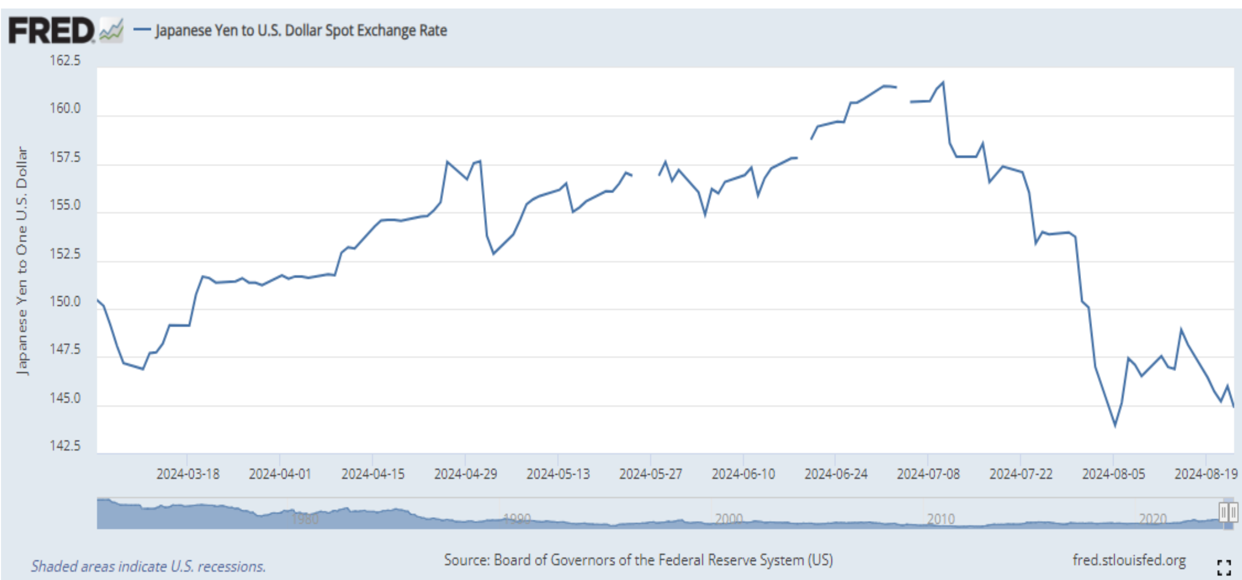
On Our Radar – September 2024

After a turbulent start to August, marked by global markets under pressure—most notably Japan's Nikkei 225 index plunging 12.4 percent in a single day—markets managed to recover, aided by central bank intervention, and closed out the month on a positive note. Despite the early decline, the S&P 500 index ended August with a 2.2 percent gain.

On August 1, 2024, the Dow Jones Industrial Average experienced a dramatic near-1000 point swing from intraday high to low, a volatility rarely seen in a stable market. Just days later, on August 5, 2024, a global market sell-off was triggered by Japan as the "yen carry trade" unraveled. The catalyst was the Bank of Japan (BOJ) raising interest rates to 25 basis points (0.25%)—the highest in seventeen years—which led to a sharp move in the U.S. dollar/yen exchange rate from about 160 to 142, forcing a rapid unwinding of massive leveraged positions.

For years, many investors had borrowed large sums in yen, often at near-zero or negative interest rates, to invest in higher-yielding assets—a strategy known as the "yen carry trade." This approach works as long as interest rate differentials and currency exchange rates remain relatively stable. However, when the dollar/yen exchange rate moved approximately 7 percent in a single day, these leveraged bets collapsed, forcing the unwinding of positions.



In response, the BOJ announced it would refrain from raising rates during periods of market instability, sparking a strong rally. Despite this, the underlying issue remains: the BOJ still needs to raise interest rates.

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)

At the Federal Reserve Bank of Kansas City's annual economic symposium in Jackson Hole, WY, Fed Chair Jerome Powell stated, "The time has come for policy to adjust," signaling that interest rates will likely be cut following the September 18, 2024, Federal Open Market Committee (FOMC) meeting.

While this news is welcome, as we highlighted last month, the 2-year Treasury yield has been suggesting since mid-2023 that the Fed should have considered lowering the federal funds rate. Unfortunately, the Fed appeared overly focused on lagging employment statistics, which, as we now know, were likely inflated by roughly 30 percent.

