TJT CAPITAL GROUP
REGISTERED INVESTMENT ADVISOR

On Our Radar – September 2023

In August, various markets experienced significant fluctuations driven by key events. Fitch Ratings downgraded the credit rating of U.S. debt (from AAA to AA+) during the month, coinciding with a notable increase in the yield on the 10-year U.S. Treasury Note, which reached 4.34 percent. This marked the highest yield since November 2007. As a result, the S&P 500 index declined 1.77 percent over the course of the month. Additionally, the price of a barrel of West Texas Intermediate (WTI) oil surged to its peak for the year, surpassing the $85 mark.

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)

On August 25, 2023, during the annual Jackson Hole Symposium in Wyoming, Federal Reserve Chairman Jerome Powell delivered a clear message regarding inflation: it "remains too high." Powell emphasized that addressing this issue and returning inflation to the target rate of 2 percent would likely necessitate a period of economic growth below the typical trend, as well as some softening in labor market conditions.

This messaging from Chair Powell has been consistent for several months, extending even to the press conferences following Federal Open Market Committee (FOMC) meetings. He has expressed that the Fed understands "the hardship that high inflation is causing" and "Without price stability, the economy doesn't work for anyone."

What's strikingly ironic, and appears to have eluded Jerome Powell's awareness, is that merely three years ago, during the same Jackson Hole Symposium, the Powell-led Fed made a substantial shift in monetary policy due to concerns that inflation was too low. In essence, the Powell-led Fed departed from decades-old principles that had fostered low and stable inflation, in favor of an untested theory aimed at generating higher inflation.

Furthermore, in 2020, Powell essentially pledged that the Fed would act promptly if inflationary pressures became excessive or if inflation expectations exceeded the levels consistent with their objectives. However, in January 2022, when inflation reached a 40-year high, the FOMC unanimously decided not to raise interest rates, maintaining them near zero.

The Fed's failure to act in a timely manner and in accordance with its initial guidance has had widespread repercussions, with the broader public bearing the consequences of this choice. It raises further questions about the Fed's objective to increase unemployment as a means to combat inflation, all stemming from their willingness to embrace a radical theory.

Moreover, given that the federal debt has surged by approximately 40 percent since 2020, reaching a staggering figure of over $32 trillion, it becomes increasingly imperative that the Federal Reserve avoid any further policy missteps.

Valuation

In calendar year 2021, earnings estimates for companies in the S&P 500 index were roughly $208. However, in 2022, these earnings dipped to $196.95. This decline, coupled with a notable increase in interest rates orchestrated by the Federal Reserve, led to a contraction in the P/E ratio (price/earnings).

Throughout the second, third, and fourth quarters of 2022, S&P 500 earnings were all lower compared to their respective figures from the previous year. However, a significant shift occurred in the first quarter of 2023. Operating earnings for the S&P 500 during this period amounted to $52.54, marking a 6.4 percent increase from the first quarter of 2022.

Since then, earnings estimates for calendar year 2023 have jumped to approximately $220. This upturn in earnings, combined with the Federal Reserve's more conservative approach to interest rate hikes, has played a pivotal role in bolstering the market's progress thus far.

Economic Cycle

In the second quarter, the U.S. economy grew at a revised rate of 2.1 percent, down slightly from the initial estimate of 2.4 percent, following a first-quarter growth rate of 2.0 percent. While the economy has shown resilience, there are unmistakable signs that it's confronting challenges.

Notably, credit card balances have surged beyond $1 trillion for the first time, with average interest rates exceeding 22 percent. Furthermore, the impending restart of student loan payments in October, after more than three years, with interest resuming in September, adds to the economic complexity.

The employment situation also appears to be tapering off. In August, the U.S. generated 187,000 jobs, causing the unemployment rate to rise from 3.5 percent to 3.8 percent. To compound matters, recent revisions have revised downward employment figures for the past few months. For instance, June's payrolls, initially reported as a 209,000 increase, were subsequently revised to a more modest 105,000.

In manufacturing, the Institute for Supply Management (ISM) survey inched up to 47.6 from last month's 46.4 but remains below the 50-level, indicating contraction. Industrial Production, on the other hand, declined by 0.2 percent from a year ago. Simultaneously, surging interest rates have driven mortgage applications to a 28-year low, with many longer-term fixed mortgage rates surpassing 7.25 percent.

Amidst these challenges, there are some positive notes. Retail sales showed a 0.7 percent increase in July, and the Federal Reserve's preferred inflation measure, core Personal Consumption Expenditures (PCE) - excluding food and energy - was at 4.2 percent, down from 5.2 percent in September 2022.

Sentiment

As a reminder, we consider investor sentiment as a contrarian indicator, particularly when it reaches extremes. In early August, bullish sentiment saw an uptick to slightly over 57 percent, marking its highest point in approximately 21 months. While this figure didn't quite reach the threshold for an outright bearish signal, it did suggest that the markets might be poised for a momentary pause or a potential pullback.

