FLOWER CITY CAPITAL

September 2018 Newsletter

Dear Members of Flower City Capital,

We hope you are enjoying the last days of summer and are ready for the back-to-school season. This month we take a deeper dive into the markets and what that means for our portfolios.

As always, we begin with an executive summary:

- The U.S. equity bull market continues its long run since 2009 with many indices hitting multiple all-time highs coupled with strong economic numbers, however valuations remain reasonable due to market uncertainty
- We have also seen unique market events recently: both Apple and Amazon have seen their company market values exceed $1 trillion
- Though Emerging Market valuations are undemanding, a strong dollar, trade wars and structural debt issues have caused their shares to underperform so far this year
- Overall the US economy is strong with low unemployment, reasonable inflation, strong manufacturing data and ample job opportunities, the Federal Reserve continues to raise short-term interest rates to try to avoid "overheating" the economy
- The current bull market is the longest on record as we approach 10 years without a major correction (>20%) after the financial crisis, we continue to look for reasons to reduce risk in portfolios, but to date have not seen compelling data to cause any major shifts

Market Return Summary

August saw the continuation of YTD trends with gains in the U.S. Large, Mid and Small cap sectors. International Developed and Emerging Markets are under pressure, while domestic and international bonds remain mostly flat if not down.

	Total Return *(As of August 31, 2018)*			
	1 Mo	**3 Mo**	**YTD**	**Yield**
Equities				
US Large Cap	3.5%	7.5%	9.9%	1.8%
US Mid Cap	3.8%	6.6%	11.5%	1.3%
US Small Cap	4.4%	6.8%	13.7%	1.4%
Intl. Developed USD	(1.7%)	(0.9%)	(2.0%)	2.8%
Emerging Markets USD	(3.8%)	(4.2%)	(6.9%)	2.3%
Fixed Income				
US Bond	0.7%	0.6%	(1.2%)	3.1%
International Bond USD	0.1%	0.8%	1.3%	0.9%
High Yield	0.6%	2.5%	1.2%	5.7%
Emerging Market Bond USD	(2.3%)	(1.3%)	(6.3%)	5.6%

**Total Return includes Dividends*

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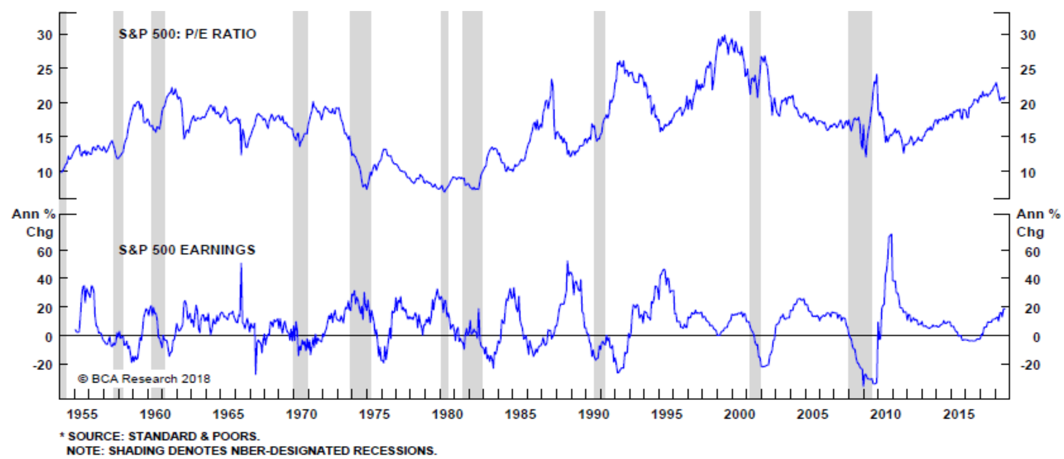
Market Deep-Dive

U.S. Equities

S&P 500 earnings growth has been ~20% this year driven by tax cuts and a supportive economic environment. However, valuations measured by the ratio of Price to Earnings have not increased at the same rate. As alluded to in our last newsletter, this can partly be attributed to reduced investor confidence due to the many "Trade War" headlines and other uncertainties.

Figure 1. S&P 500 earnings have grown rapidly while uncertainty about the future may be holding back returns



Major indices continue to grind higher hitting new all-time highs. YTD the S&P 500 index has returned approximately 10%. However, it's clear this has been driven by fundamentals (earnings & dividends) and not by the market's willingness to pay a higher multiple.

