TJT CAPITAL GROUP
REGISTERED INVESTMENT ADVISOR

On Our Radar – January 2025

The optimism sparked by Donald Trump's election, fueled by hopes for less regulation and lower taxes, hit a snag in December. The S&P 500 index fell 2.5 percent during the month, while interest rates on the 10-year U.S. Treasury Note climbed from 4.18 percent at the end of November to 4.58 percent by December 31, 2024. This increase reflected market unease following Federal Reserve Chairman Powell's efforts to justify a December rate cut. At the same time, oil prices rose over 3 percent, closing the year at approximately $71.72 per barrel.

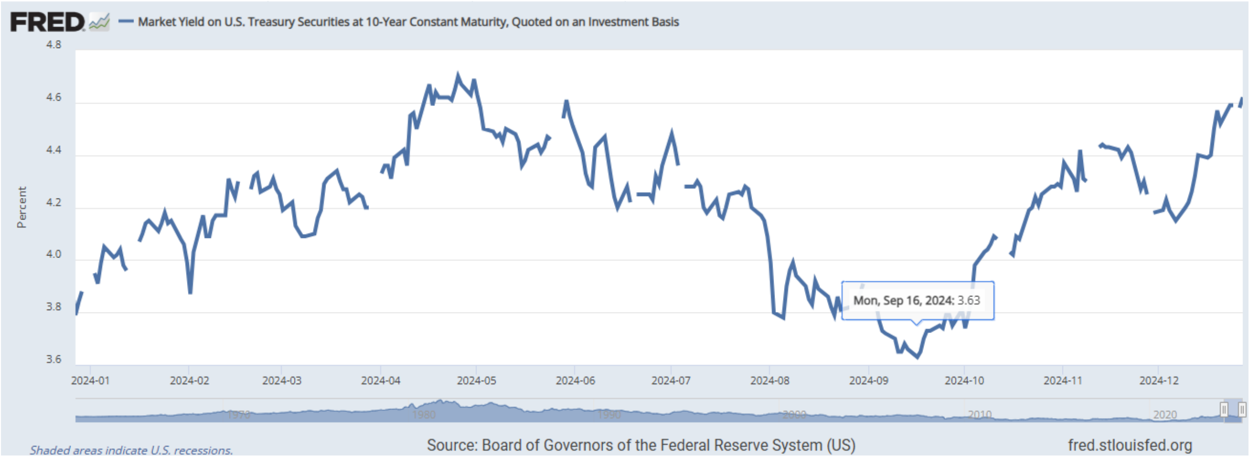
In late December, President Biden signed a continuing resolution that funds the government through March 14, 2025. The legislation also includes emergency disaster aid for hurricane-affected communities and support for farmers. This action averted another potential government shutdown. Notably, Congress last completed the full budget process with all appropriation bills on time in 1996.

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 Federal Open Market Committee (FOMC) lowered the federal funds rate by a quarter-point to a range of 4.25 percent to 4.50 percent. This move brings the benchmark rate down a full percentage point from its cycle high of 5.25 percent to 5.50 percent.

Despite the short-term rate cut, longer-term bond yields increased. Since mid-September, the 10-year U.S. Treasury yield has risen 95 basis points (0.95%), climbing from 3.63 percent to 4.58 percent, as shown in the accompanying chart. The bond market appears skeptical of Federal Reserve Chair Jerome Powell's rationale for the rate cut. If the Fed is truly data-dependent, as it claims, and core inflation (measured by Core Personal Consumption Expenditures) remains at 2.8 percent over the past year -above the Fed's 2 percent target - why cut rates now? Furthermore, the Fed's own projections indicate that inflation will tick higher in 2025, yet they anticipate it will take until 2027 to reach their 2 percent target.



Chair Powell's credibility was further strained when he remarked, "What I think people are feeling now is the effect of high prices, not high inflation." This statement is absurd. Inflation compounds, meaning when prices surged to 40-year highs before the Fed acted, and inflation continues to climb at 2.8 percent annually, consumers experience price increases layered on top of previous hikes. This compounding effect should be a basic concept, especially for a Fed Chair. Instead, Powell asserted that "inflation itself is way down." While the inflation rate has moderated from its historic highs, prices are still increasing year over year.

