TJT CAPITAL GROUP
REGISTERED INVESTMENT ADVISOR

Our Radar – February 2024

January saw the S&P 500 index rally 1.5 percent, continuing the momentum of the markets since late October, and reach a new all-time high above 4900 as U.S. lawmakers agreed on another "temporary" spending bill. As Congress continues to kick the proverbial fiscal can down the road, U.S. federal debt has increased more than $1 trillion over the past three months to over $34 trillion.

Nevertheless, the interest rate on the 10-year U.S. Treasury Note fell from 4.20 percent at year-end to 3.99 percent on January 31, 2024, while oil prices rose roughly 10 percent as tensions in the Middle East escalated.

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.

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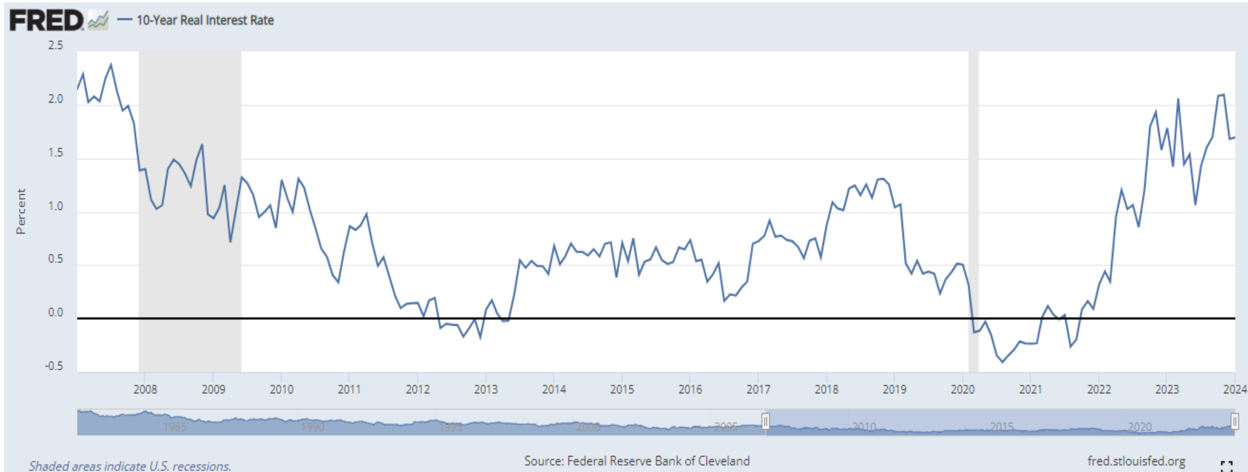
Interest Rates (Monetary Policy)

The Federal Open Market Committee (FOMC) decided to keep interest rates on federal funds unchanged at a range of 5 ¼ to 5 ½ percent. For the second time in as many months, Fed Chairman Jerome Powell said "We believe that our policy rate is likely at its peak for this tightening cycle," and if the economy evolves as expected, interest rate cuts will likely happen this year.

Mr. Powell acknowledged that inflation has come down from the highs, and that lower rents are eventually going to flow through the inflation measures. However, he went on to say the Fed "will need to see continuing evidence to build confidence that inflation is moving down sustainably toward our goal."

While the Fed is likely done with interest rate hikes, real interest rates (the nominal interest rate less the inflation rate) are well into restrictive territory. In fact, as you can see from the chart of real interest rates on the 10-year U.S. Treasury Note, they are at the highest level since before the financial crisis.

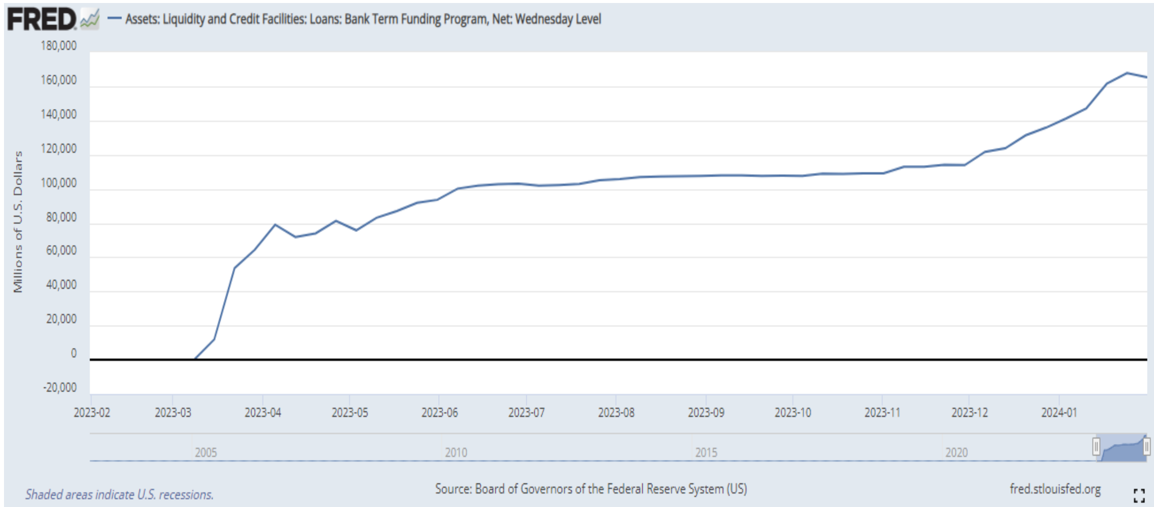


While the U.S. economy is growing, it is doing so on borrowed money. For example, the U.S. budget deficit was approximately $1.7 trillion in fiscal 2023. And for the first three months of fiscal 2024, which started on October 1st, the federal budget deficit reached $510 billion, up $89 billion or 21 percent from a year ago.

