TJT CAPITAL GROUP

On Our Radar – April 2018

The S&P 500 index experienced its first down quarter since 2015 on concerns about the rise in interest rates, a potential trade war with China, and privacy issues with some of the leading technology companies that may lead to increased regulation. The S&P 500 fell 2.68 percent in the month of March and was down 1.2 percent in the first quarter, excluding dividends.

Volatility has also returned to the markets with the S&P 500 registering six trading days of plus or minus 2 percent moves compared to zero in 2017. The Dow Jones Industrial Average (DJIA), more specifically, saw swings of minus 724, plus 669, minus 345 and plus 254 in the last few days of March.

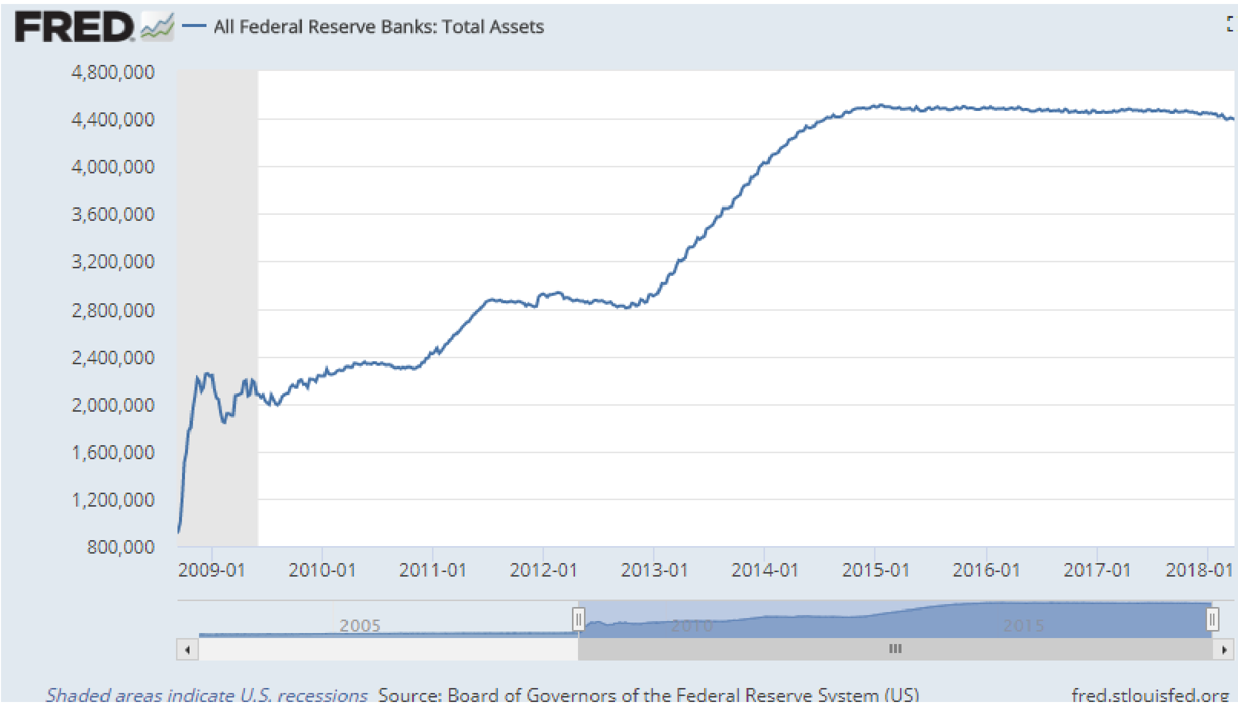
Interest rates have moved higher as the yield on the three month U.S. Treasury Bill rose to 1.73 percent from 1.39 percent at year-end, while the ten-year Treasury yield rose to 2.74 percent from 2.40 percent over the same period.

