On Our Radar – August 2024

July saw a sharp increase in volatility, marked by significant events: an assassination attempt on Donald Trump, President Joe Biden ending his reelection campaign, and Vice President Kamala Harris becoming the de facto Democratic nominee. Additionally, a software bug in CrowdStrike's cybersecurity patch crippled Windows-based operating systems worldwide, leading to widespread disruptions, including flight and surgery cancellations.

Geopolitical tensions also escalated. The price of oil rose by approximately 5 percent on July 31, 2024, following reports that Iran's Supreme Leader, Ayatollah Ali Khamenei, had ordered retaliatory strikes against Israel in response to the missile assassination of Hamas leader Ismail Haniyeh.

During the month, the S&P 500 index experienced a sharp decline of 2.3 percent in one day, its worst since December 2022, but later recovered with a rally on July 31, closing the month up by 1.1 percent. Meanwhile, the yield on the 10-year U.S. Treasury fell below 4.0 percent on August 1, down from 4.26 percent at the end of June.

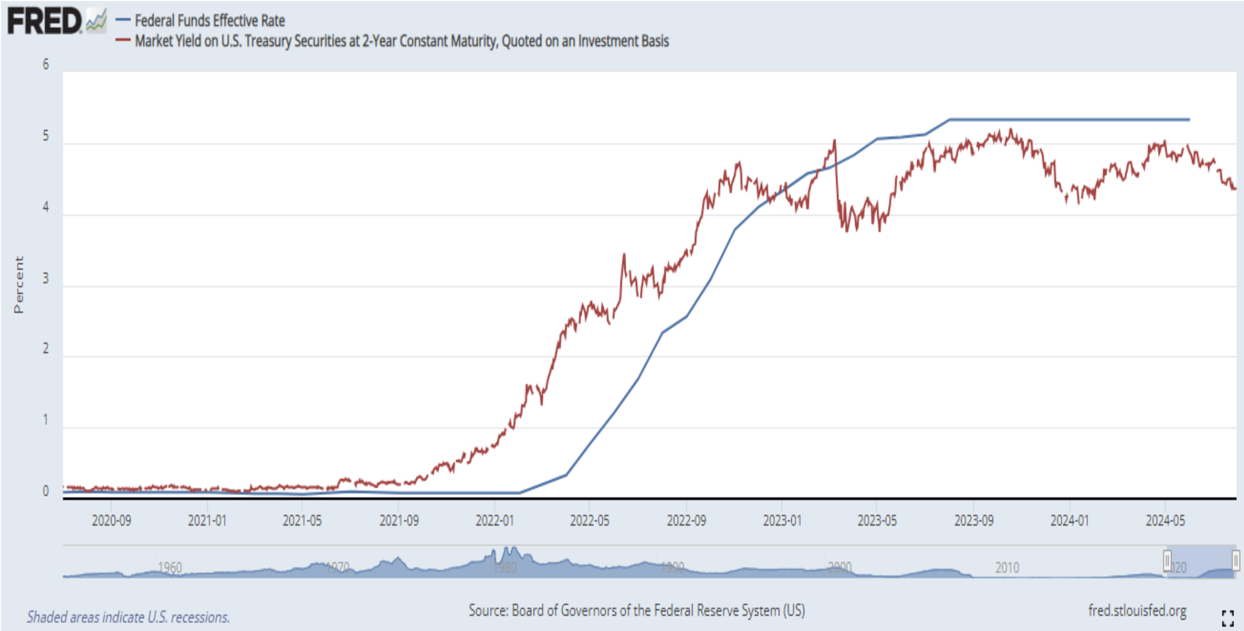
TJT Capital Group's InVEST Risk Model ® has helped our clients participate in bull markets and protect capital from the devastation of bear markets by focusing on 5 indicators that really matter when it comes to determining the health and direction of markets. The following is the most recent update.

