October 1, 2015

Dear Clients and Friends:

"It's déjà vu all over again." - Yogi Berra

The third quarter of 2015 had its own set of circumstances, but in many ways the path and volatility of the daily tape (particularly in August) was very similar to what we saw in the third quarter of 2011. Day to day downdrafts of 3% or more followed by triple digit rebounds that looked promising, but in the end markets could not sustain positive momentum to close out the quarter.

So what drove the market weakness late in the 3rd quarter? It sure wasn't U.S. economic data, which exceeded investor expectations. Jobs, wages, and consumer spending helped drive U.S. GDP up 3.9% in Q2, well above an initial reading of 2.3%. American workers are supporting economic growth, as seen in Q2 private sector wage growth of 2.2%, while the unemployment rate fell from 5.3% in June to 5.1% in August –lower even than the target set by the Federal Reserve.

In fact, given the domestic economic back drop, many were expecting the Federal Reserve to raise interest rates at its most recent meeting, especially as several Federal Reserve Board members publicly touted the benefits of a near-term rate hike. In the end, the September meeting came and went with a lot of talking and zero change in monetary policy or rates. Indeed, it was déjà vu all over again.

Global growth concerns emerge

With domestic affairs in reasonable shape, our sense is that growing international uncertainty and risks have been driving the market sell-off worldwide. Concerns over a hard landing in China (which we discussed in the August 24th letter) have spread to worries of spillover effects on commodity prices, emerging market economies and overall global trade.

In addition, the strengthening US dollar (a result of US economic strength, by the way) has led to concerns over multinational companies' ability to maintain both sales growth abroad and profit margins at home. FBB takes a more nuanced view, focusing on higher quality securities with less exposure to commodities or foreign trade.

FBB's continued shift toward quality

Throughout 2015 and continuing in the third quarter, FBB has steadily shifted client assets to higher quality investments to help offset near term market volatility and take advantage of opportunities for potential long term gain.

During the third quarter, we proactively exited positions on the lower end of the quality spectrum. For example, during June and July, we observed a decline in trading volumes for high yield bonds, especially those related to energy companies suffering from falling oil prices. We made the decision to exit an Exchange Traded Fund (ETF) that tracks these high yield bonds, avoiding a decline later in the quarter, and swapping into higher quality Treasuries. We continued to take action on the same theme by selling a position in Apache (APA) as weak commodity prices, combined with a low probability of success for a new management team, suggested declining quality and more downside than upside.

Our efforts to avoid low-quality companies also led us to seek higher quality equity investments. We initiated a position in McKesson (MCK) during the quarter on our view that the company will: 1) benefit from steady growth in branded and generic drugs, 2) use a stronger US dollar to acquire overseas distributors at a relative discount and gain scale advantages, and 3) drive growth through a multi-year shift into bio-generic drugs. We view MCK as a high quality company with minimal commodity or emerging markets exposure that is likely to meet or exceed investor expectations.

Is a Santa Claus rally in store?

Many of the current investor concerns, including China, commodities, and interest rate uncertainty, may linger into Q4, just as additional worries over a possible U.S. government shutdown re-emerge. However, our sense is that securities prices will stabilize and gradually increase on: 1) better-than-expected corporate profits, 2) an initial Fed rate hike, 3) a bottoming in oil prices, and 4) perhaps less emerging market volatility. What's more, we believe most politicians will try their best to avoid being labeled "the Grinch" by disappointing voters ahead of the holidays.

In terms of security selection, we plan to continue our efforts to choose high quality stocks and bonds with durable growth prospects and minimal down-side risk. The silver lining of Q3's market volatility is a broader shopping list for new investments offering attractive risk-reward profiles. Additionally, we will continue to look for opportunities to offset some of the capital gains realized by recognizing losses in positions that have traded into negative territory.

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"I never said most of the things I said." – Yogi Berra

A final note on interest rates

The most significant news from the September Federal Reserve meeting (aside from the non-move) was a pair of decisive comments from Chair Yellen herself—Near-term rate increases are highly likely. During the news conference following the meeting and in a speech the next week, Yellen indicated that the majority of the committee, herself included, resides in the "sometime in 2015" camp for an initial rate increase. Well, the hour is getting late.

We had an opportunity to attend a round table event with former Federal Reserve Chairman Ben Bernanke late in the quarter. Of interest, Bernanke's take on the decision not to raise rates was that it was the only viable option for the committee given what took place in global markets in August. Bernanke's main point was that the effects of August's market conditions--a rising US dollar, decline in the wealth effect, and widening credit spreads generated the equivalent of monetary policy tightening.

Bernanke's view was that an additional quarter-point increase in the Fed Funds rate in the middle of that uncertainty would have added insult to injury. What's more, he specifically said (multiple times) that the committee does not want to start a on a path of tightening from a zero-bound only to have to back away from it. Further, he pointed out that every other developed economy who has tried to tighten from a zero-bound thus far has had to back-track.

Bernanke also offered his moderate optimism for the U.S. economy, particularly compared to the rest of the world. Potential catalysts that could offer upside surprises to earnings are continued improvement within housing, growing household formation, and a potential rise in productivity. We tend to agree with Bernanke and we continue to believe that an overweight position in U.S. equities will help clients outperform.

Sincerely yours,

FBB Capital Partners' Investment Committee