TJT CAPITAL GROUP

On Our Radar – December 2018

Volatility spiked in the U.S. stock market in November with several 500-plus point moves in both directions in the Dow Jones Industrial Average. Concerns centered around a deceleration in global economic growth due to the ongoing trade war, a possible policy mistake by the Federal Reserve, the ramifications of a "divided Congress" following the mid-term elections, and a substantial decline in oil prices, among others.

Despite that, the major equity indices finished positive for the month with the S&P 500 index gaining about 1.7 percent following a calming speech by Federal Reserve Chairman Jerome Powell and hope for a de-escalation in trade tensions with China.

The price of oil dropped 22 percent in November as a barrel of West Texas Intermediate fell from over $65 to under $51. Meanwhile, the yield on the 10-year U.S. Treasury dipped to 3.01 percent from 3.23 in early November. As headlines changed, so did investor psychology and liquidity, especially since the daily price action continues to be dominated by algorithmic-type program trading.

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)

On October 3, 2018, the day the Dow Jones Industrial Average hit an all-time high, Fed Chairman Jerome Powell gave an interview whereby he said "we may go past neutral [interest rates], but we’re a long way from neutral.” That “long way from neutral” remark spooked the markets, and over the next eight weeks U.S. stocks experienced a correction of more than ten percent.

Then on November 28, 2018, Mr. Powell seemed to reverse course by stating that interest rates were “just below” the neutral range. That set the stage for a reflex rally.

At that speech delivered to the Economic Club of New York, Mr. Powell said “Interest rates are still low by historical standards, and they remain just below the broad range of estimates of the level that would be neutral for the economy – that is, neither speeding up nor slowing down growth.” The market interpreted this as a significant change from his early October comments when he suggested that interest rates were poised to go much higher.

In December 2015, when the Fed began to raise interest rates from what was effectively zero, the difference – or spread – between the yield on the 10-year U.S. Treasury and the federal funds rate – the overnight interest rate on cash reserves traded among depository institutions (banks) - was approximately 224 basis points, or 2.24 percentage points.

Following the eighth interest rate increase in September 2018, which brought the federal funds target range to a level of 2.00 to 2.25 percent, the spread between the 10-year U.S. Treasury yield and the federal funds rate narrowed to approximately 76 basis points, or 0.76 percentage points. Historically when the yield curve flattens, the economy tends to slow down, albeit with a lag.

The Fed has talked endlessly about their dual mandate of maximum employment and price stability. From that standpoint nothing seemed to change from early October to late November as the unemployment rate stood at a near 50-year low and the Fed's favorite inflation gauge, the Personal Consumption Expenditure (PCE) index, was at the Fed's preferred 2 percent target.

What did change, however, was stock and bond prices, and the Fed seemed to be concerned about the effects that rising interest rates were having on the markets. It remains to be seen what the Federal Open Market Committee (FOMC) will do at their December 18-19 meetings, but odds currently favor another interest rate hike.

