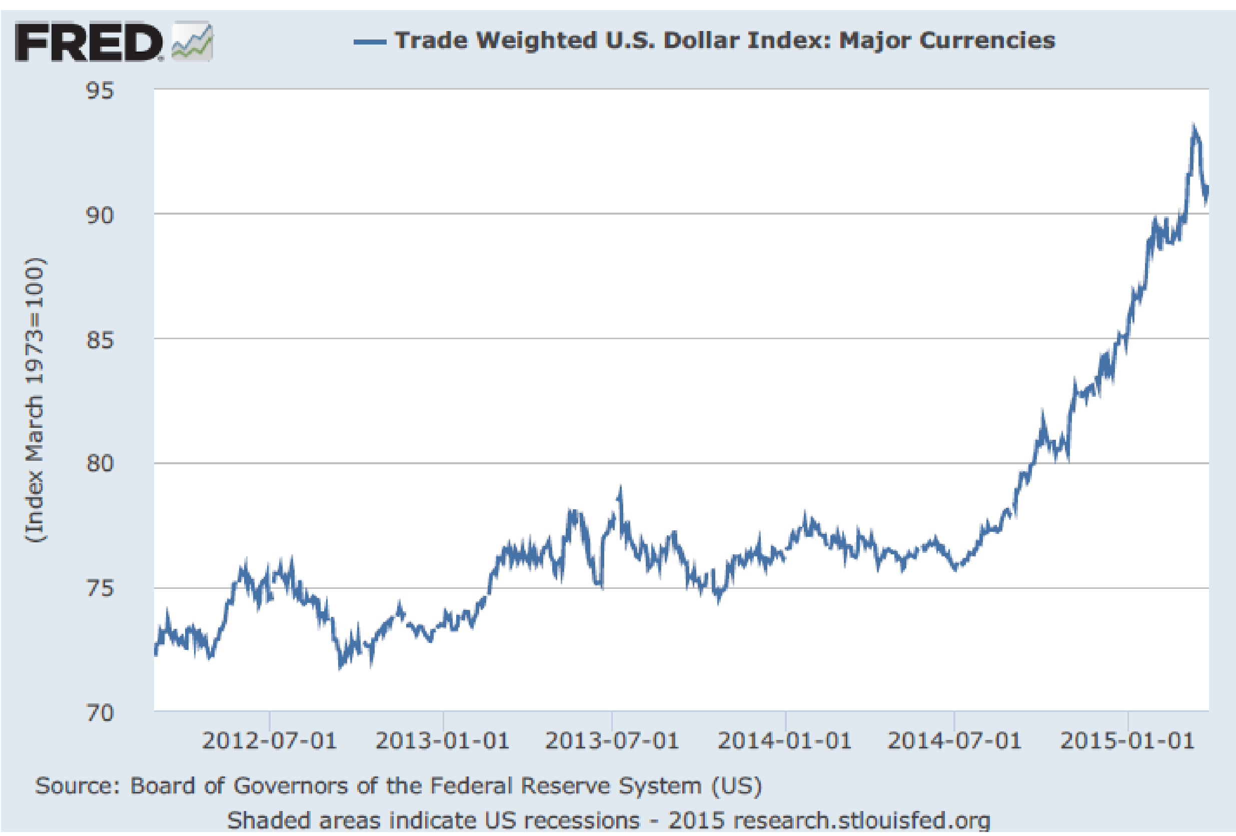
TJT CAPITAL GROUP

On Our Radar – April 2015

For the first time in more than six years the Federal Reserve indicated that an increase in the federal funds rate, which has been pinned at virtually zero since the onset of the financial crisis in the fall of 2008, will likely be warranted before the end of the year. The anticipation of that inevitability has caused volatility to pick-up across a variety of asset classes. Indeed, it took until March 27th and March 30th for the S&P 500 index to record its first back-to-back gains in the month of March, which was subsequently followed by a down day to close out the first quarter.

