On Our Radar – December 2019

The U.S. equity markets recorded all-time highs in November as momentum from trade deal optimism along with a liquidity injection from the Federal Reserve boosted risk assets. In addition, some money that had moved out of equities on concerns about an economic recession and the impeachment inquiry came back in, and some hedge funds that had bet against the market were forced to cover their short positions.

On October 11, 2019 President Trump announced a partial trade deal with China saying "we have come to a very substantial phase one deal." On October 13, 2019, President Trump tweeted "My deal with China is that they will IMMEDIATELY start buying very large quantities of our Agricultural Product, not wait until the deal is signed over the next 3 or 4 weeks."

The "deal" announced in October was supposed to have been signed in November. Yet on December 3, 2019, President Trump said at a NATO summit "in some ways, I think it's better to wait until after the election" to do a deal with China.

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)

Fed Chair Jerome Powell provided a favorable economic overview to Congress highlighted by the near 50-year low in the unemployment rate. He said the Fed sees a sustained expansion of economic activity, a strong labor market, and inflation near its 2 percent objective as the most likely outcome. However, he noted that sluggish global growth and trade developments have weighed on the economy and pose ongoing risks.

Furthermore, Chair Powell reiterated should developments emerge that cause a material reassessment of their outlook, the Fed would respond accordingly.

In mid-November, Chair Powell met with President Trump and Treasury Secretary Mnuchin at the White House to discuss the economy and, in all likelihood, monetary policy. Following that unscheduled meeting, the Fed issued a statement stating that monetary policy will be "based solely on careful, objective, and non-political analysis."

Over the years we have laid out the case that former Fed Chairman, Ben Bernanke, the architect of the post-financial crisis monetary policy, is still influencing decisions. For example, in a 2017 paper titled Monetary Policy in a New Era, Mr. Bernanke referenced a new policy-framework that included a "makeup strategy" for inflation.

In addition to Chair Powell referencing "makeup strategies" in a speech given in March 2019, Federal Reserve Bank of Chicago President Charles Evans suggested that the Fed let inflation run to 2.5 percent before considering hiking interest rates. The Fed is terrified of deflation, which according to Ben Bernanke "is in almost all cases a side effect of a collapse in aggregate demand." That is precisely why Jay Powell recently said "it is essential that we at the Fed use our tools to make sure that we do not permit an unhealthy downward drift in inflation expectations and inflation."

Valuation

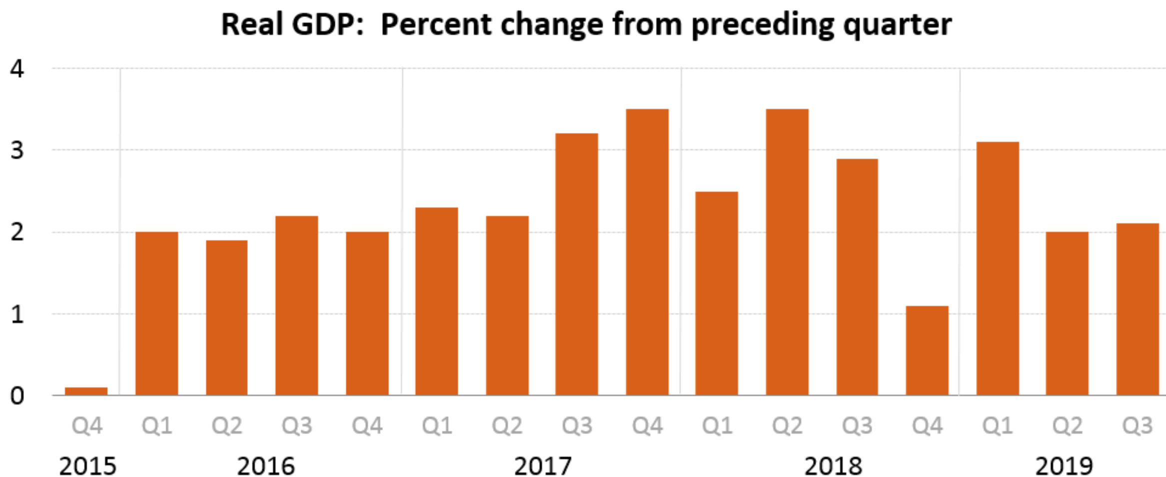
Operating earnings for the S&P 500 for calendar year 2019 are estimated to be roughly $158.50, down from an estimate of $170 in January. And 2020 estimates have been reduced from more than $185 earlier this year to less than $177.

