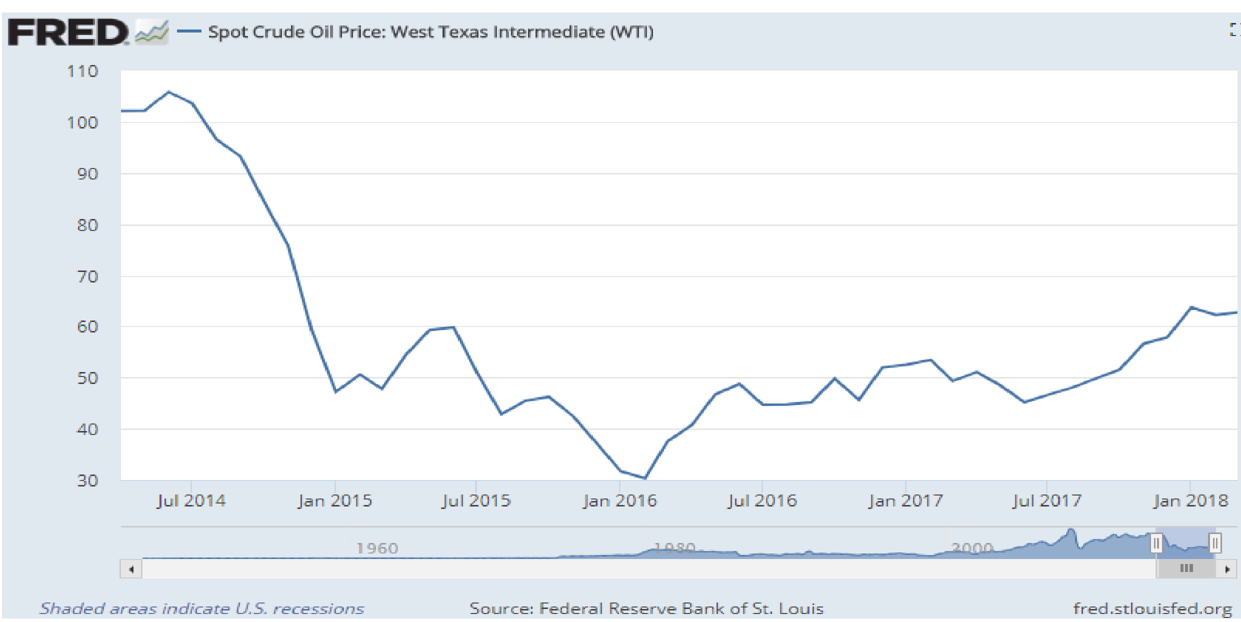
On Our Radar – May 2018

The U.S. stock market was roughly flat in the month of April following some wide swings, and both the S&P 500 Index and the bond market are down on a year-to-date basis, something that has not happened in years.

The stock market has been in a correction phase since late January and volatility has increased due to concerns of a potential trade war with China, rising interest rates, and growing tensions in Syria and Iran. Following President Trump's initial proposal to slap tariffs on steel and aluminum imports, China swiftly retaliated with announced tariffs of their own, including a 25 percent tariff on critical U.S. exports including soybeans, the biggest U.S. agricultural export to China, and airplanes. Although the proposed tariffs would not go into effect for months, if ever, clearly the threats are creating a heightened level of uncertainty for the markets.

Meanwhile, oil prices have been on the rise as a barrel of West Texas Intermediate hit $68, the highest level in four years as seen below, and the yield on the ten-year U.S. Treasury Note hit 3 percent during April, a level last seen in January 2014.



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) raised the federal funds rate by a quarter of a percentage point in March to a range of 1.50 percent to 1.75 percent. The recent minutes released from that March meeting said "all participants saw some further firming of the stance of monetary policy as likely to be warranted." Moreover, the minutes went on to say "the appropriate path for the federal funds rate over the next few years would likely be slightly steeper than [the Committee] had previously expected."

