TJT CAPITAL GROUP

## On Our Radar – June 2015

The month of May saw all-time record highs achieved in the Dow Jones Industrial Average, S&P 500, and NASDAQ Composite despite a growing sense of unease in a number of corners as a result of sluggish growth in the U.S. economy, the continued drama over the Greek debt situation, and the Federal Reserve's guidance regarding the eventual increase in the federal funds rate. Global central banks have engineered extremely low interest rates and have flooded the markets with liquidity, which has manifested itself in bull markets in many financial assets and record amounts of mergers and acquisitions, which exceeded $240 billion in May alone.

The Bureau of Economic Analysis revised the estimate of Gross Domestic Product (GDP) in the first quarter to minus 0.7 percent on an annualized basis, down from an initial increase of 0.2 percent. The downward adjustment was due to lower inventory accumulation, higher exports, along with the effects of a higher U.S. dollar, lower energy prices and the harsh winter. Industrial Production decreased 0.3 percent in April, however, it was up 1.9 percent on a year-over-year basis, while Capacity Utilization for the industrial sector fell 0.4 percentage points in April to 78.2 percent, roughly 1.9 percentage points below its long-run average.

On the positive side the Leading Economic Index (LEI) rose 0.7 percent month-over month, suggesting the sluggish economic trends seen in the first quarter may be temporary. The Institute for Supply Management (ISM) Manufacturing Index was 52.8 percent in May, up from April's 51.5 percent reading, and the ISM Non-Manufacturing Index rose to 57.8 percent in April, up from the March reading of 56.5 percent, pointing to continued growth in the service sector. Consumer Confidence rose to 95.4, according to the Conference Board, on further improvement in labor conditions and higher disposable income, as Personal Incomes rose 0.4 percent in April. Inflation, as measured by the core Personal Consumption Expenditures (PCE) – one of the Federal

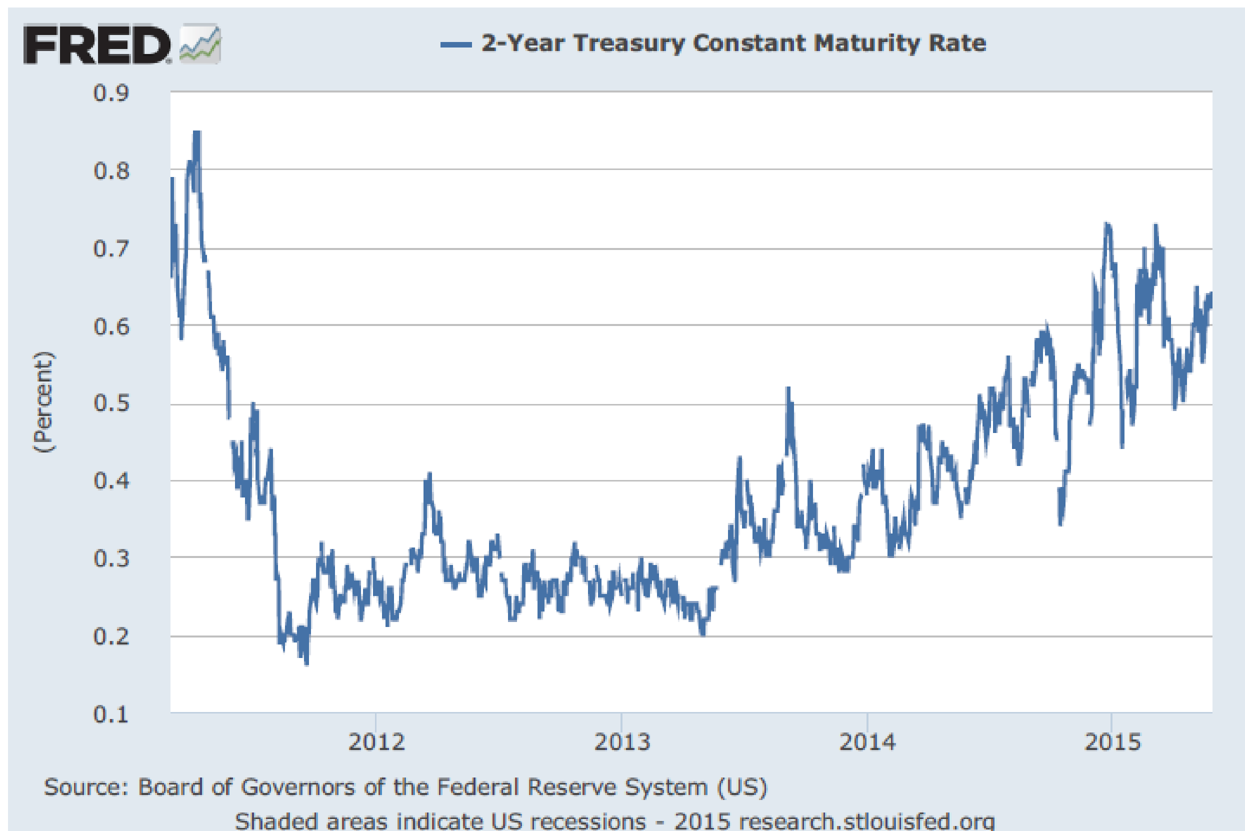
Reserve's preferred inflation gauges – increased 1.2 percent on a year-over-year basis, still below their 2 percent target.

