November 2018 Newsletter

Dear Members of Flower City Capital,

Happy Thanksgiving! We hope you all have a great day tomorrow celebrating with your families. In light of recent market events, we wanted to give you an update so you do not have to think about markets on Turkey Day.

As always, we begin with an executive summary:

<u>Market Update</u>

- We are 10 years into the current bull market following the "Lost Decade" of the 2000's
    - Market declines are common, and October was one of them with the US market hitting correction territory (~10% from a recent peak) but still flat for the year
    - Large market declines (20%) rarely occur independent of economic recessions, hence the debate about when the next recession will be

- By many counts the US economy is as strong as ever and there are few signs of weakness
    - Unemployment is currently at its lowest level since 1953
    - Earnings and economic growth in general are strong, fueled by both still accommodative monetary policy (low interest rates) and expansionary fiscal policy (tax cuts and increased government spending)

- The major question for the market and for our portfolios is whether this sell off is driven by investor sentiment & fear, or if something has fundamentally changed in the market
    - If this is in fact a temporary sentiment driven sell-off, market valuations are now below historical averages with still solid fundamentals
    - On the other hand, volatility and price declines may continue based on concerns over slowing global growth, rising interest rates and continued trade issues

- This is something we are monitoring closely for changes to our portfolios
    - In either case, we are seeing value in safer parts of the Fixed Income market (short term, higher quality) and will likely restructure away from riskier bonds in the near-term

<u>Planning Update</u>

- We have reached out to all of you who need to take Required Minimum Distributions (RMDs) from retirement accounts this year in order to process ahead of year-end

- We are also working to review opportunities for further deferred savings opportunities (IRA and Roth IRA contributions.) in 2018 & 2019. We will be reaching out to those of you who are eligible in January

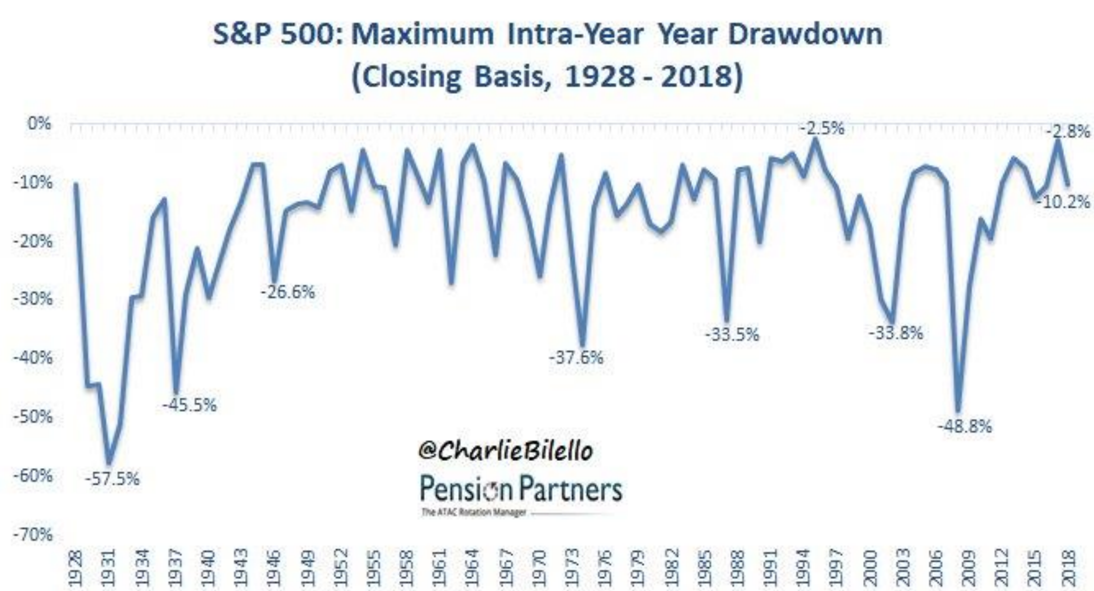
Market Overview

We are 10 years into a bull market after the "Lost Decade" of the 2000's, when the US Stock market began on soft footing as it worked off the excesses of the Dot Com boom of the late 90's and ended the decade with the Great Financial Crisis in 2008/09. Since 2010, the US stock market has seen double digit annual growth with brief pauses along the way and could continue to advance for years to come.

