TJT CAPITAL GROUP
REGISTERED INVESTMENT ADVISOR

On Our Radar November 2022

U.S. stock markets rallied to begin the fourth quarter as the S&P 500 index gained almost 8 percent in the month of October despite the fact that the yield on 10-year U.S. Treasury Notes rose to 4.10 percent from 3.83 percent at the end of September and a barrel of West Texas Intermediate crude oil rose to about $86.50 from just below $80.

Volatility remained elevated and a case can be made that the Federal Reserve may have influenced the market in a way that could backfire. On Friday October 21, 2022, an article appeared in the online version of the Wall Street Journal (not the print version) just before 9:00 am. It was significant as that Friday happened to be an option-expiration Friday where hundreds of billions of dollars-worth of options, futures, and derivatives expire.

The article quoted several members of the Fed's Federal Open Market Committee (FOMC), which also happened to be the last piece of public information prior to the "blackout" ahead of the official FOMC meeting. The article hinted that the Fed would debate the size of future hikes, giving some hope that the so-called "pivot" away from future interest rate hikes could be coming.

As a result, stock and bond markets staged a vigorously rally.

On November 2, 2022, Federal Reserve Chairman Jerome Powell seemed to pull the proverbial rug out from markets when he said "it's very premature to be thinking about pausing" interest rate hikes as the Fed has "some ground to cover" in its attempt to restore low, stable inflation, "and we will cover it."

For that reason, stock and bond markets sold off hard.

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)

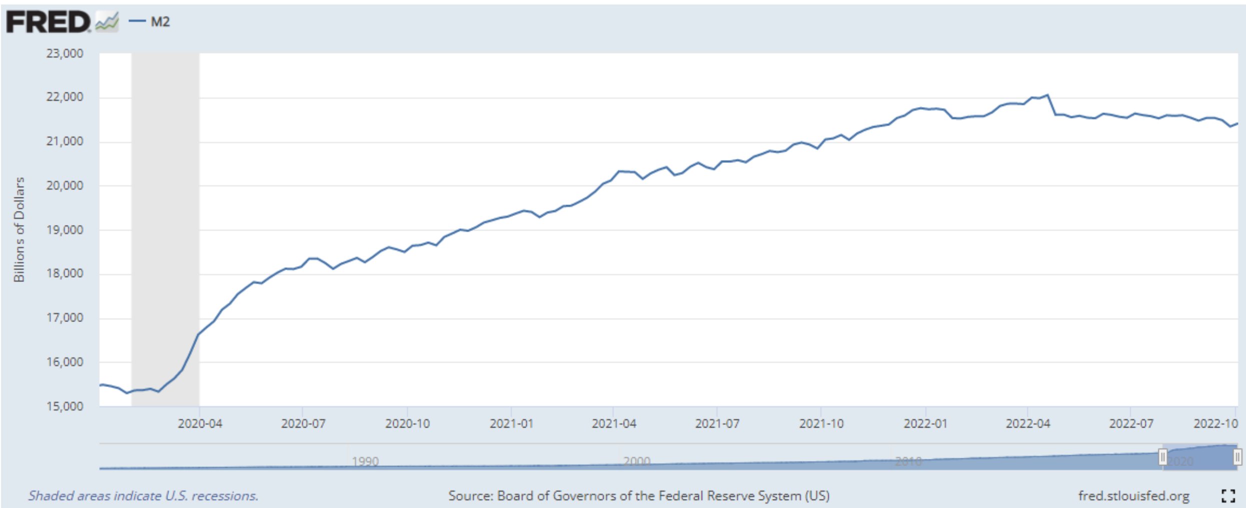
The Federal Open Market Committee (FOMC) increased interest rates by 75 basis points (0.75%) for the fourth consecutive time, lifting the federal funds target rate to a range of 3.75-to-4.00 percent. This rate of change from essentially zero to 4 percent is greater than anything the markets have seen in a very long time.

As a result of the colossal mistake by the Federal Reserve, markets have been under enormous pressure. Following yesterday's press conference, Chairman Powell did not do anything to address the markets lack of confidence in his leadership.

The Powell-Fed has yet to acknowledge what Federal Reserve Bank of New York staff said: the "inflation surge…arising from increased demand caused by very expansionary fiscal and monetary policy." In fact, according to the same article, 60 percent of inflation was due to the

Fed-inspired surge in demand. For that reason, it could be said that the Fed was the inflation arsonist.

The following is a chart of M2, which is the Fed's broadest measure of money in the economy. As you can see, M2 grew from roughly $15.3 trillion prior to the COVID-pandemic to more than $22 trillion by April 2022, an increase of more than 43 percent.



The reality is that the Powell-Fed pumped an enormous amount of money into the system and did not raise interest rates or stop purchasing bonds until inflation was nearly 8 percent – a 40-year high. Unfortunately, Powell seems to continue to blame Russia's invasion of Ukraine for inflation even though inflation was well-above 7 percent before the war broke out.

