



November 26, 2018

Hoping for more Green than Red this Holiday Season

Dear Clients and Friends,

Your FBB team spent the holiday weekend giving thanks for the gifts of family and friendship. We also had plenty of conversations around the Thanksgiving dinner table about current events, including the latest market swoon that has dragged the S&P500 down to break-even levels for the year.

While we are optimistic that stocks remain an attractive asset class for investment, we have fielded several good questions about the current volatility. The comments below summarize our current views, which highlight near-term concerns for stocks and broader themes supporting a thesis that we believe will fuel higher corporate profits and equity prices.

Why are markets red in the face?

Broader U.S. equity markets have been choppy since early October on rising geopolitical concerns that appear to be trickling down to individual companies. At the macro level, large markets such as Germany and Japan have experienced slowing economic growth which could be temporary (although a Chinese lending slowdown hints at more meaningful deceleration).

Additionally, the economic impact of a bilateral trade war between the U.S. and China continues to mount for both sides, and some experts believe tariffs could knock a full percentage point off U.S. GDP growth if future rounds of tariffs go into effect. We'll be watching a summit between the Presidents of China and the U.S. later this week for signs of where the trade war is headed.

Investors are translating these macro pressures into lower stock prices for many companies that rely on steady economic growth to fuel profits. Technology, industrial and consumer discretionary stocks have declined 12-15% since early October (compared to a ~10% hit to the S&P500) as investors worry that a slowing economy will darken the profit outlook for these cyclical industries. Making matters worse, some large companies, such as Apple, have signaled slower demand for consumer products, adding fuel to the fire for investor sentiment.

Will investors be seeing green by year-end?

Is there any way out of this mess? Our short answer: Yes. However, we see more volatility ahead as we approach the next recession. In the near term, we see a modest rebound for markets into early 2019 as investors balance fears of a slow-down with increasingly attractive valuations.

Looking at valuation, the S&P500 is now trading at about 15 times next year's profits, roughly in-line with the average valuation since 1990. If markets are fairly priced, then our sense is that stocks should respond to economic and profit growth. Leading economic indicators and manufacturing surveys still suggest meaningful growth, while future corporate profits could expand by 8-10% over the next two

years. Our belief is investors will come around to viewing an approximate 10% total return for stocks as attractive, especially at current levels.

What's next?

While we expect a modest rebound in stocks over the next few months, we're also preparing for the next turn in the economic cycle. As the Federal Reserve continues to hike interest rates into 2019 and the next recession approaches, we could see more modest growth for both the economy and for profits.

Our investment strategy at this point in the cycle is to gradually move into more defensive equity sectors, while also considering a modest shift to bonds. We favor a gradual approach, because we expect a modest rebound in equity markets followed by a period of volatility as the economy slows.

As this letter goes to print, markets are digesting Black Friday sales, and Cyber Monday e-commerce is heating up. While October and November have been choppy periods for investors, we feel that steady economic growth will lead to more green than red (for stocks) as we approach year end.

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

With warm wishes for a Happy Holiday,

FBB Capital Partners

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