Chart 6: S&P 500 – monthly semi-log scale chart; Secular bull trend 5 years old but could last another decade or more

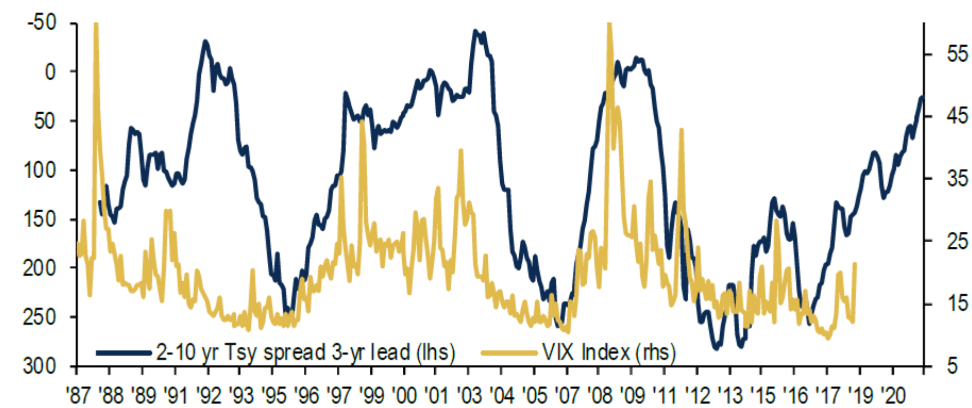
Source: BofA Merrill Lynch Global Research, Bloomberg

October saw the US market hitting correction territory (a 10% pullback from a recent high). Market declines of 10% or more are common and happen on average about once per year. 2017 was the exception as it only had a 3% decline the entire year. Large declines (20%+) are rare outside of recessions. Hence the constant debate about when the next recession will be.



Ironically, this recent pullback happened with the lowest unemployment rate since 1953 and ~25% earnings growth over the last 12 months, fueled by the double shot of tax reform and fiscal stimulus. What's likely happening is that investors are beginning to price in the impact of the Federal Reserve raising interest rates to cool the economy. The Federal Reserve's job is to "take away the punch bowl just as the party is getting good." As rates rise investors begin to worry about the market as the easy money policies during softer economic times are no longer there to support it. As a result, volatility increases.

Chart 1: The yield curve has a strong leading relationship with the VIX a measure of volatility
CBOE VIX and inverted slope of yield curve (1/31/87 – 10/31/18)



Source: CBOE, FRB, BofA Merrill Lynch US Equity & US Quant Strategy

This is a normal and natural outcome of market cycles. Again, 2017 had the least volatile market year since the go-go era of the mid-90s. 2018 is shaping up to look like a much more normal year from a volatility perspective. Economic growth continues to be strong though.

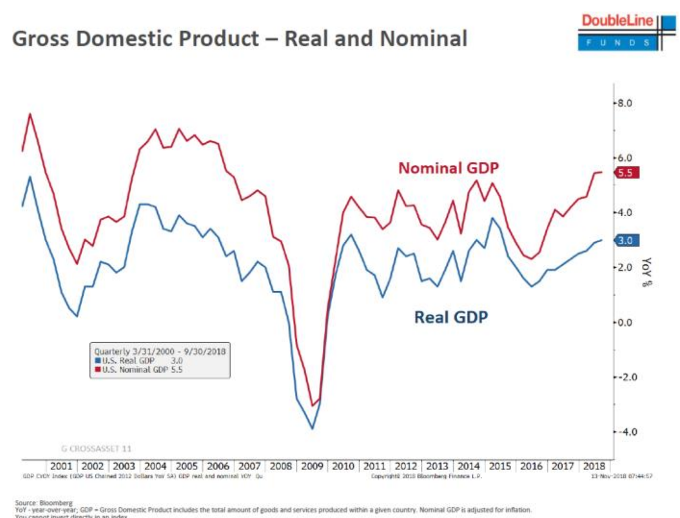
Volatility is normalizing in 2018…

S&P 500: Annualized Volatility in First 222 Trading Days (1928 - 2018)

