FBB capital partners

July 1, 2018

"Woah, We're Halfway There"
-Jon Bon Jovi, Slippery When Wet, 1986

Dear Clients and Friends:

As the calendar rolls to July, we're starting to notice that we're "halfway there," perhaps in more ways than one. With the first half of the calendar year behind us and contractionary monetary policy closing in on a three-year anniversary, we are looking back on the second quarter within the broader context of the economic and market cycle, with a focus on the Federal Reserve.

Since 2015, the Fed has hiked interest rates seven times, most recently last month. Given recent economic data, we anticipate six more rate hikes by the end of 2020. In our view, the second quarter of 2018 reflected cautious optimism among investors as the Fed reached its "halfway" point in its contractionary efforts. At FBB, we are looking ahead to anticipate how markets will perform in the latter stages of this Fed tightening cycle.

Getting Better

In early January, we anticipated a tug of war between wages and taxes. Thus far, we've seen wage concerns weigh on markets in the first quarter, while benefits of the tax cuts boosted equities in the second quarter. Broader markets rose 3.4% in the second quarter, providing many investors a sigh of relief after the nearly 1% decline in Q1. Recall that higher than expected wage inflation, combined with a stock market "melt up" that ended in late January, led to choppy markets for the remainder of the first quarter.

In contrast, inflation and market volatility both subsided in the second quarter, as investors focused on economic growth, inflation, and a jobs market – all of which were neither "too hot," nor "too cold." This "Goldilocks" narrative and 20%+ quarterly profit growth (driven partly by tax cuts) muted rising concerns of a trade war and gave investors more comfort to buy stocks, pushing markets modestly higher.

FBB took advantage of rising markets to harvest gains for larger positions and reduce holdings in stocks that had moved higher in the short term but that may face challenges longer term. One such reduction was Microsoft, as the stock's multi-year gains created an oversized position. Notably, Microsoft remains one of FBB's top holdings. Over the long term, we believe that cloud computing will continue to drive the company's growth.

On the other hand, we reduced clients' positions in Amgen, because the stock price rose despite looming generic competition for older drugs—specifically for white-blood cell production (Neulasta) and rheumatoid arthritis (Enbrel), which we believe will hurt the company over the long term. We also did some buying in the quarter, swapping into durable growth healthcare and retail stocks (Johnson & Johnson, TJX Companies) at attractive valuations. For Johnson & Johnson, sales of a new cancer drug have exceeded investor expectations, while TJX continues to improve on its execution in the discount retail space and the recent rollout of HomeSense, a brand that will likely compete with Crate and Barrel.

What's Next for the Fed, Economy and Markets?

With Q2 in the rear-view mirror, we are turning our sights to the next phase of Fed actions and potential impacts during the remainder of 2018 and beyond. We expect steady economic growth to gradually push unemployment down and inflation up, keeping the Fed on track to boost interest rates two times in the second half of 2018. Our sense is this pattern will continue with three more rate hikes in 2019 and culminating with a final hike in 2020.

Certainly, the expanding possibility of a trade war that slows economic growth could lead the Fed to stray from its "glide path" and slow the forecasted rate increases. At this point, however, we expect the U.S., China, and Europe to negotiate trade deals and dial down the protectionist rhetoric. Under-performing stock markets in China and Europe this year may send policy-makers a sign that the private sector disapproves of the rising trade barriers. What's more, trade war proposals may die down after U.S. mid-term elections.

Livin' On a Prayer

If a major trade war disintegrates and the Fed has a clear line of sight toward higher interest rates, we see reason for a more optimistic outlook. Higher interest rates should slow the economy as borrowing costs rise for employers and home buyers. In the current cycle, we expect the Fed's current snail's pace with measured quarter point hikes to continue, likely allowing equities to continue to perform well, while also making bonds more attractive.

How are We Positioned?

With the rise in interest rates, short-term Treasuries and high-quality corporate bonds with maturities inside five years have become more attractive. Our preference for quality directs us to seek corporate bonds within defensive sectors such as consumer and utility companies with solid balance sheets and stable cash flows.

As clients, friends, and your team at FBB look forward to Fourth of July fireworks and backyard barbeques, we continue to favor stocks and sectors that benefit from an economy firing on all cylinders. This has us hunting for high quality companies with reasonable valuations in the technology, industrial, and financial sectors.

With the dog days of summer approaching, we continue to monitor the temperature of the markets and investor sentiment, while remaining flexible to deal with surprises as they emerge.

With Warm Wishes for Summer,

FBB Capital Partners

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Please note that FBB's Client Vault technology will be transitioning in the quarter ahead. Keep an eye on your e-mail Inbox for instructions on how to access your new client vault via your desktop or mobile device.