TJT CAPITAL GROUP
REGISTERED INVESTMENT ADVISOR

On Our Radar January 2023

The financial markets had a challenging year in 2022 largely due to the Federal Reserve's adoption and implementation of a radical, untested theory which allowed inflation to reach a 40-year high before the Fed changed course. As a result, the markets lost confidence in the Fed, which was reflected in lower stock, bond, and commodity prices, to name a few.

For the year, the S&P 500 index declined 19.4 percent and the yield on the 10-year U.S. Treasury Note more than doubled to 3.88 percent from 1.52 percent at the end of 2021. After dismissing inflation for more than a year, the Fed frantically tried to address the problem by increasing interest rates at a record pace.

At times, to be quite candid, the Jerome Powell-led Fed has been intellectually dishonest. In one instance, a former U.S. Treasury Secretary publicly called out Mr. Powell specifically for making statements that were "analytically indefensible."

Another issue is that Chairman Powell often reads answers to questions at press conferences, which makes it look staged and gives the impression that he is not in command of the subject matter, followed by responses that seem to confirm it. As a result, the Fed's credibility has taken a massive hit.

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 Reserve raised interest rates by another 50 basis points (0.50%) in December to bring the federal funds target to a range of 4.25-4.50 percent. In response to a question, Jerome Powell said, "we need to be honest with ourselves that there's inflation…12-month core inflation is 6 percent CPI. That's three-times our 2 percent target."

A reflection of Powell's answer is an example of why the markets have lost confidence in the Fed.

Back in January 2022, when inflation was at a 40-year high and the core CPI was actually higher than the most recent report – albeit by 8 basis points (0.08%) – Chairman Powell kept interest rates essentially at zero and continued to purchase hundreds of billions of dollars of bonds. At that time, Mr. Powell referred to the multi-decade high inflation as a "high class" problem.

The January 2022 characterization seems almost delusional given that on December 14, 2022, Jerome Powell began his press conference by stating that the Fed understands "the hardship that high inflation is causing."

Unfortunately, Chair Powell continues to make statements that are at best inconsistent. For example, he referenced looking at the "historical record" regarding policy after ignoring the historical record of the consequences of allowing inflation to run. Moreover, there is no historical record of what happens after the Fed expands the money supply by a record amount and increases its balance sheet to nearly $9 trillion, just as there is no historical record of the Fed increasing interest rates 18-fold – from 0.25 percent to 4.50 percent over a nine-month period.

In another head-scratcher, Mr. Powell referenced the need to see “substantially more evidence” of lower inflation after ignoring 18 months of substantial evidence of higher inflation.

While the Fed has yet to admit it, the root cause of inflation was the change in the Fed’s policy. To summarize:

- The Fed incorrectly believed that inflation was too low, so they implemented an inflation “makeup strategy.”
- In August 2020, the Fed changed monetary policy to a radical, untested theory called flexible average inflation targeting (FAIT).
- The Fed engineered an explosion in the money supply.
- The Fed set up the markets when Powell said in August 2020, “if excessive inflationary pressures were to ratchet up above levels consistent with our [2 percent] goal, we would not hesitate to act.”
- Fed officials’ statements suggest that the Fed predetermined that they would not react to higher inflation as higher inflation was their policy objective.
- Because the Fed failed to “act” as inflation hit multi-decade highs, the markets lost confidence in the Fed.

Regarding the new Fed policy, back in March 2019, Jerome Powell referenced a “body of model-based research suggesting that some kind of [inflation] makeup policy could be beneficial.” In that speech, Mr. Powell acknowledged that central banks chose not to pursue such a policy because of the “uncertain distance between models and reality.”

Nevertheless, in August 2020, the Powell-Fed chose to roll the dice. The determination to let inflation run was on display when in November 2021, with inflation at a 30-year high, Minneapolis Fed President Neel Kashkari said the Fed “need not overreact to some of these temporary [inflation] factors.”

The Fed wanted higher inflation and they got it in spades. The Fed knew that they were experimenting with an untested theory-based policy, yet let inflation run. Over the past seven months, after high inflation became obvious, the Fed has been trying to put the proverbial fire out by raising interest rates at a record clip.

Valuation

Since the Fed began to raise interest rates in March 2022, earnings estimates for the S&P 500 index have been declining steadily. For instance, in March 2022, the calendar year 2022 estimates were roughly $225. Today, the 2022 calendar year earnings for the S&P 500 index are estimated to be about $200.

Likewise, the 2023 estimates have declined from around $250 at the end of the first quarter 2022 to approximately $226.

The relatively significant drop in earnings estimates along with the Fed's tightening policy are adding to the markets' uncertainty. The markets have been pricing in lower earnings and a lower Price/Earnings (P/E) multiple.