Nevertheless, U.S. Treasury announced that borrowing estimates for the first and second quarters of this calendar year would be around $760 billion and $202 billion, respectively, much less than expected.

In addition, the Fed announced that the Bank Term Funding Program (BTFP), the emergency vehicle created to support banks and their depositors following the failure of Silicon Valley Bank, will stop making new loans as of March 11, 2024. For some time, we have been pointing out that some banks were "gaming" the system by borrowing money from the BTFP at below market interest rates and investing in higher yielding securities.

Since the end of November 2023, banks borrowed an additional $51 billion from the BTFP, bringing the total amount of loans to more than $165 billion.



Valuation

Since the end of the third quarter, the S&P 500's earnings outlook has tempered slightly. Estimates have fallen about 3 percent to roughly $212, and 2024 expectations have dipped about 2.5 percent to nearly $239. However, this hasn't dampened the recent rally in major stock indices. This optimism stems from both anticipation of lower Federal Reserve interest rates and continued, albeit slower, earnings growth.

However, a potential wrench could be thrown into the works if the Fed's rate cuts materialize slower than expected, or if earnings growth dips further. In such a scenario, the current Price/Earnings (P/E) ratio of 20.6, based on 2024 earnings, could face pressure.

Economic Cycle

The U.S. economy grew by 3.3 percent in the fourth quarter and the Core PCE (Personal Consumption Expenditures), the Federal Reserve's preferred inflation measure, increased 2.9 percent year-over-year. On a 6-month annualized basis, Core PCE increased by 1.9 percent. New homes sales soared 8 percent in December on a month-over-month basis as mortgage rates declined. Consumer confidence rose to the highest level since 2021 and retail sales jumped 0.6 percent in December.

Meanwhile, U.S. consumer credit rose above $5 trillion for the first time as credit card balances surged, and the Leading Economic Index (LEI) declined for the 16th consecutive month.

Sentiment

Stock market rallies tend to breed bullish investors, and this time around is no different. Sentiment has soared alongside market averages, jumping from below 43 percent in late October to over 57 percent now.

However, we see this surge as a potential contrarian indicator, especially considering the current level of optimism. The gap between bullish and bearish sentiment now exceeds 40 percentage points. To put that in perspective, during the market bottom in October 2022, this "Bull-Bear spread" was a negative 19 points.

This doesn't necessarily mean a market selloff is imminent, but it's a reminder of just how far the market rally has come.

Technical Factors

The percentage of stocks trading above their 50-day moving average offers a sense of short-term market momentum. Back in October 2022, when high interest rates pressured the markets - with the 10-year Treasury yield near 5.00 percent - only a mere 20 percent of stocks were trading above their 50-day moving average.

By year-end, the landscape had dramatically changed. Optimism surged, reflected in almost 85 percent of stocks riding up with the equity markets. However, recent weeks have seen a bit of a

retreat, with the number dipping back into the 50s. This suggests a potential internal correction brewing beneath the surface of major market averages.

Time will tell if this is a pause to refresh or something else.

Outlook

After permitting inflation to reach a 40-year peak before opting to increase interest rates—a decision that heavily impacted financial markets—the Federal Reserve now appears to be signaling not whether, but when and how frequently, rates will be lowered. The anticipation has already begun to influence market behavior.

In his recent press conference, Jerome Powell reiterated that “restoring price stability is essential” and it’s the Fed’s job to “get inflation down.” Meanwhile, the Fed reaffirmed its “Statement of Longer-Run and Monetary Policy Strategy.” This is the strategy where policymakers “would promise to make up for past inflation shortfalls” to generate higher future inflation. Clearly that did not work out to well in practice.

Our criticism of the Powell-led Fed stems from their implementation of an untested theory, and the Fed’s lack of response when inflation was hitting a twenty, thirty, and ultimately a 40-year high before adjusting policy. And this approach was intentional. During Lael Brainard’s confirmation hearing for the role of Vice-Chair of the Federal Reserve in January 2022, she said “inflation was too high.” However, mere weeks later, despite inflation reaching a 40-year high, Brainard and her colleagues on the Federal Open Committee voted unanimously to keep interest rates near zero.

It has often been said that theories die one funeral at a time. While we wish no ill will, it would likely be beneficial for everyone if the academic elites left the radical experiments in the classrooms.

With the economy growing, corporate earnings expected to increase, and a less-hostile Fed, the financial markets have room to run. Historically, stocks have seen an average double-digit advance in the year following the first interest rate cut. However, it is crucial to acknowledge that the current climate is anything but your average period.

There is a legitimate question of how long economic growth fueled by trillion-dollar deficits can last. In addition, geopolitical tensions are escalating, highlighted by the killing of three U.S. service members by Iran-backed groups, which prompted the U.S. to announce plans for multi-day strikes against targets in Iraq and Syria.

Nevertheless, as we have seen over the past few years, market volatility in both directions is to be expected. This should usher in quite a few opportunities. (2.2.24)

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