On Our Radar – May 2023

In April, the S&P 500 index rallied 1.2 percent despite the Federal Deposit Insurance Corporation (FDIC) grappling with the third US bank failure in less than two months. First Republic Bank was the latest to fail, but the FDIC arranged for JP Morgan to acquire the majority of its assets under a "loss-sharing agreement," with the FDIC providing $50 billion in financing to JP Morgan. This followed the failures of Silicon Valley Bank, Silvergate Bank, Signature Bank, and the Swiss National Bank's orchestration of up to 100 billion Swiss francs in "liquidity assistance" to UBS for the takeover of Credit Suisse.

While the US Treasury Department's spokesperson stated that "the banking system remains sound and resilient, and Americans should feel confident in the safety of their deposits and the ability of the banking system to fulfill its essential function of providing credit to businesses and families," the reality is that the bank problem has not been entirely resolved. Many banks have invested heavily in bonds, which have depreciated in value due to the 20-fold increase in the federal funds rate within a year.

Consequently, many bank balance sheets are plagued with large unrealized losses, and as confidence erodes, insolvency becomes a real issue, with deposits leaving.

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)

Recently, the Federal Reserve admitted that Chairman Jerome Powell was duped into an extensive call with Russian pranksters who posed as Ukraine President Zelensky back in January. During the call, Mr. Powell was forthcoming and suggested the possibility of two more interest rate hikes followed by a pause. The Fed increased interest rates by another 25 basis points (0.25%) in March and is likely to raise them again this week. During the call, Mr. Powell had expected less than 1 percent growth in 2023. The Fed's credibility has been eroding over the past eighteen months, even before the prank call incident.

Currently, the Fed appears to be disregarding the second and third-order effects of its interest rate policy, which tends to work with a lag. For instance, billions of dollars-worth of private equity deals in recent years were funded with floating rate loans, with the interest rates on these loans having more than doubled in many cases. The increased interest expenses have caused some companies to raise prices to service the debt, leading to sticky inflation.

Meanwhile, the Fed appears almost obsessed with increasing the unemployment rate to slow down economic growth. However, by raising interest rates as much as they did, additional problems are already being felt in other parts of the market, including commercial real estate.

The Wall Street Journal recently reported on a 22-story office building in San Francisco that was valued at roughly $300 million just four years ago and might soon sell for 80 percent less due to the rising interest rate environment and layoffs. This environment has also added another risk to banks as trillions of dollars in commercial real estate mortgages are scheduled to reset at much higher rates and lower valuations, which could add to bank losses.

In addition to these concerns, the Fed's competence has been called into question due to its handling of Silicon Valley Bank. In a post-mortem on the bank, the Fed shared a slide from February 2023 where it stated, "At third-quarter-end 2022, total unrealized losses to capital totaled -110 percent." This effectively meant that Silicon Valley Bank was insolvent, and the Fed apparently knew this for months but did nothing about it.

