On Our Radar – May 2019

The S&P 500 index rose to an all-time high of 2943.83 following a 3.9 percent gain in the month of April boosted by a stronger-than-expected Gross Domestic Product (GDP) report and generally solid corporate earnings. The rhetoric from the ongoing trade tensions with China has been toned down, however, a comprehensive deal remains elusive as issues of enforcement and the roll-back of tariffs remain unresolved.

TJT Capital Group relies on our InVEST Risk Model ® to help determine financial market conditions. The following is an update on the 5 indicators that really matter, which are the basis for InVEST.

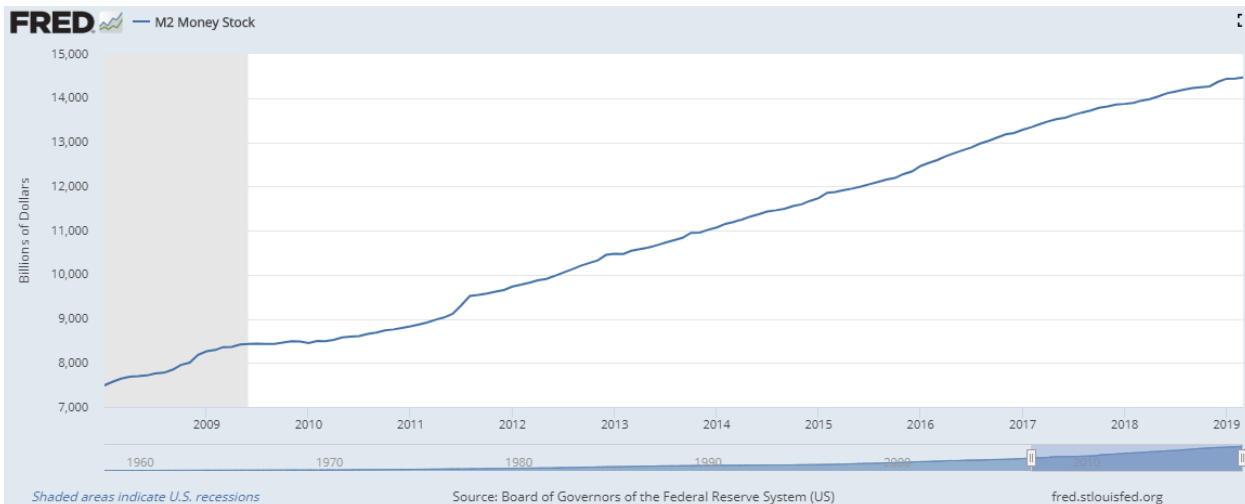
Interest Rates (Monetary Policy)

The Federal Open Market Committee (FOMC) conducted a 2-day meeting and on May 1, 2019 decided to maintain the target level for the federal funds rate at a range of 2.25 percent to 2.50 percent. The Committee acknowledged a strong labor market, solid economic growth, and subdued inflation. As such, the Fed Chairman Jerome Powell said they will be "patient" in determining what future adjustments to interest rates may be appropriate to support the economy.

The FOMC's statement said that job gains have been solid and also noted that core inflation has declined and is running below 2 percent. In fact, core inflation, which excludes volatile food and energy prices, rose just 1.6 percent in March on a year-over-year basis, and down from 1.8 percent in January and 2 percent in December, according to the Commerce Department.

Chairman Powell said he believed that the low levels of inflation were due to "transitory" factors. The problem with that statement is that the Fed has been using the "transitory" excuse for low inflation for roughly the past 8 years.

M2, a broad calculation of the money supply that includes all cash and checking deposits in addition to savings deposits, money market securities, mutual funds, and other time deposits, has roughly doubled to $14.4 trillion since the financial crisis. According to Fed theory, that should eventually create inflation. However, debt has been growing even faster, which is creating its own deflationary forces.



The European Central Bank (ECB) kept their deposit rate at minus 0.40 percent due to weak economic growth. ECB Vice-President Luis de Guindos said interest rates are likely to stay low for a long time. "The low interest rate environment is with us for the foreseeable future and is caused in large part by durable structural factors." Mr. de Guindos went on to say "Even once monetary policy normalizes, interest rates are likely to remain below levels that were common in previous decades."

