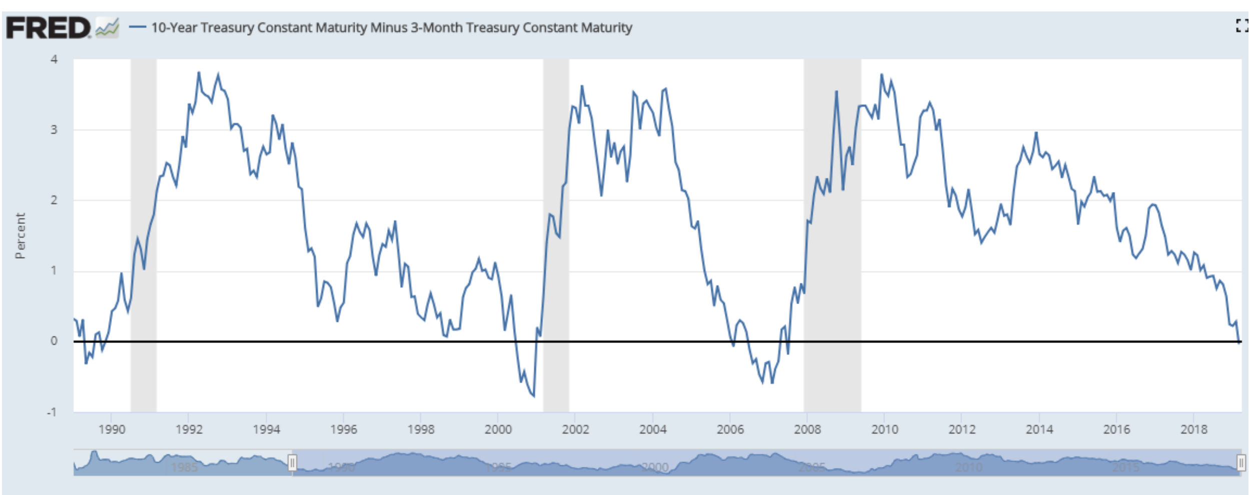
On Our Radar – April 2019

The S&P 500 gained 1.79 percent in March to close at 2834.40 as optimism over the trade negotiations between the U.S. and China and a 180 degree pivot by the Federal Reserve fueled the advance. The S&P gained 13 percent in the first quarter following the 13.9 percent decline in the fourth quarter of 2018. However, despite the impressive snapback, it is important to note that the S&P 500 traded at the 2834 level back in January 2018.

Of greater concern is that for the first time since 2007, the yield on the 10-year U.S. Treasury Note was lower than the yield on the 3-month U.S. Treasury Bill, which is known as an inverted yield curve. Specifically, on March 28, 2019, the yield on the 10-year Treasury was 2.39 percent while the yield on the 3-month Treasury Bill was 2.43 percent. The significance of an inverted yield curve is that it preceded the last three downturns as seen in the chart below, and has also preceded every recession over the past 50 years.



TJT Capital Group relies on our **InVEST Risk Model ®** to help determine financial 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) maintained interest rates on the federal funds rate at a range of 2.25 percent to 2.50 percent at their March meeting due to slowing economic growth. What is interesting is that the Fed's policy had a hand in slowing growth, and in fact was precisely what the Fed intended to do.

Back on October 3, 2018, with the Dow Jones Industrial Average trading near 26,900, Fed Chairman Jerome Powell said "we're a long way from neutral," the interest rate that is deemed to be neither accommodative nor restrictive. The Dow peaked on that day based on the expectation that the Fed was going to take away the monetary punch bowl.

Then on December 19, 2018, Chair Powell raised interest rates again and said that the balance sheet reduction was on "automatic pilot." While the Fed did not believe that the quantitative easing/balance sheet unwind would impact the markets or the economy, the markets reacted otherwise.

Some insight into the Fed's thinking was provided at the time by William Dudley, former President of the Federal Reserve Bank of New York. Following the December interest rate hike and the confirmation that the Fed's balance sheet reduction would continue, Mr. 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."

Now the Fed seems concerned about the global slowdown, and following the violent market reaction in the fourth quarter, they have changed course. In addition to putting interest rate policy on hold, the Fed intends to "slow the runoff of our [balance sheet] assets starting in May, and to cease runoff entirely in September of this year.

