On Our Radar – January 2019

The U.S. stock market came under intense selling pressure in December as fears of a major policy mistake by the Federal Reserve gripped markets. The U.S. stock market experienced one of the most volatile months in years as the S&P 500 index fell 9.1 percent in December as a slowing global economy, the effects of the ongoing trade war with China, and political uncertainty in the U.S. and Europe also weighed on markets. The decline occurred despite the S&P 500 having the largest single-day point gain in its history.

The level of angst increased with oil prices having fallen by more than 30 percent since the October high as well as daily stock swings in excess of 2 percent. Credit spreads have widened significantly with the yield on a junk bond index rising to about 8 percent from roughly 6 percent at the end of the third quarter.

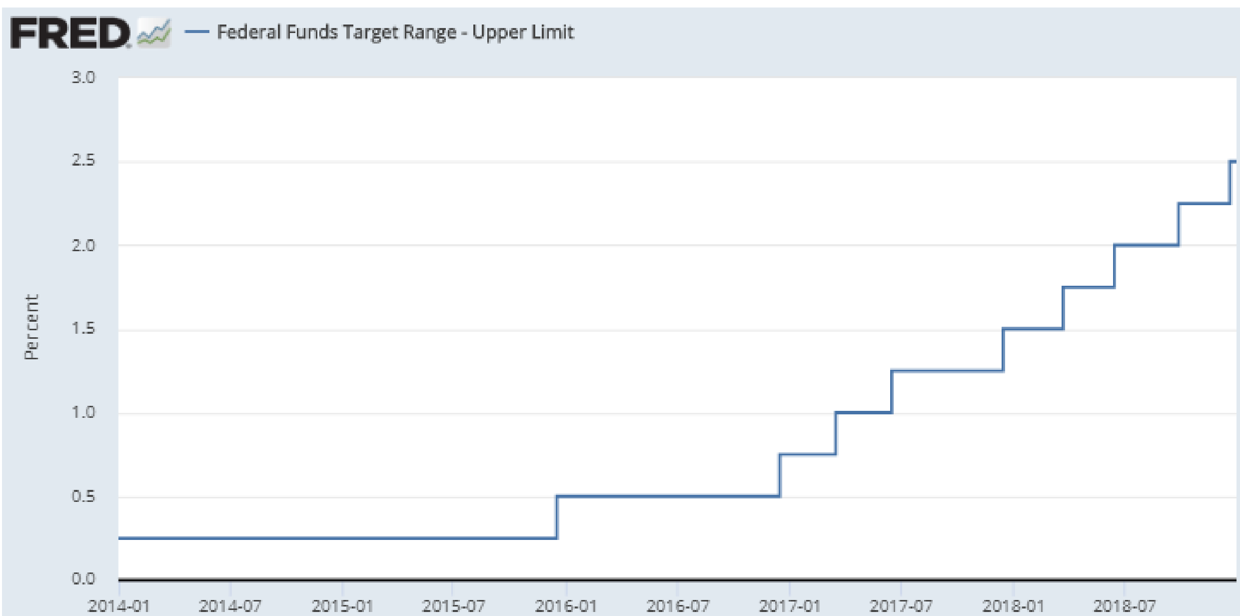
TJT Capital Group's InVEST Risk Model® has helped our clients participate in bull markets and protect capital from the devastation of bear markets by focusing on 5 indicators that really matter when it comes to determining the health and direction of markets. The following is the most recent update.

Interest Rates (Monetary Policy)

The Federal Open Market Committee (FOMC) raised interest rates on federal funds by one-quarter of a percentage point in December to a range of 2 ¼ to 2 ½ percent. This was the fourth rate hike in 2018 and the ninth since the Fed began raising interest rates in December 2015.

During his press conference Fed Chairman Jay Powell acknowledged that financial conditions had tightened and that global growth had weakened, nevertheless he said the Fed planned on hiking interest rates two more times in 2019 and that the Fed would continue to reduce the size of their balance sheet by $50 billion a month.

Following Powell's press conference the markets sold-off dramatically. Clearly, markets are concerned about the Fed making another major policy mistake. With an overnight rate of 2.50 percent, and the yield on the 10-year U.S. Treasury Note of 2.69 percent at year-end, just one more rate hike would cause the yield curve to invert, that is, short-term interest rates would be higher than long-term interest rates. The significance is that an inverted yield curve has preceded every economic recession over the past 50 years, and bear markets in stocks are associated with recessions.



