Market Update

March 12, 2018

Higher Inflation, Tariffs and Markets

The U.S. economy continues to show signs of growth with a very solid job report in February. U.S. payrolls grew by an unexpected 313,000 jobs. Unemployment stayed at a 17 year low of 4.1% and wage growth came in at 2.6%. The Fed's Beige Book also showed strong economic fundamentals, however it also included evidence that businesses are starting to pass higher cost along to customers. Inflation pressure is starting to build in the U.S. and import tariffs could increase this pressure. The Federal Reserve's inflation target is 2% and the economy is showing signs it could overshoot this target. New tariffs on steel and aluminum are set to take effect shortly, but the scope is narrower than initially announced. President Trump has excluded Mexico and Canada from the tariffs. Canada represents roughly 16% of our imported steel and Mexico is roughly 9%. Canada and Mexico account for 43% of U.S. aluminum imports. Despite producing half of the worlds steel, Chinese steel imports are less than 3% of the U.S. total. Brazil, South Korea and Russia represent 13%, 10% and 9% of U.S. imports respectively. The Commerce Department noted that employment of U.S. workers in the steel industry has shrunk by 35% in the past 20 years and the aluminum industry has seen jobs shrink by 60% between 2013 and 2016. The fear of a trade war is certainly a topic of considerable debate and media coverage and will likely dominate headlines for a time. Economic studies have shown that the overall costs to the economy from these trade battles outweigh the job gains in the protected sector. This maybe one of the reasons the administration has walked back the initial scope of countries effected by these tariffs. Even with the recently experienced market correction, the U.S. Equities markets are up on the year and appear to be poised to benefit from better labor market conditions and the recent tax plan. The blue line in the chart below represents the S&P 500 since the election in November of 2016. The Orange line is our proxy for Long Term Treasuries. We see that Treasuries remain in a price decline which is commensurate with a rising interest rate environment. It is no surprise to see REITs (Real Estate Investment Trusts), the green line, also experiencing a decline as many investors look towards REITs to increase income in their portfolios. With a rising interest rate environment REIT prices need to adjust down to compete more effectively with safer bonds such as Treasuries. Gold prices have de-coupled from bonds and REITS as the red line in our chart shows. However, one bright spot, was that Gold prices did not shoot up during the recent market correction. This is a helpful sign that the recent pull back was more of a correction than something more detrimental and longer lasting in the equities markets. The markets do appear to get a little more volatile when the rate on the 10-year treasury has moved up through 2.90%.

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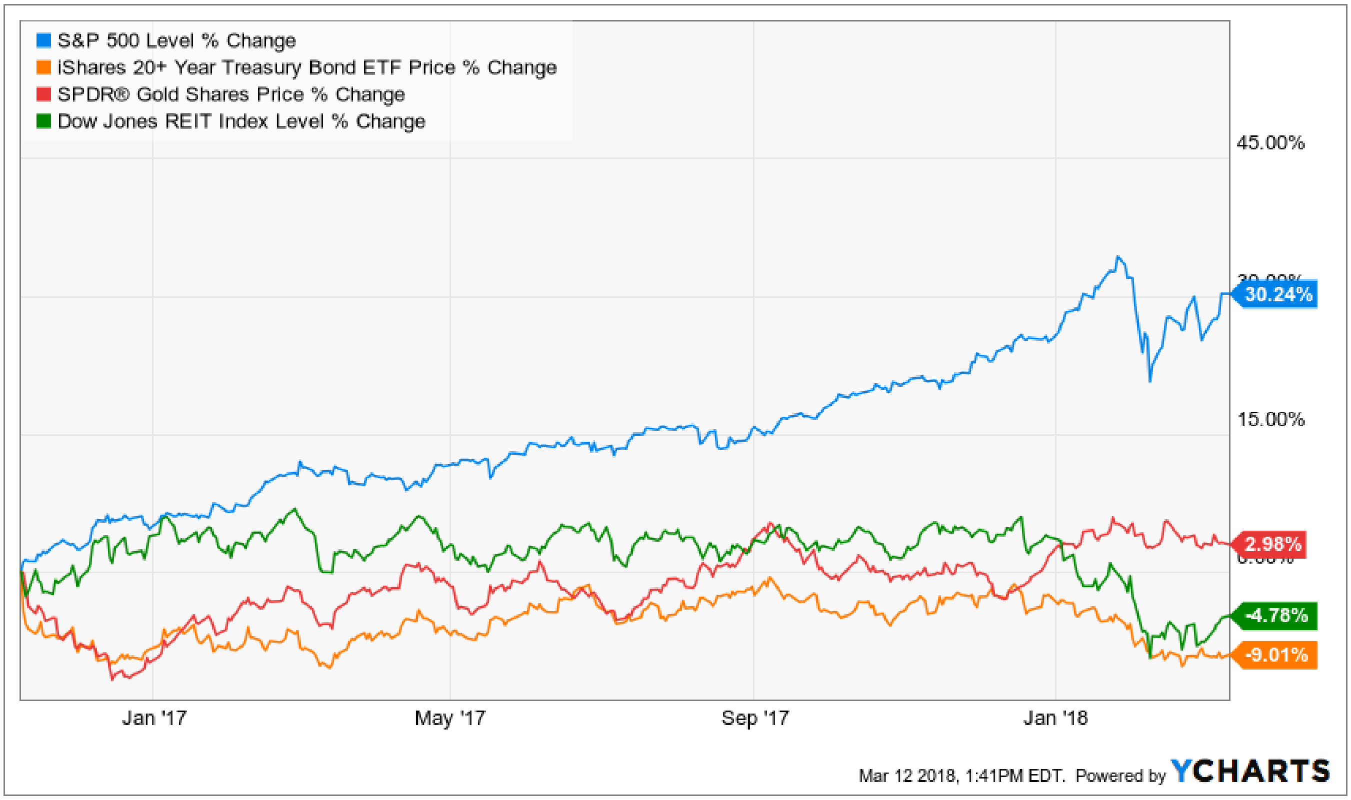

