TJT CAPITAL GROUP

On Our Radar –February 2020

U.S. financial markets began 2020 with the continued momentum seen late in 2019 on the easing of trade tensions, steady economic growth, and an accommodative monetary policy. The Dow Jones Industrial Average closed above 29,000 and the S&P 500 closed above 3300 for the first time in history. The markets were able to shrug off concerns about rising geopolitical tensions with Iran and the impeachment trial in the Senate until fears about the coronavirus started to escalate.

U.S. equity markets declined by roughly 3 percent in the last six days of January as the World Health Organization declared the coronavirus a global health emergency. Adding to those concerns is the lack of transparency about the origins of the virus and the general distrust of government institutions.

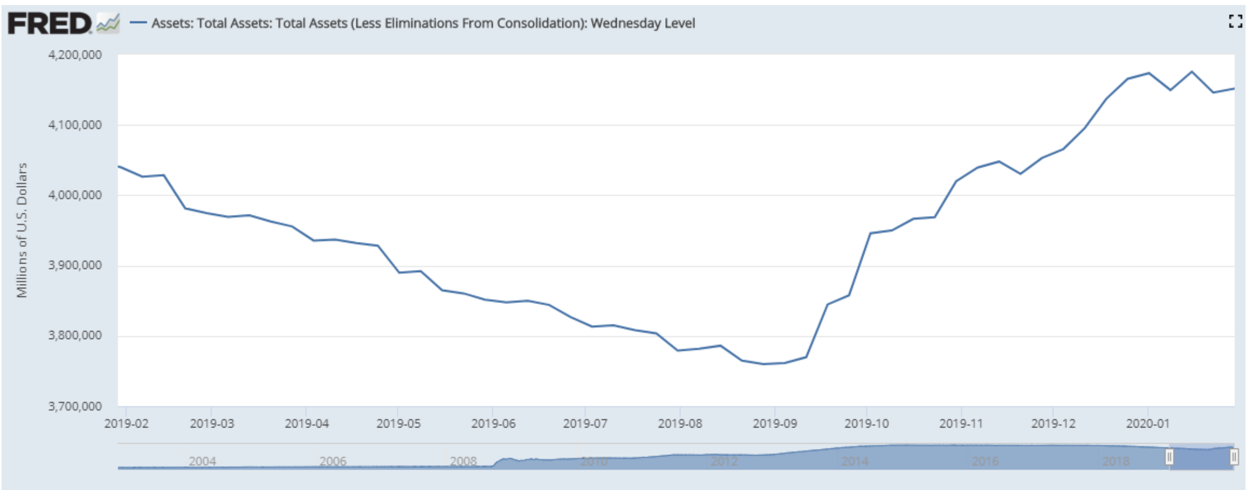
TJT Capital Group's InVEST Risk Model ® has helped our clients participate in bull markets and protect capital from the devastation of bear markets by focusing on 5 indicators that really matter when it comes to determining the health and direction of markets. The following is the most recent update.

Interest Rates (Monetary Policy)

The Federal Open Market Committee (FOMC) kept interest rates on the federal funds rate steady at a range of 1.50 percent to 1.75 percent, but did adjust the policy on "repo" (repurchase agreement) operations. As a reminder, overnight interest rates on repos spiked to about 10 percent in September 2019. At that time the Fed suggested it had to do with things such as corporate taxes, and were confident the market would soon go back to "normal."

In October, the Fed announced that they would be purchasing $60 billion worth of U.S. Treasury securities at least until the second quarter of 2020, and would conduct additional repo operations "at least through January" of 2020. The "temporary" overnight repo operations amount was roughly $120 billion a day.

In late January the Fed announced it was expanding those repo operations "at least through April 2020." After steadily increasing its balance sheet between September 2019 and January 2020 as seen below, the Fed has been less aggressive over the past few weeks. However, with the recent adjustment to policy, that is likely to change.

