TJT CAPITAL GROUP
REGISTERED INVESTMENT ADVISOR

On Our Radar – April 2023

In March, several banks failed or were in trouble, which prompted central banks to intervene with emergency liquidity injections to prevent further “bank runs.” As a result, interest rates on government bonds saw a significant decline, and some of the excess liquidity flowed into the stock market, which led to a 3.5 percent rally in the S&P 500 index for the month.

The yield on the 10-year Treasury note declined from over 4 percent in early March to 3.39 percent, and the 2-year Treasury yield fell from over 5 percent to 3.76 percent in eleven days.

In the previous report, it was noted that the surge in interest rates resulted in marked-to-market losses of nearly $1 trillion on the bonds held on the Federal Reserve's balance sheet. However, given the Fed's ability to create money, those losses were unlikely to have an immediate material impact. As regional banks lack the same capability, significant investment losses can create massive problems, as seen with Bear Stearns and Lehman Brothers in 2008.

Banks invest funds to generate interest to pay a small return on their deposit base, and they usually classify their bonds into two accounting categories: "available for sale" and "held to maturity." Bonds in the "available for sale" category are marked-to-market, which means their value is based on current market prices. As interest rates increased, the prices of longer-dated bonds decreased in value, resulting in losses for banks holding such bonds.

Bonds categorized as "held to maturity" are not subject to the "marked-to-market" valuation requirements because they are not intended to be sold. However, a crucial exception to this is that if any of the "held to maturity" bonds are sold, the entire portfolio must then be valued at current market prices.

In early March, shares of Silicon Valley Bank (SVB) stock experienced a decline of over 60 percent in a single day following its announcement that it sold $21 billion in bonds and was in search of additional capital. This news indicated that the bank was either insolvent or close to it, which triggered a run on deposits.

According to reports, at year-end SVB had $91 billion in the “held to maturity” category that were worth just $76 billion. The $15 billion “unrealized loss” equated to almost all of SVB’s shareholders equity. This created stress on other banks such as First Republic Bank, PacWest, and Credit Suisse to name a few. Central banks flooded the markets with liquidity and other measures to stave off a panic.

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 by another 25 basis points (0.25%) to a range of 4.75 percent to 5.00 percent. Roughly one year ago, in mid-March 2022, the official interest rate policy of the Federal Reserve was a range of zero to one-quarter percent. Therefore, in 12 months, the Fed has managed to increase the federal funds rate by a factor of twenty.

Moreover, this 20-fold increase has occurred after the Fed engineered the biggest quantitative easing (QE) program of all time. The Fed doubled its balance sheet to almost $9 trillion, while the federal debt rose to more than $31.4 trillion, representing an increase of 38 percent in roughly two years.

The reality is there is no precedent for this and the Fed is flying blind. Needless to say, the Jerome Powell Fed lost its credibility some time ago. As a reminder, on January 26, 2022, with inflation at a 40- year high, Chairman Powell said “In support of [maximum employment and price stability] goals, the Federal Open Market Committee (FOMC) kept its policy interest rates near zero.”

At the time, Mr. Powell referred to inflation as a “high class” problem.

A few weeks ago, Chairman Powell appeared before a Congressional Banking Committee, and when asked if the rapid increase in interest rates posed a systemic risk to the banking system, he responded with a firm "no." Literally days later, Silicon Valley Bank was put in receivership as the Federal Deposit Insurance Corporation (FDIC) deemed SVB to be insolvent.

Silicon Valley Bank became the largest bank to fail since the 2008 financial crisis and caused the Federal Reserve and the U.S. Treasury to trigger the “systemic risk exception” to protect all the deposits at Silicon Valley Bank.

There is a real question whether Powell truly understands what is really going on or is just throwing around academic jargon and referencing theories because when it comes down to the absolute basics, the Powell-Fed has failed. It is a wonder that Jerome Powell is still the Chairman of the Federal Reserve.

Valuation

While the first quarter of 2023 is over, the fourth quarter 2022 S&P 500 operating earnings have yet to be finalized. What we do know is that estimates for the fourth quarter have drifted lower since year-end by about 1.5 percent.

The markets tend to be forward looking, so it seems likely that the market is anticipating the Fed being close to the end of their rate-hiking cycle, which could allow for a higher price/earnings (P/E) ratio in some sectors.

Economic Cycle

The U.S. economy grew at a revised 2.6 percent in the fourth quarter, down from 3.2 percent in the third quarter. Gross Domestic Product (GDP) expanded by 2.1 percent in calendar year 2022, a decline from the 5.9 percent growth recorded in 2021.

Interest rate increases are clearly creating headwinds as the leading economic index (LEI) has declined for 11 consecutive months. The University of Michigan Index of Consumer Sentiment fell to 62 recently, the lowest level since the end of December, and retail sales declined 0.4 percent last month.

The Institute for Supply Management (ISM) Manufacturing purchasing managers index fell to 46.3. the lowest since May 2020. Moreover, the employment component fell to 46.9, also a post-COVID low.

The Fed's preferred inflation gauge – personal consumption expenditures excluding food and energy (core PCE) – rose 4.6 percent year-over-year.

Sentiment

Despite the volatility, bullish advisor sentiment has averaged about 43 percent in 2023. It dipped into the high 30s during the height of the banking crisis, but rallied back into the 40s at quarter end.

Meanwhile, bearish advisor sentiment has averaged just over 28 percent in the first quarter. These are about average numbers and are likely to bounce up and down with the direction of the markets.

As a reminder, sentiment measures tend to be a good contrary indicator when they are at or near extremes.

