TJT CAPITAL GROUP

On Our Radar – November 2018

Volatility returned with a vengeance in October as the market experienced the biggest monthly selloff since 2011 with the Dow Jones Industrial Average, S&P 500 Index, and NASDAQ Composite falling 5.7 percent, 6.7 percent, and 9.2 percent, respectively from their all-time closing highs. In just two days, October 10th – 11th, the Dow lost 1377 points, or 5.2 percent.

There was no shortage of reasons for the decline given various concerns including the upcoming mid-term elections, the ongoing trade war with China, concern about Federal Reserve interest rate policy, rising geopolitical tensions, and slowing global growth to name a few. Nonetheless, what is not in dispute is that the market direction changed dramatically following an interview by Fed Chairman Jerome Powell on October 3, 2018. Whether intentional or not, Mr. Powell's comments seemed to convey a greater sense of urgency on the part of the Fed to raise interest rates more aggressively.

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)

Following the September 2018 Federal Open Market Committee (FOMC) meeting Fed Chairman Powell acknowledged that the "neutral" rate – a level at which the Fed is neither accommodative nor tight – was about 3 percent. On October 2, 2018, the yield on the 10-year U.S. Treasury was 3.05 percent. The next day, Mr. Powell gave an interview whereby he said "we may go past neutral, but we're a long way from neutral." Two days later, the yield on the 10-year U.S. Treasury shot up to 3.23 percent, the highest level in seven years.

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Shorter-term interest rates from three months to 5-years followed suit and rose to their highest levels since 2008. The sharp rise in interest rates seemed to be the catalyst for the stock market correction. The Dow Jones Industrial Average (DJIA) peaked on October 3rd – the day of Powell's interview – and then began to decline.

One of the biggest risks facing the markets is a policy mistake by the Federal Reserve. Ironically, former Fed Chair Paul Volker, the legendary central banker credited with getting inflation under control in the early 1980s, said the Fed is making a big mistake with their 2 percent inflation target. Volker recently said "I know of no theoretical justification" for a 2 percent inflation target. He went on to say "[the Fed] made up the 2 percent number."

A recent comment by another former Fed Chair, Janet Yellen, added to interest rate concerns when she said "a couple more interest rate increases are necessary to stabilize growth at a sustainable pace and stabilize the labor market so it doesn't overheat." This seems to indicate a change in thinking at the Fed with monetary policy being determined by their current theory rather than economic data ("data dependent"). Clearly, higher interest rates will not help the housing sector.

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 at roughly 17.3 times earnings. However, given that we are entering the last two months of 2018, the market should start to discount 2019 earnings estimates.

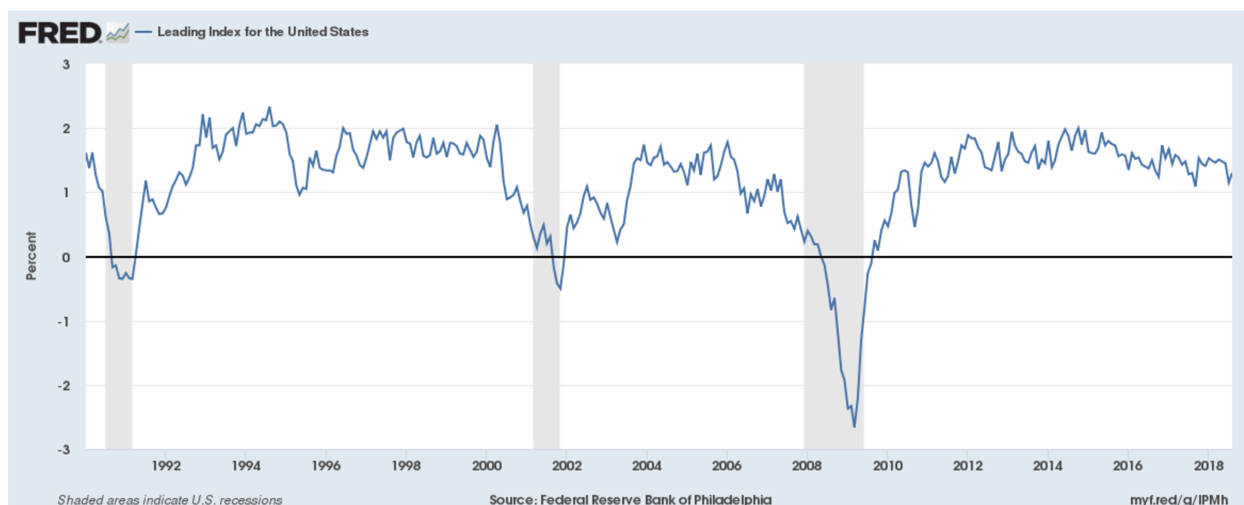
For 2019, S&P 500 operating earnings estimates are roughly $176, putting the forward P/E ratio at about 15.8 times earnings. Therefore, we view current valuation to be in fair territory considering the level of interest rates and inflation.