Unprecedented global central bank policy is the reason why interest rates on 2-year government bonds are negative in Germany, France, Switzerland, Japan, and about a dozen other countries. The longer this goes on, it increases the likelihood that this will have significant long-term implications

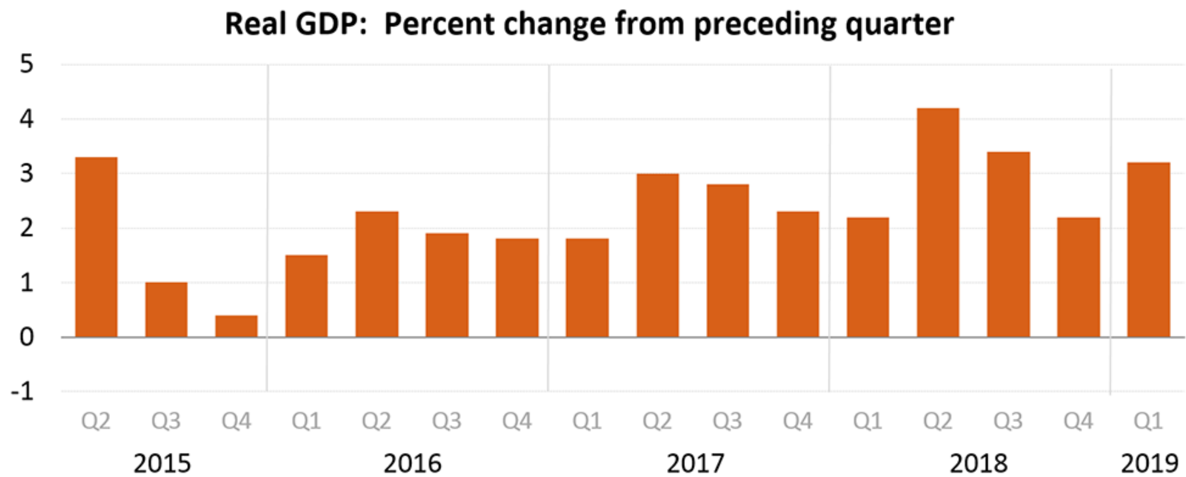
Valuation

S&P 500 consensus operating earnings estimates for 2019 are roughly $165, and are

expected to rise to $185 in 2020. Therefore, the forward Price/Earnings (P/E) ratio for the S&P 500 index is roughly 17.8, 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

Real Gross Domestic Product (GDP) increased 3.2 percent in the first quarter of 2019, up from the 2.2 percent pace in the fourth quarter of 2018, according to the preliminary estimate by the Bureau of Economic Analysis. Despite the government shutdown earlier in the year, the economy got a boost from an increase in inventories and net exports, both of which tend to be volatile. However, domestic final sales grew by just 1.4 percent in the quarter, which suggests that growth may slow from this headline number in the second quarter.



The Institute for Supply Management (ISM) Manufacturing Index fell to 52.8 percent in April from the previous reading of 55.3 percent. While readings above 50 percent indicate economic growth, this was the weakest report since October 2016. Moreover, the New Orders Index fell 5.7 percentage points in one month. On the positive side, the

Conference Board Consumer Confidence Index rebounded to 129.2 in April, up from 124.2 in March.

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 29 percent in late December to over 56 percent, the highest since early October 2018.

As a reminder, early October 2018 was the peak in the Dow Jones Industrial Average that, to date, has not been exceeded.

Technical Factors

While the S&P 500 index along with the NASDAQ Composite have made new all-time highs, the Dow Jones Industrial Average and the Dow Jones Transportation Average have not. That divergence could be a warning sign and is worth keeping an eye on.

Outlook

The combination of trade tensions, tariffs, policy uncertainty, and tighter financial conditions caused global economic growth to decelerate. Many financial markets have rebounded as some of these issues have been addressed. While the Federal Reserve's pivot from quantitative tightening – raising interest rates and reducing the size of their balance sheet – eased financial conditions, some of the other issues, such as a concrete trade agreement with China, remain unresolved.

