On Our Radar April 2022

The month of March saw big swings in stocks, bonds, and commodities as the Russia/Ukraine war entered its second month, inflation rose to roughly a 40-year high, and the Federal Reserve signaled a significant change forthcoming in monetary policy.

The S&P 500 fell 5.26 percent in January, 3.00 percent in February, and 4.57 percent between March 1 and March 14, 2022, before gaining nearly 11 percent over an eleven-day period to finish down 4.9 percent in the first quarter.

A barrel of West Texas Intermediate crude oil rose as high as $130 in March as President Biden announced a ban on Russian imports of oil, although technically it does not go into effect for a few more weeks. In fact, a tanker carrying 680,000 barrels of oil left Taman, Russia on March 22, 2022 for New Orleans, LA. After April 22, 2022, the U.S. will no longer allow oil imports from Russia.

Nevertheless, in an effort to reduce gasoline prices at the pump, President Biden announced a plan to release 1 million barrels of oil per day from the strategic petroleum reserve. Oil ended March near $100 a barrel.

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) raised interest rates on federal funds to a range of one-quarter to one-half percent after pinning them near zero following the onset of the pandemic. Unfortunately, the Fed waited for inflation to hit a 40-year high before changing policy, and everyone is literally paying the price for that mistake.

Over the years we have pointed out that Fed Chairman Jerome Powell often repeats a word or phrase in an attempt to get a message across. In his March 16, 2022 press conference, Chairman Powell said "price stability" 23-times, almost as if to remind himself that one of the Fed's dual mandates is price stability.

It is clear that the Fed has lost credibility in the marketplace, and what Mr. Powell says is not as important as what he does. For example, in a post FOMC speech, he acknowledged that "inflation is much too high," and that there was an "obvious need to move expeditiously to return the stance of monetary policy to a more neutral level." However, that same week the Fed increased the size of its balance sheet by another $8.1 billion. Given that "inflation is much too high," the Fed should have stopped purchasing bonds several quarters ago.

In August 2020, the Fed changed its monetary framework. At that time Mr. Powell said, "Of course, if excessive inflationary pressures were to build or inflation expectations were to rachet above levels consistent with our goal, we would not hesitate to act." When asked about what he meant by excessive inflationary measures, Powell said “it means not very high above 2 percent.”

In his March 2022 press conference, Jerome Powell said “nothing in our new framework or in the changes we made has caused us to wait longer to raise interest rates.” To be charitable, this does not pass the smell test. When inflation hit a 20-year high, then a 30-year high, and now a 40-year high, at no point did the Fed think they needed to adjust policy before March 2022?

What appears more likely is the Fed made a social decision to let inflation run hot in an attempt to address the unemployment rate of certain segments of the population. But rather than admit that their policy was wrong, the Fed doubled down on a dangerously wrong theory. Now, the Fed is forced to raise interest rates and reduce the size of its balance sheet at a time when economic growth is already weakening.

If you want to know why the Fed got inflation so wrong, a recent piece from Liberty Street Economics (put out by the Federal Reserve Bank of New York) provides some clues. It stated, “The identification of the factors driving inflation is only as good as the model that produces it, and **our model is omitting many relevant aspects of reality.” (Emphasis added).**

Valuation

S&P 500 operating profits for calendar year 2022 are expected to be around $225, putting the P/E (price/earnings) ratio at roughly 20.1-times earnings. While earnings estimates have been steadily rising, the rate of change has been slowing of late.

What is more important, however, is the uncertainty around what the “market” thinks the proper P/E ratio should be given the current high inflation, rising interest rates, and a Federal Reserve that has signaled the end of quantitative easing (QE) and the beginning of quantitative tightening (QT).

