On Our Radar – June 2024

Driven by solid corporate earnings, a Federal Reserve slowing its bond sales, and a decrease in interest rates, the S&P 500 index reached a new high of 5321 in May before closing at approximately 5277, marking a 4.8 percent increase for the month. However, volatility in the stock and bond markets has increased significantly. The S&P 500's rally in May followed a 4.1 percent decline in April. Additionally, the Dow Jones Industrial Average dropped about 2000 points, or 5 percent, in eight days before rebounding with a 1.8 percent gain on the month's last trading day.

Oil prices also fluctuated, with West Texas Intermediate crude falling from nearly $82 a barrel in late April to around $77.23 by the end of May. In the U.S. Treasury market, the yield on the 10-year Note closed at 4.20 percent in March, 4.69 percent in April, and 4.51 percent in May.

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 minutes from the Federal Open Market Committee (FOMC) meeting held on April 30 – May 1, 2024, reveal that inflation is proving to be more persistent than previously anticipated. While the Federal Reserve acknowledged that inflation has slowed significantly over the past year, it noted a slight increase in recent months, with inflation still above 2 percent.

A key takeaway from the minutes is that the Fed will slow the pace of its sales of U.S. Treasury securities from its balance sheet. Specifically, the minutes stated, "Almost all participants expressed support for the decision to begin to slow the pace of decline of the Federal Reserve's securities holdings in June by reducing the monthly redemption cap on Treasury securities from $60 billion to $25 billion, maintaining the monthly redemption cap on agency debt and agency mortgage-backed securities (MBS) at $35 billion, and reinvesting any principal payments in excess of the $35 billion cap into Treasury securities."

While the Fed may delay an interest rate cut by a few months, effectively postponing a reduction in the "cost" of money, it has been working to increase the availability of money. The chart below shows the year-over-year change in M2, a broad measure of money supply. As indicated by the green arrow, the Fed began to reduce the contraction phase around the time of the Silicon Valley Bank failure. Since then, the year-over-year change in the money supply has turned positive, adding liquidity to the system.

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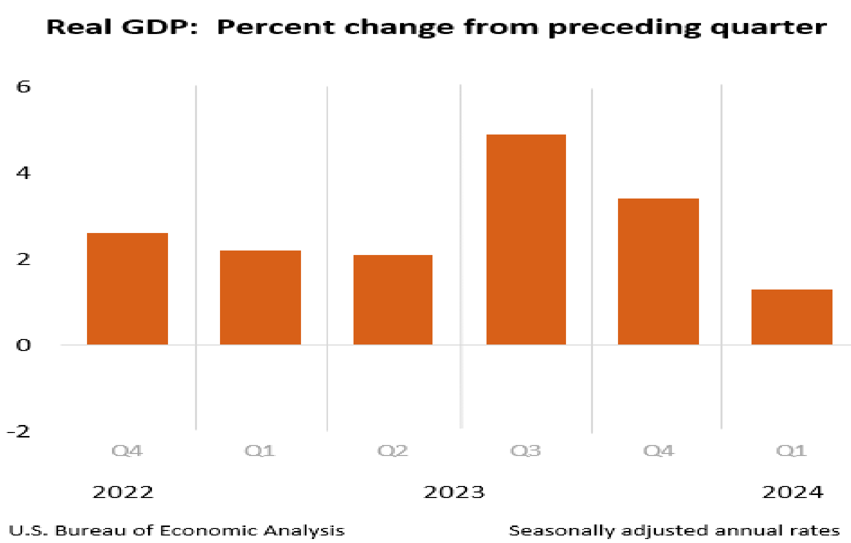
Valuation

Given that major U.S. stock indexes have reached several all-time highs this year, it's no surprise that bullish sentiment has been elevated, as it typically mirrors the direction of the equity markets. Notably, bullish sentiment peaked at over 62 percent in late March, only to drop below 47 percent after the market's decline in April. Since then, bullish sentiment has been rising in tandem with the rebound in major indices. While it is currently high, it is not currently at extreme levels.

Economic Cycle

The U.S. economy grew at a revised pace of 1.3 percent in the first quarter, down from the 3.4 percent pace in the fourth quarter of 2023 and lower than the initial estimate of 1.6 percent. Despite this growth, concerns are mounting about potential economic vulnerabilities, as more people are falling behind on credit card payments and auto loan delinquencies are rising.