Interest Rates (Monetary Policy)

On July 31, 2024, the Federal Open Market Committee (FOMC) decided to maintain the target range for the federal funds rate at 5 ¼ to 5 ½ percent. Fed Chairman Jerome Powell indicated that the Committee does not plan to reduce interest rates until they are more confident that inflation is trending towards its 2 percent target.

For the past four years, we have criticized the Powell-led Federal Reserve for being behind the curve in its interest rate policy. This latest decision could be another misstep. Historically, there has been a strong correlation between the 2-year Treasury yield and the federal funds rate. A significant gap between these two rates typically suggests that the federal funds rate is either too low or too high. The Fed's decision to keep rates low for an extended period between late 2021 and 2022 contributed to inflation reaching a 40-year high, as shown in the adjacent chart.

Since around mid-2023, the 2-year Treasury yield has indicated that the Fed should consider lowering the federal funds rate. Despite this, the Fed seems overly focused on employment statistics, which are traditionally seen as lagging indicators. Furthermore, Mr. Powell himself has acknowledged that the labor market data "may be a bit overstated."



When the Powell-led Federal Reserve adopted an unconventional and untested "makeup strategy" for inflation, Powell assured markets that the Fed would "not hesitate to act" if inflation moderately exceeded 2 percent. However, we all witnessed the outcome.

On a related note, Powell's reading of a prepared answer to the first question at the FOMC press conferences came across as rehearsed, potentially further undermining his credibility as a subject matter expert.

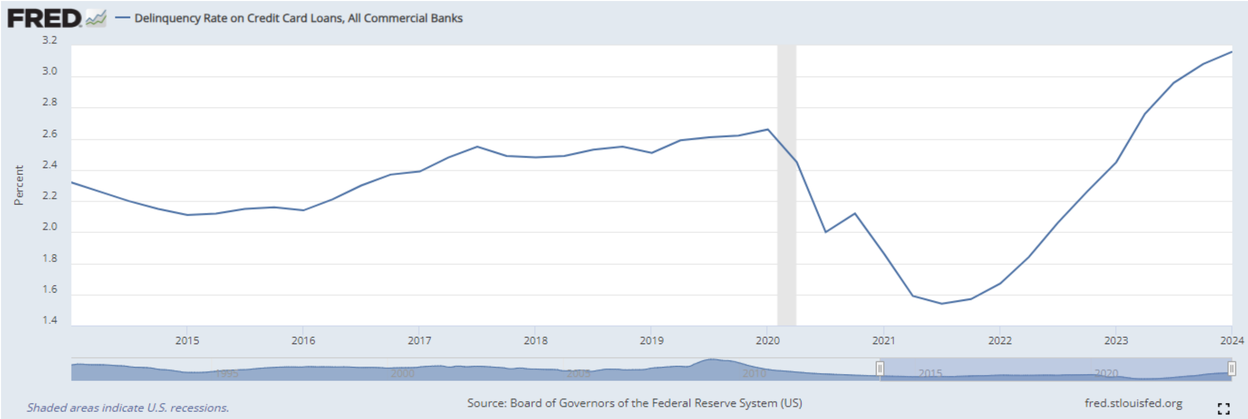
Valuation

The operating profits for the S&P 500 index are projected to reach around $236 for the calendar year, resulting in a Price/Earnings (P/E) ratio of approximately 22.5 times earnings. Earnings for 2025 are anticipated to grow by about 17 percent. This elevated market valuation is driven by expectations of higher earnings growth and lower interest rates from the Federal Reserve.

In contrast, the small-cap Russell 2000 index experienced a significant rally; however, around 40 percent of the companies in this index are unprofitable. When factoring in these companies with losses, the actual P/E ratio exceeds 80 times earnings—something to keep in mind.

