On Our Radar – January 2024

In December, U.S. stock and bond markets experienced a significant rally, rounding off a robust year. This surge came after Federal Reserve Chairman Jerome Powell hinted at an end to interest rate hikes, a move that caught the markets off guard. This was particularly surprising given Powell's earlier comments on December 1, 2023, where he deemed it "premature" to discuss interest rate cuts. Yet, in a notable shift, just 12 days later, he acknowledged that interest rate cuts were “a discussion for us at our meeting today.”

The banking sector witnessed significant upheavals, with the collapse of Silicon Valley Bank in March and the failure of First Republic in May — the latter marking the second-largest bank failure in U.S. history. Paradoxically, these events spurred positive market reactions as the Federal Reserve infused liquidity via the Bank Term Funding Program (BTFP). By the end of the year, the BTFP's value escalated to over $135 billion, a significant jump from under $65 billion at the end of March.

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's abrupt reversal on interest rate cuts within a mere twelve-day span, though beneficial for the markets, exemplifies the dwindling credibility of the Powell-led Fed. This loss of trust is linked to some of the poorest bond returns since the Civil War and significant turmoil in the banking sector.

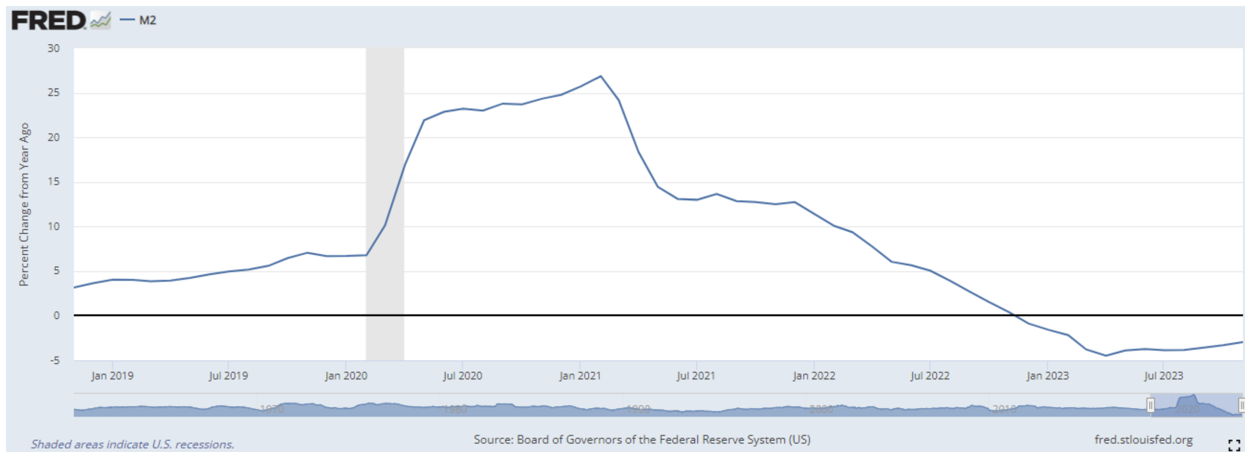
Analyzing the Powell-Fed's policy reveals three fundamental missteps. Initially, the Fed began with the assumption that inflation was too low, which required a strategy to boost inflation. This new Fed framework changed long-standing monetary principles, particularly the warning from former Fed Chair Paul Volcker who said, “The real danger comes from encouraging or inadvertently tolerating rising inflation.” Finally, the Fed disregarded the findings from another ex-Fed Chair, Ben Bernanke, about the destabilizing effects of delayed stimulus during a period of economic recovery. Following the COVID-lockdown recession, the Powell Fed underwent a radical shift in monetary policy.

Powell's inconsistent stances have raised doubts about his expertise in monetary policy. Recall in July 2022, with the federal funds rate at 2.25 percent to 2.50 percent, Powell described this as the "neutral" range, implying a rate that neither impedes nor accelerates economic growth. However, former U.S. Treasury Secretary Larry Summers contested this, highlighting the implausibility of a 2.5 percent federal funds rate being neutral with the consumer price index up 9.1 percent and PCE inflation up 6.9 percent. In fact, Mr. Summers called Jerome Powell’s comments “analytically indefensible.”

In January 2022, despite inflation reaching a 40-year peak, the Federal Open Market Committee maintained its policy interest rate near zero. This decision, as indicated by

statements from Fed Governors, wasn't due to inaction but rather a deliberate choice, with higher inflation seemingly being the objective.

However, what the Fed overlooked was the inflationary consequence of a nearly 27 percent annual increase in the money supply as of February 2021. This oversight, as indicated in the chart below, played a role in fueling high inflation. Since then, there's been a 3 percent year-over-year reduction in M2, a broad measure of money in the financial system, which is now exerting a deflationary pressure.



