TJT CAPITAL GROUP
REGISTERED INVESTMENT ADVISOR

On Our Radar – November 2023

In October, the U.S. stock and bond markets experienced a decline, driven by escalating geopolitical tensions, rising interest rates, and concerns over political discord in Washington, D.C. The S&P 500 index saw a decrease of approximately 2.2 percent for the month, while the yield on the 10-year U.S. Treasury Note rose from 4.59 percent to 4.88 percent by the end of October. Crude oil prices also dropped by about 8.8 percent, settling at $81.54 per barrel.

This decline in the S&P 500 index marks the third consecutive month of losses, coinciding with the upward trend in interest rates. To illustrate, the yield on the 10-year U.S. Treasury Note stood at approximately 4.0 percent in early August, but by late October, it had surged to just above 5.0 percent. This represents a significant shift in a relatively short span of time. While we have been highly critical of the Federal Reserve for some time, there have been few prominent figures willing to call them out. However, just a week ago, Jamie Dimon, the CEO of J.P. Morgan, candidly stated, “I want to point out the central banks eighteen months ago were 100 percent wrong.”

When confidence wanes, markets tend to feel the impact. Encouragingly, historical data shows that markets often rebound after oversold conditions, such as those observed at the close of October. Over the last ten years, the S&P 500 has rallied in the month of November in 9 out of 10 instances.

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 Open Market Committee (FOMC) recently opted to maintain current interest rates, holding the target range for federal funds steady at 5.25 percent to 5.50 percent. In September, the Fed's preferred inflation measure, Core Personal Consumption Expenditures (PCE), showed a year-over-year increase of 3.7 percent. This is a slight dip from the 3.8 percent and 4.3 percent seen in August and July, respectively.

During a speech at the Economic Club of New York, Fed Chairman Jerome Powell asserted that when interest rates were raised in March 2022, it became evident that a more restrictive monetary policy was necessary. Notably, Powell seemed to present this as an insightful observation, though it's worth noting that by March 2022, inflation rates had already reached a 40-year high.

For a considerable period, we've contended that the Fed lost its credibility when it veered away from decades of sound monetary policy in favor of an elite academic theory that ultimately failed the test of the marketplace. The Fed’s policy shift was predicated on the belief that inflation, averaging 1.5 percent, was too low compared to their (arbitrary) 2 percent target, prompting them to implement an inflation "makeup strategy."

In August 2020, Chair Powell introduced this new monetary framework, acknowledging that no central bank had previously adopted such a policy. He assured the public that "if excessive inflationary pressures were to ratchet up above levels consistent with our [2 percent] goal, we would not hesitate to act."

Regrettably, Powell failed to do what he said the Fed would do, resulting in significant negative repercussions for the majority of the population. Furthermore, the Fed's pursuit of higher inflation has upended conventional portfolios, as the assumption that lower stock prices would be offset by higher bond returns has proven to be detrimental. In fact, a thirty-year bond purchased in the summer of 2020 has seen a 50 percent decline in value.

Valuation

At the start of the year, initial projections for the 2023 S&P 500 operating earnings stood at approximately $226. However, by the end of the third quarter, these estimates had been adjusted downward to around $220. Following a flurry of recent earnings reports and corporate guidance for the fourth quarter, these figures have been further fine-tuned, now hovering just above $218.

Despite the Federal Reserve's decision to raise interest rates again in July, the federal funds rate has maintained an average of roughly 5.49 percent since early May. Should the prevailing sentiment among market participants be that the Fed's interest rate hikes have reached their conclusion or are nearing completion, the stock market will shift its attention to the projected 2024 profits for the S&P 500 index. These are presently estimated to be in the vicinity of $244, reflecting an increase of about 12 percent over the current estimate for 2023.

Economic Cycle

In the third quarter, the U.S. economy expanded by 4.9 percent, a significant jump from the 2.1 percent pace in the second quarter. Notably, the main drivers of this growth were consumer spending and inventory accumulation, particularly by automakers who prepared for anticipated strikes.

Although there was a positive uptick of 0.3 percent in Industrial Production, it's worth noting that over the past year, the increase has been modest, standing at only 0.1 percent.

Turning to the Institute for Supply Management (ISM) Manufacturing Index, it declined to 46.7 from its September reading of 49. This marks a concerning trend, as the index has now been below the crucial 50-level – indicating contraction – for twelve consecutive months.

Meanwhile, Consumer Confidence experienced a dip, falling to 102.6 in October from 104.3 in the previous month. This decline can be attributed to higher interest rates and apprehensions regarding the geopolitical situation.

In the housing market, the 30-year fixed mortgage rate surged to 8 percent, and existing home sales plummeted to a 13-year low.

Sentiment

In October, an unexpected development occurred amid rising volatility: bullish sentiment saw a notable increase. Given our perspective that sentiment, especially when it reaches extremes, tends to serve as a contrarian indicator, we did not interpret this uptick as a positive sign. However, towards the latter part of October, we observed a significant and welcome decline in bullish sentiment, which we see as a more constructive shift.

