April 1, 2018

First Quarter 2018: A Bracket-Buster?

Dear Clients and Friends,

After a spectacular 2017, the first quarter of 2018 has reminded us that the market can---and often does---move in unexpected ways. Just as top seeded teams in the NCAA tournament are sometimes lulled into a false sense of first-round security, so too were investors, as markets started the New Year with continued upward momentum from 2017.

In our January newsletter, we discussed potential upside from tax cuts and downside risk from wage growth. Both of these themes came into play early in the year. In January, we saw an exuberant market rallying behind tax cuts and earnings growth, and by February, concerns over wage inflation came more into focus, triggering a market sell-off and a return of volatility. New worries have emerged with the potential for a trade war or a "tech wreck" overshadowing the balance of the year. Still, we remain confident that steady economic growth and rising profits will lift markets above current levels by year-end.

What happened?

Broader markets were down slightly for the quarter, but there was plenty of choppiness along the way. The late 2017 tax cuts drove what some investors called a "melt up" in December and January, as stocks chased rising earnings and profit expectations. By February, the "melt up" became a "melt-down" (not dissimilar to UVA's dramatic rise and fall), after fears of rising wages and inflation pushed stocks into the red and the volatility index (VIX) higher.

Some investors spent much of 2017 betting successfully that the VIX—sometimes referred to as the "fear index"—would remain low. Those investors bet that low volatility would continue making money in 2018. However, the spike in volatility in late January and early February spurred a rush for the exits, leading to forced selling amid a broader market correction of 10% from recent highs. Markets stabilized a bit in late February and early March, but the roller coaster ride continued in late March on fears of a tech sector decline and a potential trade war. Data security concerns for social media companies prompted investors to reconsider the attractiveness of the previously top seeded FANG stocks (Facebook, Amazon, Netflix, and Google), while protectionist measures directed toward China raised geopolitical concerns. Our sense is investors will continue to wrestle with both of these themes into the second quarter.

During the quarter, we continued to add to sectors benefiting from a growing economy and rising rates, while reducing our exposure to sectors that may struggle this year. We trimmed our real estate (Cohen and Steers REIT) and utility holdings (Eversource), as high dividend-paying stocks in these sectors often lose momentum in a rising interest rate environment. We also added to more cyclical sectors including technology (Visa) and financials (PNC), as they tend to benefit from growing numbers of business transactions (payments processors) and higher rates (banks).

What's next?

Will the rest of the year be more like Q1 or 2017? Historically, 10% market downturns take place about every 33 weeks. If history is any indication (which, we acknowledge, is often not the case), we should be "off the hook" at least for some time, in light of the correction that bottomed on February 8 and then again on March 23.

The past quarter has reminded us, that like March upsets, volatility in markets is normal. The *lack of* volatility in 2017 was, in fact, abnormal. For the balance of 2018, we expect a return of volatility in what we'd consider to be a more typical pattern, as investors battle with the ever-changing dynamics of risk and reward. *Will FANG stocks keep under-performing, or do current prices represent incredible bargains for high-growth tech companies? Will protectionism threaten global trade, or will governments dial down the rhetoric and allow GDP growth to continue?* We believe both of these debates will wind down in the coming months, as tech companies continue growing and global buyers and sellers see the gains from negotiated trade disputes.

Early thoughts on the next economic cycle

Moving beyond the controversies of the moment, we are starting to think about more meaningful dynamics that could tip the scales toward a continuation of the current bull market or lead to sustained declines ahead of a recession. The themes we outlined in January —taxes and wages— continue to seem most relevant for the time being. While the new tax cuts may give a boost to near-term profits and economic growth, they may actually accelerate the timing of the next recession amid rising budget deficits. What's more, rising wage growth could trigger inflation, which could further slow economic growth.

With these factors in mind, investors may begin to think about potential timing for the next economic slowdown. When bond markets become bearish on growth, it has historically been a telltale sign of an impending recession. Like an unconditioned team playing late into overtime, the bond market starts to cry uncle when the 2-year and 10-year Treasury bonds trade at the same yield, thus producing a flat yield curve –often an indication that bond markets expect sluggish economic growth ahead. Some analysts project a flat yield curve in late 2019, which could imply a recession by mid-2021.

How are we positioning?

At FBB, we consider a host of scenarios for global markets and for the economy. The recession scenario described above is just one potential outcome. In general, we have a favorable view of markets and economies over the next one to two years, but we are beginning to consider a more conservative stance as we move beyond this period.

With this in mind, we remain comfortable with exposure to both equity and bond markets through the balance of the year. On the equity side, investors may begin to look at corporate profit growth forecasts for 2019, which currently stand at 10%. Even if the growth rate slows and next year's forecasts come in a bit, we could still see stocks up 5-10% in 2018.

Within equities, we are inclined to continue adding to cyclical sectors, including financials and technology. We believe that rising interest rates, steady economic growth, and reasonable valuations continue to make these sectors attractive. We also see upside from diversifying into U.S. small- and mid-caps as well as international equities. For bonds, we continue to add high quality corporates and municipals with gradually higher yields.

As March Madness winds down, we continue to manage your portfolio with an offensive playbook focused on valuation and quality, while executing a diversified defensive strategy focused on income. As always, we will continue to seek those rare opportunities to press.

With Warm Wishes for Spring,

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