TJT CAPITAL GROUP
REGISTERED INVESTMENT ADVISOR

On Our Radar – July 2024

In June, the S&P 500 index reached another new high, driven by strong corporate earnings, a decline in the yield on the 10-year U.S. Treasury Note, and continued moderation in inflation. This has led the Federal Reserve to maintain its forecast for a rate cut later this year.

The S&P 500 index rose by 3.4 percent in June, while the yield on the 10-year U.S. Treasury Note dropped to 4.36 percent from 4.51 percent at the end of May. Additionally, the price of a barrel of West Texas Intermediate Oil increased to approximately $81.54 from $80.12 the previous month, following OPEC+'s decision to extend production cuts until the end of 2025.

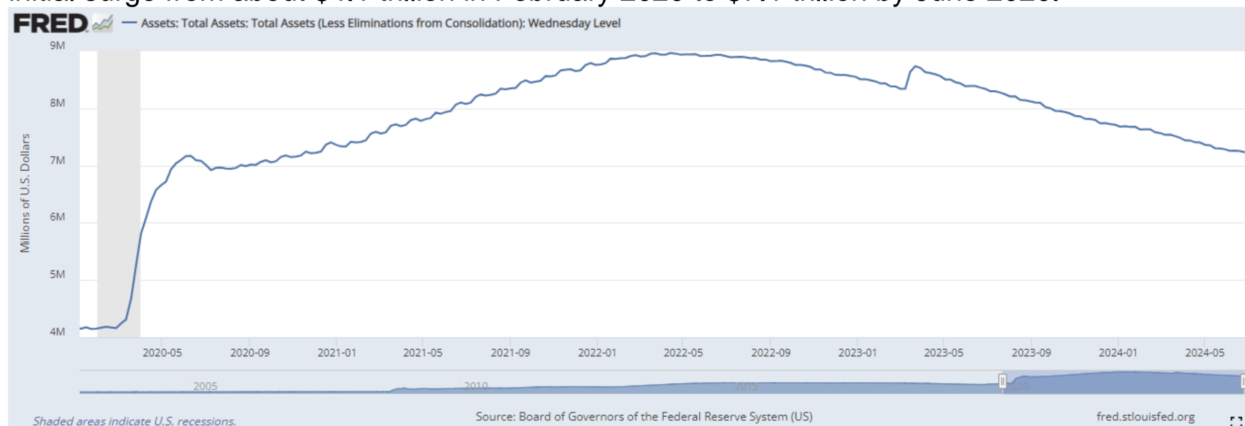
TJT Capital Group's InVEST Risk Model ® has helped our clients participate in bull markets and protect capital from the devastation of bear markets by focusing on 5 indicators that really matter when it comes to determining the health and direction of markets. The following is the most recent update.

Interest Rates (Monetary Policy)

The Fed's preferred inflation gauge, Core Personal Consumption Expenditures (PCE), recorded a year-over-year increase of 2.6 percent, down from the previous reading of 2.8 percent. Core PCE readings have exceeded the Fed's 2 percent target since March 2021. Notably, in August 2021, Fed Chairman Jerome Powell stated that these elevated inflation readings were "likely to prove temporary." More than three years later, it is clear that this period has been anything but temporary. Although the 2.6 percent reading is down from the peak of 5.57 percent, prices are still rising.

The Congressional Budget Office (CBO) now expects the budget deficit for the 2024 fiscal year, ending September 30, 2024, to be $1.9 trillion—about $400 billion higher than projected in February 2024. Deficit spending can be likened to a performance-enhancing drug: it may yield beneficial short-term results but can cause long-term damage.

The Fed's balance sheet stands at roughly $7.2 trillion, virtually unchanged for the third consecutive week. This moderation comes as Fed Chairman Jerome Powell announced that the Fed will slow the pace of sales of U.S. Treasury securities from its balance sheet. Although the balance sheet has decreased from its $8.96 trillion peak in April 2022, it remains above the initial surge from about $4.1 trillion in February 2020 to $7.1 trillion by June 2020.



The Fed faces a dilemma: while claiming to be "data dependent," its own forecasts predict a slightly higher Core PCE reading at year-end, yet it has signaled an interest rate cut. This adds to the confusion for those trying to understand the Fed's reasoning. Essentially, Chairman Powell indicated that the Fed does not foresee a change in current conditions, yet it signals a rate cut by the end of the year.

The Powell-led Fed lost significant credibility when Mr. Powell deviated from established monetary principles in favor of an untested inflation "makeup strategy" to boost inflation. Many hold Mr. Powell at least partially accountable for the spike in inflation. After introducing the new policy, he stated, "of course, if excessive inflationary pressures were to ratchet up above levels consistent with our goal, we would not hesitate to act." However, Mr. Powell did not act until inflation reached a 40-year high.

