The AUTUS Review
(Fourth Quarter, 2015)

The Economy

The Wall of Worry just seems to keep getting higher. Sustained bull markets usually face inherent challenges, so it is often said that for a market to continue to move higher in the face of these uncertainties, it has to climb a "wall of worry." The economic expansion is getting long-in-the-tooth, the Fed recently began tightening interest rates, oil prices have plummeted, China has devalued its currency, the dollar has strengthened, and the profit cycle may be peaking. Indeed, investors have plenty to worry about.

In December, the Federal Reserve raised interest rates for the first time since 2006. The Fed Funds rate had been near 0% for seven years, reflecting the severity of the financial crisis. Moving toward normalization of rates signals the Fed's confidence in the sustainability of the economic recovery. But the unknown magnitude and timeframe of future rate increases causes uncertainty for the financial markets. We see the Fed following a cautious, wait-and-see approach toward further tightening.

China's decision to devalue their currency in order to stimulate domestic economic growth has led to sharp sell-offs in global equities. European economies are fragile, and austerity measures and quantitative easing are only beginning to help. Japan continues to battle an inconsistent recovery. And the emerging world is struggling in the face of depressed commodity prices. Global economic recovery has certainly not been synchronized up to this point. But most economies are just now benefiting from a slew of accommodative factors – lower energy prices that act as a tax cut, lower bond yields which provide a monetary boost, and a large currency devaluation. Perhaps these concurrent stimuli will finally lead to a synchronized global lift in economic activity in the coming months.

The strength of the U.S. dollar continues to be a concern in that it makes goods sold by domestic producers more expensive for foreign buyers. This strength stems from the fact that growth in the U.S. has been stronger than growth in overseas economies. Stimulative efforts by China and by the ECB, coupled with an aging U.S. expansion, lead us to believe this relative economic strength could shift away from the U.S., presenting a more favorable currency environment.

Troubling as well has been the relentless decline in oil prices. With tepid global demand, and continued pressure on the supply side, prices will likely remain depressed. Lower energy costs are a net benefit to a vast majority of businesses and consumers. But energy company earnings have plummeted, leveraged players may be on the brink of default, the high-yield market has been impacted, and the overall stock market has viewed the volatile energy environment as just one more major thing to worry about.

The Capital Markets

The current bull market is the fifth longest in history, and its gain is the fifth best. But global economic uncertainties have finally led to increased volatility and a pause in the great bull run. The U.S. market experienced its first 10% correction in 2015 in over 3 years, and was essentially flat for the year. Mid-cap and small-cap indexes had negative returns, as did developed international equities. Emerging markets fell by 15%.

In spite of all the Wall-of-Worry factors, forecasting the market's future returns comes down to two key inputs: earnings and valuation. The U.S. earnings cycle peaked last year, profit margins are at record levels, and more than half of corporate earnings are coming from share buybacks. Consensus has S&P 500 earnings growing at around 7% in 2016, largely because Energy profits could stop declining and the dollar shouldn't present the same headwind. This would be a constructive scenario, but will be challenging to achieve. As for valuation, the market P/E is currently around 16x, somewhat rich by historical standards. Given that interest rates may be rising, inflation could heat up, and profits are stretched, it's difficult to make a case for P/E expansion; the stock market appears fully valued.

Portfolio Implications

Equity

Bear markets don't usually occur without recessions, and we're not forecasting a recession. We do believe that, with stretched valuations and inconsistent earnings across sectors, we'll see more of a stock-picker's market. We've been more heavily weighted in the Health Care, Consumer, and Technology groups, which have shown solid earnings gains. Going forward, we'll be watching for a turnaround in some depressed Industrials and Materials stocks, and will perhaps look to increase International exposure.

Fixed Income

We remain cautious on bonds, expecting a modestly rising rate environment over the next 1-2 years. Investment grade corporate bonds offer reasonable value, while Treasuries seem expensive. Portfolio durations should be less than five years. The high-yield market has been very difficult, as credit spreads have widened and energy bonds have fallen sharply. But overall default rates remain low, so we see some value in the high-yield sector.

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Don Cuppy
don@autusam.com

Mark Fiedler, CFA

Steve Fields, CFP®

Kipp Goll, CFA