Economic Cycle

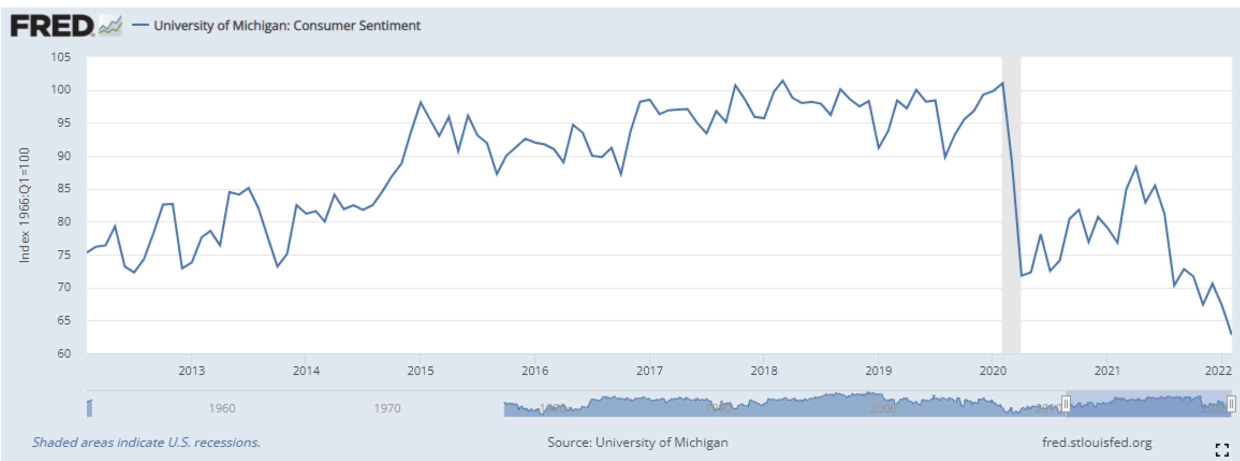
The Consumer Price Index (CPI) rose 7.9 percent year-over-year in February, the largest 12-month advance since July 1981. As such, interest rates rose across the board, with the yield on the 10-year U.S. Treasury Note rising from 1.83 percent at the end of February to as high as 2.50 percent before ending the month at 2.32 percent. Of greater significance is the yield on the 2-year U.S. Treasury security trading higher than the yield on the 10-year Treasury security, which is known as an inverted yield curve.

While an inverted yield curve does not guarantee a recession, it usually signals a tougher environment ahead.

The U.S. economy added 431,000 jobs in March and the unemployment rate fell to 3.6 percent. However, higher interest rates and energy costs are weighing on certain segments of the economy. For example, with mortgage rates the highest in years, existing home sales declined 2.4 percent year-over-year, the seventh consecutive decline.

The Institute for Supply Management (ISM) Manufacturing survey fell to 57.1, the lowest level since September 2020. Moreover, the new-orders index dropped almost 8 percentage points to 53.8 percent, which is a key leading indicator of future growth.

The University of Michigan consumer sentiment reading has seen one of the largest 12-month drops on record. With higher interest rates on credit cards and mortgages along with higher food and energy costs, there is less money available for other discretionary purchases. Since the consumer represents nearly 70 percent of the U.S. economy, slower economic growth is on the horizon.



Sentiment

Bullish investor sentiment dropped below the 30 percent level and bearish sentiment rose to more than 34 percent the week that Russia invaded Ukraine. At the end of March, the bull and bear ratio has been roughly even given the higher level of uncertainty.

As trading has become thinner, investors should not be surprised by wider swings in investor sentiment.

Want to have *On Our Radar* automatically sent to your email every month?

Click Here to Sign Up

Technical Factors

From a technical viewpoint, the markets saw an extreme flush as the number of stocks that were trading above their 50-day moving average fell below 19 percent on news of Russia invading Ukraine.

Following that oversold condition, the markets rallied into quarter-end as the S&P 500 index gained almost 11 percent in less than two weeks. As such, the number of stocks trading above their 50-day moving average surged to more than 60 percent.

