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## On Our Radar – July 2018

Ongoing trade tensions dominated the headlines and market action in the month of June as concerns mounted that any tariffs imposed by the U.S. against our trading partners would be met with swift retaliation. The tit-for-tat threat of a trade war saw an escalation in rhetoric as China's President Xi reportedly said "In the West you have the notion that if somebody hits you on the left cheek, you turn the other cheek…In our culture we punch back."

Collectively, China, the European Union, and Canada, among others, have threatened or have actually begun to implement initial tariffs against the U.S., with a potential for more that could reach into the hundreds of billions of dollars in goods should negotiations stall.

Despite that, the S&P 500 index eked out a 0.48% gain in June, excluding dividends, with some wide swings based upon the headlines of the day. For the first half, the S&P 500 gained 1.67 percent, excluding dividends. Oil prices rose to their highest level since 2014 as a barrel of West Texas Intermediate crude traded above $74. The yield on the 10-year U.S. Treasury Note was 2.85 percent at the end of June, up from 2.40 percent at year end.

TJT Capital Group relies on our InVEST Risk Model ® to help determine whether we have bull market or bear market conditions, with a goal of participating in bull markets and protecting capital in bear markets. The following is an update on the 5 indicators that really matter.

### Interest Rates (Monetary Policy)

As expected, the Federal Open Market Committee (FOMC) raised interest rates on federal funds for the second time this year by 25 basis points, or (0.25 percent) in June, bringing the new target rate range to 1.75 percent to 2 percent. The FOMC meets in late July / early August, and again on September 25-26, 2018, and will likely raise interest rates at one of those meetings as the outlook for economic growth remains favorable, the unemployment rate is quite low, and inflation tracks higher.

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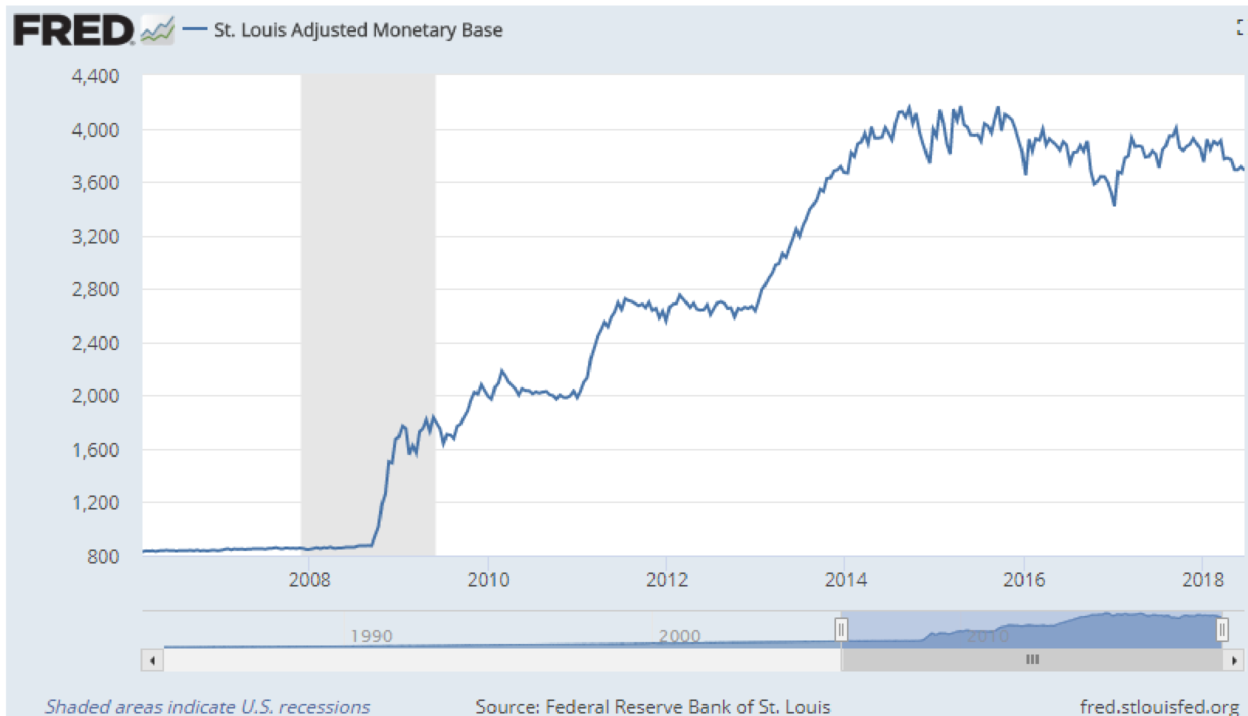
The Fed's favorite inflation measure is the index for Personal Consumption Expenditures (PCE), which increased 2 percent on a year-over-year basis, at the core level. That said, the "real" or inflation-adjusted federal funds rate is still technically negative as the lower range of the federal funds rate is below the inflation rate, which is striking more than nine years into an economic expansion.

