On Our Radar December 2022

Amid the ongoing war between Russia and Ukraine, the mid-term election drama in the U.S., and escalating tensions in China as a result of severe COVID lockdown policies, a number of markets experienced impressive moves in the month of November.

For example, the S&P 500 index rallied roughly 5.4 percent in November and closed the month up 13.8 percent from its mid-October low. In addition, the yield on the 10-year U.S. Treasury Note fell from 4.10 percent to 3.68 percent, with 30 basis points (0.30%) of that taking place on one day.

The catalyst for the large moves was an inflation report. After a 9.1 percent year-over-year increase in the Consumer Price Index (CPI) in June, the CPI increased “only” 7.7 percent year-over-year in October. While obviously still high, there is evidence that deflationary forces are having the desired effect. As a result, the U.S. dollar index has declined roughly 6 percent over the past four weeks.

Oil prices are well off their peak, trading around $80 a barrel compared to more than $122 a barrel in June. And many other commodities such as aluminum, lumber, steel, soybeans, and wheat, to name a few, are also down significantly since the summer. The price direction is a welcome sight.

Meanwhile, the cryptocurrency world was rattled by the bankruptcy of FTX, a company that was run by Samuel Bankman-Fried. Earlier this year FTX raised a funding round with a valuation of about $32 billion. One prominent Silicon Valley company invested $150 million and published an over-the top glowing article about FTX on its website on September 22, 2022.

Unbelievably, the article stated:

- “FTX will be the super-app. Banking will be disrupted and transformed by crypto.”
- “Crypto is money that can audit itself, no accountant or bookkeeper needed.”
- “The FTX competitive advantage? Ethical behavior.”

On November 11, 2022, FTX filed for bankruptcy. In front of a bankruptcy judge, John Ray, FTX’s new Chief Executive Officer and the person who was in charge of Enron following its bankruptcy scandal said, “Never in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information as occurred here.”

Another attorney for FTX estimated the number of creditors to be “more than 1 million,” up from the previous estimate of 100,000, and told the judge a substantial amount of assets are either missing or stolen.

The Silicon Valley fund was forced to write down its $150 million investment to zero and issued an apology as details emerge about what appears to be massive fraud. Remarkably, Samuel BankmanFried testified in front of Congress twice in the past 12 months and was a very large donor, seemingly in an attempt to buy influence at the highest levels of government. Unfortunately, a lot of that money may have been stolen, but there is a lot we still do not know.

In his December 7, 2021 testimony in front of Congress, Samuel Bankman-Fried said, on FTX "there is complete transparency about the open interest, there is complete transparency of the positions that are held, there is a robust, consistent risk framework applied." In contrast, it appears that up to $8 billion of FTX client assets are missing.

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 rate another 75 basis points (0.75%) to a range of 3.75 percent to 4.00 percent. Fed Chairman Jerome Powell went on to say that inflation is too high and "rates have to go higher and stay higher for longer."

In Mr. Powell's opening statement, he said "The historical record cautions strongly against prematurely loosening policy." This is more than a bit ironic as the Powell-Fed ignored the "historical record" about the risks of letting inflation run to multi-decade highs before raising interest rates. Nevertheless, the Fed has raised the target interest rate 16-fold (from 0.25% to 4.00%) since March, an incredible rate of change that has no precedent.

What does have significant historical precedent is the U.S. Treasury yield curve. As you can see below, every time the yield on the 10-year Treasury Note has fallen below the yield on the 3-month Treasury Bill for an extended time going back more than 30 years – also known as an "inverted yield curve – a recession has followed (gray vertical lines).

As of the close of business on December 1, 2022, the 3-month Treasury yield was 4.33 percent and the 10-year yield was 3.53 percent. Therefore, the "treasury curve" was inverted by 80 basis points (0.80%), indicating that the probability of an economic recession is very high.

Valuation

As a result of slower U.S. economic growth and higher input costs due to inflation, 2022 operating earnings estimates for the S&P 500 index have declined from roughly $226 near the end of the first quarter to about $201. In addition, as interest rates rose, the price that the market is willing to pay for those earnings (Price/Earnings or P/E ratio) has declined.

In 2022, the markets have been adjusting to both lower 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.

Economic Cycle

The U.S. economy grew at a revised 2.9 percent in the third quarter, up from the previous estimate of 2.6 percent. However, that is obviously a backwards looking statistic and markets tend to look ahead.

The Leading Economic Index (LEI) fell for the eighth consecutive month, down 0.8 percent in October. The most recent Institute for Supply Management (ISM) Manufacturing survey fell to 49 from the previous month's 50.2, with a level below 50 indicating contraction. Moreover, new orders dropped to 47.2 from 49.2 and the prices paid component fell to 43. The Prices Paid Index has also fallen for eight consecutive months and is down from a March 2022 high of 87.1. For perspective, that is the lowest "prices paid" reading since May 2020.

Industrial production contracted 0.1 percent month-over-month and U.S. pending home sales fell more than 36 percent from a year ago, the largest annual drop in history. Initial unemployment claims have been trending higher with the 4-week moving average of roughly 228,000 up from the April 2022 low of about 170,500. Outplacement company Challenger Gray said job cuts soared 127 percent in November, and household debt increased at the quickest pace in the third quarter to $16.5 trillion - challenging the narrative that the consumer is in great shape. As a result, consumer confidence declined again in November.

Sentiment

Bullish and bearish sentiment has essentially been moving up and down with the major market averages for most of this year.