The fact of the matter is many interest rates have been rising faster than the federal funds rate as "real rates" (federal funds rate less the inflation rate) are still negative. Said another way, the markets are ahead of the Federal Reserve. That can be seen looking at the yield on the two-year U.S. Treasury Note, which has increased from 1.27 percent in September 2017, to 1.89 percent at year-end, to 2.49 percent on April 30th as seen in the following chart.

Valuation

Current operating earnings for the S&P 500 for calendar year 2018 are estimated to be roughly $158, up from about $124 in 2017, putting the Price/Earnings (P/E) ratio just below 17-times earnings. A large part of the earnings growth can be attributed to the recovery in the energy sector as well as the reduction in corporate taxes. With interest rates on the rise, we consider the market to be in fair-value territory.

Economic Cycle

The U.S. economy grew at an annual rate of 2.3 percent in the first quarter of 2018, according to the advanced estimate, down from the fourth quarter's pace of 2.9 percent. The Leading Economic Index (LEI) has registered positive reading in each of the past three months, and the Institute for Supply Management (ISM) manufacturing and nonmanufacturing surveys, although down from the previous highs, are both well above the growth/contraction line of 50.

The Conference Board Consumer Confidence index rose to 128.7 in April after dipping in March. Inflation, however, is gradually moving higher. The headline Consumer Price Index (CPI) rose 2.4 percent year-over-year, and the Federal Reserve's favorite inflation gauge, Personal Consumption Expenditures (PCE), increased 2.0 percent year-over-year.

Sentiment

Investor sentiment is quite bullish given the recent pullback in the market. The percentage of bullish advisers hovers near 50 despite the market dropping roughly ten percent from the late January highs.

Technical Factors

A number of technical indicators are negative. For example, the Dow Theory is in negative territory as both the Dow Jones Industrial Average and the Dow Jones Transportation Average broke below previous established lows.

Outlook

The correction in the U.S. stock market has been ongoing for the past three months. This is not unusual as the two major components of a correction are, by definition, time and price. The markets are adjusting to the new headwinds of higher interest rates, lower economic growth, and the risk of a trade war, among other things. Moreover, over the past 50 years the U.S. stock market has experienced a correction of sorts in years when there is a mid-term election.

Since the financial crisis, debt levels across the globe have skyrocketed. The U.S. federal debt has more than doubled since 2008 to roughly $20.5 trillion. In addition, the U.S. borrowed a record $488 billion in the first quarter of 2018, and the recent tax cuts and spending increases will increase the U.S. budget deficit to more than $1 trillion, according to the Congressional Budget Office. Given the explosion of debt, higher interest rates will at some point have a negative effect on the economy.

The market is also dealing with the uncertainty of President Trump's unprecedented – some would say radical - way of "negotiating" through his use of social media. For example, in early March he tweeted "trade wars are good, and easy to win." Then, in early April, as the stock market was under pressure, he tweeted "we are not in a trade war." With trillions of dollars invested in various instruments, including some leveraged algorithmic-programmed computer trading strategies, a simple tweet in a less liquid market could have unintended consequences.

In summary, large and growing deficits, rising interest rates and increased trade tensions have created headwinds for the markets. That said, the Federal Reserve's monetary policy is still accommodative, although much closer to neutral than they have been in years. The U.S. economy is growing, and corporate profits for the S&P 500 for calendar year 2018 are estimated to be $158. Therefore, the forward Price/Earnings (P/E) ratio is less than 17-times earnings, which we consider to be in fair-value territory.

On the other hand, investor sentiment is quite bullish despite the recent pullback and a number of technical indicators, such as the Dow Theory, are negative.

Overall, the combination of our major market indicators is still in constructive territory, though less so than in 2017 when all of them were flashing a "green" light. Therefore, we believe this correction is providing selective opportunities to deploy capital.

Do not hesitate to contact us if we can be of any help. InVEST with confidence. (5.1.18) personalized investment advice from TJT Capital Group, LLC. Please request a copy of our disclosure statement for further information.