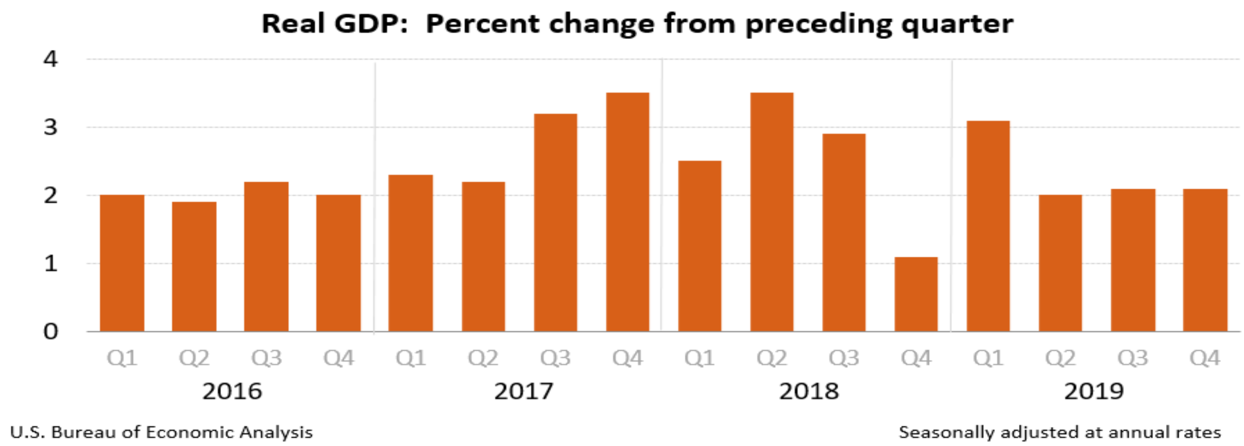


Valuation

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. Year-over-year earnings growth is expected to be roughly 10 percent. 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 2.1 percent in the fourth quarter and 2.3 percent for the 2019 calendar year, down from 2.9 percent in 2018, due to fading effects of the tax cuts and fallout from the trade war. The Institute for Supply Management (ISM) Manufacturing survey rose to 50.9, the highest in six months, from 47.8 the previous month. U.S. consumer confidence rose on optimism about the trade deal, which should help consumer spending, and near-record mortgage rates are supporting housing.



In contrast, Industrial Production fell 0.3 percent last month and declined 1 percent on a year-over-year basis, and the Leading Economic Index (LEI) has declined in four of the last five months. In addition, although the unemployment rate held steady at 3.5 percent, non-farm payrolls increased by only 145,000. Last year saw the slowest pace of job creation since 2011.

Sentiment

According to Investors Intelligence, bullish sentiment rose to about 59 percent recently, essentially mirroring the rise in the stock market. However, bullish sentiment levels above 60 percent have previously corresponded with an increase in short-term volatility.

Technical Factors

New highs in the major equity indices confirm the bullish uptrend that has been going on since October, precisely with the Fed expanding their balance sheet. When asked about the correlation, Fed Chairman Powell responded that it is "very hard to say with any precision" what is affecting the stock market.

Outlook

New stock market highs were seen as the U.S. and China finally signed the Phase One trade agreement and Congress approved the USMCA (U.S.-Mexico-Canada) trade agreement, which replaced the North America Free Trade Agreement (NAFTA).

The positive sentiment was tested early in the month on fear of an outbreak of war between the U.S. and Iran due to a drone strike on an Iranian intelligence commander. Iran responded in kind by firing missiles at multiple bases in Iraq. As the tense situation progressed and cooler heads ultimately prevailed, the market advance continued with new highs across the board. That was until fears of the coronavirus caused volatility to spike.

In addition to a selloff in stocks, the bond market saw yields on the 10-year U.S. Treasury Note fall below the yield on the 3-month Treasury Bill (known as an inverted yield curve). Whether that persists or not remains to be seen, but it is a reflection of the unknown impact of coronavirus on economic activity.

We have pointed out that Fed Chairman Jay Powell has a tendency to repeat words or phrases that he wants to convey to the markets. Over his tenure he has often repeated "sustain the expansion" and "act as appropriate" to indicate the Fed's support for economic growth. In his January 29, 2020 press conference Mr. Powell referenced "ample" reserves eighteen times. Clearly the Fed is going to make sure that liquidity is flowing.

What is ironic is that the Fed is doing this even as we have negative real interest rates. The Fed's preferred inflation measure - core personal consumption expenditures (PCE) - increased 1.6 percent year-over-year, yet the three-month Treasury Bill yielded 1.55 percent at the end of January. Therefore, short-term interest rates are lower than inflation.

While the liquidity backdrop is favorable and the economy is growing, investors should brace for more volatility due to these ongoing developments and the proliferation of trading algorithms, which can cause wide swings in prices. (2.6.20)

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