TJT CAPITAL GROUP

On Our Radar – October 2018

September marked the ten-year anniversary of the Lehman Brothers bankruptcy that caused the financial markets to seize up around the globe. And as is often the case, there is a lot of "revisionist history" going on by a number of key players in an attempt to deflect criticism. However, as you will see, there were many things that preceded the Lehman Brothers filing that sowed the seeds of the crisis. The good news is that much has changed for the better, yet some important lessons are starting to fade.

The S&P 500 Index gained 0.4 percent in September and achieved an all-time high despite an escalation of the trade tensions with China. The U.S. imposed an additional 10 percent tariff on $200 billion worth of goods from China, and China has said it will not be threatened into negotiations. Tariffs are a tax, and at some point consumers will see more costs rise.

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)

The Federal Open Market Committee (FOMC) raised interest rates by 25 basis points (0.25%) on the federal funds rate for the third time this year bringing the range to 2.00 to 2.25 percent. Much was said in the press about the Fed statement eliminating a sentence referring to monetary policy being "accommodative," however, in opening his press conference Chairman Powell stated "financial conditions remain accommodative."

The reason for the removal of that sentence is because it is self-evident. The federal

funds rate is still below the rate of inflation, and is also below the “neutral rate” of 3 percent based upon the estimate of the other members of the Committee. Moreover, the Fed’s balance sheet is still north of $4.2 trillion.

Valuation

S&P 500 consensus operating earnings estimates for 2018 and 2019 are about $157 and $177, respectively. The tax cuts, a pick-up in U.S. growth, and a significant rally in oil prices are largely responsible for the near 25 percent quarterly earnings increase.

Based upon current earnings estimates, the forward price/earnings ratio on the S&P 500 index is approximately16.5-times 2019 earnings, about even with the past 25-year average. With relatively low interest rates and low inflation, we consider valuation to be in “fair” territory.

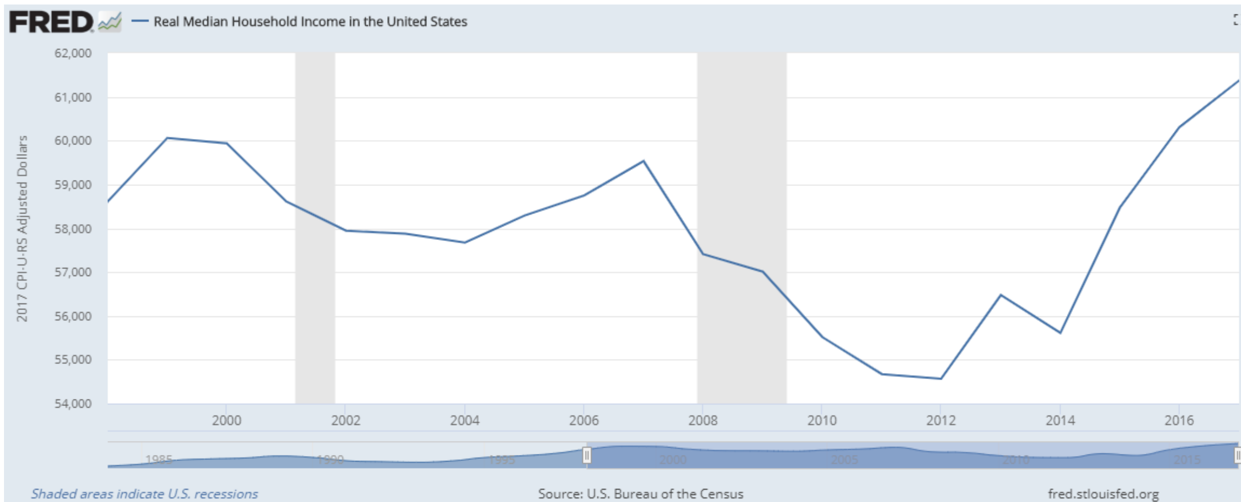
Economic Cycle

The U.S. economy grew at 4.2 percent in the second quarter and is on track for solid growth to continue. The Leading Economic Index (LEI) increased 0.4 percent month-over-month and is up 6.7 percent year-over-year, the Conference Board Consumer Confidence Index rose to 138.4 in September, not far from an eighteen year high, and the Institute for Supply Management (ISM) Manufacturing survey was 61.3 percent, a fourteen-year high.

In addition, Industrial Production has increased for three consecutive months, and the National Federation of Independent Businesses (NFIB) recently reported that small business optimism rose to the highest level in almost 50 years.

Another positive is median income, which rose above $61,000 for the first time in 2017,

finally exceeding the 1999 high as seen in the following chart. Congress also approved a Continuing Resolution to fund the government through December 7, 2018, avoiding a potential government shutdown ahead of the mid-term elections.



