TJT CAPITAL GROUP

On Our Radar – March 2019

The rally in financial assets continued in the month of February with the S&P 500 index gaining 2.97 percent as the Federal Reserve backed off from their quantitative tightening policy (reducing the size of their balance sheet). However, while the gains since late December are welcome, the reality is that from February 28, 2018 to February 28, 2019 the S&P 500 index is up 2.6 percent, not much more than the yield on the one-year Treasury Bill.

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)

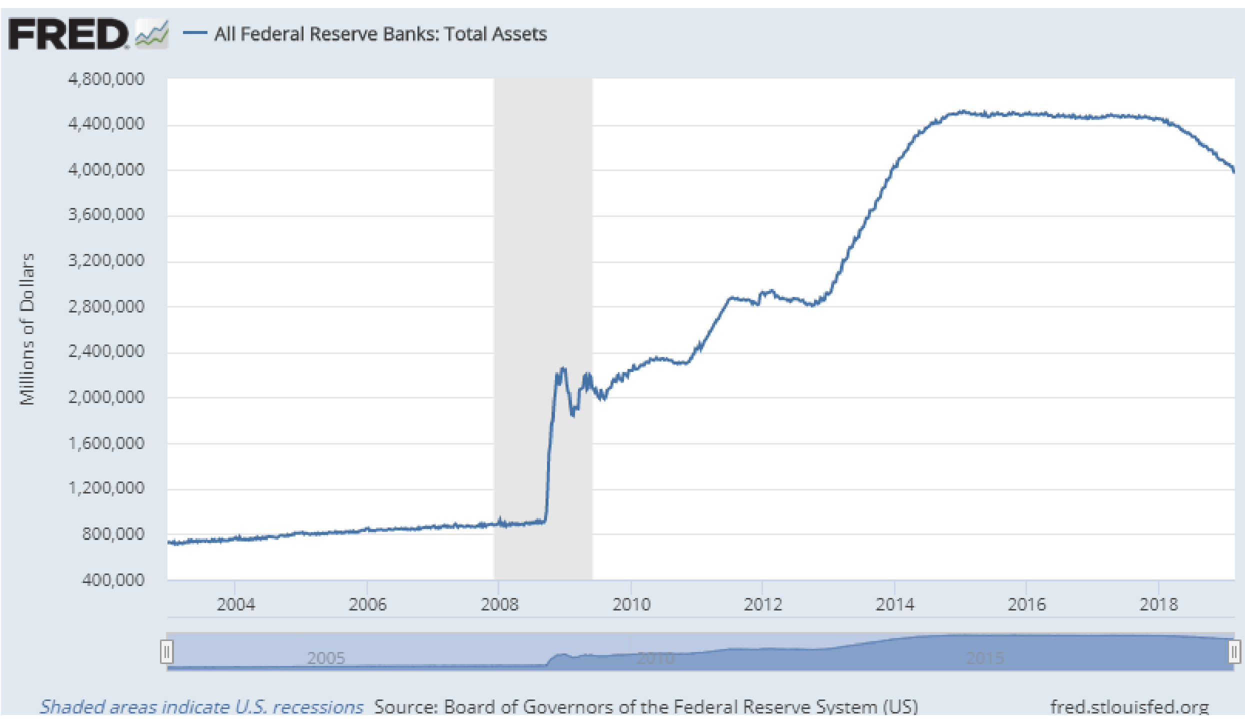
Minutes of the January 29-30, 2019 Federal Open Market Committee (FOMC) meeting were released and provided more details regarding the Fed's recent policy change. To say the Fed backtracked from their position just 2 months ago is an understatement. Their policy regarding the balance sheet went from a reduction in size that was on "automatic pilot" to one that is likely to halt further sales of securities later this year.

In December Fed Chairman Powell said "to normalize policy…we would effectively have the balance sheet runoff on automatic pilot and use monetary policy, rate policy, to adjust to incoming data" (Emphasis added).

The fact of the matter is in 2018 the Fed tightened policy by increasing interest rates and reducing the size of their balance sheet as the economy was slowing and inflation was benign. They did so due to their theories, many of which have been wrong for years.

The Fed was forced to acknowledge that their policies were one of the main culprits in the fourth quarter decline. In the January minutes the Fed said "participants raised a number of questions about market reports that the Federal Reserve's balance sheet runoff and associated "quantitative tightening" had been an important factor contributing to the selloff in equity markets in the closing months of last year." The Fed went on to say they did not fully appreciate "the tightening of financial conditions and the associated downside risks to the U.S. economic outlook that had emerged since the fall."

The Fed's balance sheet is approximately $3.97 trillion, down from a peak of over $4.5 trillion, with a majority of the decline having occurred in 2018 as seen below. Following the selloff in the fourth quarter, the Fed said it is "important to be flexible in managing the process of balance sheet normalization, and that it would be appropriate to adjust the details of balance sheet normalization plans in light of economic and financial developments." In other words, since the markets sold off, the Fed will now be "patient" in their approach, something they referenced 13-times in the minutes.