Federal Reserve Governor Michelle Bowman addressed the Fed's delayed response, stating, "It seems likely to me that the U.S. experience during the years leading up to the pandemic, when inflation was persistently low, made it hard for many to foresee how quickly that situation could change."

Valuation

The companies in the S&P 500 index are projected to report earnings of approximately $239 in the 2024 calendar year, and around $276 in 2025, reflecting a growth of over fifteen percent. Based on these earnings estimates, the S&P 500 is trading at a Price/Earnings (P/E) ratio of 22.8 times for 2024 earnings and 19.7 times for 2025 earnings.

If the economy continues to grow, inflation falls to the Federal Reserve's 2 percent target, and earnings meet expectations, these P/E ratios are high but reasonable. However, if economic growth slows and earnings estimates are revised downward, the market could experience a correction.

Economic Cycle

The U.S. economy grew at a revised pace of 1.3 percent in the first quarter, down from the initial estimate of 1.6 percent, primarily due to lower consumer spending. The Federal Reserve's broad money supply indicator, M2, turned negative on a year-over-year basis in November 2022. As the renowned economist Milton Friedman noted, monetary policy has a long and variable lag regarding its impact on the economy, and perhaps that impact is now becoming evident.

The four-week moving average of weekly unemployment claims has reached its highest level since December 2021, as illustrated in the chart below. Additionally, job openings have decreased from 9.1 million a year ago to slightly over 8 million today.

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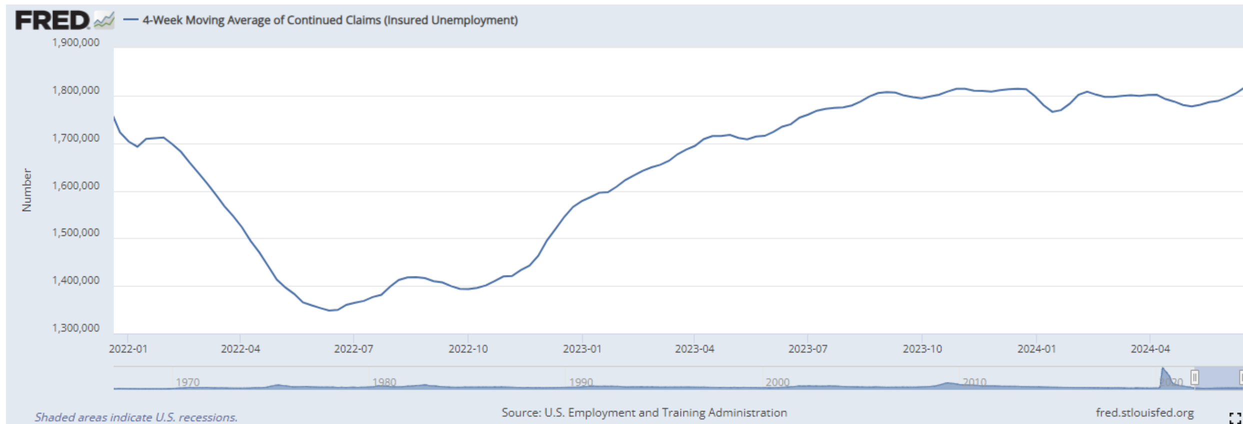


U.S. retail sales increased by just 0.1 percent in May, a disappointing figure since sales are reported in nominal terms, without adjusting for inflation. Essentially, if inflation is running at 2.6 percent and retail sales rise by only 0.1 percent, the entire "increase" is due to higher prices. Worse still, April's retail sales were revised down to a 0.2 percent decline. Consumer confidence dropped to 100.4 in June from 101.3 in May, as elevated inflation and high interest rates continue to burden consumers.

Existing home sales fell for the third consecutive month, and new building permits dropped 3.8 percent, with high interest rates and inflation weighing on consumers. The ISM Manufacturing Purchasing Managers Index unexpectedly declined to 48.5 in June from 48.7 the previous month, marking the third consecutive month of contraction.

Sentiment

Investor sentiment often mirrors market trends. Given that major U.S. stock indexes have hit several all-time highs this year, it's unsurprising that bullish sentiment is elevated.

However, we pay attention when sentiment reaches extremes in either direction, as it tends to reflect investors' past actions. In other words, when sentiment is very bullish, there's a high likelihood that investors are already heavily invested.

In recent weeks, over 60% of advisors have been bullish, while the percentage of bearish advisors has been in the upper teens. The ratio of bulls to bears is more than three to one, indicating significant optimism. If anything challenges the bullish narrative, markets could see increased volatility.

