The AUTUS Review

(Second Quarter, 2015)

The Economy

Over the last six years, the economic expansion has been characterized by modest growth and low inflation. To be specific, real GDP growth has averaged about 2.2% since the end of 2009 and inflation, as measured by core CPI, has averaged around 2% over the same period. More recent economic activity does not suggest a meaningful deviation from these trends as the economy is expected to bounce back from another negative first quarter.

Against this backdrop, there exists much angst and hand wringing over the timing and necessity of tighter monetary policy for the first time in 8 years. Past rate hike campaigns have been associated with either stronger growth or higher inflation. For this reason, we do not believe that we are on the precipice of an aggressive, persistent tightening move by the Federal Reserve. *If* they move at all in 2015, they will likely tiptoe.

While growth is not robust and inflation is tame for now, labor markets should be watched closely for constraints and pricing pressures. The unemployment rate is down to 5.3% and wage inflation has ticked up recently. This may be part of the Fed's concern and the reason they have led the markets to expect a rate hike in 2015.

Housing and auto sales are two areas of strength, reflecting much healthier consumer balance sheets and improved labor markets. Business expenditures remain an area of concern. While business spending has bounced back in the recovery, the longer-term trend since the beginning of the millennium is less than impressive, which limits future growth potential. This in part explains lower productivity and is one area of the economy we would like to see get much stronger.

Whether it's China, Puerto Rico, or the southern representatives of the EU, global economies are agitating again. Greece should get its due respect as a meaningful concern for markets, but some perspective is important. The Greek economy is similar in size to that of Detroit and the drama has been ongoing and well-advertised for over 3 years. Which is to say, there has been plenty of time for banks, other debt holders, and economic planners to prepare for the fallout. Systemic risk, or contagion, is always a concern, but credit markets do not reflect the sort of risk that was evident preceding similar events in recent years. Going forward, a more relevant focus will be on the implications for the much larger economies of Spain and Italy.

The bottom line is that we have a domestic economy that continues to make modest progress and will likely continue to do so, barring a monetary policy mistake or some form of external shock. For now, we expect more of the same – modest growth and tame inflation.

The Capital Markets

Domestic equity markets made little progress in the first half of 2015. Given the steady ascent of the previous three years, this consolidation is not altogether surprising. Sector performance varied widely, with health care and financials doing the best and utilities and energy at the bottom. The broad market is trading at a price/earnings multiple of about 17.5. This is modestly above the average of the last 50 years. Not expensive, not cheap. With corporate profit margins near record levels and wage pressures slowly building, better revenue growth will likely be necessary to propel the market forward from current valuations.

Developed international markets outperformed for the first time in a while as European and Japanese central banks continued their stimulus programs. Additionally, lower energy prices, and currency moves spurred optimism about future growth. As the European Union continues to wrestle with structural issues, market valuations there are becoming more attractive.

Interest rates are moving higher again in 2015 after making new lows earlier in the year. The 10-year Treasury bond has moved from 1.68% in February to 2.49% at the end of June, but remains in the middle of the range of the last four years. The move in shorter duration bonds has been less dramatic. With a fed move at the forefront, interest rates will likely remain volatile, but inflation expectations would need to move considerably higher for rates to break above their four-year range.

Portfolio Implications

Equity

Our primary emphasis remains on large and mid-cap domestic companies that exhibit sustainable long-term growth characteristics, quality earnings, solid cash flow, and healthy balance sheets, while exercising sensitivity to relative valuation. Due to a more favorable currency backdrop and more compelling valuations, we are looking for opportunities to add modestly to developed international exposure.

Fixed Income

The recent spike in interest rates is a sharp reminder of the risks associated with reaching for yield via long duration portfolios. We continue to be focused on balancing yield with interest rate risk by maintaining disciplined, structured portfolios with average maturities in the short-intermediate range, as well as a strong emphasis on investment grade bonds.

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