TJT CAPITAL GROUP
REGISTERED INVESTMENT ADVISOR

On Our Radar – October 2023

August market weakness extended into September, driven by concerns regarding Federal Reserve policy and the potential for a U.S. government budget standoff. The S&P 500 index experienced a significant 4.87 percent decline during September, with the majority of this drop occurring after the Federal Open Market Committee (FOMC) meeting on September 19-20, 2023. Despite the Federal Reserve maintaining steady interest rates, they revised their predictions, anticipating interest rates to be 50 basis points (0.50 percent) higher at the close of 2024 and 2025 compared to their assumptions just three months prior.

We choose to use the term "prediction" deliberately, given the Fed's track record of inaccurate forecasts. This has eroded market confidence in the institution, exemplified by the 10-year U.S. Treasury rates, which climbed from 4.09 percent at the end of August to 4.59 percent by September's close, marking the highest levels since August 2007.

Meanwhile, West Texas Intermediate (WTI) oil prices surged to $95 towards the end of September, a staggering 40 percent increase since June. This jump was fueled by supply cuts from Russia and Saudi Arabia, stoking concerns of an impending imbalance in the oil market.

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 opted to maintain the federal funds interest rates within the range of 5 ¼ to 5 ½ percent. However, they revised their outlook for 2024 and 2025, as shown below:

	As of June, 2023	As of September, 2023
2024 Rate Estimate	4.6%	5.1%
2025 Rate Estimate	3.4%	3.9%

Given the consistent inaccuracy of the Fed's projections, attempting to predict the federal funds rate two years in advance seems futile. In simpler terms, the Fed's forecasts have proven to be unreliable to the point of being nearly meaningless.

Recall that in July 2022, former U.S. Treasury Secretary Larry Summers argued that with the Consumer Price Index (CPI) at 9.1 percent and Personal Consumption Expenditures (PCE) at 6.9 percent, deeming a 2.5 percent federal funds rate as "neutral" was implausible. Summers critiqued Jerome Powell's remarks, calling them "analytically indefensible."

In September 2022, the Fed outlined their projections for 2023, with a median GDP estimate of 1.2 percent, a median total PCE forecast of 2.8 percent, and a median federal funds projection of 4.6 percent. However, the actual economic performance defied these projections.

Year-to-date total PCE averaged a notable 4.2 percent, painting a different picture from the initial estimate. Furthermore, the federal funds rate averaged 4.92 percent, and the Fed indicated the possibility of rates rising further this year.

Valuation

The interest rate on the 10-year-Treasury saw a substantial increase, climbing from roughly 3.37 percent in early May to 4.59 percent at the end of September. Such a pronounced uptick in interest rates typically exerts downward pressure on the Price/Earnings (P/E) ratio of the markets.

Up to this point, this pressure has been relatively restrained, thanks to the resilience of corporate earnings and economic growth. However, it's worth noting that the effects of a rising interest rate environment often manifest with a lag, meaning that the ultimate impact has likely yet to be seen.

That said, the earnings projection for the S&P 500 in calendar year 2023 is expected to be about $219.95, which would be an increase of roughly 11.5 percent from the 2022 earnings. Currently, the estimates for 2024 earnings are $245. It is crucial to bear in mind that in the event of a recession, this figure is likely to undergo a downward revision.

Economic Cycle

The first quarter GDP for 2023 jumped to 2.2 percent, followed by a second quarter GDP of 2.1 percent. The latest reading of the Fed's preferred inflation indicator, Core Personal Consumption Expenditures (Core PCE), which excludes food and energy costs, registered a 3.9 percent year-over-year rise, a slight dip from the previous reading of 4.3 percent.

While the Institute for Supply Management (ISM) Manufacturing index hit 47.6, with levels below 50 signaling contraction, the services sector expanded to 54.5, up from 52.7 the preceding month. Industrial production saw a 0.4 percent uptick in August, and retail sales experienced a 0.6 percent month-overmonth surge.

Regrettably, consumer confidence waned once more in September, reaching its lowest point in four months. New home sales saw an 8.7 percent drop, while housing starts plummeted over 11 percent in August, a consequence of substantially higher mortgage rates.

Sentiment

We view sentiment as a contrary indicator, particularly when it reaches extremes. This means that exceptionally bullish sentiment is usually a sign that a substantial number of investors have already taken positions in the market. Conversely, when bearish sentiment lingers at or near extremes, it frequently indicates that the market has already experienced a significant pullback.

