

## Newsletter

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Dear Members of Flower City Capital,

We hope all is well and you are having a great start to the warmer weather.

The stock market has returned to positive territory for the year after a rout in February. To be sure there are some jitters in the economy and markets with rising rates, fiscal stimulus and geopolitical concerns as we move into a late expansion cycle. We remain invested as always and are taking risk where it counts.

In other news we have now moved into our new office located at 132 Allens Creek Rd, Suite 220. Please feel free to stop by any time and say hello!

### Executive Summary

As always, we begin with an executive summary for those who do not wish to read further.

- Fiscal policy is decisively expansionary considering the recent Tax Cuts and Jobs Act as well as increased government spending.
  - This will continue to drive unemployment lower which is not sustainable and may place upward pressure on inflation.
  - Markets are nervous that easy fiscal policy late cycle will prompt monetary policy to assume a steeper path of rate hikes to cool the overheating economy.
- The United States yield curve has flattened further with the 10-year treasury surpassing 3% for the first time in almost a decade as rates rise on the short end and spreads continue to tighten (not as much return for a given level of risk).
  - As rates continue rising the risk/reward tradeoff may be increasingly compelling.
  - In fact, the 10-year treasury yield is now greater than the S&P 500 dividend yield.
- Market volatility has increased and will likely remain elevated while short-term trade tensions and the media's "breaking news" will continue attributing market swings to a single factor or event.
  - Additionally, the Fed Put (central bank tendency to ease monetary policy and support markets) is likely out of sight removing its smoothing effect.
- Earnings growth has remained strong and companies are distributing more cash to the form of share buybacks or dividend increases, largely driven by tax reform.
  - Notably, Apple recently announced a \$100 billion buyback.
- Commodities have remained the best performing asset class of 2018 YTD largely driven by supply and demand.
  - Crude oil and gasoline prices are at record highs as are energy companies.
- As many of you know, we utilize eMoney Advisor as our financial planning technology. We are excited to share that significant enhancements have been made to the mobile version of the client portal. We look forward to walking you through this at an upcoming meeting, but please don't hesitate to contact us if you would like to discuss this in the meantime.

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### Implications for our portfolios

#### Equity

Our portfolios are slightly overweight equities as the broader environment remains favorable. Rising short-term rates, average valuations and continued growth should help equities to perform better than bonds. We are also positioned with a slight bias to non-US equity where we find more attractive valuations and growth prospects.

#### Fixed Income

We expect short term rates to continue rising and are therefore minimizing interest rate risk (duration) through the use of floating rate funds. These funds hold short-term bonds with less exposure to rising interest rates. This limits the downside potential as bond prices fall when rates rise. To balance this out we have added a credit fund, offering yield without as much interest rate risk.

Through an active approach in selecting our fixed income allocation, we are able to create a portfolio with higher yield and lower duration than benchmark indices.

### Markets Overview

After struggling to explain inflation weakness throughout much of 2017, Fed officials are now contemplating when to apply the brakes in the form of a steeper rate hike path.

As you can see in Figure 1, all measures of US inflation have picked up recently towards what is generally considered a healthy and targeted rate of about 2%. Normally we would expect the federal government not to apply greater stimulus in the form of spending and tax cuts in this environment. However, it is evident in Figure 2 that is not the case with elevated government debt.

Figure 1.

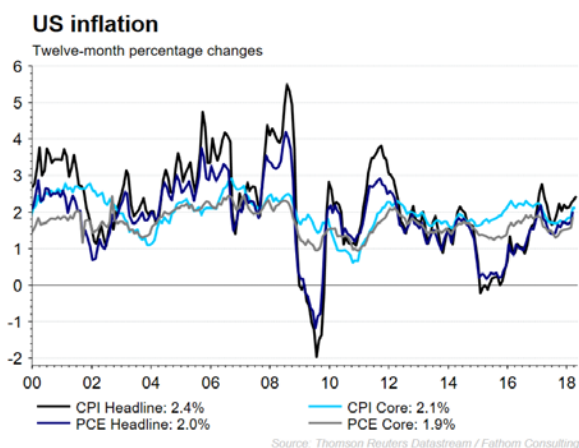
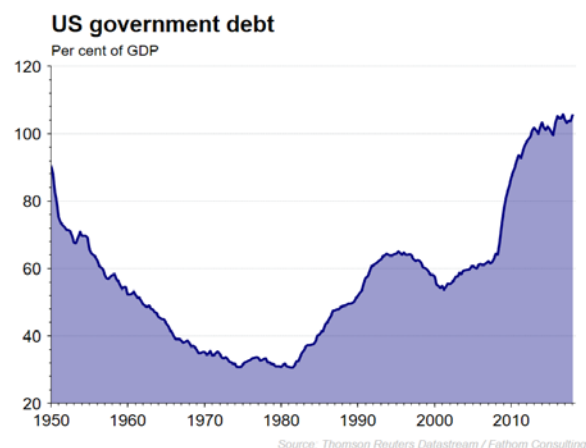


