vice-Chair Brainard was previously against “removing [accommodative] policy preemptively,” she recently stated “we are committed to avoid pulling back [restrictive policy] prematurely.”

At the time Jerome Powell introduced the new inflation “makeup strategy,” he boasted that the Fed was the first central bank to adopt this new theoretical framework. Yet Chairman Powell has not accepted responsibility for the catastrophic error despite blaming the Russian invasion. It’s worth noting that the Consumer Price Index was up 7.5 percent before Russia invaded Ukraine.

Nevertheless, the Fed should not compound the policy error by overtightening at a pace that markets cannot handle. The Fed has done enough damage.

To that point, the Fed's view on inflation has changed materially since the 2007-2008 financial crisis. Consider this: In August 2007, as the initial impact of the subprime mortgage problem took down two Bear Stearns hedge funds, the Ben Bernanke-Fed's "predominant policy concern remain[ed] the risk that inflation will fail to moderate as expected."

However, in mid-March 2022, with the Consumer Price Index (CPI) up nearly 8 percent year-over-year – the highest since 1982 – the Powell-Fed's interest rate range for federal funds was "zero to one-quarter percent."

Problems occur when unchecked theories are carried too far. It appears that Powell decided to blindly follow an untested theory based on a false assumption and were determined to see it through until the end. Unfortunately, the Fed did not raise interest rates – its primary tool – until inflation was nearly 8 percent.

Obviously, the markets have been under a great deal of pressure. Clearly there is an economic component to asset prices, however, psychology also plays a critical role. When confidence in the Fed or other central banks erodes, bouts of fear and panic rise.

It is often said that markets stop panicking when central bankers start panicking. On October 3, 2022, the Federal Reserve Board held a closed meeting under expedited procedures. Over the weekend there were concerns about the health and stability of at least one large financial institution as its credit default swaps (insurance on the institution's corporate bonds) surpassed levels seen during the last financial crisis.

A Fed meeting just eight business days after the Federal Open Market Committee meeting may indicate that the Fed is worried that they may have hiked interest rates too far, too fast. If so, given the oversold condition of the markets over the past few weeks, markets could experience a healthy bounce.

To sum up, markets are unstable because Fed policy has been unstable. A pause by the Fed would be welcomed. (10.4.22)