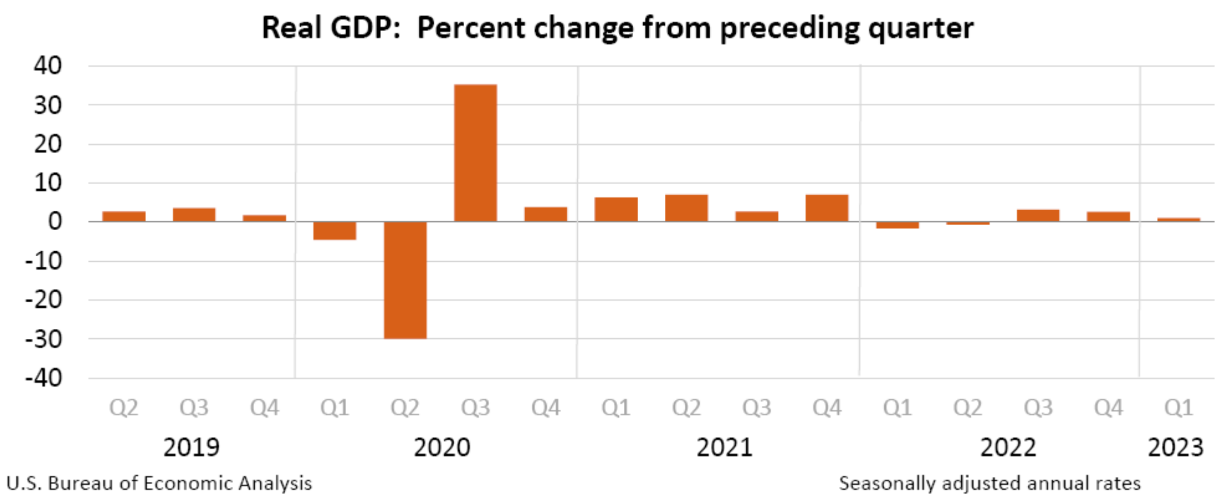
Valuation

Fourth quarter earnings for the S&P 500 index were $50.37, down a little more than eleven percent from the fourth quarter 2021. In fact, the last three quarters of earnings for the S&P 500 in 2022 were down year-over-year. In total, calendar year 2022 earnings were down 5.4 percent as compared to 2021.

Significantly higher interest rates and lower earnings are the recipe for a lower stock market. Moreover, the Fed's monetary policy has been so wrong over the past eighteen months that the lack of market confidence is an ongoing headwind for valuation measures.

Economic Cycle

The US economy grew by 1.1 percent in the first quarter, down from the previous quarter's increase of 2.6 percent. In addition, the Institute for Supply Management (ISM) Manufacturing index reported a figure of 47.1 for the month of April, indicating contraction for the sixth consecutive month, while the Leading Economic Index (LEI) experienced a decline for the twelfth consecutive month. Furthermore, consumer confidence decreased to a nine-month low.



On the plus side, industrial production rose, and the unemployment rate was recently 3.50 percent. However, the Federal Reserve aims to engineer higher unemployment in an attempt to reduce wages and inflation, thereby increasing the odds of a recession.

Sentiment

The flood of money injected into the markets by the Fed in an effort to alleviate a banking crisis generated a rally following the failure of Silicon Valley Bank. As is often the case, bullish sentiment rose along with the market indices.

That said, bullish sentiment near the end of April hit 50 percent, the highest level since early January 2022. A big uptick in bullish sentiment following the recent rally may be a signal that the market needs a breather, especially in a choppy market.

Technical Factors

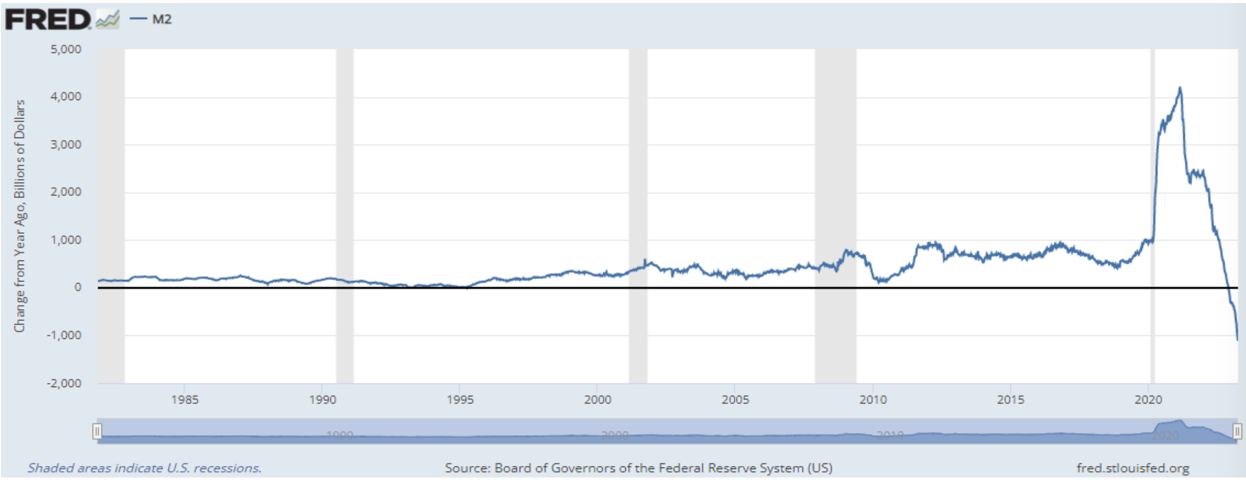
As of the end of April 2023, the Dow Jones Industrial Average was up 3.8 percent, the S&P 500 was up 0.9 percent, and the NASDAQ Composite was down 1.3 percent since the end of July, 2022.