Year	Vol	Year	Vol	Year	Vol	Year	Vol	Year	Vol
1928	14.1%	1946	23.3%	1964	5.0%	1982	18.3%	2000	22.0%
1929	37.8%	1947	14.6%	1965	6.9%	1983	13.9%	2001	22.2%
1930	26.9%	1948	15.8%	1966	12.1%	1984	12.8%	2002	26.7%
1931	39.7%	1949	12.1%	1967	8.4%	1985	10.1%	2003	17.8%
1932	55.6%	1950	14.1%	1968	9.1%	1986	14.7%	2004	11.4%
1933	50.3%	1951	11.1%	1969	10.0%	1987	32.6%	2005	10.6%
1934	26.8%	1952	8.2%	1970	15.9%	1988	17.8%	2006	10.3%
1935	18.5%	1953	9.6%	1971	9.8%	1989	13.4%	2007	15.3%
1936	17.8%	1954	8.7%	1972	8.0%	1990	16.5%	2008	38.3%
1937	29.1%	1955	16.0%	1973	13.7%	1991	13.8%	2009	28.8%
1938	33.1%	1956	11.9%	1974	21.8%	1992	10.0%	2010	18.8%
1939	27.1%	1957	12.5%	1975	15.9%	1993	8.9%	2011	23.2%
1940	23.0%	1958	8.4%	1976	11.4%	1994	9.8%	2012	13.0%
1941	13.6%	1959	9.5%	1977	9.1%	1995	7.6%	2013	11.4%
1942	14.1%	1960	10.4%	1978	12.4%	1996	11.7%	2014	11.1%
1943	13.5%	1961	8.1%	1979	11.0%	1997	18.4%	2015	15.4%
1944	9.1%	1962	17.3%	1980	16.4%	1998	20.4%	2016	13.7%
1945	12.5%	1963	7.2%	1981	13.8%	1999	18.8%	2017	6.8%
Note: Closing Prices (does not include intra-day)								2018	15.3%

Pension Partners @CharlieBilello

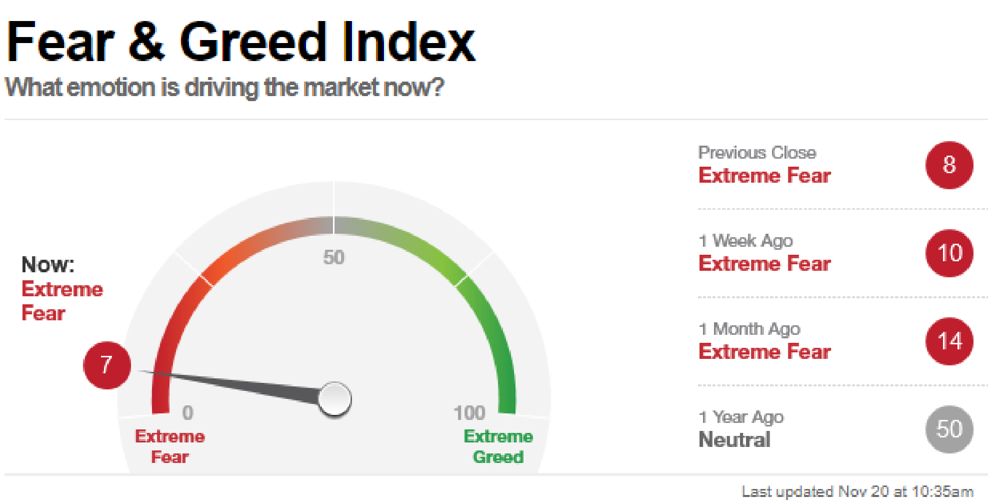
…while the US economic backdrop remains strong



The recent pullback combined with strong earnings growth has brought the US market multiple back below historical averages, therefore alleviating a lot of the high valuation strain seen in the last few years.

S&P 500 multiples are below historical averages… *…while the index has remained largely flat YTD*

Of course, this wouldn't happen if everyone was feeling optimistic. In fact, some investors are downright terrified. The November 20th Fear/Greed index is registering extreme fear, which is usually a good buying opportunity.



CNN Business 11.20.18

For all of this doom and gloom, it may surprise you to learn that US market is now merely flat for the year (i.e. January rally of 7% + 2% dividend yield minus a 10% pullback from peak). What is happening is the US is joining the rest of the global markets in a correction.

