TJT CAPITAL GROUP

On Our Radar – August 2019

The S&P 500 index gained 1.3 percent in July and recorded its first close above the 3000 level in history, however, the index fell 1.5 percent in the last few days of the month as the Federal Reserve cut interest rates for the first time since 2008.

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)

Following an interest rate hiking cycle that saw the Federal Reserve raise the federal funds rate nine times since late 2015, the Federal Open Market Committee (FOMC) lowered the target rate by a quarter of a percentage point to a range of 2 percent to 2 ¼ percent. The Fed took back the quarter-point rate increase that they made in December, but did so by taking a huge hit to their credibility.

For years, the Fed said monetary policy was "data dependent," that is, they would adjust policy accordingly to achieve their statuary mandate of full employment and price stability. At his July 31, 2019 press conference, Fed Chairman Jay Powell acknowledged that the "outlook for the U.S. economy remains favorable," and that we have a "strong jobs market and inflation close to our objective."

Then why the interest rate cut? The basis for the rate cut was a slowdown in global growth and uncertainty regarding trade policy. As many are aware, both of those issues were present in the fourth quarter of 2018 when the Fed hiked interest rates. In fact Chairman Powell said "I think global growth started to slow down in the middle of last year" at his July press conference.

In addition, the Fed now seems to be concerned with the level of inflation. For roughly the past seven years, and as recently as May 2019, the Fed reiterated that inflation levels below their 2 percent target were due to "transitory" factors. Now, Chairman Powell gave "muted inflation" as a reason to cut interest rates. What is important to note is that "consumer price index-type" inflation has not been the problem in the past two downturns; asset inflation - technology bubble in 2000 and real estate/sub-prime mortgage credit in 2008 - was the problem.

While the Fed claims to be "data dependent," their erratic behavior over the past nine months seems to indicate they are anything but. In fact, an argument could be made that they are making up policy on the fly, which carries enormous risk more than ten years into a cycle.

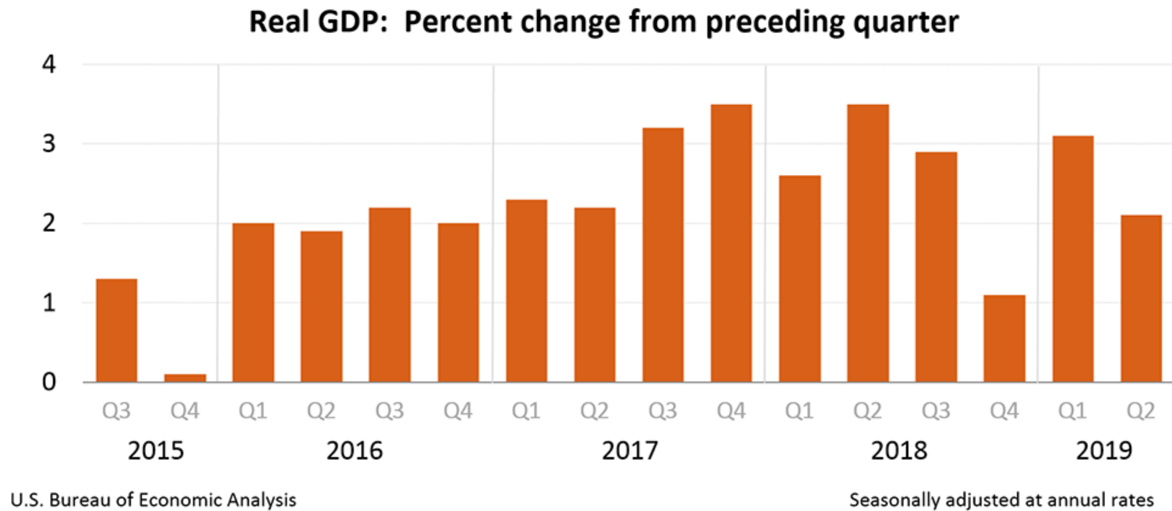
Valuation

Operating earnings for the S&P 500 for calendar year 2019 are estimated to be roughly $162, down from roughly $169 earlier this year. That puts the current year Price/Earnings (P/E) ratio at roughly 18.3 times earnings, which we believe is a fair value given the current levels of interest rates and inflation.

However, many estimates are based upon a pick-up in the economy in the second half of the year. The longer the trade uncertainty persists, the higher the risk is to those earnings estimates.

Economic Cycle

The U.S. economy grew 2.1 percent in the second quarter, down from the first quarter's 3.1 percent pace. Government spending rose 5 percent, the fastest pace since the second quarter of 2009 just as the economy was emerging from the depths of the financial crisis.



While the Conference Board Consumer Confidence Index rose to 135.7, up from 124.3 in June, the Institute for Supply Management (ISM) Manufacturing Survey fell to 51.2 percent, the lowest level since August 2016. The recent Leading Economic Index (LEI) fell 0.3 percent in June, following an unchanged reading and 0.1 percent gain, respectively, in the previous two months. And inflation, as measured by the core Personal Consumption Expenditures (PCE) rose 1.6 percent year-over-year.

Sentiment

Bullish investor sentiment continues to follow the market, and as such, the percentage of bullish advisors rose above 57 percent, a level that has flashed a "yellow light" in the past.

Technical Factors

Despite the headlines and the bullish sentiment, there are a number of indices such as the Dow Jones Transportation Average, Russell 2000 (Small-cap index – see chart), and S&P Mid-

cap that have not come close to exceeding their 2018 highs. Small cap stocks have historically peaked ahead of large cap stocks. Technically speaking, that is a cautionary sign.