On the other hand, real estate is slowing as existing home sales were unchanged in August after four consecutive months of decline. Retail sales gained only 0.1 percent in August, and the Federal Reserve's favorite inflation gauge, the Personal Consumption Expenditures (PCE) rose 2.3 percent year-over-year. Oil prices are up nearly 50 percent over the past year and higher interest rates are starting to impact housing.

Sentiment

Bullish investor sentiment has been on the rise with the recent rally in U.S. stocks, and is now at levels seen in late January just prior to a ten percent selloff. Therefore, as a contrary indicator, we view sentiment as negative.

Technical Factors

Technical factors continue to be mixed, with a series of both positive and negative

action. While the Dow Theory flashed a “Buy” signal, the NASDAQ Composite did not make a new high in September. Since the NASDAQ has been the leader all year, that may be a non-confirmation to keep an eye on.

Outlook

In a recent op-ed piece written in the New York Times about the financial crisis, former Fed Chairman Ben Bernanke, and former Treasury Secretaries Henry Paulson and Timothy Geithner wrote that “the American financial system outgrew the protections against panics that were put in place after the Great Depression.” They went on to say that an “antiquated regulatory system made identifying these risks difficult.”

Yet, as has been argued by former U.S. Treasury and Federal Reserve officials, a more accurate assessment is that the Fed, at best, ignored signs that were evident, and, at worst, enabled the imbalances to develop. For example, back in 2004, with the Fed’s blessing, the leverage thresholds on major Wall Street banks that were put in place following the Great Depression were changed. Leverage ratios essentially went from being capped at roughly 12-times to an unlimited amount. As we know, some major banks leveraged their equity by 40-times or more, whereby 2.50 percent decline in prices wiped out their entire equity capital.

Furthermore, in 2007 a former Federal Reserve Governor, Edward Gramlich, wrote a book titled Subprime Mortgages: America’s Latest Boom and Bust. Mr. Gramlich had been warning about the effect of predatory lending for years. It fell on deaf ears.

Nevertheless, financial alchemists found a way to turn pools of the least credit-worthy borrowers into “AAA-rated” securities, theoretically providing them with the same risk profile of a U.S. Treasury security. Therefore, based upon Basel Rules, “AAA-rated” securities were deemed to be as good as cash and required no reserves against it. So

with major banks' cost of capital around 3 percent, highly leveraging an 8 percent-plus yield on "AAA-rated" securities seemed to make sense.

When the evidence began to suggest that something was amiss, a number of government officials were either naive or tried to be cheerleaders. Consider the following statements as examples:

- "the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained." Ben Bernanke 3/28/07

- "[the subprime fallout] will not affect the economy overall." Ben Bernanke June 20th, 2007

- "The Federal Reserve is not currently forecasting a recession." Ben Bernanke January 2008
  - o "The United States is in a recession and it began in December 2007." National Bureau of Economic Research Dec 1, 2008

- "In my judgment, we are closer to the end of the market turmoil than the beginning." Henry Paulson May 16, 2008

- Experiencing the "most severe financial crisis" in the post-World War II era. Investment banks are seeing "tremendous runs on their cash,"… "Without action, they will fail soon." Ben Bernanke September 19th, 2008

To be fair, Ben Bernanke was clearly concerned about what was developing in the economy, which is why he engineered so many interest rate cuts. But Lehman Brothers turned out to be the catalyst that set the markets on fire. The reality is that the Fed orchestrated the takeover of Bear Stearns by J.P. Morgan in March 2008. Many market players looked at Bear Stearns as being precedent, and invested accordingly.

The Lehman Brothers bankruptcy created an enormous shock that affected the whole financial system. A money market that held a large amount of Lehman Brothers short-term notes had to be bailed out, causing investors to lose confidence. That led to questions about counter-party risk, causing what was essentially a “run on the banks.”

AIG was, in effect, selling “insurance,” also known as credit default swaps, on billions of dollars of sub-prime mortgages with virtually no reserves. When AIG was forced to put up collateral in massive quantities, they were unable to do so. As such, the government stepped in.

This is a simplified version to provide investors with some context as it is very easy to forget what took place at the time. Indeed, there were many other issues that had an impact, including, for example, the elimination of the “short-sale rule”, another Depression-era protection that was repealed in 2007.

Nonetheless, as previously stated, there were signs that things were changing for the worse in 2007. Not only were housing prices declining and interest rates rising, initial employment claims were moving higher as was the unemployment rate. In addition, the fourth quarter of 2007 saw S&P 500 operating earnings decline by 27 percent from the third quarter.

