



Volatility Is Back: Embrace the Volatility

April 1, 2016

Dear Clients and Friends,

Well, that was interesting. The first quarter of 2016 may go down as the most volatile in recent memory with the S&P 500 down 10% between January 1 and February 11. Meanwhile, investors worried that plunging oil prices were signaling dwindling demand for energy and, potentially, threat of a near-term recession. FBB used the short-lived downturn as an opportunity to continue trimming holdings of lower-quality stocks and bonds whose fundamentals were showing deterioration and shifted proceeds into higher quality securities.

Fortunately, equity markets snapped back into positive territory after oil prices bottomed at \$26 a barrel in February and rebounded dramatically toward \$40 by the end of the quarter. Investors have since realized that global energy demand (including China) remains stable amid falling supplies. Sometimes volatility works in your favor.

What's driving the volatility?

As we enter the second quarter, FBB believes that several forces are pointing toward macroeconomic changes, including: stabilization of the dollar, slowly rising interest rates, a gradual rebound in oil, and upward pressure on equities to match improving fundamentals.

Together, these forces may sound like a bullish recipe for equities. However, investors may have a hard time finding the right ingredients for success, as markets struggle to predict the timing and magnitude of these macroeconomic shifts, which may generate even more volatility in equity markets for the balance of 2016.

The CBOE Volatility Index, also called the VIX or the fear index, uses current data to predict future volatility. As of this writing, the VIX is currently in the mid-teens, well below late 2015 and early 2016 levels, which were in the mid to high twenties.

Our sense is volatility and the VIX index will revert toward higher long-term averages in the twenties, as investors' place bets on shifting macro fundamentals. Daily market volatility is likely to remain elevated, although another 20% round trip journey (10% down and 10% up) like the one we experienced in the first quarter is less likely.

One dynamic in particular that may drive greater uncertainty is a changing relationship between oil and stocks. Historically, stock prices and the price of crude oil have been un-correlated. While recent history has shown quite the opposite (as equities and crude oil have traded in lock step), once again (similar to



the price level of the VIX) this is not the norm—in fact this is very abnormal. Now that oil and commodities have rebounded from multi-year lows, we expect this abnormal pattern of high correlation to break down.

Another persistent driver of uncertainty this year will be interest rates and their potential path. At the moment, an April Fed rate hike seems off the table and Janet Yellen may be signaling that chances of a June hike are dwindling. As we manage client portfolios, we continue to focus on the timing, magnitude, and impact of the Fed rate hikes, especially for financial services stocks, higher dividend paying companies, and bonds.

Searching for investments benefiting from volatility

With an expectation of rising volatility as a backdrop, we are looking to embrace the uncertainty by seeking out stocks that benefit from a higher VIX index. One such company is CME Group, the former Chicago Mercantile Exchange. We favor CME not only for growth, but also for income. At first glance the stock appears to pay a nominal 2.5% dividend yield; however, if the company continues to pay special dividends (as it has for the past several years), the real yield to investors will be closer to 5%.

Looking beyond individual securities, FBB continues to manage client portfolios with a focus on quality, income and the potential for long-term outperformance. During periods of elevated volatility, high- and low-quality companies often trade at similar valuations, creating opportunities to buy great companies at the same price as mediocre ones. We look forward to embracing volatility in 2016 as we seek out high quality investments at attractive prices.

With Warm Wishes for Spring,

FBB Capital Partners

Note: Please SAVE THE DATE for the following upcoming events, further details to follow via e-mail:

- On April 7th at 2pm (EST), FBB will host a conference call with clients to discuss our Investment Outlook. Please send questions in advance of the meeting to katie@fbbcap.com. The dial in is: (Local) 301-298-1561 / (Toll-Free) 800-719-7514. The access code is: 707517.
- On April 27th at 2pm, FBB will co-host the second of four calls this year with Greg Valliere, an expert in political and economic trends who will help enlighten us on potential investment implications of the presidential election.
- *Please keep an eye out for an enrollment e-mail with instructions how to access your new FBB client Vault in the weeks ahead.*

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