July 1, 2019

China + Fed = Volatility

Dear Clients and Friends,

Markets have been on a tear in 2019, up 19% through the end of June. Still, many investors are feeling less than excited about the rally—perhaps because the ascent has only taken us back to where we left off last September, immediately prior to the late 2018 selloff. This round trip has felt a bit like a sabbatical.

So, what's driving this market "sabbatical" for 2018-19? We would argue that investor fears around trade disputes with China and Federal Reserve policy have driven most of the volatility over the past nine months. As we look back at the second quarter of 2019 and look ahead to the remainder of the year, we believe China and the Fed will continue to dominate investors' attention.

Unfortunately, we see additional market volatility as these themes play out, but we also remain confident that U.S. equities will remain attractive amid 1) a soft economic landing, 2) modest improvement in corporate earnings, and 3) reasonable valuations. This letter explores some of these themes in greater detail and reviews FBB's market positioning as China, the Fed, and volatility continue to drive investor sentiment.

April and June were Pretty Good, but What Happened in May?

Broader equity markets were up a modest 4% in the second quarter, as stocks finally recovered from the downturn of late 2018. However, this favorable quarterly performance comes at the end of a few volatile months as stocks rose in April, fell in May, and bounced back again in June.

China and the Fed fueled much of the monthly volatility. Between January and late April, investors cheered as the Fed moved from tightening (raising interest rates) to a more neutral stance. Then in early May, the White House proposed a new round of tariffs on China, which led to a sharp downturn amid worries that a trade war could lead to a recession or a decline in corporate profits. However, the Fed in June seemed more willing to cut interest rates amid a worsening trade war, again providing investors bullish confidence.

Cautious Optimism

So what's next for markets as we look ahead to the second half? We expect a bit more volatility on the interplay between China, the Fed, and investor expectations. With stocks back to all-time highs, our sense is investors expect some moderation in the U.S. - China trade dispute, as well as one (or several) more Fed rate cuts.

Markets moved positively on news of a pause in tariffs and reset in negotiations between the U.S. and China at the G20 Summit. We still expect the Fed to cut interest rates by a quarter of a point at its next meeting on July 31 with potential for another rate reduction later in the year

However, despite concerns of a global economic slowdown, we remain cautiously optimistic on stocks as we take a broader view beyond these two issues.

As mentioned above, we see a gradual economic slowdown rather than a hard landing. We see full employment, low inflation, Fed rate cuts, and consumer confidence offsetting trade disputes, which collectively have the weight to push a recession out to 2020 or later.

We also anticipate a slow-but-steady improvement in corporate earnings beginning in the third quarter on easier comparisons following the 2018 tax cuts. Finally, we see stocks trading right around long-term averages, as measured by price to earnings (P/E) ratios.

Playing Offense and Defense

Given the continual shifting of rate expectations and geopolitical uncertainty, we've taken several defensive steps to protect client portfolios, while also playing offense to take advantage of rising volatility. At a high level, we've trimmed our equity exposure and added to cash and bonds as a way of reducing downside risk in equities.

Speaking of bonds…A decline in Treasury yields has lowered the total return potential for most bond investors this year. Rather than reaching for yield from risker bond asset classes, we've been buying short-term Treasuries and three- to five-year corporate bonds to generate defensive income.

Within stock portfolios, we've also sold equities that tend to have more exposure to ups and downs in the economy, such as housing-related financial services companies. At the same time, we continue to own stocks that benefit from rising volatility, such as CME Group (Chicago Mercantile Exchange), which was one of our top performers during the quarter.

We have also increased our position in American Tower, which offers a mix of offense (rising demand for 5th generation wireless technology) and defense (barriers to entry and annual rent increases). Our sense is companies with stable growth, such as American Tower, will maintain premium valuations as markets remain volatile.

The second quarter of 2019 helped markets catch up to prior highs, and at these levels we may see some choppiness as the China and Fed themes continue to play out. However, our broader view of the economy, earnings, and valuations suggest cautious optimism as we see opportunities to own attractive stocks and bonds. As we enter the second half of the year, we remain committed to our core investment principles while being ever mindful of your goals and objectives.

Wishing you a Happy Fourth of July and a relaxing summer,

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