FLOWER CITY CAPITAL

August 2018 Newsletter

Dear Members of Flower City Capital,

We hope all is well and that you are enjoying your summers.

As always, we begin with an executive summary:

- Equity Markets have stabilized a bit over the past month with international stocks rebounding and US stocks continuing to rise on strong earnings growth
- Bond markets remain flat if not negative with unattractive risk / reward tradeoffs and the expectation of future interest rate increases
- We are not yet reducing our exposure to risky assets (stocks) - we continue to monitor the current market environment for any developments or impacts on our portfolios
- Geopolitical risks exist, especially related to world trade, however like the rest of investing it is very difficult to profit by making active predictions about the future

Market Summary

	Total Return *(As of July 31, 2018)*			
	1 Mo	**3 Mo**	**YTD**	**Yield**
Equities				
US Large Cap	3.4%	6.5%	6.2%	1.8%
US Mid Cap	2.1%	7.7%	7.5%	1.4%
US Small Cap	1.2%	8.5%	9.0%	1.4%
Intl. Developed USD	2.1%	(0.9%)	(0.4%)	2.5%
Emerging Markets USD	3.7%	(2.9%)	(3.1%)	2.3%
Fixed Income				
US Bond	(0.0%)	0.6%	(1.8%)	3.1%
International Bond USD	0.1%	0.5%	1.2%	0.9%
High Yield	1.8%	1.6%	0.6%	6.1%
Emerging Market Bond USD	2.6%	0.2%	(4.1%)	5.4%

**Total Return includes Dividends*

Positive economic news and corporate earnings helped push US stock prices back towards the upper-end of their recent ranges. Investors may be focusing on tailwinds such as further government spending and tax cuts.

At the same time International Developed stocks have turned positive after a negative Q2 and economic slowdown. Emerging Markets have also stabilized recently after a challenging first half of the year.

As the US economy moves forward, tight labor market conditions could eventually cause wages to increase – companies may be forced to raise wages in order to attract and retain talent. While maybe not a bad thing by itself, this is a key input to inflation. With US Fiscal policy still expansionary, the Fed may raise rates faster than expected to prevent an overheating economy.

This uncertainty continues to harm bond prices, which fall as rates rise because fixed coupon payments become less valuable.

The continued strength of the equity market faces risks ahead which prompts the question when to dial back exposure to risky assets (stocks.) At this point we believe both economic and corporate fundamentals remain supportive of still reasonable valuations.

Geopolitical Analysis

One can't turn on the TV or read the paper without seeing a "Trade War" headline recently. We therefore thought it would be worthwhile to share how geopolitical events have historically impacted portfolios.

In order to do that we much first define what constitutes geopolitics. Essentially, geopolitics has to do with the changing political climate around the world. How nations and economies interact with each other is one of the longest running facets of modern society. Though disputes between nations and disagreements amongst prominent political figures makes for great headlines, they don't typically drive market returns. The result is usually some short-run volatility as people deal with uncertainty and a return to long-term trends driven by economic fundamentals such as demographics and productivity.

When geopolitics leaves the headlines and begins to impact economic fundamentals is when they can start to shape market returns. For example, China's Communist Party has notably been engaging in structural reforms intending to limit growth which have weighed on all Emerging Markets. It is through this lens that we can view the recent "Trade War" rhetoric.

We know that a potential $250 billion tariff looks like a big number and makes for a dramatic headline. However, when compared to a $20 trillion US economy (measured by Gross Domestic Product (GDP) - or roughly all of the goods and services produced by an economy) the estimates range from a 0.1% - 0.3% impact on US GDP. The most recent Q2 US GDP showed annual economic growth of 4.1%. So clearly even a 0.3% hit would result in still very strong 3%+ growth.

What this "Trade War" is really doing is impacting investor sentiment. The market does not like uncertainty and it has taken the recent trade brinkmanship to heart in reducing the multiples that investors are willing to pay for companies. Hence why US earnings growth has exceeded 20% this year, but the US market has only increased ~6% YTD. There are also some localized impacts as the impact on global supplies chains has a disproportionate impact on certain industries.

Geopolitical analysis is important, especially when considering our approach of focusing on macroeconomic trends informing portfolio allocation. It does not however consist of listening to pundits or predicting political action. Instead it consists of proactively understanding the confluence of global policy decisions and what that means for our portfolios.

As always please do not hesitate to contact us with any questions, investment or otherwise.

Michael E. Rizzolo
Managing Partner

Thomas H. Hawks III
Senior Partner

Vincent J. Crane
Analyst