TJT CAPITAL GROUP

On Our Radar – June 2019

The escalation of the trade war between the U.S. and China is starting to bite as the S&P 500 index fell by 6.5 percent in the month of May. As a reminder, over a year ago, on March 2, 2018, President Trump wrote on Twitter "trade wars are fun, and easy to win."

On April 29, 2019, The Wall Street Journal ran a headline "Mnuchin Suggests China Trade Talks Could Wrap Up by End of Next Week." At the conclusion of the last public meeting between the U.S. and China on May 10, 2019, Treasury Secretary Steve Mnuchin said the talks were "constructive." A few hours later President Trump threatened China with tariffs on an additional $325 billion worth of goods from China.

In late May President Trump announced plans to impose tariffs on goods coming into the U.S. from Mexico. The uncertainty around global trade is destabilizing at best. It is clear that the Treasury Secretary's May 10th trade talks were anything but "constructive." The fact of the matter is we live in a global economy with supply chains all over the world. The notion that trade policy can change with one tweet is unsettling to say the least.

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)

On May 1, 2019 the Federal Open Market Committee (FOMC) decided to leave interest rates unchanged as they said "Economic growth and job creation have both been a bit stronger than we anticipated, while inflation has been somewhat weaker." In fact, the Fed's favorite inflation measure – core Personal Consumption Expenditures (PCE) - rose 1.6 percent year-over-year.

The reason for that low inflation reading, according to Fed Chairman Jay Powell, is due to "transitory" factors. Unfortunately, the Fed has been using that term for about seven years to explain why inflation has not been at the Fed's 2 percent objective.

While the U.S. stock market has not made much progress over the past 17 months, as you will see later, the Fed Chairman has had an enormous effect on the market in both directions. Consider, for example, the movement of the Dow Jones Industrial Average (DJIA) when Jay Powell has spoken:

Date	Powell Quote	DJIA Next Month(s)
Oct. 3, 2018	"We're a long way from neutral [rates]"	-18.7%
Jan. 4, 2019	"There is no preset path" for raising rates. "Patient"	+13.4%
May 1, 2019	"decided to leave policy interest rate unchanged"	-5.8%

This is by no means to suggest that monetary policy is the only factor, but it confirms that it is a very important factor.

The reality is what happened in the stock market in the fourth quarter was not what scared Jay Powell. What happened in the bond market – that is, no new high yield debt was issued over a 41-day period – is what scared Jay Powell. The debt market is like oxygen to the economy. Although nominal GDP (excludes inflation) grew by more than 5 percent in 2018, the national debt grew by more than 6 percent! So when a credit market shuts down, the Fed takes notice.

As seen below, interest rates on high yield debt rose from about 6 percent in late September 2018 to more than 8 percent by year-end. After Jay Powell's soothing words about Fed policy being "patient," yields dropped back down towards the 6 percent level. However, they are on the rise again, up to 6.6 percent as of May 31, 2019.

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 16.6, 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 3.1 percent pace in the first quarter. However, Gross Domestic Product (GDP) benefitted from a jump in inventories and a lower GDP deflator, which is used to calculate the real or inflation-adjusted GDP.

While unemployment is low and the Conference Board Consumer Confidence Index rose to 134.1 from the previous reading of 129.2, the Institute for Supply Management (ISM) Manufacturing Index fell to 52.1 percent, the lowest since President Trump has been in office.

More recently, durable goods orders fell sharply, consumer spending was flat in April, Industrial Production declined at an annual rate of 1.9 percent in the first quarter, and the housing and auto sectors are seeing increased headwinds.

Sentiment

Bullish investor sentiment turned lower in May as the markets came under increasing pressure. The number of bullish advisors in the Investor Intelligence survey dropped to 49 percent, down from over 56 percent at the end of April. Higher bullish sentiment is an indication of less money on the sidelines to invest, therefore we use the rise and fall of bullish sentiment as a contrary indicator.

Technical Factors

The S&P 500 index made a new all-time closing high on April 30, 2019, while the NASDAQ Composite made a new all-time closing high on May 3, 2019. Meanwhile, the Dow Jones Industrial Average made its all-time high back on October 3, 2018, and the Dow Jones Transportation Average peaked back in September 2018. The longer the divergence between the "Dow" indices and the S&P 500/NASDAQ goes on, the more it becomes a potential warning sign.

Outlook

As the spat with China goes into its one-year anniversary, it seems to be less of a trade war and more of an economic war. The narrative coming from the administration seems to be that China has more to lose, however, there are usually casualties on both sides in any war as well as unintended consequences. A barrel of West Texas Intermediate oil, for example, fell by double digits in the month of May.

The U.S. raised tariffs from 10 percent to 25 percent on $200 billion worth of Chinese goods, and China retaliated by raising tariffs on $60 billion worth of U.S. goods.

For background, in May 2018, the White House issued a Joint Statement of the United States and China Regarding Trade Consultations that stated "a consensus on taking effective

measures to substantially reduce the United States trade deficit in goods with China." On May 21, 2018, President Trump wrote on Twitter "China has agreed to buy massive amounts of ADDITIONAL Farm/Agricultural Products – would be one of the best things to happen to our farmers in many years."

