TJT CAPITAL GROUP
REGISTERED INVESTMENT ADVISOR

On Our Radar – October 2024

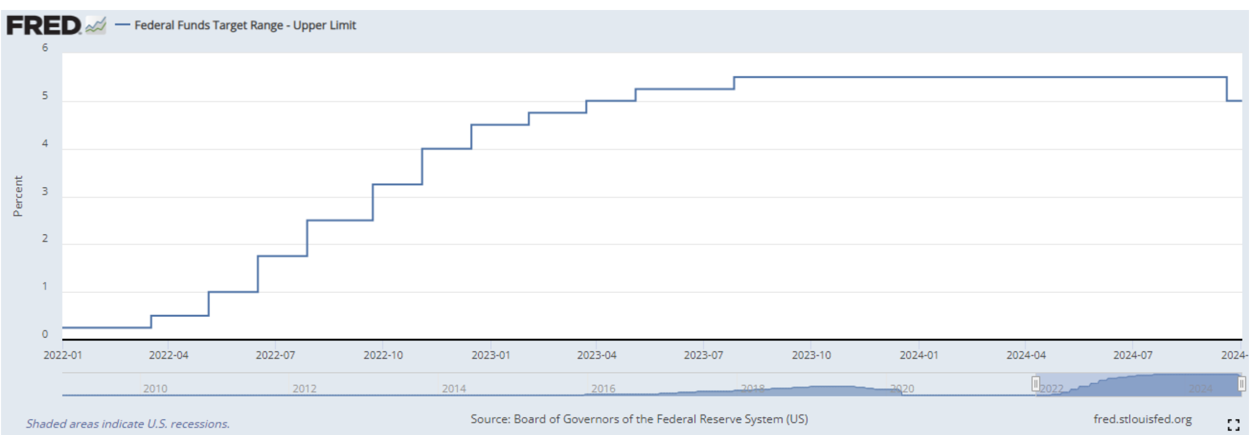
The Federal Reserve reduced the federal funds rate by 50 basis points (0.50%), bringing it to a range of 4.75 percent to 5.0 percent. This action helped lift the S&P 500 index by 2.0 percent in September. Meanwhile, the yield on the 10-year Treasury Note fell to 3.81 percent, down from 3.91 percent at the end of August, and the price of West Texas Intermediate (WTI) oil dropped by more than $6, settling at approximately $68.31 per barrel by the end of the month.

In our previous update, we noted that "rising geopolitical tensions remain unresolved." On October 1, 2024, Iran retaliated against Israel for recent strikes in southern Lebanon, further escalating tensions in the Middle East. Although the conflicts between Russia and Ukraine, and Israel and Hamas, have been ongoing, market desensitization should not lead to complacency. A senior White House official also warned that a direct military attack by Iran against Israel would result in severe consequences for Iran.

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 last Federal Open Market Committee (FOMC) meeting before the presidential election, the Federal Reserve opted for a 50-basis point (0.50%) interest rate cut, bringing the federal funds rate to a range of 4.75 percent to 5.0 percent. In our view, the choice of a half-point cut, rather than the more typical quarter-point, is no coincidence. As we noted in May 2024, "Given that this is an election year, despite official denials, the Fed is acutely aware of the potential political implications of its decisions."



We've long reminded investors that in September 2012, roughly seven weeks before a presidential election, the Ben Bernanke-led Fed launched the third round of quantitative easing (QE). Bernanke's rationale was that the economy wasn't growing fast enough, though this sluggishness was largely due to congressional gridlock, as both parties sought to avoid giving the other an advantage ahead of the election.

While Bernanke's move may have been well-intentioned, we have argued that it introduced further dysfunction, as Congress has since increasingly relied on the Fed to handle economic matters that should be its responsibility.

In his press conference following the recent rate cut, Fed Chairman Jerome Powell used the term "recalibration" nine times, seemingly providing the Fed with more flexibility to adjust policy going forward.

For example, Powell has long emphasized that the Fed would be "data dependent." However, in this press conference, he referenced "estimates" of an upcoming inflation report to justify the larger-than-expected rate cut. Let's hope these estimates are more accurate than the ones that led Powell to wait until inflation reached a 40-year high before raising rates.

The reality is that the Fed has been behind the curve for years. Initially, the Powell Fed made the bold assumption that inflation was too low, prompting the adoption of an inflation "make-up strategy." Then, unwilling to acknowledge this mistake, the Fed delayed raising interest rates for too long. More recently, as of late August 2024, the effective federal funds rate was 150 basis points (1.50 percentage points) above the yield on the 2-year Treasury Note, a clear indication that the Fed's interest rate policy was out of sync with the broader markets.

Valuation

Over the past few months, Operating earnings estimates for the S&P 500 for calendar year 2024 have declined from over $241 to around $236. Nevertheless, the equity market has rallied on a decline in inflation and the hope that the Federal Reserve continues to cut interest rates. However, the Price-to-Earnings (P/E) ratio has climbed from less than 22-times earnings to more than 24-times earnings.

