July 1, 2017

Buyers Everywhere… But will They Stay for Summer?

Dear Clients and Friends,

In the second quarter, buyers bid up the prices of stocks and bonds alike. For their part, stocks gained approximately ~2.6% while equity markets continued to experience subdued volatility. Bond prices also ran higher, as the 10-year treasury yield returned to levels not seen since the Federal Reserve began raising rates 18 months ago. Despite this seemingly tranquil performance, three meaningful conflicts lurk beneath the surface:

1) Stock and bond investors are at odds over the economy's growth prospects.
2) Wages and inflation remain low, despite an economy nearing full employment.
3) The U.S. Dollar continues to decline, despite improving economic indicators.

While we're unlikely to solve all of these riddles in our second quarter letter, we do believe that companies will continue to grow earnings in these puzzling times, suggesting that markets may continue to grind higher.

Stocks and bonds not seeing eye to eye

With bond yields declining in the face of Federal Reserve rate hikes in March and again in June, and equity markets advancing, it seems that equity and fixed income investors continue to be at odds. As bond investors began to expect less fiscal stimulus and came to grips with lower inflation, the 10-year U.S. Treasury yield declined in the second quarter from 2.42% to a low of 2.14%, elevating bond prices.

Stocks and their price to earnings (PE) ratios also increased during the second quarter, suggesting equity investors are more bullish on growth prospects than bond investors. Investors seem to be "buying the dips" more aggressively than sellers are exiting the markets.

Given their differing perspectives on growth, investors in each asset class can co-exist—*for a while*, at least. Bond markets are generally focused on broader economic growth, which may be stable in the 2% range (but lower than euphoric post-election projections of nearly 3%).

Equity investors, on the other hand, are more focused on profit growth, an indicator of broader economic expansion. After nearly two years of sluggish earnings, a recent rebound has stock investors bullish on prospects for future earnings growth, both domestically and abroad.

Inflation and currency also behaving differently

Two additional and unexpected trends we are watching this year are low wage growth and a weakening U.S. Dollar. While a falling unemployment rate might suggest better bargaining power for wages, it appears that a mix of demographics (retiring workers) and a lack of corporate pricing power may be holding back wage increases. This trend has benefited corporate margins, while keeping inflation in check, and may ultimately reduce the number of Fed rate hikes for the balance of the year.

Separately, improving growth in Europe and emerging markets, along with low U.S. bond yields, may be driving demand for the Euro, while lowering the relative value of the Dollar. We believe Europe and emerging markets are finally recovering from the Great Recession, although risks remain for both. A weaker Dollar is beginning to provide some currency relief for U.S.-based multinational companies who suffered during the Dollar rally of mid-2014 to late 2016.

So, where to invest?

With these unexpected market dynamics in the background, we took advantage of rising stock markets to exit companies with expensive valuations and struggling fundamentals in retail and apparel, as well as in aerospace and defense. At the same time, we added to equities where we feel secular trends are more favorable—for example, we made investments in software and travel and leisure, focusing on rising demand for cloud computing and for experiences over physical goods.

Outlook for the second half

We're cautiously optimistic on equities for the second half, as steady economic growth allows companies to focus on growing sales, expanding margins, and beating estimates. We expect this bottom-up growth to offset global macro risks such as a further decline in commodity prices or an unexpected slow-down in China amid concerns over real estate prices and debt levels.

If investor sentiment remains stable, as we expect it will, then rising earnings expectations should continue to drive stocks. We expect stocks to perform well during the second quarter earnings season, which heats up in mid-July.

Within equities, we'll be monitoring the technology sector this summer, since the group has outperformed so far this year. When compared to the rest of the market, the tech sector is trading at a higher multiple than it has historically. That said, we believe many tech companies are poised to beat investor expectations and continue to raise growth targets, which could support a sustained rally.

As discussed above, we see the stock and bond markets going off-script this year. While we have a relatively favorable outlook for stocks, in the near term we are a bit more cautious on bonds. We expect interest rates to remain low amid subdued inflation until a likely Fed rate hike later in the year pushes 10-year Treasury rates closer to 2.5%.

As many take time to celebrate our nation's independence this coming week, FBB continues to manage your portfolio with a focus on quality, income, and the potential for long-term outperformance, while remaining ever mindful of risk management. We will continue to keep an eye on new market puzzles that emerge in the weeks and months ahead, while seeking investment opportunities at attractive prices.

With Wishes for Safe Summer Travels,

FBB Capital Partners

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