On Our Radar – July 2019

The U.S. stock market rallied in June following one of the worst monthly declines in May as President Trump's threat to place tariffs on Mexico were cancelled, the Federal Reserve hinted of a July interest rate cut, and hopes for a truce in the ongoing trade war with China increased.

The Dow Jones Industrial Average (DJIA) rallied 7.1 percent in June, the biggest June rally in about 81 years, after declining by 6.6 percent in May. However, despite the attention-grabbing headline, the DJIA ended the month of June approximately 7 points higher than the April 30, 2019 closing level.

Moreover, although the markets have enjoyed an impressive first half in 2019, consider this: the "Dow" had to have the best monthly gain since 1938 in order to close just below a level it reached in January 2018 – about eighteen months ago. Clearly the markets have experienced massive volatility without much progress. In fact, even the S&P 500 index has gained just 2.4 percent from January 2018 to June 28, 2019.

What's more, the January 2018 levels reached were approximately one month after President Trump signed the Tax Cut and Jobs Act, which ushered in year-over-year earnings growth of 22.6 percent, 24.5 percent, and 24.2 percent earnings gains, respectively, in the first quarter, second quarter, and third quarter of 2018.

Ten years into the recovery from the financial crisis, markets have been impacted by concerns over trade policy, rising geopolitical tensions, and a deceleration in global growth. The uncertainty has been real.

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.

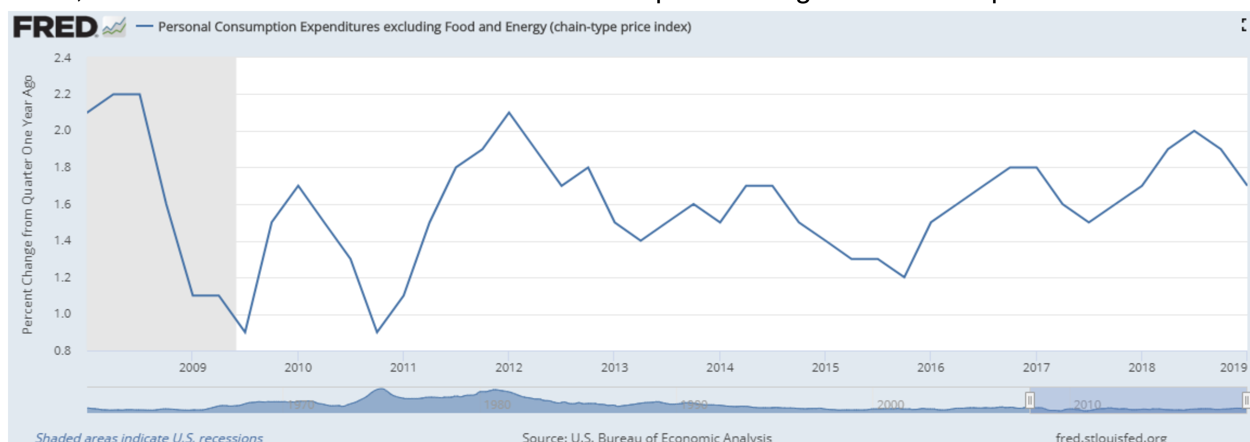
Interest Rates (Monetary Policy)

On June 3, 2019, the S&P 500 index closed at 2744.45, down 6.8 percent from its April 30th closing level, with much of that decline attributed to rising global tensions, including the threat of tariffs on Mexico. On June 4, 2019, Fed Chairman Jay Powell opened a speech regarding "developments" that occurred in May and said "as always, we will act as appropriate to sustain the expansion."

Over the next twelve days, and after a Federal Open Market Committee (FOMC) meeting, the S&P 500 gained 7.6 percent. While the advance was welcomed, it further exposed the dominance of algorithmic trading as well as a rising lack of liquidity in markets.

On June 19, 2019, Chairman Powell gave a press conference in which he laid out reasons for an interest rate cut at the next FOMC meeting in late July. This should be no surprise as the U.S. Treasury bond market has been signaling the Fed is behind the curve for some time as 10-year U.S. Treasury yields were below 3-month Treasury yields for the entire month of June.