As the market looks ahead to the year 2020, the forward price/earnings (P/E) ratio is roughly 17.8-times earnings. Given the current level of interest rates and inflation, we consider the market to be fairly valued.

Economic Cycle

The U.S. economy grew at a revised 2.1 percent pace in the third quarter, up from the previous estimate of 1.9 percent growth. The concerns about a recession seem premature at this point, however, there is no doubt that the global economy is still dealing with the headwinds from the ongoing trade war.

For example, the Leading Economic Index declined for the third consecutive month and the Institute for Supply Management (ISM) Manufacturing survey dropped for the fourth consecutive month.



Moreover, Industrial Production is down 1.1 percent year-over-year and the Conference Board Consumer Confidence Index declined for the fourth consecutive month. On the other hand, retail sales rose 3.1 percent year-over-year.

Sentiment

According to Investors Intelligence, bullish sentiment rose above 58 percent at the end

of November, up about 6 percentage points from late 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

After peaking in July, U.S. equity markets traded in a range until new highs were achieved beginning in early November in the Dow Jones Industrial Average, the S&P 500, and the NASDAQ Composite. The new highs corresponded to the Federal Reserve increasing the size of its balance sheet and growing optimism over a trade deal with China.

While the major U.S. equity averages have several new highs this year, the Dow Jones Transportation Average is still down roughly 7. 5 percent from a year ago as the manufacturing side of the economy continues to struggle.

Outlook

Objectively speaking, over the past eighteen months the Trump administration has touted several “trade agreements” yet, to date, nothing of substance has come through. For example, on May 19, 2018, the White House issued a press release stating that “ China will significantly increase purchases of United States goods and services.”

It is obvious that there is a serious issue of trust on both sides. A recent “tell” that the Phase 1 trade deal perhaps was in trouble could have been seen from a tweet from the editor of the Global Times, a China state-controlled newspaper, when he wrote a “friendly reminder” to U.S. farmers not to rush out and buy new tractors “until a trade deal is signed and still valid six months after.”

The “Phase 1” deal was supposed to be the so-called low-hanging fruit. If both sides can’t get the so-called easy part done, how are they going to tackle the more complicated issues such as intellectual property and forced technology transfers?

Further complicating issues is that President Trump signed the Hong Kong Human Rights and Democracy Bill, which caused China to threatened retaliatory consequences. What’s more, President Trump has still not decided on whether to go forward with additional tariffs scheduled to take effect on December 15, 2019.

What President Trump has vowed to do is impose new tariffs on steel and aluminum imported from Argentina and Brazil. In addition, he has threatened tariffs on imports from France due to their new digital tax on U.S. technology companies.

While protectionism is on the rise, it is clear that the Fed has used monetary policy to underwrite the trade war risk. The Fed has referred to their recent interest rate cuts and expansion of their balance sheet as “some insurance against ongoing risks.” The Federal Open Market Committee (FOMC) meets again on December 10-11, 2019, although no change in interest rate policy is expected.

To sum up, the U.S. economy is growing and monetary policy accommodative, which is usually a good combination for risk assets. That said, much of the recent rally can be attributed to the trade “deal” that has yet to be signed. Any disappointment in a trade deal could pressure the markets.

Year-end portfolio rebalancing and tax-loss selling in December may also bring wide swings. Furthermore, computer generated algorithmic trading in thin markets has the potential to exaggerate moves on any surprise headlines or tweets.

While the news has been filled with reports regarding the impeachment proceedings, it

has been quiet about the fact that Congress has until December 20th to approve an appropriations bill for the rest of fiscal 2020. As this is an election year, there is essentially zero probability for another government shutdown. However, that does not mean it will not be without drama over the next few weeks.

Despite the headlines, narratives, and ongoing drama, we continue to be focused on opportunities that the market may present, and look to take advantage of volatility. (12.3.19)

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