TJT CAPITAL GROUP

On Our Radar – August 2018

The equity market rallied in July despite the fact that the official trade war with China commenced on July 6, 2018. As President Trump had been threatening China with tariffs for months leading up to that date, it allowed ample time for hedges to be put on to protect against a falling market. As the world did not come to an end in early July, many of those hedges were removed, cash came in, and the market rallied.

The relief rally has not eliminated the uncertainty around a protracted trade war with China, which continues to be a potential headwind for the markets. As with any "war," there are always casualties, notwithstanding President Trump's tweet that "Trade wars are good and easy to win." Some studies have estimated that agricultural farmers have losses in excess of the $12 billion in farm aid that the Trump administration has pledged to mitigate the effects of tariffs.

The U.S. trade deficit with China was approximately $375 billion last year, although there are nuances to that figure. For example, some technology products that are made in South Korea are sent to China for testing and packaging. Therefore, most of the value of those components is not produced in China. Nevertheless, President Trump's goal is to reduce the size of the trade deficit.

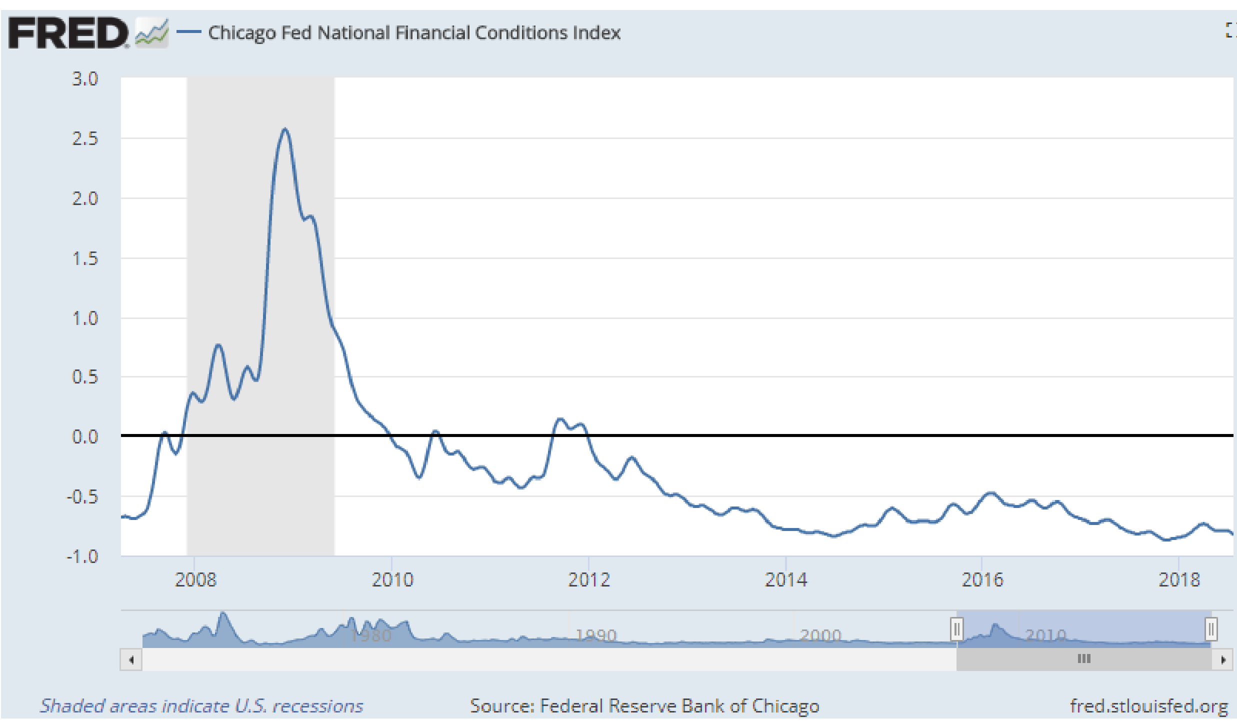
TJT Capital Group's InVEST Risk Model® has helped our clients participate in bull markets and protect capital from the devastation of bear markets by focusing on 5 indicators that really matter when it comes to determining the health and direction of markets. The following is the most recent update.

Interest Rates (Monetary Policy)

Chairman Jerome Powell commented at the Semiannual Monetary Report to Congress that the job market continued to strengthen, the unemployment rate is near the lowest level of the past two decades, and that inflation (Personal Consumption Expenditures) “increased 2.3 percent over the twelve months ending in May.” As such, the Fed would look to “gradually return interest rates to a more normal level without disrupting financial markets or the economy.”

The size of the Fed’s balance sheet is approximately $4.27 trillion, down only about 5 percent from the peak of roughly $4.5 trillion seen in January 2015. The Fed is extremely concerned about financial stability, and is trying to wean the markets off of their quantitative easing program without tightening financial conditions too much.

As seen in the accompanying chart, when financial conditions tighten materially, as they did in late 2007, it is usually a harbinger of difficult times as liquidity in the economy evaporates. The Fed is well aware of this, which is why they are gradually changing policy. Nevertheless, interest rates continue to move higher.



Valuation

Current operating earnings for the S&P 500 for calendar year 2018 are estimated to be roughly $158, with estimates for calendar year 2019 at about $175. Much of the increase is due to the corporate tax cut and the recovery in the energy sector.

