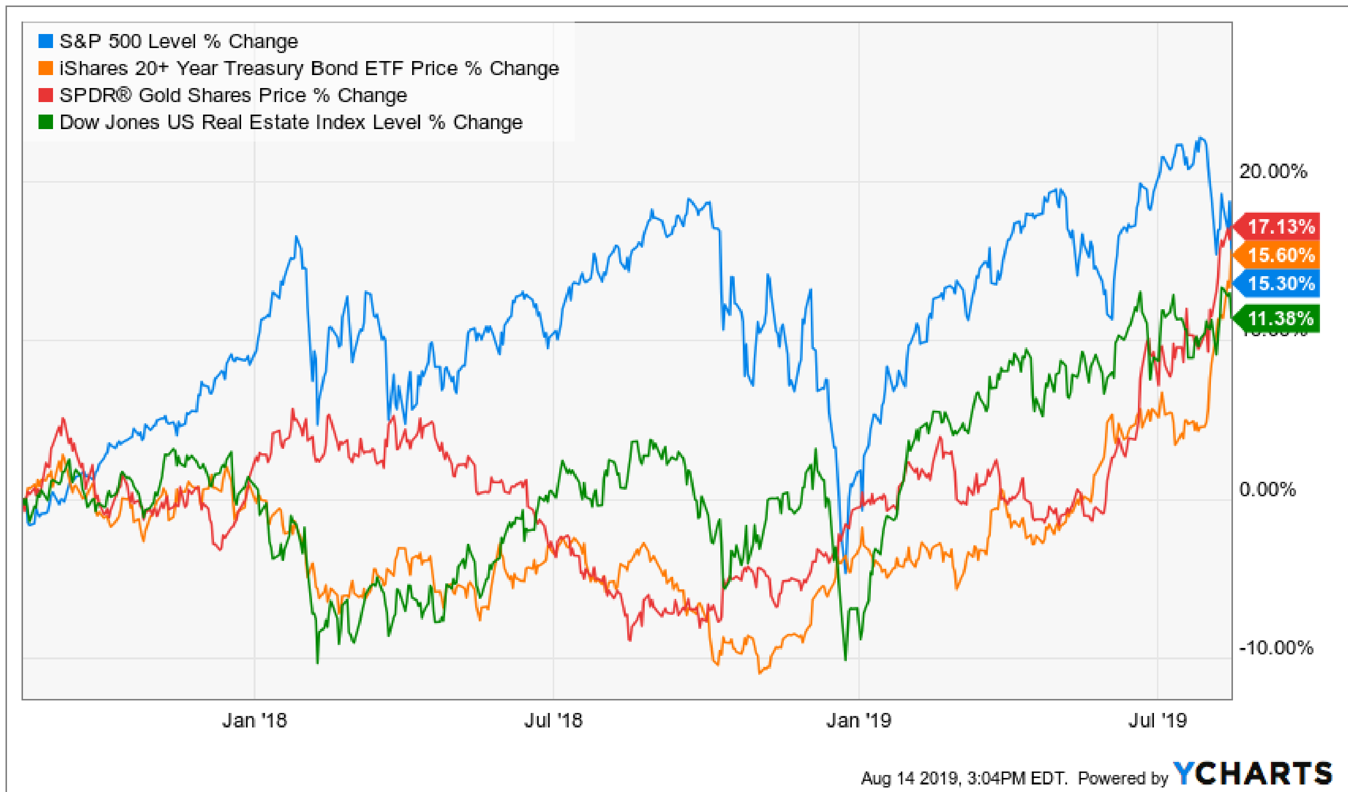
Market Update

August 14, 2019

Yield Curve Inversion, Recession Signaling and China Trade Issues Front and Center of News Cycle

