Market Update

April 13, 2018

Tariff and Trade War Tension Ease a Bit and Earnings Season Arrives

Tariff and trade war tensions eased a bit with China coming out and extending two olive branches to the Trump administration. The first olive branch was President Xi Jinping working to further facilitate pressure on North Korea to sit and have talks with the U.S. on denuclearization. Then, President Xi Jinping announced that China will look into protecting international businesses from Chinese theft of intellectual property and reducing the current 25% tariff China has had on imported automobiles. This tariff was already in place and is different than his previous comments, that he would increase the tariffs by an additional 25% bringing them to 50%. The U.S. markets cheered on these developments.

The FBI raids on President Trumps personal Attorney Michael Cohen did slow the markets down a bit but did not derail the markets completely. Goldman Sachs analysts also came out with a study that suggested a trade war with China would shave off about 0.1 percentage point from GDP. They mentioned it would pose minimal risk to the S&P 500 companies profits and they reiterated their year-end price target of 2,850 for the S&P 500. This all helped put the markets in more of a cautious rally mode going into the bulk of earning season, which analysts expect to be very good. We see from the chart below that the S&P 500 has trended a bit sideways after several retests of the earlier lows this past February. The good news has been that the retesting of the lows occurred right near the 200-day moving average and the S&P 500 has bounced a few times off those levels. The 200-day moving average is an important technical indicator that suggests if it is breached with any significant amount of volume and time, the market is set up for worse days to come. Defending that level as the markets have done, is equally important in providing a resistance level of support for the market to consolidate to and mount its next leg upward toward newer highs. Of course, we do not know for sure what news will come out to derail the latter, but so far, the latter is appearing to hold true.

Other good news from these charts is that Gold has seemed to trend sideways and not rise significantly as the long bond price and REIT Index have continued to show a divergent pattern from Gold and the equity markets. Certainly, headlines out of Washington will continue to influence the psychology of the markets and its participants. The unpredictable nature of what is occurring in U.S. politics has increased market volatility since the beginning of 2018, back to more normalized levels. Prior to the start of this year, market volatility as measured by the VIX was trending at historically low levels. That said, the recent rise although more in line with historical norms, has increased volatility. Those who had become complacent are coming back to more normalized levels of overall concern, which is inherent in the uptick in volatility.

The chart below shows the percent change since November 2016 for the S&P500, TLT (our proxy for long dated Treasuries), GLD our proxy for Gold and the Dow Jones REIT index which tracks general performance of Real Estate Investment Trusts.

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Information in the chart above was taken from sources we believe to be reliable; however; we do not guarantee its accuracy or completeness.

The Treasuries yield curve experienced a small amount of flattening since last month. This is likely indicative of the increased rhetoric about trade and tariffs and news coming out in politics. The curve has not had a chance to fully factor in the commentary out of China and the perceived relief from President Xi Jinping's commentary. It does appear that all maturities are rising in rates, but the shorter end of the curve may be seeing a touch more in rate increase. This can also be attributed to the recent comments out of the Federal Reserve which controls the over night borrowing rate that banks are charged by the government. This rate, the Federal Funds rate, now sits between 1.5% and 1.75%. It appears that the Federal Reserve is content with its current path to raise rates over time, as economic data suggest it is necessary to slow down the economy. The Fed estimates that the longer run neutral interest rate is around 2.9%. They feel getting to this number will be necessary in order to combat an overheating economy.

