Market Update

August 15, 2018

Turkey's Economic Crisis Is Now the Focus

- Global equity markets were hit Friday by fears that Turkey's deepening economic crisis will spread. The Turkish lira plummeted as investors have lost confidence that the Erdogan regime will be able to steer Turkey through its current crisis.
- We are seeing follow through fear grip markets this week, however it begs the question, what does it have to do with Walt Disney Co's earnings ability or many other U.S. companies for that matter?
- Two issues on the table are: Big U.S. Banks exposure to Turkey is key to understanding if this is a reason to be concerned longer term, and the degree of contagion to other countries.
- Meanwhile, U.S. inflation continued its gradual rise in July. Notably core CPI inflation reached a new cycle high of 2.4%.
- Economic conditions in the U.S. argue for a rate hike in September, and Turkey-related turmoil seems unlikely to derail that.

The graph below shows that equity market's and longer-term treasuries remained relatively range bound from month to month. This is depicted in the blue line for the S&P 500 and the orange line for TLT our proxy for longer term treasuries. What we do see is a pick up in REIT's and a precipitous drop in gold. The green line below is for the Dow Jones Real Estate Investment Trust index and the Red line is for GLD our proxy for gold prices. It is notable that gold is underperforming, as a store of value, which is an indication that economic conditions and other assets remain attractive. Gold tends to do very well in times of crisis, contagion and overall economic uncertainty. Gold is currently signaling that these issues are not on the table and the current fear of Turkish contagion may be very short lived. We will continue to monitor this indicator, as well as many others, as things develop. A secondary indicator would also be a larger recovery in the price of long-term treasuries and treasury bond and notes, in general, as investors run to safety. Although rates are down today, signaling prices going up, there is no sign of broad based purchasing of Treasuries, which would indicate a rush to safety. The key worry is the degree of contagion to other countries. Turkey has significant trade and banking ties with Europe, but not enough to fuel a contagion effect. Still, the lira rout has hit European bank shares with exposure to the country and banking authorities are on high alert.

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The US. Treasury yield curve below, has shifted up a slight bit, since last month. A shift up in all maturities made up much of the change in the yield curve. For the U.S. economy, attention was focused on consumers and producer prices for July. Overall, the story is that inflation continues its gradual march upwards. Core consumer price inflation hit a new cyclical high in July, up 2.4%. July PPI (Producer Price Index) prices were up for categories that likely contain products from China subject to new import tariffs. We are likely already seeing some impact from the new tariffs, but these prices have been rising for some months, suggesting an upward trend was in place pre-tariffs. The Fed's task will be to disentangle how much of this is thanks to tariffs, and how much is due to a hot economy. Price pressures justify Fed rate increases in the months ahead. So far, Turkey-related market volatility seems unlikely to delay a September hike. Looking into 2019, however, if we don't start to see some move upward in longer-term yields, Fed hikes may be in jeopardy. The Fed does not want to cause an inversion of the yield curve.

PROMINENCE CAPITAL

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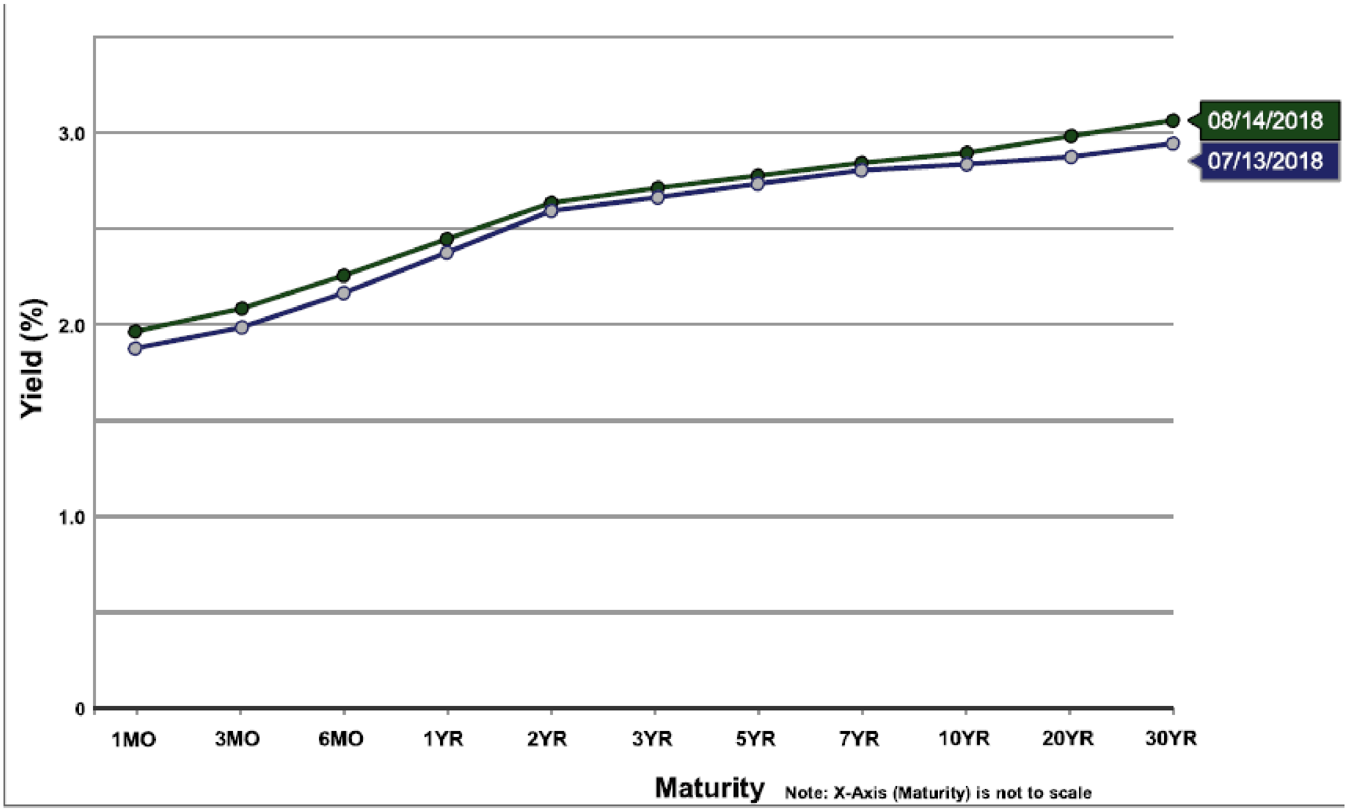

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https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/Historic-Yield-Data-Visualization.aspx

We still feel that there are signs of a later stage economic environment, as evidenced by wage increases, inflation and rising interest rates. The US could stay in this economic phase for an extended period. The biggest concern for the economy in the next 12 months is still the Federal Reserve increasing rates too quickly to combat inflation, which can often stifle growth. Our outlook is more cautious for the remainder of this year, although we do feel there is more opportunity for growth.

Overall, we prefer domestic equities over international equites although some international markets may become more attractive as the U.S. economic cycle continues to mature. We are currently bearish on fixed income and interest rates and believe that the future will bring a higher rate environment. As mentioned in the past, we are looking at combating the decline in fixed income prices 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 looking 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.

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