Simultaneously, by the end of October, bearish sentiment had climbed to its highest point since March 2023, aligning with the distressing events surrounding the failure and subsequent rescue of depositors at Silicon Valley Bank.

With prices on the decline and apprehension on the rise, the likelihood of at least a counter-trend rally has notably increased, if not more.

Technical Factors

The decline in U.S. stock indices has resulted in a decrease in the number of stocks on the New York Stock Exchange showing "point and figure" (chart) buy signals, which is a key technical breadth indicator. This figure has dropped from roughly 52 percent in early August to below 25 percent by the close of October. In simple terms, this decline aligns with the recent trend of weakness or downward movement observed over the past few months.

Since the initial shock of COVID-19 in early 2020, this indicator has not dropped below 20 percent during market corrections. While there's no absolute assurance it won't happen, the technical indicators currently suggest an oversold condition.

Outlook

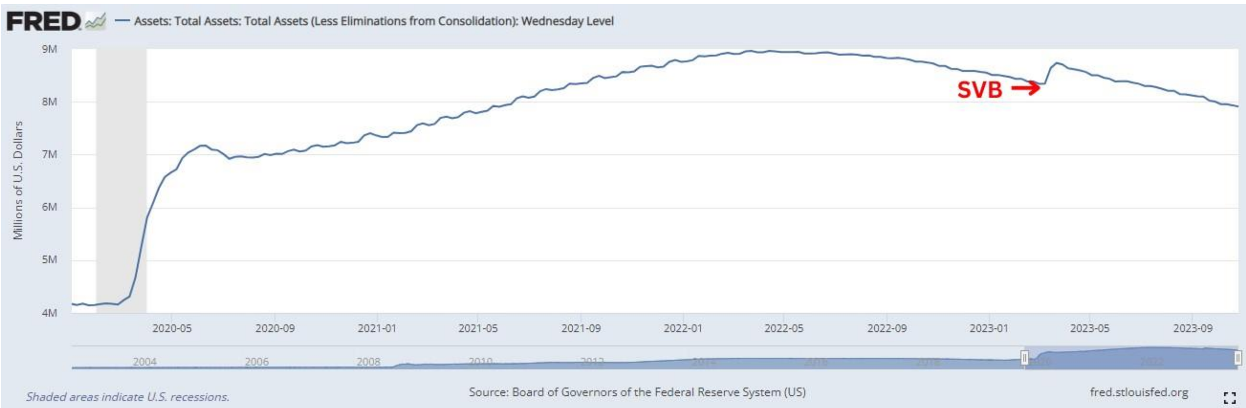
The markets have been experiencing increased volatility, driven by long-term interest rates reaching their highest levels since 2007 and escalating geopolitical tensions, notably with the Hamas attack on Israel leading to the deadliest offensive in fifty years. Israel's Prime Minister, Benjamin Netanyahu, declared the country to be at war.

In the bond market, concerns have arisen due to credibility issues at the Fed, coupled with significant debt accumulation in Washington, D.C., trillion-dollar budget deficits, and record borrowing by the U.S. Treasury. With federal debt standing at $33.6 trillion, U.S. Treasury Secretary Janet Yellen expressed confidence in the U.S.'s ability to finance two wars, a sentiment that should not provide much comfort.

In the fiscal year 2023 (which ended in October), the U.S. budget deficit reached $1.7 trillion. Consequently, the U.S. Treasury now needs to raise a record $776 billion in the final months of the year.

Despite these challenges, given the heightened global uncertainty and the emergence of a second major conflict, central banks are likely to continue their cautious approach with regards to further interest rate hikes.

Beneath the surface, the bond market's negative impact on certain banks' balance sheets has been somewhat overlooked. As indicated below, the Fed had to expand its balance sheet to mitigate any fallout from the Silicon Valley Bank (SVB) failure in March 2023. This injection of liquidity provided a boost to the markets, a move that the Fed has been gradually unwinding in recent months.



Certainly, the financial conditions are being shaped by the pronounced increase in interest rates and reduced liquidity, creating noticeable headwinds. Additionally, it's important to acknowledge that the ramifications of the Fed's policy missteps are anticipated to unfold over time, with second and third-order effects, like labor strikes due to inflationary pressures yet to fully materialize. Ultimately, higher wages tend to find their way to consumers.

Another important consideration is that mutual funds commonly conclude their fiscal year on October 31. Consequently, the month of October often witnesses lower trading volumes, potentially magnifying price movements in either direction.

While market volatility is expected to persist, it's worth noting that several markets have already undergone significant price adjustments. This reflects an elevated level of concern, even as corporate profits demonstrate an impressive level of resilience. Given that central banks are inclined to put a pause on interest rate hikes, and coupled with the recent decline in investor sentiment, it's notable that the percentage of stocks trading below their 50-day moving average has dropped to approximately 15 percent. Historically, this has been associated with opportune entry points. (11.2.23)

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