TJT CAPITAL GROUP

On Our Radar – September 2019

On August 31, 2018, the S&P 500 index closed at 2901.52. One year later, on August 31, 2019, the S&P 500 stood at 2926.46, a gain of 0.85 percent with some significant swings in volatility along the way.

On July 31, 2019, the Federal Open Market Committee (FOMC) cut interest rates for the first time following nine rate hikes between 2015 and 2018. The S&P 500 was 2980.38 at that time. Over the next few weeks the S&P 500 had three daily declines that were greater than 2.5 percent, and it closed down 1.8 percent in the month of August. Clearly there is a lot going on, and interest rate cuts are not a panacea.

The ongoing trade war, questionable Federal Reserve policy, slowing global growth, drastic currency moves, and an economic crisis in Argentina are but a few of the major issues weighing on the markets.

On September 1, 2019, the U.S. put an additional 15 percent tariffs on approximately $112 billion worth of imports from China. In response, China introduced tariffs on about $75 billion worth of U.S. goods, including crude oil.

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)

Monetary policy is extremely important for the markets, especially in a mature cycle. Therefore, it is critical for the Fed to maintain the market's confidence. That said, Fed Chairman Powell seems to be a walking contradiction, which could test that confidence.

Consider the following:

- In Powell's most recent speech on August 23, 2019, he said that "effects of monetary policy are felt with uncertain lags of a year or more," then goes on to admit that the "global growth outlook has been deteriorating since the middle of last year," when the Fed continued to tighten policy.

- He said the "neutral real rate of interest" - the theoretical interest rate that is neither accommodative nor tight – is unpredictable and "cannot be directly observed," yet in October 2018 he said "we are a long way from neutral." So in August the "neutral" rate was unpredictable but almost a year ago it was quite clear.

- Powell said "Low inflation seems to be the problem of this era," yet on May 1st he said "there's good reason to think that these [low inflation] readings are particularly influenced by some transitory factors." For seven years the Fed claimed low inflation was due to "transitory" factors; now it is a problem.

- And while slowing global growth, trade policy uncertainty, and muted inflation were ignored in the fourth quarter of 2018 when the Fed hiked interest rates, those factors are now the reason to expect further rate cuts this year.

The reality is that the Powell-led Fed made a policy mistake in 2018. It was not so much the level of interest rates but the rate of change. Using the lower end of the federal funds range, Jay Powell increased interest rates by 80 percent in about ten months, which was the largest interest rate increase in U.S. history. Today, the current federal funds interest rate is higher than every point on the U.S. Treasury yield curve from 1-month to 30-years. The Fed is still behind the curve and will lower interest rates again in September.

A big issue seems to be that the Fed relies on "model simulations," which was the basis behind Chairman Powell saying last December "if you just run the quantitative easing models in reverse, you would get a pretty small adjustment in economic growth and real outcomes." Roughly two weeks later, the markets forced Chairman Powell to change his tune.

Fed models caused former Fed Chairman Ben Bernanke to state in January 2008 "The Fed is not currently forecasting a recession" at a time when the worst recession since the Great Depression actually began one month earlier.

In December 2018, the Fed's models indicated they needed to raise rates to slow the economy down. Those models were wrong. Now the Fed is terrified that the economy is slowing down, so they will be looking to cut aggressively. This type of policy uncertainty only adds to market volatility.

Valuation

Operating earnings for the S&P 500 for calendar year 2019 are estimated to be roughly $162, and about $181 in calendar year 2020. As we are on the cusp of the fourth quarter, the market tends to look ahead. As such, the forward Price/Earnings (P/E) ratio (2020) is roughly 16.1 times earnings, which we believe is a fair value given the current levels of interest rates and inflation.

However, the ongoing trade war and weakness in the global economy is causing many to have a low confidence level in those earnings. Essentially the longer the trade uncertainty persists, the higher the risk is to those earnings estimates.

Economic Cycle

The U.S. economy grew at a revised 2 percent pace in the second quarter, down 0.1 percent from the first estimate. Of greater concern was the drop in both the Conference Board Consumer Confidence Index and the University of Michigan Consumer

Sentiment Index. The Michigan survey saw the largest monthly decline in almost seven years, and is now at the lowest reading of the Trump administration.