At the time the S&P 500 hit its summer peak, bullish sentiment stood at an impressive 57 percent. Since then, it has dropped into the low 40s, a shift attributed to the rise in interest rates on U.S. Treasury securities.

We anticipate that sentiment will continue to ebb and flow in tandem with the bond market until it stabilizes.

Technical Factors

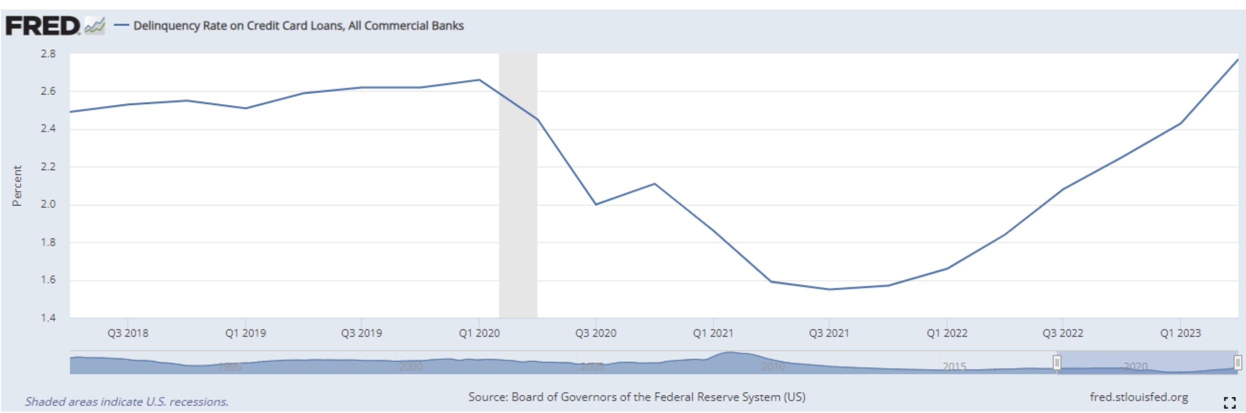
Much like sentiment, technical indicators offer insights into potentially overbought or oversold conditions. In July, over 73 percent of stocks were trading above their respective 50-day moving averages. However, more recently, his figure has dropped substantially, hovering now in the low 20 percent range.

Consequently, although a few major U.S. stock indices have managed to hold on to solid gains to date, there has been a notable retreat in a considerable number of individual stocks.

Outlook

As of October 1, 2023, it seems that the U.S. government is poised to avert a shutdown thanks to bipartisan legislation that secures funding until mid-November. While this interim resolution merely defers the budget quandary, it does allow for some extra time to craft a more comprehensive agreement.

Nevertheless, certain other concerns that have been influencing market sentiment, such as escalating U.S. Treasury yields, ongoing United Auto Workers (UAW) strikes, and the recommencement of student loan repayments amid credit card delinquencies surpassing pre-pandemic levels as seen below, continue to pose challenges.



We've long been critical of the Powell-led Federal Reserve, and with each press conference from Jerome Powell, it only reinforces our perspective. The root cause of inflation can be traced back to the flawed assumption among academic elites that inflation was too low. This led to a shift in Federal Reserve policy towards an inflation makeup strategy known as flexible average inflation targeting (FAIT). Unfortunately, Jerome Powell has yet to come to terms with this.

