On Our Radar – May 2024

The S&P 500 index experienced a 4.1 percent decline in April, following a ten percent rally in the first quarter of 2024, as the economic landscape became increasingly uncertain. Slowing economic growth, rising interest rates, and escalating tensions in the Middle East, sparked by Israel's military action against Iran, contributed to the decline. Furthermore, the Federal Reserve's forecast of three interest rate cuts as recently as late March have been pushed back.

The yield on the 10-year U.S. Treasury Note surged to 4.69 percent by the end of April, up from 4.20 percent at the end of March and 3.88 percent at the start of the year. This 81 basis point (0.81%) increase in just four months raises concerns about the Fed's monetary policy, particularly given the rapid growth of U.S. government debt.

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 maintain the federal funds rate target range at 5-1/4 to 5-1/2 percent, but announced plans to scale back its sale of U.S. Treasury securities from $60 billion to $25 billion per month. This move can be seen as a compromise, as it doesn't involve cutting interest rates outright.

During his May 1, 2024 press conference, Fed Chair Jerome Powell emphasized the need for "greater confidence" that inflation is declining before considering rate cuts. Despite three consecutive months of higher-than-expected inflation numbers, Powell downplayed a rate hike, stating "it's unlikely that the next policy rate move will be a hike."

When asked if the ongoing election year influenced monetary policy decisions, Powell asserted that it "just isn't part of our thinking." However, the Fed's actions suggest otherwise. For instance, in December 2023, Powell unexpectedly hinted at three potential interest rate cuts in 2024, starting as early as March. This came just 12 days after he stated it was "premature to speculate" about policy easing.

Historically, the Fed has made significant moves during election years. In September 2012, just weeks before the presidential election, the Fed announced the third round of quantitative easing (QE3), injecting massive monetary stimulus because Congress was playing election-year politics. Similarly, in December 2015, then-Fed Chair Janet Yellen suggested four possible rate hikes in 2016, a presidential election year, but the Fed only hiked rates once, in December 2016, after the election.

Valuation

Earnings estimates for S&P 500 companies are projected to reach $240 in 2024 and $275 in 2025, representing year-over-year growth of 13% and 14%, respectively. This follows an

estimated 8.4% increase in 2023 to $213.50, up from 2022. Looking ahead, 2024 earnings are expected to rise another 12.4% to $240.

In terms of valuation, the S&P 500 index is trading at around 18.6 times 2025 earnings estimates, which may not be considered cheap. However, if the Federal Reserve begins cutting interest rates and these estimates prove accurate, the market multiples could be considered reasonable.

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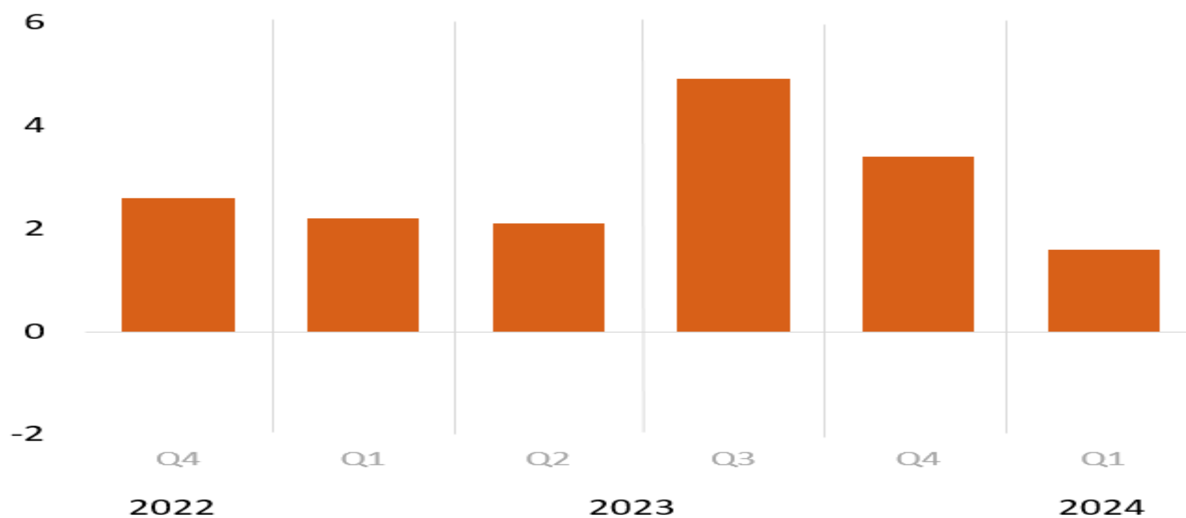
Economic Cycle

Oil prices, although down nearly 2 percent in April, remain 14 percent higher than at the start of the year. Meanwhile, the U.S. economy grew at a pace of 1.6 percent in the first quarter, a significant slowdown from the 3.4 percent and 4.9 percent growth rates seen in the fourth and third quarters of 2023, respectively (as shown in the chart below). However, this weakness appears to be driven by the volatile components of exports and inventories.



