October 1, 2018

Tough Advice in 2018; Sell in May and Go Away!

Dear Clients and Friends,

Skeptics who decided to “sell in May and go away” missed out on the market’s best quarter since 2013, as corporate profits surged and rising trade barriers failed to slow a resurgent U.S. economy. The third quarter of 2018 felt a lot like 2017 with quarterly stock market performance moving decidedly higher.

The S&P 500 rose ~7.6% in the third quarter—well above the first-half performance when shares were up only ~3%. The impressive equity performance in the third quarter came as a relief to many investors who were concerned that geopolitical events would torpedo markets over the summer. Rising tariffs and contentious trade negotiations led many to worry about slowing economic growth and rising inflation.

Meanwhile, a rising U.S. dollar drove a currency meltdown in Turkey, leading to fears of global contagion across emerging markets. Currencies and equity markets in Argentina, Russia, and elsewhere declined in sympathy. Equity investors took these challenges in stride, as they continued to place capital in high-quality domestic assets with improving fundamentals and reasonable valuations.

Keeping a Close Eye on Mid-terms and the Fed

As we look ahead to near-term catalysts, we are focusing on the U.S. mid-term elections in early November. On average, stock markets tend to trade sideways in the 10 months preceding a mid-term election and then outperform in the three months following election day. With the S&P500 having climbed more than 10% into early October, we may be looking at a more modest post-election ascent this time around.

In September, the Federal Reserve hiked the federal funds rate for the third time this year, while hinting that the U.S. central bank has taken its foot off the gas. The announcement validated that, at least for this cycle, the Federal Reserve is no longer in the business of stimulating our economy by maintaining unusually low interest rates.

As we move into the Fed’s December 19 meeting, investors are wondering whether another rate hike will lead to an economic slowdown. Our sense is that the U.S. economy will be able to digest another two or three interest rate hikes before we see a noticeable slowdown (although sectors such as housing may feel the pain more quickly).

How are we positioning?

With the U.S. economy growing 4.2% in the second quarter and ~3% growth likely in the second half of the year, we remain comfortable with our exposure to cyclical companies, as they typically outperform in a growing economy. We are generally at or above market weight for cyclical sectors such as financials and industrials, and we continue to look for new investments in technology and a newly-formed sector called communication services, which includes internet, media and telecom companies such as Alphabet and Verizon. This new sector dramatically changes the composition of the consumer discretionary and technology sectors, while eliminating the former telecommunications sector.

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Our interest in buying companies that are economically sensitive supported our follow-on purchase of Roper Technologies (ROP) during the third quarter. Since our initial purchase of the industrial company in 2009, we have been impressed by management's ability to consistently generate growth above investor expectations. Over the years, Roper has distinguished itself by acquiring poorly-run industrial companies and converting them into profitable investments. Over the next four years, the company plans to invest $7B in this arena, which will likely increase the company's profits and boost investor sentiment.

While we continue to add new growth-oriented stocks, we are cognizant that the U.S. is in the latter stages of an economic cycle. As the next slowdown approaches, we are mapping out strategies for portfolio stability. Rising rates continue to make high-quality Treasuries and corporate bonds more attractive. As longer dated bonds mature or cash awaits investment, we are adding both short-term Treasuries and high-quality medium-term corporate issues to bond portfolios, while minimizing the duration of longer dated bonds. As we discussed in last quarter's letter, we believe that the attractiveness of these shorter-term opportunities within fixed income will persist as interest rates rise.

As we look forward to the changing seasons and cooler temperatures, we begin to reflect on what's important to us. We want to take this opportunity to thank you for the confidence you place in the FBB team. We sincerely appreciate your trust and will continue to do our best to earn it. As always, if you have friends or family members who you think would benefit from a conversation with us, it would be our pleasure to speak with them.

With Warm Wishes for Fall,

FBB Capital Partners

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