Of greater concern was Powell's contention that Fed policy was going to be "data dependent" but that the runoff of the balance sheet was "on automatic pilot." On its face that position appears to be inconsistent. How can the Fed claim to let the data determine the appropriate policy, yet be on automatic pilot when it comes to reducing their

balance sheet? What's more, the "automatic pilot" approach is at odds with the

Brainard principle, something Powell highlighted in August 2018, which recommends that when you are uncertain about the effects of your actions, you should move slowly.

Furthermore, despite claiming to be data dependent, Jay Powell did not provide an intelligent rationale for why the Fed hiked rates when inflation declined as did their own projections for economic growth. Said another way, by Powell's own statements the data didn't necessarily support a rate hike.

It would seem as though Mr. Powell has blind faith in the Fed's models, the same ones that failed so miserably between 2007 and early 2009. In addition, those models have been wrong on inflation for seven consecutive years. Every time inflation came in below the Fed's target they excused it as being "transitory."

Regarding the unwinding of QE Powell said "if you just run the quantitative easing models in reverse, you would get a pretty small adjustment in economic growth and real outcomes." Perhaps Mr. Powell should be reminded that the Fed is prone to mistakes such as:

> - "And I see nothing to suggest that these [tech] opportunities will peter out anytime soon." Alan Greenspan March 6, 2000 (Four days prior to the March 2000 NASDAQ Peak)
>
> - "the impact on the broader economy and financial markets of the subprime market seems likely to be contained." Ben Bernanke March 28, 2007
>
> - "[the subprime fallout] will not affect the economy overall" Ben Bernanke June 20, 2007
>
> - "The Federal Reserve is not currently forecasting a recession." Ben Bernanke January 10, 2008 (the recession began in December 2007)

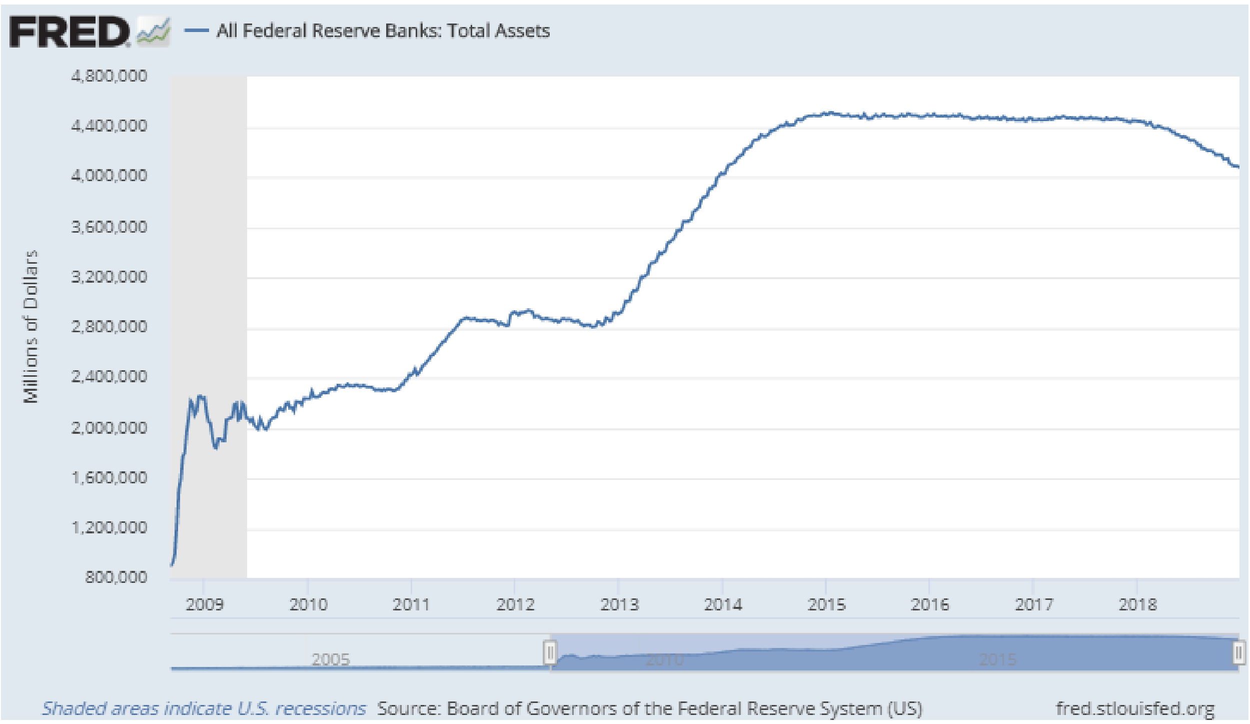
As a reminder, we have never had quantitative easing ("QE") in the U.S. prior to the financial crisis and, therefore, we have never experienced a reversal. The market seems to think that tightening monetary policy when the economy is slowing and inflation is declining is inappropriate. What's more, had the Fed's models been accurate they would have stopped quantitative easing after the first round. However, since QE was essentially an experiment with unknown outcomes, the Fed embarked on several additional rounds including QE2, Operation Twist, and QE3.