- China responded to the threat of additional U.S. tariffs by halting agricultural purchases and allowing its currency to weaken beyond the psychologically important 7 yuan to the dollar level.
- Central banks around the world responded to the heightened risk posed by the spiraling trade war, by proactively cutting policy interest rates.
- The U.S. services sector showed signs of cooling in July, as the ISM non-manufacturing index declined to 53.7 from 55.1 the previous month.
- Yield curve inversion and recession headlines are dominating today's news headlines, but perspective is important

U.S. equities markets are retreating today after a rebound just the day prior on some positive news regarding delaying tariffs on Chinese goods. This provided a positive signal regarding China trade negotiations. The downward move today comes on the heals of the U.S. treasury yield curve inverting. This means that the interest rate on 2-year Treasuries is higher than the rate on 10-year Treasuries. This has become a signal for a coming recession, as it has preceded the last seven recessions.



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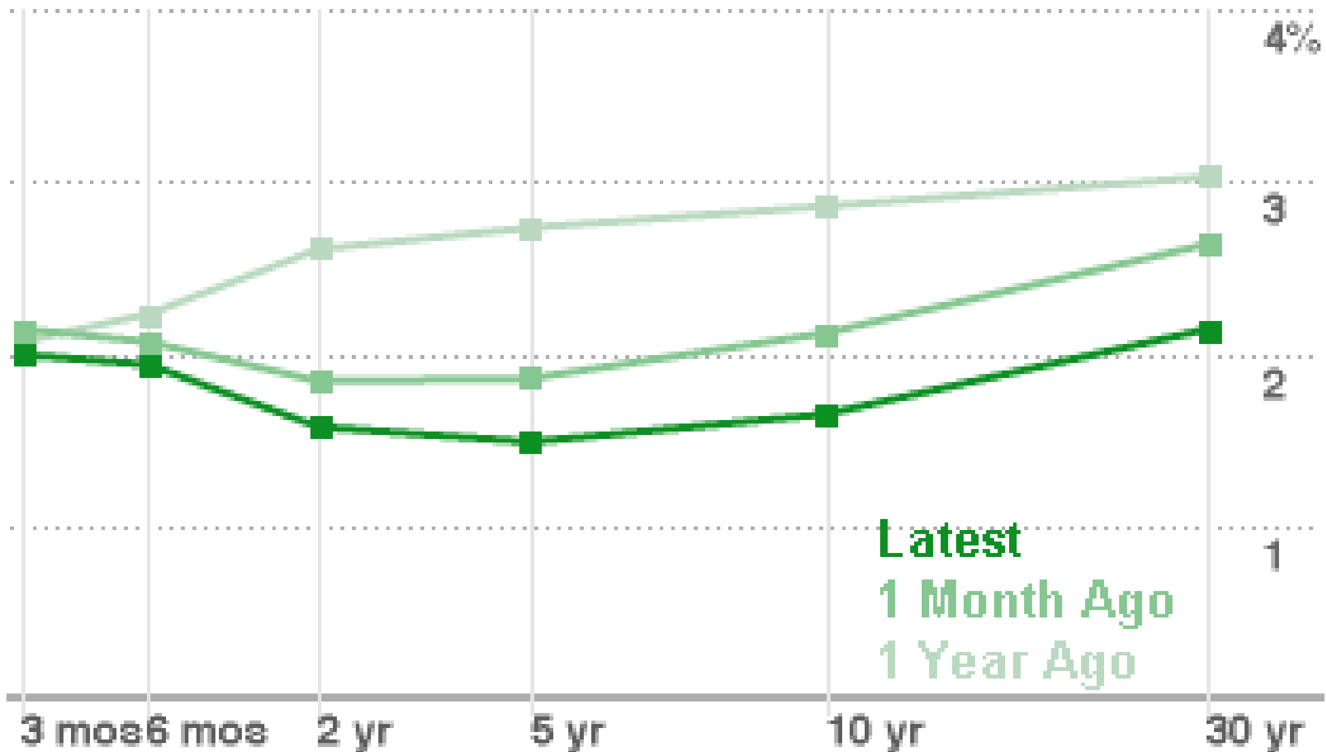
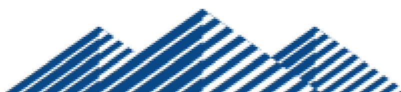
The markets are certainly reacting in the short term to U.S. currency strength, the global recession, central bank rate reductions, Chinese trade tensions, and protests in Hong Kong, as a move toward treasuries has occurred from traders. Traders are looking to try and capitalize on short term market conditions to book profits and are not taking a longer-term view. This is important to keep in mind, when it comes to matching investment decision making, for the goals established, for the money invested. Longer term portfolio management is more about cushioning a portfolio to reduce the impact of shorter-term downward market directions. History shows that an inversion, while not an upbeat sign about the coming state of the economy, doesn't necessarily translate to a lasting selloff in equity markets. The durability of the stock market might be a point lost on investors Wednesday afternoon.