Economic Cycle

The U.S. economy grew at an estimated 3.5 percent pace in the third quarter, led by consumer spending, which grew by 4 percent. Moreover, the Leading Economic Index (LEI) increased for the twelfth month in a row, suggesting further economic expansion ahead.

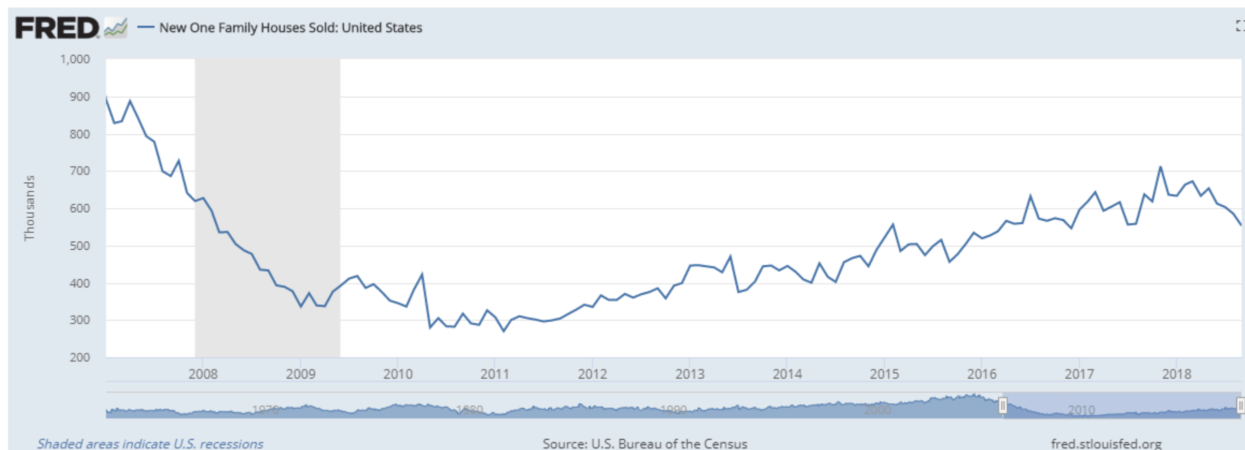
The Conference Board Consumer Confidence Index rose to 137.9 in October following a modest increase in September, and remains near an eighteen year high. The Institute for Supply Management (ISM) manufacturing survey edged down to 57.7 percent, still well above the growth threshold of 50 percent. In addition, Industrial Production was up 5.1 percent on a year-over-year basis.

As seen in the following chart, the Leading Index has declined in advance of previous economic recessions (shaded areas). Given that history, a recession does not appear to be on the near-term horizon.



On the other hand, higher interest rates are having an impact on the housing market. While the housing market has seen a recovery since the end of the financial crisis, new home sales, as seen in the chart below, remain well-below the previous peak. Rising

interest rates are flowing through to mortgage rates, which is putting pressure on affordability. Simply put, the housing sector is struggling and further interest rate hikes are unlikely to be helpful.



Sentiment

Bullish sentiment in early October was at the highest level since January, just prior to the late January/early February selloff. Since then, investor sentiment, a contrary indicator, has improved as the level of bullishness has declined materially from early October.

Technical Factors

The technical picture is mixed. While all major equity averages are above their respective 2018 lows from earlier in the year, the number of stocks making new 52-week lows has expanded considerably.

