TJT CAPITAL GROUP
REGISTERED INVESTMENT ADVISOR

On Our Radar – July 2023

In the month of June, the U.S. markets rallied impressively as the overhanging concern of the debt ceiling was alleviated, providing a boost to market sentiment. Furthermore, a brief military coup in Russia emerged and dissipated almost as swiftly as it began, easing geopolitical tensions for now.

The Federal Reserve decided against raising interest rates in June. However, Federal Reserve Chairman Jerome Powell conveyed a clear indication that more interest rate hikes were on the horizon. During the month, the S&P 500 index rose 6.47 percent, the interest rates on the 10-year U.S. Treasury Note increased from 3.64 percent at the end of May to 3.81 percent, and the price of a barrel of oil dropped about $1 compared to the previous month, settling at around $70.50.

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 June, the Federal Open Market Committee (FOMC) chose to maintain the federal funds target range at 5.00 to 5.25 percent. However, Chairman Powell indicated that further interest rate hikes were likely, stating that "nearly all participants expect that it will be appropriate to raise interest rates somewhat further by the end of the year." In fact, he mentioned to Congress that it would be "appropriate to raise interest rates twice more this year."

This decision and the inconsistency between Powell's statements and actions have raised questions about the Federal Reserve's credibility, which was a key factor in the market decline of 2022. Despite acknowledging the need for higher interest rates due to perceived high inflation, the Fed chose to pause.

Chair Powell's introduction of the Fed's new inflation "make-up strategy" in August 2020 emphasized that "if excessive inflationary pressures were to ratchet up above our [2 percent inflation] goal, we would not hesitate to act." However, the Powell-led Fed did not adhere to its own forward guidance. In January 2022, despite inflation reaching a 40-year high, the Fed kept interest rates near zero and continued purchasing hundreds of billions of dollars worth of bonds.

The unanimous decision of the Fed not to raise interest rates in January 2022 was accompanied by Powell referring to the high inflation as a "high-class" problem. More recently, he has expressed awareness of the hardship caused by high inflation, aiming to convey that the Fed understands the impact on the public. As seen in the following chart, Powell should have understood the impact as inflation adjusted earnings have been declining for years.

Valuation

Heading into 2023, there was an expectation that S&P 500 operating earnings would reach approximately $225, a significant increase from the $197 recorded in 2022. However, by June 30, 2023, halfway through the year, the earnings estimates had been revised downwards to a little over $217. Despite the adjustment, this still represents a growth rate of over ten percent.

Following the interest rate shock of 2022 and the inaccuracy of the 2022 earnings estimates, many institutional investors were rightly cautious about the 2023 projections. Consequently, many investors had positioned their portfolios with a bias towards the short or bearish side, indicating a lack of confidence in the optimistic earnings outlook.

However, as the economy demonstrated resilience and defied the bearish expectations, coupled with the injection of liquidity into the financial system by the Federal Reserve following the failure of Silicon Valley Bank and other institutions, some of those who had taken short positions were compelled to cover their negative bets as the markets continued to advance.

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Economic Cycle

The first-quarter U.S. Gross Domestic Product (GDP) received a positive revision, increasing from the previous estimate of 1.3 percent to a healthier 2 percent. However, this upward adjustment raises concerns about the credibility of economic reports, given the significant disparity.

In May, the Leading Economic Index (LEI) experienced its 14th consecutive monthly decline, indicating a tightening of credit conditions and foreshadowing a potential slowdown in economic activity.

The Institute of Supply Management (ISM) Manufacturing report experienced a decline from 46.9 in May to 46.0. Similarly, the ISM Services index recently dropped from 51.9 to 50.3, just above the crucial 50- level that separates growth from contraction.

On a positive note, New Home Sales had a notable increase of 12.2 percent in May. However, this increase did not prevent overall home prices from recording their first year-over-year decline in over a decade. Despite this mixed performance in the housing sector, Consumer Confidence exhibited a noteworthy improvement, reaching its highest level since January 2022.

Inflation figures showed a moderation trend. The Core Consumer Price Index (CPI) rose by 5.3 percent over the past year, marking a decline from the peak of 9.1 percent seen last summer. Meanwhile, the Core Personal Consumption Expenditures (PCE), the preferred inflation gauge of the Federal Reserve, increased by 4.6 percent on a year-over-year basis.

Sentiment

When considering investor sentiment, we find extremes of both optimism (referred to as "Greed") and pessimism (known as "Fear") to be valuable contrary indicators. This is because psychology tends to exhibit similar patterns during major market peaks and bottoms. In many instances, investor sentiment tends to align with short-term market trends.

In early March, there was a decline in bullish sentiment, coinciding with the need to rescue several banks. However, after the initial setback, the Federal Reserve injected hundreds of billions of dollars into the market, leading to stabilization and subsequent recovery. As the markets regained strength, investor sentiment became more optimistic. The percentage of "bulls" rose from below 40 to over 54 by the end of June.

While 54 percent may not be considered extreme in absolute terms, it does represent the highest proportion of bullish advisors since November 2021.

