FBB capital partners

October 12, 2018

Market Update and Investment Outlook

Dear Clients and Friends,

Well that was quick. Following a fairly smooth ride in the third quarter, volatility came back abruptly in early October as fears of rising interest rates and a worsening trade war have upset the markets. Still, despite the latest decline in investor sentiment, we expect opportunities ahead as markets reflect on stable fundamentals elsewhere, such as surging corporate profits, steady GDP growth, low inflation, and plenty of jobs to go around.

Why are markets falling?

The S&P500 fell about 7% between September 20 and October 11 on fears that two forces are squeezing profits: rising interest rates and rising costs of the trade war. Investors are likely drawing a straight line from potentially lower profits to lower stock prices. However, let's unpack these two risk factors to see if there's more bark than bite here.

Rising rates: Our sense is investors were fairly comfortable with the Federal Reserve's gradual approach to higher interest rates as a way of taking its foot off the gas (monetary stimulus). However, a big move up in 10-year treasury bond yields over the past week may have jolted some investors into panic mode. Investors may have wondered if much higher rates are coming much sooner, suggesting the bond market could hit the brakes on the stock market's forward progress.

While investors are feeling squeezed on one side with rising rates, they are also feeling more pressure on another front from a worsening trade war. Similar to the interest rate dynamic, most investors over the past few months seemed to view rising trade war risks as manageable, especially for US companies which tend to trade less than their European or Asian peers.

However, the last few days brought a string of profit warnings from companies such as Micron Technology (semiconductors), PPG (paints), Ford, Fastenal (industrial distribution) and LVMH (luxury). These comments likely led investors to a logical conclusion that a little pain now could mean a lot more pain over the next year for profits.

How significant was this week's drop and what's next?

In the grand scheme of things, this week's reversal seems more like noise rather than a signal, in our view. Historically, broader markets decline between 5 and 10% every 2 to 8 months. The last correction was in the February-March timeframe, suggesting we were about due for another round of bumpy markets.

Market volatility always feels uncomfortable and this one fits the pattern. However, we are taking this week's move in stride and putting the stock market in a broader context of what's working. As mentioned above, we believe steady economic growth can support rising corporate profits, which should drive equity performance.

We believe companies can expand sales a bit faster than GDP growth, say in the low to mid-single digits. Companies are improving efficiencies and buying back stock, which gives us comfort in roughly 10% earnings growth over the next year or two. We generally see stock prices tracking next year's earnings growth and if this pattern continues we would expect the broader market to rise about 10% in 2018 and perhaps a similar amount in 2019. Dividends continue to add nearly 2%, suggesting a bit more upside.

So when could markets turnaround? We may see stocks trade in a range during a choppy earnings season over the next few weeks as CEO's grapple with investor concerns over rising rates and rising costs from the trade war. However, coming out of earnings season we get to the mid-term elections in early November. Historically, stocks have struggled to make gains ahead of mid-term elections, but then we generally see upside post-election. 2018 could fit into this pattern.

What is FBB doing amid the current volatility?

We continue to diversify and rebalance as markets present us with changing dynamics and opportunities. As markets moved up late in the third quarter we looked to add some equities that have less sensitivity to the economic cycle, in case we start to see some cooling. Additionally, as market valuations moved up over the past few weeks we screened portfolios for stocks that could use some pruning.

Now that markets and valuations have come down, we are also looking to add to companies that have durable growth drivers and attractive risk / reward profiles. We are currently looking in the ecommerce, technology, and banking industries in particular, and we hope to share our equity portfolio changes with you in our next quarterly update letter. Separately, we are also taking advantage of rising bond yields by adding new corporate and municipal bonds with higher yields.

As this letter goes to print, markets appear to be stabilizing. Our sense is we will continue to see stabilization over the coming weeks and perhaps a Happy Halloween surprise. As we head into a crisp Fall weekend, we look forward to monitoring market developments and managing client portfolios for long-term performance and income.

If you have specific questions you would like to address your Portfolio Manager would be happy to speak with you.

With best wishes from your FBB team,

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