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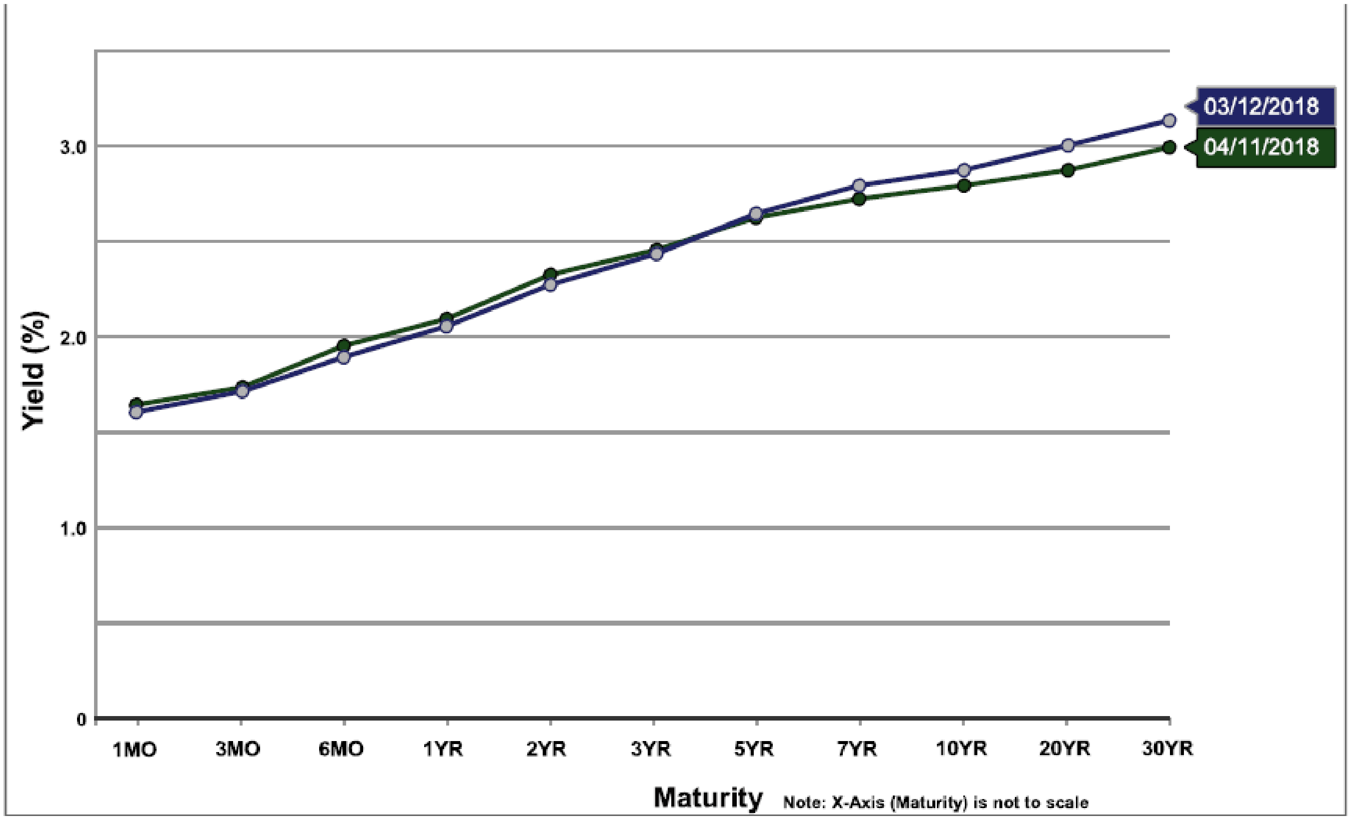

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https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/Historic-Yield-Data-Visualization.aspx

Another aspect that may potentially affect the markets is whether or not the U.S. can come to an agreement on renegotiating NAFTA. There have been some indications that these negotiations are going well and maybe getting closer to a better deal for all three countries. This may have even impacted China's decision to ease trade tensions, as a better deal with our neighbors to the north and south may have put some pressure on China.

Our view remains that the fundamental back drop of the economy should provide the markets with a platform for continued growth. We see earnings season coming in over the next several weeks with positive numbers. Commentary and future forecast from the companies are going to be very important indicators for the health of the equity markets. However, we are starting to see signs of a later stage economic environment as evidenced by wage increases, inflation and rising interest rates. The biggest concern for the next 12 months is still the Federal Reserve increasing rates too quickly, to combat inflation, which can often stifle growth. Preliminarily, our outlook is more cautious for this year, although we do feel there is more opportunity for growth.

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Overall, we still prefer domestic equities over international equites. International markets, especially developed international markets, continue to look attractive. Most all our portfolios hold a percentage of their assets in international investments, which should benefit from improved economic indications globally. We are currently bearish on fixed income and interest rates and believe that the future will bring a higher rate environment. One way we are looking at combating the decline in fixed income prices is by shifting some of our fixed income holdings to floating rate securities. These tend to hold value better in rising rate environments. Also, we are starting to look at ways to directly combat inflation such as investing in Treasury Inflation Protected Securities (TIPS). These securities have important tax ramifications and are typically most appropriately used in retirement accounts where the current tax effects are reduced and often eliminated. It is important to maintain discipline regarding strategic asset allocation. Tactically, the shift to holding some floating rate bonds or bond funds and TIPS should help reduce some of the pressure on the bond allocations in our portfolios.

If you have questions or would like to discuss this further with regard to your personal portfolio, please contact me at 310-433-5378.

James M. Liotta, CFP®, CPWA®, AIF®, NSSA®, MBA
President
Prominence Capital GP, LLC.
jliotta@prominencecapital.com
www.prominencecapital.com

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