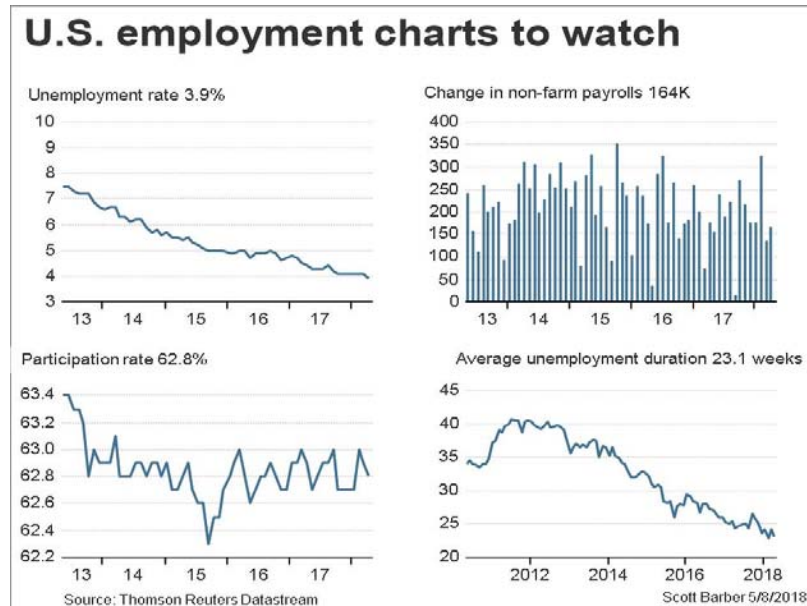
Figure 2.



At 3.9% the US Unemployment rate is the lowest it's been in the past decade (see Figure 3). Low unemployment is generally a good thing, however there is a point where it becomes too low and unsustainable, resulting in upward pricing pressure.

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Figure 3.



Seen in Figure 4, the yield curve continues to flatten as short-term rates rise (investors are not compensated on the long end of curve for taking additional risk). The 10-year treasury rate has now surpassed 3% and is expected to continue rising. Bond prices fall as interest rates rise, increasing yields. This is concerning to equity investors as the equity market becomes less attractive relative to fixed income. This is evident in Figure 5 where the S&P 500 dividend yield is actually less than the 10-year treasury rate.

Figure 4.

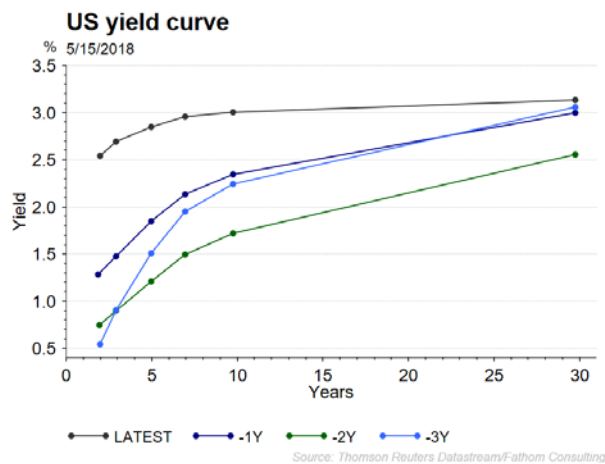
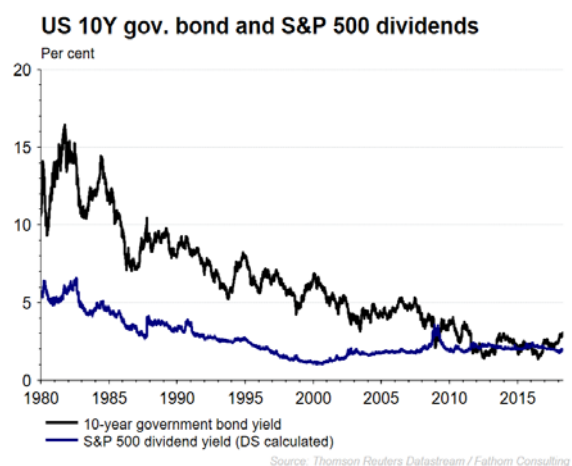