Technical Factors

The S&P 500 index dropped by nearly 5 percent following the failure of Silicon Valley Bank. The percentage of stocks trading above their 50-day moving average fell from over 55 percent at the beginning of the month to less than 20 percent around mid-March. Once the Federal Reserve added hundreds of billions of dollars in liquidity and essentially guaranteed bank deposits, the markets rallied.

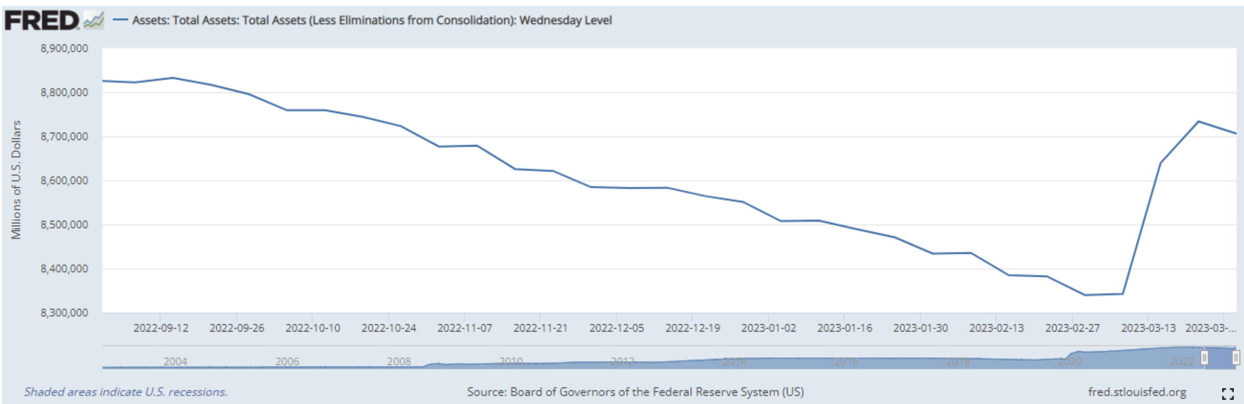
That said, the U.S. equity market experienced a rotation out of sectors that did well or held up better in 2022 back into growth sectors. For example, in the first quarter of 2023, the Dow Jones Industrial Average gained 0.38 percent, while the S&P 500 and NASDAQ Composite rallied 7.02 percent and 16.7 percent, respectively.

Outlook

The massive increase in debt along with the fastest interest rate increase in history, is having second and third-order effects. The failure of Silicon Valley Bank, Signature Bank, and the "takeover" of Credit Suisse are real-world examples.

As concerns mounted about the health of the banking industry, volatility in most asset classes increased dramatically. The Fed and the U.S. Treasury came to the rescue, changed policy on the fly, and flooded the markets with liquidity.

As seen in the following chart, the Fed increased their balance sheet by roughly $363 billion in about two weeks. Markets generally respond positively to an infusion of liquidity. This is in addition to the new Bank Term Funding Program, which allows banks to exchange certain bonds that have declined in value for 100 cents on the dollar. The goal was to eliminate an institution's need to sell securities in times of stress.



However, a bigger question looms: is there more to come? The significant impact of bonds on bank balance sheets has been further compounded by a brewing commercial real estate problem. Reports suggest that smaller banks hold over $2 trillion in commercial real estate debt, while higher interest rates have put pressure on commercial property valuations.

Additionally, many owners have floating-rate mortgages that move up (and down) with the federal funds rate and often reset annually. As a result, monthly debt service has been on the rise.

The Powell-led Fed deviated from longstanding monetary policy principles that kept inflation low for decades and adopted a radical, untested theory. The decision was based on the belief of some academic "experts" that inflation was too low, and the Fed needed to introduce an inflation "makeup strategy."

The Fed is getting reacquainted with the consequences of its failed theoretical experiment.

In his March press conference, Powell made a point to emphasize the unanimous decision by the FOMC to raise interest rates. However, it is somewhat concerning that Powell appeared to ignore the unanimous decision to keep interest rates near zero when inflation reached a 40-year high. Unexamined groupthink is not a virtue and raises more questions about the Fed's competence.

Renowned economist Milton Friedman said, "It always takes 6-12 months to quantify a move in rates impact on the underlying economy – thus central bankers most often over ease and over-tighten."

As of late March, the futures market for April 2024 interest rates was trading significantly below the Fed's median forecast. This is not unexpected given this Fed's history of inaccurate forecasts since the policy change. It appears as though the Fed was committed to continuing its experiment regardless of the evidence at hand.

Over the weekend, Saudi Arabia led a group of major oil producers to agree to cut production in a move to increase prices. The price of a barrel of oil jumped 5 percent. The timing of this announcement is interesting. It is noteworthy that Russia and China leaders, Putin and Xi, recently discussed the possibility of using China's yuan as settlement currency for foreign trade. The move appears to be aimed at diminishing the role of the U.S. dollar and, as a result, curbing U.S. global influence.

In light of the fact that we currently have unprecedented levels of debt both at the federal and state levels – for instance, California is anticipating a budget deficit of $22 billion – as well as consumers, it is critical that policies are crafted intelligently. If confidence in our institutions and leaders continues to erode, it will likely cause a wider range of outcomes.

Even though the media will likely continue to feature headlines concerning the ongoing war, China, the debt ceiling, and the legal challenges of certain politicians, among other things, it is crucial to remember that we may be on the verge of witnessing one of the most remarkable technological transformations in history – artificial intelligence. Consequently, the opportunities are likely to be exciting. (4.4.23)