TJT CAPITAL GROUP

On Our Radar – March 2016

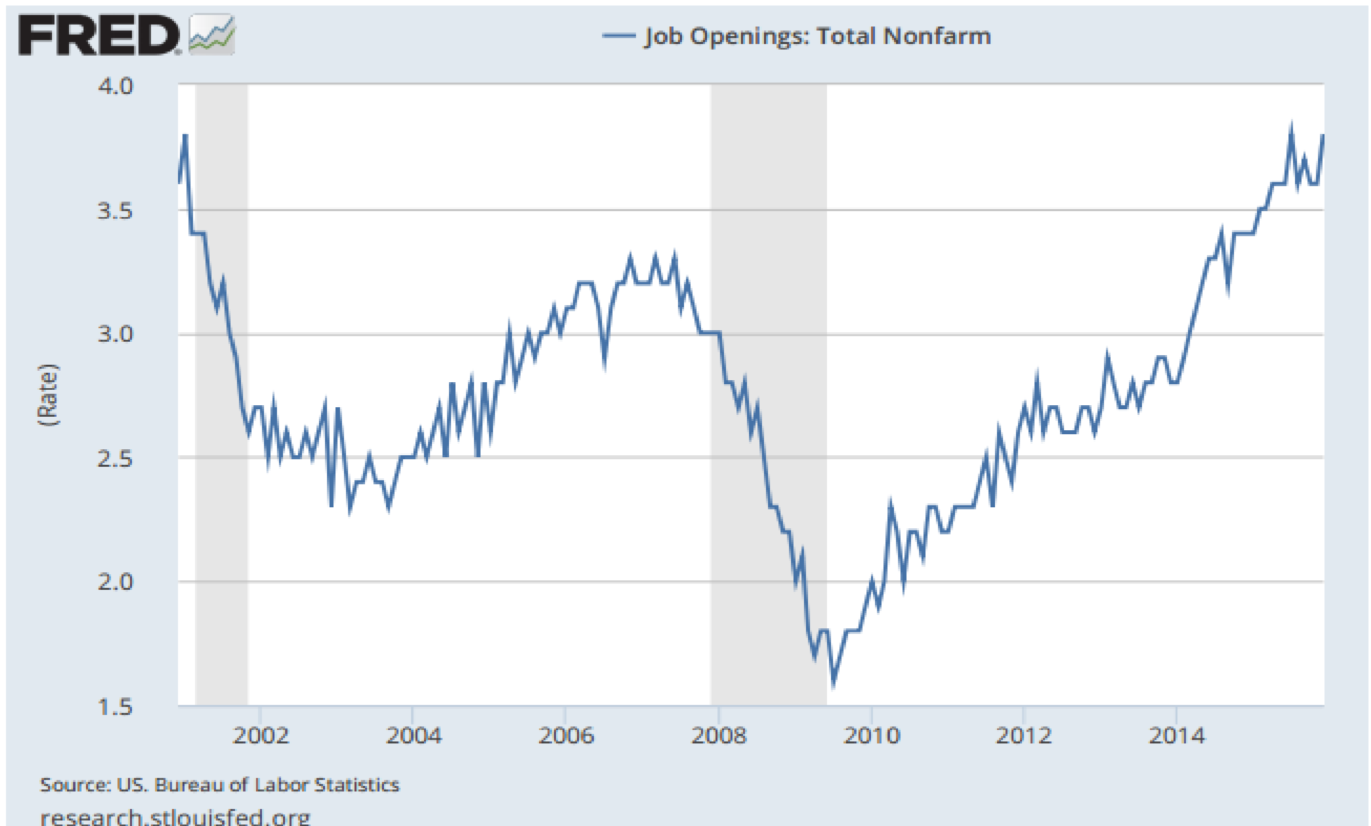
Markets across the globe continued to experience tremendous volatility in February on concerns about a slowing economy, a further collapse in oil (commodity) prices, lower corporate earnings, and the effects of a contentious election cycle against a backdrop of lower liquidity as a result of the implementation of the Volker Rule, part of the Dodd-Frank Act. In the U.S. stock market, roughly 60 percent of trading days in 2016 saw prices move in excess of 1 percent. To emphasize the point, on Monday February 22, 2016, the Dow Jones Industrial Average (DJIA) rose 220 points; on Tuesday, February 23rd, the DJIA fell 180 points; and on Wednesday, February 24th, the Dow declined 265 points before rallying to close the day with a gain of about 53 points.

