TJT CAPITAL GROUP

On Our Radar – October 2019

The S&P 500 index gained 1.7 percent in September despite headwinds from slowing global growth, the ongoing trade war with China, rising geopolitical tensions in the Middle East, and the new impeachment inquiry into President Trump. The S&P 500 closed out September at 2976.74, compared to 2980.38 at the end of July and 2913.98 on September 30, 2018.

Since the Federal Reserve initially cut interest rates on July 31, 2019, the S&P 500 was roughly flat at the end of September, and had gained 2.3 percent over the previous twelve months. Clearly the trade tensions have had a lot to do with that, and it has been an exhausting exercise. One day President Trump bashes China at the United Nations General Assembly, and literally the next day he says a deal with China "could happen sooner than you think."

President Trump's supporters suggest his version of "3-D chess"- a complicated negotiating game that works to his advantage – is helping, while his detractors say it is an indication of an ad hoc policy that changes depending on what the markets are doing at that time.

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)

The Federal Open Market Committee (FOMC) cut interest rates by a quarter of a percentage point for the second time since late July in order to "provide insurance against ongoing risks." While acknowledging that the "baseline outlook remains favorable," that is, the labor market remains strong and economic activity has been rising, the Committee moved to offset uncertainty due to "trade policy developments," among other risks.

In early September Fed Chairman Jay Powell said "we're not forecasting or expecting a recession." However, he has heard from business contacts that "uncertainty about trade policy has discouraged them from investing in their business." Yet that sentiment goes to a key question that the Fed has not answered with any clarity. Which is, how will interest rate cuts encourage companies to increase capital spending when the rules of the trade-game are changing rapidly?

With the effective federal funds interest rate higher than all U.S. Treasury yields going out to 10-year maturities, the odds are rising that the fed will cut interest rates again.

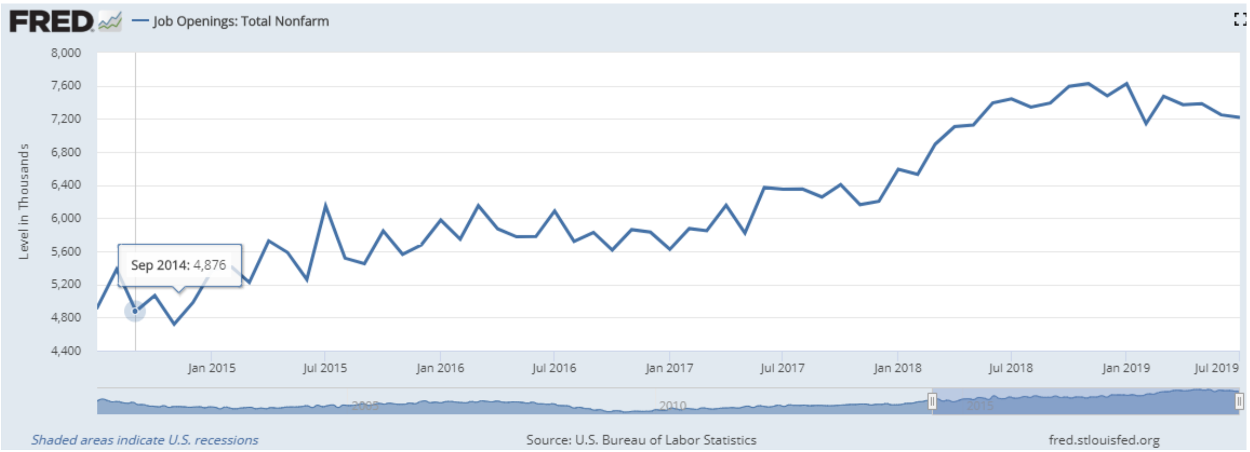
Valuation

Operating earnings for the S&P 500 for calendar year 2019 are estimated to be roughly $161, down from $170 in January. And 2020 estimates have been revised from more than $185 to $180. Therefore, the current year and next year price/earnings (P/E) ratios are 18.4-times and 16.5-times, respectively.

As such, we believe the U.S. equity market is trading at fair value given the current levels of interest rates and inflation. However, the uncertainty regarding trade policy and potential new tariffs puts a greater risk on those earnings estimates.

Economic Cycle

Although the U.S. economy grew 2 percent in the second quarter, the headwinds mentioned earlier are starting to weigh on growth. For example, while the unemployment rate was 3.5 percent in September, there have been five consecutive downward revisions to the payroll data between April and August. Moreover, the number of job openings - a leading indicator of employment - peaked in November 2018 as seen in the chart below, and has fallen by more than 5 percent since then.



The pace of employment growth has slowed. The monthly non-farm payrolls are averaging 11.4 percent fewer jobs in 2019 than they did in the first nine months of 2018. Meanwhile, the Conference Board Consumer Confidence Index fell to 125.1 in September from 134.1 in August, and the Leading Economic Index (LEI) has shown no gain in two of the past three months. Construction spending is down 1.9 percent year-over-year.

The Institute for Supply Management (ISM) manufacturing index dropped to 47.8 in September, the lowest reading since June 2009. A number below 50 indicates contraction, and this is the second sub-50 reading in as many months. The ISM Manufacturing index peaked in August 2018 at 60.8 and has been on a downward trend since.

The ISM Non-Manufacturing (service sector) survey fell to 52.6 percent from 56.4 percent in August. This was the lowest reading in three years. Clearly, the global economy is slowing down and the U.S./China trade dispute is at the heart of it.

Sentiment

Bullish sentiment, according to Investors Intelligence, rose above 55 percent at the end of September, up about 12 percentage points from August. Over the past six months, bullish levels above 55 have corresponded with an increase in volatility, at least on a short-term basis.