A year later, on May 23, 2019, President Trump announced a second round of aid to farmers totaling $16 billion following the $12 billion package last July. Clearly the "massive" amounts of agricultural purchases never materialized.

President Trump has tweeted "Tariffs will bring in FAR MORE wealth to our Country than even a phenomenal deal of the traditional kind." Meanwhile, a letter from the Footwear Distributors & Retailers of America said "There should be no misunderstanding that U.S. consumers pay for tariffs on products that are imported."

On May 24, 2019, President Trump said "it's happening, it's happening fast and I think things probably are going to happen with China fast." Despite that, China recently said "We oppose a trade war but are not afraid of a trade war." In addition, China used the phrase "don't say I didn't warn you" to express that they have no intention of giving in to threats from President Trump. Furthermore, China has threatened to ban rare earth exports to the U.S., with roughly 80 percent of U.S. rare earth supplies coming from China.

And while President Trump boasts that this is the best economy in history, the stock and bond markets are not buying it. Consider this: Since President Trump signed the Tax Cuts and Jobs Act into law on December 22, 2017, about 16 months ago, the S&P 500 gained 2.5 percent through May 31, 2019. And that occurred despite greater than 20 percent earnings growth in the first three quarters of 2018. Clearly the trade war is causing a level of uncertainty that is weighing on the markets.

Moreover, the yield on the 3-month U.S. Treasury Bill was 2.35 percent while the yield on the 10-year U.S. Treasury Note was 2.14 percent. That "inverted" yield curve – where short-term interest rates are higher than long-term interest rates - has occurred before each recession over the past 50 years, including the last three recessions as seen in the following chart.

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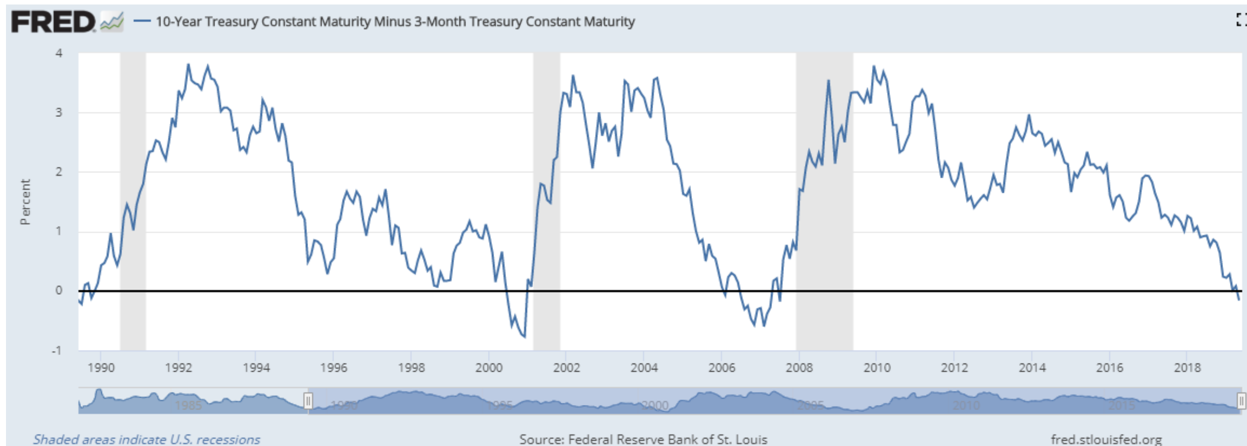

The yield curve is telling the Federal Reserve that they need to cut interest rates as monetary policy is too tight. It is also suggesting that the economy is likely to weaken. Viewed through the lens of history, tariffs can wreak havoc as they create tail risk. It is often said that if you see a disaster coming from a long way there are things that you can do to mitigate it; it's the surprises that can cause big problems.

Despite the ongoing trade battle with China, President Trump's tweet about Mexico tariffs was a surprise. In a leveraged economy with algorithmic-driven trading, one tweet can cause a financial accident.

Simply put, an uncertain environment has become more uncertain. Good quality companies are at risk as a few postponements of orders by a few weeks or months is enough for a stock to get hammered as it may "miss expectations." President Trump has delayed auto tariffs by 6 months, but that does little to help industry CEO's to plan effectively.

The fact of the matter is President Trump could single-handedly put the global economy into a recession, so how this trade dispute evolves from here is critical. While the U.S. economy is growing, it is also decelerating at a fast pace. And although the Fed is likely to cut interest rates soon, U.S. earnings have been boosted by the tax cut, which will not be repeated. Corporate share buybacks have been a key catalyst to the bull market and may not continue at the same pace.

In any market, confidence is a critical factor. When important trade or economic policy can change in an instant, confidence can erode quickly. The recent action in markets is telling the administration it is no longer about what the administration (Trump) says, it's about what they do.

While volatility can be unnerving, it can also bring opportunities. Therefore, we are on the lookout for opportunities that may present themselves as fear creeps into the markets.

If you are dissatisfied with your investment results and would like your money to work smarter for you, give us a call. (6.4.19)

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