TJT CAPITAL GROUP
REGISTERED INVESTMENT ADVISOR

On Our Radar – February 2023

After a tumultuous year in the markets in 2022, when the Federal Reserve underwent an unprecedented interest rate hike cycle with an 18-fold increase in the federal funds rate over nine months and a war between Russia and Ukraine broke out, the S&P 500 index rebounded in January with a 6.2 percent rally. Interest rates on the 10-year Treasury Note fell from 3.88 percent at the end of 2022 to 3.52 percent on signs that inflation is decelerating.

In our last piece we highlighted the fact that despite the massive interest rate hikes in the second half of 2022, the S&P 500 index registered a 1.4 percent increase. While that was not something to cheer about, it was an indication that perhaps a good portion of the selling was behind us as stocks tend to bottom on bad news.

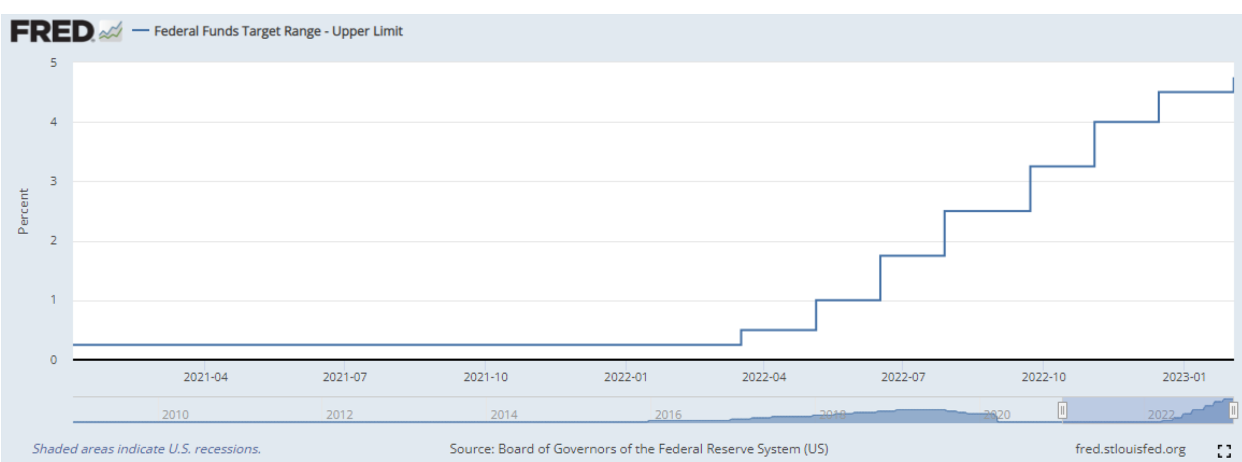
Another reason for the January rally is likely due to positioning. For example, net speculative S&P 500 futures contracts have been negative (net short positions) for 32 consecutive weeks, indicating a persistent bet that the S&P 500 index would decline. What's more, a prominent Wall Street firm suggested that there was no reason for investors to take on risk, which is quite extreme. In addition, the fourth quarter saw equity fund allocations underweight by the most since 2005.

As a result, investor sentiment had gotten so negative, a small bit of good news had the potential to spark a rally.

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) raised interest rates on federal funds by 25 basis points to a target range of 4.50 percent to 4.75 percent. This compares to rates of zero to one-quarter percent at this time last year.



The rate of change in interest rates was largely responsible for the market weakness in 2022. That, and the loss of confidence in the Federal Reserve.

It is important to review how this came about. In a January 19, 2023 speech, Federal Reserve Bank of New York President John Williams said “For three decades preceding the pandemic, the inflation rate averaged almost exactly 2 percent,” which is the Fed’s target.

Given that the Fed’s official inflation target is 2 percent, one would rightly wonder why the Fed changed policy.

In December 2017, the Fed’s preferred measure of inflation – the Personal Consumption Expenditures (PCE) increased by 1.7 percent compared to the previous year. However, in a 2017 Fed paper that was recently released after a mandatory 5-year embargo (due to Ben Bernanke not wanting the public to know what was going on during the financial crisis), the paper declared that “the inflation trend is unlikely to rise to 2 percent in the future without a significant change in monetary policy.”

So, the Ivory Tower academics drastically altered long-standing monetary policy that had maintained stable inflation for decades due to their belief that inflation was insufficiently low, and their brilliance would resolve this roughly 0.3 percent “predicament.”

As previously stated, Jerome Powell introduced the new flexible average inflation targeting policy in August 2020 - also known as the inflation makeup strategy - with the declaration that "should inflationary pressures rachet up above levels consistent with our [2 percent] goal, we would not hesitate to act." In September 2020, Mr. Powell assured markets that the Fed was “prepared to adjust policy” so that inflation would “not [run] very high above 2 percent.”

In fact, Chairman Powell was so proud of the Fed’s new monetary policy that he boasted, “We’re the first central bank to adopt this framework.”