Given that track record a little modesty or humility on the part of the Fed would have been welcomed. But what the market has been witness to has been a public debate on the so-called "neutral rate" – the theoretical interest rate that is neither accommodative nor restrictive. Over the past few months Mr. Powell's opinion on that subject has morphed from "a long way from neutral" in early October to "just below neutral" in late November to "we're at the lower end of the range of neutral" in December. This does not instill confidence.

It is a fact that the Dow Jones Industrial Average peaked on October 3, 2018, the same day that Powell said we're "a long way from neutral" and that the Fed "may go past neutral." In addition, the Fed formally set the inflation target at 2 percent in 2012. Former Fed Chairman Paul Volker recently said "I know of no theoretical justification" for the 2 percent inflation target and that the Fed made up the 2 percent number.

To be perfectly candid, the Fed is conducting policy on the fly. In December 2015, former Fed Chair Janet Yellen raised interest rates for the first time since the financial crisis. She suggested the Fed would raise interest rates several more times in 2016. The Fed raised interest rates only once, in December 2016, following the presidential election.

The Fed's balance sheet as of December 26, 2018 was $4.075 trillion, down roughly 9 percent from the end of the third quarter. Monetary conditions are clearly becoming more restrictive.



What's more, the Fed seems to be ignoring some of the theories it espoused during the monetary stimulus such as "higher stock prices will boost consumer wealth and help increase confidence , which…will further support economic expansion" (Bernanke Washington Post November 4, 2010). By Ben Bernanke's own thesis, wouldn't the Fed take into consideration that lower stock, bond and housing prices could be a headwind for wealth, confidence and economic growth?

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 15.9 times earnings.

For 2019, S&P 500 operating earnings estimates are roughly $171, putting the forward P/E ratio at about 14.6 times earnings, the lowest ratio in some time. Keep in mind, however, that higher interest rates tend to cause P/E ratios to contract. 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 3.4 percent in the third quarter, down 0.1 percent from the previous estimate and the 4.2 percent pace in the second quarter. The recent unemployment rate was 3.7 percent and inflation was up about 1.8 percent year-over-year.

Nevertheless, there are clearly some signs that the tailwinds from the Tax Cut and Jobs Act of 2017 are behind us as the Leading Economic Index (LEI) increased 0.2 percent in November after falling a revised 0.3 percent in October. Moreover, the Conference Board Consumer Confidence Index fell to 128.1 in December from 136.4 in November.

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.

