TJT CAPITAL GROUP
REGISTERED INVESTMENT ADVISOR

On Our Radar – June 2023

May was a month of mixed performance in the markets. The Dow Jones Industrial Average experienced a decline of 3.4 percent, while the S&P 500 index managed a modest gain of 0.2 percent. In contrast, the NASDAQ Composite showed strength with a rise of 5.7 percent. Additionally, the yield on the 3-month U.S. Treasury Bill increased from 5.10 percent at the end of April to 5.52 percent in May, reflecting concerns surrounding the U.S. debt ceiling negotiations. Moreover, the yield on the 10-year Treasury Note rose by 20 basis points to 3.64 percent, and the price of oil dropped by more than 11 percent, settling just above $68 per barrel.

The market experienced significant volatility during May, largely due to ongoing debt ceiling negotiations in Washington D.C. However, an agreement to raise the debt ceiling was ultimately reached, and it was expected to be signed by President Biden over the weekend. This news provided relief to the markets, resulting in a rally on June 2nd, as the U.S. avoided the potential risk of default.

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)

In early May the Fed increased the rate on federal funds by another 25 basis points (0.25%) to a range of 5.00 to 5.25 percent. This recent increase represents a 21-fold increase in the federal funds rate in about 14 months. This rate of change has never happened before, and when you consider this has occurred as the federal debt has rocketed by more than $8 trillion or 35 percent since the first quarter of 2020, the range of outcomes from second and third-order effects remains wide.

In addition to the interest rate hikes, the Fed's balance sheet is approximately $8.38 trillion, down from its $8.9 trillion peak in 2022 but up slightly from early March following its $400 billion emergency liquidity injection following the failure of Silicon Valley Bank.

The Federal Open Market Committee (FOMC) meets again on June 13-14, 2023. Despite Chairman Jerome Powell saying "failure to get inflation down would prolong pain," a number of Fed officials, including vice chair nominee Philip Jefferson, have suggested skipping a rate hike this month to assess the data.

As economist Milton Friedman famously said, "monetary actions affect economic conditions only after a lag that is both long and variable." More recently, the Fed has usually hiked interest rates until the point where something in the economy breaks. Well, we have already seen the failure of several regional banks, and there are signs of emerging commercial real estate stress that could add to bank woes.

Valuation

The level of interest rates and corporate earnings are two key factors that determine whether

the markets are overvalued, undervalued, or trading around fair value. Since the beginning of the year, the yield on 3-month U.S. Treasury Bills has risen from around 4.53 percent to 5.44 percent. Meanwhile, the yield on the 10-year U.S. Treasury Note has remained relatively flat at around 3.70 percent.

Corporate earnings estimates for the S&P 500 in calendar year 2023 are expected to be about $218.60, up 11 percent from 2022 earnings. The combination of relatively flat longer-term interest rates and rising corporate earnings has supported equities so far this year.

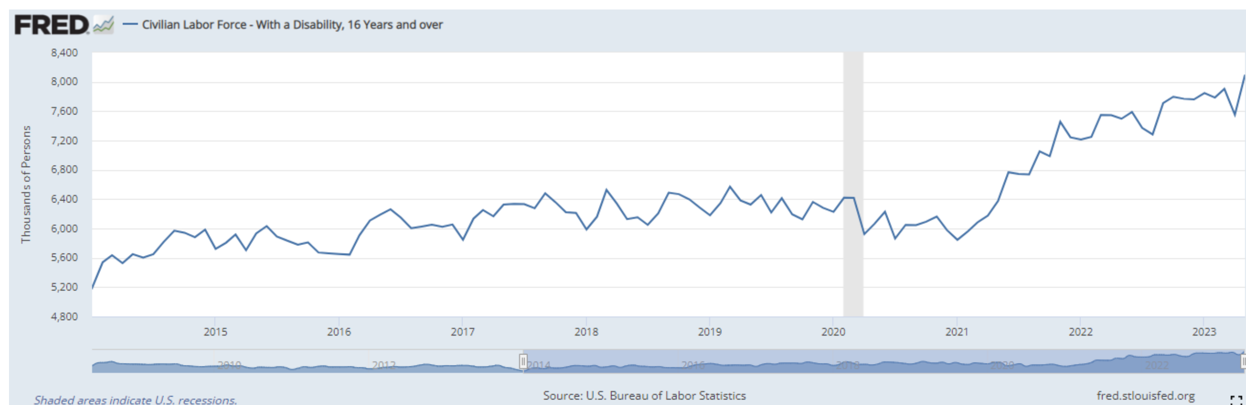
However, it is important to note that the markets are forward-looking. Currently, 2024 earnings are estimated to be $244 for the S&P 500. However, if the economy were to experience a recession, that figure would likely be revised lower.