Update for 11/20/18

	Total Return (As of November 20, 2018)			
	1 Mo	3 Mo	YTD	Yield
Equities				
US Large Cap (S&P 500 Index)	-4.4%	-7.2%	0.5%	1.9%
US Mid Cap (Russell 2500 Index)	-4.5%	-12.8%	-3.3%	1.5%
US Small Cap (Rusell 2000 Index)	-4.6%	-14.4%	-3.3%	1.5%
Intl. Developed USD (MSCI Eafe Index, Net of Dividends)	-3.1%	-8.2%	-10.5%	2.9%
Emerging Markets USD (MSCI Emerging Markets Index, Net of Dividends)	0.2%	-7.1%	-14.2%	2.5%
Fixed Income				
US Bond (BBarclays US Aggregate Index)	0.5%	-1.1%	-2.0%	3.4%
International Bond USD (BBarclays Global Aggregate Index)	0.1%	-1.7%	-3.1%	1.1%
High Yield (BBarclays US High Yield Index)	-2.0%	-2.3%	-0.5%	6.7%
Emerging Market Bond (BBarclays Emerging Mkts Index, Unhedged)	-0.9%	-1.1%	-4.1%	5.9%

The sell-off is also making many companies more attractively priced. The big names (Apple, Google, Netflix, Amazon, Facebook) are all down now ~25% on average. Morningstar, an investment research company, does a fair value assessment of many individual companies and the recent rout has caused parts of the market to trade at a discount to fair value.

FLOWER CITY CAPITAL

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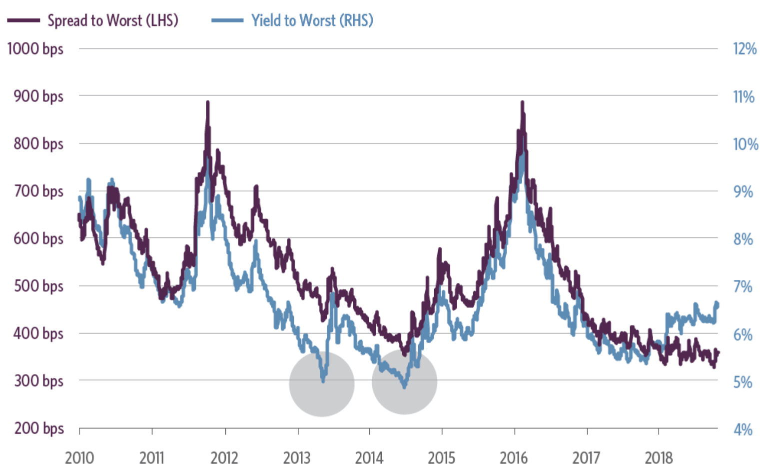
The major debate for markets and for our portfolios is if markets will continue to pullback on concerns of slowing global growth, rising interest rates, trade concerns and a policy error by the Fed or if this is a temporary fear driven sell off. We are monitoring this closely to see if we should make any changes to our portfolios. Either way, we are starting to see more value in the safer parts of the bond market (i.e. short-term, high quality) and will likely look to reduce our exposure to riskier bonds in the near-term as credit spreads have hit or are nearing their bottom for the cycle.

High-Yield Corporate Bond Yields See Resistance at 5 Percent



Source: ICE Bank of America Merrill Lynch, Guggenheim Investments. Data as of 10.22.2018.

Planning Overview

We are currently focused on major year end planning opportunities. We have processed Required Minimum Distributions (RMDs) for everyone needing to take them from eligibile retirement accounts. For those of you eligible to contribute to IRAs or Roth IRAs we will be reaching out in January to process for 2018 and even 2019. As rising rates helped precipitate the decline in both stock and bond prices globally we have been harvesting losses to try to minimize any tax exposures for 2018. It is also worth pointing out that the new tax code has it made so that only ~3% of the population will itemize their deductions going forward. Therefore, should you be charitably inclined, you might consider a "charitable lumping" strategy where you give several years at once if you're trying to take a deduction for tax reasons.

Please do not hesitate to contact us with any questions, investment or otherwise.

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