The Greek debt dilemma continues to impact markets as they owe the International Monetary Fund (IMF) 1.5 billion euros over the next few weeks, and nearly 12 billion euros this year. Greece needs to make the payments due in June in order to secure an additional 7.2 billion euro aid package. However, Greece is caught up in what is ultimately a no-win situation: each time they accept money it comes with conditions that further inhibit economic growth. Over the past five years, which coincides with the first Greek rescue package, Greece's economy has contracted by approximately 25 percent and their debt level is approaching 200 percent of Gross Domestic Product (GDP). Once the weight of debt passes a certain point a restructuring, at a minimum, is required. However, the International Monetary Fund (IMF) has been taking a hard line to date, putting further pressure on the Greek government. This has caused Greece Prime Minister Alexis Tsipras to lash out at the "absurd" demands seeking to impose "harsh punishment" on the Greek people. Whether Greece is using that type of rhetoric as a negotiating ploy remains to be seen.

## Federal Reserve

The Federal Open Market Committee (FOMC) released the minutes from their April 28-29, 2015 meetings which made clear that members are painstakingly concerned about properly communicating their intentions to the marketplace. The Fed does not want to surprise the markets as it clearly did in May 2013 when Ben Bernanke suggested the Fed might reduce the amount of bond purchases later that year. That revelation, which caught the markets off guard, subsequently became known as the "taper-tantrum" as it caused wide swings in the prices of many assets, including stocks, bonds and currencies. For example, the yield on the 10-year U.S. Treasury Note rose from 1.64 percent in early May to 2.50 percent by late June.

While not talked about in the media, the fact of the matter is that interest rates on shorter-term securities have been rising for years. Indeed, the yield on the two-year U.S. Treasury Note, as seen in the following chart, bottomed back in 2011.




Nevertheless, the Fed is concerned about the liquidity mismatch as bond market participants expect daily liquidity in funds with average maturities going out several years. The Fed said bond market volatility "may be greater than it had been in the past" due to "decreased inventories of bonds held by broker-dealers, and elevated assets of bond funds." The lower inventories are directly due to the increased capital requirements by the Fed. So while the Fed has attempted to shore up deficiencies exposed by the last financial crisis, they may actually be planting the seeds for the next one. According to Fed Chair Janet Yellen, "the Federal Reserve and the other banking agencies have substantially increased capital requirements," and that "regulatory minimums for capital relative to risk-weighted assets are significantly higher." Ms.

Yellen went on to say "Higher capital standards provide large, complex institutions with an incentive to reduce their systemic footprint." However, with mutual funds and Exchange Traded Funds (ETFs) owning a significant amount of bonds, if and when there is ever a rush or even a trot to the exits, the banks and broker-dealers will not be willing to significantly increase their exposure due to capital surcharges that may be imposed. So while the Fed has tried to strengthen liquidity, it may have actually reduced it as a result of unintended consequences. Therefore, participants should expect volatility to rise, not fall, as liquidity will likely depend on investors other than banks and broker-dealers stepping in.

In a speech last week Fed Chair Janet Yellen said "if the economy continues to improve as I expect, I think it will be appropriate at some point this year to take the initial step to raise the federal funds rate." She went on to say that "it will be several years before the federal funds rate would be back to its normal, longer-run level." Nevertheless, the Fed is concerned about the impact rising interest will have on the market. Federal Reserve Vice Chairman Stanley Fischer has gone out of his way to reiterate that the path to higher interest rates is certainly likely to be slow and gradual.

## Europe / Asia

The European Central Bank (ECB) announced plans to accelerate its bond purchase program (Quantitative Easing) ahead of the summer months, and reaffirmed their commitment to continue quantitative easing through September 2016, purchasing roughly $65 billion a month in bonds. We have made the case that central banks seem to be coordinating strategy in an attempt to accelerate global economic growth. Central banks are trying to increase aggregate demand by encouraging spending, using the so-called wealth-effect (also known as asset inflation), and trying to decrease savings through negative interest rates. Furthermore, they are using currency devaluation as a way to prevent deflation from taking hold. The determination of central bankers was on display when Fed Vice-Chair Stanley Fischer said "with one decision – the decision to

implement QE – it became clear that the ECB has the capacity both to decide to implement monetary policy at the zero lower bound – indeed below the zero lower bound – and to succeed in implementing that policy."

The Bank of Japan is committed to buying approximately $720 billion worth of bonds in their version of Quantitative Easing as they are determined to reach a 2 percent inflation target. Inflation generally makes the burden of debt more bearable, and with Japan's debt to Gross Domestic Product (GDP) over 225 percent, that is important as higher inflation reduces the real value of debts. As a result of monetary policy, the value of the yen has fallen to approximately 124 versus the U.S. dollar, down from roughly 101 a year ago. Similar to what was experienced in the U.S., Quantitative Easing has propelled the Japanese Nikkei 225 stock index rose to 20,563.15 at the end of May, the highest in fifteen years.