While the Federal Reserve is conditioning the markets to expect a liftoff of interest rates from the "zero lower bound," 47 central banks have actually cut interest rates this year, with Sweden, Russia, China, Hungry and Romania being the latest. The trend of foreign central banks cutting interest rates has caused the U.S. dollar to appreciate more than 20 percent on a trade weighted basis since July 2014, as seen in the chart below. This extreme strength in the U.S. dollar is most certainly going to impact corporate revenues and earnings, especially for multi-



national companies. The U.S. economy is trying to regain its footing following the sluggish 2.2 percent Gross Domestic Product in the fourth quarter of 2014, which was a significant slowdown from the 5 percent pace seen in the third quarter. Lower energy prices, a higher dollar, concerns about the Fed raising interest rates, and geopolitical tensions in the Middle East continue to weigh on markets. Add to that another harsh winter, especially in the northeast, and you have the makings of a further deceleration of economic growth in the first quarter. The combination of these events has caused swings in stocks, bonds, currencies and commodities. Nevertheless, the S&P 500 index closed out the first quarter up 0.44 percent, the NASDAQ Composite gained 3.48 percent, while the Dow Jones Industrial Average fell 0.26 percent, excluding dividends. The yield on the ten-year U.S. Treasury has declined roughly 24 basis points (0.24%) since year-end, despite a relatively significant uptick in early March, and the price of a barrel of West Texas Intermediate oil closed out the first quarter below $48.

While the economic expansion is entering its seventh year, it is still one of the weakest expansions in the last 60 years, notwithstanding unprecedented monetary stimulus by global central banks. The U.S economy expanded at a 2.4 percent pace for calendar year 2014, and has not seen 3 percent annual growth since 2005. Recently, consumer spending increased a seasonally adjusted 0.1 percent in February, following two consecutive declines, and orders for nondefense capital goods, excluding aircraft, has declined for six straight months. On the positive side, personal income rose 0.4 percent in February, the Case-Shiller 20-City Composite saw home prices rise 4.5 percent year-over-year, and non-farm employment has increased by an average of 274,000 per month over the last twelve months. In addition, U.S. consumer confidence rose to 101.3 in March, according to the Conference Board, up from 98.8 in February. The Institute for Supply Management (ISM) Manufacturing index was 51.5 percent in March, down from 52.9 percent in February, suggesting the manufacturing sector is still expanding but at a slower clip.

There is an expectation that the U.S. economy will show signs of regaining momentum as we enter the second quarter. Should the pick-up in economic growth not materialize, it may push back the timing of the Fed's first interest rate hike.

Federal Reserve

On March 18th the Federal Open Market Committee (FOMC) made the much anticipated decision to remove the word “patient” from its forward guidance, and suggested that the federal funds rate would likely move off the “zero bound” later this year depending upon economic conditions. However, in the press conference that followed Fed Chair Janet Yellen was quick to point out that “just because we removed the word “patient” doesn’t mean we are going to be impatient. Moreover, even after the initial increase in the target funds rate, our policy is likely to remain highly accommodative to support continued progress toward our objectives of maximum employment and 2 percent inflation.”

That a highly accommodative stance is going to remain following any interest rate hike is a result of the Fed acknowledging that “economic growth moderated,” and that a higher dollar has caused “a weaker outlook for exports.” As such, members of the FOMC reduced economic growth projections for 2015 and 2016 to 2.3 percent and 2.7 percent, respectively. Moreover, Janet Yellen said “The central tendency of the inflation projections for this year is now below 1 percent, down noticeably since December.” In fact, Personal Consumption Expenditures, the Fed’s preferred inflation gauge, is currently running at 0.33 percent on a year-over-year basis, well-below the Fed’s target of 2 percent. According to the Fed’s estimates, they do not expect inflation to hit their 2 percent target until 2017. However, Janet Yellen acknowledged that the Fed cannot wait to achieve objectives before you begin to adjust policy due to the risk of “overshooting” objectives, which could potentially undermine the economy.

