On Our Radar – January 2020

The 2019 year began with the ongoing partial government shutdown, the Robert Mueller investigation into election interference, the continuation of the trade war with China, and a Federal Reserve that rattled markets by raising interest rates four times and stated the reduction of their balance sheet was on "automatic pilot."

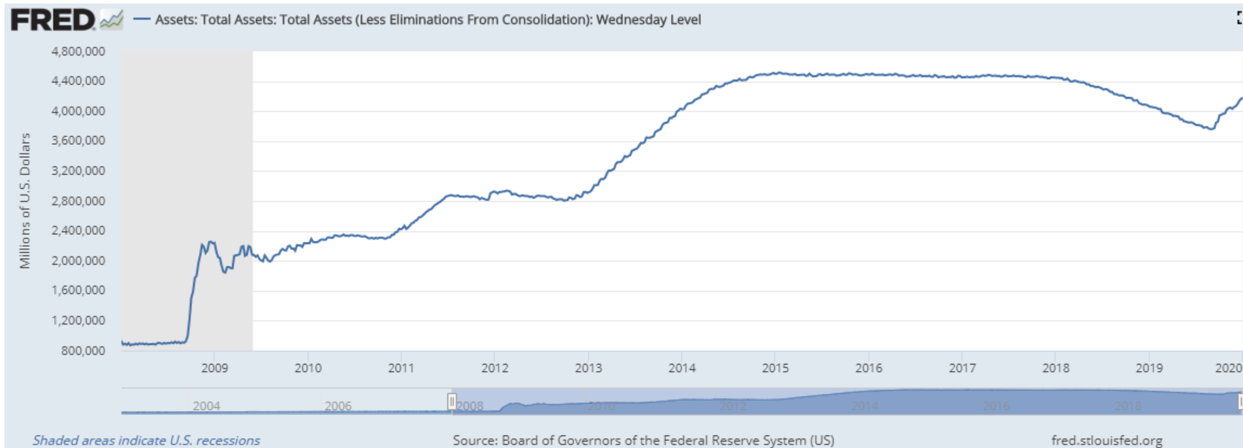
As the 2019 year came to a close, the Mueller Report turned out to be a non-event, a "Phase 1" trade agreement with China was announced, the Federal Reserve cut interest rates three times and began to increase the size of their balance sheet again, and the S&P 500 index rallied by more than 28 percent.

The political drama in Washington continued, however, with the House of Representatives voting to impeach President Trump primarily along party lines, yet the articles of impeachment have not been sent to the Senate at this time. The 2020 New Year began with rising geopolitical tensions as a result of a deadly drone strike on an Iranian general.

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 Reserve increased the size of their balance sheet by roughly 11 percent to more than $4.17 trillion in an effort to address issues in the overnight lending market as some short-term interest rates rose to more than 10 percent in mid-September. As you can see from the following chart, the Fed began to unwind the amount of securities they held beginning in the second quarter of 2018, reducing the amount to roughly $3.76 trillion in August 2019. That is about the time when the "plumbing" in the overnight repurchase agreement ("repo") area of the financial markets began to experience distress.



The Fed expects to continue with overnight repurchase operations until January 14, 2020, and is expected to purchase $60 billion of Treasury Bills at least into the second quarter. While that may alleviate the problem in the short-term, some are suggesting that the post financial crisis liquidity requirements need to be adjusted.

The Fed's favorite measure of inflation - the core personal consumption expenditures - rose 1.6 percent year-over-year. And with the economy growing, the unemployment rate at a 50-year low, and trade tensions substantially reduced, the Fed is expected to hold interest rates steady over the next few months.

