

Market Update

July 20, 2018

Chinese Tariffs and Feds Upbeat View of Economy

- Since last market update, action on Chinese import tariffs has dominated the economic news, but markets remained positive overall, likely reflecting relief that oil prices have come off their recent highs.
- Since China retaliated to the first salvo of U.S. tariffs, the U.S. is moving ahead with the process to impose a further 10% tariff on \$200 of Chinese goods, after a two-month consultation period. Tariffs will make the Fed's job of reading inflation signals more difficult.
- So far, June CPI data showed inflation rising steadily, as expected. But, it is still too early to see much impact from tariffs in consumer prices.
- Economic data was a mixed bag this week: retail sales were a bright spot, but housing starts unexpectedly plunged in June.
- In his testimony to Congress, Fed Chair Powell offered an upbeat view of the U.S. economy, and noted that the risks posed by trade protectionism would not push them off course on further rate hikes.

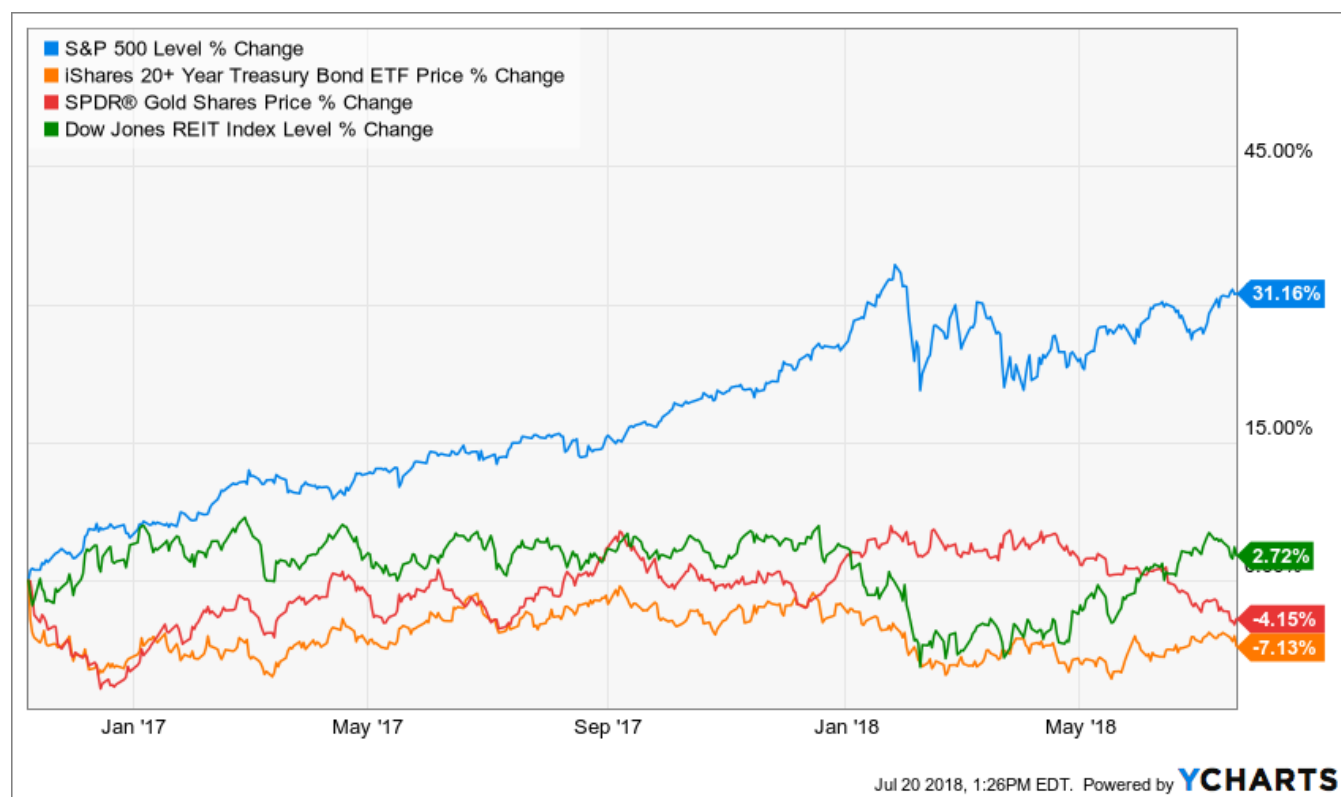
These tariffs will raise input prices for many American businesses, but the extent to which they are passed on to consumer prices will depend on the competitive environment, of the industry. If businesses can't pass on price increases to their customers (for fear of losing too much market share), they may have to cut costs by reducing staff or planned investments. Both actions will crimp growth in the overall economy. If tariffs are fully passed on to consumers you get higher inflation, and slower growth by a different channel. The federal government may mitigate the negative impact by funneling the tax revenues back into the economy. There is always the potential that the tariffs are reversed before any meaningful impact is made on the economy.