The People's Bank of China cut its policy rate again in early May bringing it down to 5.10%, the lowest level since 1996. Clearly China is in the midst of an aggressive easing cycle as it attempts to offset a decline in real estate and provides monetary incentives to boost economic growth. China's economy grew 7 percent in the first quarter, the slowest quarterly advance since 2009. The government is trying to transition the economy from an export oriented one to a more internally focused.

## Outlook

The markets continue to frustrate both the bulls and bears alike as it deals with so many crosscurrents. For every "bubble" proclamation out there some well-respected investor is stating otherwise. While a vast majority of investors are confused, we will reiterate what we have always said: no one knows what the markets are going to do, so we will always rely on facts and our indicators to evaluate conditions and act accordingly. What is unusual about this market is that there seems to be a heightened sense of concern, which, on one hand is understandable given the scars of 2008 were so

devastating. However, despite the multi-year bull market in stocks, Wall Street equity allocations since 2009 have been below average for the entire advance. Moreover, today, there is almost $11 trillion sitting on the sidelines earning virtually nothing. This, however, is in contrast with the Fed's goal as former Fed Chairman Ben Bernanke recently reiterated that "monetary easing works in part by raising asset prices, like stock prices."

While no one knows the final outcome of these policy initiatives, clearly equity markets have benefitted handsomely. Likewise, no one knows the impact on markets as a result of the proliferation of "alternative" assets such as hedge funds, which by and large attempt to offset risk in one market by shorting (a negative bet) in another market. This focus on alternatives may turn out to be a case of Wall Street selling "yesterday's results" as the industry has a history of selling what investors should have purchased years ago, and a vast majority have a propensity to invest looking backwards. Unfortunately, as the industry gets individuals to invest looking through the rear-view mirror, the real money is actually made looking through the windshield even though it is never as clear.

The paradox of risk is that when perceived as high, it is generally less so. Indeed, elevated risk levels can usually be found where there has been a concentration of capital and where a number of participants believe the risk is actually low (think "AAA-rated" sub-prime mortgages, for example). It is precisely because the risks are understood and that the potential so significant that central banks seem to be coordinating policy. The concern about what can go wrong is why there is almost $11 trillion sitting idle in cash. Nevertheless, central banks share a desire not to repeat the 2008 experience again anytime soon. In fact, the Fed has gone so far as to have created a new office to identify emerging risks to the stability of the broader financial system. That does not mean that markets cannot go down: it means that the next time markets do decline significantly there is a high probability that the genesis will be

something other than what caused the last one, that is, something other than mortgage-backed securities and extreme bank leverage.

While a number of pundits constantly focus on the stock market, the notion of paying governments for the privilege of lending money to them strikes us as insane. However, market history is littered with examples of extremes. Which brings us to an important question: what should the Price/Earnings (P/E) ratio on a blue chip stock be when the yield on 5-year German bunds is **minus** 0.01 percent? Moreover, investment decisions by insurance companies, pensions and endowments are not made in a vacuum. There are not too many pensions that can meet their obligations, or actuarial assumptions for that matter, with interest rates around the globe as low as they are. The level of interest rates and inflation matter a great deal.

We always try to provide perspective to investors as we live in a dynamic world filled with data, much of which can be very confusing. Moreover, there is always the peanut gallery to deal with as they make their daily predictions with headlines designed to "click here." The fact is there are a number of very important variables that taken in combination – not isolation – influence markets. Furthermore, successful investing does not equate to Newtonian physics, and therefore, it is important for investors to have context concerning any one data point. For example, there has been a lot of chatter recently about the U.S. stock market not having a 10 percent correction in several years. While true, the market has in the past gone almost 7 years (1990-1997) without a ten-percent correction. Nevertheless, there is no doubt that the market has experienced some major adjustments over the last few quarters, including a near 50 percent decline in the price of oil in roughly seven months, and a roughly 25 percent decline in the value of the euro relative to the U.S. dollar. Furthermore, there have been significant adjustments in individual companies, sectors and industries that have clearly been in bear markets. As to whether that internal correction is enough to prevent an across the board correction – only time will tell.

We would remind readers that famed economist and money manager John Maynard Keynes said investment success "is always to the minority and never to the majority." Therefore, it would be unusual for the masses to be right as it is a documented fact that the vast majority consistently underperform and following conventional wisdom has produced dreadful results. So the fact that there are concerns shared by the investment community is actually a good thing as, generally speaking, it is the absence of fear that makes markets vulnerable. If successful investing were easy, everyone would do it well.

As always, we evaluate conditions based upon the facts, not predictions, and rely on our risk "Traffic Light" for asset allocation guidance. With monetary policy still accommodative, the economy expected to continue its uneven growth, valuation in fair territory, investor sentiment still cautious, and technical indicators in decent shape, our risk-light remains in "Green" territory. Therefore, we believe conditions are still constructive. And while that is not to say that the broad markets are immune to a decline or that there won't be bouts of volatility, if those should occur we would view them as a buying opportunities until such time that our indicators turn negative. (6.2.15)

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