Economic Cycle

The U.S. economy grew 3.2 percent in the third quarter following two quarters of contraction. The Leading Economic Index (LEI) fell 1.00 percent in November, the ninth consecutive decline. Industrial Production also declined 0.2 percent in November.

Homebuilder sentiment has fallen for a record twelve consecutive months as new home sales declined more than 15 percent from a year ago, and retail sales decreased 0.6 percent in November.

Consumer confidence ticked up on the deceleration in gas prices. The Fed's favorite inflation gauge – core personal consumption expenditures (Core PCE) – while still high, showed the smallest increase in roughly a year. That said, credit card balances jumped 15 percent year-over-year, the fastest pace in two decades. With the average annual percentage rate for balances over 22 percent, that is not consistent with a strong consumer narrative.

Sentiment

Near the October low in the S&P 500, the spread between the stock market bulls and bears reached a multi-year high of minus 191 percent.

Specifically, the percentage of stock market bulls were 25 percent while the percentage of bears rose to 44.1 percent.

For years we have pointed out how extreme investor sentiment is often a good contrary indicator. When "everyone" is bearish, it often suggests that vast sums of money have already left the markets.

From the mid-October low until December 31, 2022, the S&P 500 index rallied more than 7 percent.

Technical Factors

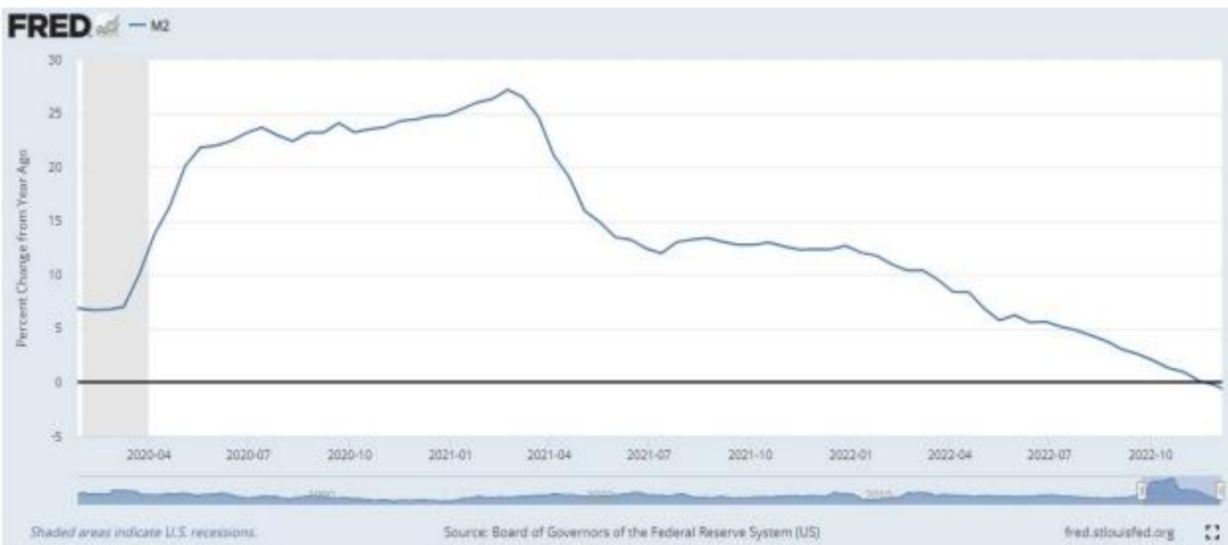
From early January, the trend in the U.S. stock and bond markets has been down, with some relatively powerful counter-trend rallies along the way. The percentage of stocks trading above their 50-day moving average is a way to gauge whether the stock market is overbought or oversold.

For example, at the mid-October low, only 3 percent of stocks were trading above their 50-day moving average – a very oversold condition. That percentage rose into the low 80s as the S&P 500 rallied north of the 4000 level in late November.

While choppy action may continue to be in store, tailoring purchases and sales into weakness or strength should help one navigate a volatile market.

Outlook

After increasing at a 25 percent pace during the pandemic response, M2 – a broad measure of money in the system - actually fell year-over-year for the first time in decades. While famed economist Milton Friedman once said, “Inflation is always and everywhere a monetary phenomenon,” in 2021, Powell lectured Congress stating 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.”



Mr. Powell could not have been more wrong. Unfortunately, he did not explain why a 25 percent increase in the money supply would not lead to higher inflation.