So the Fed is trying to walk the tightrope between holding interest rates too low for too long, and tightening policy too soon. What should be more important to investors is the fact that the Fed is not shrinking the size of their roughly $4.5 trillion balance sheet. As stated in the press conference, “the Committee will continue its policy of reinvesting proceeds from maturing Treasury securities and principal payments from agency debt and mortgage-backed securities.”

Europe / Asia

On March 9, 2015 the European Central Bank (ECB) began its 60 billion euro a month quantitative easing program, which is expected to run until September 2016. As a result of continued global central bank intervention to drive down interest rates, trillions of dollars worth of government bonds currently have negative interest rates. At the end of March, five-year German government bonds yielded negative 0.10%, and ten-year Switzerland bonds yielded negative 0.09 percent, meaning lenders must pay these respective governments to hold their money.

While unprecedented, the European economy is benefitting from low interest rates, a weak euro, lower oil prices, and rising bank lending. The Eurozone's flash Purchasing Managers Output Index (PMI) rose to 54.1 in March, a 46-month high. As seen in the following chart, there is a high correlation between the PMI Output Index and Eurozone Gross Domestic Product (GDP).

Source: Markit, Eurostat. GDP = gross domestic product

As a result, expectations for acceleration in economic growth have been on the rise. Consumer confidence in the European Union continues to improve rapidly and has surpassed levels going back to 2001. Of course, the ongoing possibility of a Greek exit from the Eurozone continues to hang over the market as the country faces an April 9th deadline of paying the International Monetary Fund (IMF) 450 million euros. Greece continues to struggle with an unemployment rate above 25 percent and a debt-to-GDP level of approximately 176 percent.

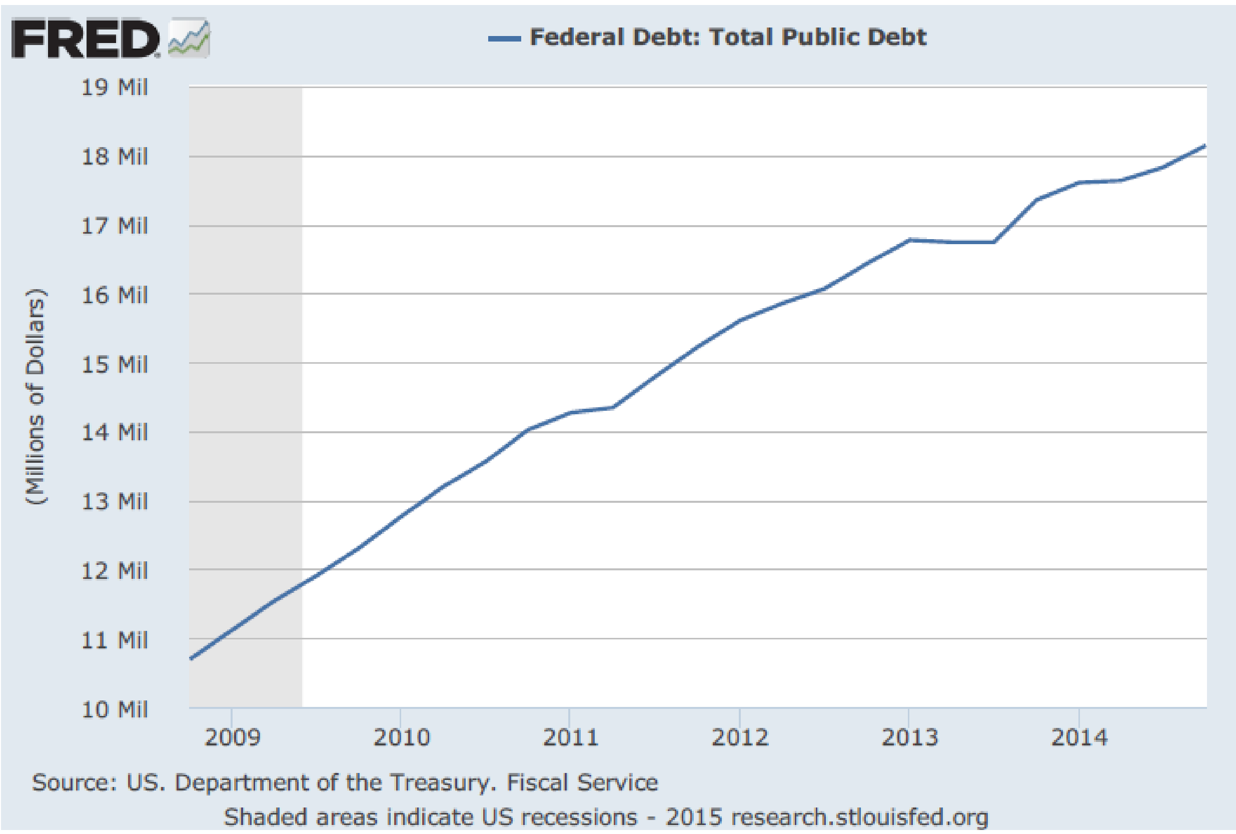
The People's Bank of China (PBOC) cut lending and deposit interest rates by 0.25 percent in March following a series of easing steps taken since November. PBOC Governor Zhou Xiaochuan said China needs to be "vigilant" to guard against the risk of disinflation, and suggested that the bank has "room to act" if necessary. China's economic growth for the first two months of 2015 showed a greater degree of slowdown than had been estimated as Industrial Production growth slipped to 6.8 percent year-over-year compared to 7.7 percent expected, and retail sales grew 10.7 percent compared to expected growth of roughly 11.6 percent.

