January 1, 2019

Markets Deliver a Lump of Coal

Dear Clients and Friends,

Instead of three French hens and a partridge in a pear tree, investors suffered three corrections and a bear market leading up to the holidays and New Year's Eve. While the broader markets have taken away some of the holiday cheer with a -13.5% fourth quarter performance, we remain cautiously optimistic amid a landscape of steady economic growth and stock valuations that look increasingly attractive. This letter will dig into the reasons for this quarter's disappointment and look at what a recovery might look like in the New Year.

The Grinch Stole the Santa Claus Rally

Anxiety surrounding trade wars, a slowing economy, and a Federal Reserve dishing out tough medicine drove broader markets into 10% correction territory in late October, again in late November, and a third time in early December. The final insult came just as shoppers were wrapping up holiday purchases around a Fed meeting on December 19. The meeting confirmed an anticipated interest rate hike but disappointed investors by signaling further tightening measures in 2019. The announcement was enough to drive stocks into bear market territory on Christmas Eve with major indices down 20% from recent September highs. U.S. small caps also declined ~20% in light of a possible recession and the threat of rising interest rates weighing heavier on the sales and less secure balance sheets of smaller capitalized companies.

Factors that drove U.S. stocks lower in the fourth quarter also weighed on global markets. Fears over central bank tightening, rising tariffs, economic deceleration abroad, and political disputes in the UK, Italy, and France, drove European stocks down 11%.

Emerging markets, which have struggled for some time, managed to outperform developed markets, but still declined 6%. Commodities were also volatile. Oil prices fell 35% in the fourth quarter on fears of overproduction and slowing demand ahead of an anticipated recession.

A 2019 Performance in Three Acts

As volatile as 2018 was, we believe that 2019 could prove to be equally challenging. There could, however, be a silver lining. Since World War II, back-to-back declines in the S&P500 have occurred only twice, and both during multi-year downturns (1970s stagflation and the dot-com bust of the early 2000s).

Markets may remain choppy in 2019, as stocks potentially experience three separate phases: recovery, stabilization, and volatility ahead of a possible recession. We generally see the recovery and stabilization phases as supportive of stocks, while pre-recession jitters may weigh on sentiment.

Before we look at upside and downside scenarios for stocks, let's examine the underlying market drivers—namely GDP growth and corporate profits. Tax cuts helped boost U.S. economic growth to about three percent in 2018. However, as the fiscal stimulus wears off and the trade war takes a bigger bite, we anticipate a slowdown in economic growth in 2019. While slower year over year, it is worth noting that the expected pace of growth at 2.5% is still above the prior decade's trend (below two percent).

While the economy may hum along in 2019, corporate profits are another story. Tax cuts sparked a blistering 20% rise in company earnings in 2018. This year, we expect that stable tax rates and rising tariff expenses will yield corporate profit growth about one-third of last year's rate.

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Continued growth for the economy and for profits could add fuel to a recovery that may have begun on December 26, when broader markets rose around five percent (including a 1,000-point day for the Dow). From a timing perspective, we've seen a recent pattern of stocks going up about the same number of weeks that they went down. If this pattern persists for a full recovery, we could be looking at a 17% return between December 31 and late March.

Moving beyond a possible recovery, investors may take a closer look at quarterly earnings, as stocks enter a more stable phase. If profits grow seven percent in 2019, and investors view stock valuations as reasonable, we could also see additional upward momentum in the five to 10% range for stocks.

While the early part of 2019 may see upside for markets, we could see a more cautious end to the year, as investors begin to worry more about a potential recession. We'll be watching the bond market (particularly two- and 10-year Treasury yields) and manufacturing surveys for clues as to the potential timing.

Managing through the Volatility

We've been gradually taking a more defensive posture over the past quarter, and we expect to continue this shift ahead of the next turn in the economy. Our general strategy will be to continue adding high quality government bonds, while trimming stocks that rely on rapid GDP growth and adding capital to more defensive sectors.

On the bond side, we think yields may stabilize at or slightly above current levels on perhaps two more Fed rate hikes in 2019. With this in mind, we've been buying Treasury bonds with maturities inside five years that offer yields above the S&P500's dividend yield. We've funded bond purchases by trimming equities in areas that would be most sensitive to a global economic slowdown (such as semiconductors).

We've also added to sectors that generally outperform just ahead of recessions (energy stocks) and those that historically generate steady results during a downturn (defense contractors). Looking ahead, we also favor utilities, which should avoid volatility related to an ongoing tariff war, as well as REITs, which tend to become more attractive toward the end of a Fed tightening cycle.

As we say farewell to a challenging 2018 holiday season for markets, we look forward to a New Year that has the potential for more favorable outcomes. We expect to navigate 2019's twists and turns guided by our core investment principles while being ever mindful of your goals and objectives.

With Warm Wishes for a Happy New Year,

FBB Capital Partners

Please note that we expect Charles Schwab and TD Ameritrade 1099 deliveries to go through several revisions again this year. Additionally, there are a couple of portfolio positions which may generate K-1's. Given the typical late timing of these items (March), we advise against filing your 2018 tax returns early. Please contact your portfolio manager with any questions.