TJT CAPITAL GROUP

On Our Radar – November 2019

The S&P 500 index gained 2 percent in October and recorded an all-time high as the Federal Reserve cut interest rates and progress was reportedly made on the ongoing trade war with China. After exceeding the 3000 level in July and again in September - only to be followed by sharp declines - the S&P 500 broke through for the third time and took out the July high of 3025.86 to close at 3037.56 on October 31, 2019.

As noted many times, the U.S. stock market had not made material progress for the past 22 months as concerns about President Trump's trade war, Federal Reserve policy, slowing global growth, and rising geopolitical tensions have weighed on investor confidence.

Another issue that has weighed on confidence is history as many investors recall the carnage that the recession of 2008 caused. Ever mindful of the "last war," investors are keen on not making the same mistake again. What is ironic is that many recessionary signs of 2008 were ignored, especially by professionals. For example, 50 out of 50 economists surveyed by the Federal Reserve Bank of Philadelphia in February 2008 were not forecasting a recession. Fifty out of 50 professional economists were wrong as the worst recession since the Great Depression officially began in December 2007 – more than two months prior.

For months leading up to the 2008 recession the vast majority of professional economists and strategists ignored a number of signs including rising unemployment, a substantial decline in home prices, tight monetary policy (inverted yield curve), declines in the Leading Economic Indicators and corporate profits, among other things. In fact, S&P 500 operating earnings declined more than 30 percent year over year in the fourth quarter of 2007 alone.

Mindful of that, investors are not waiting for the official signs before they take cover. In the third quarter of 2019 equity funds saw the largest quarterly withdrawal since the financial crisis. Clearly the lingering concerns about the trade war and the more recent impeachment inquiry are affecting confidence as well as capital flows.

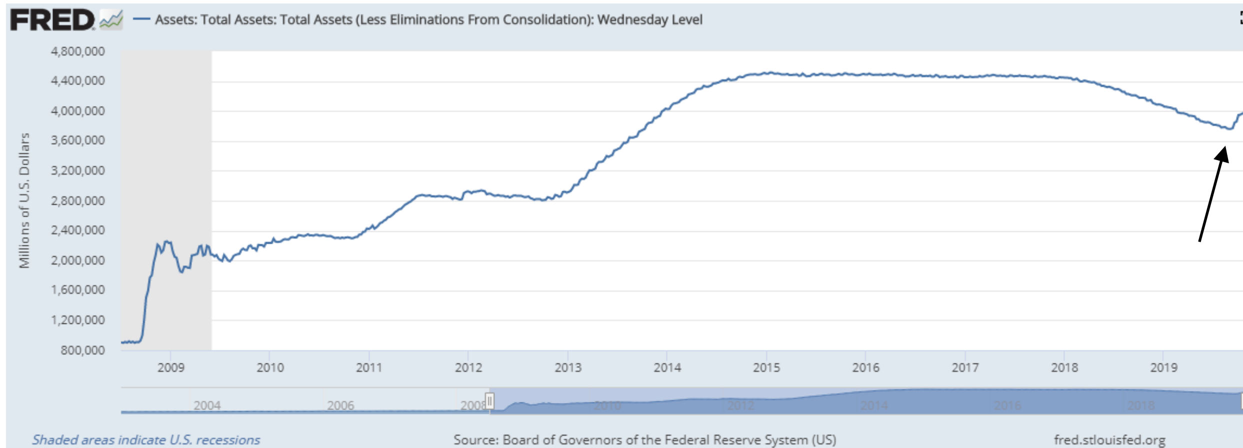
TJT Capital Group's InVEST Risk Model ® has helped our clients participate in bull markets and protect capital from the devastation of bear markets by focusing on 5 indicators that really matter when it comes to determining the health and direction of markets. The following is the most recent update.

Interest Rates (Monetary Policy)

The Federal Open Market Committee (FOMC) lowered interest rates on federal funds for a third time this year to a range of 1.50 percent to 1.75 percent. While acknowledging that the job market is healthy and household spending continues to be strong, Fed Chair Jay Powell suggested "trade developments" are the reason behind weak business investment. Specifically, the Fed cut interest rates due to "global developments and to provide some insurance against ongoing risks."

With respect to the Fed, it is not just what they say but what they do. For example, Chairman Powell says the Fed is "data dependent," but he admits they raised interest rates in 2018 as the global economy slowed and the trade war was causing uncertainty. Now the Fed is cutting interest rates, not because of employment and inflation (stable prices) - their mandate - but as a result of risks and uncertainties.

The other thing that the Fed is doing is increasing the size of their balance sheet as seen in the following chart. For the first time since 2014 the Fed's balance sheet is intentionally growing. At the end of October, the Fed's balance sheet stood at $4.01 trillion, up 6.9 percent from the early September level. While the Fed points out that this "Balance Sheet Normalization" is required to address the need for additional reserves in the system and not technically "QE" (quantitative easing), it nonetheless is adding additional liquidity to the system, which is a positive.



