TJT CAPITAL GROUP
REGISTERED INVESTMENT ADVISOR

On Our Radar – August 2023

July saw a continued rally in the equity markets, with the S&P 500 index gaining 3.11 percent. This impressive performance was fueled by cooling inflation and the resilience of the U.S. economy, despite the Federal Reserve raising interest rates by 25 basis points, reaching the highest level since January 2001, with a federal funds target range of 5.25 percent to 5.50 percent.

However, some of the positive factors that contributed to the rally may be shifting. Oil prices surged more than 15 percent in July after Saudi Arabia announced an extension of its one million barrel per day supply cut. Additionally, interest rates on the 10-year U.S. Treasury Note climbed above 4.0 percent, up from 3.32 percent in May. Furthermore, the U.S. dollar showed signs of strengthening, having declined by over 12 percent since last September. While a weaker dollar can benefit U.S. companies operating abroad by reducing product costs and potentially boosting profits, a stronger dollar may create headwinds.

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 Reserve once again raised interest rates, bringing the upper range of the federal funds rate to 5.50 percent. This significant increase represents a 22-fold jump since March 2022.

Our criticisms of Chairman Jerome Powell's monetary policy have been longstanding, and his recent press conference did little to sway our stance. We have consistently argued that Powell has been less than forthright in his communications. Notably, a former U.S. Treasury Secretary publicly called him out for making statements that were "analytically indefensible."

In his latest address, Mr. Powell claimed that the Fed's job, assigned by Congress, is to get inflation under control. However, we find this assertion to be intellectually dishonest. The Fed's mandate is to achieve low and stable inflation, a goal that was successfully maintained for more than 25 years before the Powell-led Fed implemented a radical and untested monetary policy shift in 2020.

Looking at the data below, Core PCE averaged 1.5 percent annually from 2010 to 2020, demonstrating that inflation remained well within acceptable levels.

Core PCE Average (based on calendar reporting dates):

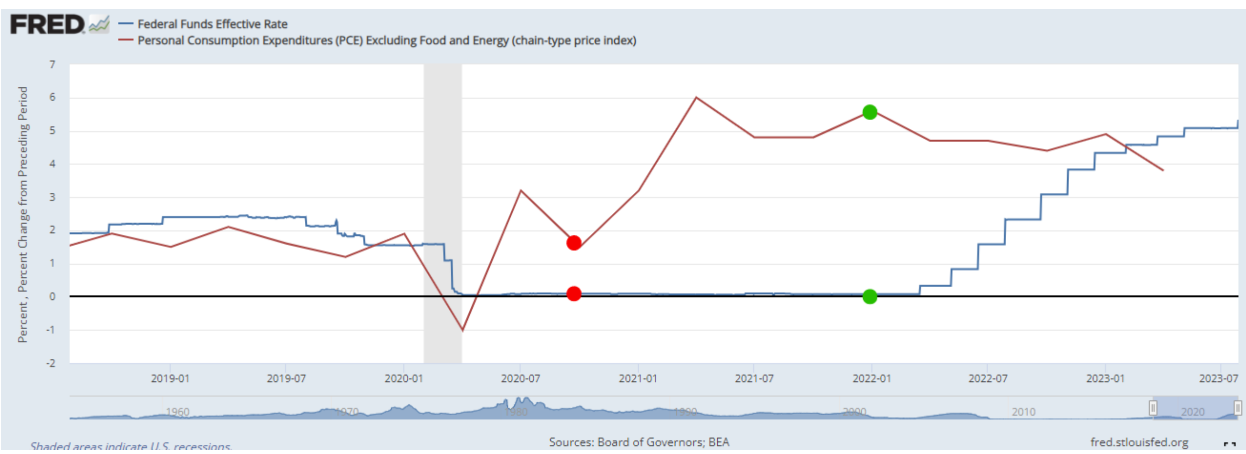
2010: 1.33	2017: 1.50
2011: 1.40	2018: 1.82
2012: 1.86	2019: 1.67
2013: 1.36	2020: 1.26 *Fed changed Policy in August 2020
2014: 1.48	2021: 2.98

2015: 1.28	2022: 4.55
2016: 1.62	2023 4.6% (First 6 months)

Despite this, the Powell-led Fed felt compelled to alter monetary policy because inflation was slightly below the Fed's arbitrary 2 percent target, which was only introduced in 2012.