Technical Factors

The NASDAQ Composite continues to lead the market's advance, but a closer look at the numbers reveals a notable trend. As of the end of June, 110 NASDAQ stocks reached new 52-week highs, while 158 hit new lows. This disparity suggests that the rally is increasingly driven by a smaller group of companies, a phenomenon that warrants attention.

From a technical perspective, broad market participation is indicative of strength, while a narrowing of leadership is often a sign of a more mature market phase. Although this doesn't

necessarily foreshadow an imminent reversal – as more stocks could still join the rally – the divergence is worth monitoring.

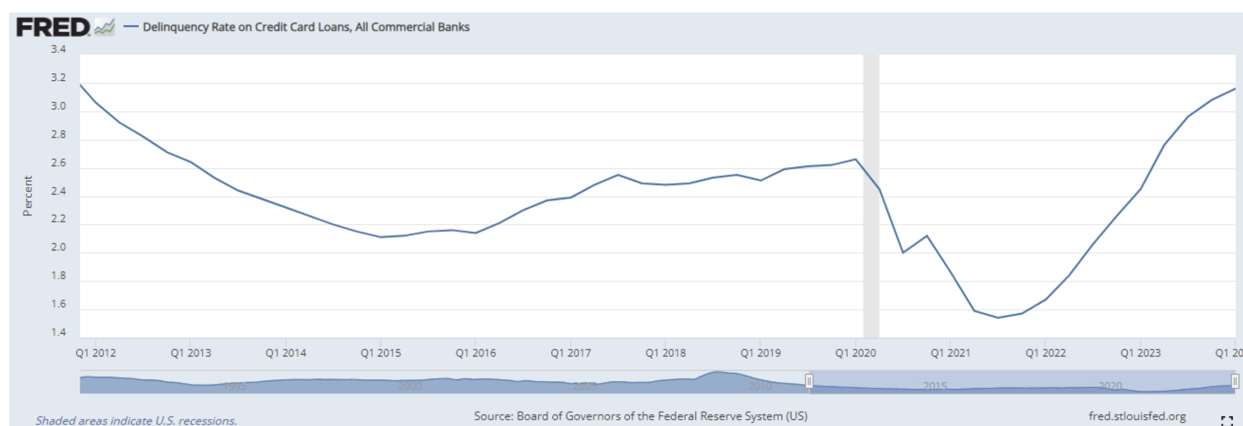
Another indicator, the percentage of stocks trading above their 50-day moving average, has remained below 50% for several weeks. This metric provides additional insight into the market's cycle, hinting at a more nuanced narrative beneath the surface of the ongoing advance.

Outlook

U.S. Treasury Secretary Janet Yellen has described the current U.S. economic strategy as "modern supply side economics," which involves “investing” (read borrowing money) to boost productivity in order to generate higher wages and economic growth. This approach assumes that borrowing is essentially limitless and that deficits do not matter. However, if this assumption is incorrect, it could have serious implications.

Currently, U.S. federal debt stands at approximately $34.6 trillion, with an annual interest expense exceeding $1 trillion. In a leveraged economy, the remedy for high inflation—higher interest rates—could be problematic if rising debt service costs lead to increased defaults, thereby impacting the economy.

Credit card delinquencies are now at their highest levels since the fourth quarter of 2011, as shown in the following chart, and auto loan delinquencies are also on the rise. Many cars purchased in recent years have negative equity, meaning the car's current value is less than the amount owed. Coupled with issues in commercial real estate and rising defaults on venture capital investments, the negative consequences of increased debt levels and higher interest rates are becoming evident.



In the commercial real estate sector, approximately $1.2 trillion of debt in the U.S. is due to be rolled over, according to the Mortgage Bankers Association. Early indications suggest that these issues could persist for some time. For instance, a major real estate company defaulted on several hundred million dollars worth of bonds backing a building at 1407 Broadway in New York City, yet a major credit rating agency still rates these bonds as "double A," just one notch below the highest "triple-A" rating. If this rating does not accurately reflect the current market reality, other bonds tied to commercial real estate properties might also be mis-rated.

Geopolitically, Russian President Vladimir Putin visited North Korean leader Kim Jong Un for the first time in 24 years, and they reportedly agreed on a new mutual defense pact with commitments to aid each other if either nation is attacked.

In the U.S., following the recent presidential debate, there are legitimate questions about who the final candidates will be come November. With two ongoing wars, rising geopolitical tensions between the U.S. and China, growing debt levels with annual federal interest expenses exceeding $1 trillion, and political shakeups in several countries, the potential for increased instability exists.

As such, we are closely monitoring these events and believe that if volatility increases, it will present opportunities to capitalize on. (7.6.24)

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