By the close of August, bullish sentiment had dropped to approximately 43 percent, representing a rather notable shift over a brief span. During this period, a number of stocks experienced double-digit declines.

As we entered 2023, bullish sentiment remained subdued in the wake of the turbulent markets witnessed in 2022. Since then, it has predominantly mirrored the general market direction, rising and falling in tandem.

Technical Factors

Much like sentiment, the technical indicators of the equity market have tended to ebb and flow in sync with the major indices. At the close of the year, less than 40 percent of stocks were trading above their respective 50-day moving averages. This figure surpassed 75 percent in February, only to plummet below 20 percent when news of the failure of several banks surfaced in March.

Following the Federal Reserve's infusion of liquidity through the Bank Term Funding Program (BTFP), the percentage of stocks trading above their 50-day moving average rallied to over 70 percent in July before receding to the low thirties range by the close of August.

Outlook

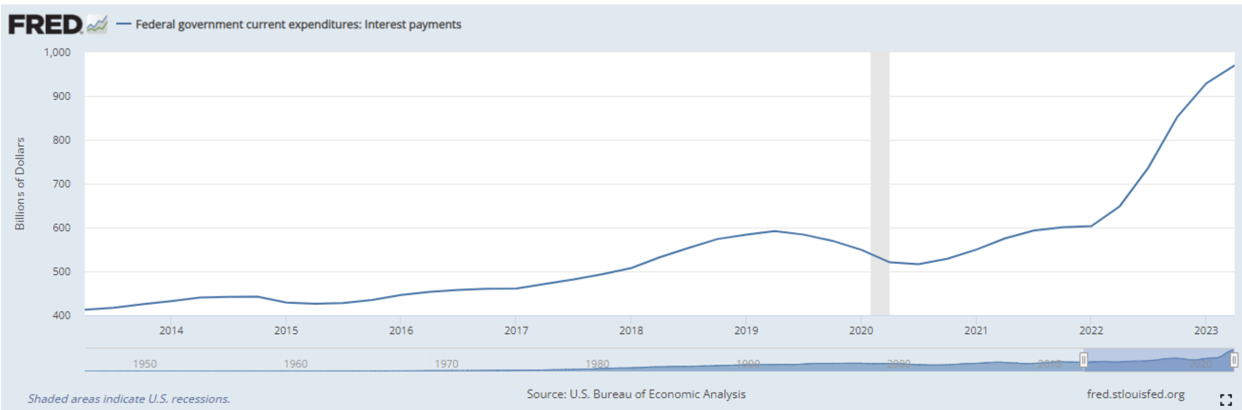
Up to this point, the U.S. economy has displayed resilience, and the equity market has reacted favorably to a slowdown in inflation. Nevertheless, several significant challenges continue to loom on the horizon. Perhaps the most prominent among these is the substantial surge in debt coinciding with the Federal Reserve's unprecedented ascent in the federal funds rate - a remarkable 22-fold increase occurring within a span of approximately sixteen months.

Adding to these concerns, credit card balances have now surpassed the historic threshold of $1 trillion, bearing an average interest rate exceeding 22 percent. Furthermore, after an absence of over three years, student loan repayments are poised to recommence in October, with interest resuming in September. This is happening at a time when credit card delinquencies and auto loan delinquencies have been on the rise.

When Fitch Ratings downgraded the U.S. credit rating, they specifically cited the "anticipated fiscal deterioration over the next three years" alongside concerns about diminishing financial governance and recurring debt ceiling confrontations. The reference to a "standoff" in this context may materialize sooner than expected.

Despite Congress temporarily suspending the debt ceiling in early June, they must still pass 12 separate appropriations bills before the September 30, 2023 deadline. Failure to do so would necessitate the enactment of a "continuing resolution" to provide interim funding, and the absence of such measures could result in government shutdowns.

The overarching reality is that the United States is charting an unsustainable trajectory, with federal debt surging by over 40 percent since 2020. Furthermore, interest payments on this debt have escalated significantly, with projections indicating that by year-end, interest expenses alone could exceed $1 trillion—almost doubling the amount paid in 2020, as seen below.



What is equally concerning is the diminishing reliability of government data. This issue becomes evident when we observe consistent downward revisions in various economic indicators throughout the year, including payrolls, Gross Domestic Product (GDP), new home sales, and the Job Openings and Labor Turnover Survey (JOLTS).

The truth of the matter is that this unprecedented debt increase and concurrent record-breaking interest rate hikes lacks historical precedent. Such circumstances often give rise to second and third-order effects that may not align with the Federal Reserve's outlook. For instance, the recent surge in worker strikes, spanning from pilots to Hollywood, with the United Auto Workers looming on the horizon, likely stems from wages failing to keep pace with the escalating cost of living, among other factors.

Therefore, these developments are poised to maintain a heightened level of market volatility. However, if inflation remains manageable and corporate earnings sustain their strength, we can reasonably anticipate a market with several investment opportunities on the horizon. (9.5.23)