Market Update

February 14, 2018

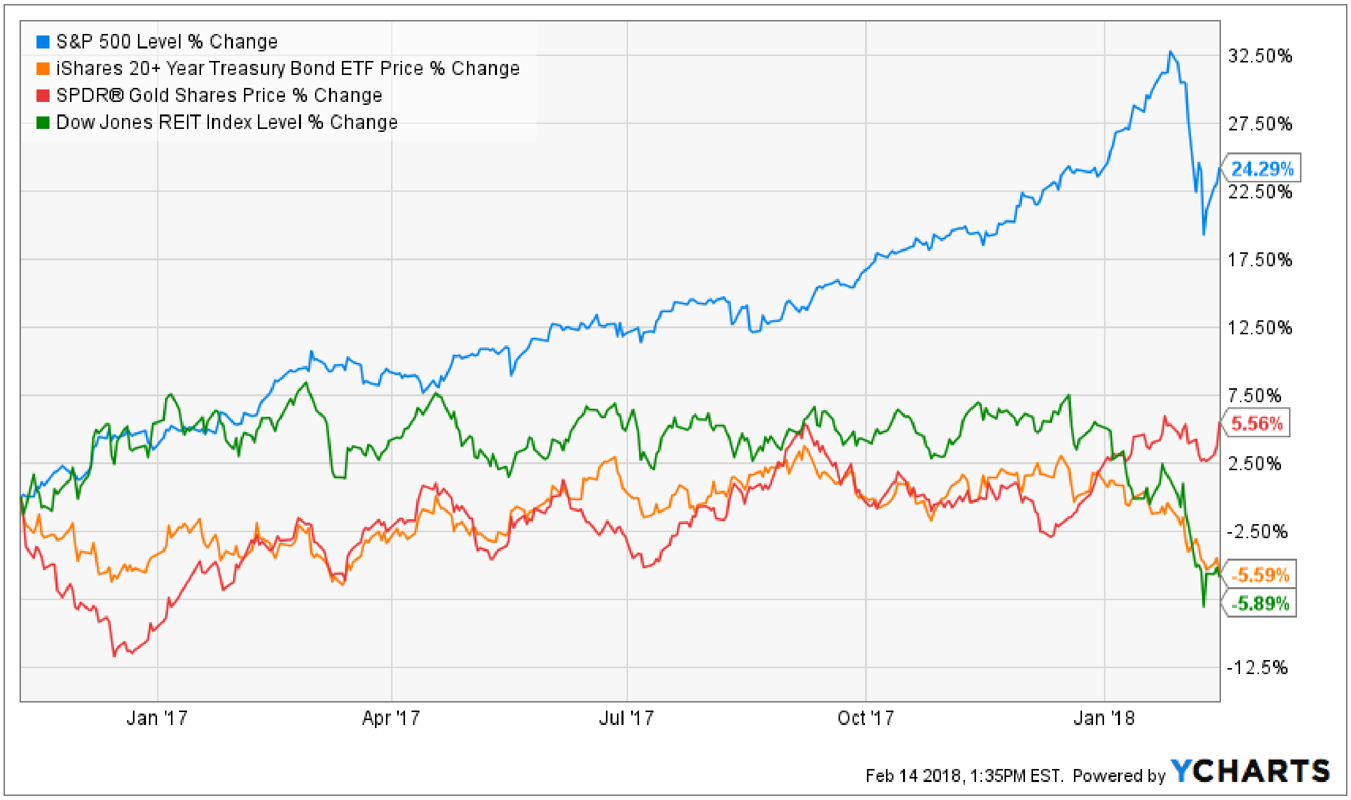
Stock Market Corrects as Fundamentals Remain Strong