While the Fed is adjusting the cost of money, however, they have not really made a dent in reducing the availability of money. As you can see in the adjacent chart, the adjusted monetary base is still quite high, especially compared to the pre-2008 financial-crisis level.




## Valuation

Operating earnings for the companies in the S&P 500 index are expected to be roughly $157 in calendar year 2018, which equates to a price/earnings (P/E) ratio of 17.3. We view valuation to be in fair-value territory, especially considering the current interest rate environment. As we enter the second half of the year, however, the market should start to look forward to 2019, where current profits estimates call for low double-digit growth.

## Economic Cycle

The U.S. economy grew at an annual rate of 2 percent in the first quarter, according to the third estimate, slightly lower than the previous estimate of 2.2 percent. The job market remains healthy with the unemployment rate at 3.8 percent, the lowest level in nearly two decades. The Institute for Supply Management (ISM) Manufacturing index was 60.2 percent in June, up 1.5 percent point from May's survey. Retail sales rose 0.8 percent in May, nearly twice the expected pace, and the Leading Economic Index (LEI) increased 0.2 percent in May, which bodes well for future growth.

However, uncertainty surrounding trade caused both The Conference Board Consumer Confidence Index and the University of Michigan Consumer Sentiment readings to decline. And higher oil prices will eventually result in higher inflation readings.

## Sentiment

After bullish sentiment peaked at a 30-year high in January, which coincided with the Dow Jones Industrial Average (DJIA) trading above 26,000, the level of euphoria died down as the market corrected. Since then, bullish sentiment has been range-bound, similar to a number of major market averages.

## Technical Factors

A majority of technical indicators are mixed, with some such as the Dow Theory currently on a “Sell” signal, while others are more neutral. This type of action is consistent with a market that is correcting. Some sectors are doing well, such as technology, while others, such as consumer staples and telecom, are underperforming.