Economic Cycle

In terms of economic indicators, the U.S. economy grew at a revised rate of 1.3 percent in the first quarter, up from the initial estimate of 1.1 percent. The Federal Reserve's preferred inflation gauge, the Personal Consumption Expenditures (PCE) index, rose by 4.4 percent year-over-year, slightly higher than the previous month's reading of 4.2 percent, but lower than the 5.4 percent figure reported in January. The Leading Economic Index (LEI) fell for the thirteenth consecutive month.

Although the number of new jobs increased by 339,000, the unemployment rate rose from 3.4 percent to 3.7 percent. It's worth noting that there has been growing skepticism regarding these numbers, as the seasonally adjusted "Employment Level" actually saw a decline of 310,000 jobs. Additionally, the Massachusetts Department of Unemployment Assistance (DUA) has acknowledged a significant rise in fraudulent unemployment claims, raising concerns about potential exploitation of the system. This skepticism and the presence of inaccurate data could further complicate matters for the Federal Reserve, which now claims that its policy decisions will be "data dependent."

Concerns have also emerged regarding individuals applying for disability benefits, as depicted in the chart below. The number of recipients has skyrocketed to over 8 million people, representing a staggering 36 percent surge of over 2 million individuals since January 2021.



The Consumer Confidence index fell to 102.3, and the Institute for Supply Management Manufacturing index also remained below the threshold of 50 for the seventh consecutive month, indicating contraction in the sector. Furthermore, tighter lending standards resulting from regional bank stress and weaker economic growth have led to a decline in demand for commercial loans, even below levels observed during the depths of the pandemic.

While retail sales experienced a modest increase of 0.4 percent in May, U.S. household debt reached a new record high of $17.05 trillion. This is particularly concerning as the average interest rate on credit card balances exceeds 20 percent, indicating potential headwinds for consumers going forward.

Sentiment

We view sentiment as a contrary indicator when it reaches extremes. This means that when bullish sentiment is at an extreme, it is usually a sign that the majority of investors are already positioned in the market. On the other hand, when bearish sentiment is at or near an extreme, it is often a sign that the market has already fallen significantly and that sentiment is simply reflecting those conditions.

In October 2022, negative sentiment reached its highest level in more than a decade. This was right around the time that the S&P 500 index hit its 2022 low. Since then, both bullish and bearish sentiment have been range-bound.

Technical Factors

Similar to sentiment, technical factors can be used to identify overbought and/or oversold conditions. At the end of 2022, less than 40 percent of stocks were above their respective 50-day moving averages. Recently, that figure has risen to just above 43 percent. This indicates that a relatively small number of companies have been responsible for the majority of the equity market's advance.

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Outlook

Several members of the Federal Reserve (Fed) have been discussing inflation, drawing parallels to the lessons learned from the 1970s, emphasizing the importance of not halting measures prematurely until inflation is effectively conquered. While the financial media and other Fed officials echoed this sentiment, they failed to grasp the core issue. In reality, the Powell-led Fed embarked on a monetary experiment based on flawed assumptions about inflation, implementing an untested and radical monetary policy driven by theory.

The hypocrisy is astounding: while making references to lessons from the 1970s, they blatantly disregarded the actual lessons from that era. Picture this scenario: if you were a Fed Governor entrusted with the responsibility of maintaining low and stable prices, and yet you altered policy to adopt an inflation make-up strategy because you believed inflation was too low, averaging 1.7 percent over a decade instead of an arbitrary 2 percent target. Subsequently, you allow inflation to reach a 40-year high before considering raising interest rates, all the while continuing to purchase $120 billion worth of bonds each month for several additional months.