Last week all major U.S. stock indices entered correction territory by Thursday. The markets had pulled back 10% or more for the first time, since the November 2015 to February 2016 correction. Stocks took 4 months to recover from that correction. A pull back in the market of 10% or more signifies a market correction. Bear markets do not officially begin until the market corrects by 20% or more. From a historical stand-point, all corrections are different in performance, length and recovery time. On average, since World War II, the average correction is down 13% in a 4-month period and takes another 4 months to fully recover. This suggests there could potentially be more down days to come where a retesting of the low's set last Friday occur. This does not mean that this correction will be like others or close to the historical averages. There are very good reasons that we believe may make this correction different. The core reasoning that this correction could be different and potentially shorter than most are very solid fundamental economic underpinnings. This correction is rooted in fear of inflation starting to tick up due to a good wage report showing an uptick in wages, a corresponding increase in interest rates creating a shift in the positively sloped yield curve and a new Federal Reserve Chairman starting his tenure. The triggering event that increased the velocity of this correction was the poor management of a derivatives investment product linked to the VIX. The VIX is the Chicago Board Options Exchange Volatility Index, which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. When a product that is designed to take advantage of low VIX volatility was managed/designed poorly, it broke down as volatility spiked forcing the sale of S&P500 futures to raise cash to meet its obligations. This happened as technical levels in the markets were breached. These types of issues take time to unwind and the markets appeared to trade erratically as this issue was worked through.

What is most important to remember is that this sell-off was not triggered by weak economic data for either the U.S. or the global economy. This sell-off was likely because U.S. markets had not had a correction in a very long time. In 2017, there was not one down month in the market. This created a situation where the markets were technically overpriced and needed a retracement. These types of sell offs are common in bull markets. What was uncommon was the length of time we have gone through without a down market. The confluence of inflation fears, rising rates and a triggering event created a rapid decline from the all-time highs set in January.

As I write this update, the markets have been in a 4-day relief rally bringing them close to the levels where they started 2018. It is our belief that recapturing the recent all-time highs may take a few months, but the bull market trend is still intact, and we feel the markets may set higher highs by the end 2018. We are cautious in the very short term and do think there is potential to see a retest of lows depending on short term news events and technical selling. However, we believe the depth of the selloff is mostly in and the bottom has likely been set.

In the chart below, we are tracking the S&P500 (blue line) our proxy for the U.S. equities markets, the orange line is for TLT, our proxy for long term Treasury Bonds, the red line is for GLD, our proxy for Gold. We added the green line, which is the Dow Jones REIT index, to track the performance of Real Estate Investment Trusts. This chart shows performance since November 9th of 2016.