Of greater concern, however, is the seemingly erratic policy of the Fed. The Fed has two mandates: maximum employment and price stability. The most recent unemployment rate was 3.8 percent, near the lowest in roughly 50 years, and the Fed's favorite inflation gauge, Personal Consumption Expenditures (PCE) excluding the volatile food and energy components was 1.7 percent in the first quarter as seen in the adjacent chart. In fact, since the financial crisis, the core PCE has been above the Fed's 2 percent target for all of 1 quarter.



Therefore, inflation – at least according to the way the Fed measures it – does not seem to be the problem.

In the past, however, the markets have experienced trouble when the Fed has strayed from its mandate. As you may recall, former Fed Chairman Alan Greenspan argued against derivatives being regulated, and was a proponent of expanding home ownership. While the latter was a noble objective, providing mortgages to people with no job or income verification did not work out too well.

It used to be said that Fed policy was like an aircraft carrier, that is, it took a long time to make a turn. However, under Chairman Powell's stewardship, monetary policy seems to change based upon the level of the S&P 500 index and not based upon coherent monetary principles.

For example, the reasons Mr. Powell recently gave regarding the likelihood of "additional monetary policy accommodation" were due to "crosscurrents," including slower global growth, inflation that is lower than the Fed's 2 percent goal, and trade tensions. However, all of those things were present in December when the Fed raised interest rates for the fourth time in 2018, and said the reduction in the size of their balance sheet was on "automatic pilot." Essentially, Jay Powell has put the Fed's credibility on the line as he has seemingly moved to a new objective called "sustain the expansion," a term he used nine-times at his June press conference.

Valuation

Operating earnings for the S&P 500 for calendar year 2019 are estimated to be roughly $164, putting the current-year Price/Earnings (P/E) ratio at roughly 17.9 times earnings, which we believe is a fair value given the current levels of interest rates and inflation.

Economic Cycle

Although the U.S. economy grew at an annual pace of 3.1 percent in the first quarter, there are signs that growth is slowing. For example, the Institute for Supply Management (ISM)

Manufacturing Survey in June was 51.7 percent, the lowest since 2016, and the New Orders Index was flat at 50, the lowest since December 2015. Moreover, the Conference Board Leading Economic Index was unchanged in May following a 0.1 percent increase in April.

Meanwhile, the Conference Board Consumer Confidence Index fell nearly 10 points in June to 121.5, its lowest level since September 2017, and New Home Sales fell. In addition, the 4-week moving average of unemployment claims has jumped nearly 10 percent since the second week of April. Historically an upturn in unemployment has been a precursor to an economic slowdown or worse.

Sentiment

Bullish investor sentiment has rebounded off the low levels seen as a result of the May selloff, and are now at levels that indicate the market may need a cooling off period. In late May, the percentage of bullish advisors fell below 43. At the end of June that number was above 53 percent.

Technical Factors

An all-time high was recorded in late June on the S&P 500 index, however, the Dow Jones Industrial Average was still trading below the level seen in Early October 2018,

while the NASDAQ Composite has not exceeded the late April 2019 intra-day high at this point.

Outlook

On June 18, 2019 European Central Bank (ECB) President Mario Draghi spoke of the ongoing financial crisis and the need to "counter demand shocks." He also provided some insight into one of the tools that central banks have used: forward guidance. He spoke of the time in 2012 when the bank announced Outright Monetary Transactions (OMT) and went on to say "while OMT was never activated, the effect of its announcement was equivalent to that of a large-scale asset purchase programme."

Yet that specific tool proved to be a temporary fix as the bank went on to implement unconventional measures including lowering interest rates into negative territory and implementing large scale asset purchase programs. As of today it is estimated that nearly $13 trillion of government issued debt carry negative interest rates. For example, the 10-year yields on bonds issued by Germany, Sweden, France, and Austria are all negative, that is, investors actually pay for the privilege of lending their money.