Although Mr. Powell attempted to downplay the Fed's earlier belief that inflation was "transitory," his speech notably lacked any acknowledgment that he led the push for the Fed's "makeup strategy" on inflation, a policy that allowed inflation to reach a 40-year high before the Fed acted.

Moreover, Mr. Powell has overlooked the fact that the Fed has been actively involved in monetizing a significant portion of U.S. government debt by purchasing billions of dollars' worth of bonds. The U.S. budget deficit for fiscal year 2024 is estimated to be around $1.7 trillion. As the renowned economist Milton Friedman famously stated, "Every budget is balanced. There is no such thing as an unbalanced federal budget. You are paying for it. If you are not paying for it in the form of explicit taxes, you are paying for it indirectly in the form of inflation or borrowing."

Valuation

Operating profit estimates for the S&P 500 remain in the range of $237 for 2024 and $276 for 2025. Based on these projections, the index is currently trading at roughly 20.5 times its expected 2025 earnings.

This Price-to-Earnings (P/E) ratio is fueled by optimism around continued earnings growth and the expectation that the Federal Reserve will cut interest rates later this month. However, if earnings growth stumbles or the Fed delivers an unexpected decision, the P/E ratio could face downward pressure.

Economic Cycle

The U.S. economy grew at a revised rate of 3.0 percent in the second quarter, up from the initial estimate of 2.8 percent. The Institute for Supply Management (ISM) reported that its manufacturing index rose to 47.2 last month, up from 46.8 in July, though any reading below 50 indicates contraction in the manufacturing sector.

The unemployment rate rose to 4.3 percent, the highest level since November 2021. Additionally, the Bureau of Labor Statistics annual benchmark payroll revision was minus 818,000, meaning that actual job growth was nearly 30 percent lower than initially reported. The magnitude of the revision raises doubts about the true strength of the U.S. economy.

Sentiment

In late July and early August, bullish sentiment in the stock market reached extreme levels, with readings surpassing 64 percent. The Bull-Bear spread also climbed above 49 percent, indicating that the market was highly susceptible to negative news. That news arrived in the form of a temporary collapse in the yen carry trade, triggering a brief yet sharp decline in global markets.

Since then, sentiment has stabilized, returning to more neutral levels.

Technical Factors

As we pointed out last month, the NASDAQ Composite reached an all-time high of 18,671 on July 11, 2024, 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.

Since then, the NASDAQ Composite has seen considerable volatility, with sharp moves in both directions, as capital seems to be rotating into other segments of the market. However, the percentage of stocks trading above their 50-day moving averages has surged past 80, signaling that the market may be approaching overbought territory.

Outlook

Market volatility has increased over the past few months, despite the recent rally in equities following the sharp selloff in early August. While the rally is noteworthy, it's important to recognize that many of the underlying causes of volatility, such as concerns about the sustainability of economic growth, federal debt and fiscal deficits, the U.S. election, and rising geopolitical tensions, remain unresolved.

A series of events, led by Japan, triggered the dramatic selloff, prompting central banks to intervene, albeit mostly through verbal assurances—such as pledging not to raise interest rates during times of instability. Although the Fed has signaled that interest rate cuts are imminent, it’s worth noting that they have often lagged in adjusting policy, which means much of the expected rate cut may already be factored into the market.

The upcoming election is likely to significantly impact policies, including corporate tax rates and capital gains taxes. However, it's crucial to remember that the next U.S. government funding bill is due by September 30, 2024, marking the end of the fiscal year. Congress must pass either a full appropriations bill or a continuing resolution to prevent a government shutdown. Amendments attached to the funding bill could heighten political tensions, potentially delaying the funding process.

Additionally, there is the potential for an automatic tax increase in 2025 due to the expiration of the personal income tax cuts from the Trump administration. While corporate tax cuts were made permanent—highlighting the influence of corporate interests in Washington—the individual tax cuts, worth about $150 billion in total, are set to expire.

Meanwhile, escalating tensions in the Middle East and increasing military aggression between Russia and Ukraine are unfolding at a time when there are legitimate questions about who is truly calling the shots at the White House. Given these unresolved issues, investors should be prepared for continued elevated volatility. (9.4.24)

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