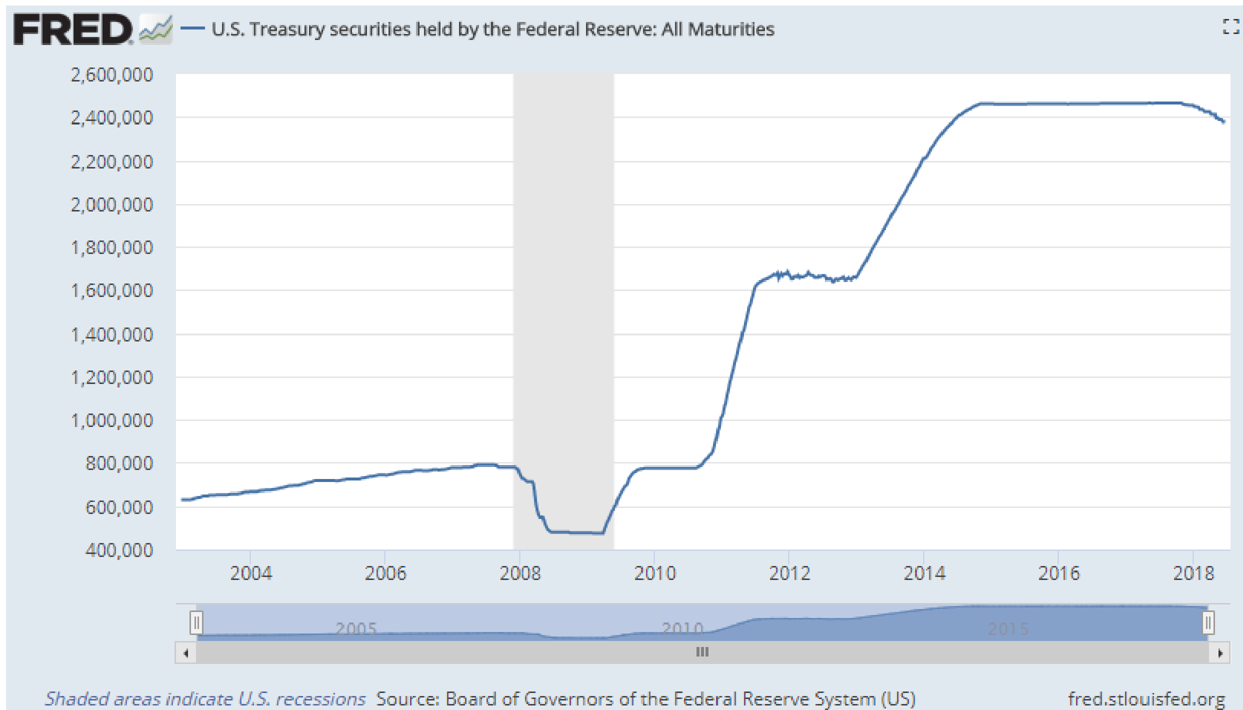
## Outlook

The European Central Bank (ECB) announced plans to continue their bond purchase program of 30 billion euros a month until the end of September 2018, and then expects to reduce the purchase amount to 15 billion euros a month until the end of December 2018. After December, the ECB will cease purchasing new bonds, although they will continue to reinvest principal payments from maturing securities "for an extended period of time…and for as long as necessary to maintain favourable liquidity conditions."

Moreover, as the ECB weans the market off their "non-standard monetary policy measures" (also known as massive bond purchases), the central bank said they will keep interest rates unchanged "through the summer of 2019." and "as long as necessary to ensure that the evolution of inflation remains aligned with the current expectation of a sustained adjustment path."

Massive liquidity injections by the world's largest central banks have had a major influence on assets prices over the years. Fed Chairman Powell said "the economy is doing very well," so the Fed plans to gradually return "interest rates to a more normal level." At the same time, the ECB is attempting to signal the end of its asset purchase program. Since this gradual exit from coordinated quantitative easing has never been done before, the central banks will attempt to slowly retreat while being sensitive to financial stability.

The Federal Reserve's balance sheet is roughly $4.1 trillion, of which approximately 58 percent or roughly $2.38 trillion is in U.S. Treasury securities as seen below. Therefore, so much is riding on the central banks to gradually ease their way out from under quantitative easing programs without making a policy mistake. As illustrated, the Fed actually reduced the size of their Treasury security holdings in 2008 just as the unemployment rate was rising, the subprime mortgage market was under intense pressure, and liquidity was evaporating. In an effort to prevent a repeat of that, the Fed will be conducting a press conference after every Federal Open Market Committee (FOMC) meeting beginning in January 2019 in an effort to better communicate their intentions.




Outside of a central bank policy error, the potential for an actual trade war is the biggest risk to the markets. The notion that you can have a trade war, should it actually escalate into that, without casualties, or where only one side wins, defies logic. New tariffs and regulations have already caused some steel prices to rise and other agricultural prices to fall.

So while the economy is doing well, uncertainty regarding trade is on the rise. Even within the administration there seems to be a lack of coordination or in some cases infighting, with respect to the approach with China. For example, U.S. Treasury Secretary Steve Mnuchin said it was "unfortunate" that the market got "mixed messages," during a particularly volatile trading session when, in fact, those other messages came from President Trump's Director of Trade.

It is important for Trump's team to get on the same page. With so much money in new and untested products, some of which involve leveraged algorithmic trading, liquidity can evaporate quickly. Moreover, a number of computer trading strategies are dominated by momentum, which is one of the reasons why the Dow Jones Industrial Average was down eight days in a row during June.

Nevertheless, rather than get caught up in the headlines of the day, which almost always contain both positive and challenging issues, we continue to focus on the key variables that have historically had the greatest influence on market prices. The tug of war on trade, ongoing political discourse, and debates on policy are unlikely to go away anytime soon. That said, the outlook for economic growth remains favorable, the Federal Reserve's policy remains accommodative, although less so than it was, and corporate profits are on the rise. Those factors are constructive and suggest higher prices ahead.

On the other hand, investors' sentiment is still relatively robust, which is a contrary indicator, and the trend of the market has been, for the most part, sideways to down since late January. Corrections are the rule, not the exception, especially in years when there is a mid-term election.

While volatility could remain high until trade policy gets resolved, our outlook remains constructive despite some headwinds, and would use weakness as an opportunity to increase exposure.

So, if what you have been doing has not been as effective as it could be, give us a call because we can help. (7.3.18)

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