FBB capital partners

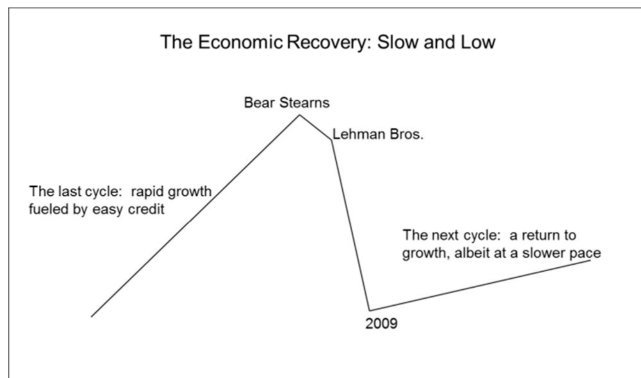
October 2, 2014

Dear clients and friends,

"If history repeats itself, and the unexpected always happens, how incapable must Man be of learning from experience."
- George Bernard Shaw

The economic recovery from the "Great Recession" turned 5 years old last quarter.

We first posited our "slow and low" economic outlook at the start of the recovery, believing the pace of expansion would be slower than was typically experienced after a recession, with concurrently lower levels of inflation and interest rates. The graphic to the right, which we've recycled from a presentation made in 2009, illustrates this view. Credit-related growth had accelerated in the prior 10 or so years, with looser credit standards for everything from residential housing to commercial real estate, credit cards to car loans. To our thinking, the excesses of the prior credit cycle, which reached an inflection point with the collapse of Bear Stearns and Lehman Brothers, were not likely to recur, and bank lending capacity would be severely limited in the years ahead.



This view proved largely correct, with the economy expanding at the slowest pace among modern post-recessionary periods, as shown in the table on the left. Yet, the recovery has also been more stable than typical, weathering the storms of the US fiscal cliff (more than once), a resultant downgrade of the bellwether US Treasury's credit score, the near collapse and resurgence and spiral downward again of the Euro, and an ongoing list of global near-calamities. Corporate profits are at all-time highs, corporate balance sheets are as healthy as they've ever been with gobs of cash on the books, and inflation is tame.

Recession ending	Peak GDP recovery*
March 1975	6.2% by 1976
December 1982	8.5% by 1984
March 1991	4.3% by 1992
December 2001	4.4% by 2003
June 2009	3.1% by 2010

*Year over year % change

It is therefore somewhat worrisome to read, just last month, a report by the Federal Reserve that banks are once again easing credit standards, loosening the lending criteria for mortgages and a variety of other consumer and business loans. These developments could suggest more rapid growth ahead, which is arguably a good thing. But they could also be a harbinger of higher risk, credit-fueled growth – the kind that ended so painfully at the end of the last decade.

We are reminded in a recent Goldman Sachs report **that economic expansions do not die of old age**, but rather are killed. Right now there are no expansion-killers in site – specifically no excessive inflation, therefore little reason for the Federal Reserve to aggressively hike interest rates to cool off growth, which can sometimes bring on a recession. And there are presently very few severe financial imbalances, such as the housing bubble and extreme borrowing that quashed the last expansion. The recovery should therefore continue for the foreseeable future at its slow and low pace, but with a yellow flag indicating more caution is warranted should the pace accelerate.

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Stocks and bonds finished the third quarter of 2014 relatively unchanged from where they began, with the S&P 500 stock index rising a mere fraction of a percentage point in price, and the 10-year US Treasury note yielding around 2.50% at both the start and end points.

However, the markets experienced **higher levels of volatility** in the third quarter, with much of the consternation attributable to an increase in global economic uncertainty. Europe's deflationary slowdown is being exacerbated by sanction-impaired trade with Russia. "Abenomics" in Japan has ended with little in the way of productivity gains to show for all the hype. The Middle East remains a global hot spot as ISIL gained a stronger foothold in Syria. The Ebola virus has apparently been carried beyond Africa's borders. And concerns are rising that peaceful pro-democracy protests in Hong Kong could turn into China's next Tiananmen Square disaster, or worse.

Whether or not these global forces further impact the US markets will be the focus of the coming quarter.

Meantime, stock market valuations appear quite reasonable relative to most historical earnings multiples. And while the Federal Reserve is likely to being raising the Federal Funds target sometime next year (probably June, but possibly as soon as March), we do not expect a significant increase in longer-term bond yields in the foreseeable future. With these points in mind, we believe markets can continue to grind higher, even though near-term global events could make the ride bumpier.

Sincerely yours,

Mitch Schlesinger
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