# The AUTUS Review

***(First Quarter, 2015)***

## The Economy

Now it gets interesting. After three years of some of the lowest volatility in memory, nervousness and uncertainty have returned to the financial markets, resulting in wide daily swings in stock prices. Investors had become complacent with a market that moved steadily upward, without much variance or any significant pullbacks. But recently, plummeting oil prices, a rapidly declining Euro, and the prospects of a less accommodating Federal Reserve have increased the anxiety level. Volatility is back.

The oil price decline has been breathtaking. The root cause is a simple case of supply and demand imbalance; increased supply, primarily from hydraulic fracturing (fracking) in the U.S., has resulted in a supply glut. Compounding the problem, Russia, the world's largest exporter, has some fundamental reasons not to cut production (weather, lack of storage capacity), and their economy is so dependent on oil output. OPEC, driven by the Saudi oil minister, has decided to keep the cartel's total production at 30 million barrels a day, despite sharply lower prices. With a stagnant global economy, demand has not been enough to meet supply. Clearly, significantly lower oil prices are a net benefit to a large component of the economy, particularly the consumer. But when a major asset class is in such free fall, it tends to rattle the nerves of investors.

Weakness in Europe has led the ECB to initiate a quantitative easing program. QE actions are designed to expand the monetary base, lower bond yields, inflate asset values, and weaken the exchange rate. The dollar continues to strengthen, with the Euro-to-dollar exchange rate falling from around 140 to 107. This poses a challenge for U.S. companies, as it makes their goods more expensive to foreign buyers and reduces the value of the profits earned abroad when converted back into dollars.

The U.S. Federal Reserve has a mixed picture when assessing when to begin raising interest rates. They've prepared the markets for a tightening move later this year, although the magnitude and pace remain unclear. Their tone recently has been more dovish. But short rates have been close to zero for more than six years and the yield on the 10-year Treasury is still below 2%. Interest rate levels that are near historical lows, for this long, would certainly portend a dire scenario. Our sense is the Fed is being abundantly cautious due to the severity of the 2008 crisis. U.S. real GDP growth has been between 3.5% and 5% in four of the last six quarters, and unemployment has declined to 5.5%. Consumer sentiment is at an 11-year high, auto sales are near a 17 million annual pace, bank lending has risen by 8% in the last year, and corporate profits are at record levels. This sure doesn't seem like an environment for interest rates to be at all-time lows.

## The Capital Markets

The first quarter of 2015 marked the 9th consecutive quarter in which the S&P 500 has risen. The index has only had three other stretches that long in the last 70 years. This steady, uninterrupted advancement in the stock market has led to a very high level of investor optimism, which is somewhat concerning. Investor sentiment is currently at one of its highest levels since 1900. When investors are exuberant, they tend to ignore valuations and fundamentals. So while the recent uncertainty about energy prices and central bank policies has already resulted in more volatility, it has not produced a widespread sell-off. Consolidating some of the gains of the past few years and reintroducing anxiety and caution would actually be considered healthy if this advancement is to be sustained.

In the bond market, longer U.S. Treasuries have been the best performers in recent years. A global flight to quality and rock-bottom interest rates in other developed countries like Germany and Japan have contributed to this.

## Portfolio Implications

### Equity

Large-cap domestic stocks led virtually all other equity categories for several years through 2014. Small-caps, developed international, and emerging markets all trailed the returns of the S&P 500. This trend has begun to reverse in recent months. International stocks have been benefiting from the liquidity provided by the ECB's quantitative easing efforts. Small-cap stocks tend to do well in periods of economic growth and rising inflation; they also happen to be reasonably valued at present levels. So we continue to believe that equity portfolios should be well diversified, with international and small-caps complementing a core large-cap component.

### Fixed Income

Trying to predict the direction and expected level of interest rates has proven to be a fool's game. That said, interest rates at historic lows, a less accommodative Fed, and a steady global economic expansion should eventually lead to higher rates. As such, we remain cautious on bonds. We continue to find value in BBB-rated investment grade corporates in the 3-8 year maturity range.

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