Technical Factors

Throughout this year, despite some unsettling headlines and daily fluctuations, the equity markets have displayed a choppy but predominantly upward trend. Remarkably, the S&P 500 index has recorded positive performance in every month except for February, when it experienced a decline of 2.6 percent.

Even in the face of challenges, such as the failure of multiple banks, in March, the S&P 500 index managed to achieve a gain of 3.5 percent. During the height of the bank crisis, the percentage of stocks trading above their 50-day moving average dropped below 20 percent. However, by the end of the month, this figure had rebounded and surpassed 35 percent.

The gradual ascent of the percentage of stocks trading above their 50-day moving average continued, and finished above 64 percent at the close of the second quarter. In other words, a greater number of stocks are displaying bullish patterns rather than bearish ones.

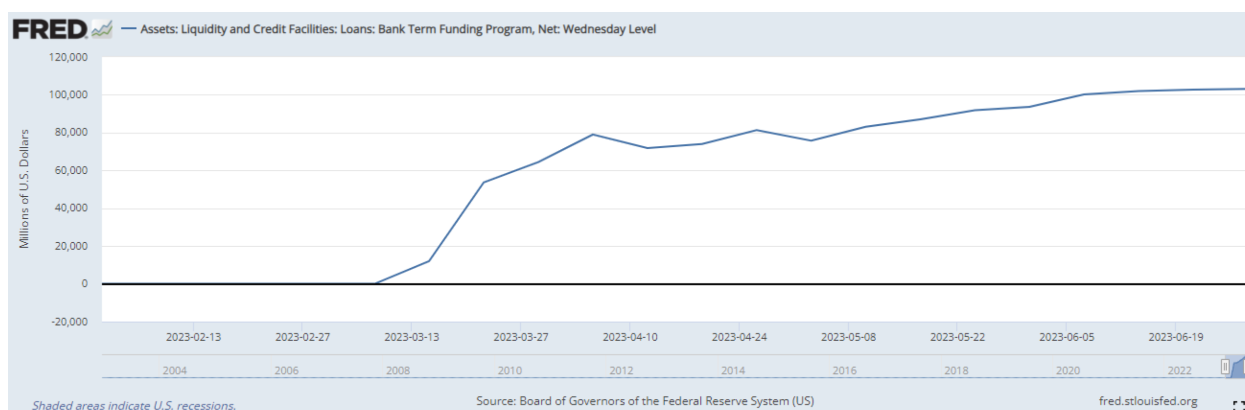
Outlook

Regarding inflation and the Fed’s monetary policy, one notable observation is that the Powell-led Federal Reserve disregarded several fundamental principles established by former Fed Chairman Ben Bernanke, who was instrumental in designing the Fed's quantitative easing (QE) program. For instance, when apprehensions regarding QE initially emerged, Bernanke assured a national television audience that the Fed possessed the necessary tools to manage inflation. In 2010, he explicitly stated, "We could raise interest rates in 15 minutes" to prevent inflation from spiraling out of control. Bernanke further emphasized the Fed's commitment to keeping inflation below the two percent threshold.

Bernanke's keen understanding of the perils associated with inflation became evident in August 2007. Shortly after the collapse of two Bear Stearns subprime mortgage hedge funds, under Bernanke's leadership, the Federal Reserve underscored the persistent risks of inflation. The Fed emphasized “the risks that inflation would fail to moderate as expected continued to outweigh other policy concerns” and that “inflation remained the most significant policy concern.”

In a recent May 2023, paper by Ben Bernanke and Olivier Blanchard on inflation, they get straight to the point: "Policymakers were slow to react," as they persisted in their expectation that inflation would eventually return to the Federal Reserve's 2 percent target by 2023.

As the Federal Reserve remains determined to bring inflation back to its 2 percent target by raising interest rates in an attempt to curb wages and demand, it simultaneously employs other means to inject liquidity into the system. A notable example is the surge in emergency loans to banks through the Fed's Bank Term Funding Program (BTFP), which was established after the failure of Silicon Valley bank. The BTFP recently reached an all-time high of over $103 billion. In essence, distressed securities have seemingly been magically swapped at the Fed for their full face value (100 cents on the dollar), which some claim is another form of QE.



Essentially, the Federal Reserve's injection of liquidity in order to prevent additional bank failures could have unexpectedly acted as a catalyst for the market's upward movement, apparently causing bank "losses" to vanish into thin air. This unconventional intervention by a central bank was also evident in September 2022, when the Bank of England (BOE) purchased substantial amounts of long-term bonds to halt a market downturn. At that time, the pound was

valued at slightly less than 1.04 against the U.S. dollar. Presently, the pound stands at approximately 1.27 against the dollar.

However, despite the rally thus far, as the market embarks on the second half of the year, it must confront several challenges. These include the anticipated continuation of the Federal Reserve's interest rate hikes, a deceleration in the U.S. economy, the resumption of average student loan payments amounting to around $300 per month, and persistent geopolitical tensions.

As a result, these should cause an uptick in volatility, thereby providing attractive opportunities. (7.3.23)

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