The Institute for Supply Management (ISM) Manufacturing index finally broke above the 50-level threshold in March, reaching 50.3, indicating expansion for the first time since September 2022. Meanwhile, the ISM Services index retreated to 51.4, down from 52.6 in the previous month.

The Leading Economic Index (LEI) experienced a 0.3 percent decline in March, following a 0.2 percent increase in February. On the inflation front, the Core Personal Consumption Expenditures (Core PCE), which excludes food and energy prices, rose 2.8 percent year-over-

year. However, the 3-month annualized Core PCE jumped to 4.4 percent, significantly above the Federal Reserve's 2 percent target.

In the fourth quarter of 2023, credit card delinquency rates remained elevated, surpassing pre-COVID levels, suggesting that higher interest rates are starting to strain consumers. Although retail sales posted a 0.7 percent monthly increase, it's essential to note that this gain doesn't account for price inflation. In other words, consumers may be spending more while purchasing fewer items, which could contribute to the decline in consumer confidence. The Conference Board Consumer Confidence Survey dropped to 97, down from 104.7 in March, hitting its lowest level since July 2022.

Sentiment

We believe investor sentiment serves as a contrarian indicator, especially when it reaches extreme levels. Recently, the Bull-Bear sentiment gap surpassed 48, just before the market's volatility surge. Not only have recent quarterly revenue and earnings reports driven price movements, but forward guidance from companies has, in some cases, had an even more significant impact on share prices.

In the long term, these pullbacks can be beneficial, prolonging the life of a bull market. However, since the 2008 financial crisis, the market's trajectory has been heavily influenced by Federal Reserve policy, which has played a significant role in shaping market direction.

Technical Factors

The equity market's April selloff brought a much-needed correction to the overbought conditions that had built up over the past few months. The percentage of stocks trading above their 50-day moving averages plummeted into the thirties, down from the lofty seventies and eighties seen late last year and earlier this year.

This shift could pave the way for a counter-trend move, provided corporate earnings continue to demonstrate strength. However, the trajectory of interest rates and the bond market will play a crucial role in shaping the market's direction, and these factors are heavily dependent on future Federal Reserve policy decisions.

Outlook

Market volatility jumped in April, driven by escalating geopolitical tensions (Israel and Iran), rising interest rates, and persistent inflation. Several prominent consumer companies have warned that consumers are facing sustained pressure, which is impacting their financial results. As we noted last month, the Federal Reserve has become a significant source of uncertainty in the bond market. Ironically, the same Fed that was confident that we needed an inflation “makeup strategy” and believed rising inflation was transitory – so much so that they waited until inflation hit a 40-year high before raising interest rates - now requires "greater confidence" before cutting interest rates. Again, this is after Chairman Powell opened the window in December 2023 for at least three interest rates cuts in 2024, just 12 days after saying it was “premature to speculate when policy might ease.” This shift in Powell’s stance is concerning and reduces the market’s confidence in the Fed.

Inflation causes a real erosion of wealth and purchasing power, yet the Fed's policy decisions seem to be influenced by academic theories rather than practical understanding and well-established principles. In an answer to a question at his March 2024 press conference, Mr. Powell said 30 years ago "some academics posited…" That is the problem!

Over the past three decades, the global economy has undergone significant transformations. However, a crucial warning from former Federal Reserve Chairman Paul Volcker remains eerily relevant. Volcker, credited with curbing the rampant inflation of the 1970s and early 1980s, cautioned that **"the real danger comes from encouraging or inadvertently tolerating rising inflation"** [emphasis added].

Notably, a group of academics persuaded Jerome Powell to adopt an untested "inflation makeup strategy" for monetary policy, despite Powell acknowledging that it was "largely untried." In a book written by Paul Volcker, he called the change to the central bank's approach to managing the economy "ill-advised."

Jerome Powell has tried to deflect blame and shift the focus to the COVID-lockdown supply shock, but this explanation is misleading. The surge in demand was fueled by the Fed's 27 percent increase in the money supply within a year, despite 2020 being the first recession in history where incomes expanded.

Paradoxically, higher interest rates are causing companies to raise prices. For instance, many companies have floating rate loans, so companies must increase prices to service their debt as the Fed raised interest rates more than 500 basis points (5.00%). This adds to existing pressures from higher energy prices, medical costs, and insurance costs. The latest Consumer Price Index report showed a 22.2 percent increase in auto insurance costs.

After two consecutive strong quarters in the equity markets, the combination of rising geopolitical tensions, slower economic growth, sticky inflation, and a significant increase in federal government debt weighed on markets in April. However, if the bond market stabilizes, companies and industries with revenue and earnings growth should continue to do well, albeit with higher market volatility.

As we are in an election year, despite the denials, the Fed is keenly aware of the potential political implications of its decisions. (5.6.24)

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