TJT CAPITAL GROUP

On Our Radar – September 2015

The Dow Jones Industrial Average (DJIA), S&P 500 and NASDAQ Composite fell 6.56 percent, 6.25 percent, and 6.85 percent, respectively, in August, which was highlighted by a dramatic 1089.42 point decline in the DJIA in the first ten minutes of trading on Monday August 24, 2015. That extreme selloff was shortly followed by a two-day rally of 988.33 points, the largest in history. Although last month we stated that trading in August "can subject the markets to large swings," and that "it is not unusual for periods of low volatility to be followed by periods of high volatility," we did not anticipate a decline of 1692.28 DJIA points in four days.

The catalyst for the decline seems to have been a combination of factors including the devaluation of the Chinese renminbi (yuan), which surprised the markets. On or about August 11, 2015, the International Monetary Fund (IMF) decided that the yuan would not be part of a reserve currency basket, at least for another year. Soon thereafter, China officially devalued their currency. As the U.S. plays a dominant role in the IMF, China's response may have been a way to retaliate against the U.S. In addition, a deceleration in China's economic growth along with a strong U.S. dollar have caused a massive bear market in commodities, led by the near 60 percent decline in the price of oil. This is putting further economic pressure on oil producing countries including Russia and Saudi Arabia.

Furthermore, there is growing concern about the Federal Reserve's unconventional monetary policy given that the federal funds rate is still at an emergency level of zero percent six years after the official end of the 2009 recession. The Fed is going to have to raise rates as the fallacy of their theories is starting to be exposed. For example, a recent working paper written by Stephen D. Williamson of the Federal Reserve Bank of St. Louis states that "there is no work, to my knowledge, that establishes a link from QE to the ultimate goals of the Fed - inflation and real economic activity. Indeed, casual evidence suggests that QE has been ineffective in increasing inflation." Mr. Williamson went on to say "QE causes inflation to fall," and that "The Fed has undershot its inflation target of 2% since early 2012."

The final piece of the waterfall decline in the last week of August may have been related to the Dow Theory, a technical tool that gave a "sell signal" at the close of business on Thursday August 20th. While the Dow Theory is part of our array of indicators, it is worth noting that the last major sell signals by the Dow Theory in August 2011 (a time when our overall risk indicators were in "Yellow" light territory) ultimately resulted in a "buy" signal at a higher price in December 2011. Back then, Standard & Poor's downgraded the credit rating of the United States, which caused the S&P 500 index to drop over 6 percent in one day. Nevertheless, at a minimum it signals a correction in the markets, the first one since the summer/fall of 2011. The typical correction process involves both time and price. That is, a significant decline followed by a reflex rally, then a "retest," or further bouts of weakness and rallies over a period of weeks or months as investors adjust positions.

As for the U.S. economy, it continues to grow at a slow and uneven pace. Second quarter Gross Domestic Product (GDP) was revised up to 3.7 percent from the previous estimate of 2.3 percent. And while durable goods rose 2 percent in July, the Institute for Supply Management (ISM) Manufacturing Index fell to 51.1 percent from July's reading of 52.7 percent and 53.5 percent in June. Nevertheless, there have been pockets of strength with housing starts near an 8-year high and auto sales that were better than expected.

Federal Reserve

The Federal Reserve seems intent on raising interest rates at some point if for no other reason than to get off the "zero lower bound," which has been in place since December

2008. While forward guidance was supposed to provide more clarity to the marketplace, the Fed originally said they would raise interest rates when the unemployment rate hit 6.5 percent. The July jobs report released in August showed unemployment at 5.3 percent. The Fed's moving of the goalposts over the past few years has caused more confusion than clarity.