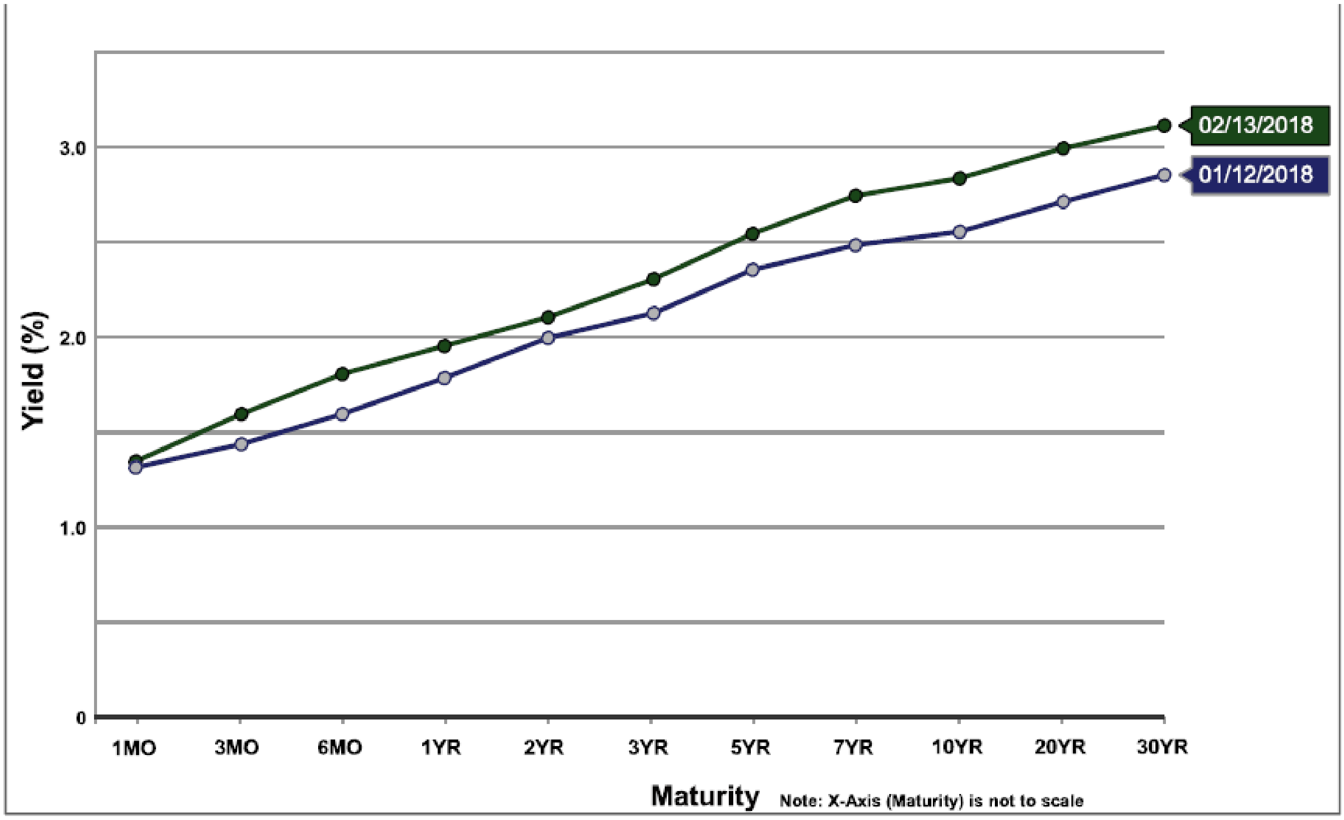


Information in the chart above was taken from sources we believe to be reliable; however; we do not guarantee its accuracy or completeness.

We can see from the chart above that interest rate sensitive investments such as bonds and real estate have seen a decline in principal value. Gold has ticked up since the start of this year and decoupled from bonds. It is important to point out that when equities markets go through periods of stress investment in safe-haven investments like Treasuries, Gold and to a lesser degree REITs often ticks up. In the recent sell-off, gold ticked up a little bit as the very end of this chart shows, but the other investments that typically attract capital like Treasury bonds and REITs did not. This can be considered a sign that the sell off was more of a technical over bought market issue than anything more nefarious.

Market Update

February 14, 2018



Information in the chart above was taken from sources we believe to be reliable; however; we do not guarantee its accuracy or completeness.
https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/Historic-Yield-Data-Visualization.aspx

The treasury yield curve in the chart above shows that since last month, treasury rates have moved up and the yield curve has steepened. A steepening yield curve is indicative of a strong economy. We watch the yield curve as an indicator of a recession and corresponding bear markets. The yield curve historically has flattened quickly and then inverted prior to a recession. We are not seeing this type of activity in the curve and we feel more steepening is the likely path over the next 12months.

As mentioned, the fundamental back drop of the economy should provide the markets with a platform for continued growth. The biggest concern for the next 12 months is 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. The emergence of bubble like phenomena in cryptocurrencies is concerning. At this point, we do not see it being a systemic issue, but that does not mean that it won't become an issue sometime in the future. 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, which tend to hold value better in rising rate environments. It is important to maintain discipline regarding strategic asset allocation. Tactically the shift to holding some floating rate bond or bond funds 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®, AIF®, NSSA®
President
Prominence Capital GP, LLC.
jliotta@prominencecapital.com
www.prominencecapital.com

PROMINENCE CAPITAL