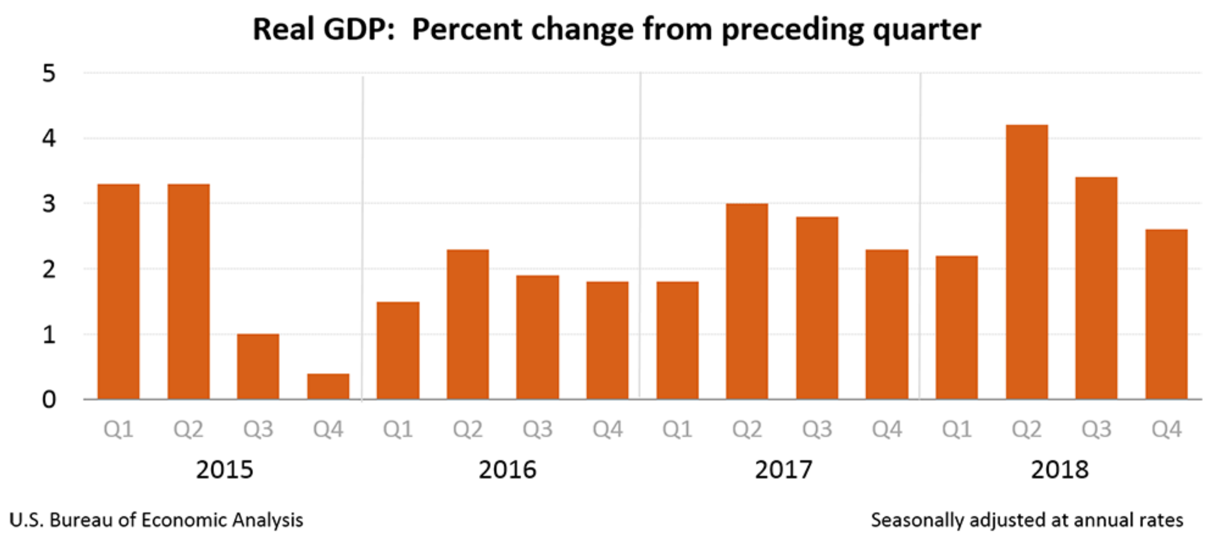


Valuation

Operating earnings for the S&P 500 for calendar year 2019 are estimated to be roughly $166, putting the current-year Price/Earnings (P/E) ratio at roughly 16.7 times earnings, which we believe is a fair value given the level of interest rates and inflation.