Valuation

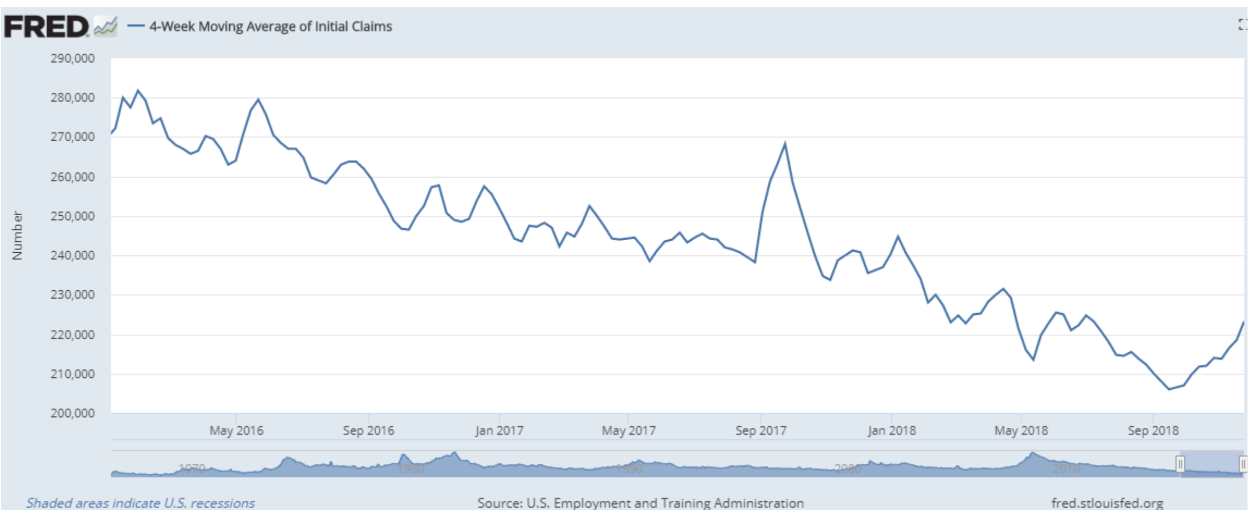
Operating earnings for the S&P 500 for calendar year 2018 are estimated to be roughly $157, putting the current-year Price/Earnings (P/E) ratio at roughly 17.9 times earnings. However, given that we are entering the last month of 2018, the market should start to discount 2019 earnings estimates.

For 2019, S&P 500 operating earnings estimates are roughly $175, putting the forward P/E ratio at about 15.7 times earnings. Therefore, we view current valuation to be in fair territory considering the level of interest rates and inflation.

Economic Cycle

U.S. economic growth for the third quarter was unrevised at 3.5 percent, down from the second quarter's 4.2 percent growth rate. The Institute for Supply Management (ISM) Manufacturing Survey rose to 59.3 percent in November, up from October's reading of 57.7 percent. Non-farm payroll gains were 250,000 in October and the unemployment rate remained at 3.7 percent. In addition, average hourly earnings rose 3.2 percent year-over-year, the strongest since 2009.

The Leading Economic Index increased 5.9 percent year-over-year, suggesting continued economic growth ahead. On the other hand, new durable goods orders, a proxy for business capital investment, fell 4.4 percent from last month following a downward revision in September. Housing showed further signs of softening, with new home sales down 12 percent from a year ago, while existing home sales fell 8.9 percent month-over-month. Moreover, Initial unemployment claims have increased about ten percent in the past three months, as seen in the chart below, and are at the highest level since March 2018. Clearly there are some headwinds.



Regarding the economy, what is not known, however, is how much demand has been pulled forward in anticipation of further tariffs. The U.S. trade deficit grew to a record $77.2 billion in October as imports from China grew and exports fell.

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 number of bullish advisors dropped to 38.3 percent, the lowest since May 2016.

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. We saw an initial low made at the end of October followed by a reflex rally. That rally ended and the market is in the process of retesting, and in some cases, breaking the recent lows. As such, volatility should remain elevated.

