On Our Radar – December 2023

After three consecutive monthly declines into late October due primarily to rising interest rates, a strong counter-trend rally emerged in both the bond and stock markets during November. This rally, propelled by a drop in the yield on the 10-year U.S. Treasury Note from over 5.00 percent in late October to 4.37 percent by month-end, resulted in an impressive 8.9 percent surge in the S&P 500 index.

By July 31, 2023, the yield on the 10-year Treasury had dipped below 4.00 percent. However, in a remarkably short span, it soared above 5.00 percent for the first time since 2007. This sharp increase in interest rates exerted downward pressure on equity prices.

October data revealed hedge funds heavily shorting U.S. Treasury securities and equity futures, reaching record levels, thereby betting on future price declines. Yet, with the release of October employment data indicating a mere 150,000 increase in payrolls - the smallest gain since January 2021 - and revisions of 101,000 jobs downward for the previous two months, bond interest rates declined as hedge funds rushed to cover their negative bets.

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) opted to keep federal funds' interest rates steady within a target range of 5 ¼ to 5 ½ percent. Fed Chairman Jerome Powell hinted at potential future interest rate hikes, stating that "All participants believed it prudent to maintain a restrictive stance on policy until clear signs of inflation decline emerge."

Despite this stance, longer-term interest rates in the bond market declined materially, seemingly rejecting these remarks. This is understandable given how badly the Fed mismanaged monetary policy. The Fed undermined decades of sound monetary policy principles all because a few intellectual elites deemed inflation at 1.5 percent to be too low. Consequently, the Powell-led Fed pursued an unconventional inflation "makeup strategy," leading to inflation hitting a 40-year peak before interest rates were adjusted.

The repercussions of these actions have been deeply felt across bank balance sheets. For instance, according to the Federal Deposit Insurance Corporation's (FDIC) quarterly bank data, unrealized losses, primarily from U.S. Treasury and mortgage-backed securities, have soared to over $600 billion.

Regarding inflation, the Consumer Price Index (CPI) was unchanged on a monthly basis while registering a 3.2 percent increase year-over-year. This represents a notable decrease from the 7.1 percent spike in November 2022 and the staggering peak of 9.1 percent in June 2022.

Of particular note is that the CPI does not include real-time housing data, which makes up more than 30 percent of the index. Therefore, there is a significant lag in data, which impacts the

Fed's basis for interest rate policy decisions. Additionally, crude oil prices have experienced a consistent five-week decline, dropping to approximately $75 a barrel from over $81 a barrel at the end of October.

Valuation

S&P 500 companies are expected to earn roughly $214.34 per share in 2023, marking an 8.8% increase from 2022. Looking ahead, estimates project further growth, with 2024 earnings anticipated around $243 per share, representing a 13.5% jump.

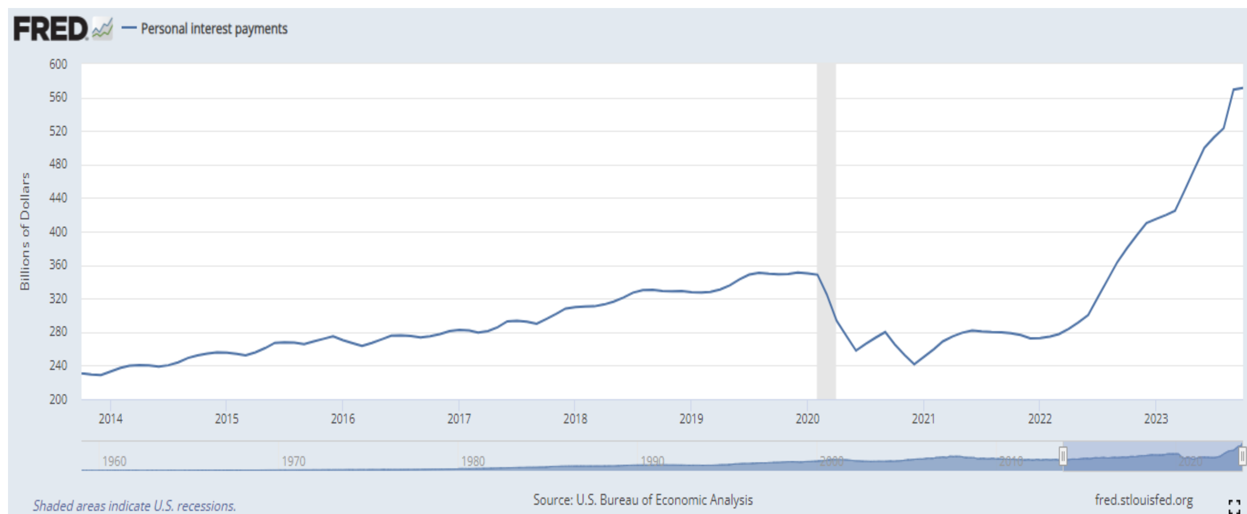
This translates to a current price-to-earnings (P/E) ratio of approximately 18.9 for the S&P 500 index based on 2024 estimates. If the Federal Reserve cuts interest rates next year, as some analysts anticipate, this P/E ratio could rise, potentially making the index even more attractive to investors.

Economic Cycle

The third-quarter U.S. economic growth was revised to a 5.2 percent pace, up from the initial 4.9 percent estimate, primarily due to automakers building up inventory in anticipation of United Auto Workers strikes.

The Institute for Supply Management (ISM) Manufacturing index remained under the contraction mark at 46.7 in November, marking thirteen consecutive months below the 50-level, while the ISM Services index slowed for the second consecutive month to 51.8 from 53.6.