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)

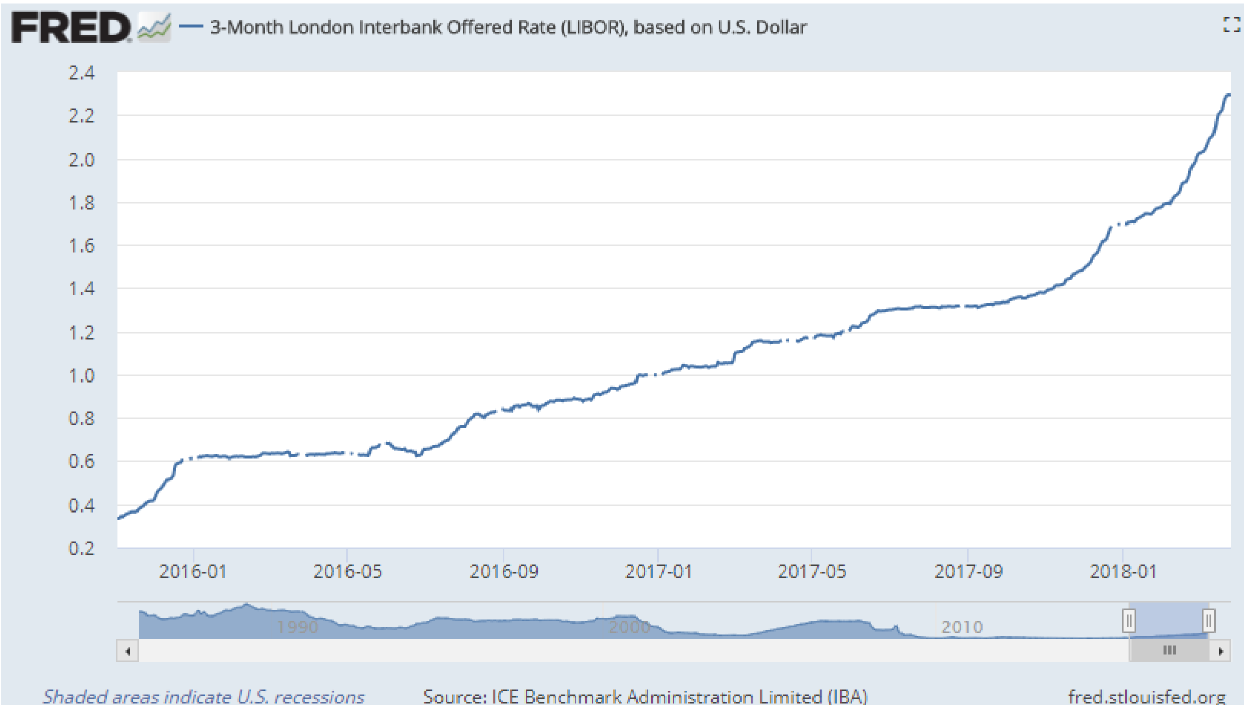
New Fed Chairman Jay Powell conducted his first press conference following the March Federal Open Market Committee (FOMC) meeting in which the Fed raised interest rates on federal funds by 0.25 percent (0.25%) to a range of 1.50 -1.75 percent. Chairman Powell affirmed his commitment to reducing the size of the Fed's balance sheet and gradually increasing short-term interest rates. The Fed's balance sheet, as seen in the adjacent chart, is approximately $4.39 trillion, down only 2.7 percent from its $4.51

trillion peak seen in early 2015.



The Fed expects the U.S. economy to grow by 2.7 percent in 2018, and increased their estimate of Gross Domestic Product (GDP) in 2019 to 2.4 percent, up from the previous forecast of 2.1 percent. According to the Fed, inflation is behaving as personal consumption expenditures (PCE) increased 1.8 percent year-over-year, below their target of 2 percent.

Although the federal funds rate rose to a new range of 1.50 percent to 1.75 percent, the yield on 3-month LIBOR (London Interbank Offered Rate) has risen to 2.31% as seen in the following chart. LIBOR is a base interest rate used to determine the borrowing costs for trillions of dollars, including some mortgages.



So while the Fed may be intent on gradually increasing the interest rate on federal funds, other market interest rates are moving up at a faster pace. That said, Chairman Powell indicated that the Fed intends to hike rates at least two more times in 2018 and possibly another three interest rate hikes in 2019.

