August 6, 2019

China, the Fed, and volatility: Short-term concerns, but recovery likely

Dear Clients and Friends,

The summer break from market volatility was nice while it lasted. As you have likely seen, global stock markets have become more volatile in recent days, ending a stretch of gradually rising markets throughout most of June and July. While these periods of volatility are fairly common, this particular downturn came on rapidly and may be leading investors to review their assumptions. This letter provides our thoughts on the latest market volatility and reviews how FBB is managing portfolio risk.

To recap recent market action, broader markets fell ~3% on August 5th, capping a rough stretch of about six trading days since July 26th, where markets fell a total of ~6%. As we moved through the July Fourth holiday with high stock prices and relatively low volatility, investors expected to hear good news as the summer rolled on. In particular, markets likely anticipated favorable outcomes for: 1) corporate earnings, 2) trade negotiations with China, and 3) Federal Reserve actions.

Unfortunately, one out of three wasn't good enough for markets as confusing language from the Fed and spiraling uncertainty regarding China trade policy offset a favorable corporate earnings picture. During a 24-hour period between July 31st and August 1st, investors got a double whammy as the Fed downplayed future interest rate cuts, followed by unexpected news of additional 10% tariffs on Chinese goods coming into the U.S.

The last straw was news on August 5th of a declining Chinese currency, potentially in retaliation to the pending 10% tariffs. Investors seem more focused on these future concerns, rather than the recent past results from corporate America as second quarter earnings are exceeding estimates by ~5%.

If you feel like you've seen this movie before, you'd be right, sort of. In late 2018, markets declined nearly 20% on investor fears of more restrictive Federal Reserve policy. Then in May, broader markets fell ~7% on concerns that new Chinese tariffs would depress economic activity. The one difference between the last two downturns and the current one is speed, since the prior corrections took weeks or months, while the latest move has played out over roughly a week's worth of trading. These past three periods of market volatility share several themes: The Fed, trade disputes, and historical regularity. Our base case scenario is an expectation that we will see more of the same over the next few quarters as these themes continue to play out.

We could see market choppiness leading up to a meeting of central bankers in Jackson Hole in late August as well as heading into another possible Fed interest rate cut on September 18th. On trade, we expect additional market volatility as the U.S. and China build up and then possibly tear down trade barriers. Finally, we look to historical patterns of market volatility as a reminder that stock market declines of 5% or even 10% are not uncommon.

So, should investors worry about a 'hurricane season' of uncertainty with the Fed, China, and volatility? While markets could be choppy over the next several months, *we are cautiously optimistic* as we focus on the bigger picture: a stable economy, improving earnings, and reasonable stock valuations.

In general, we are seeing a soft landing for the US economy as the trade dispute, so far, is mostly impacting export-oriented manufacturers. Trends in business confidence, hiring, jobs, and consumer confidence will be key to gauging a manageable slowdown for the economy. Additionally, we'll be watching interest rates and the yield curve for clues on how the bond market views the health of the economy.

Over the past several months, FBB has been positioning portfolios toward a more defensive posture. However, at the same time we continue to look for opportunities as great businesses become cheaper during these market swoons.

With that in mind, we've maintained a more cautious stance in recent months with above-average cash levels and a preference for defensive stocks at this point in the cycle. Recent purchases include drug companies, property casualty insurers, and cell phone tower REITs. These sectors generally have less exposure to the economy than, for example, banks, heavy equipment companies or commodity-sensitive firms.

We continue to look for investments where near-term dislocations may mask a high-quality business trading at a discounted valuation. We believe the current market moves may unveil additional opportunities for FBB clients.

Sincerely yours,

FBB Capital Partners' Investment Committee

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