Unfortunately, what was supposed to be a short-term solution due to the financial crisis has turned into something more. As a result, Mr. Draghi recently said that "the risk outlook remains tilted to the downside" and as such, "additional stimulus will be required." He reaffirmed the bank's commitment to use all tools necessary including forward guidance, further cuts in policy interest rates, and additional asset purchases "to fulfill our mandate and achieve our objective."

More than ten years into the recovery following the financial crisis the markets continue to deal with the monetary experiment known as quantitative easing. While one might think that we should be well on our way toward a more normal environment – like getting a positive return when you lend money to governments – the central banks seem willing to go deeper into unchartered territory. Maybe that is why Chairman Powell recently said "Perhaps it is time to retire the term "unconventional" when referring to tools that were used in the crisis."

The reality is no one knows the longer-term implications of quantitative easing/negative interest rates. However, it certainly seems as though some of the global political angst can be attributed to the imbalances that negative interest rates have created. In the U.S., there is little doubt that the Fed's "generosity" over the years took pressure off Congress to work together to enact fiscal incentives.

Now there is increasing pressure on the Fed, which may affect its independence. President Trump has criticized the Fed for raising interest rates in December and reducing the size of their balance sheet. In fact he recently tweeted that the "Federal Reserve…doesn't know what it is doing." Chairman Powell pushed back by saying damage arises when policy bends to political interests.

However, contrary to general opinion, it is debatable whether the Fed has been truly independent. For example, Fed Chairman Ben Bernanke began "QE 3" in September 2012, less than two months before a Presidential election. And Janet Yellen said she was going to raise interest rates four-times in 2016, and only did so once following the election of Donald Trump. Of course there were issues with slowing global growth and the UK vote to leave the European Union ("Brexit"), but the facts remain.

Of greater concern is that former Federal Reserve Vice-Chairman Stanley Fischer said there was a good chance the Fed would not have raised interest rates in December if President Trump had been less vocal. What Mr. Fischer suggested, as it relates to monetary policy, is something other than what the Fed wants people to believe.

We highlight the Federal Reserve because monetary policy is such an important variable. The major direction of the stock market is dominated by monetary considerations. So when the Fed gives reasons for a future interest rate cut that existed in the fourth quarter when the Fed raised rates, it suggests the Fed is making things up on the fly. That sentiment appeared to be validated when the Fed's balance sheet reduction went from being on "automatic pilot" in December to a completely different policy in January.

In fact, in December Jay Powell said "If you run the QE easing models in reverse, you would get a pretty small adjustment in economic growth." Only in "Theoryland" can you cut interest rates to nearly zero and pump trillions of dollars into the system, then reverse that and expect only a pretty small adjustment. The Fed has opened themselves up to valid criticism. Now, just a few months later, the Fed is essentially saying "unconventional" is now conventional.

When asked about risk, Mr. Powell said unlike 2008, "the risk isn't in the banks…it's in market-based vehicles." Said another way, the risk is held by investors in vehicles such as hedge funds and exotic exchange traded funds (ETFs), which is why it is extremely important for market participants to have confidence in the Fed as debt has exploded and liquidity has shrunk.

Nevertheless, with the economy continuing to grow albeit at a slower pace and the Fed suggesting an interest rate cut in July, conditions remain constructive. And while corporate earnings are expected to grow in 2019, the market, as previously mentioned, has not advanced much for about 18 months due to rising economic, trade, and geopolitical tensions.

Early in an advance risks are usually overestimated as the wounds from the previous downturn are still fresh. Later in an advance risks tend to be underestimated as the scars of the previous cycle fade. Given where we are, and the fact that central banks are operating in unchartered territory, there is opportunity, but you want to be selective.

While the market welcomes the upcoming interest rate cut, counterintuitively, it was the first interest rate cut following a tightening cycle (January 2001 and September 2007) that occurred prior to the last two difficult market environments.

Please let us know if we can be of any help. InVEST with confidence. (7.1.19)

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