It's worth noting that in February 2021 Powell told a Congressional committee that "there was a time when monetary policy aggregates were important determinants of inflation and that has not been the case for a long time." He then doubled down stating the once-strong link between the money supply and inflation "ended about 40 years ago."

This is stunning arrogance and hubris.

Noted economist Milton Friedman famously said, "Inflation is always and everywhere a monetary phenomenon, in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output."

Jerome Powell's background is an attorney. His natural legal default mode seemed to be on display a year ago when he attempted to justify his "inflation is transitory" narrative by saying "transitory is a word that people have had different understandings of."

That is nonsense. It is quite clear what Powell meant by "transitory" when in April 2021 he said, "these one-time increases in prices are likely to have only transitory effects on inflation."

Jerome Powell also ignored one of former Fed Chairman Ben Bernanke's warnings from 2008. Bernanke said stimulus that comes too late "could be actively destabilizing if it comes at a time when growth was already improving."

Now, because of his mistake, Jerome Powell believes "we need to have softer labor market conditions." Since when did Congress task the Fed with increasing unemployment? This is totally misguided as higher unemployment is not the solution for families dealing with higher food and energy costs.

If anyone should lose their job, it should start with Jerome Powell who radically changed decades of monetary policy principles in order to bet on an untested inflation "makeup strategy."

Moreover, employment is a lagging indicator. For example, following the financial crisis, the National Bureau of Economic Research declared the recession ended in June 2009, yet the unemployment rate peaked at 10 percent in October 2009.

Importantly, global debt is around $350 trillion while global GDP is roughly $100 trillion. The world is awash in debt at a time when confidence in central banks is eroding quickly. Furthermore, Fed remittances to the U.S. Treasury – essentially an IOU - reached $5.3 billion in late October. In other words, the Federal Reserve's net income turned negative as they are now losing money on their bond portfolio. This does not inspire confidence.

Also of note, the U.S. Treasury said it will need an additional $150 billion this quarter than it previously expected.

Valuation

S&P 500 operating profits for calendar year 2022 continue to decline and are expected to be around $204, putting the P/E (price/earnings) ratio at roughly 19.1-times earnings. Calendar year 2023 earnings estimates have come down to roughly $230, but given that companies are still seeing high input costs, estimates are fluid and likely to change.

What is more important, however, is the uncertainty around what the "market" thinks the proper P/E ratio should be given the Fed's aggressive interest rate hiking cycle. Thus, it is not just the level of earnings that matter but what the market is willing to pay for those earnings. Higher interest rates tend to put downward pressure on Price/Earnings (P/E) ratios.

Economic Cycle

The U.S. economy grew 2.6 percent in the third quarter due primarily to a narrowing of the trade deficit. This growth compares to the contractions of 1.6 percent and 0.6 percent in the first and second quarters, respectively. In addition, Industrial Production increased 0.4 percent in September.

Unfortunately, inflation continues to run hot. The Consumer Price Index (CPI) rose 8.2 percent yearover-year, and the Fed's favorite inflation gauge – Personal Consumption Expenditures (PCE) rose 6.2 percent over the past 12 months.

The Institute for Supply Management (ISM) Manufacturing index fell to 50.2 from 50.9, with the 50-level being the line between growth (above 50) and contraction (below 50). Importantly, new orders fell to a contractionary 49.2. The Leading Economic Index (LEI) decreased 0.4 percent in September, and is down 2.8 percent over the previous six months.

The Conference Board Consumer Confidence Index fell to 102.5 down from 107.8 in September. Sharply rising mortgage rates have put enormous pressure on the housing market as new home sales plunged 11 percent month-over-month in September. Existing home sales have contracted every month this year and are down more than 23 percent from a year ago.

It's worth noting that as of October 31, 2022, the 3-month vs. 10-year U.S. Treasury yield curve "inverted" as the three-month Treasury yield was higher (4.22%) than the 10-year Treasury (4.10%). While not a perfect indicator, an inverted yield curve has preceded every recession since 1961.

Sentiment

Bearish investor sentiment has exceeded bullish sentiment for seven consecutive weeks. At one point in early October, bearish sentiment was more than 19 percentage points higher than bullish sentiment, the widest spread since March 2009.

As most investors may recall, that was a very good time to increase risk allocation. However, the one glaring difference was back then, the Fed was lowering interest rates and purchasing bonds ("QE"). Today, the Fed is hiking interest rates and reducing the size of their balance sheet.

Technical Factors

The percent of stocks trading above their 50-day moving average rose from about 3 percent at the end of September to more than 50 percent recently.

Moreover, the number of stocks on the New York Stock Exchange making new 52-week highs has advanced from single digits to the high 80s of late. Likewise, the number of new lows has declined from over 1000 to a few hundred.