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The Treasury yield curve remains positively sloped with short-term rates lower than long-term rates, although there appeared to be a touch of flattening to the curve, since last month. The shorter end of the yield curve moved up slightly with even less of a move up in rates, as you continue out along the curve to longer dated bonds. The new Federal Reserve Chairman, Jerome Powell, recently spent a couple of days testifying on the economy to the Senate, where he mentioned that the Fed stands poised to raise rates at a gradual rate. The implementation of tariffs could have an impact on the Feds calculous going forward regarding the pace at which they raise interest rates. The economic data does need to come in and support increased rates however, and the number one issue the markets face is how aggressive the Fed ultimately will be in doing so.

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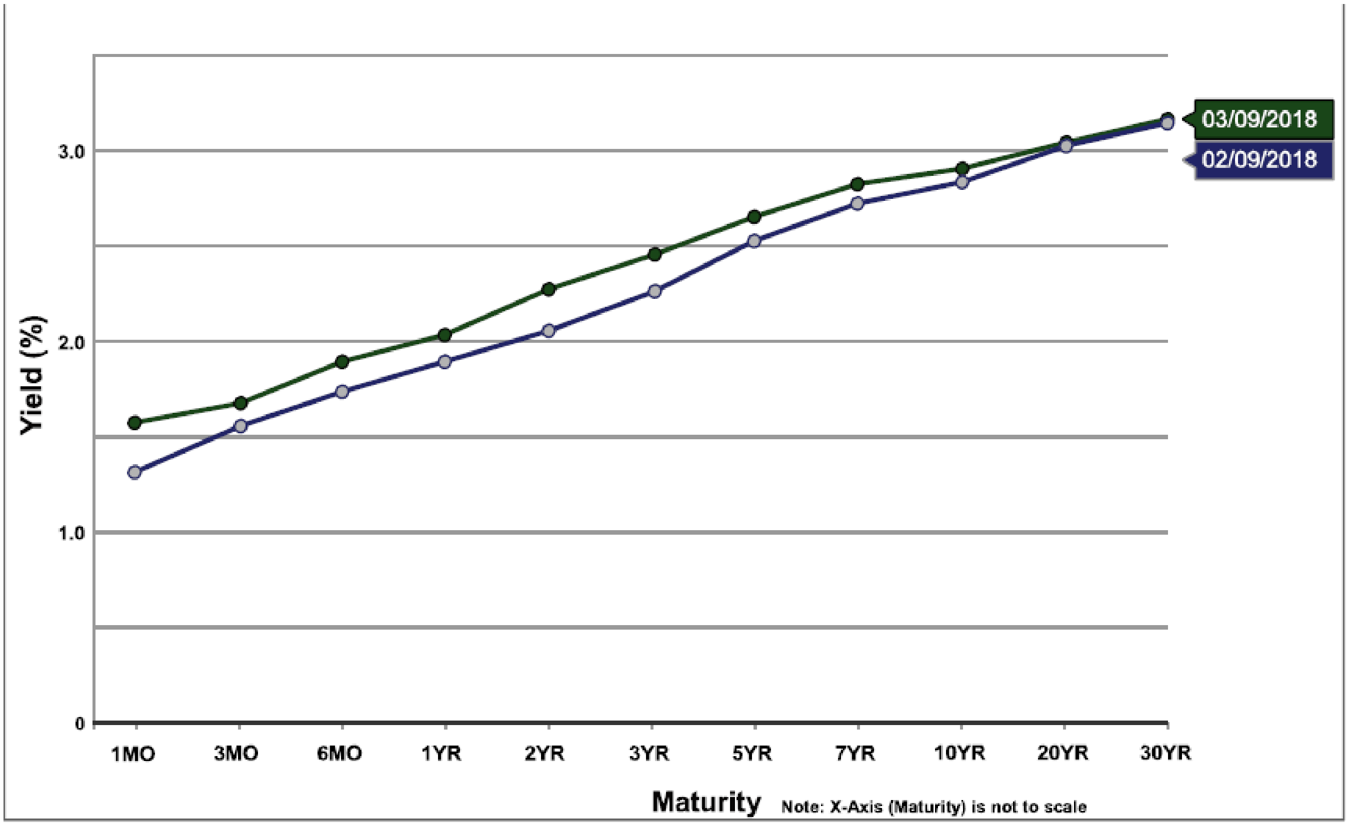

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https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/Historic-Yield-Data-Visualization.aspx

Our view is the fundamental back drop of the economy should provide the markets with a platform for continued growth. 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 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. 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.

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