The Institute for Supply Management (ISM) Manufacturing Index fell to 48.7 in the latest report, down from 49.2 the previous month. A reading above 50 indicates growth, so this decline signals contraction. Notably, new orders dropped by 3.7 percent, the largest decrease since June 2022. Higher borrowing costs have also impacted the housing market, with the National Association of Realtors reporting a 7.7 percent decline in its pending home sales index, the largest drop since February 2021.

On a positive note, consumer confidence rebounded to 102 in May after falling to 97 in April. Additionally, the Fed's preferred inflation gauge, Core Personal Consumption Expenditures (Core PCE), increased by 2.8 percent year-over-year, unchanged from the previous month.

Sentiment

We view investor sentiment as a contrarian indicator, particularly when it reaches extreme levels. The stock market's rally since late October has been accompanied by a significant shift in bullish sentiment, climbing from just over 40 percent to more than 60 percent. Additionally, the Bull minus Bear ratio has escalated to the mid-40s range, a figure that is considered quite elevated by historical standards.

To illustrate, during the market's peak in October 2007, the Bull minus Bear spread reached 42.4 percentage points. Although this indicator alone doesn't predict an imminent market downturn, it suggests that any disappointing news or unfavorable developments could exert pressure on the market.

Technical Factors

On May 29, 2024, the Dow Jones Transportation Average closed at 14,782, dipping below the May 1 closing low of 14,864. For followers of Dow Theory, this breach is a warning signal that warrants close observation to see how it recovers and whether the Dow Jones Industrial Average shows any signs of weakness.

Like market sentiment, the percentage of stocks trading above their 50-day moving average fluctuates with market trends. However, extreme values in either direction often serve as contrary indicators.

In late April, when the yield on the 10-year U.S. Treasury Note hovered around 4.70 percent, equity markets faced selling pressure, causing the percentage of stocks above their 50-day moving average to drop to about 30 percent. Since then, as interest rates have declined and stock indexes have risen, this percentage rebounded to above 60 percent before falling back to the low 50s.

Outlook

Growth in the U.S. economy has largely been driven by an increase in federal debt, which has risen by approximately 10 percent to $34.6 trillion since early 2023. Coupled with higher interest rates, interest payments now exceed $1.5 trillion, up from just over $505 billion in the third quarter of 2020. This unsustainable pace poses a significant risk to markets.

As famed economist Milton Friedman stated, “[inflation] is always and everywhere a result of too much money.” The Powell-Fed's inflation “makeup strategy” experiment disregarded sound monetary principles in favor of an academic theory. In June 2022, Fed Chair Jerome Powell remarked, "In terms of inflation, we had a 128-month expansion, and we never did quite get inflation back to 2 percent." Because inflation only averaged 1.5 percent over more than ten years, some academics convinced Powell to change monetary policy to increase inflation.

However, inflation tends to burden many while enriching a few. Even former Federal Reserve Chair and current U.S. Treasury Secretary Janet Yellen admitted in Italy that the "substantial increases" in the cost of living are problematic for many people.

It seems the government has little intention of paying off the debt. Previously, the idea was to grow the economy while gradually paying down the debt. This shifted to gradually inflating and repaying debt with "70-cent dollars." For decades, academics considered having the U.S. Treasury default only on bonds owned by the Federal Reserve, reasoning that since the Fed "printed" money to purchase the bonds, ordinary people would not be hurt. Recently, we have seen attempts to eradicate some debt (such as student loans) with the stroke of a pen.

We are now in uncharted territory on several fronts. The Biden administration recently announced new tariffs on certain Chinese-produced goods, such as solar cells and semiconductors, which may exacerbate ongoing geopolitical tensions. Additionally, according to Secretary of State Antony Blinken, President Biden approved the use of U.S. weapons by Ukraine inside Russia.

Currently, the U.S. economy is growing, and the Fed is adding liquidity behind the scenes. However, consumers appear to be cutting back, as retail sales were flat on a month-over-month basis. Headwinds are developing, likely leading to elevated volatility. We believe these expected market swings will continue to present opportunities. (6.4.24)