In a sense, the Fed is flying blind. It is unlikely that the Fed has any idea what the ramifications of an 18-fold increase in interest rates over a nine-month period will do to the economy. What’s more, in September, no members of the Fed expected rates to go above 5 percent. In December, 17 out of 19 expected the federal funds rate to go above 5 percent. As a result of that abrupt change, the equity markets promptly fell over 2 percent. At the risk of stating the obvious, it is fair to wonder if the Fed has been paying attention.

The Fed seems to be obsessed with the labor market. According to the Fed’s projections, the unemployment rate, which was 3.5 percent in October, is expected to rise to 4.6 percent in

2023. There has never been a 0.6 percent increase in the unemployment rate that did not translate into a recession. Yet when Mr. Powell was asked about a possible recession, he said it would not qualify as a recession because the Fed was forecasting economic growth.

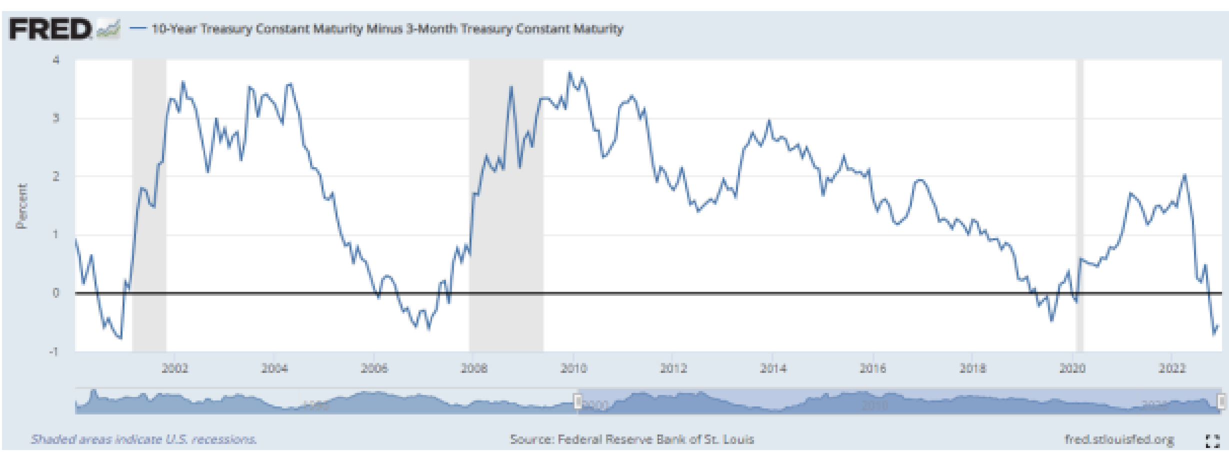
This is the same Fed that in late January 2022, with PCE inflation over 6 percent, was forecasting inflation to be 2.6 percent at the end of 2022. The Fed's forecasts have been so wrong as to be almost meaningless.

It's worth noting that Mr. Powell has failed to make a convincing case as to why the Fed seems compelled to increase the unemployment rate in order to lower inflation when in 2019 the unemployment rate was 3.5 percent with inflation less than 2 percent.

Ironically, in October 2020, soon after the new flexible average inflation targeting policy was implemented, Fed Vice Chair Lael Brainard said, "to support the inflation makeup strategy…the Committee needed to stay the course resolutely," meaning do not react to higher inflation. Two weeks ago, Chairman Powell said the Fed needed to "stay the course" and continue to hike interest rates.

Just as "staying the course" turned out to be the wrong monetary policy strategy in 2021, it is likely to be the wrong monetary policy strategy in 2023.

For months, the yield on the 3-month Treasury Bill has been higher than the yield on the 10-year Treasury Note, which is referred to as an inverted yield curve. That situation has often been a harbinger of recessions in the past, and was present prior to the recessions in 2001, 2008, and 2020.



While we have been critical of the Powell-Fed for over a year, we view the fact that many have come to see things our way as a positive development. In other words, if a majority of investors are expecting a recession, there is a high probability that a good portion of that is already reflected in today's prices. Moreover, there is a high probability that the Fed will have to pause interest rate hikes at some point in 2023 and possibly even cut interest rates as the economy slows.

The Fed seems to be the last to know because they are mired in theory. However, that does not mean that the Fed won't overtighten. Nevertheless, despite the massive interest rate hikes by the Federal Reserve over the past six months, the S&P 500 index actually gained 1.4 percent between June 30, 2022, and December 31, 2022, while the Dow Jones Industrial Average increased 7.7 percent.

Although volatility is unlikely to go away anytime soon, the markets seem to be digesting the news and perhaps a change in monetary policy at some point in 2023. Generally speaking, stocks tend to bottom on bad news, and the markets have had their share in 2022. (1.4.23)