On Our Radar – September 2018

The S&P 500 index rallied in the month of August to close above the 2900 level for the first time in history. At 2901.52, the S&P gained roughly 3 percent in August as a strong dollar attracted foreign capital, in addition to a healthy U.S. economy, accommodative Federal Reserve policy, and higher corporate profits.

Another factor in the market's advance has been "short covering" as negative bets placed in anticipation of a market decline due to the ongoing trade war, political uncertainty, and the rout in some emerging market currencies (Turkish lira, Argentina peso, South Africa rand), did not materialize. As such, a number of those bets turned into "buy" orders as the market advanced.

Much has been said about this being the longest bull market on record, which, all things being equal, might have some significance. As discussed later, things are far from resembling the bull market conditions of the 1990s.

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) decided to maintain the target range for the federal funds rate at 1.75 percent to 2.00 percent. They did so despite stating that "the labor market has continued to strengthen and that economic activity has been rising at a strong rate. Job gains have been strong, on average, in recent months, and the unemployment rate has stayed low. Household spending and business fixed investment have grown strongly."

The FOMC is scheduled to meet again on September 25-26, 2018 and is expected to raise interest rates on the federal funds rate by 25 basis points or 0.25 percentage points.

Of more significance was the speech given by Federal Reserve Chairman Jerome Powell at the Jackson Hole, WY symposium, whereby he spoke of the Fed's dilemma of "moving too fast and needlessly shortening the expansion, versus moving too slowly and risking a destabilizing overheating." He then proceeded to advocate for the "Brainard principle," which recommends that you should take a cautious approach to monetary policy when you are uncertain about the effects of your actions.

In what can be described as revisionist history, Chairman Powell also provided a boost to the markets as he highlighted former Fed Chair Alan Greenspan's seemingly successful approach to monetary policy. Ironically, many believe it was Greenspan's overly loose policies that were responsible, in large part, to the technology and real estate excesses that developed prior to the last two bear markets. In fact in March 2000, at the peak of the previous tech bubble, Alan Greenspan said regarding "lofty equity values"…"And I see nothing to suggest that these opportunities will peter out any time soon."

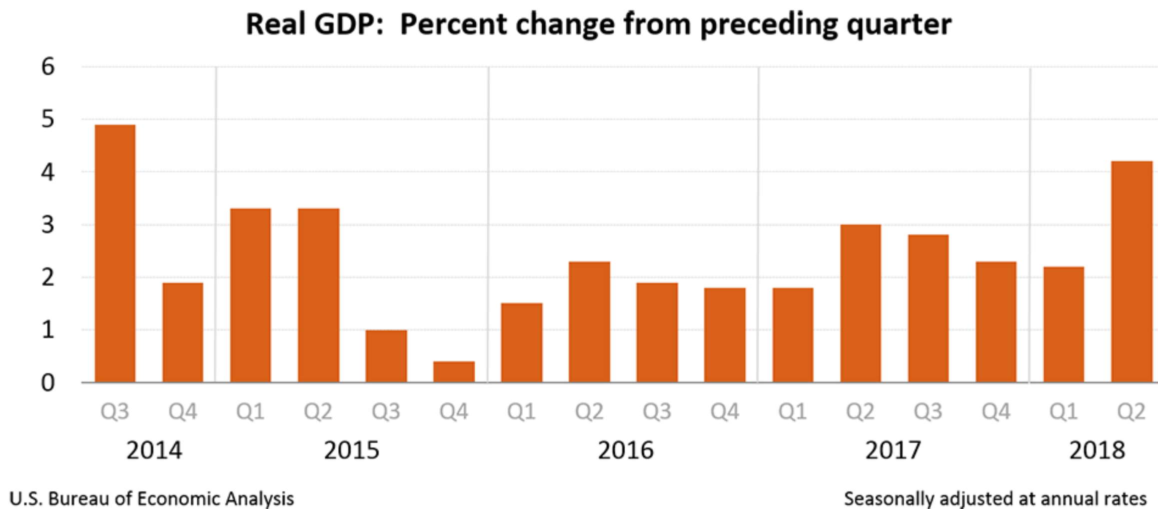
Valuation

Operating earnings for the S&P 500 for calendar year 2018 are estimated to be roughly $157, putting the current-year Price/Earnings (P/E) ratio above 18. However, given that we are entering the last month of the third quarter, the market will start to discount 2019 earnings estimates.

For 2019, S&P 500 operating earnings estimates are roughly $177, putting the forward P/E ratio at about 16.3 times earnings. Therefore, we view current valuation to be in fair territory considering the level of interest rates and inflation.