Although retail sales were up 3.1 percent year-over-year, the Institute for Supply Management (ISM) Manufacturing survey fell to 49.1 percent, with the New Orders Index falling to a seven-year low. Historically, when the ISM Manufacturing index drops below 50, the probability of a recession is about 65 percent.

Sentiment

Bullish investor sentiment continues to follow the market, and as such, the percentage of bullish advisors fell below 44 percent from above 57 percent in July. We view sentiment as a contrary indicator, so a lower "bullish" figure is positive.

Technical Factors

Despite the volatility over the past 12 to 18 months, the market has been in a trading range and has not made much progress over the past year. Small cap stocks have underperformed, the Dow Jones Transportation Index is well below its September 2018 high, and the number of stocks hitting new 52-week lows have exceeded those making 52-week highs recently.

So the technical picture is mixed with some sectors doing well and others under pressure.

Outlook

Incoming European Central Bank (ECB) President Christine Lagarde said "I do not believe that the ECB has hit the effective lower bound on policy rates." Therefore, Ms. Lagarde is suggesting that the negative interest rates seen in many European countries are likely to go even more negative. The German 30-year bond yield is negative 0.20 percent. In addition, the central bank is likely to explore additional asset purchases.

Meanwhile, German business confidence fell to the lowest level in seven years after it was reported that their economy contracted in the second quarter.

The United Kingdom's new Prime Minister, Boris Johnson, has said the UK must leave the European Union (EU) on October 31, 2019, even if there is no deal. This is adding to concerns about a slowdown in the region.

China's currency (yuan) fell to the lowest level in 11 years on further trade tensions and a slowing economy as seen in the following chart. China's industrial production slowed to 4.6 percent year-over-year as did retail sales, which slowed to 7.6 percent growth from the previous month's 9.8 percent pace. China is also expected to start avoiding U.S. crude oil imports as trade tensions increase. The U.S. was the top energy producer last year, while Beijing became the world's largest oil buyer in 2017.

To be clear, the Federal Reserve has a very difficult task, especially when you consider that the non-traditional tools such as quantitative easing, and low and negative interest rates have never before been done on this scale. However, they are not doing themselves any favors. In the fall of 2018, every single FOMC participant that submitted a forecast of interest rates had the "neutral" rate well above existing rates, which led to the Fed raising interest rates late last year. Every single one of them was wrong.

The Fed’s job is even more challenging when you consider the “Jekyll and Hyde” policy regarding trade. That is not intended to be a political statement, just an observation.

For example, in early August President Trump tweeted “it is even more obvious to everyone that Americans are not paying for the Tariffs – they are being paid for compliments of China.” Roughly one week later, President Trump tweeted “we’ve delayed [some tariffs] so they won’t be relevant in the Christmas shopping season. Just in case they might have an impact on people.” This begs the question: if China is paying the tariffs, why is the Administration concerned about the Christmas shopping season?

The pressure appears to be building. Following a 623 point decline in the Dow Jones Industrial Average on Friday August 23, 2019, President Trump at the G7 Summit said China called “twice” over the weekend to discuss trade. In contrast, several sources in China said top level phone calls did not take place. Nevertheless, the market rallied on the favorable “news.”