What stands out is that back in 2017, no one seemed to be overly concerned about inflation being around 1.5 percent. However, some academic elites were worried that such "low" inflation in the U.S. might lead us down a path similar to Japan's experience, which saw annual deflation on seven occasions between 2000 and 2009. To address this concern, the Powell-led Fed introduced an inflation "makeup strategy," officially known as flexible average inflation targeting.

The impact of the Fed's policy shift is evident in the chart below. The red dots represent August 2020, a time when Core PCE (red line) hovered around 1.3 percent, and the federal funds rate was nearly at zero. Fast forward to January 2022 (green dots), and despite inflation still being near a 40-year high, the Fed unanimously voted to maintain interest rates at zero. This was the point where the Fed's credibility was shot.



Furthermore, despite Powell acknowledging in January 2022 that the Fed's "balance sheet is substantially larger than it needs to be," the Fed persisted in purchasing hundreds of billions of dollars' worth of bonds. In an interesting choice of words, Powell referred to inflation as a "high class" problem.

Recently, Mr. Powell has been keen to convey that the Fed is well aware of the hardships caused by high inflation. His proposed solution is to soften labor market conditions to bring supply and demand into better balance and alleviate inflationary pressures.

In essence, Powell suggests that increasing the unemployment rate is the way to tackle the inflation problem caused by the Fed's actions. In other words, to address a problem created by the Fed, more people would have to lose their jobs.

Perhaps it would be beneficial for the Fed to take a step back from implementing radical theories and instead examine the factors contributing to the tight labor market conditions. It is puzzling that the labor force participation rate has declined from 66.2 percent in 2008 to the current 62.6 percent, as depicted in the chart below. Understanding these dynamics could provide valuable insights into addressing the current economic challenges.

Therefore, if the labor force is estimated to be around 160 million, it is concerning that more than 5.7 million people are no longer available for work. This significant decline in labor force participation raises important questions about the underlying factors contributing to this trend.

Instead of pursuing a policy that may intentionally lead to putting more people out of work, the Fed should prioritize a comprehensive examination of the factors responsible for this decline. Identifying the underlying issues is crucial for developing effective strategies to better handle the labor market challenges and promote economic stability.

By focusing on the root causes of the shrinking labor force, the Fed can work towards implementing measures that encourage workforce participation, create opportunities for employment, and foster a robust and sustainable economy. This approach would be more likely to yield positive outcomes for both individuals and the broader economy, aligning with the Fed's mandate of promoting maximum employment and stable prices.

Valuation

In the first quarter of 2023, S&P 500 companies reported operating earnings of $52.54, which was 6.4 percent higher than the corresponding period in 2022. While a number of companies are in the process of reporting their second quarter results, the estimates of $52.55, if realized, would equate to a 12 percent increase over the second quarter of 2022.

In terms of market dynamics, the combination of higher earnings and lower inflation has clearly had a bigger influence on stock prices than higher interest rates by the Federal Reserve.

Economic Cycle

The initial estimate of Gross Domestic Product (GDP) showed that the U.S. economy grew 2.4 percent in the second quarter, slightly up from the 2 percent growth reported in the first quarter. A key factor remains the deceleration in inflation, with the Federal Reserve's preferred inflation gauge, core PCE (Personal Consumption Expenditures), rising 4.1 percent year-over-year, down from the previous reading of 4.6 percent. Additionally, the more familiar CPI (Consumer Price Index) increased by 3 percent year-over-year, a notable decline from last summer's peak of 9.1 percent.

