On Our Radar – February 2019

The U.S. stock market rallied in January as the S&P 500 index gained 7.8 percent following the 9.1 percent drubbing that took place in December. Concerns about the government shutdown, ongoing trade war with China, and a major policy mistake by the Federal Reserve weighed heavily on the markets late last year. Those concerns receded in January as the government shutdown ended, trade talks with China continued, and the Federal Reserve made a 180 degree reversal in policy.

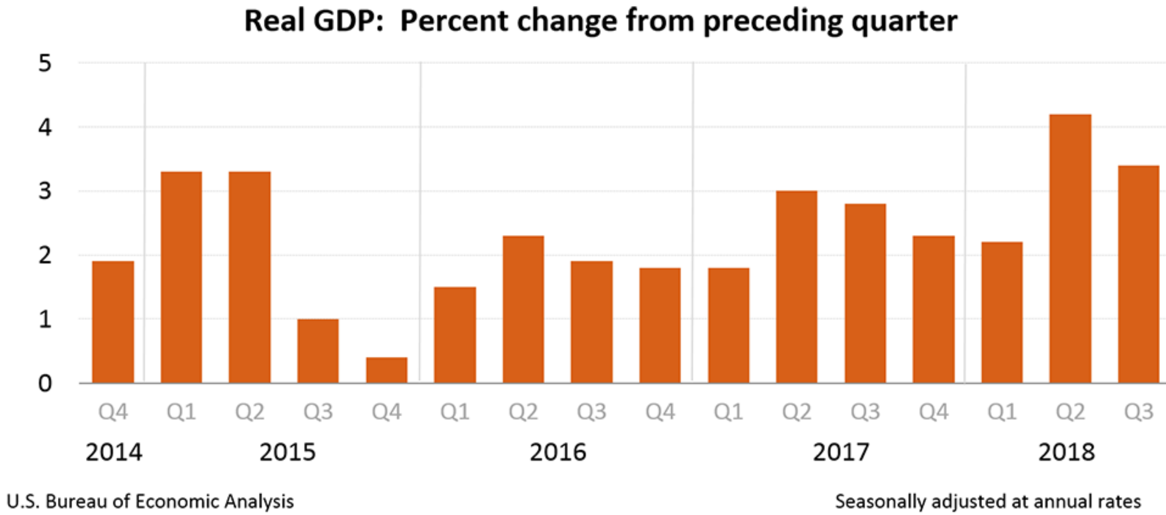
TJT Capital Group relies on our InVEST Risk Model ® to help determine whether we have bull market or bear market conditions with a goal of participating in bull markets and protecting capital in bear markets. The following is an update on the 5 indicators that really matter.

Interest Rates (Monetary Policy)

On December 19, 2018, Fed Chairman Jerome Powell raised interest rates on federal funds and said that the Fed saw two additional interest rate hikes in 2019. In addition, he said the shrinking of the Fed's balance sheet was on "automatic pilot." The Fed did this despite admitting that global economic growth had slowed and that financial conditions had tightened materially. The markets reacted violently.

Hiking rates for the fourth time in a year when the economy was slowing and the effects of the tax cuts were wearing off in the midst of a trade war with China seemed to defy common sense. However, as we have often stated, the Fed lives in the world of theory.

To provide some perspective, the U.S. economy grew at 4.2 percent and 3.4 percent, respectively, in the second and third quarters of 2018. The Fed viewed that "above trend growth" as a threat to inflation despite the fact that the growth was unlikely to be sustained and the Fed's views on inflation have been wrong for more than seven years.



The Fed's response can be traced back to something Former Fed Chair Janet Yellen said at a Congressional testimony back in late 2017. She said "if we allow the economy to overheat, we could be faced with a situation where we might have to…raise rates and throw the economy into recession" in order to prevent inflation from taking hold.

On January 4, 2019, Chairman Powell during a panel discussion actually read from a script as he tried to sooth the markets. He started out by saying "there is no preset path for policy" and that the Fed would be patient going forward. Of course that completely contradicted what Jay Powell said just sixteen days earlier stating that the Fed's balance sheet reduction was on "automatic pilot." Yet in the Federal Open Market Committee (FOMC) minutes of the meeting where they agreed to raise rates, there was no mention of the balance sheet. That is because the Fed did not believe it would have an impact.

Only in the Fed's world of theory are the effects positive when their balance sheet is expanded by trillions of dollars (QE) but have little or no effect when it contracts (Quantitative Tightening).