Often times, extreme readings one way or another are suggestive of a possible counter-trend move. For example, at the recent mid-October 2022 low in the S&P 500 index, the spread between the bulls (25.0%) and the bears (44.1%) was minus 19.1 percent, the widest since March 2009.

Since mid-October, the S&P 500 index is up more than 11 percent.

Technical Factors

Along with sentiment, extreme technical figures in either direction often precede a counter-trend move. At the end of the third quarter, for instance, the percentage of stocks that were trading above their 50-day moving average fell to roughly 3 percent.

In mid-June of this year, another time when the markets were under pressure, the percentage of stocks trading above their 50-day moving average fell to roughly 2 percent.

The subsequent rallies following the end of the third quarter and mid-June declines saw the percentage of stocks trading above their respective 50-day moving averages climb above 73 percent.

Outlook

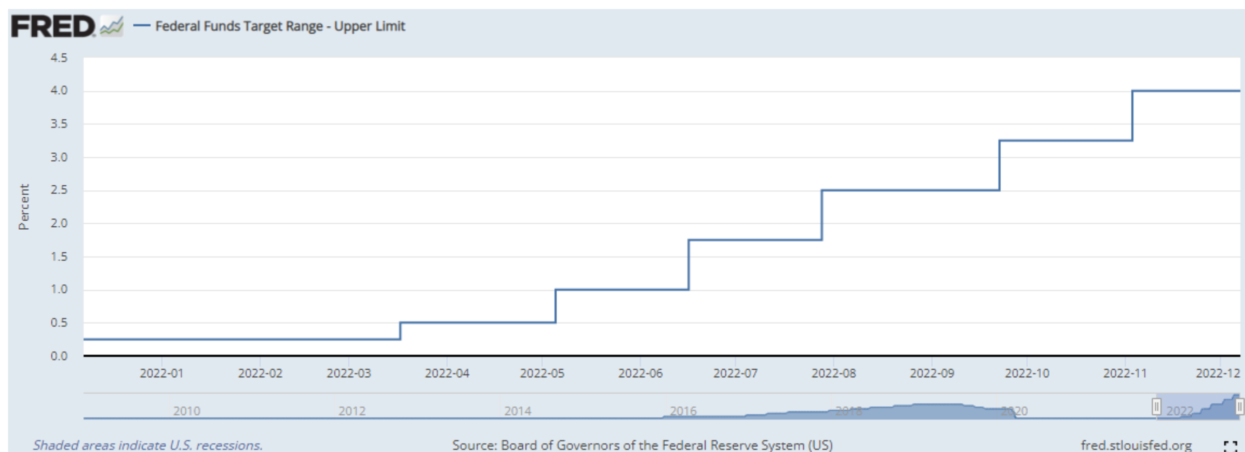
This year has been challenging primarily because of the massive policy mistake by the Federal Reserve. The Powell-Fed risked decades of low, stable inflation based on sound principles – something the Fed was mandated to do by Congress in 1977 – by implementing a radical "inflation makeup strategy," only to let inflation run to a 40-year high before raising interest rates.

In addition to theory-induced blindness, the Fed seemingly relied more on their projections than the actual data. For example, in January 2022, with Personal Consumption Expenditures (PCE) Inflation - the Fed's preferred inflation gauge - up 6.1 percent year-over-year, the Fed's staff still expected PCE inflation of 2.6 percent in 2022.

As a result of that wildly optimistic forecast and arguably a rogue policy change, the Powell-Fed lost its credibility. As a result, stock and bond prices fell as inflation continued to move higher. Ultimately, this forced the Fed to come to grips with reality.

Recently, some members of the Federal Open Market Committee (FOMC) have returned to those principles for guidance, including the Taylor Rule, which prescribes a value for the federal funds rate based on the values of inflation and economic slack.

For instance, near the end of 2021, with PCE inflation up 5.7 percent, the Taylor Rule implied a federal funds rate of nearly 7 percent. The Fed's actual rate was zero-to 0.25 percent. In an effort to regain credibility and attempt to get control of inflation, the Fed has embarked on one of the most dramatic interest rate hiking cycles in history, with federal funds going from near zero in March to roughly 4 percent in a matter of about eight months.



Mr. Powell has blamed Russia's war with Ukraine in part as a reason for high inflation, yet admitted in early November that "we're now 18 months into this episode of high inflation." The fact is by April 2021, long before the Russia/Ukraine war, nearly all measures of core inflation exceeded the Fed's stated longterm goal by a large margin, yet the Fed was actively denying that inflation was a problem.

The Fed believed that inflation was too low so they implemented an untested theory called flexible average inflation targeting (FAIT). As inflation continued to move higher, the Powell-Fed ignored facts and history of the damaging effects that high inflation has on an economy for the sake of a theory.

Having let inflation run hot before adjusting policy, the Fed's focus is on "taking forceful steps to moderate demand." The Fed is trying to slow the economy (demand) just right so that supply and demand are in better balance. The reality is the Fed could not get inflation right, so the probability that they are going to engineer a demand slowdown without causing a recession is low.

The extremely inverted yield curve is signaling that the Fed is already too tight. Unfortunately, the Fed is focused on increasing the unemployment rate - a lagging indicator – as a solution to a problem that their policy helped cause.

The good news is that a lot of excesses in markets have been corrected, and the likelihood of a recession seems to be priced in to a number of securities. Moreover, financial conditions have actually improved quite a bit from mid-October levels, which is encouraging.

While volatility is likely to stay high, at some point in 2023 it is reasonable to expect the Fed to tap the brakes on rate hikes. The markets are usually ahead of the Fed, and we are seeing signs that some sectors are beginning to anticipate a Fed pivot. (12.2.22)

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