Figure 2. US Indices across the board have increased

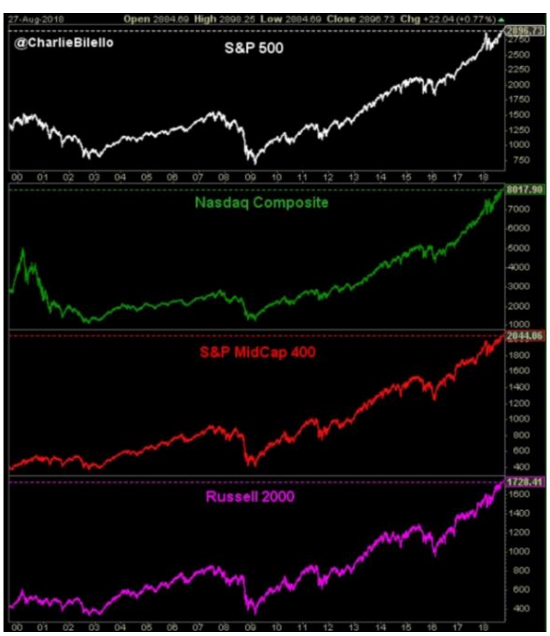
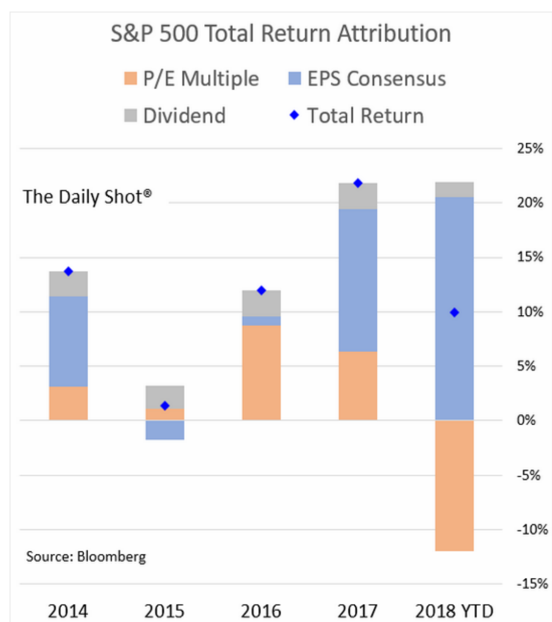


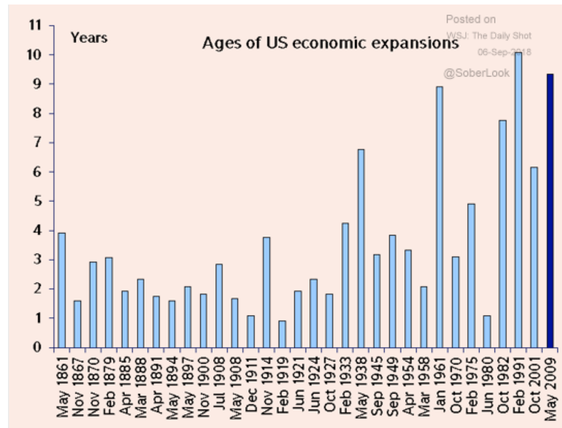
Figure 3. But markets have not been willing to pay



It’s also clear that the U.S. equity market has diverged significantly from the rest of the world. This equity bull-market has correlated with economic expansion.

Figure 4. 2018 has seen significant global divergence

Figure 5. This is the 2nd longest economic expansion



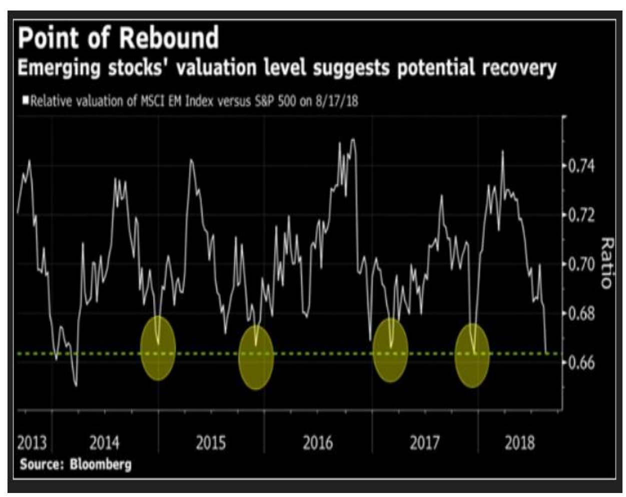
International Equities

There have been many Emerging Market countries in the news lately facing “currency crises” and market sell-offs. Turkey, Argentina, South Africa, India etc., are facing the continued threat of negative trade policy, declining economic strength and significant debt levels while governments have been slow or unwilling to adopt the necessary changes going forward.

The Dollar has appreciated as US interest rates rise and global growth slows. With a relatively weaker currency, it’s more difficult for EM countries to repay debts and participate in global trade.