Technical Factors

Despite the volatility over the past year-and-a-half, the market has been in a trading range and has not made much progress over the past year. In fact the Dow Jones Industrial Average ended September at a level that was below the high reached in January 2018, some 21 months ago.

Small cap stocks, the Dow Jones Transportation Average, and many international markets have continued to underperform.

Outlook

The European Central Bank (ECB) announced plans to take their deposit rate further into negative territory and restart their bond purchase program on November 1, 2019. Their deposit rate is now minus 0.50 percent down from minus 0.40 percent, and they will be buying 20 billion euros a month of bonds. ECB President Mario Draghi, the architect of this policy, will be leaving his post at the end of October.

The United Kingdom's new Prime Minister Boris Johnson said he plans to provide a final offer to Brussels for the UK to leave the European Union. If there is no agreement, Mr. Johnson has indicated that the UK is prepared to leave on October 31st as the "Brexit" has been delayed twice following a referendum in 2016.

Complex economic and geopolitical conditions present both a challenge and an opportunity. While monetary policy can support asset prices, in reality it can do little to address economic uncertainty due to the ongoing trade tensions, where policy can seemingly change in a tweet.

In May, President Trump said "we're not ready to make a deal." He tweeted that "Tariffs will bring in FAR MORE wealth to our Country than even a phenomenal deal of the traditional kind."

In June, President Trump said "It is me right now that is holding up the deal,… And we're going to either do a great deal with China or we're not going to do a deal." In September, President

Trump said "China's being affected very badly. We're not, we're not being affected." The U.S. and China represent roughly 40 percent of the global economy. It is becoming more obvious to all parties that the global economy is indeed being affected. The recent air-pocket in the U.S. equity markets may serve as a catalyst for more constructive trade talks scheduled for October 11, 2019.

The unprecedented drone attack on Saudi oil production is a stark reminder that tensions in the Middle East can flare up anytime, and clashes in Hong Kong are on the rise.

Every cycle creates new excesses. Years of low interest rates and excess liquidity has allowed a plethora of so-called unicorn companies that were going to change the world to be financed despite continuing to lose vast sums of money. A commercial real estate company called WeWork may turn out to be this cycle's poster child.

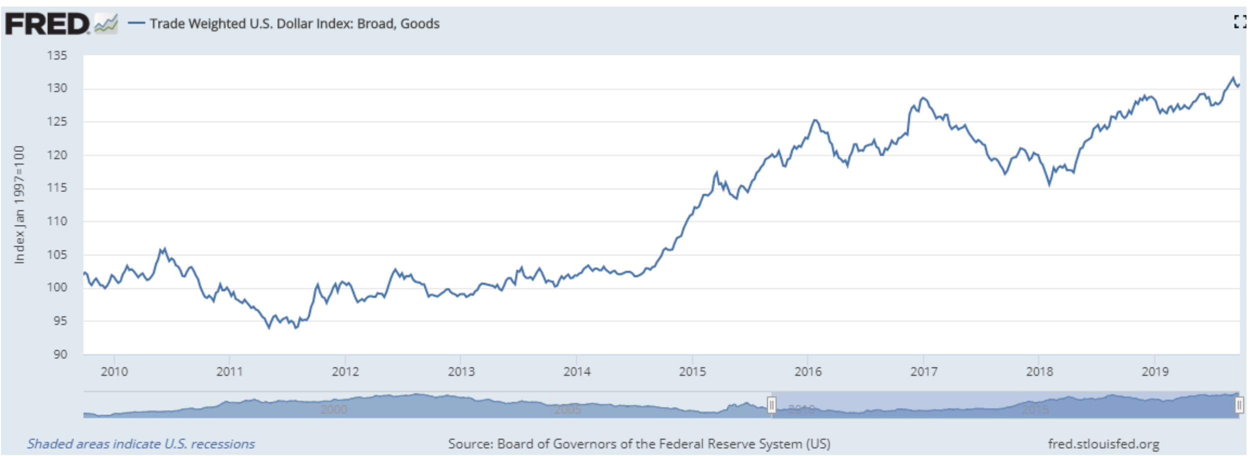
WeWork signs multi-year leases for office space and then re-leases them on a short-term basis. They are the largest landlord in New York, Chicago, and London. In 2018 WeWork lost $1.6 billion on revenues of $1.8 billion.

Real Estate billionaire Sam Zell said "Every single company in this space has gone broke." This time, however, WeWork seemingly took it to an entirely new level. In what had been valued at $47 billion in January based on a fundraising round, WeWork was unable to go public at less than one-third of that value in September.

At the pace at which WeWork is burning through cash, it has been reported that the company could run out of money by the second quarter of 2020. It failed to raise $3 billion in an initial public offering (IPO), which would have provided access to an additional $6 billion in bank financing.

A side effect of central banks pumping money into the system is that there has been a massive build-up of debt in private companies that may not have a path to profitability. The music may have stopped for some of these companies. Perhaps the next time WeWork attempts to go public they should think about changing their mission from "elevate the world's consciousness" to something more beneficial to investors.

The market has been frustrating for bulls and bears alike. While the U.S. economy is still expanding, the pace of growth is decelerating as are corporate profits. And while the Federal Reserve "will act as appropriate to sustain the expansion," the U.S. dollar is at a multiyear high as seen in the chart, which puts downward pressure on exports and corporate profits.



On October 2, 2019 the Trump administration announced that the U.S. will impose tariffs on $7.5 billion of European imports beginning October 18, 2019. The longer these trade issues go on, the more likely financial volatility will be on the rise.

Please feel free to forward this to a friend, and let us know if we can be of any help. **InVEST** with confidence. (10.3.19)

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