On Our Radar – March 2023

Following a 6.2 percent rally in January, the S&P 500 index fell 2.6 percent in February as the Federal Reserve raised interest rates for the eighth time since March 2022. By the end of the month, the yield on the 10-year Treasury Note increased to 3.92 percent from 3.52 percent, and crude oil prices (WTI) declined about $2 a barrel to just under $77, down from roughly $79 at the end of January.

As of February 28, 2023, the 3-month Treasury Bill yield was 4.88 percent while the 10-year Treasury yield was 3.92 percent. With short-term interest rates higher than long-term rates by 96 basis points (0.96%) – known as an inverted yield curve – the odds of an economic recession have increased materially as the "inversion" has persisted for the past 18 weeks.

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 25 basis points (0.25%) to a range of 4.50 percent to 4.75 percent.

Literally one year ago, with CPI inflation up nearly 8 percent, the Federal Reserve's target range for federal funds was zero to one-quarter percent. At the time we said Fed policy was unhinged from reality and that "we consider this reckless behavior."

The fact of the matter is the Fed wanted higher inflation. As far back as 2017, internal Fed papers were questioning "whether the FOMC is on track to achieve its [2 percent] inflation objective over the medium term."

For instance, in November 2021 with inflation up close to 7 percent, Minneapolis Fed President Neel Kashkari told Bloomberg that the Fed shouldn't overreact to "temporary" inflation. In January 2022, with inflation up 7.5 percent, Chairman Jerome Powell referred to inflation as a "high class" problem.

More recently, Mr. Powell has begun his press conferences by stating the Fed understands "the hardship that high inflation is causing."

Several members of the Fed appear to be emphasizing that they recommended at the February FOMC meeting a half-point increase rather than the quarter-point increase that was ultimately implemented, likely in an effort to salvage their reputations and maintain a sense of credibility. However, despite this insistence, it is noteworthy that none of these individuals chose to dissent from the decision to keep rates at zero during a critical moment in January 2022 when inflation reached a 40-year high.

Valuation

Over the past few quarters, the operating earnings for the S&P 500 have shown a declining trend, which is attributed to slower growth and higher inflation. Based on estimates, the fourth quarter of 2022 earnings are expected to be approximately $51.69 once all companies report. If this estimate is close, it would indicate an 8.8 percent year-over-year decline in fourth quarter earnings.

In addition, this would mark the third consecutive quarter of year-over-year earnings deceleration. Higher interest rates and lower earnings are likely to continue to create headwinds for the markets.

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Economic Cycle

The U.S. economy grew at a revised 2.7 percent pace in the fourth quarter of 2022, down from the initial estimate of 2.9 percent and 3.2 percent in the third quarter. Non-farm payrolls increased by 517,000 in January and the unemployment rate ticked down to 3.4 percent. The “seasonal adjustment” – basically an estimate - was so large that many wonder about its accuracy. The difference between two surveys conducted by the Bureau of Labor Statistics – the Household survey and the Establishment survey – is more than 2 million jobs.

The latest Consumer Price Index (CPI) report on inflation was up 6.4 percent year-over-year, and the Fed’s preferred inflation gauge - core PCE (Personal Consumption Expenditures) - which excludes food and energy costs, rose 4.7 percent from a year ago.

The Leading Economic Index (LEI) fell 0.3 percent in January and has been down for ten consecutive months. Industrial production was unchanged in January after falling 0.6 percent and 1.0 percent in November and December, and the Institute for Supply Management (ISM) Manufacturing index for February was 47.7. This has been below the level of 50 for the past four months, which indicates contraction.

Higher interest rates continue to weigh on housing as existing home sales fell for a 12th straight month. The Conference Board Consumer Confidence Index fell for the second straight month, and consumer expectations continue to lean towards a recession. Nevertheless, retail sales rebounded last month.

U.S. household debt increased by $394 billion in the fourth quarter of 2022, the largest quarterly increase in 20 years, and closed out the year at a record $16.2 trillion. Student debt loan payments were suspended due to COVID, and the Supreme Court recently heard arguments about whether the Biden Administration has the authority to cancel some of that debt. According to the Congressional Budget Office (CBO), the cost of the payment pause through May of 2022 was over $112 billion.

Sentiment

For the past few months, bullish and bearish advisor sentiment has generally mirrored the up and down movements in the markets. For instance, bullish sentiment rose above 48 percent in early February following January's gain.

As of early March, bullish sentiment had declined roughly 10 percentage points as the month of February gave back some of those gains.

Technical Factors

The percent of stocks trading above their 50-day moving average is often used as a signal of overbought and/or oversold conditions. At year-end, less than 40 percent of stocks were above their respective 50-day moving average. By early February, that figure rose above 78 percent.

Recently, that number has fallen to about 52 percent as a result of February's 2.6 percent decline in the S&P 500 index.

Obviously, those numbers do not tell the whole story. So far, 2023 has seen some sector rotation as money has come out of 2022 winners such as energy and rotated into some of the hardest hit areas of 2022 like technology.

While there are a lot of crosscurrents, the fact that the S&P 500 index was up around 4.9 percent at the end of February from its June 30, 2022 close is notable given the historic rise in interest rates by the Federal Reserve.

Outlook

Our criticism of the Fed has spanned more than a year. In early December 2021, we wrote "the Fed has been denying that inflation was becoming a problem by disregarding evidence to the contrary." Failing to acknowledge the emergence of inflation had a direct impact on the credibility of the Fed, and our willingness to publicly express these views was not always well-received. However, it now appears that others have joined us in speaking out against the Fed's handling of the situation.