Based on historical P/E ratios, the market's valuation has moved into more expensive territory. That does not mean that the market has to decline, it just means that one of the cushions - such as low valuation – is no longer present.

Economic Cycle

The final Gross Domestic Product (GDP) reading for the second quarter showed growth of 3.0 percent, a significant improvement from the 1.6 percent pace in the first quarter. Retail sales edged up 0.1 percent month-over-month, housing starts jumped 9.6 percent on a seasonally adjusted annual basis, and Industrial Production increased 0.8 percent month-over-month, though it remained flat compared to a year ago.

The Institute for Supply Management (ISM) Manufacturing Index came in at 47.2, signaling contraction, as any level below 50 indicates a slowdown. Notably, this data was recorded before approximately 50,000 members of the International Longshoremen's Association went on strike, marking their first walkout since 1977. This strike will disrupt shipments at ports from Maine to Texas, which handle about half of the nation's ocean shipping. The economic impact will largely depend on the duration of the work stoppage.

In the meantime, the Conference Board's Consumer Confidence Index fell sharply to 98.7 from 105.6, marking the largest one-month decline in three years, as concerns about a cooling job market contributed to the drop.

Sentiment

In recent months, market volatility has picked up, with investor sentiment closely mirroring the ups and downs. This dynamic was exemplified in the early August selloff and subsequent rebound and in September when the S&P 500 fell 4.1 percent in one week only to rebounded 4.0 percent the next.

In line with these swings, Bullish sentiment has seesawed, dipping to the low 40 percent range during declines and rallying to the mid-50 percent range during the recoveries. While these shifts don't indicate the extreme sentiment levels typically associated with market turning points, they do underscore the choppy conditions currently prevailing in markets.

Technical Factors

Similar to sentiment, the percentage of stocks trading above their 50-day moving averages has closely tracked market fluctuations. Over the past few months, this metric has oscillated between approximately 55 percent and 81 percent. Notably, readings above 80 percent typically indicate overbought conditions.

Although readings above 80 percent does not necessarily indicate an imminent reversal, it does increase the probability of a potential pause or shift in the market.

Outlook

In September, the European Central Bank (ECB) reduced interest rates by a quarter-point (0.25%) - the second cut in three months—and indicated that borrowing costs would likely continue to decline in the coming months as inflation eases and economic growth in the euro zone weakens.

Last month, we discussed the Japanese "yen carry trade," which briefly caused global markets to seize up overnight. Although markets quickly rebounded, the underlying issues remain unresolved. Last week, after the Tokyo Stock Exchange closed for the week, news emerged that Shigeru Ishiba was likely to become Japan's next Prime Minister. Japanese equity futures fell by about 5 percent in response. Mr. Ishiba supports the Bank of Japan's shift away from decades of ultra-loose monetary policy and favors gradually raising interest rates, which have hovered near zero for over a decade.

Meanwhile, China introduced a major policy change aimed at revitalizing its economic growth following a real estate crisis and rising debt issues. The People's Bank of China, the country's central bank, rolled out its largest stimulus package since the pandemic, lowering bank reserve requirements by 50 basis points (0.50%), unlocking about $142 billion for new lending, and injecting the equivalent of $10.6 billion in liquidity into the financial system. China's goal is to maintain an annual economic growth rate of around 5 percent.

Much like in August, the markets experienced a rocky start in early September, only to stage a strong recovery. The week ending September 6th saw the worst performance of 2024, with a 4.1 percent drop, followed by the best week of the year, as the markets rallied 4.0 percent by the week ending September 13th.

This level of volatility has been seen across other markets as well. For example, oil prices fell nearly 4 percent after Saudi Arabia abandoned its unofficial $100-per-barrel target and announced its readiness to increase production. However, as tensions in the Middle East escalated, oil prices quickly jumped again.

While inflation is cooling, prices are still rising, albeit at a slower pace, following the double-digit increases of recent years. Nevertheless, the Federal Reserve has signaled that it is ready to adopt a less restrictive interest rate policy. It appears that part of the Fed's "recalibration" involves shifting to a new preferred inflation gauge. For years, the Fed has focused on Core Personal Consumption Expenditures (Core PCE), which excludes food and energy prices, to measure inflation. Recently, however, the Fed has been highlighting the broader Personal Consumption Expenditures (PCE) measure to justify its recent rate cut. The key difference: Core PCE rose 2.7 percent year-over-year, while PCE increased by only 2.2 percent.

Regardless, with the economy growing, corporate profits on the rise, and the Federal Reserve signaling further interest rate cuts, market conditions appear favorable. However, it would be unwise to overlook escalating geopolitical risks.

In a speech at the United Nations last week, Israeli Prime Minister Benjamin Netanyahu warned Iran, "If you strike us, we will strike you." As this update goes to print, reports indicate that Iran has fired over 150 missiles at Israel. While this could be just another phase in the ongoing tensions in the region, with limited long-term effects on the economy or markets, investors should remain vigilant. (10.4.24)