Wild swings were also seen in the oil market, with a barrel of West Texas Intermediate (WTI) falling below $27 before ending the month north of $33. And the British pound fell from 1.46 to the U.S. dollar to 1.39, a decline of nearly 5 percent in a few weeks on concerns about a possible UK exit from the European Union (also known as “Brexit”). Meanwhile, the yield of the ten-year U.S. Treasury Note fell to a February low of 1.57 percent from 2.27 percent at year-end, only to close the month at 1.74 percent.

By mid-February it seemed that a number of investors were convinced that the U.S. economy was headed for a recession. A 10 percent to 20 percent decline in the price of oil is generally considered a positive development. However, a 70 percent decline has the potential to set-off non-linear events, such as sovereign wealth funds selling assets to meet budget requirements and bankruptcies for overleveraged companies.

The U.S. economy continues on its slow growth trajectory as a result of positives and negatives. Fourth quarter Gross Domestic Product (GDP) rose 1 percent on an annualized basis from an initial estimate of 0.7 percent. The number of Job openings suggests that employment growth will continue, and retail sales rose for the third

consecutive month, and are up 3.4 percent year-over-year. In addition, over that same time frame average hourly earnings are up 2.5 percent. The Institute for Supply Management (ISM) Non-manufacturing index, or services index, was 53.5 percent in January, down from 55.8 percent in December, but still signaling growth.



Meanwhile, the ISM Manufacturing index was 49.5 in February, up from January's reading of 48.2 percent. A reading below 50 indicates contraction, something that has occurred over the past four months due to the lingering effects of a strong dollar, slow global growth and the collapse in energy prices. The Conference Board Leading Economic Index (LEI) fell 0.2 percent in January following December's 0.3 percent decline, and the University of Michigan Consumer Sentiment fell to 91.7.

Federal Reserve

In light of the recent spike in volatility, Fed Vice Chairman Stanley Fischer acknowledged in a speech that they are “closely monitoring global economic and financial developments” following the first interest rate hike in many years. Mr. Fischer recognized the volatility caused by the “ongoing structural adjustments in China and the effects of the declines in the prices of oil and other commodities, “yet it was “difficult to judge the likely implications.” He reiterated that “monetary policy remains accommodative” and that there was a benefit “to maintaining a larger balance sheet for some time.”

Federal Reserve Bank of New York President William Dudley was more direct stating “financial conditions are considerably tighter than they were at the time of the December meeting.”

What is at stake is not just the Fed’s interest rate policy but their credibility. The fact of the matter is the Fed has engaged in historic monetary accommodation yet the U.S. economy has grown at roughly a 2 percent pace since mid-2009. Furthermore, the Fed’s own forecasts for economic growth and inflation have been consistently revised downward as economic reality has not come close to their theoretical expectations.

What’s more, less than two months after the Fed’s first interest rate hike in December 2015, and a forecast that suggested the possibility of as many as four interest rate hikes in 2016, Fed Chair Janet Yellen in Congressional testimony said the Fed was open to the possibility of negative interest rates. She said “I wouldn’t take [negative interest rates] off the table,“ although she did not expect the economy to require them. Nevertheless, just talking about negative interest rates does not instill confidence. In fact, the recent Fed stress tests for financial companies included a scenario where “short-term interest rates fall to negative ½ percent by mid-2016.”

Europe / Asia

The European Central bank (ECB) meets on March 10, 2016 to determine whether to embark on further monetary easing. The Eurozone Purchasing Managers Index for both manufacturing and services fell to 52.7 in February from 53.5 in January. In addition, consumer prices in the 19-nation bloc fell 0.2 percent in February, thereby providing incentive for further policy stimulus.