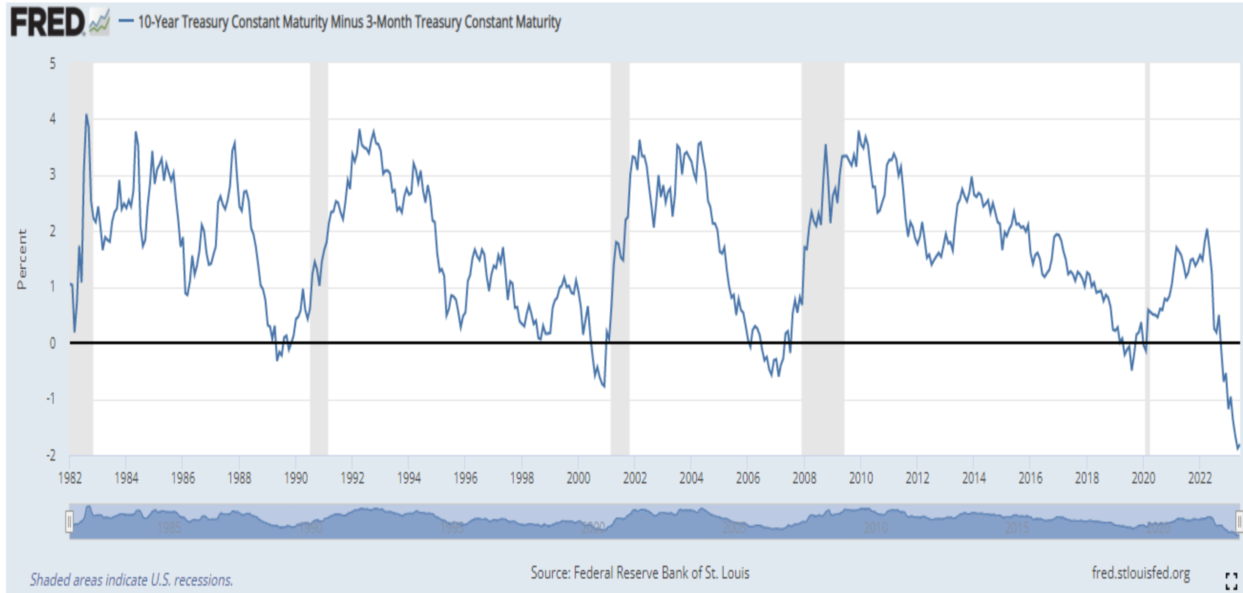
Furthermore, the Fed compounded their error by dismissing evidence that clearly indicated inflation was accelerating. For instance, in mid-April 2021, the Consumer Price Index (CPI) recorded a 0.6 percent increase, implying an annual rate exceeding 7 percent. Instead of raising concerns, the Fed disregarded these signs of inflation significantly surpassing their target.

The Fed's policy shift unleashed the inflation genie, resulting in severe consequences, including the collapse of several banks. Throughout history, major economic problems have rarely stemmed from low consumer price inflation but rather from asset deflation, such as the subprime mortgage crisis of 2007-2008.

Nevertheless, the Powell-led Fed sought higher inflation and remained steadfast in their pursuit. However, they pushed their experiment too far, allowing inflation to soar to a 40-year high before finally raising interest rates. In order to catch up with inflation-induced stress, the Fed increased the federal funds rate a staggering 21-fold over a fourteen-month period. Certain banks, like Silicon Valley Bank, failed to properly manage their bond portfolios, resulting in losses exceeding their tangible equity and necessitating rescue efforts.

Recently, a Fed official stated that a slowdown in the labor market is needed for inflation to subside. This notion seems absurd, as it implies that the Fed is fixated on increasing the unemployment rate as a consequence of their policy mistakes, all while the gradual rise of artificial intelligence is expected to replace numerous jobs over time.

The harsh reality is that, just like the Federal Reserve had no clear foresight into the consequences of their new policy, they remain uncertain about the impact of their countermeasures. As depicted in the chart below, we observe an "inverted yield curve," wherein the yield on the 10-year U.S. Treasury is below that of the 3-month Treasury. However, what truly catches the eye is the magnitude of this inversion, surpassing previous instances.



Although the debt ceiling crisis has been successfully averted, the substantial increase in debt and interest rates, coupled with the Fed's commitment to reducing the size of its balance sheet, are poised to maintain high levels of market volatility. It is important to note that such volatility often presents opportunities, especially as we approach the end of the interest rate hike cycle. (6.2.23)

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