Economic Cycle

The U.S. economy grew at a revised 4.2 percent in the second quarter, according to the Bureau of Economic Analysis, up 0.1 percent from the first estimate. Moreover, the



Conference Board Leading Economic Index (LEI) rose for the tenth month in a row to 110.7, industrial production grew 4.2 percent year-over-year, and the Consumer Confidence Index rose to the highest level in almost 18 years, suggesting the economy will continue to expand at a solid pace.

On the other hand, higher mortgage rates seem to be creating headwinds for housing as home sales decreased 0.7 percent month-over-month and declined 1.5 percent year-over-year. In addition, foreclosures increased year-over-year for the first time in three years.

Sentiment

Bullish advisor sentiment from Investors Intelligence has risen to levels last seen in late January/early February of this year, just prior to a sharp selloff. While higher levels of

bullishness does not automatically mean a selloff is imminent, it does suggest that the market is more euphoric. Therefore, any negative surprise in the data could be a catalyst for a pause or pullback.

Technical Factors

The S&P 500 index and NASDAQ Composite reached all-time highs in late August, however, the Dow Jones Industrial Average (DJIA) has not exceeded its late January closing high. However, we consider the technical picture to be mixed, with a number of positives and negatives.

The Dow Jones Transportation index has exceeded its January high, which could bode well for a possible attempt at a new closing high for the DJIA .

Outlook

The European Central Bank (ECB) purchased about 25 billion euros worth of public and private assets in the month of August, and is likely to reduce the average monthly purchases to 15 billion euros “after September 2018.” The asset purchases are expected to end in December 2018.

The market distortions created by central bank policy are starting to show some cracks. For example, at the end of August the yield on the 5-year German government bond was minus 0.24 percent. It was the thirst for yield which allowed Argentina to issue 100 year bonds in June 2017 despite having a well-known history of defaulting on their debt.

Less than one year later, Argentina requested a $50 billion loan from the International Monetary Fund (IMF) as their currency has declined over 50 percent versus the U.S. dollar.

In the 1990s bull market, the Fed's balance sheet never got materially above $500 billion. Today it is still north of $4 trillion. Moreover, negative interest rates on government bonds still exist in countries such as Germany and Switzerland.

The inflation adjusted federal funds rate is negative more than 9 years after the financial crisis. The Fed's favorite inflation gauge, Personal Consumption Expenditures excluding food and energy ("Core PCE"), rose 2.3 percent year-over-year while the effective federal funds rate is currently 1.9 percent. Negative real interest rates were not seen in the 1990s.

The Fed's activism is also quite different. A microcosm of that can be seen by examining the August 2015 selloff, when the Dow Jones Industrial Average fell by more than 1000 points one morning. Shortly thereafter, the Fed's Vice Chairman Stanley Fischer said he expected volatility to "settle fairly quickly."

A similar statement was issued by St. Louis Fed president James Bullard who was confident that volatility would be "settled down" by the September FOMC meeting.

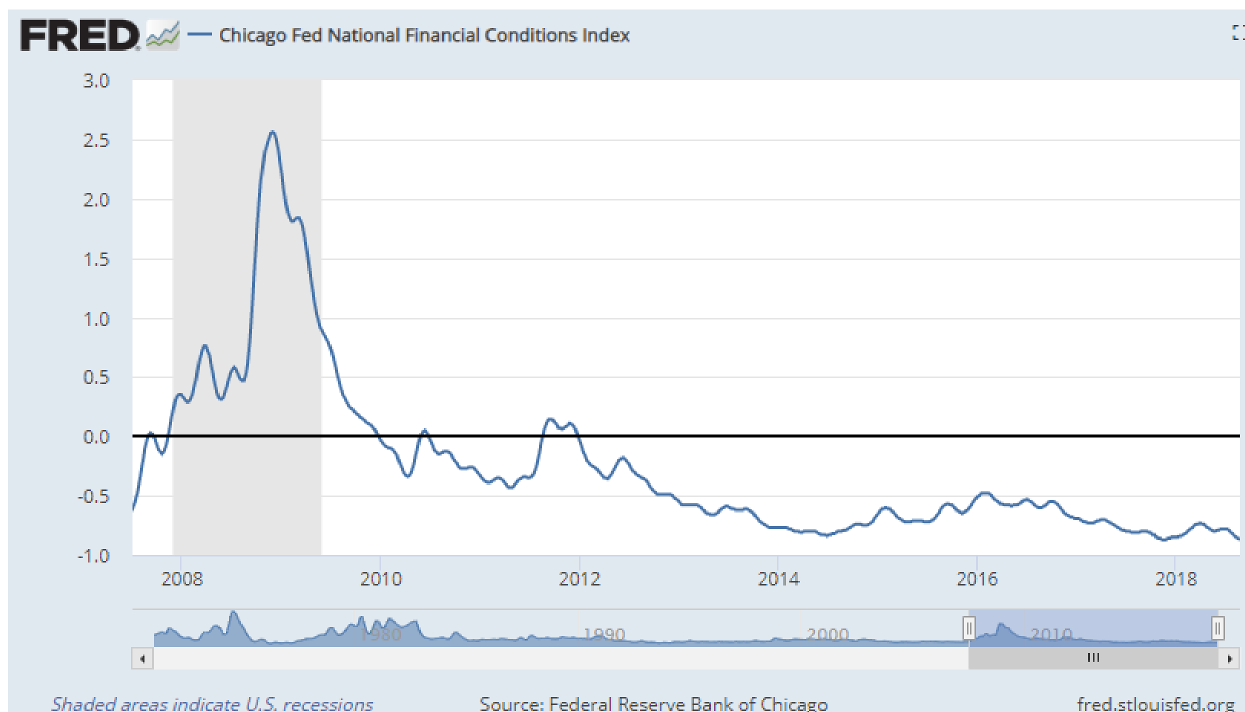
At the time, given the market disruption, these statements were considered quite bold.