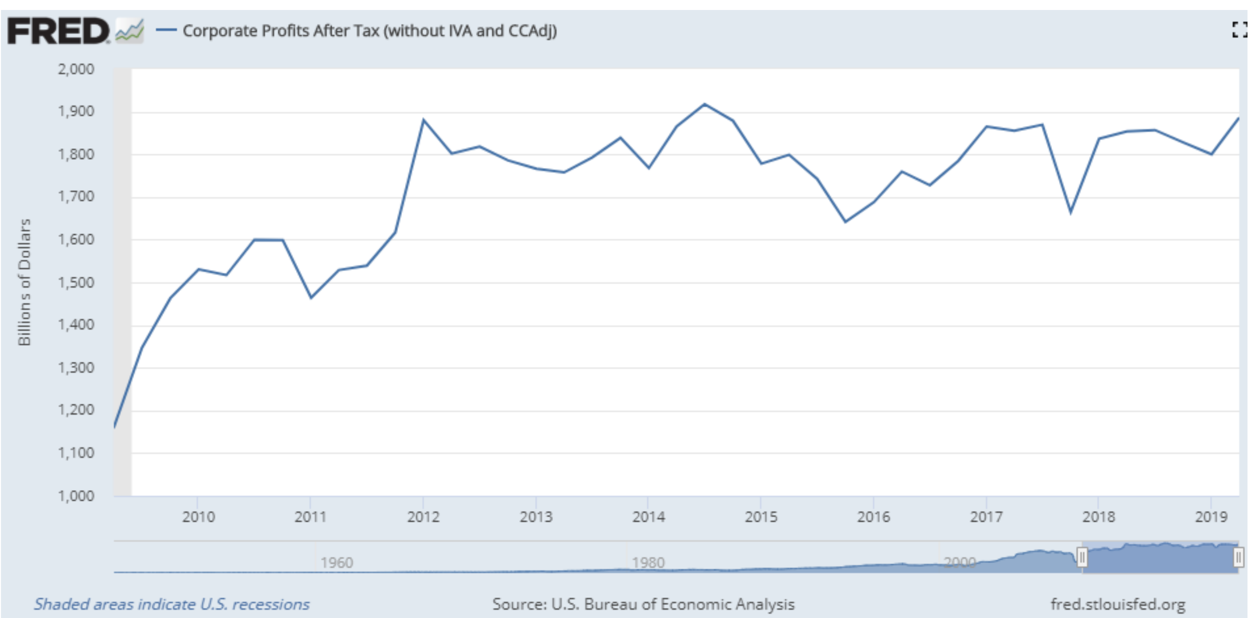
Chairman Powell has repeatedly said the Fed “will act as appropriate to sustain the expansion,” but has been unable to say how lower interest rates will offset uncertainty due to ongoing trade hostilities.

The Fed is contemplating additional asset purchases at some point in the future. After reviewing the effects on “non-traditional” policy tools previously used, the Fed said because many of the potential costs “failed to materialize, the Federal Reserve might have been able to make use of balance sheet tools even more aggressively over the past decade in providing appropriate levels of accommodation.”

However, there are costs associated with the Fed’s policy that may not be taken into consideration. For example, debt has exploded without a corresponding increase in growth, and the budget deficit this fiscal year is likely to be above $1 trillion.

Furthermore, public and private pensions around the world are falling further behind due to low or negative interest rates. At some point benefits may have to be cut. In addition, low or negative interest rate policies are keeping zombie companies alive, thereby adding to the supply/demand imbalance seen in some industries.

Corporate share buybacks, which have actually fueled a good portion of the market advance, were the slowest in the past six quarters. This is a signal that corporations are potentially tightening their belts. This is important because corporate profits actually peaked in the third quarter of 2014 at roughly $1.91 trillion as seen in the chart below. Earnings per share, however, have continued to rise due to massive share repurchases that have occurred over the past five years.



As previously stated, the S&P 500 index is virtually at the same level it was one year ago. This has occurred at a time when the U.S. economy has grown and corporate profits have been on the rise. Clearly the ongoing trade war is having an impact, and the longer it goes on the more it is likely to impact the markets.

On the other hand, President Trump has to understand that the ongoing trade dispute will affect his re-election chances, and he could quickly change course. As a reminder, in early 2018 President Trump said “I will never sign another [spending] bill like that again,” and went on to sign two more. We point this out for context that President Trump can and does change his mind.

The bottom line is that global growth is slowing and uncertainty is on the rise. Lower interest rates may support asset prices, but do little to address economic growth. While earnings growth is slowing due to the fading effects of President Trump’s tax cuts, a stronger U.S. dollar could cause additional earnings headwinds as foreign profits are repatriated.

As the rhetoric is likely to grow louder and more emphatic, we will keep our eye on the ball and look to exploit opportunities. Underneath the surface some companies and sectors have seen significant price corrections, which now offer a more compelling risk/reward than they have in a while. Nevertheless, we expect volatility to remain on the high side and are prepared to act accordingly.

Please feel free to forward this to a friend, and let us know if we can be of any help. InVEST with confidence. (9.3.19)