Figure 5.



Markets will likely remain volatile and choppy considering the advanced stage expansion, relatively little economic slack left, continued geopolitical concerns as well as changing monetary and fiscal policy. However, strong recent earnings growth suggest valuations are not too high relative to historical averages (please reference Figures 6 and 7).

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Figure 6.

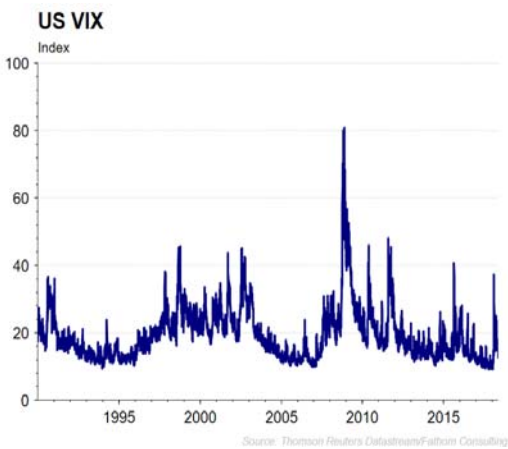
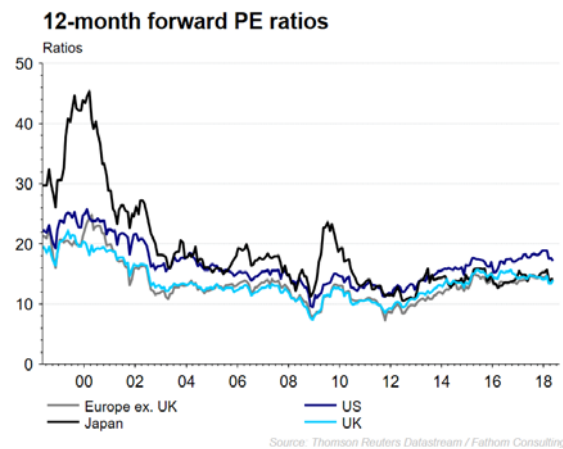


Figure 7.



### Planning /Investment Insights

In past newsletters we have talked about staying invested for the long-term and maintaining discipline as the market moves up and down. In addition to implementing a financial plan we are able to stick with, awareness of the existence cognitive biases and mental shortcuts makes maintaining discipline even easier. To summarize, cognitive biases are systematic deviations from the norm or what we would expect in one's decision making. These biases result from mental shortcuts we unconsciously take (heuristics), social influences or even emotional motivations.

There have been many types of different cognitive biases identified. We have highlighted a few that are particularly relevant for investing:

- Confirmation Bias: The tendency to search for and interpret information in a way that confirms someone's preconceptions or personal beliefs.
- Hindsight Bias: The inclination to see past events or patterns as predictable.
- Framing: Analyzing an issue without all the facts or looking at something with too narrow of a mindset.

This is not to suggest that we are flawed and irrational, but instead that awareness of how we make decisions and act in the face of uncertainty is important. For example, we all know "buy low and sell high," but in practice this is much harder because of cognitive biases. If you'd like to read more we'll point you to two great books on the subject: [Thinking Fast and Slow](#) by Daniel Kahneman and [The Undoing Project](#) by Michael Lewis.

**We are committed to providing timely and relevant insights on the markets and key planning areas. If there are any specific topics of, let us know and we will do our best to add them in future letters. Please do not hesitate to contact us with any questions, investment or otherwise.**

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