The Conference Board Leading Economic Index (LEI) continued its decline for the 19th straight month. This consistent decline in LEI was accompanied by consumer confidence facing pressure due to elevated borrowing costs impacting monthly expenditures. Moreover, inflation-adjusted U.S. retail sales witnessed a year-over-year decline of 1.6 percent, and existing home sales hit a 13-year low in October. The following chart illustrates a significant 136 percent rise in personal interest payments since the low in December 2020.



Sentiment

We pay close attention to investor sentiment, especially when it reaches extreme levels. While bullish sentiment did not plummet to an extreme following the Hamas attack on Israel in early October, it did dip to around 42 percent, while bearish sentiment climbed above 25 percent.

However, since bond yields began their significant decline in late October, bullish sentiment has rebounded to roughly 55 percent. In the past, periods of bullish sentiment exceeding 60 percent have often coincided with market peaks. This doesn't automatically signal an imminent market decline, but it suggests that a pause might be due.

Meanwhile, consumer sentiment has tumbled from its summer high above 70 to the low 60s, reflecting the impact of rising interest rates on spending.

Technical Factors

Similar to investor sentiment, technical indicators for the equity market have mirrored the movements of major indices. Following three consecutive months of negative returns in the S&P 500, the percentage of stocks trading above their 50-day moving average plunged to around 15 percent. Historically, dips below 15 percent have often presented attractive entry points, although it can and often does go lower.

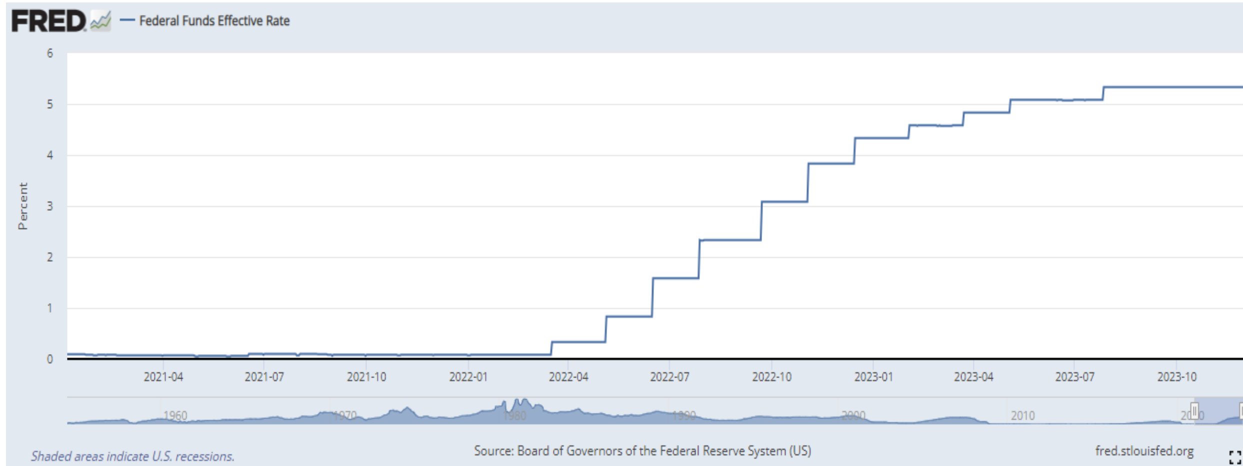
However, the recent market rebound has caused this percentage to skyrocket to over 70 percent. While it could climb further, it wouldn't be surprising to see a period of consolidation following the significant rally. Additionally, December's arrival tends to thin market activity as we approach the holidays.

Outlook

Stock and bond markets experienced a dramatic upswing after extreme negative hedge fund positioning and indications that the Fed's rate hiking cycle may be nearing its end. The markets welcomed signs of a softening labor market, a key factor for the Fed to consider when pausing rate hikes, and continued downward trends in inflation data.

The Fed's unwavering focus on tying rate hikes to labor market strength while disregarding the actual trajectory of inflation has been a source of criticism. For instance, the Producer Price Index (PPI), a measure of wholesale inflation, fell by 0.5 percent in October and has only increased by 1.3 percent over the past year.

Despite a 22-fold increase in the upper range of the federal funds rate, from 0.25 percent to 5.50 percent as seen in the following chart, Fed Chair Jerome Powell said that he is “not confident” the Fed has done enough to curb inflation. We view that as a positive considering that The Powell-Fed had long downplayed the severity of inflation, only to later acknowledge its detrimental effects and “without price stability, the economy does not work for anyone.”



Much of the volatility in the stock and bond markets over the past two years stems from the Fed's eroded credibility. It's worth recalling that when inflation reached a 40-year high in January 2022, the FOMC unanimously decided to keep interest rates at near zero. Moreover, former Fed Vice Chair Lael Brainard expressed concerns about high inflation during her Congressional testimony in mid-January 2022, yet still voted against raising interest rates despite inflation being at its highest level in four decades. These actions suggest that the Fed had predetermined its decision not to raise rates regardless of data.

In essence, the Powell-Fed's adherence to an unorthodox inflation "makeup strategy" has undermined decades of sound monetary policy principles, all because a few intellectual elites deemed inflation at 1.5 percent to be too low. This strategy has had far-reaching consequences, including the unsustainable accumulation of government debt and fiscal policy. As a result, Moody's rating agency downgraded its outlook for the U.S. to negative from stable, citing rising risks to the nation's fiscal strength.

The recent temporary spending bill, which funds some federal agencies until January 19, 2024, and others until early February 2024, merely postpones the need for a real budget. Additionally, the ongoing conflicts between Hamas and Israel, as well as Russia and Ukraine, continue to pose escalating risks and could further exacerbate market volatility.

Nevertheless, it appears that a major headwind that has had an enormous influence on the markets – the Federal Reserve’s hostile monetary policy – may be ending. That would be a significant change. (12.5.23)

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