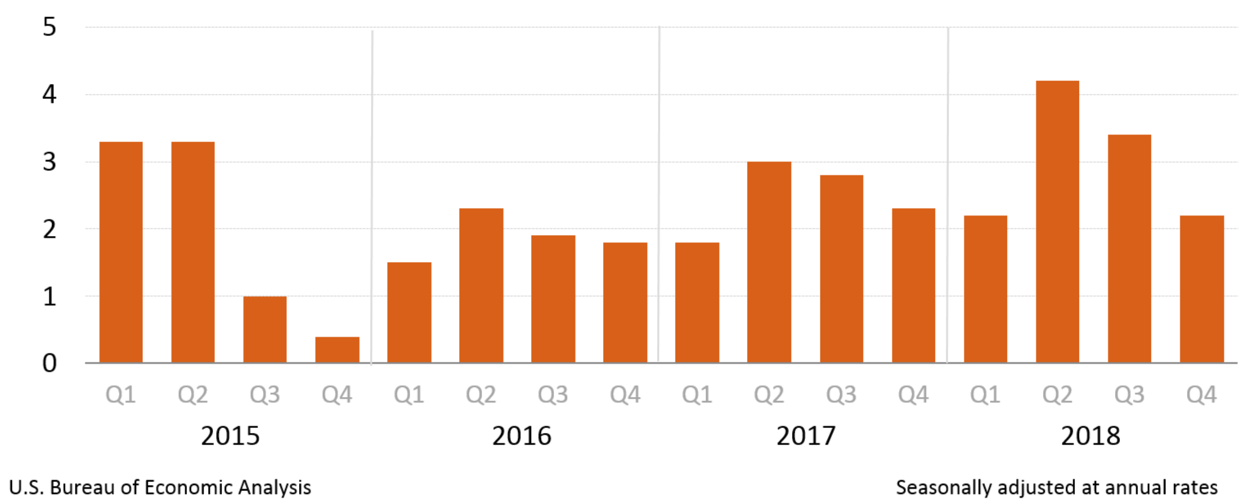
Valuation

S&P 500 consensus operating earnings estimates for 2019 are $165, which have steadily declined from as high as $176 back in September as a result of the slowing global economy, government shutdown, and ongoing trade war. Therefore, the forward Price/Earnings (P/E) ratio for the S&P 500 index is roughly 17.1, which is higher than the 25-year average of 16.1-times earnings. However, as interest rates have declined since the beginning of the year, we consider valuation to be in fair territory.

Economic Cycle

The U.S. economy grew at a revised 2.2 percent in the fourth quarter of 2018, down 0.4 percentage points from the initial estimate and down from the third quarter's 3.4 percent pace, according to the Bureau of Economic Analysis. This figure puts 2018 annual Gross Domestic Product (GDP) at 2.86 percent. The Conference Board Leading Economic Index (LEI) rose 0.2 percent in February, the first increase in five months.

Real GDP: Percent change from preceding quarter



Industrial production increased 0.1 percent in February following January's 0.4 percent decline, and the recent Institute for Supply Management (ISM) Manufacturing Survey rose to 55.3 percent from the previous month's 54.2 percent reading. However, U.S.

Retail Sales fell 0.2 percent in February, the second decline in the last three months, while the Conference Board Consumer Confidence Index declined to 124.1 from 131.4 in February.

Sentiment

Bullish investor sentiment has been on the rise since the Federal Reserve decided to pause their rate-hiking cycle. The number of bullish advisors in the Investor Intelligence survey has risen from below 30 percent in late December to approximately 52 percent in late March.

At the peak in the market back in the late September/early October 2018 time frame bullish sentiment approached 62 percent. So despite the advance from below 30 percent a few months ago, bullishness sentiment still has room to run.

Technical Factors

A good portion of the technical damage that was done to the markets in the fourth quarter has been repaired. For example, the percentage of stocks trading above their 50-day moving Average was 68.9% at the end of March.

However, the last signal generated by the Dow Theory was a “Sell” due to the breakdown of the Dow Jones Transportation Average.

Outlook

Three months ago Fed Chair Powell said “we have a strong forecast for 2019” despite the fact that there was an ongoing trade war with China, European economic growth was slowing, unresolved policy issues such as “Brexit” remained, and the U.S. was facing a possible government shutdown. The Fed tightened anyway.

Only when the stock and bond markets reacted negatively did the Fed hit the pause button, so clearly they were not being "data dependent" as those were not new issues. It is a stark reminder as to why the Fed has gotten it so wrong in the past; they live in a world of theory.

On March 20, 2019 Fed Chairman Jerome Powell said "My colleagues and I have one overarching goal: to sustain the economic expansion." Perhaps that is why Chairman Powell went on 60 Minutes the Sunday after he gave a speech titled Monetary Policy: Normalization and the Road Ahead. In that speech Mr. Powell touched on a "makeup strategy" and "makeup stimulus" in order to deal with slower growth and low inflation.

Regardless of potential new theories being introduced, what we know is that ten years following the financial crisis the monetary experiment conducted by the central banks is still ongoing. What the long-range implications are remains to be seen. European banks and some pension funds are coming under pressure due to the low rate environment.

Given that only three months ago the Fed was conducting a totally different policy is a signal that things are fluid. The system was not designed for negative interest rates, and with the massive increase in debt, any loss of confidence in central banks could test markets. Moreover, at some point the bill for the debt build-up will come due.

Already some states are enacting somewhat radical taxes in order to generate incremental revenue.

Nevertheless, with the Fed on pause and many global central banks looking at additional stimulus, monetary accommodation is back. That said, it seems to be having diminishing effects on economic growth notwithstanding the rally in global equities.

The U.S. yield curve is signalling a slowdown, however, it may be a result of the distortions created by global central bank policy. The risk is that the longer it goes on, the closer we may get to an inflection point whereby the medicine is hurting the patient.

A resolution of the trade conflicts would go a long way towards adding stability to the global economy. While there are reports that talks with China are progressing, President Trump has threatened the European Union with more tariffs if they do not negotiate a trade deal with the U.S. He said, “if they don’t talk to us, we’re going to do something that’s going to be pretty severe economically.”

We would not be surprised to see volatility stay elevated as there are several issues that could cause sentiment to become less enthusiastic. The markets have come a long way and with first quarter earnings season on the horizon, any shortfall will likely cause a reaction in price. As it stands now, first quarter earnings for the S&P 500 are expected to be roughly flat year-over-year, a significant change from the 26 percent seen a year ago.

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