January 1, 2017

More Surprises Ahead?

Dear Clients and Friends,

As we say farewell to a 2016 full of political and economic surprises, we wonder if 2017 will bring more of the same. As we look back on the UK's decision to leave the European Union (the Brexit vote), the surprising U.S. election outcome, and, now, the Dow Jones Industrial Average approaching 20,000, we are reminded that investors should continue to build fully diversified portfolios that take into consideration a broad range of potential outcomes.

Uncertainty = Volatility

Before we jump ahead to 2017 forecasts, let's take a quick look at a volatile final quarter of 2016, where broader markets fell 4% ahead of the U.S. election, but then rose nearly 9% post-election, to settle on a 5% net gain for the quarter. We believe this kind of market volatility may continue, and we favor financial companies such as exchanges and online brokers as a way to benefit from market swings.

Early in the fourth quarter FBB trimmed utility and consumer staples holdings on a view that rising interest rates make bonds slightly more attractive compared to these lower-risk , dividend-heavy equities. We also increased our exposure to Internet advertising, and we diversified our real estate holdings by adding a self-storage REIT, as we expect faster economic growth to drive earnings upside for these sectors.

Risk Appetites Growing in 2017

So what are FBB's forecasts for this year? Our sense is that investors expect the new administration will stimulate more economic growth, either through policy changes or the perception thereof. But what does faster economic growth mean for financial markets? We believe consumers, business leaders, and investors are shifting from risk aversion to risk-seeking behavior as they take advantage of greater economic opportunity.

We believe the Brexit vote and the U.S. election were turning points in this shift to higher risk appetites. Investors, desperate for low risk securities, pushed ten-year U.S. Treasury yields to 1.37%, just after the late June Brexit vote. However, Treasury yields have rallied to 2.55% as of late December, suggesting a decrease in demand for risk-free investments.

Faster growth and rising risk appetites will likely trigger other changes this year. We expect more inflation, as oil prices and wages creep up. We also expect at least two interest rate hikes this year, as Janet Yellen attempts to prevent overheating. Higher U.S. interest rates will likely draw in foreign investment, boosting the value of the Dollar and slowing U.S. exports.

As we think about financial markets in 2017, a risk-on theme suggests growth equities, emerging markets, corporate bonds, and high-yield debt may outperform lower risk securities such as high dividend stocks and Treasury bonds. However, since our time horizon spans several years, we are taking a balanced approach to risk this year.

Our views on dividends are an example of our preference for diversified portfolios. While we have reduced holdings in the utility and consumer staples sectors, we continue to favor dividend paying companies. These investments will pay off in the event that U.S. economic growth fails to accelerate or the Federal Reserve delays interest rate hikes. This diversification should also help to reduce portfolio volatility in the face of any unexpected macroeconomic or political surprises in 2017.

Putting our 2017 themes into practice

As we enter 2017, we favor high quality companies with multi-year growth prospects whose valuation levels do not yet reflect their full growth potential. We believe PNC Bank is an example of one such company well positioned for 2017. Our meeting with PNC's head of corporate banking this year highlighted the company's multi-year plan to penetrate new markets outside of its East Coast core. Building on this secular growth theme, we view rising interest rates as a catalyst that will drive PNC's earnings higher. What's more, the potential for regulatory relief and faster economic growth may boost investor sentiment and valuation. Finally, PNC's domestic branch network reduces exposure to a stronger Dollar, a threat that many multi-national companies must continue to contend with.

As we wrap up 2016 and begin to map out 2017 strategies, FBB continues to manage client portfolios with a focus on quality, income, and the potential for long-term out-performance. We look forward to taking advantage of any unexpected volatility in the coming weeks and months as we seek out high quality companies at attractive prices.

With Best Wishes for the New Year,

FBB Capital Partners