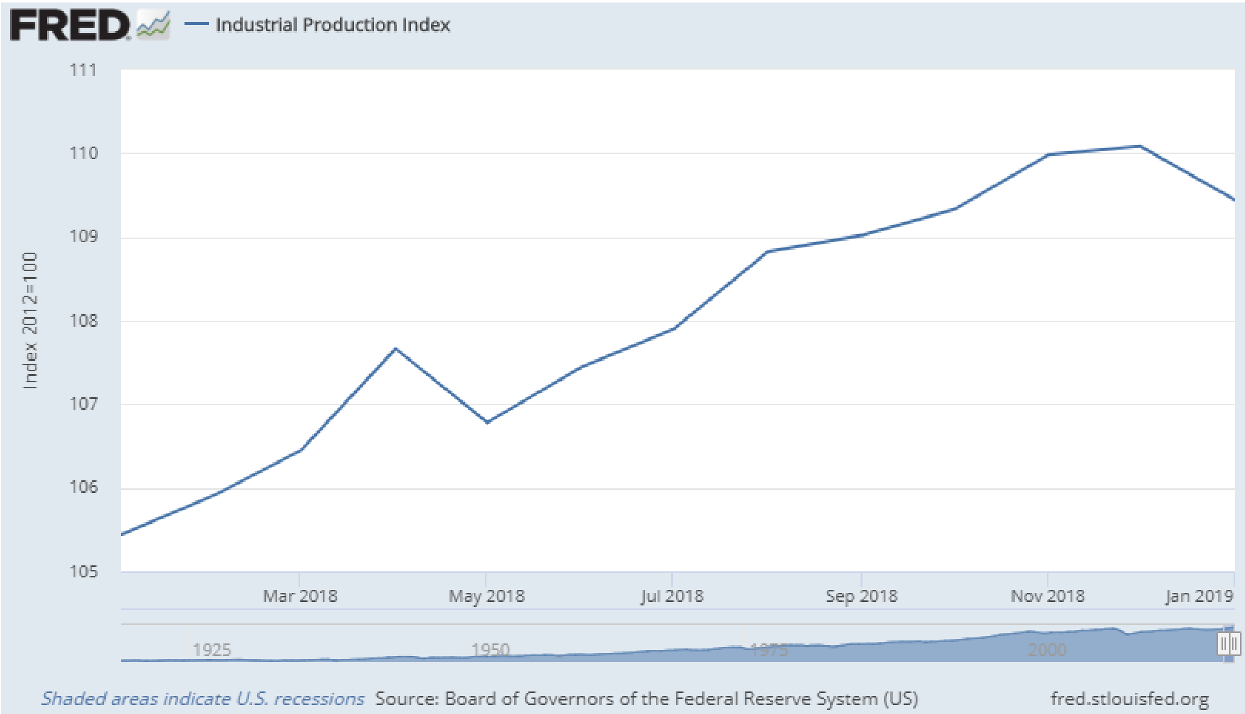
Economic Cycle

The U.S. economy grew 2.6 percent in the fourth quarter of 2018, a solid pace but a deceleration from the third quarter's 3.4 percent increase. The government shutdown and slower global growth will likely impact first quarter growth as well. Nevertheless, the U.S. economy grew 2.9 percent in 2018, up from 2.2 percent in 2017 due primarily to the tax cuts.



The Conference Board Consumer Confidence Index rebounded to 131.4 in February, up from 121.7 in January as the government shutdown ended. It is still below the 18-year high recorded last October. The Institute for Supply Management (ISM) Manufacturing survey was 54.2 percent in February, down 2.4 percentage points from January's reading.

On the other hand, housing starts fell 11 percent in the last month of 2018 and sales of existing homes fell 1.2 percent in January. In addition, the Leading Economic Index (LEI) declined 0.1 percent in January based upon preliminary data as a result of the government shutdown. Industrial production decreased 0.6 percent in January, as seen in the following chart, and U.S. retail sales fell 1.2 percent month-over-month in December, the largest drop since September 2009.



Sentiment

Investor sentiment has rebounded off the low levels seen in late December, which may need a cooling off period. In late December, the percentage of bullish advisors fell below 30. At the end of February that number was near 52 percent.

Technical Factors

The rally has repaired some of the technical damage that occurred in the fourth quarter. However, just as the selloff was extreme, so has been the rally. For example, the percentage of stocks trading below their 50-day moving average fell to about 1 percent in February. Following the 2-month rally, that number rose above 90 percent. So in a relatively short period of time the market has gone from oversold to overbought.

Outlook

The U.S. markets have had a powerful rally since year-end, however, they have not had much of a gain on a year-over-year basis. For years we have emphasized the importance that monetary policy has on the markets, often emphasizing that liquidity moves markets.

What also moves markets is corporate stock purchases. Since 2010, non-financial debt has grown by about 60 percent to roughly $9.7 trillion, and corporate earnings have increased by approximately 27 percent. However, S&P 500 earnings have increased by around 60 percent, a majority of which is due to share buybacks. In 2018, for example, it is estimated that companies in the S&P 500 repurchased $939 billion worth of shares.

Recently, Senators Charles Schumer and Bernie Sanders said they are planning to introduce a bill that would prevent corporations from buying back its own stock. That obviously is something to watch closely.

One year ago President Trump tweeted "Trade wars are good, and easy to win." Looking back, some people may have a different take. Nevertheless, over the past few weeks there has been report after report that the U.S. and China are making great strides in resolving the trade dispute. However, given that those same sentiments have been providing a bid to markets over the past few weeks, the anticipation of a resolution may have caused markets to get ahead of themselves as computer-based algorithmic trading still dominates.

While the U.S. economy is more resilient to the global deceleration than most, it is not immune. The deceleration in global growth in the second half of last year along with the temporary government shutdown and lingering effects of the trade war will likely show up in softer first quarter numbers. That the Fed is on hold will eliminate some head winds, but most of that has likely been discounted.

S&P 500 operating earnings are estimated to grow, and with the forward Price/Earnings (P/E) ratio at roughly 16.7-times earnings, we believe the market valuation is fair given the level of interest rates and inflation. Again, investor sentiment has rebounded off the low levels seen in late December, which may need a cooling off period.

As the equity bull market enters its tenth year, it is not unusual to see bouts of volatility without much year-over-year gain as the markets deal with slower growth, rising geopolitical concerns, and headwinds (or the elimination of tail winds) from global monetary policy.

As we have written about for years, quantitative easing ("QE") is an experiment that has never been done to this degree in history. Therefore, there is no playbook for the Fed, other central bankers, or investors. Today there is roughly $11 trillion worth of sovereign debt that is yielding negative interest rates as a result of QE. How that plays out remains to be seen.

What we do know is that volatility is here to stay. We also know that there are some powerful trends that seem likely to continue to advance as the digital economy evolves, which could provide substantial opportunities for investors.

Please let us know if we can be of any help. InVEST with confidence. (3.4.19)