FBB capital partners

March 16, 2020

Current Market Conditions: Frequently Asked Questions

Dear Clients and Friends,

As we continue to follow developments related to the coronavirus and its impact on markets, we've received lots of client questions about what's happening, what's next, and how FBB is positioning portfolios. We hope the following will help you understand our current thoughts:

How long will the coronavirus continue to affect the markets?

We expect the markets to continue to be volatile until we can measure the impact of the virus more accurately. More accessible testing will contribute to an acceleration of this process. Following that, economic data scheduled for release over the coming 4-6 weeks should begin to provide a clearer picture on the real economic impact.

Could the virus push the U.S. into a recession?

Since the virus is pressuring both supply and demand, our sense is we could see a recession beginning with the April quarter, since we've yet to see any meaningful economic impact to jobs and growth from the virus through mid-March.

How do stocks usually react in a recession?

In the past 11 recessions, stocks have declined, on average from peak to trough, about 30%. These figures include the last two recessions, the dot com bust in the early 2000s and the financial crisis of '08-09, which were much deeper market corrections on the order of 50%.

How are broader stock and bond markets performing?

As of Friday March 13th, the S&P500 in price terms has declined (20%) from a peak on February 19, 2020. However, over the past year the broader market is down (3.5%). Bonds have helped with portfolio diversification as baskets of short-term U.S. Treasury bills have returned about 3% over the past year. In the past 18 months we've had essentially two bear markets (late 2018 and early 2020) as well as one major bull market (calendar 2019). Despite these major up and down moves, the S&P500 is only down (7.5%) from September 2018 levels.

What's going on with interest rates?

The Federal Reserve cut interest rates two weeks ago and did so again over the weekend to the 0-0.25% range. These rate cuts, coupled with rising global demand for safe-haven securities such as government bonds, are pushing bond prices up and yields down. We expect yields on U.S. Treasury bonds to remain at or below 1% for some time, suggesting that investors may start to view bonds as insurance and diversification for stocks, rather than as a source of significant income. Global monetary policy has been evolving day to day, we continue to monitor their activities particularly related to short-term (overnight funding) measures.

What's next for the economy and markets?

Our base case scenario is that a worsening virus pressures supply and demand enough to trigger an average recession, which could push equities down by another 5% to 10%. However, we could also see a more rapid recovery for the economy and markets—what some are calling a "v-shaped" recovery. If supply and demand struggle to recover for an extended period, we could see more downside (closer to a 50% decline).

How is FBB positioning as we move through these market challenges?

We entered this downturn with a fairly defensive posture, having trimmed some expensive tech stocks tied to the global economy, such as Palo Alto Networks (PANW). As markets began to decline in February, we sold another stock, CME Group (CME), which seemed to have overly optimistic expectations. We also added to our position in Berkshire Hathaway (BRK), because we believe Warren Buffett will use his company's balance sheet to buy high-quality assets trading at a discount (as he did during the 2008-2009 recession). In early March, we expected markets to fully price in a recession and we took additional equity exposure off the table by trimming our technology hardware and media holdings. When we feel that broader markets have fully priced in the risk of a recession, we will look for opportunities to increase equity investments.

Summary

Over the next few weeks, investors will attempt to digest mountains of data, which will either signal the next leg up or down for markets. We have laid out a base case for what may happen with the virus, the economy, and stocks. However, we remain flexible and vigilant as market dynamics change. We believe this challenge will pass, and we remain committed to keeping clients invested in high quality stocks and bonds that can help offset inflation and build wealth for retirement goals.

We believe the current market moves may create additional opportunities for FBB clients. There are several companies on our "buy list" that we will continue to monitor in hopes of purchasing high quality businesses at relative discounts to their intrinsic valuations.

Finally, we would like to once again thank you for your trust and confidence in the FBB team as we strive to be responsible stewards of your capital. As schools and events are closed over the course of the next couple of weeks, we will be transitioning to more phone calls rather than in-person meetings, we appreciate your assistance in making this happen.

We wish you and your loved ones safe and healthy days ahead.

Sincerely yours,

FBB Capital Partners' Investment Committee