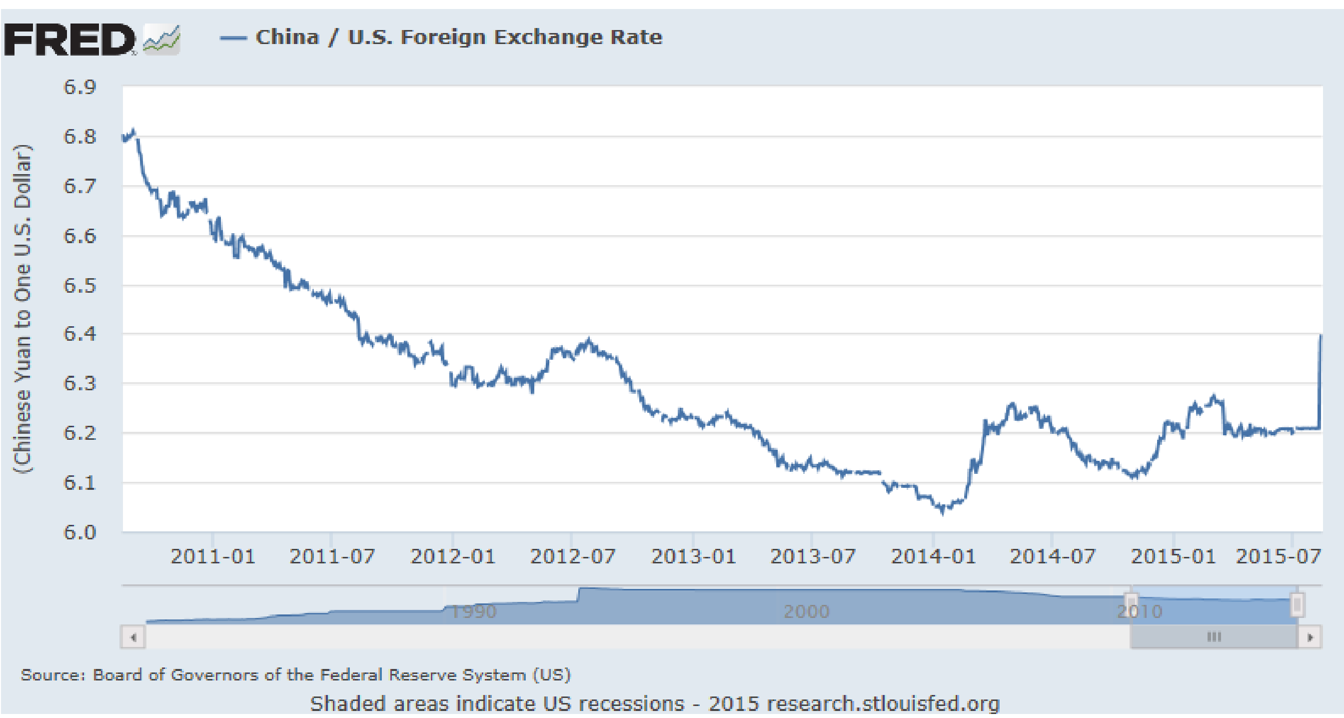
Federal Reserve Vice Chairman Stanley Fischer acknowledged that the Personal Consumption Expenditure (PCE) "index, excluding food and energy is up 1.2 percent over the past year" primarily due to a rise in the value of the U.S. dollar, lower commodity prices, and slower growth in China. This is well below the Fed's 2 percent inflation target. Mr. Fischer stated that the "path of interest rates matters more than the particular timing of the first increase." Nevertheless, he said that with "inflation low, we can probably remove accommodation at a gradual pace."

According to the Taylor rule, a monetary policy guide that provides "recommendations" for the level of interest rates, the Fed should have changed their zero interest rate policy back in 2010. What the Fed has essentially done is subsidize borrowers and penalized savers. In fact, year-to-date corporate bond issuance is at an all-time record. Moreover, global debt has grown to roughly $200 trillion, which is weighing on economic growth. As a result, countries will be under pressure to grow their economies, inflate their way out, and/or devalue their currencies in order to continue to service the debt. If, however, the Fed raises interest rates, it could place further pressure on international currencies. Nevertheless, Mr. Fischer closed his remarks by adding "I am well aware that, when the Federal Reserve tightens policy, this effects other economies," but he believes a strong U.S. would benefit the global economy.

Europe / Asia

The Eurozone economic recovery slowed in the second quarter as Gross Domestic Product (GDP) in the 19-nation region rose 0.3 percent. The massive increase in volatility in stocks, commodities, and currencies caused a so-called "flight to quality" with German 2-year bond yields falling to **minus** 0.21%. Once again, paying governments for the privilege of holding ones cash seems extreme, but it provides a glaring example of the overall level of concern.