Former Fed Chairman Ben Bernanke, the architect of quantitative easing in the U.S., went to great lengths to highlight the impact that QE would have on the markets, including what he called the portfolio balance channel. He said "the Federal Reserve's purchases of longer-term

securities affect financial conditions by changing the quantity and mix of financial assets held by the public."

In his January 30, 2019 press conference, Chairman Powell said the Fed's goal is "to sustain the economic expansion" and "avoid unnecessarily market disruption." He then went on to say that the "ultimate size of our balance sheet will be driven principally by financial institutions demand for reserves," which is a complete change in Fed policy in just six weeks.

Valuation

S&P 500 consensus operating earnings estimates for 2019 are $169.61, up from the current 2018 estimate of roughly $157. Therefore, the forward Price/Earnings (P/E) ratio for 2019 is roughly 15.9, which is just slightly below the 25-year average of 16.1-times earnings. However, it is not unusual for the P/E ratio to decline when the Federal Reserve is raising interest rates.

Obviously the key will be whether the earnings estimates come through as the global economy is decelerating and energy prices have fallen.

Economic Cycle

The U.S. economy continues to plug along as non-farm payrolls increased 304,000 in January bringing the unemployment rate to 4 percent. The Institute for Supply Management (ISM) Manufacturing Index for January was 56.6 percent, up 2.3 percentage points from the previous month. However, due to the lingering concerns, the Leading Economic Index (LEI) has declined in two of the past three months. Moreover, as the effects of the tax cut fade, growth is likely to slow.

That sentiment is reflected in the Conference Board Consumer Confidence Index, which fell to 120.2 in January from 126.6 in December and 136.4 in November. Of greater concern was that

future expectations declined by more than 10 points, the lowest reading since the November 2016 elections.

Sentiment

What should come as no surprise, bullish investor sentiment has been on the rise, essentially advancing in lock-step with the early 2019 rally. The number of bullish advisors in the Investor Intelligence survey has risen from below 30 percent in late December to approximately 45 percent in early February.

Historically, the spike in the level of bullishness in such a relatively short period of time suggests that a pause or pullback could happen at any time.

Technical Factors

A majority of technical indicators have rebounded given the recent rally. In late December the number of stocks trading above their 50-day moving average fell to less than 1 percent. In early February that number rose above 70 percent.