Outlook

The key question on investors' minds is whether the recent action is a correction or something worse. As a reminder, corrections are the rule, not the exception, in bull

markets. In addition, October marks the fiscal year-end for a large number of mutual funds. Therefore, some of the price action may have been exacerbated by tax considerations of mutual funds.

Corrections also serve to purge excesses. For example, in addition to sentiment, a recent study found that over 80 percent of U.S. listed initial public offerings (IPOs) through September lost money in the 12 months leading up to their public debut. That is a sign of froth.

Notwithstanding the rally in the last two days of October, corrections are usually a process that involves time and price. Therefore, investors should expect big price swings in both directions for at least the next few weeks.

Although difficult, especially in times of stress, we encourage investors to try not to be over-influenced by the headlines or the narratives, but focus on the variables that have historically had the biggest influence on market prices.

Clearly, the outcome of the mid-term elections are weighing on the markets as there is a question whether the pro-business policies which have been favorable to the markets will continue. In addition, the Fed seems intent on raising interest rates, which could create headwinds for economic growth. Furthermore, the trade war with China is starting to impact more and more U.S. companies, especially with respect to supply chains.

Another risk is the systematic or algorithmic strategies that dominate day-to-day trading. We have pointed out many times that these post-financial crisis strategies are price insensitive, that is, they will just as easily buy a stock at $100 as they will sell the same stock at $85 (or vice versa). Fundamentals seem to matter less than price momentum.

For example, on October 29, 2018, between approximately 2:45 p.m. and 3:30 p.m., the Dow, S&P 500, and NASDAQ Composite dropped 507 points, 57 points, and 88 points, respectively – more than 2 percent each - only to recover somewhat in the last thirty minutes of trading. The good news is that type of "flush" can often signal short-term capitulation – a "get me out at any price" response after weeks of selling - that tends to lead to a healthy bounce. That seems to be the case as the initial bounce began on October 30th.

By definition, corrections typically involve a series of positive and negative price swings over weeks or months. For example, while the S&P 500 and NASDAQ Composite, to date, made their 2018 low during the February decline, the Dow Jones Industrial Average made its 2018 low in April.

Nevertheless, higher interest rates are affecting markets. For example, yields on "junk bonds" rose in October from 6.19 percent to 6.82 percent as seen in the next chart. Moreover, Janet Yellen said she was "worried about the systemic risks" associated with certain types of corporate loans.

What is ironic is that about a year ago Ms. Yellen said she did not expect another financial crisis in her lifetime. Now that she has left the Fed she is concerned about the

size of loans issued to companies that increased dramatically under her watch. Central bankers are often criticized for living in a world of theory.

This is the second correction of the year. The January/early February selloff was more technical in nature as the fundamentals of revenue growth and earnings growth along with a seemingly patient Federal Reserve provided healthy conditions for a rally. The current correction is more fundamental in nature as interest rates and tariffs are starting to impact revenues and earnings in a number of industries.

Clearly, the markets are adjusting to higher interest rates, softening global growth, and slower earnings growth. Moreover, the US Treasury will be issuing about $1.5 trillion in new debt in fiscal year 2019.

Although the Fed is likely to increase interest rates more, interest rates are still low by historical standards. The U.S. economy continues to expand, and corporate earnings are expected to grow, although not at the same pace seen in recent quarters.

So while volatility is likely to remain high and odds favor a healthy bounce prior to year-end, panics can create opportunity as leadership can change. For example, the averages were being driven by a few large companies that rose significantly in value, some of which bore the brunt of the recent decline. It is not unusual for new companies or sectors to emerge as the next group of leaders after a decline.

Moreover, as President Trump continues to campaign ahead of the upcoming elections, he tweeted that he "had a long and very good conversation with President Xi Jinping of China. We talked about many subjects, with a heavy emphasis on trade. Those discussions are moving along nicely with meetings being scheduled at the G-20 in Argentina."

Any progress to reduce trade tensions would likely result in a significant rally, especially in international markets.

Do not hesitate to contact us if we can be of any help. InVEST with confidence. (11.1.18)

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