

Market Update

November 14, 2018

After the Mid-Term Elections, Focus Shifts to China Trade Negotiations and Interest Rates

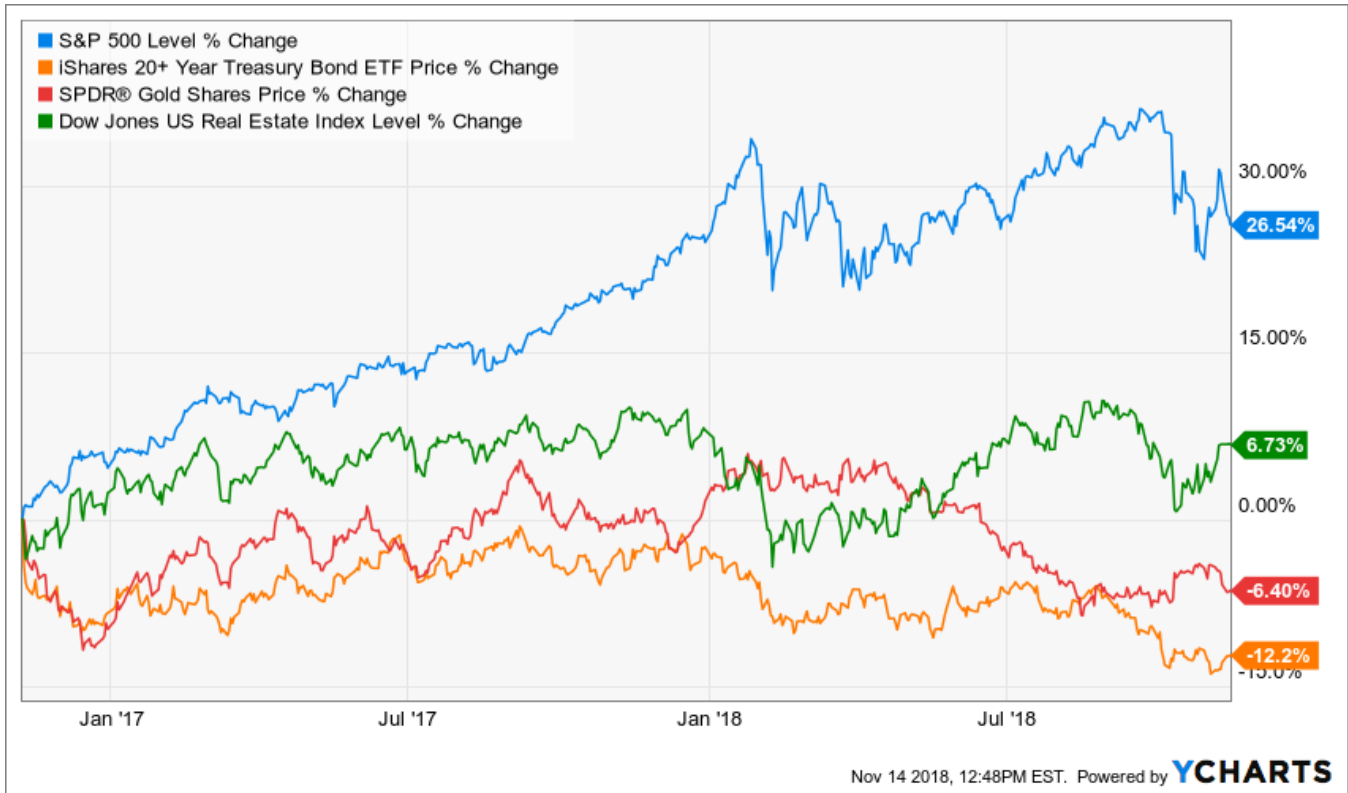
- Between the midterm elections and a Fed rate decision, there was plenty of news last week. But, after the dust settled, there was very little new information.
- In the midterm elections, Democrats gained a majority in the House of Representatives and Republicans tightened their grip on the Senate. A divided Congress through 2020 will temper parts of Trump's agenda and could make some upcoming fiscal tests more challenging.
- As expected, the Federal Reserve left rates unchanged, with a largely unchanged statement. Recent economic data suggest the next hike is coming in December.

Congress is now gridlocked through 2020, which raises questions on a variety of areas. Currently, 25% of governmental discretionary spending for the 2019 fiscal year is under a temporary funding agreement until December 7th. Congress will likely kick the can into early 2019, which sets up a potential funding battle and the risk of a partial government shutdown in the New Year. Government shutdowns are a risk with a divided government, but typically these do not have a meaningful impact on economic activity (as they have not proved long lasting). More important in our view, is that the debt ceiling must be raised or suspended, which is set to be reinstated in March of 2019. This could also produce some headlines but ultimately, we believe, an agreement will be made. There are automatic spending cuts of about \$100 billion set for 2020. Congress needs to look at legislation to address the impact of these spending cuts on the economy.

We see from the chart below, that US equities (blue line in chart) remain in a shorter-term bottom seeking pattern, that could be setting up a reverse head and shoulders pattern, from a technical analysis perspective. This would signal a rebound back towards the years higher levels if it fully materializes. Real Estate investments appear to be continuing its overall sideways trend, as the green line indicates. Interest rates are certainly adding to the difficulties in this space, where there is a slight downward bias to the trend. Gold and Bonds are also continuing their overall downward price direction, as the red and orange lines represent respectively.

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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.

For some perspective on how the year has turned out so far, the chart below provides year-to-date rates of returns for some of the most widely used equity indexes as benchmarks.

Symbol	Name	Description	Year to Date Returns
^MSEM	MSCI Emerging Markets	The MSCI Emerging Markets index is a stock market index that is designed to track emerging less developed international stock market performance.	-16.61%
^MSEAFE	MSCI EAFE	The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. & Canada.	-11.32%
^RUT	Russell 2000	The Russell 2000 Index is a small-cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index.	-1.35%
^RUA	Russell 3000	The Russell 3000 Index is a capitalization-weighted stock market index, maintained by FTSE Russell, that seeks to be a benchmark of the entire U.S stock market. It measures roughly 98 to 99% of the U.S stock market.	1.27%
^SPX	S&P 500	The Standard & Poor's 500, often abbreviated as the S&P 500, or just the S&P, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.	1.82%
^DJUSRE	Dow Jones US Real Estate Index	The index is designed to track the performance of real estate investment trusts (REIT) and other companies that invest directly or indirectly in real estate through development, management, or ownership, including property agencies.	-1.12%

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The information in the above chart shows that international investment in equities has been the biggest underperformer, impacting well diversified global portfolios, more so than domestic equities.

We continue to feel that there are signs of a later stage economic environment. 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. The two biggest remaining themes impacting the markets today are the negotiations with China on tariffs and interest rate policy. Our outlook for the remainder of this year is that there still is opportunity for a move back up, towards the all-time highs achieved in late September-early October. Many analysts on Wall Street are suggesting the same. However, how well negotiations go with China and what Jerome Powell and the Federal Reserve do at the beginning of December will be critical.

Overall, we prefer domestic equities over international equities although, some international markets may become more attractive as the U.S. economic cycle continues to mature. One area that we are starting to look at making some shifts in domestic equities is between growth and value stocks. Value stocks tend to move more slowly in either direction when the markets react to stimulus. In later stage economic environments, a tactical shift to overweighting value type stocks will reduce portfolio risk. This is an area we are now looking to make tactical changes over the course of the coming months and into next year. 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. They are typically and 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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