Figure 6. EM currencies have depreciated significantly

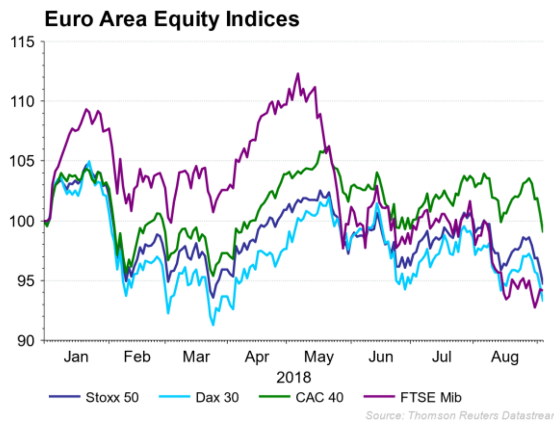
Figure 7. Valuations suggest EM may have hit bottom



Notably China’s overall deceleration is one of the biggest questions for the global growth picture ahead. It remains to be seen whether the government will enact any sort of stimulus to jumpstart the market and economy.

Elsewhere in the developed economies, markets are largely flat with lackluster economic data.

Figure 8. Euro equity markets are down



Fixed Income

The Federal Reserve recently signaled it will continue to gradually raise interest rates. By doing so the Fed is working to moderate a strong US economy that's pumping ahead on the backs of expansionary fiscal policy. It's a careful balance though, where raising rates too quickly could prematurely dampen any further growth, and raising too slowly could enable inflation to spiral upward. With core measures of inflation such as the Personal Consumption Expenditures price index reaching the Fed's 2% target, this strategy appears to be working.

It's worthwhile to remember where we've been. Following the 2008 Financial Crisis, the Federal Reserve began a historic period of easy money policy. By purchasing bonds and lowering the rate at which banks borrow from each other in the short-term, the Fed sought to inject money into the economy and influence borrowing and spending levels.

This was additive to the roughly 30-year long-term trend of declining interest rates. As interest rates fall, bond fixed coupon payments become more valuable which increases the price. Bonds have become less attractive as this trend has reversed.

Figure 9. The Fed has gradually raised interest rates

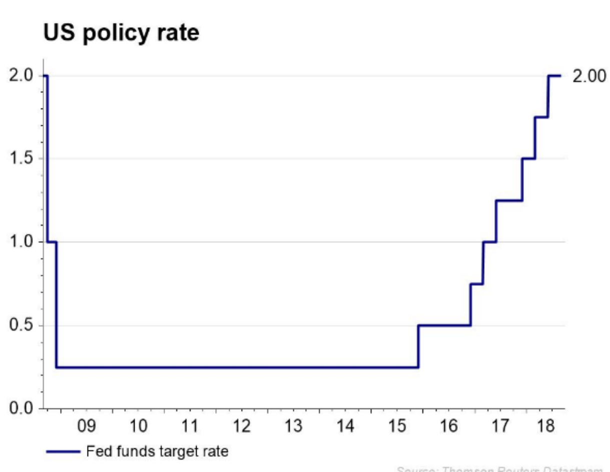


Figure 10. Marking the end of their LT decline

Our Portfolios

Our portfolios have tactically tilted towards more risk exposure in terms of stock vs bond mix for much of the year. Approximately 10-years deep into the current bull-market and arguably nearing the top of global business, economic and credit cycles, the question becomes when we should recalibrate our risk exposure and by how much.

Typically, as long as the economy keeps growing it's positive for stocks in the near-term. It's rare for bear markets to occur outside a recession and currently there are few signs of a pending dramatic slowdown in the economy.

Presently, generally accepted recession indicators such as the Housing Market, Earnings and inflation offer no signal for a near-term economic downturn.

Figure 11. There are no warning signs of an impending recession

Recessionary indicators point to limited downside risk

Posted on WSJ: The Daily Shot 05-Sep-2018

Recession Dashboard

@SoberLook

Start of Recession	Yield Curve	Inflation Trends	Job Creation	Credit Perform	ISM Mfg.	Earnings Quality	Housing Market
Nov-73	↓	↓	↓	↓	↓	--	↓
Jan-80	↓	↓	↓	↓	↓	--	↓
Jul-81	↓	↑	↑	↓	↓	--	↓
Jul-90	↓	↓	↓	↓	↓	↓	↓
Mar-01	↓	↓	↓	↓	↓	↓	↔
Dec-07	↓	↓	↔	↓	↓	↓	↓
Present	↑	↔	↑	↑	↑	↑	↑

Key: ↓ Recessionary ↑ Expansionary ↔ Neutral

Source: Standard & Poor's, Federal Reserve, BLS, National Statistical Agencies, NBER, ISM, Census Bureau, Haver Analytics®, Credit Suisse

We believe it's too early to dial back risk within our portfolios. Investors who do may end up hurting performance rather than helping it due to the associated opportunity costs.

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

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