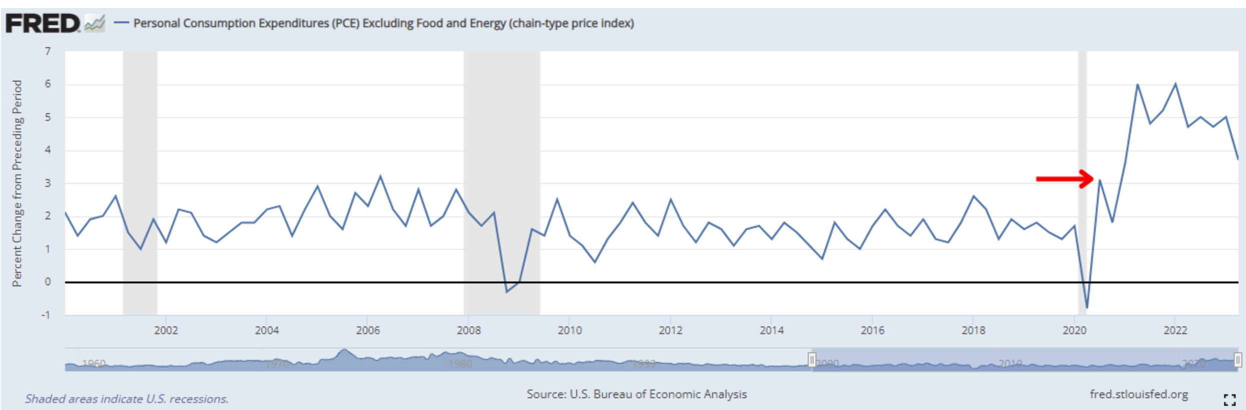
A recent paper released by economists at the Federal Reserve Bank of New York aptly characterizes the mistake made by the Powell-led Fed: it was "well understood theoretically, but there [was] little empirical evidence to substantiate it."

During his September 2023 press conference, Chair Powell went so far as to assert that rising interest rates were "not because of inflation." While this may hold some truth, there's a valid concern in the markets regarding a substantial surge in debt, coupled with a Federal Reserve that maintained policy rates near zero even as inflation soared to a 40-year high.

In accordance with well-established principles, longer-term interest rates are indeed influenced by the underlying rate of inflation, expectations of future inflation, and a risk premium.

While we agree that inflation isn't the sole factor, questions about policy and competency are increasingly surfacing. In 2020, former Fed Chair Janet Yellen pointed out that "Over the last decade, inflation has averaged 1.5 percent, while the Fed's target is 2 percent." She expressed genuine concern that inflation was too low.

As recently as August 2022, Chairman Powell referred to the "low and stable inflation of the past quarter century." Yet, due to the belief held by certain academics that they could precisely fine-tune policy, the Powell-led Fed adopted an untested theory (see Red arrow below), that contributed to a 40-year high in inflation.



Since then, Jerome Powell has been attempting to deflect criticism. In January 2022, Mr. Powell stated, "For a long time, we've been tightening on the expectation of high inflation which never came." This led the Powell-led Fed to discard the notion of preemptive monetary policy adjustments, believing that high inflation was improbable. In doing so, Mr. Powell seemed to overlook the fact that proactively adapting to higher inflation had paved the way for decades of low inflation.

The Powell-led Fed's significant shift in stance towards inflation is evident in the following responses: In 2010, when former Fed Chairman Ben Bernanke addressed concerns about quantitative easing (large-scale asset purchases by the Fed) and potential inflation, he confidently asserted that the Fed "could raise interest rates in 15 minutes if we have to." However, in November 2021, when inflation was more than three times the Fed's 2 percent target, Federal Reserve Bank of Minneapolis President Neel Kashkari suggested that the Fed "need not overreact to some of these temporary [inflation] factors." This approach ultimately led to inflation reaching a four-decade high.

Paul Volcker, the Federal Reserve Chairman credited with effectively combating inflation and establishing monetary policy principles that contributed to decades of low inflation, wisely stated, "The real danger comes from encouraging or inadvertently tolerating rising inflation." This statement encapsulates the Powell-led Fed's critical error.

Furthermore, in March 2019, when Chair Powell advocated for inflation "makeup strategies" in that speech, he acknowledged the "uncertain distance between models and reality." Despite this caution, the Powell-led Fed fully embraced the concept, and now appears to be revisiting the earlier principles in an attempt to rectify the problem they played a part in creating.

A prime example of the "real danger" that Mr. Volcker warned about is evident in the recent workers' strikes. For instance, the UAW has organized walkouts at all three major U.S. automakers simultaneously. Additionally, the union is advocating for a substantial 40 percent pay increase over four years, as well as the reinstatement of benefits lost in prior negotiations.

We understand that monetary policy is a complex arena. However, when the Fed implements a radical and untested policy based on a theoretical framework, and asserts that they will respond if inflation moderately exceeds their 2 percent target, yet allows inflation to reach a 40-year high before adjusting interest rates, the responsibility lies with them.

In plain terms, the combination of elevated interest rates and a continually growing federal debt, occurring simultaneously with signs of consumer caution, has prompted several markets to reassess risk. Although the economy is still expanding and job growth remains positive, corrections in various markets are creating opportunities for more favorable entry points. (10.3.23)