Outlook

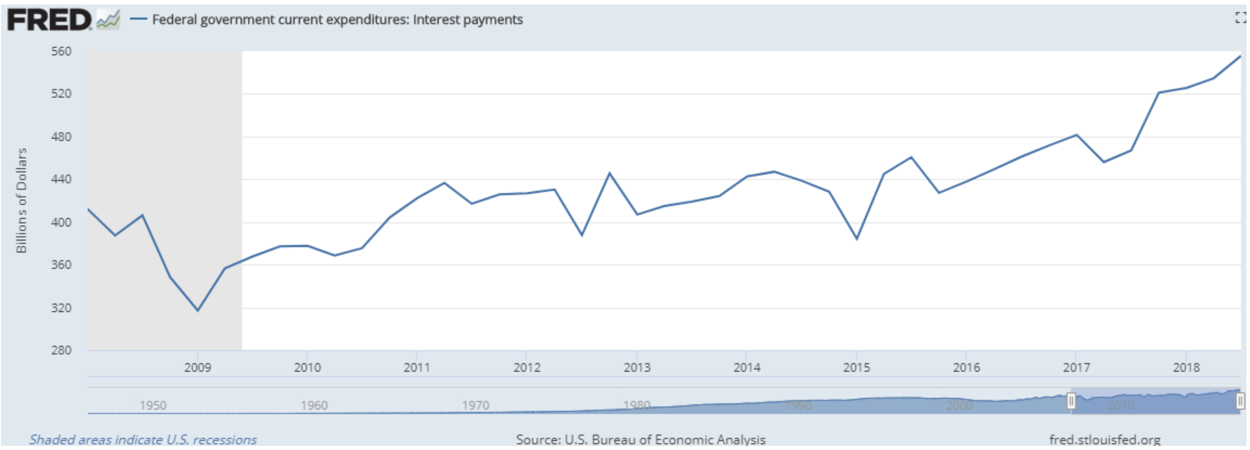
We have often said that the Fed lives in an alternate universe of theory versus the real world that everyone else resides in. For the past few years the Fed has debated what the so-called neutral rate is, however, if you do not know what that rate is, how do you know whether you are “a long way from neutral” or “just below” it? The fact is, they don’t.

What we do know is that when the Fed talked about hiking interest rates beyond the so-called neutral rate, it caused the bond and equity markets to sell off. When interest rates rise, price/earnings ratios (P/E ratios) tend to decline.

Interestingly, the Fed’s recently published Fed Financial Stability Report stated that “the economic effects of our gradual rate increases are uncertain, and may take a year or more to be fully realized.”

Clearly the Fed’s view on interest rates affects the markets, and Jerome Powell’s revised view that interest rates are “just below” neutral gave the market a boost.

However, the Fed’s interest rate posturing caused the U.S. dollar to rise to the highest level in a year-and-a-half, which creates headwinds for economic growth. Moreover, higher interest rates have caused payments on federal debt to soar to $555 billion as of late November as seen in the following chart, the highest on record.



As the market digests the Fed's outlook, the biggest news seems to be the de-escalation of trade tensions between the U.S. and China that was announced following the G-20 (Group of 20 nations) meeting in Argentina. Although there was very little substance behind the headlines, for now, there is a cease-fire. The good news is that the increase in tariffs that could have gone into effect in January 2019 are off the table at this point.

The goal is to complete a more comprehensive trade agreement in the next 90 days covering broader and more substantive issues, including forced technology transfers, intellectual property and cyber theft. Unfortunately, there was confusion from the White House as to when the 90-day period actually begins, so the lack of agreement on basic details is a concern.

The markets are also dealing with a number of domestic issues including the possibility of diminished tailwinds from the tax cut, lower liquidity from the Fed and global central banks ("quantitative tightening"), Democrats taking control of the House of Representatives and the impact that may have on President Trump's agenda. Moreover, the markets are trying to determine whether the massive job cuts announced

at General Motors are company specific or indicative of a broader slowdown.
We always assess the evidence to determine market conditions as there are usually positives and negatives at any point in time.

All trade wars have casualties and this one is no different. For example, while President Trump has said that the tariffs on steel and aluminum have benefitted U.S. manufacturers, the reality is that the stocks of many of those companies are down substantially over the past six months. Moreover, many U.S. companies have seen raw material price increases, which impacts their bottom line. Therefore, a long-lasting trade agreement with China would be a big plus.

Whether a trade deal with China ultimately comes to fruition or not remains to be seen. However, the U.S. economy is still poised to grow, the Federal Reserve has, at a minimum, dialed down their expectations for the number of interest rate hikes, and corporate profits estimates for 2019 are slated to rise, albeit at a slower pace than seen in 2018. That should provide some support.

On the other hand, volatility is not likely to go away anytime soon. The bottom line is our risk model is still constructive and we expect additional opportunities to develop, but one needs to be more selective at this stage of the cycle. Tax-loss selling as we get closer to year-end may also be a factor.

Do not hesitate to contact us if we can be of any help. InVEST with confidence. (12.3.18)