For background, transcripts of FOMC meetings are issued 5 years after the meeting. What is of note is the statement by current Fed Chairman Powell from the October 23-24, 2012 meeting when he stated that he was concerned about "unloading our short volatility position." Clearly the post-financial crisis Fed has been involved in more than just bonds.

During that same meeting Chairman Powell said "Investors really do understand now that we will be there to prevent serious losses."

As a reminder, key provisions of the post financial crisis Dodd-Frank Act gave regulators the responsibility to track and respond to possible risks to the financial system as a whole. Time will tell whether the Fed will be there to backstop the equity markets in the future.

Regardless, what we do know is that tight money has preceded difficult markets in the past. As can be seen below, the Financial Conditions Index, a proxy to measure the "tightness" of liquidity, is among the lowest readings of the past ten years. Tight money is the opposite of what we have today.



The economy is also extremely important as 7 of the past eight bear markets began with the onset of an economic recession. A recession does not appear to be on the horizon at this time. In addition, aggregate corporate earnings have increased for the eighth consecutive quarter.

So the big three variables, the Fed's monetary policy, the economy, and corporate

profits, are all positive. On the other hand, investor sentiment, a contrary indicator, is negative in our view as the recent run-up in prices has caused euphoria to creep back into the markets. Moreover, the market seems to be ignoring a potential shakeout from some of the damage seen in emerging markets.

Risks, however, have not gone away, and some of the biggest risks over the years have seemingly come from “left field.” One possible risk is the ongoing trade war. Although the narrative is that the U.S. will prevail in a protracted trade war, that remains to be seen. President Trump has threatened to implement tariffs on an additional $200 billion worth of products imported from China. China will likely respond in kind.

China has indicated that they have no intention of giving into threats as the official newspaper, the China Daily, responded by saying “To the thinking person, there are few things more disconcerting than a tweet by the U.S. President, as they initially seem to accord to reality but then quickly turn into messages from some alternative universe.”

Meanwhile, the trade negotiations with our neighbors in North America is still unsettled. While Trump has taken a bow for a verbal trade agreement with Mexico, talks with Canada have broken down. Furthermore, any new trade deal must be ratified by Congress, whereby the outcome of midterm elections will most definitely have a say.

In addition, the trade dispute with the European Union is far from settled. Just weeks after President Trump and European Commission President Jean Claude Junker held a conference in the White House Rose Garden highlighting an agreement, President Trump reportedly reneged on an auto deal. Details matter more than headlines.

The longer-term effects on trade are simply unknown. Just recently President Trump signed a waiver on steel and aluminum from certain countries based on insufficient quantity or quality available in the U.S.

Another risk to the markets is that trading is dominated by algorithms. Computerized trading programs do not think, they execute. As momentum is one of the primary factors in many trading algorithms, the computers will just as easily buy something that has risen from 200 to 300 in a month as they will sell something at 80 that has fallen from 150. Said another way, many trading algorithms are price insensitive, and fundamentals matter little.

To be clear, our risk model is positive, however, we recognize that we are not in the early innings of this ball game. Bull markets tend to top out on good news, not bad news. As such, we are keenly looking at risks that could impact markets and will be ever vigilant.

As the mid-term elections are roughly two months away, we would not be surprised to see volatility pick up. To say the least it will be a contentious time. Nevertheless, with monetary policy still accommodative, the economy growing and market valuation roughly equal to the 25-year average, we are still constructive and would use weakness to accumulate positions.

Please let us know if we can be of any help. InVEST with confidence. (9.3.18)

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