In a recent paper written by several economists including former Fed Governor Frederick Mishkin, it concluded that "the Fed's failure to act preemptively in 2021" was "a significant error."

Economist John Kenneth Galbraith once said, “Faced with a choice between changing one’s mind and proving there is no need to, almost everyone gets busy with the proof.” This is what the Federal Reserve seems to be doing.

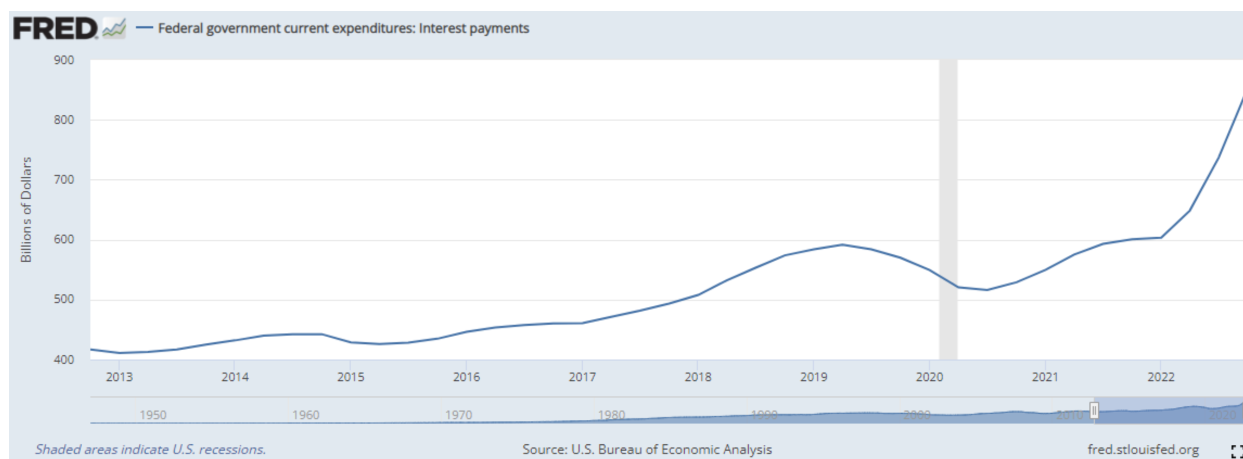
Regrettably, present-day Fed members have attempted to shift responsibility for their mistakes by attributing them to the pandemic and war, rather than acknowledging their own decision to deviate from decades of established monetary policy principles that had previously resulted in low and stable inflation.

By gambling on a radical and untested policy that was premised on an egregiously incorrect assumption that inflation was too low, the current Fed failed to adequately reflect on the potential consequences of their actions.

Furthermore, the Fed appears to be disregarding the fact that Chair Powell was intellectually dishonest in August of 2020 when he claimed that the Fed would not hesitate to take action “if excessive inflationary pressures were to ratchet up above levels consistent with our [2 percent] goal.”

Despite inflation reaching a 40-year high of nearly 8 percent in January of 2022, the Powell-led Fed chose to maintain interest rates at near-zero levels and continued purchasing billions of dollars' worth of bonds for several additional months. This decision is a primary reason why the 30-year Treasury bond suffered a decline of more than 32 percent over the course of 2022.

The global debt to Gross Domestic Product (GDP) ratio currently stands at approximately 350 percent, while in the United States, federal debt has soared to $31 trillion, double the amount from a decade ago. As interest rates begin to climb, the cost of servicing this outstanding debt also rises. For instance, during the second quarter of 2020 (positioned just to the right of the vertical grey bar in the graph below), interest payments were $520 billion. However, by December 31, 2022, interest payments had skyrocketed to more than $850 billion, reflecting an alarming 63 percent increase.



The unsustainability of this trend underscores the critical importance of maintaining credibility within the Federal Reserve. Unfortunately, the Powell-led Fed has jeopardized much of this credibility by departing from decades of successful low-inflation policy and instead embracing a

radical and untested "inflation makeup strategy." This strategy was based on the misguided assumption that inflation in the United States was too low, and as such, it may have further exacerbated the unsustainable trajectory of the country's debt burden.

The U.S. has already exceeded its $31.4 trillion debt ceiling, which is likely to lead to increased political wrangling over the next few months.

The Federal Reserve's untested policy approach has undermined confidence in the system, leaving it more vulnerable to instability. In fact, reports suggest that the Fed's extensive bond portfolio may have incurred mark-to-market losses amounting to nearly $1 trillion.

While the Fed is not going to go broke as they can always "print" more money, these losses are just one of the many factors that have contributed to the growing fragility of the system under the Powell-led Fed.

The combination of a slowing economy, a 4-to-5 percent increase in the cost of financing new transactions, and a Federal Reserve that is trying to catch-up with higher inflation that they helped unleash, is likely to keep volatility high over the next few months.

The possible escalation in the Russia/Ukraine war is a wildcard, as is potential increased tensions between China and Taiwan. Recently, U.S. Treasury Secretary Janet Yellen warned China that helping Russia will have consequences. China responded that it will retaliate against the U.S. over violations of its sovereignty.

The current situation demands that our leaders navigate these unprecedented circumstances with great care. The question that remains is whether they possess the necessary skills to meet these challenges. (3.2.23)

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