After initially neglecting the soaring inflation rates, Powell has acknowledged the risk of overextending their policy, asserting a focus on avoiding such errors. Yet, it's important to recognize that a negative year-over-year growth in the money supply has historically correlated with challenging economic periods.

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Valuation

As we entered 2023, analysts anticipated healthy earnings for the S&P 500, with estimates hovering around $226.50 per share. But as the majority of fourth-quarter results are set to roll in, current estimates are roughly $213.50 for the full year, representing an 8.4 percent increase compared to 2022.

That the major U.S. equity indices performed better than earnings growth highlights the dynamic interplay between earnings and the influence of inflation and monetary policy. For instance, in 2018, despite robust earnings growth of 21.7 percent, the S&P 500 declined 6.2 percent as the Powell-Fed hiked interest rates. The difference in 2023 was that the Fed introduced the Bank Term Funding Program (BTFP), thereby injecting additional liquidity into the system, and inflation was well below year-earlier levels.

Looking ahead to 2024, analysts currently estimate earnings per share of around $242. This translates to a Price/Earnings (P/E) ratio for the S&P 500 of approximately 19.7 times earnings.

Economic Cycle

The U.S. economy grew at a revised 4.9 percent pace in the third quarter while headline inflation (Personal Consumption Expenditures, or PCE) fell 0.1 percent in November, the first monthly decline since April 2020. The Federal Reserve's favorite inflation gauge – core PCE – rose 3.2 percent year-over-year, down from 3.4 percent the previous month.

While the unemployment rate ticked down to 3.7 percent from 3.9 percent, the number of job openings fell to 8.7 million from 9.5 million the previous month. This startling decline of almost 800,000 job openings in a single month raises questions about the accuracy of these government-produced economic statistics. Additionally, the Leading Economic Index (LEI) continued its downward trend, declining by 0.5% in November, marking 20 consecutive months of decrease.

On the positive side, U.S. retail sales rose 0.3 percent in November, consumer sentiment rose to 69.7 from 61.3 the previous month, the Institute for Supply Management (ISM) services index was above the 50-level – indicating growth – for the eleventh consecutive month, and Industrial Production increased 0.2 percent in November.

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.

In late October, bullish sentiment was below 43 percent. By year-end, that number rose to almost 57 percent. Meanwhile, the bearish percentage fell to about 18 from well over 25. While not necessarily extreme, sentiment seems to be mirroring the recent powerful advance in the markets.

Technical Factors

As October drew to a close, pessimism was in the air. The 10-year Treasury breached the 5.00 percent mark, and the Dow Jones Industrial Average was in negative territory for the year. This was confirmed by the percentage of stocks trading above their 50-day moving average, which fell to15 percent.

With the two-month rally, that same technical indicator - the percentage of stocks above their 50-day moving average – jumped to more than 84 percent. Historically, that type of momentum is a sign of strength, albeit with the possibility of a pause to refresh.

That said, it is important to keep in mind that this period is nothing like we have seen in the past, so historical precedent may or may not apply.

Outlook

The year 2023 was marked by several significant events and shifts in the global landscape. The U.S. grappled with an increasing federal debt and continued interest rate hikes by the Federal Reserve. Internationally, the ongoing conflict between Russia and Ukraine persisted, accompanied by the failure of several U.S. banks. Notably, there were dramatic developments such as an attempted military coup against Vladimir Putin, a surprise attack by Hamas against Israel, and a pivot by the Federal Reserve towards interest rate cuts to name a few.

In October, hedge funds took record short positions in U.S. Treasury futures and similar bearish bets on U.S. stocks through Commodity Trading Accounts (CTAs). This extreme positioning eventually reversed, triggering a significant rally in the markets.

The rapid policy shift by the Powell-led Federal Reserve raises questions about its underlying motivations. Factors such as the changing inflation rate, the decline in M2 money supply, or economic weaknesses in China could have influenced this change. Political considerations, particularly in an election year, cannot be overlooked. For those who believe the Fed is not political, we would remind you that Fed Chairman Ben Bernanke ushered in "QE3" (the third round of quantitative easing) in September 2012 – about seven weeks before the presidential election.

Looking ahead, the Federal Reserve's Statement of Economic Projections (SEP) anticipates three interest rate cuts in 2024, while the federal funds futures market predicts six cuts, signaling a major policy shift that could positively impact the markets.

Geopolitically, risks are escalating, as evidenced by recent attacks on commercial vessels in the Red Sea by Iranian-backed Houthis, which could disrupt global shipping and potentially fuel inflation. Domestically, the U.S. Congress approved an extension on the debt ceiling a couple of months ago and passed temporary appropriations on 4 bills until January 19, 2024, and 8 bills until February 2, 2024.

As these spending bills get negotiated, it could be a catalyst for additional volatility as this is an election year. (1.3.24)

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