FBB capital partners

October 1, 2016

Party Like It's 1999

Dear Clients and Friends,

Despite a late-quarter selloff, U.S. stocks saw their best performance of 2016 in the third quarter (up 3.3%), with all three major indices hitting all-time highs in mid-August, a feat we haven't seen since December 31, 1999. Fortunately, this is where the similarities to the euphoric market conditions of 1999 end, as stock valuations remained well below those seen in the Dot com boom of the late '90s. Bond yields also reached new lows with the 10-year U.S. Treasury yield bottoming at a paltry 1.32% in July following the UK's vote to break ties with the European Union (also known as the Brexit vote). In this client letter, we'll explore what got us here, what FBB's been doing, and what's next as we review the third quarter and look towards upcoming catalysts in late 2016 and early 2017.

Following a flat 2015 and a volatile first half of 2016, what drove the recent strength in equities? In prior quarters, fears over commodities, China, and Brexit raised global uncertainties. However, in the third quarter steady economic growth and a timid Federal Reserve boosted investor sentiment and lowered the so-called fear index (the VIX volatility index).

Markets seemed to hold their breath going into the third quarter, preparing for the next series of negative news headlines. But as new risk factors failed to materialize, these dynamics combined to drive a relief rally for stocks. Bond yields also rebounded, as central banks signaled concerns over negative near-term interest rates.

Moving up the quality curve

We took advantage of the subdued volatility to continue to add high quality companies, while trimming exposure to those with rising risks. During the third quarter, we acquired American Tower, a U.S.-based cell tower operator with an under-appreciated growth strategy in emerging markets. We also purchased Arch Capital; a property-casualty insurer that we feel is in the early innings of gaining share in the fragmented mortgage insurance market.

We kept a balanced approach to equities by offsetting these additions with two sales, McDonalds and T. Rowe Price. We previously favored McDonalds' management change and new growth strategies, but we believe execution risks are rising and investors are fully valuing the company's improvements. We exited T. Rowe Price amid a secular shift away from actively managed mutual funds and concerns over performance following a string of portfolio manager departures.

Preparing for earnings, elections, and rising rates

With stocks reaching all-time highs, investors may wonder if markets are ready for a breather in the fourth quarter. We believe that growth in corporate profits, reduced political uncertainty, and a modest rise in interest rates will fuel a gradual increase in equities. However, meaningful variations to these catalysts could drive stocks above or below our assumptions. Here is our take on these upcoming events:

- **Green shoots for corporate profits.** Earnings for S&P500 companies declined from April 2015 through at least June 2016, as collapsing oil prices depressed energy sector profits. In fact, investors expect corporate profits to decline again by about ~2% in the third quarter. We believe companies will report that third quarter profits exceeded expectations by about 3 to 4%, resulting in profit *growth* of 1 to 2% for the quarter. In our view, an end to the corporate profits recession of the past five quarters should help sustain equity valuations.
- **Modest post-election relief rally on tap.** We believe the House, Senate, and Presidential elections will result in divided government, likely reducing potential investor fears of one-party control, which could pose a greater threat to markets. While volatility around the election seems likely, our sense is that the final outcome will drive a slight increase in investor sentiment.
- **Another December rate hike approaching.** Janet Yellen's comments during a September Fed meeting suggest to us that the stars are aligned for another December rate hike. From our perspective, we believe that low unemployment, rising inflation, and generally stable financial conditions set the table for Fed monetary tightening. We also believe that investors are prepared for a December rate hike, which should result in a minimal impact on stocks. Higher-yielding equities may begin to feel pressure in 2017, as investors begin to shift from bond proxies, such as utilities and consumer staples to bonds. We will follow up on this theme during our next client communication.

As we head toward year-end and begin to think about 2017, FBB continues to manage client portfolios with a focus on quality, income, and the potential for long-term outperformance. We look forward to taking advantage of any unexpected volatility in the coming weeks and months, as we continue to seek out high quality opportunities within both equities and bonds.

With Best Wishes for autumn,

FBB Capital Partners

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Note: Please keep an eye out on your inbox for further information on the following upcoming events:

- Quarterly conference call in early October.
- **On November 3 at 11 am**, FBB will co-host the last of four calls this year with our friend Greg Valliere, an expert in political and economic trends who will help enlighten us on potential investment implications of the presidential election.
- Year-end conference call in December to review the 2016 and preview 2017.

We have moved! *You'll find that FBB Capital's Bethesda office at the same address, and even the same suite number, but we have moved into new office space across the hall. Feel free to ask for a tour during your next visit.*