Yet despite that, according to the Federal Reserve Bank of Philadelphia, in early 2008 not one of 50 professional forecasters were predicting an economic contraction. Likewise, despite an inverted yield curve – which has preceded every recession going back to the 1960s, a decline in housing, employment, and earnings, not 1 of twelve major Wall Street firms forecasted a decline in the market for 2008. In fact, while the S&P 500 Index finished 2007 at roughly 1468, the consensus target of the twelve strategists for 2008 was 1640, with none forecasting a down year. The S&P 500 finished 2008 at 903.

Since the financial crisis the Fed has forced banks to rebuild their capital and maintain minimum risk-based capital ratios near the levels that existed prior to what came to be known as the “Bear Stearns exemption.” And as Fed Chairman Powell recently stated, “the banks take much less risk than they used to.”

What seems to be lost is the potential negative impact of large amounts of debt, which has skyrocketed since 2009. In addition, many investors still seem to cling to the next forecast. Since the financial crisis, there have been scores of people who have consistently called for the end of the bull market in stocks, some of whom have been predicting an impending “crash” as far back as 2014.

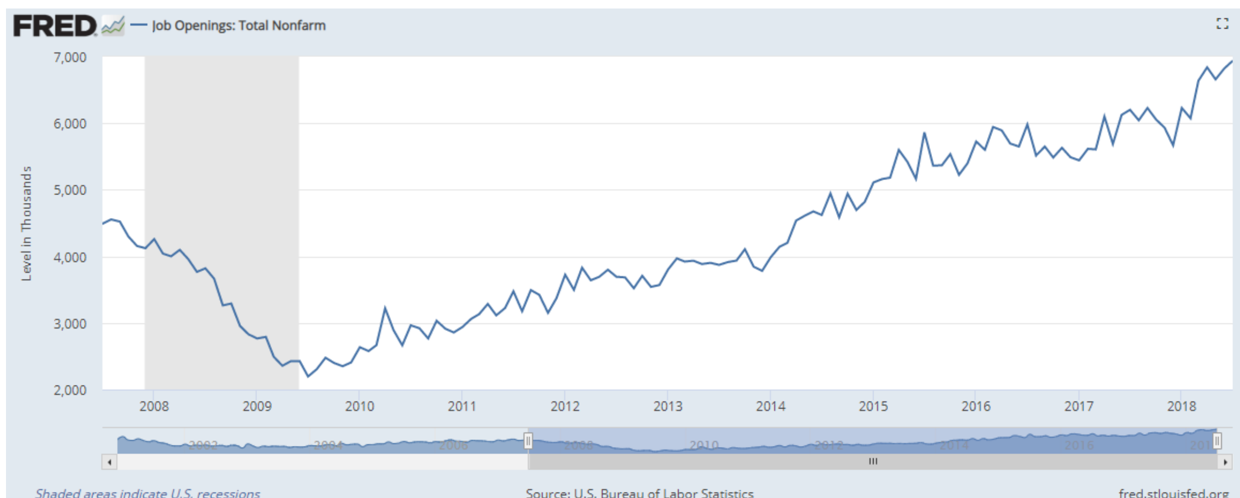
Since the U.S. market bottomed in 2009, the U.S. markets have endured an Eurozone recession, a Japanese earthquake and tsunami, a Greek crisis, a U.S. government shutdown, the so-called “fiscal cliff,” an oil price collapse, a China currency devaluation, several natural disasters and terrorist attacks, numerous global elections, the worst start to the year – ever – in 2016, and, so far, a trade war, to name a few. At any point along the way there were always things to worry about, and you can be sure that many of those constantly making depressing assumptions used them to justify their negative predictions.

The fact that a certain view is accepted does not make it valid. Often times, so-called conventional wisdom is wrong. Regarding politics, which seems hard to get away from, clearly people have strong opinions on both sides. That said, using politics as the basis to invest or not invest has been a losing proposition for decades.

Our message has always been to filter out the “noise” and never lose sight of the most important variables. Of the five key variables that historically have had the most influence on market conditions, the “big 3” are Federal Reserve monetary policy, the economy, and corporate profits, all of which are currently positive. Again, the market is

dynamic and not necessarily controlled by a single issue.

With that in mind, Fed policy is still accommodative with the current federal funds rate below both the rate of inflation and the Fed's current estimate of "neutral" policy. The U.S. economy is growing, and should continue to post solid results. For example, the number of job openings, as seen in the next chart, is at an all-time high. And S&P 500 corporate profits are expected to post another 20 percent year-over-year gain in the third quarter. As such, market conditions are still constructive.



Given that the market advance is well into its ninth year, however, we remain alert for any major changes in our risk assessment. Higher interest rates, the longer-term effects of a trade war, and elevated rhetoric and vitriol of Washington, D.C. politics could impact sentiment. As such, we would not be surprised to see volatility increase and remain vigilant to opportunities that may develop. (10/1/18)

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