Outlook

The Eurozone economy grew at 0.2 percent on a quarter-over-quarter basis, and the latest inflation reading was 1.1 percent. Outgoing European Central Bank (ECB) President Mario Draghi indicated that additional interest rate cuts and a resumption of asset purchases are likely in September.

The trade war is having a ripple effect. German factory orders, for example, have fallen 8.6 percent year-over-year, the biggest drop in a decade. China's economy grew 6.2 percent in the second quarter, down from 6.4 percent in the first quarter and 6.6 percent in calendar year 2018. Moreover, China has banned individual travel to Taiwan, and tensions between China and Hong Kong seem to be escalating.

Monetary policy is an extremely important variable when it comes to financial conditions. Financial markets run on confidence, and when confidence erodes, bad things happen. The Fed is involved in arguably one of the greatest monetary experiments in history, therefore, it is critically important for the Fed to maintain investors' confidence, especially when debt levels have exploded.

Fed policy tends to work with a lag, similar to tapping the brakes in a car. That is, the car's momentum continues, and it doesn't come to an immediate halt. That is why during periods of uncertainty, the Fed historically raised interest rates slowly. The Fed raised interest rates four times in 2018, and reduced the size of their balance sheet without giving much thought to the lag-factor, and financial conditions tightened considerably.

As a result of the Fed tightening, in addition to the ongoing trade war, fourth quarter Gross Domestic Product (GDP) grew at a revised 1.1 percent, down from the previous estimate of 2.2 percent. Now the Fed is focused on "sustaining the expansion."
We have argued for some time that a good deal of the dysfunction in Washington, D.C. can be related to the Fed's "non-traditional" policies. Rather than working together to solve some of the problems, too many have outsourced some of that to the Fed.

The trade war has been going on for more than a year, and seems to be escalating. For a good portion of that time – and to be clear, this is not an attempt to be political in any way, but to objectively and impartially look at the facts – President Trump has suggest progress. Consider the following:

- "China has agreed to buy massive amounts of ADDITIONAL Farm/Agriculture products" May 21, 2018

- "China has agreed that, during the negotiation, they will begin purchasing large amounts of agricultural product from our great farmers." June 29, 2019

- "China agreed to buy agricultural product from the U.S. in large quantities, but did not do so." August 1, 2019

As a result of that last tweet from President Trump, he said the U.S. will put additional tariffs of 10 percent on the remaining $300 billion of goods and products coming from

China on September 1st.

The fact of the matter is tariffs reduce global trade, which reduces growth, which reduces earnings, which can have a major impact on equity prices. In fact, 2019 S&P operating profit estimates have come down from over $169 to roughly $162, a decline of about 4 percent even though the economy is growing.

The longer the trade impasse goes on, the greater the potential for a shock, especially given the leverage in the system. The big question is whether the seemingly new Fed policy to “sustain the expansion” is enough to offset weaker growth.

It should be pointed out that late cycle mistakes by the Fed have been very costly to investors. As a reminder, former Fed Chairman Alan Greenspan essentially tried to “sustain the expansion” in March 2000 when he said “And I see nothing to suggest that these [technology] opportunities will peter out anytime soon” just days before the NASDAQ peaked.

In September 2007, the Fed cut interest rates and said “Today's action is intended to help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and to promote moderate growth over time."

In June 2008 former Fed Chairman Ben Bernanke also championed the economy when he said “Despite a recent spike in the nation’s unemployment rate, the danger that the economy has fallen into a “substantial downturn” appears to have waned.”

Given that this is currently the longest economic cycle in U.S. history, it is a time to be vigilant. The markets have had an impressive move, yet the large equity indices are generally in the neighborhood of the highs made in late January 2018.

Different cycles bring different risks. If trade tensions persist, softer economic growth will likely put additional pressure on corporate profits, which will likely pressure capital expenditures and even stock buybacks, which have greatly fueled the advance.

Another risk is the proliferation of algorithmic trading, which seems to focus more on trend and momentum than fundamentals.

We have always said that early in a cycle risk is overestimated as most investors are shell shocked from the previous downturn, and most stock prices reflect what has happened. And late in a cycle risk tends to be underestimated as complacency tends to set in as people let their guard down.

Last month we cautioned that "counterintuitively, it was the first interest rate cut following a tightening cycle (both in January 2001 and September 2007) that occurred prior to the last two difficult market environments."

We look at things as they are and endeavor to execute accordingly. To be clear, the risk level has risen. Today the 30-year German government bond yield fell to zero percent, and Swiss government bond yields were negative going out 50 years. That is not how the system was designed.

How things play out from central bank largess remains to be seen, but it is unlikely to be in a straight line. Clearly we expect volatility to be on the rise, which will likely challenge the general complacency we currently see in the markets.

After a decade we believe the industry has lulled investors into "riding out the storm" because every selloff in the past ten years was followed by a new recovery high. About a year before Bear Stearns required a Federal Reserve orchestrated rescue by J.P. Morgan, New Century Financial – essentially ground zero for sub-prime mortgage originations – filed for bankruptcy. It took a while to feed through the system.

The trade dispute has been going on for more than a year, and despite positive comments about pledges, virtually none of them have happened.

Just a few day ago President Trump said [European} “Auto tariffs are never off the table.” The reality is that interest rate cuts do virtually nothing to undo the uncertainty of potential from threats about future tariffs.

Simply put, our sense is that things are lining up in a way that could put investor complacency to a real test, a risk that we do not believe is priced into the markets. Should that happen, it would present remarkable opportunities for cash to be deployed.

So while our level of concern is rising and we would not be surprised if volatility picked up, so is the opportunity set that comes along with that.

Please let us know if we can be of any help. **InVEST** with confidence. (8.2.19)

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