Adding to the anxiety in the region is an upcoming UK referendum on June 23, 2016 as to whether Britain should remain in the European Union (EU). The EU is an economic and political partnership involving 28 European countries and has been in effect since the end of World War II. It has essentially become a single marketplace, however, the biggest issues seem to be over immigration and negotiating individual trade agreements.

In Asia, the Japanese economy continues to struggle despite massive amounts of quantitative easing and negative interest rates. Exports dropped 12.9 percent yearover-year as demand weakened in China and other local markets. The Bank of Japan now charges lenders 0.1 percent to park reserves with the central bank, while the yield on Japan's 10-year government bond is negative 0.07%.

The People's Bank of China (PBOC) recently set the yuan at 6.545 compared to roughly 6.20 for most of 2015. Furthermore, the central bank cut the reserve requirement ratio by 0.50 percent (50 basis points) to 17 percent for all lenders. This recent move marks the fifth cut in the reserve requirement over the past twelve months in an effort to support the world's second largest economy.

Outlook

Sharp declines in a wide variety of markets and elevated levels of volatility are clearly

impacting investors. A recent report showed fund managers holding the highest cash balances since November 2001, and the Investors Intelligence Bull/Bear ratio fell to 0.63 in mid-February, the lowest reading since March 9, 2009.

There is no doubt that investors are becoming increasingly sensitive to volatility. The intensity of the recent decline cannot be ignored as the lows registered on February 11th exceeded the closing lows recorded on August 25, 2015. However, since the low point about two weeks ago, the Dow Jones Industrial Average, S&P 500 and NASDAQ Composite have gained 5.4 percent, 5.6 percent and 6.8 percent, respectively.

A lesson of 2008 is that illiquidity can be fatal, therefore, many choose to “shoot first” and ask questions later. A vast amount of money has gone into “alternative” strategies, including so-called smart beta or dynamic hedging products. Simply put, as markets decline those managers tend to purchase additional “insurance,” which tends to drive prices lower. Conversely, when prices rise there is a tendency to reduce negative exposure. Essentially they are looking for a perfect hedge, which does not exist.

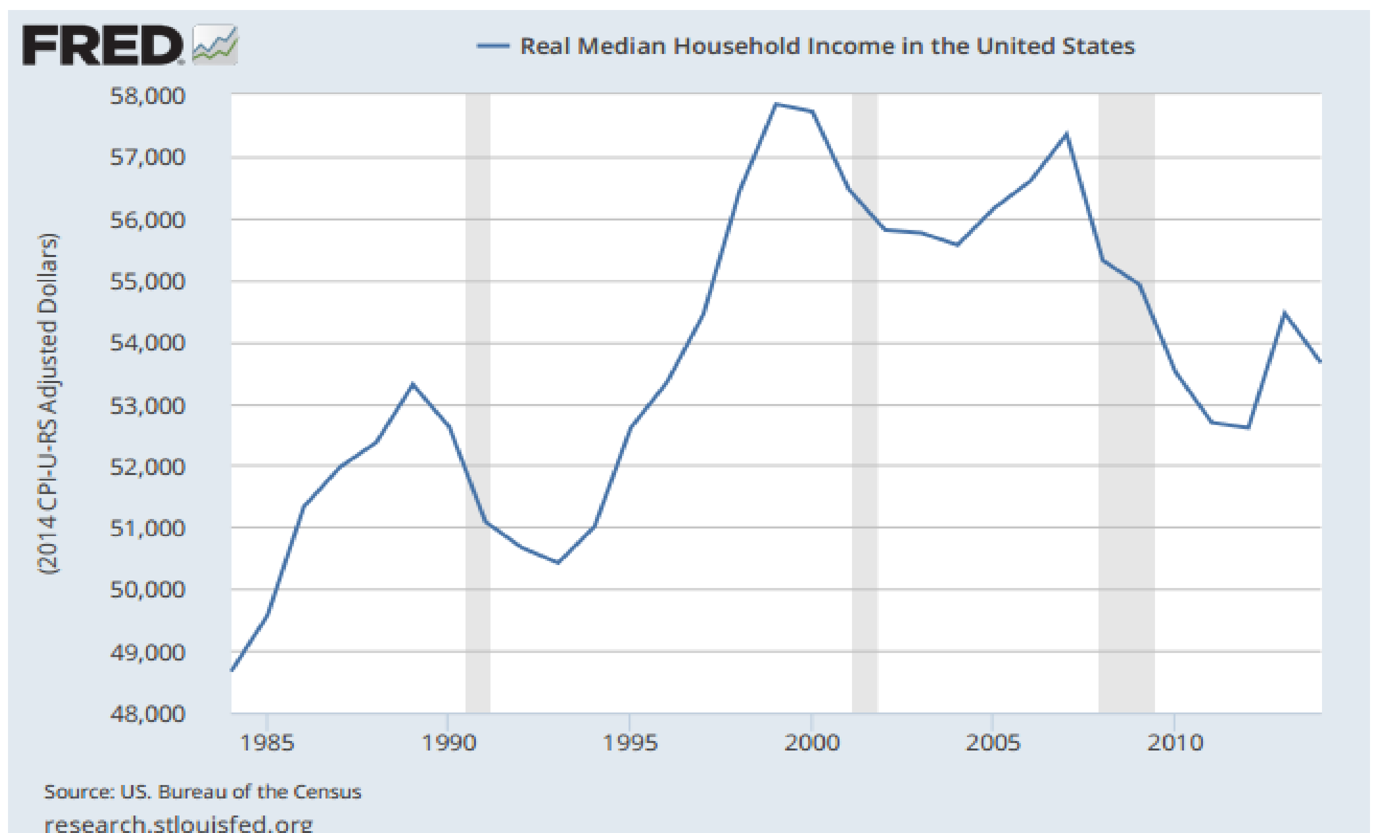
The fact of the matter is the markets are in many ways acting normally. After the first round of quantitative easing (“QE I”) the U.S. stock markets experienced a greater than ten percent correction. After the second round of quantitative easing (”QE II”) the U.S. markets experienced a greater than ten-percent correction. Since the end of “QE III,” the U.S. market experienced a greater than ten-percent correction. Nevertheless, at the end of February, the S&P 500 index was down approximately 5.4 percent year-to-date and off 9.3 percent from its all-time high.