The chart on the next page shows that since last month's update, equity markets have continued to maintain a positive direction. The blue line represents the S&P 500. The real estate investment trust index (REIT) continues to look range bound as it moved closer to the top of its trading range in this graph. The green line represents the Dow Jones REIT Index. Prices for longer term U.S. Treasury dropped back down a bit since last month. The orange line in the graph represents TLT our proxy for long term bonds. Finally, Gold has dropped in price considerably since last month. The red line in our chart below represents GLD our proxy for Gold.



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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.

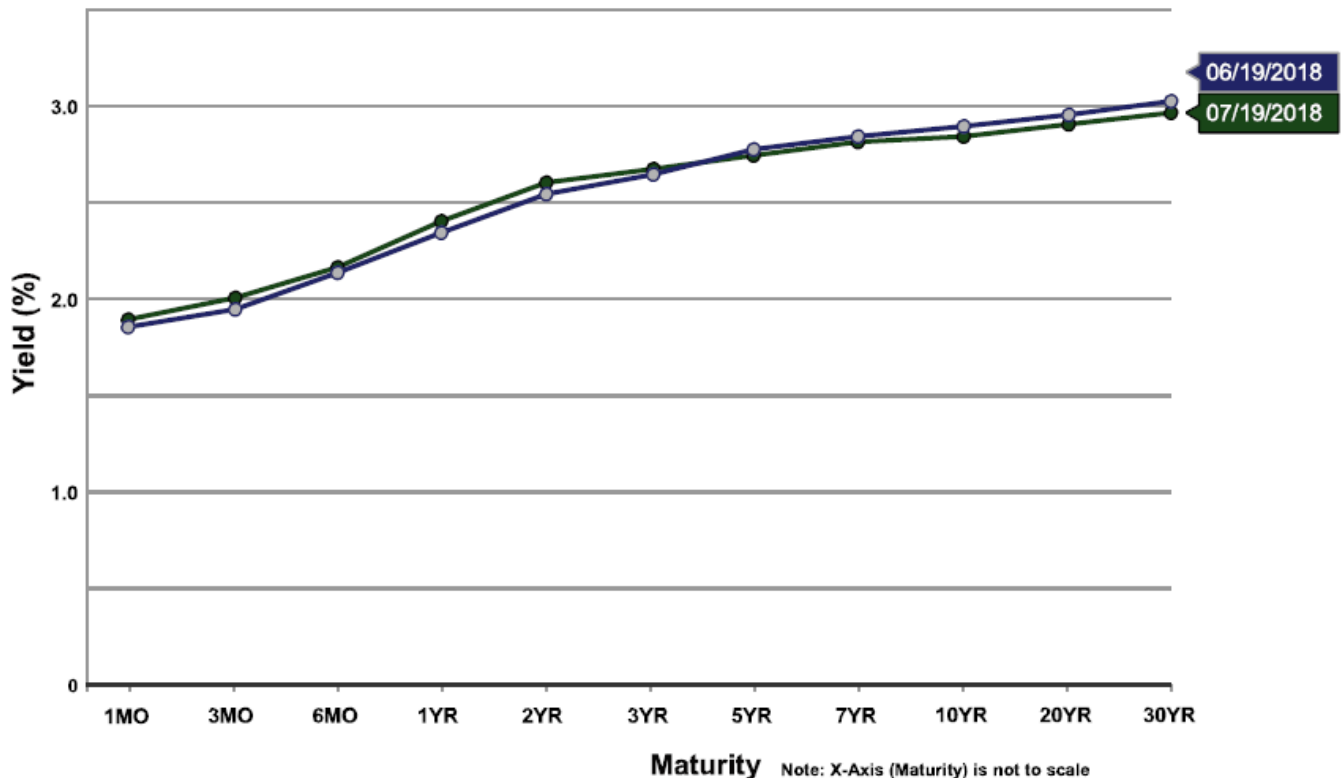
The US. Treasury yield curve below, has shifted up a slight bit, since last month. A shift up of short to intermediate term rates made up much of the change in the yield curve. In his recent testimony to Congress, Fed Chair Powell offered an upbeat view of the U.S. economy, and mentioned that the risks posed by trade protectionism would not push them off course on further rate hikes. He noted the strong labor market, rising after-tax incomes, and healthy growth in business investment. He also praised progress on the inflation front, and somewhat downplayed the risk stemming from trade protectionism, noting that “the risks to the outlook were roughly balanced”. He concluded, that “the FOMC believes that, for now, the best way forward is to keep gradually raising the federal funds rate.” In other words, current trade risks are not enough to derail the Fed from hiking rates on a quarterly basis.

The U.S. economy continues to be red-hot, but this pace of expansion will be hard to sustain going forward as it starts to bump against capacity constraints, particularly on the labor front. Higher material prices, wages and shortages of labor in some sectors featured prominently in the latest Beige Book.



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

Our view remains that the fundamental back drop of the economy should provide the markets with a platform for continued growth. However, 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. Preliminarily, 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 equities although some international markets may become more attractive as the U.S. economic cycle continues to mature. 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

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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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