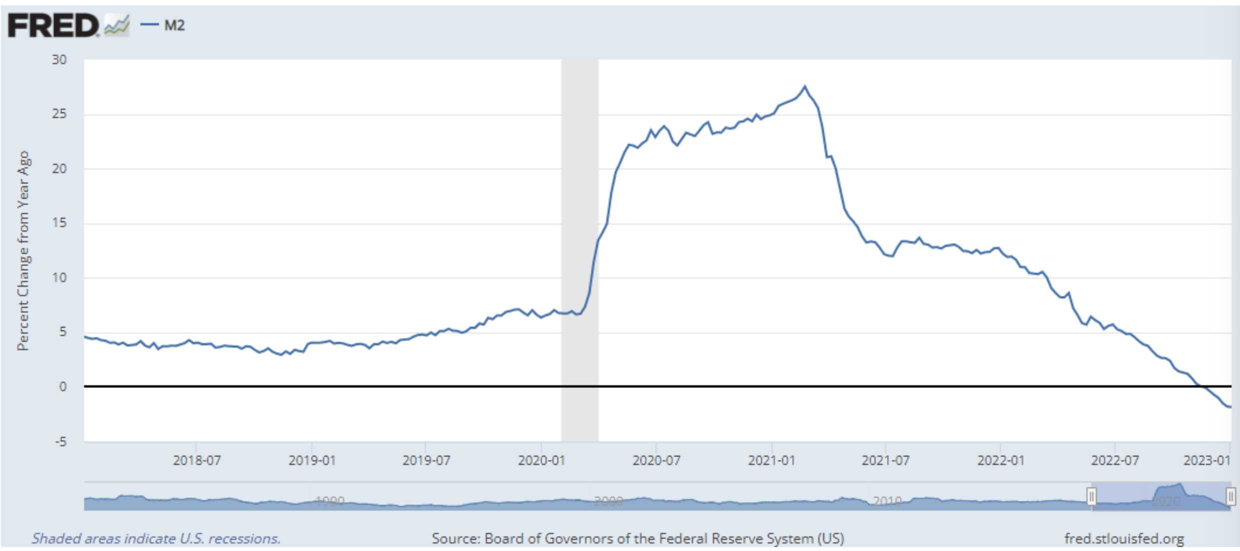
Candidly, the Federal Reserve misled the markets.

The Federal Reserve took a radical and untested approach in an attempt to boost inflation, but failed to promptly correct their course, which resulted in significant losses. Now, it is stunning that the Fed seems perplexed that market participants would question their every word after having guided investors to one of the worst years in some time.

When you downplay a 40-year peak in inflation as a "high class" problem, as Mr. Powell did in January 2022, and then later try to convey the severity of the situation by echoing that the Fed is acutely aware “of the hardship that high inflation is causing,” this suggests a disconnect from reality.

Nevertheless, famed economist Milton Friedman proclaimed - and the Powell-Fed ignored - that "inflation is always and everywhere a monetary phenomenon." According to Friedman, an increase in money printing tends to result in inflation albeit with a lag, while a decrease in the money supply generally results in declining inflation.

As depicted in the chart below, M2 - a broad measure of money - peaked in early 2021 with a 27 percent increase. It was primarily this unprecedented expansion of the money supply that facilitated the onset of inflation as inflation was at a 40-year high prior to Russia's invasion of Ukraine.



However, the year 2022 closed with a remarkable contraction of 1.8 percent year-over-year in the money supply, resulting in a subsequent deceleration of inflation with a slight lag. For instance, the Consumer Price Index (CPI) recorded an annualized growth rate of 10.7 percent from January to June 2022, while it dropped to 0.3 percent from June to December 2022.

Unfortunately, the Powell-Fed has ignored the significance of the money supply, instead focusing almost exclusively on elevating the unemployment rate in an effort to "moderate demand" and attain their 2 percent inflation target.

Given the Fed's recent history, speech writers may craft the words and Mr. Powell may recite them, yet the markets have been ignoring the Fed's "guidance" for some time. In other words, many market participants acknowledge that the Fed took an untested theory too far, incurring significant costs. The markets are focusing on established facts.

And the facts are this: All maturities on the U.S Treasury curve from 1-year to the 30-year Treasury are yielding less than the upper limit of the federal funds rate.

Valuation

Significantly higher interest put pressure on the Price/Earnings (P/E) ratio of the major market indices, however, inflation has also affected companies bottom line.

As it now stands, it appears that the fourth quarter earnings for companies in the S&P 500 will be down almost 9 percent from the fourth quarter 2021 level. Higher rates, higher inflation, Fed interest rate hikes, and lower corporate earnings are a recipe for lower stock prices.

Many companies have announced job layoffs in an effort to protect corporate profit margins going forward as they are anticipating slowing economic growth.

Economic Cycle

The U.S. economy grew 2.9 percent in the fourth quarter of 2022. However, the prospects for the first quarter of 2023 appear less favorable. The Leading Economic Index (LEI) has declined for ten consecutive months, and the Institute for Supply Management (ISM) Manufacturing Index dropped to 47.4 in January, its lowest level since June 2020. Furthermore, the new orders index declined to 42.5, signaling contraction.