In September, overnight lending rates surged to a peak of around 10 percent as liquidity became extremely tight. In an effort to calm markets, the Fed announced that they would be purchasing $60 billion worth of Treasury bills “at least into the second quarter of next year.”

Valuation

Operating earnings for the S&P 500 for calendar year 2019 are estimated to be roughly $159, down from an estimate of $170 in January. And 2020 estimates have been reduced from more than $185 to $177. Therefore, the current year and next year price/earnings (P/E) ratios are 19.1-times and 17.1-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, as we have seen over the past few quarters, the uncertainty regarding trade policy and potential new tariffs puts a greater risk on those earnings estimates.

Economic Cycle

The U.S. economy grew at 1.9 percent in the third quarter according to the preliminary estimate by the Bureau of Economic Analysis. This compares to growth of 2 percent in the second quarter and 3.1 percent in the first quarter.

In particular, the Institute for Supply Management (ISM) Manufacturing index was below 50 - signaling contraction - for the third month in a row. The Leading Economic Index (LEI) fell for the second month in a row, and retail sales fell in the latest reading. Moreover, the Conference Board Consumer Confidence Index fell to 125.9 in October and has declined for three months in a row, and Industrial Production is down year-over-year. The U.S. economy is obviously slowing.

Sentiment

Bullish sentiment, according to Investors Intelligence, was about 54 percent at the end of October, up about 7 percentage points from early October. Sentiment has been more of a coincident indicator this year as rising and falling levels of bullishness have followed the rallies and declines.

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, until recently the market has been in a trading range and has not made much progress over the past 22 months. That said, should the trading range see a breakout, there is a high probability of follow-through.

In addition to the rally in the Dow Jones Industrial Average, market participants will be watching the Dow Jones Transportation Average (DJTA), which has been range-bound as well. Should the DJTA take out its 2019 high, it could make a run at the all-time high seen in September 2018.

Outlook

Global markets have been dealing with uncertainty for the past eighteen months due primarily to the ongoing trade war and the Federal Reserve's monetary policy (quantitative tightening). While the Fed has addressed the latter, business spending has been contracting not because of interest rates but because businesses do not know what the rules of the game are. The uncertainty around tariffs, which has affected global economic growth, are causing some companies to tap the brakes and push out orders.

The longer the trade tensions went unresolved, the higher the likelihood that it would eventually be felt in the U.S. In early October, President Trump announced a "substantial phase one" deal with China. While the deal is still being negotiated, China will reportedly purchase U.S. agriculture products and the U.S. will delay additional tariffs that were to go into effect in October.

Some people think nothing much has changed, while others believe progress is being made. Nevertheless, major issues such as future tariffs and the treatment of intellectual property still remain.

A new issue - the impeachment inquiry - has arrived, which could impact markets.
One of the hardest aspects to the recent environment is the overreaction to "news," which may or may not be true, but not necessarily relevant. Today we are bombarded with opinions that are designed to grab your attention, not necessarily to give you the facts. So-called experts are on display on a daily basis with no shortage of opinions on subjects ranging from politics and sports to climate science and the markets.

In total, at best, it is unproductive. At worst, some of it borders on intentional deception. We have written about the private company WeWork recently as it was valued in January at about $47 billion. Following a failed bid at an initial public offering, the value reportedly fell to $8 billion. Yet just a few months ago a well-respected New York investment bank put the value of WeWork between $62 billion and $96 billion. How can that be?

TJT Capital Group, LLC • 9 W. Broad Street • Stamford, CT 06902 • 877.282.4609 tel • 203.504.8849 fax • tjtcapital.com

Rather than get caught up in the headlines of the day, we focus on the things that have mattered the most. At this point our indicators are not suggesting a recession is on the horizon. The U.S. economy is more than $21 trillion, and it does not turn on a dime. However, if a recession does materialize, it would not be a surprise. It is the surprises that do the most damage.

Likewise, should the House of Representatives impeach President Trump, it would not be a surprise. If, however, the Republican-led Senate were to convict the President based upon what is known today, that would be a surprise to the markets. The aforementioned is not a prediction, but is a non-biased, non-political market observation.

With the economy still growing and monetary policy more accommodative, the market conditions have actually improved. What is unlikely to change, however, is the volatility that we have experienced over the past twelve months. As such, we believe declines present buying opportunities. (11.5.19)

Want to have *On Our Radar* automatically sent to your email every month?

Click Here to Sign Up

Disclaimer: This is for informational purposes only and does not constitute an offer to buy or sell any securities. Past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the investment, investment strategy, or product made reference to directly or indirectly in this article will be profitable or suitable for your portfolio. Nothing mentioned herein is a substitute for personalized investment advice from TJT Capital Group, LLC. Please request a copy of our disclosure statement for further information.