Reflecting this skepticism, the 2-year Treasury yield—often viewed as a proxy for market expectations of the federal funds rate—rose significantly. It ended December at 4.25 percent, up from 3.49 percent just three months earlier. This increase followed the Fed's adjustment of its 2025 headline inflation (Personal Consumption Expenditures) forecast to 2.5 percent, up from 2.1 percent.

Valuation

Operating profits for the S&P 500 index are expected to reach approximately $233 in 2024, translating to a Price/Earnings (P/E) ratio of about 25 times earnings. Looking ahead, earnings in 2025 are projected to grow by roughly 16%, bringing the forward P/E ratio down to nearly 22 times.

This elevated market valuation reflects optimism around higher earnings growth and expectations for lower interest rates from the Federal Reserve. However, with longer-term interest rates rising since the Fed began cutting short-term rates in September, any change to the narrative of strong earnings growth or lower rates could put downward pressure on the P/E ratio.

Economic Cycle

The U.S. economy's third-quarter growth was revised upward to 3.1 percent, compared to an earlier estimate of 2.8 percent. Retail sales increased by 0.7 percent, while the housing market showed mixed signals: existing home sales rose to an eight-month high, but housing starts fell 1.8 percent month-over-month.

Consumer Confidence dropped over 8 points in December to 104.7, reflecting some caution among consumers. In contrast, U.S. small business confidence surged, reaching its highest level in three and a half years.

Sentiment

As we often emphasize, market sentiment typically moves in tandem with the direction of market averages, both upward and downward. However, the key signal lies not in the general fluctuations of bullish or bearish sentiment but in the extremes at either end of the spectrum.

In late November and early December, bullish sentiment surged above 60 percent, likely driven by expectations of another Federal Reserve interest rate cut. Yet, when the Fed reduced rates by a quarter percentage point and the S&P 500 fell nearly 3 percent in a single day, bullish sentiment began to fall. By the end of the month, it had dropped by nearly ten percentage points.

Technical Factors

Since late November, the major equity indices have experienced a notable correction underneath the surface as seen in the percentage of stocks trading above their 50-day moving averages. About four weeks ago, nearly 70 percent of stocks were trading above this benchmark. By the end of the year, however, that number had plunged to less than 20 percent.

This shift reflects the impact of rising long-term interest rates, coupled with growing concerns over potential policy changes under the incoming Trump administration.

Outlook

The S&P 500 posted a gain of over 23 percent for the year, but December brought increased volatility. On December 18, 2024, markets reacted sharply to the Federal Reserve's cautious stance on further interest rate cuts. The Dow Jones Industrial Average fell 2.5 percent, the S&P 500 dropped 2.9 percent, and the NASDAQ Composite slid 3.5 percent in a single day. For December, the Russell 2000 index, which tracks small-cap companies, declined more than 8 percent.

By year-end, both the Dow and the S&P 500 closed at levels below their post-election highs on November 6, 2024, the day after Donald Trump's presidential victory. The NASDAQ Composite, however, managed a 1.7 percent gain over that period. Despite the post-election rally, many stocks have recently retreated as elevated valuations and uncertainty over the incoming administration's policies have weighed on investor sentiment.

Sectors such as pharmaceuticals and soft drinks are dealing with potential policy changes that could impact profitability. For instance, the possible elimination of pharmacy benefit managers or restrictions on soft drink purchases under the Supplemental Nutrition Assistance Program (SNAP) have raised questions about future earnings.

Additionally, concerns about tariffs loom large. If new tariffs are imposed, retaliatory measures from other countries could drive up inflation. Such developments would come at a time when the national debt has surpassed $36 trillion, a more than 55 percent increase since the first quarter of 2020. This trajectory is widely regarded as unsustainable and poses significant risks.

On the geopolitical front, instability persists. In Syria, decades of rule by Bashar al-Assad came to an abrupt end as rebel forces seized Damascus, forcing him to flee in a matter of days.

The markets are often sensitive to significant change, and there are many potential shifts on the horizon. While some proposed policies appear logical, history suggests that unexpected challenges and unintended consequences are inevitable. Adding to market uncertainty, recent reports indicate mutual fund managers have reduced cash holdings to record lows. This could amplify volatility in the short term, potentially creating both risks and opportunities in the near future. (1.3.25)

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