Currently, the Dow Jones Industrial Average, the S&P 500 and the Nasdaq Composite indexes are trading at least 2.7% lower on Wednesday (http://www.marketwatch.com/story/dow-futures-down-over-300-points-on-global-growth-concerns-yield-curve-inversion-2019-08-14). But, over the longer stretch, stocks have tended to rise firmly following the closely watched recession alarm.

On average, the S&P 500 has returned 2.5% after a yield-curve inversion in the three months after the episode, while it has gained 4.87% in the following six months, 13.48% a year after, 14.73% in the following two years, and 16.41% three years out, according to Dow Jones Market Data. On top of all that, a yield-curve inversion, doesn't instantly result in an economic recession. From 1956, past recessions have started on average around 15 months after an inversion of the 2-year/10-year spread occurred, according to Bank of America Merrill Lynch.





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Our belief is still that there are signs of a later stage economic environment. Any future recession we feel would be mild in comparison to others, at this point. It is worth noting that several catalysts are on the horizon, that could slow down the eventual arrival date of a recession, which is indicated by two successive quarters of negative GDP growth. We are a long way from that as of today, but must continue to watch the data as it comes in. The biggest concern for the economy in the next 12 months continues to be the Federal Reserve interest rate decisions. Chinese trade issues could quickly turn into a positive, if a deal is made. This would potentially create a reason for equities to rally. The Federal reserve also has some ammunition regarding interest rates and balance sheet management that it can implement to help the U.S. economy work through the global issues at the forefront of the inversion, in the yield curve. The Federal reserve dual mandate is to enact monetary policy decisions to combat inflation and maintain employment. A key factor missing right now is hyper inflationary pressures, commonly seen before recessions in the global marketplace. We currently view this as a positive. Fiscal policy decisions from the U.S. government are also elements that can come into play should we need to see some type of further action, to augment Federal Reserve policy decisions.

Having a disciplined investment and risk management process regardless of market action is the foundational elements to our portfolio designs. It is this portion of the approach of portfolio management that helps consistently reduce the long run risk taken in a portfolio of investments. Speculating about near term directions in the markets can be and often is a difficult and risky proposition. We can control the risk and process we take in our portfolio construction, but we cannot control market performance.

Overall, we prefer domestic equities over international equities. We prefer more value-oriented stocks vs. growth stocks currently. As we have stated in the past, 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 can reduce portfolio risk. As we watch interest rate policy decisions from the Federal Reserve, we will evaluate our stance and potentially look to opportunities that exist in more of the growth areas of the market. These are areas we are looking at, to continue to make tactical changes, over the course of the coming months. We are currently neutral on fixed-income and interest rates. It is important to maintain discipline regarding long-term strategic asset allocation. However, as market conditions dictate, we are looking at tactical opportunities to reduce risk in portfolios, if necessary.

If you have questions or would like to discuss this further regarding your personal portfolio, please contact me at 310-469-7254.

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

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