As we enter the fall season, the market should start to discount the 2019 earnings. At the end of July the S&P P/E (price/earnings) ratio was 18.8-times 2018 estimates, and approximately 16-times 2019 earnings estimates. With interest rates and inflation still relatively low, we view equity market valuation to be in fair territory.

Economic Cycle

The markets were also boosted by solid economic and earnings reports. The U.S. economy grew at a 4.1 percent pace in the second quarter, up from the 2.2 percent pace seen in the first quarter, and the best quarter since the third quarter of 2014. Ironically, some of the growth was actually due to the impending trade war as companies stockpiled additional inventory in advance.

The Leading Economic Index (LEI) rose 0.5 percent in June, suggesting continued growth ahead, and aggregate corporate earnings were running more than 20 percent ahead of a year ago figures, with a good portion of that due to the tax cut.

On the other hand, existing home sales dropped for the third straight month, and purchases of new homes is at the slowest pace in eight months. In addition, the Consumer Confidence index was 127.4 in July, down from 130.8 in the first quarter.

Sentiment

Bullish advisor sentiment from Investors Intelligence was 54.9 percent at month end.

We view bullish sentiment as a contrary indicator as a higher number implies that money has already been invested. Therefore, the relatively high bullish sentiment is actually a negative in our view.

Technical Factors

A number of technical factors that we look at are mixed, with some positives and negatives. This is consistent with the choppy action the market has experienced since late January. The last signal from the Dow Theory, for example, was a "sell" signal.

Outlook

The European Central Bank (ECB) announced that they expect key interest rates to remain at their present levels "at least through the summer of 2019, and in any case for as long as necessary" to ensure that inflation moves close to their 2 percent target. The ECB will continue to purchase 30 billion euros worth of bonds until the end of September, and then reduce the monthly purchase amount to 15 billion euros until the end of December 2018.

Nevertheless, interest rates have been moving up in many countries, albeit from a low level.

Despite the initial reaction by the U.S. equity markets, a protracted trade war with China is a real possibility, which would have major longer-term implications. Bond markets are already becoming increasingly jittery as input prices rise at a time when central banks attempt to extract themselves from years of massive bond purchases. Considering the explosion of debt since the financial crisis, real bond market weakness could spill over to stocks.

Following a nine year equity bull market, with federal debt in excess of $21 trillion –

more than double the 2008 amount, and with a surge of new investment products that have not been tested in a tough market, the stakes are high.

The narrative (from the Trump administration) seems to be that China has more to lose, so that it is just a matter of time before China is forced to concede. Hence President Trump's tweet that "Trade wars are good, and easy to win."

For background, in late May it appeared as though U.S. Treasury Secretary Steve Mnuchin had negotiated a deal with China for them to purchase more U.S. products and reduce the size of the trade deficit. President Trump reportedly nixed that deal. Then, as July 6th approached, China's finance ministry stated that they would "absolutely not fire the first shot" in a trade war.

Tariffs were initiated by the U.S. on July 6th on roughly $34 billion worth of imports. China followed suit. Then, Larry Kudlow, chief economic adviser, publicly stated that China's President Xi Jinping doesn't want to make a deal. A spokeswoman for China's foreign ministry said Mr. Kudlow "distorted the facts and made bogus accusations" which was "shocking and beyond imagination." She further stated that the U.S. "flipflopping and promise-breaking is recognized globally."

President Trump met with Jean-Claude Junker, President of the European Commission, in late July to talk trade. Following that meeting, President Trump tweeted "European Union leaders told me that they would start buying soybeans from our great farmers immediately." However, Mr. Junker told reporters that the U.S. "heavily insisted to insert the whole field of agricultural products [soybeans]…We refused that."

Nevertheless, following that meeting Larry Kudlow said the "U.S. and EU will be allied in the fight against China." Mr. Kudlow believes that increasing tariffs on China will bring them to the negotiating table. Yet in that same interview Mr. Kudlow admitted that communications with China “have gone very dark.”

On July 31st the U.S. markets rallied on a report that hinted trade negotiations with China were going to restart. However, less than a day later President Trump threatened China with tariffs on an additional $200 billion worth of goods.

Clearly we are dealing with a high level of uncertainty, which could cause another spike in volatility similar to what we saw in late January/early February. There are always casualties in war, and the Trump administration may be overplaying their hand and underestimating China’s resolve. The U.S. has an important mid-term election in less than 100 days; China’s President Xi Jinping is essentially leader for life. Moreover, China’s economic nationalism has led to boycotts of certain foreign brands in the past.

Trade aside, the major variables that have historically been favorable to the markets are present. The economy is growing, corporate profits are on the rise, and interest rates, while moving up – are not at the levels that have been hostile to economic growth in the past. Investor sentiment, however, a contrary indicator, is more bullish than we would like to see given the uncertainty around trade. And our technical work is neutral with both positives and negatives.

That said, significant uncertainty exists due specifically to the trade issue. Tariffs cause prices to rise, which eventually flows through to the consumer. Moreover, tariffs can wreak havoc with one’s supply chain as lead times for materials are pushed out and companies are forced to scramble to find additional resources. In addition, many companies are not going to look to expand capacity until we are closer to a resolution.

So while our $20 trillion economy is not going to be hurt by a few weeks of higher prices, the market is not priced for a long trade war. As a reminder, issues with China have caused spikes in volatility in the past, such as August 2015 (DJIA down 1000 points in a day) and January-February 2016 (S&P 500 down about 11 percent). As such, we will be very vigilant as to how this plays out.

Do not hesitate to contact us if we can be of any help. **InVEST** with confidence. (8.2.18)