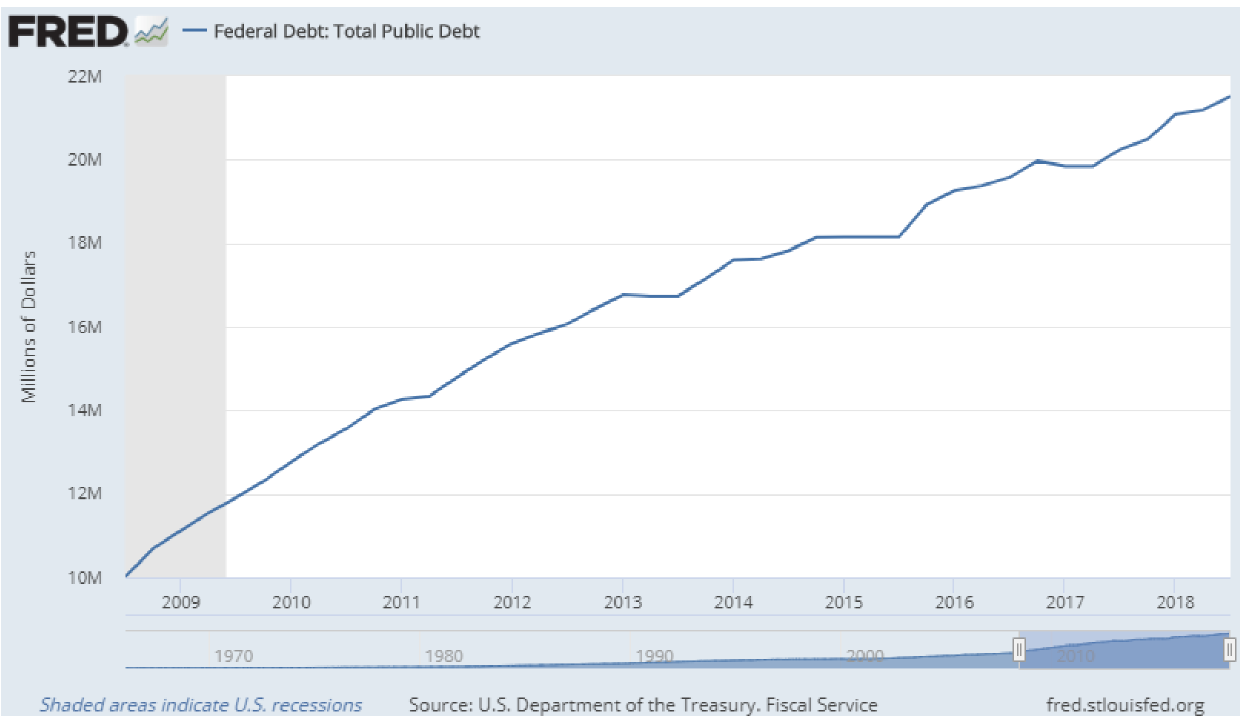
Technical Factors

From a technical standpoint we reached some extremes in late December. For example, the percentage of stocks trading above their 50-day moving average dropped below 1 percent, and the number of stocks on the New York Stock Exchange hitting a

52-week low exceeded 1250. Moreover, the Put/Call ratio, which is an indicator of fear, hit its highest level in years.

Outlook

Since the financial crisis global debt has exploded. In the U.S., government debt has grown by more than $1.3 trillion in just the past year to more than $21.5 trillion, and non-financial debt has grown by roughly 60 percent over the past eight years. What made that possible was the Fed's unconventional monetary policy of zero interest rates along with their massive asset purchase ("QE") program.



Now that monetary policy is in the process of being normalized at a time when economic growth in Asia, Europe and the U.S. is slowing, the markets have been adjusting to that reality. In addition, the U.S. government is running the largest deficit in years as the budget deficit for November was $205 billion, the largest on record.

Regarding a possible policy mistake by the Fed, former Federal Reserve Bank of New

York President William Dudley said the Fed “need[s] to slow the economy down” and so “tighter financial conditions aren’t really a bad thing for the Fed to achieve its objectives.”

As background, following the financial crisis the Fed embarked on the largest monetary experiment since the Great Depression. Back then, from 1932 to 1936, the economy and the stock market saw dramatic gains. In 1937, however, the Fed believed that the economy could do without the stimulus, and hiked interest rates prematurely. The economy and the market sputtered to put it mildly.

So if the intention of the Fed is to use monetary policy to slow down the economy, they may get their wish, along with unintentional consequences. Pumping money into the economy is the easy part; extracting it at a time when the global economy is slowing will likely prove to be more challenging.

To state the obvious, there has been a lot of de-risking by the markets over the past few months. So while volatility is likely to remain high given the fact that algorithms continue to dominate trading, corrections tend to clear out excesses and can provide excellent investment opportunities.

While monetary conditions have clearly tightened, current market prices are more reflective of that reality. U.S. economic growth is likely to slow, yet corporate earnings are expected to grow in the high single digits in 2019, and the forward Price/Earnings (P/E) ratio is currently below 15-times. Bullish investor sentiment, a contrary indicator, has taken a serious hit, which again reflects the recent mood of the market.

However, when markets have a decline similar to what has occurred, the technical damage usually takes some time to heal. That said, while the extreme volatility is unnerving, opportunities are usually best when news is worst. The policy uncertainty should provide opportunistic entry points.

Do not hesitate to contact us if we can be of any help. InVEST with confidence. (1.2.19)