Economic Cycle

The U.S. economy showed mixed signals. It grew at an annual rate of 2.8 percent in the second quarter, according to initial estimates, up from 1.3 percent in the first quarter but below the 3.4 percent growth in the fourth quarter of 2023. The Federal Reserve's preferred inflation measure, the Core Personal Consumption Expenditures (PCE), increased by 2.6 percent year-over-year, the lowest reading since March 2021. However, inflation continued to disproportionately affect lower-income households. Credit card delinquencies reached their highest levels in over a decade as seen in the chart below, and subprime auto loans surged 16 percent year-over-year.



The Institute for Supply Management (ISM) Manufacturing Survey fell to 46.8 from 48.5 the previous month, indicating contraction, while existing home sales declined by 5.4 percent in June. These indicators suggest that higher interest rates are having a notable impact on certain sectors of the economy.

In July, non-farm payrolls grew by 114,000, while the unemployment rate rose to 4.3 percent, marking a 0.9 percentage point increase from last year's cyclical low. Historically, a 0.6 percentage point increase in the unemployment rate has always preceded a recession.

Sentiment

Over the years, investor sentiment has often mirrored the market's ups and downs. Generally, these fluctuations in bullishness or bearishness don't carry much significance. However, when sentiment reaches extreme levels, it warrants attention.

In late July, the Bull minus Bear spread hit 49.3 percentage points, the highest in years. Historically, when bullish sentiment becomes this one-sided after an extended rally, it typically indicates little margin for error, as a significant amount of capital is already invested in the markets. Any disappointment, particularly for those who joined the rally late, could face challenges.

For context, the Bull - Bear spread is now higher than the percentage of Bulls at the beginning of this market advance around fall 2022. To use an analogy, when too many are on one side of the market, any concerns may cause a shift in positioning.

Technical Factors

On July 11, 2024, the NASDAQ Composite reached an all-time high of 18,671, only to close the day down 1.95 percent. In contrast, the Russell 2000 index surged more than 3.5 percent. These dramatic shifts on the same day suggest a significant change in market dynamics.

In the past—before the rise of algorithmic trading—a drop like the NASDAQ's would have been considered a "buying climax." Since then, increased volatility has occurred without the index setting new highs. Historically, a spike in volatility often precedes a change in market direction. Therefore, the market's behavior in the coming weeks and months will be critical to watch.

At one point during the month, the Russell 2000 index closed more than four standard deviations above its 50-day moving average—an extreme reading. These violent moves, at the very least, warrant a reassessment of risk exposure.

Outlook

Recent economic growth in the U.S. has largely been driven by government deficit spending and increased capital investment by technology companies building artificial intelligence infrastructure. Notably, the U.S. national debt recently surpassed $35 trillion, continuing on an unsustainable trajectory.

It appears that the Biden administration and Washington, D.C., are embracing Modern Monetary Theory (MMT). This economic perspective suggests that deficits do not matter for countries like the U.S. that issue their own currency, as they cannot run out of money in the same way households or businesses can because the Federal Reserve can "print" money.

However, as demonstrated by the Fed's inflation "makeup strategy," problems can arise when theories are taken too far, resulting in unforeseen consequences. There's a significant gap between academic theory and market reality. For example, Long Term Capital Management, which failed spectacularly in the late 1990s and required a massive Wall Street bailout orchestrated by the Fed, had two Nobel Laureates on its team.

In the current U.S. economic landscape, some sectors are clearly slowing, yet the Fed seems hesitant to acknowledge this, as they often rely on outdated data. It's worth recalling that the U.S. economy grew by 2.5 percent in late 2007, just before tipping into a recession.

As the Federal Reserve confronts the reality of its interest rate policy mistakes and prepares for rate cuts, the market could become increasingly unstable, especially with rising tensions in the Middle East. The recent extreme market swings suggest that investors are reducing their risk exposure amid significant uncertainty heading into the fall, due to an unprecedented series of events.

History shows that when the Fed is slow to react, market swings can become more pronounced. However, it's crucial to remember that such volatility can also present unique opportunities. (8.2.24)