The Institute for Supply Management (ISM) Manufacturing survey for July reported a reading of 46.4, marking the ninth consecutive sub-50 reading indicating contraction. Furthermore, economic indicators such as the Leading Economic Index (LEI) and Industrial Production showed declines, and home prices fell year-over-year for the first time in eleven years due to the impact of higher mortgage rates on buyers.

On a more positive note, consumer confidence, as measured by the Conference Board, rose to 117 from the previous month's 109.7, partly influenced by moderating inflation. Some additional factors that could be contributing to this rise in confidence include stealth stimulus measures, such as President Biden's Department of Education's announcement of the automatic discharge of $39 billion in Federal student loans in the coming weeks. That said, while this represents a relatively small percentage of the total outstanding student debt of $1.7 trillion, student debt payments are set to resume after more than three years of paused payments.

Sentiment

Bullish sentiment has surged hand in hand with the fresh peaks achieved by the major averages in 2023. At the end of July, the measure of Bullish Sentiment, as gauged by Investors Intelligence, jumped to 55 percent. This milestone represents the highest level attained since November 2021 – a timeframe that coincided with the peak of the NASDAQ Composite index.

As a reminder, our perspective on sentiment remains that of a contrarian indicator, particularly when it reaches extremes. A case in point is the period around October 2022, where bullish sentiment dropped to approximately 25 percent, which coincided with the low in the S&P 500 index.

In the event that Bullish sentiment surpasses the 60 percent threshold, the likelihood of a pause or pullback rises materially.

Technical Factors

As the equity market indices rallied to new highs in 2023, a parallel advance occurred in the percentage of stocks trading above their 50-day moving averages. In the latter part of June, this percentage experienced a dip, hovering around 52%; however, as July drew to a close, it rebounded significantly, crossing the 73 percent level.

Although the initial half of the year saw the major indices being buoyed primarily by a handful of companies, the recent upswing has ushered in a more widespread participation. An illustrative case can be found in the New York Stock Exchange, where the momentum heading into August was seen as 225 companies reached new 52-week price highs, while only 16 companies registered new 52-week price lows.

Outlook

After the turbulence experienced in 2022, markets have shown a robust recovery, driven by several factors. Lower inflation, a weakened U.S. dollar, modest expectations entering 2023, and some unconventional stimulus have contributed to this positive trend. Notably, unsuspected shocks have introduced new liquidity, totaling billions of dollars, into the markets.

One such initiative is the Fed's Bank Term Funding Program (BTFP), which came into being after the failure of Silicon Valley Bank and others. The BTFP has grown to over $105 billion, enabling distressed bonds to be "exchanged" with the Fed at full value, essentially erasing losses. Additionally, JP Morgan reported net income of $2.4 billion attributed to the "rescue" of First Republic bank.

While the Fed has attempted to reduce liquidity through interest rate hikes and bond sell-offs, they have concurrently taken measures to safeguard the banking system by adding liquidity through other channels. The Fed has acknowledged that trouble is brewing in the commercial real estate market as there have been some high-profile defaults by major real estate funds recently.

Furthermore, the U.S. has provided considerable aid, amounting to over $115 billion, to Ukraine since the onset of the war with Russia. As a consequence, some of the funds allocated to Ukraine are finding their way back to U.S. companies, creating unique circumstances that have, thus far, favored the market. Nevertheless, geopolitical tensions have been on the rise. The Russia/Ukraine conflict has escalated, and China has implemented export controls on crucial metals used in semiconductor manufacturing, raising concerns about potential disruptions in the global supply chain.

In addition to these developments, the U.S. Treasury announced that third-quarter borrowings are now estimated to reach $1 trillion, higher than the previous estimate of $733 billion. Although the market's advance has been welcomed, it has not eliminated potential risks. Therefore, it would not be surprising to witness a return of volatility, which should present additional opportunities. (8.2.23)

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