In addition, the Conference Board Consumer Confidence Index fell to 107.1 and retail sales declined 1.1 percent in December, following a 0.6 percent drop in November. Given that consumer spending constitutes nearly 70 percent of the economy, the recent trend toward a slowdown in the first quarter is unmistakable.

Sentiment

After nearly 2 months of investor sentiment readings where the percentage of bears exceeded the percentage of bulls, the week ending November 18, 2022 saw the percentage of bulls get back in the lead.

Since then, the percentage of bulls seems to be mirroring the up and down moves in the S&P 500, although all the while staying ahead of the bears.

Recently, the percentage of bulls has exceeded 47 percent, the highest reading in over a year.

Technical Factors

The market rally from year-end has seen the percent of stocks above their 50-day moving average jump from below 40 percent to over 78 percent, which signals an overbought position.

That said, it does not mean that the market is going to automatically pause or decline. As mentioned, investor sentiment has been under pressure for more than a year given the Fed's interest rate hikes as well as the ongoing Russia/Ukraine war.

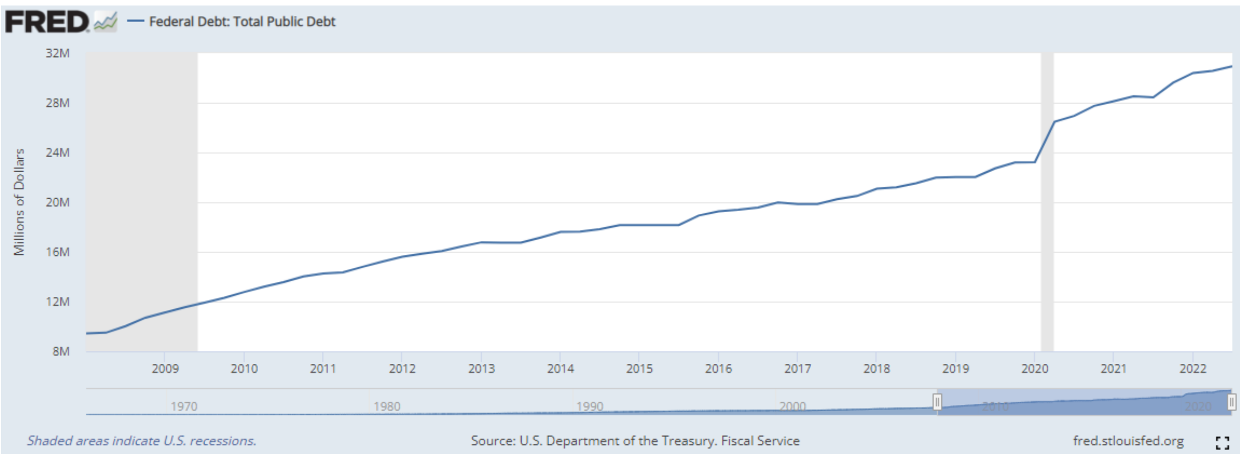
Managers who may have had a difficult couple of years may feel compelled to put some cash to work as they do not want to fall further behind their benchmarks.

To date, there has been a bit of a rotation as some of the hard hit sectors in 2022 have seen the biggest bounces, while other sectors that did well – like energy – have sat out the rally so far.

Outlook

As the markets navigate a slowing economy and Fed policy, the US reached its statutory debt limit of $31.4 trillion prompting a series of "extraordinary measures" by the Treasury Department to avoid a default on government debt. Treasury Secretary Janet Yellen said there should be little to no impact until June 5, 2023. Nevertheless, the drama starts now. Janet Yellen said a default "would be devastating…catastrophic." She said the same thing a couple of years ago. House Speaker Kevin McCarthy said "We're not going to default."

Since 2008, the debt has increased more than 3-fold and is up by more than 33 percent since 2020. This acceleration seems unsustainable.



The personal savings rate is near a 17-year low and credit card debt is at record levels. This is likely to act as a headwind on consumer spending.

A year ago, the Fed shocked markets after they were forced to acknowledge that inflation was more than temporary, a narrative that they were touting since mid-2021. Today, if a recession were to occur, we do not believe many would be surprised as a number of indicators have been pointing in that direction. It's the surprises that tend to have the biggest impact on the markets.

One such surprise could be geopolitical. Both Germany and the U.S. have reportedly agreed to send tanks to Ukraine in what could be an escalation in the war with Russia.
Another could be additional mistakes and a further loss of confidence in the Federal Reserve, which can lead to increased volatility in financial markets, including stocks, bonds, currencies and commodities. One U.S. dollar index (DXY) has seen the value of the dollar fall by more than 10 percent since late September. A weak dollar could prevent foreign government from buying our debt.

Nevertheless, it is probable that asset positioning and algorithms will maintain an outsized influence on the markets. To use a metaphor, if too many people are on one side of the boat, be it positive or negative, the boat can tip over. Therefore, as we have seen over the past few weeks, algorithms will look to exploit volatility as investors sentiment shifts.

So, while volatility is unlikely to go away, the Fed is nearing the end of its interest rate hikes and many excesses have been corrected. (2.2.23)

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