Over that nine-month period, the markets have experienced rallies and selloffs with very little to show for it. However, when the market pendulum has gone to extremes - either overbought or oversold readings – opportunities have presented themselves.

For instance, near the late September/mid-October lows, the percentage of stocks trading above their 50-day moving average got to low single digits. Fear was high, yet it appears that a lot of stocks had quite a bit of bad news priced in. While that current percentage was up around 40 at the end of April, essentially a neutral reading, keeping track of extreme readings can help with entry or exit points.

Outlook

One thing that has been puzzling about the Federal Reserve is the apparent discrepancy between their words and actions. Chairman Powell frequently cites history as a guide, but it is unclear which specific historical events he is referring to. A look at the chart of M2, which measures total money including cash, checking and savings accounts, among others, going back more than 40 years, reveals that there has never been a roughly $5 trillion change in such a short period of time. This raises questions about the relevance of Powell's history comments.



There is a legitimate concern in the market that the Fed may be aware of deep problems but not know how to properly address them. For example, the Fed knew about the problems at Silicon Valley Bank but did nothing to address them ahead of time. After adopting a radical, untested monetary theory, Mr. Powell seems to be resorting to the "old playbook" of raising interest rates to increase unemployment, reduce wages, and slow growth. This is in contrast to other central banks, which did not implement the inflation "makeup strategy" due to the uncertain distance between models and reality.

Former Fed Chairman Ben Bernanke warned that stimulus that comes too late "could be actively destabilizing if it comes at a time when growth is already improving." Unfortunately, this seems to be exactly what the Powell-Fed did. Moreover, the idea that the Fed's policy is to slow down economic growth in order to reduce wages for their policy mistake is unconscionable. Powell himself said in September 2020 that if excessive inflationary pressures were to ratchet up above levels consistent with their 2 percent goal, they would “not hesitate to act.” However, the Fed waited until inflation hit a 40-year high before taking action.

Aside from the Fed, the market is also dealing with other issues, such as the U.S. government debt ceiling. U.S. Treasury Secretary Janet Yellen has warned that failure to raise the debt ceiling would trigger an economic catastrophe, driving household payments on mortgages, credit card balances, and auto loans higher. Ironically, this is precisely the outcome of current Federal Reserve policy.

Republicans have managed to pass a bill through the House of Representatives that would lift the U.S. debt ceiling by $1.5 trillion if there are cuts to spending, but the Democrats have repeatedly balked at it, which puts a potential government shutdown in play. Credit default swaps (CDS), which are like insurance on a government default, have risen above 100 basis points (1.00 percent) for the first time ever, even higher than levels hit during the global financial crisis.

Geopolitical issues also remain a concern. In addition to the ongoing Russia/Ukraine conflict, the Biden administration has briefed China in advance of plans to bolster military drills in the region, prompting China's military to declare its readiness to fight.

While uncertainty is likely to remain high, the Fed has injected about $223 billion into the markets since the failure of Silicon Valley Bank, helping to fuel the recent market advance. At this time, the market seems to be more concerned with the availability of money rather than the cost to borrow. Nonetheless, we anticipate that volatility swings will create opportunities for investors to take advantage of. (5.2.23)