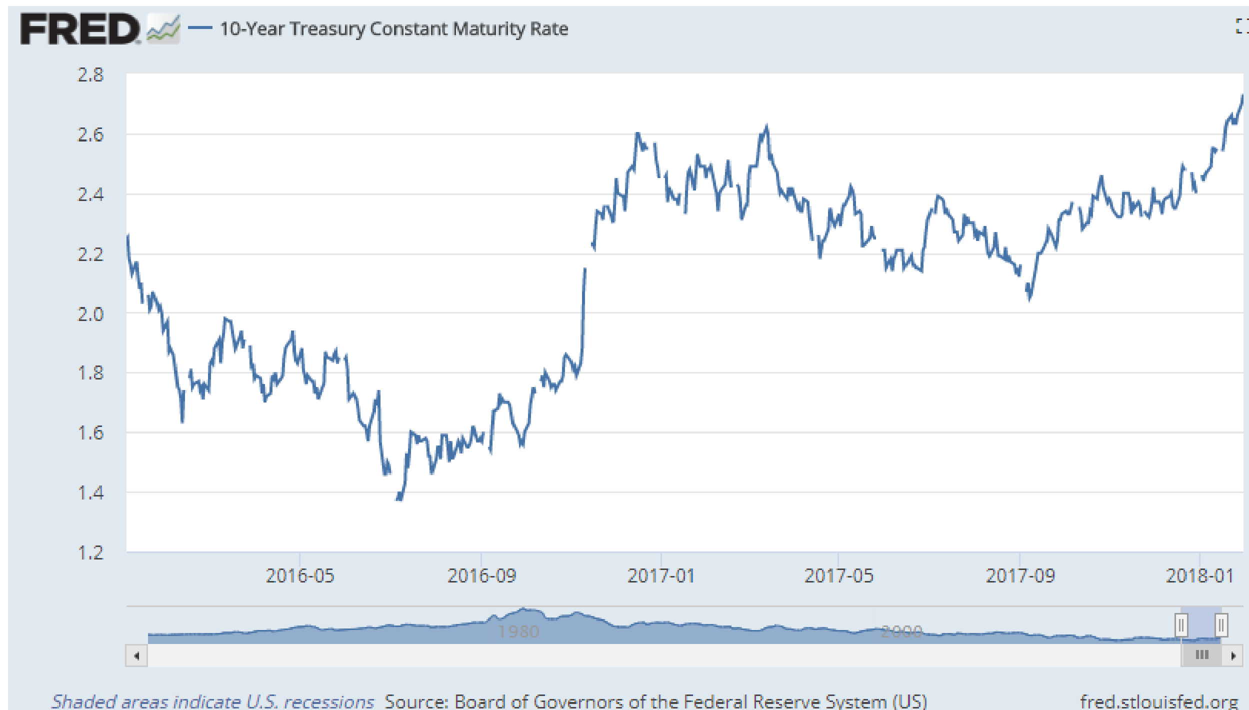
TJT CAPITAL GROUP

On Our Radar – February 2018

The upward momentum in U.S. stocks continued in January as the Dow Jones Industrial Average exceeded 26,000 for the first time in history on expectations for continued economic growth, higher corporate profits due to the new tax reform, and bullish sentiment.

The S&P 500 index gained 5.6 percent in January. Meanwhile, interest rates rose with the yield on the 10-year U.S. Treasury hitting 2.72 percent, the highest level in nearly four years and roughly double the yield from the summer of 2016 as seen below. What's more, the U.S. dollar has fallen about 3 percent in 2018, and is down roughly 13 percent against a basket of major currencies over the past year.



Gross Domestic Product (GDP) rose 2.6 percent in the fourth quarter and was up 2.5 percent for calendar year 2017, according to the Bureau of Economic Analysis. The

Leading Economic Index (LEI) rose 0.6 percent in December and Industrial Production rose 0.9 percent. The Conference Board Consumer Confidence Index increased to 125.4 in January, up from 123.1 in December.

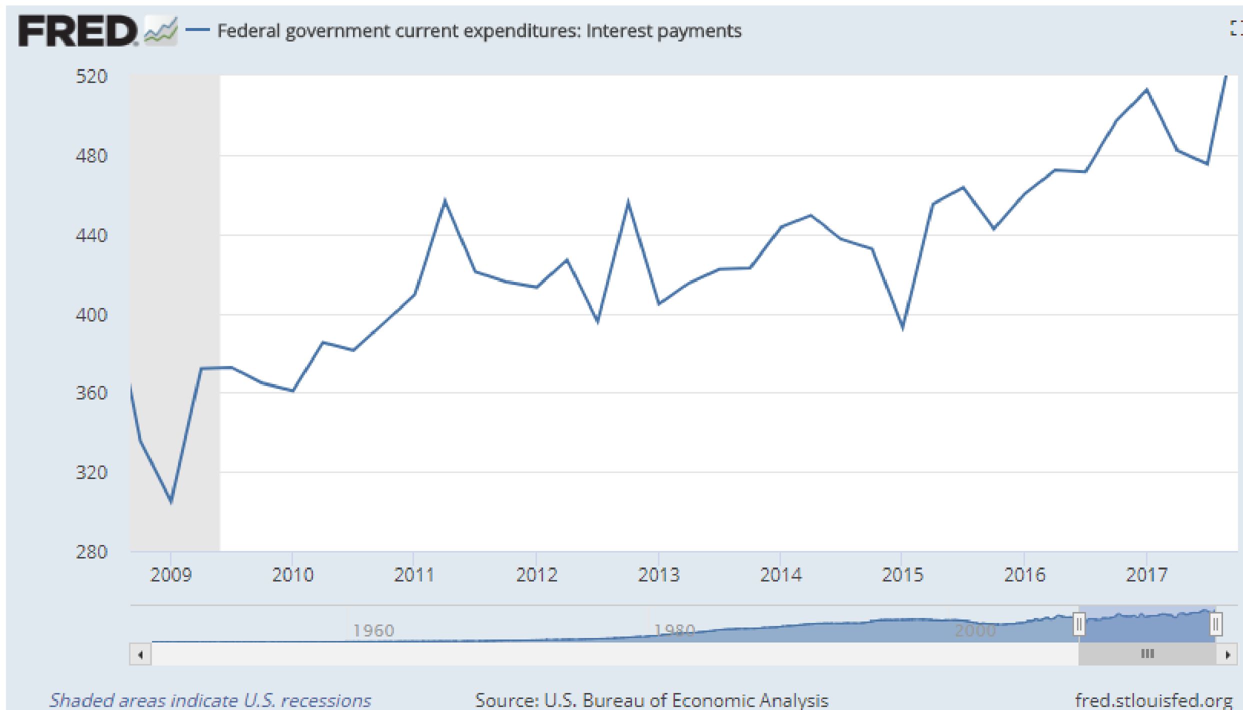
On the other hand, crude oil prices are up 15 percent year-over-year and the headline Consumer Price Index (CPI) rose 2.1 percent year-over-year.

