



October 15, 2014

Dear clients and friends,

As you've surely noticed, stock market volatility has increased dramatically since the end of September.

In our quarterly letter to you two weeks ago we highlighted the market's escalating shakiness as being driven by global economic weakness rather than US softness:

Much of the consternation (is) attributable to an increase in global economic uncertainty. Europe's deflationary slowdown is being exacerbated by sanction-impaired trade with Russia. "Abenomics" in Japan has ended with little in the way of productivity gains to show for all the hype. The Middle East remains a global hot spot as ISIL gained a stronger foothold in Syria. The Ebola virus has apparently been carried beyond Africa's borders. And concerns are rising that peaceful pro-democracy protests in Hong Kong could turn into China's next Tiananmen Square disaster, or worse.

We also suggested that "near-term global events could make the ride bumpier." While there hasn't been a significant change in the topics being discussed or a sudden change in global trends, the volume of that discussion has become amplified in recent weeks, specifically relating to Europe's economy and the near-hysteria over Ebola.

Regarding the news "over there," the International Monetary Fund (IMF) had cautious comments this week about Europe's economic slowdown and the possibility of **deflation**. That's not "new news," as we've mentioned it to you previously, but the latest comments helped send the yield on German 10-year *bunds* to record lows. Rates on the safe-haven and relatively attractive US Treasuries dropped in tandem to levels last seen in early 2013. Why are our rates higher than European rates? We've got a modicum of inflation over here, tied with that "slow and low" economic expansion we discussed again in our last letter.

The Wall Street Journal had an interesting comment about the economic impact of the Ebola virus this morning: "In a world gripped by Ebola fear, it's worth remembering that the bigger threat to the global economy and markets lies not with people afflicted by the virus but with those who aren't."* Recent epidemics – SARS, avian influenza, swine flu – demonstrated that **public risk aversion** in the form of empty hotel rooms and declines in air travel and restaurant dining, or what the World Bank calls "aversion behavior," could produce more economic harm than the direct costs of fighting and containing those outbreaks.



We believe the Ebola-related “fear factor” is compounding the stock market’s worries, yet the potential domestic economic impact may prove less than feared. As the Journal article states, Ebola’s high fatality rate and horrific symptoms are likely exaggerating the public’s concerns even if populations are not nearly as vulnerable as they are to airborne flu. Thankfully, these anxieties are not yet elevated enough to do lasting harm to markets in Europe or North America.

We recognize that the US economy is not immune to weakness spreading from the rest of the world, nor is the US population immune to an Ebola outbreak, real or feared. To date, the economic data are consistent with our five-year-old slow and low economic outlook (a slower than typical recovery following the 2008 mortgage crisis, with concurrently lower levels of inflation and interest rates.) Strong fundamentals in the US stock market have not diminished, as corporate earnings and margins remain near all-time highs. However, we are watching global and domestic developments carefully, and will adjust portfolios as we believe necessary.

We also encourage investors to view rising volatility in the context of broader market moves. While most US stock indexes (and the stock side of portfolios) have fallen from the peaks set this past summer, they are currently relatively flat year-to-date even after the recent gut-wrenching roller coaster ride. A period of modest back-filling should be viewed as normal following last year’s strong equity market gains. Perhaps more surprising to many is the strength this year in the bond markets, which get little coverage in the popular press, yet remain an essential element in our investment portfolios. We’ll have an update on our bond market outlook toward the end of the year, as news (and fears) about changes in Federal Reserve interest rate policy will assuredly be making the headlines before the New Year.

Sincerely yours,

FBB Capital Partners

*Wall Street Journal, Oct 15, 2014, “For Ebola’s Market Impact, Follow the Fear, not the Virus”