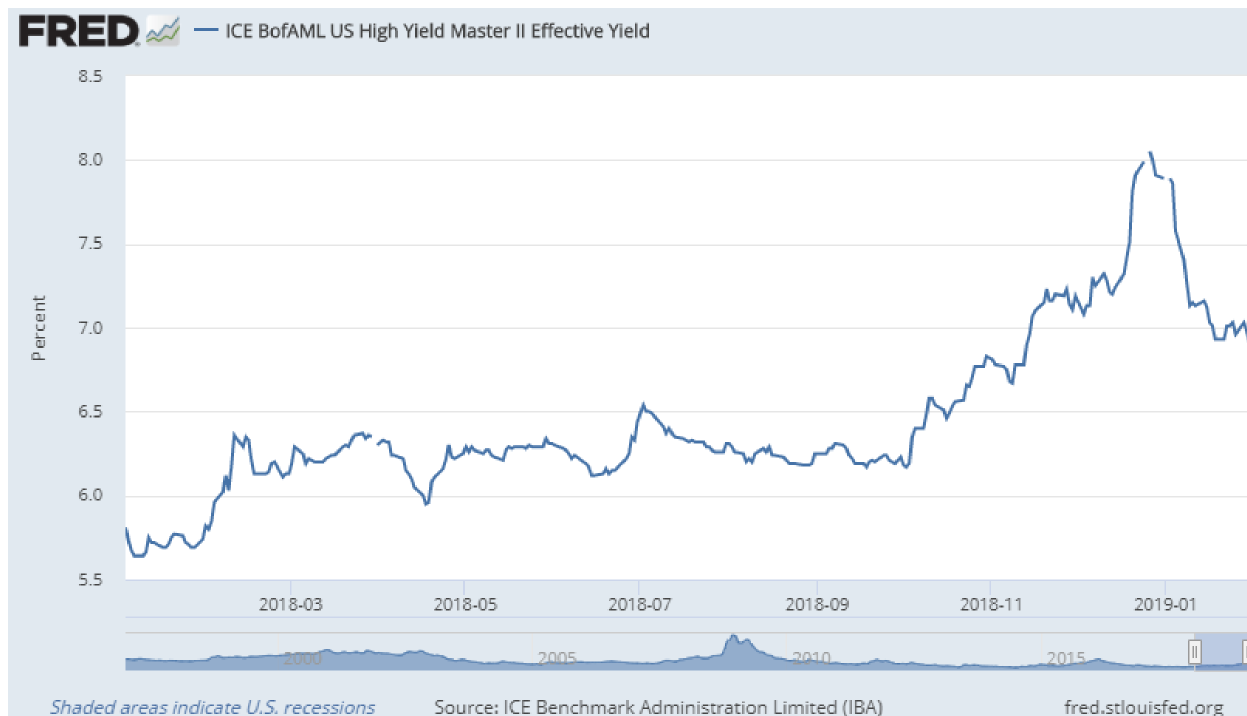
Outlook

The markets rebounded from the extremes seen in late December as a number of concerns have at least temporarily been addressed. The Federal Reserve has done a complete 180 degree turn with respect to monetary policy, the longest government shutdown in history is over – for now at least, and trade negotiations with China are progressing.

Regarding the Fed, while the policy change was obviously helpful in the short run, their credibility may have been impaired in a way that could hurt markets in the long term. The fact of the matter is the Fed continued to raise interest rates as financial conditions tightened

materially. Credit spreads were widening, the yield curve had inverted (1 year Treasuries yielded more than 7-year Treasuries) yet the Fed tightened anyway.

High yield bond rates rose from about 6 percent in October to over 8 percent in late December as seen in the following chart. Since then interest rates have come down, but they are still elevated compared to where they were in early October.



What's more, the Fed said they would pause because inflation was low, and oil prices had recently declined. Well, inflation was low in December, which they ignored, and oil prices rose 18 percent in January, the biggest monthly gain in history.

With respect to credibility, Chairman Powell attempted to sell the fact that the Fed was going to be data dependent, but clearly the Fed hit the pause button because of the swoon in the stock market. Of greater concern is knowing what the Fed's policy is going to be moving forward.

At best, Jerome Powell's comments have been erratic. After raising interest rates for the third time in September 2018, he danced around the questions relating to the level at which interest

rates were neutral – not accommodative, not tight…just right. Yet on October 3, 2018, just seven days later, he went on TV and said interest rates are "a long way from neutral" and that the Fed may "go past neutral." The Dow Jones Industrial Average peaked on October 3, 2018.

To be fair, Chairman Powell is in a difficult position. QE had never been done before, so the attempted reversal of that was unlikely to be a smooth ride. That said, it is tough to have confidence when policy seemingly changes based upon the theory of the week. This is complicated. Interest rates went to zero for years, debt has exploded, which is precisely why the Fed should have moved slower given that monetary policy works with a lag. That is, it takes time for interest rate cuts – or hikes – to work through the economy.

Now the Fed seems to be boxed in.

Another concern is whether the Fed truly understands how the markets have actually evolved. We say that with all due respect, but it is a fact that the Fed gave its blessing for the removal of the short-sale rule in the summer of 2007, just prior to the onset of the financial crisis.

Today, algorithm-based computer programs dominate trading. Because many of them are momentum based, we are seeing more and more one-direction moves. It's one of the reasons why we saw the Dow Jones Industrial Average have up and down daily moves in excess of 1000 points in 2018.

In addition, the Dodd-Frank Act, which significantly reduced the major banks ability to trade stocks and bonds for their own accounts following the financial crisis, has possibly impaired liquidity in ways that are not clear to all participants. And the market–making functions of a New York Stock Exchange specialist - an obligation to buy when there are no buyers and sell when there are no sellers - have all but disappeared.

Today many hedge funds have stepped in to fill the void, however, a number of them are using the same type of momentum strategies. In all likelihood that will lead to increased swings in volatility similar to what we have seen over the past few months.

Therefore, we believe that volatility will create more opportunities. The reality is we are ten years into a bull market, so investors will want to be more surgical in their approach. The U.S. economy is slowing as the effects of the tax cut fade, and Federal Reserve monetary policy seems to be on hold. Corporate earnings have generally been solid, with some companies highlighting specific weakness in China, and investor sentiment has swung back from the despair seen in late December to a moderately bullish outlook.

The markets are still facing persistent uncertainties, however, and until those get resolved, volatility will likely remain high as the algorithms influence prices. Those swings are what will create opportunities in the sectors of the U.S. economy that are showing some outstanding growth.

If what you have been doing has not been as effective as it could be, do not hesitate to give us a call. (2.4.19)

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