China's economic challenges have certainly been a major catalyst for the recent weakness. The Shanghai Stock Composite fell roughly 38 percent in ten weeks, and the devaluation of the yuan against the U.S. dollar set-off a ripple effect in global markets. However, a glance at the following chart will show that China's currency peaked back in early 2014, roughly eighteen months ago (approximately 6.05 yuan to the dollar versus approximately 6.4 recently.) So while the markets were surprised by the move, the change in trend in the currency had been in place for some time.



Nevertheless, China's devaluation follows the decline in the euro, down roughly 20 percent year-over-year versus the U.S. dollar, and the Japanese yen, down about 14 percent year-over-year. There is no doubt that countries are trying to gain a competitive economic advantage by manipulating their currencies.

Outlook

Global markets including U.S. equities are undergoing their first correction since 2011. The equity bear market in China, uncertainty around the first interest rate hike by the Federal Reserve in nine years, and technical factors are causing adjustments in all assets. The massive decline in commodities took the CRB Commodities Index below the 200 level for the first time since May 2003, fueling concerns about global deflation.

As investors' fears escalate, it potentially causes a negative feedback loop, putting more pressure on both the financial markets and the real economy. An interesting paradox is that while central banks have created massive amounts of money with quantitative easing programs, market liquidity is low. Therefore, wide swings in a variety of assets have become the norm. For example, the price of a barrel of West Texas Intermediate oil rose nearly 25 percent in three days, only to fall more than 7 percent the next day. Substantial rallies, even in bear markets, are the rule not the exception.

Adding to wild market swings are the 2X and 3X "Ultra" and "Inverse" exchange traded funds (ETFs) on everything from oil to interest rates to stocks, bonds, currencies, and even volatility. Liquidity in markets has been low for even the most "liquid" markets, such as currencies and U.S. Treasuries. Traders jumping in and out of 2X and 3X bull and bear funds are having a dramatic impact on all markets. In addition, the Volker Rule - part of the Dodd-Frank Act that prevents banks from certain kinds of proprietary trading - went into effect on July 21, 2015. Therefore, a potentially large buyer (or seller) is no longer in the market. It is more than a bit ironic that the NASDAQ Composite made its all-time high on July 20, 2015, the day before.

When the Fed announced an "end" to their last round of quantitative easing on October 29, 2014 (be advised that the Fed continues to reinvest proceeds from their mortgage backed securities and U.S. Treasuries), the Dow Jones Industrial Average, S&P 500 and NASDAQ Composite stood at 16,974.31, 1982.30, and 4549.23, respectively. As of August 31, 2015 the Dow, S&P 500 and NASDAQ closed at 16,528.03, 1972.18, and 4776.51, respectively. Obviously, the NASDAQ Composite is the only major U.S. equity index that is higher. While the Fed knows full well that there is going to be a market adjustment to the slight change in policy, the reality is that the Fed's largesse took pressure off of the White House and Congress to enact fiscal reform. Unless and until both monetary policy and fiscal policy are working in tandem, economic growth is likely to be stuck in mediocrity.

At this point our "Traffic Light" risk indicator is still constructive, notwithstanding the significant volatility and recent decline. The Dow Jones Industrial Average experienced the largest two-day point decline in history followed by the largest two-day point advance. To summarize our current views, monetary policy is still accommodative and the yield curve is not close to being inverted (short-term interest rates above long-term rates). Economic growth is still positive with first half Gross Domestic Product (GDP) averaging 2.15 percent. We consider the markets to be trading at fair value, that is, not overvalued or undervalued. Investor sentiment - a contrary indicator - has recently exhibited signs of increased bearishness with the American Association of Individual Investors showing more bears than bulls. In addition, the number of bullish advisors from Investors Intelligence was recently the lowest since 2010. History suggests that if so many are bearish they have already reduced their exposure. Regarding market technical factors, on the negative side is the sell signal in the Dow Theory. Offsetting that is the fact that only 10.6 percent of stocks on the New York Stock Exchange are trading above their 50-day moving average. Historically, when that number gets below 15 percent it has been a good entry point.

For comparison, in 2000, when our “Traffic Light” turned negative, every one of the indicators was flashing a “Red” light. Currently, since only one of our components is “Red” (Dow Theory), we view this move a correction in a bull market and recommend adding to positions on weakness. Investors would do well to remember what famed economist and money manager John Maynard Keynes said, “It is largely the fluctuations which throw up the bargains and the uncertainty due to fluctuations which prevents other people from taking advantage of them.” (9.2.15)