Outlook

Stocks, bonds, and commodity markets have seen some extreme moves over the past few months. The price of nickel soared more than 250 percent in a few days causing the London Metal Exchange (LME) to close the market for roughly a week and cancel billions of dollars' worth of trades. Reportedly, a Chinese company was looking at billions of dollars of losses, which prompted the Hong Kong Exchanges and Clearing - the owner of LME – to "intervene."

The trend towards greater globalization has taken a hit as supply chains have been weaponized. While Germany and the EU made a colossal energy policy mistake that relied on Russia for a significant portion of its energy needs, they are in a bind as it would take approximately 3 years for Germany to become independent of Russian gas. In the meantime, Vladimir Putin has said Russia wants its gas exports to Europe to be paid in rubles, thereby sidestepping some of the sanctions.

Disruptions in everything from oil and gas to food, fertilizer, and rare earth minerals, among others, are putting pressure to onshore and build strategic stockpiles. The so-called "just-in-time" inventory model is moving toward "just-in-case." This is happening at a time when the Federal Reserve is completely divorced from reality and their almost fanatical devotion to theory has put the economy at risk of stagflation (slow growth and high inflation) or worse. The Fed let inflation rise to 40-year highs, yet still kept its official federal funds rate at a range of zero to one-quarter while continuing to purchase additional bonds. Now, the Fed is forced to change policy at a time when global economies are slowing.

As one corporate executive stated, "I wonder if anybody at the Fed has picked up the phone and called a business person and said, hi, what do you think is happening with inflation?" He went on to say "either businesses are going to make a lot less money or they are going to raise their prices."

It certainly seems like the Fed was in on what Treasury Secretary Janet Yellen referred to as "modern supply side economics," which she stated was the Biden administration's strategy "to address longstanding structural issues relating to "income equality, racial disparities, and climate change."

When you pull back the curtain and examine the facts, oftentimes there is an agenda. Literally, the first day in office President Biden shut down the Keystone pipeline and halted all new leases on federal lands in addition to stopping development at ANWR in Alaska.

While that was taking place, the Chief Executive Officer (CEO) of an asset manager with over $10 trillion used the term "decarbonize" nine-times in his 2022 annual letter to corporate CEOs, and wrote about doubling the size of its "stewardship team" in order to "understand your company's progress." Many believe that this CEO issued a veiled threat to companies that if they do not move quickly enough to a "green economy," proxy votes could be used against management.

Recall that President Biden's original nomination for the Comptroller of the Currency, Saule Omarova, said regarding companies in the oil industry, "we want them to go bankrupt if we want to tackle climate change." Sarah Bloom Raskin, President Biden's nominee for the Federal Reserve, withdrew due to push back over her view that banks should deny credit to companies in the fossil-fuel industry.

It is no wonder that investment in oil and gas exploration and production in 2021 was nearly 25 percent below 2019 levels. While it is likely that COVID may have had something to do with it, so too did an agenda. It will take decades to transition to a fossil-free energy policy, if ever, given the need to build redundancy into the system.

As previously stated, it's not what they say, it's what they do. On March 3, 2022, President Biden signed an executive order on Venezuela stating that the country poses "an unusual and extraordinary threat to national security." Less than a week later, the Biden administration sent officials to Venezuela in an attempt to buy oil from Nicolas Maduro.

To complicate matters more, President Biden stated "With regard to food shortages, it's going to be real," following a meeting with NATO allies in Brussels as Russia and Ukraine are the "breadbasket" of Europe. Some countries are already stockpiling food and banning some exports.

With the economy slowing, inflation running at multi-decade highs, and a Federal Reserve tightening monetary policy, the markets have experienced significant price moves as a result of a wider range of outcomes. At a time like this, confidence in leadership is essential. That includes the White House, the Fed, and Congress. The markets are looking for solutions, not finger pointing.

Short of that, investors should expect volatility to remain elevated, which one should look to take advantage of. (4.5.22)

TJT Capital Group, LLC ● 9 W. Broad Street ● Stamford, CT 06902 ● 877.282.4609 tel ● 203.504.8849 fax ● tjtcapital.com