Valuation

Current operating earnings for the S&P 500 for calendar year 2018 are estimated to be roughly $156, putting the forward Price/Earnings (P/E) ratio at roughly 17-times, which we consider to be in fair territory.

Economic Cycle

The U.S. economy grew at 2.9 percent in the fourth quarter of 2017 based on the latest revision, and 2.3 percent for calendar year 2017. Industrial Production increased by 1.1 percent in February and the Leading Economic Index (LEI) rose by 0.6 percent.

The Institute for Supply Management (ISM) Manufacturing Index decreased by 1.5 percentage points in March from the February reading, and the Conference Board Consumer Confidence index fell to 127.7 in March from 130 in February. Retail sales fell 0.1 percent month over month and pending home sales declined 4.7 percent.

Sentiment

Bullish advisor sentiment from Investors Intelligence has dropped to around 48 from a high of nearly 66 percent in late January. While the decline in the level of bullishness is welcome, as a contrary indicator it is still above levels that we consider to be positive.

So while bullish sentiment has come down off the extremes seen in late January, there seems to be a wide gap between what people say and what they do. For example, the NASDAQ 100 (symbol QQQ) exchange traded fund saw the largest weekly fund inflow in mid-March since the October 2000 high.

Technical Factors

With regard to the market technicals, not only has volatility increased and the upward trend changed, but the Dow Jones Industrial Average (DJIA) broke below its February 8, 2018 low. That is clearly a negative. Moreover, the Dow Jones Transportation Average (DJTA) is very close to breaching its February low as well, which would put the Dow Theory in negative territory.

Outlook

Markets around the globe are dealing with an elevated level of uncertainty including higher interest rates, a potential trade war with China, and rising geopolitical tensions. The U.S. trade deficit with China is roughly $375 billion, however, the real issue is over forced technology transfers and intellectual property rights.

While President Trump may understand his true end game when it comes to China, the global marketplace does not. Moreover, while Donald Trump tweeted “When a country (USA) is losing many billions of dollars on trade with virtually every country it does business with, trade wars are good, and easy to win.” China’s trade ministry responded by saying “the malicious practices of the U.S. are like opening Pandora’s Box, and there is a danger of triggering a chain reaction that will spread the virus of trade protectionism across the globe.”

China is also aware that the new Director of the White House National Trade Council wrote a book titled The Coming China Wars: Where They Will Be Fought, How They Can Be Won. A recent quote in the Global Times attributed to the ruling party said "American politicians better realize sooner rather than later that China would never submit if the U.S. launched a trade war."

In addition, tariffs tend to be inflationary simply due to the increase in cost. Reducing foreign competition, while perhaps noble in attempting to address a trade deficit, rarely results in lower prices for consumers.

What seems to be as important as trade tensions, if not more important although getting less press, was the recent passage of the Taiwan Travel Act, a law that encourages Taiwanese government officials to visit America and vice versa. The Chinese government warned recently that it will use “military pressure” against the United States if it does not “correct its mistake” of passing that law that was signed by President Trump.

In summary, the tailwinds provided by a growing economy, low interest rates and the anticipation of the tax cuts may be behind us for the time being. The markets are now dealing with headwinds in the form of a potential escalation of trade wars and rising geopolitical tensions.

Last month we wrote “A trade war, however, is potentially a game changer as it could increase costs, reduce profit margins, and inhibit the flow of goods.” That scenario seems to be playing out. How far it goes remains to be seen.

As for our indicators, monetary policy is still accommodative, although clearly less so than it has been as interest rates are clearly rising. The economy is growing, although President Trump’s call for 3 percent or greater economic growth does not seem to be in the cards according to the Federal Reserve, and valuation is in fair territory.

At this point three of our indicators including monetary policy, the economy and valuation are still constructive. Our sentiment and technical indicators, however, have moved into negative territory. As such, our overall risk model is still positive, but we are clearly in a more mature phase of the cycle. That said, we will remain vigilant to the incoming data for any improvement or deterioration in the indicators.

InVEST with confidence. Please call us if we can be of any assistance. (4.5.18)