While the technical damage to the market has been meaningful and is likely to take time to heal, there are some hints of progress.

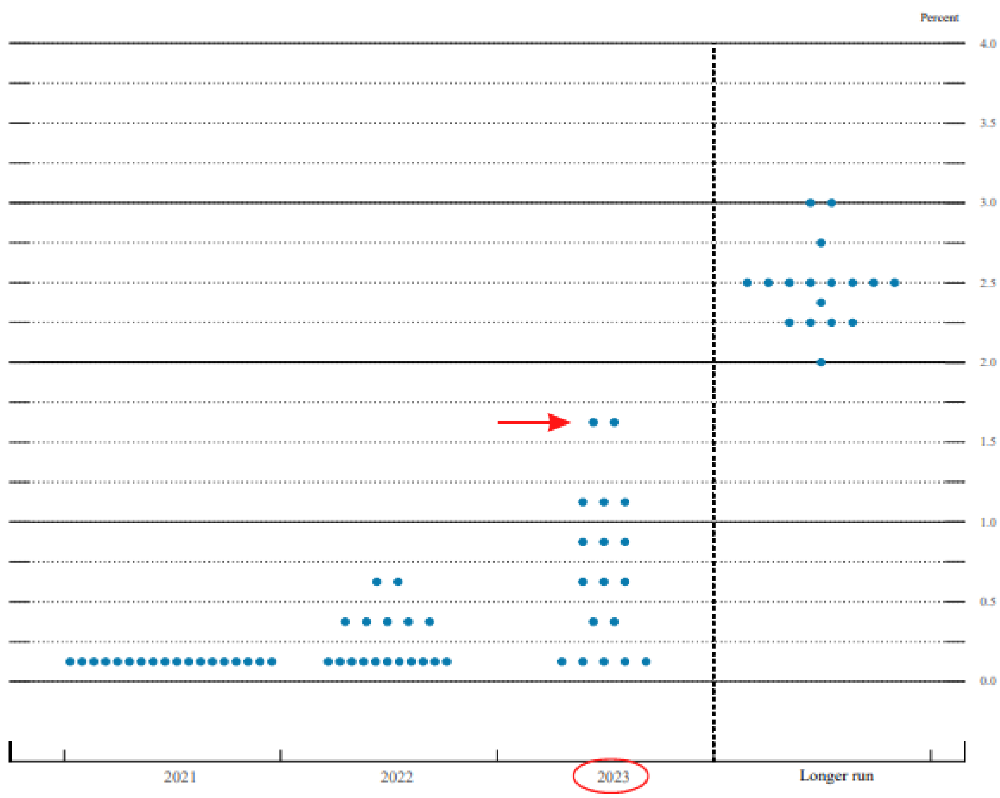
Outlook

Milton Friedman also said “Inflation is the most destructive disease known to modern societies. There is nothing which will destroy a society so thoroughly and so fully as letting inflation run riot.”

Well, that was something that probably was not covered in law school. Nevertheless, Powell seems to have gotten the memo as he recently said “without price stability, the economy does not work for anyone.”

So, how did we get here? Theory. What took place seems to resemble Long Term Capital Management, which required a massive bailout in the late 1990s despite having 2 Nobel Laureates on its board. One version can be summed up as follows: our theory is right; the market is wrong! As Albert Einstein said, “In theory, theory and practice are the same. In practice, they are not.”

The following is the FOMC “Dot Plot” from June 2021. Even though the June 2021 CPI was 5.4 percent – the highest in 13 years - and Personal Consumption Expenditures (PCE) was 4.00 percent, both more than double the Fed’s 2 percent target, according to members of the FOMC, the highest expected rate on federal funds for 2022 was 0.625 percent, and **1.625 percent in 2023.**



This certainly seems to be the case of “our theory is right; the market is wrong.”

As a reminder, the Fed just took interest rates on federal funds to a range of 3.75 to 4.00 percent, and indicated they are not done.

Instead of Powell being “guided by our mandate” of low, stable prices, it appears that the Fed predetermined that they were not going to respond to higher inflation.

Consequently, the Fed is engaged in an unprecedented interest rate hiking cycle in an economy that has become increasingly leveraged. Liquidity in markets is down and trading algorithms are causing outsized moves, which exaggerates a feedback loop that is perhaps unrelated to fundamentals.

Sadly, in an attempt to get the inflation genie back in the bottle, the Fed admits that it is “taking forceful steps to moderate demand,” as if that is going to solve higher energy and food prices.

Needless to say, a good portion of the Fed interest rate hike has already likely occurred, and prices reflect that. Leverage is being unwound at a very fast pace, and confidence is low. Nevertheless, while volatility is likely to remain high, it is important to keep in mind that since 1950, the S&P 500 has not been down from the November midterm election through the next 6 months over the past 18 cycles. (11.3.22)