What's more, China's determination in becoming a global influence can be seen in the number of countries becoming founding members of the China-led Asian Infrastructure Investment Bank (AIIB), an international financial institution that could rival the International Monetary Fund (IMF) and World Bank, which are heavily influenced by the United States. Despite protests from the U.S., some of our closest allies, including the UK, have been formally accepted as founding members of the bank, a reflection of the change in future economic power.

Outlook

The trend over the past six months has been a significant pick-up in volatility in several major asset classes. The month of March saw the U.S. dollar index (DXY) have its biggest intraday move in six years, while a barrel of West Texas Intermediate oil registered a six-year intraday low of $43.57. The S&P 500 index saw 3 one-day moves in excess of plus 1.21 percent, and 3 one-day down moves in excess of minus 1.40 percent. The 10-year Treasury saw its yield swing 41 basis points (0.41%) from the intraday monthly high to the intraday monthly low. This is a reflection of the uncertainty created by decelerating economic growth, the effects of a rising dollar, a possible modest increase in the federal funds rate, and rising geopolitical tensions in Yemen.

When the Federal Reserve instituted its zero percent interest rate policy on federal funds, the national debt was roughly $9.96 billion. Today it stands at $18.14 trillion as seen in the adjacent chart. In order to have any realistic chance of servicing that debt (i.e. paying interest and principal), the U.S. economy is going to need to grow. If not, the U.S. economy is going to face significant challenges, to put it mildly. That is one of the primary reasons why central banks are so determined to increase the rate of inflation. Either you reduce the debt burden by growing the economy or inflating to "kick the can down the road," or you will need to restructure the debt at some point in the future. Greece is currently facing that dilemma.



Former Fed Chairman Ben Bernanke recently stated the "real or inflation-adjusted return on lending to the U.S. government is currently about minus 0.1 percent." Volatility aside, the S&P 500 index has returned approximately 4.8 percent over the past six months. While not gangbusters by any stretch of the imagination, it still represents one of the best asset classes, especially compared to negative real returns. Pensions, endowments, insurance companies, and even a majority of individual investors cannot live on zero or negative returns for extended periods of time.

While the Fed seems determined to modestly increase interest rates, Janet Yellen reiterated that "even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the long run.” Gradually increasing interest rates is a long way from tightening monetary policy.

We will continue to rely on our Tactical Allocation Market Composite (TAMC) for direction, which is still constructive. We believe we are in a transition period as market adjusts to the likelihood of an interest rate increase, and the effects of the higher dollar on exports, revenues and earnings. As such, we continue to recommend adding to positions on weakness.