Meanwhile, the U.S. is threatening tariffs on the European Union over $11 billion worth of goods, including wine, over subsidies to aircraft producer Airbus.

In addition, geopolitical tensions are heating up as Venezuela opposition leader Juan Guaidó attempted to bring renewed pressure on President Nicolás Maduro to step down. U.S. National Security Adviser John Bolton accused Russia of interfering in Venezuela. Russian Foreign Minister Sergei Lavrov reportedly said Russia and the U.S. had irreconcilable positions on Venezuela, but that they had agreed to continue talks.

While it is obvious that the markets have had a pretty impressive run, we are seeing some indications of excess that could be a precursor to an increase in volatility. For example, a number of "hot" initial public offerings are taking place with companies that do not have earnings, some of which are more than doubling in price on the first day of trading.

In addition, reports show that large speculators were net short a record amount of futures contracts on volatility, betting that market volatility will remain low. While these two specific data points do not mean the market is going to roll-over, they do point to a rising element of euphoria and complacency.

It could also be in response to a recent quote by Larry Kudlow, the Director of the National Economic Council who said "I don't think rates will rise for the foreseeable future, maybe never in my lifetime."

While that may be true, and good for the financial economy, parts of the real economy continue to experience headwinds, as seen in the Industrial Production Manufacturing output, which is still below the pre-crisis level.

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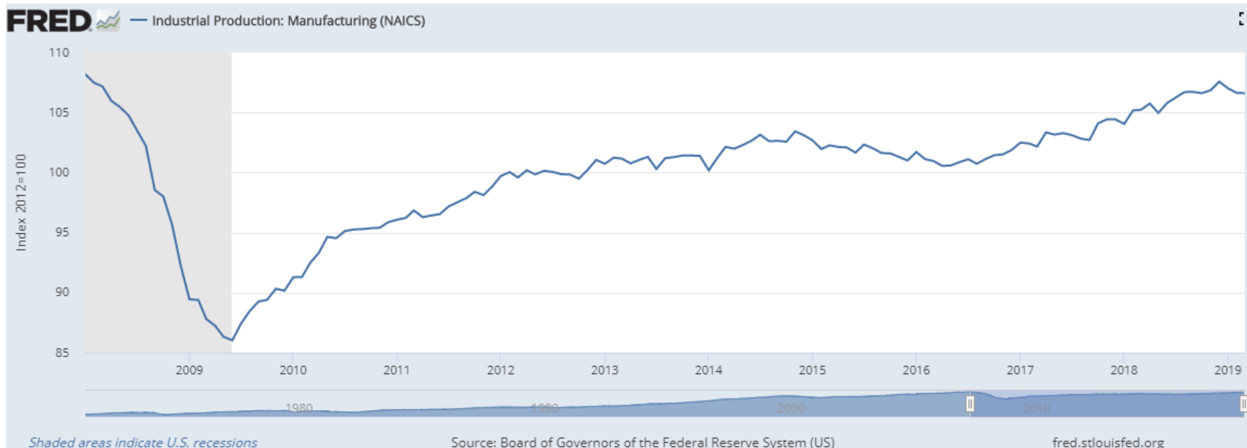

The FOMC statement noted that economic activity rose at a solid rate, but repeated that household spending and business fixed investment slowed in the first quarter. As a result, Fed policy is accommodative. First quarter earnings have been mixed, however, with some sectors thriving while others struggle. S&P 500 operating profits for the first quarter are expected to grow by less than 2 percent on a year-over-year basis.

One of the risks is that the Fed has never done Quantitative Easing before, yet they talk and act like they know the ultimate outcome. Therefore, confidence in central banks remains key as global growth decelerates and geopolitical concerns persist.

As we saw in both the fourth quarter of 2018 and first quarter of 2019, as long as trading algorithms continue to dominate price action, there will be volatility. We will continue to weigh the risk/reward in an attempt to exploit opportunities as they develop.

If you are dissatisfied with your investment results and would like your money to work smarter for you, give us a call. (5.2.19)

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