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

Click Here to Sign Up

Valuation

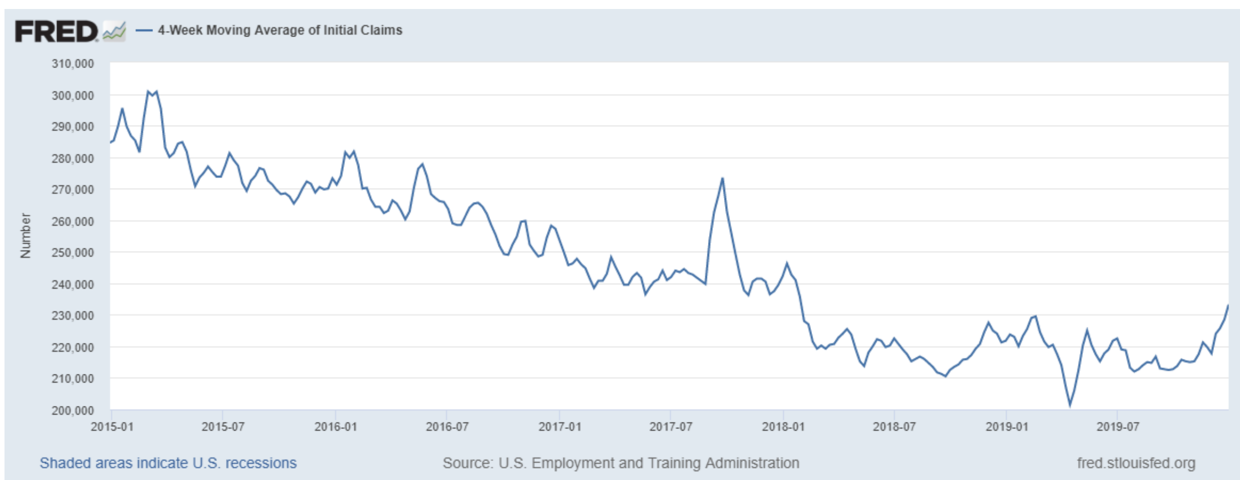
The S&P 500 index ended the 2019 calendar year at 3230.78. As we await fourth quarter earnings, the earnings estimates for 2019 are roughly $158, which translates into a price/earnings (P/E) ratio of 20.4.

Operating earnings for the S&P 500 for calendar year 2020 are estimated to be roughly $175, which puts the forward P/E ratio at 18.4-times earnings. Given the current level of interest rates and inflation, we believe the U.S. equity market is trading at fair value.

Economic Cycle

The U.S. economy grew at an average pace of 2.4 percent in the first three quarters of 2019 despite the headwinds from trade tensions. Manufacturing, however, was impacted by the slowdown in global growth. The Institute for Supply Management (ISM) Manufacturing index fell to 47.2 in December, the fifth consecutive reading below 50 – signaling contraction – and the weakest since June 2009.

While the unemployment rate ended the year at a 50-year low of 3.5 percent, the four-week average of unemployment claims rose to more than 233,000 at the end of December. This is the highest level since early 2018 and more than 15 percent above the April 2019 low. This needs to be watched closely as it is consistent with the recent Leading Economic Index, which was unchanged in November following 0.2 percent declines in both September and October.



Sentiment

According to Investors Intelligence, bullish sentiment rose about 58 percent recently, essentially rising in lock-step with the stock market rally since early October. Over the past six months, bullish levels above 55 have corresponded with an increase in volatility, at least on a short-term basis.

Bullish sentiment above 60 percent was present in October 2018 right before the double-digit decline in the market averages.

Technical Factors

The market broke out of its 22 month trading range in October just as the Federal Reserve began to increase the size of its balance sheet. Over that near-90 month period, half of the weeks showed a positive return and half a negative return.

As we wrote a couple of months ago, "should the trading range see a breakout, there is a high probability of follow-through." That is exactly what has happened.

That said, the rally has pushed the percent of stocks trading above their 50-day moving average to more than 70 percent, a level that is considered overbought.

Outlook

While the 2019 headline returns are impressive, it is important to remember that as of August 2019, the S&P 500 index was up roughly 1 percent from its January 2018 level. That was nineteen months without much progress, which included several bouts of weakness as uncertainty surrounding the ongoing trade war weighed heavily on sentiment, especially as additional tariffs were threatened.

It has been reported that the Phase 1 trade deal with China is scheduled to be signed in mid-January, and that China has agreed to purchase American farm goods such as soybeans in exchange for reduced tariffs. There is some skepticism about just how much was accomplished

because the administration has not released the fine print. Phase 1 was supposed to be the easy stuff.

The Mueller Report has been replaced with impeachment proceedings as the thing that Washington is obsessed with along with the 2020 elections. The House of Representatives did find time to approve the new United States-Mexico-Canada Agreement (USMCA) on trade, now it awaits Senate approval.

The returns in the U.S. equity markets over the past decade have far exceeded the international markets, including emerging markets. In addition to economic growth and positive nominal interest rates, the U.S. markets also attracted foreign capital due to the general strength of the U.S. dollar. As the dollar rose in value relative to other currencies, it attracted more capital. Should the trade weighted dollar weaken and the global economy begin to improve, especially in manufacturing, it may be a catalyst for international markets to improve.

With the economy growing, corporate profits expected to rise, and a more accommodative Federal Reserve, the conditions for the U.S. markets are still favorable. However, like we saw in 2018, volatility could spike at any time as computer-generated algorithms still dominates daily trading. Moreover, as geopolitical tensions in the middle-east are on the rise, any retaliation by Iran could set the stage for a more challenging environment, especially following a rally.

Yet as we have seen since 2009, markets can go down but they have yet to stay down as the Fed is printing. Therefore, we would view any spike in volatility as an opportunity. (1.6.20)

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.