There is no doubt that the U.S markets are facing headwinds. However, as Warren Buffett stated in his just-released annual report: “It’s an election year, and candidates can’t stop speaking about our country’s problems (which, of course, only they can solve). As a result of this negative drumbeat, many Americans now believe that their

children will not live as well as they themselves do. That view is dead wrong."

With a contentious election front and center, Mr. Buffett reminds us that "clashes of this sort have forever been with us – and will forever continue. Congress will be the battlefield; money and votes will be the weapons. Lobbying will remain a growth industry."

The mood of the markets seems to be consistent with the mood of the electorate. There is concern about the direction of the country, exploding debt levels, unfunded liabilities, an inept Congress, and real median income that are at levels last seen in the mid-to-late 1990s. In addition, there are concerns about the effectiveness of Federal Reserve/central bank policies. Ultra-low interest rates, enormous bond purchases, and lots of talk (forward guidance) have not generated the responses monetary theory expected.



On the other hand, a vast majority of investors are underweight equities and overweight bonds and cash given those well-recognized headwinds. Globally, the value of government bonds with negative interest rates is in excess of $6 trillion. Investors, therefore, are willing to pay governments money for the privilege of lending to them, which makes no sense to us.

As far as our Risk Model is concerned, monetary policy is still accommodative, notwithstanding the end of QE III a while back. The U.S. economy continues to grow, albeit slowly and unevenly, but we do not see a recession in the near term. With respect to valuation, we believe the market is undervalued as S&P 500 profits are expected to grow in 2016 to approximately $119. Investor sentiment – a contrary indicator – is extremely positive as we have seen recent data that is similar to that recorded at the March 2009 lows. Technically, the Dow Theory is on a “sell” signal, putting only one of five categories in negative territory. However, the near 15 percent rally in the Dow Jones Transportation Average since mid-January is not far from generating a “Buy” signal. Should that happen, equity exposure across the industry would likely move increase. Nevertheless, the combination of our five key variables keeps our risk “Traffic Light” in “green light” territory and we expect higher prices. Volatility, however, will likely remain high. (3.2.16)

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