Federal Reserve

The Senate confirmed Jerome "Jay" Powell as the next Chair of the Federal Reserve, and he will officially take over from Janet Yellen on February 3, 2018. The Federal Open Market Committee (FOMC) held its target range for the federal funds rate at 1.25 – 1.50 percent, however, the Committee expects further increases in short-term interest rates with expectations for the next move in March.

The Federal Reserve has increased interest rates five times after having been pegged at zero percent for years following the financial crisis. Nevertheless, Federal Reserve Bank of New York President William Dudley admitted that "financial conditions today are easier than when we started to remove monetary policy accommodation" despite 15 consecutive quarters of economic growth.

We have written for years about the Fed's seemingly obsessive focus on inflation, especially when it comes to determining monetary policy. Last fall Fed Governor Lael Brainard admitted that "inflation has come in stubbornly below target for five years," yet they do not know why. Clearly, low interest rates helped the federal government keep interest payments down despite a doubling of the federal debt to more than $20.2 trillion. However, interest payments have been on the rise after being relatively flat for years, as seen below, and further interest rate hikes will put more pressure on the federal budget.



Europe / Asia

The European Central Bank (ECB) kept interest rates at minus 0.40 percent on their overnight deposit facility and stated that they expect interest rates "to remain at their present levels for an extended period of time, and well past the horizon of the net asset purchases." The net asset purchases (quantitative easing) of 30 billion euros a month are intended to run until September 2018. However, the ECB has repeatedly stated that they stand ready to "increase the asset purchase programme in terms of size and/or duration."

The Eurozone economy grew 2.5 percent in the fourth quarter, and confidence in the economy was near a 17-year high. The German economy grew 2.2 percent in 2017, the fastest pace in six years. Meanwhile, the yield on German 5-year bonds rose 29 basis points (0.29%) in a month, bringing the yield up to 0.07 percent.

That backdrop caused German central bank President Jens Weidmann to say it would

be "appropriate" for the European Central Bank to stop its bond purchases this year.

The Bank of Japan (BOJ) said it would continue its massive stimulus program as “inflation expectations have moved sideways” recently, and that risks to prices remain “skewed to the downside.” Nevertheless, Japanese factory activity in January showed its strongest growth in nearly four years.

China’s economy grew at 6.9 percent in 2017, above the government’s target of 6.5 percent. China’s foreign currency reserves rose to $3.1 trillion, the highest in the world.

Outlook

Global markets have been supported by synchronized global growth and continued monetary accommodation by the major central banks. Clearly, the magnitude of the advance in the equity markets has been impressive, to say the least. However, after going well over a year without even a 3 percent pullback, there are signs that have been present prior to episodes of market turbulence in the past.

The first is rising interest rates. For example, interest rates on the two-year Treasury security have risen from 1.27 percent in September to 2.17 percent, a 90 basis point (0.90%) increase in about five months. The second is large inflows. According to a major bank, a record $102 billion has flowed into equity funds in January alone. The third is valuations. Although the new tax bill will reduce corporate taxes, the market’s advance has been greater than the increase in earnings estimates. The fourth is rising investor enthusiasm (complacency). A survey of investor “bulls” is the highest in more than 30 years. Add that to the record amount of money raised in January through initial public offerings (IPOs), the near-vertical rise of equity markets over the past few months, and the lowest cash levels in history at mutual funds and you have conditions in place for a pick-up in volatility.

That said, our risk model is still constructive, but it does not preclude a long overdue pullback. The U.S. economy is growing, corporate profits are rising, Federal Reserve's monetary policy is still accommodative and the trend of the market has been up. However, valuation is neutral as the S&P is near fair value and the bullish investor sentiment, a contrary indicator, is negative.

Moreover, the Dow Jones Industrial Average fell more than 300 points on January 30th. While only a 1.3 percent decline, it had been months since the market experienced a decline of that sort. In addition, the price of Bitcoin dropped more than 60 percent in the past five weeks. While Fed Chair Janet Yellen referred to Bitcoin as a speculative asset, the fact that a number of markets are seeing a pick-up in volatility is notable.

Another cause for concern is so many new financial products dominated by computer algorithms, a number of which are focused on momentum and not traditional fundamentals. A vast majority of these new products have not been tested over a full market cycle. Should volatility pick-up, the liquidity that markets have come to assume may not always be there. As such, it is no time to be complacent. (2.1.18)

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