The AUTUS Review

(First Quarter, 2016)

The Economy

Generating robust economic growth has been a global challenge since the current recovery began almost seven years ago. This ongoing condition has made world economies more susceptible to periodic "growth scares," or fear that we are slipping into recession. We have been in the midst of another such scare since the end of 2015. Indeed, real GDP growth came in just under 2% for 2015, with the fourth quarter slowing to an annualized growth rate of just 1.39%.

Consequently, it is curious that the Federal Reserve decided to tighten monetary policy at the end of last year, with an eye towards further firming throughout 2016. This combination of slowing growth and increased hawkishness from the Fed has created great uncertainty and increased volatility in financial markets.

Janet Yellen and the other members of the Fed can be forgiven to some degree in that there have been some signs of better growth and higher inflation to come. For one, the U.S. labor market continues its positive trend, with the unemployment rate at just 5% (down from its cyclical peak of 10% in 2009), and weekly unemployment claims at the lowest level since the 1980s. Also, wage growth continues to improve. In recent weeks, the Fed has walked back their tighter money stance and markets have responded positively.

Commodity markets have been another source of disruption and uncertainty for the economy. While it is reasonable to assume that lower energy prices are a net positive for the U.S., the dramatic drop in energy prices over the last 18 months has created its own set of financial risks that are yet to be fully quantified. The recent rally in oil and other commodities has assuaged some of those fears, while keeping the benefits from lower prices intact.

While the picture in the U.S. is far from perfect, our economy remains a source of economic stability and growth compared to the rest of the world. China and other emerging markets have seen significant capital outflows as they grapple with slower growth. The EU continues to struggle with structural issues that are impeding growth.

While the current expansion is getting on in years and growth is sputtering again, economic cycles do not typically die of old age alone. Rather, they are more commonly upended by an external shock or a monetary policy mistake. With the Fed adopting a more dovish stance in the last month, it appears they may have backed away from such a mistake. With modest growth, an absence of excess, and rational monetary policy, it seems unlikely we are on the verge of recession. If higher interest rates result from better growth as the year progresses, this should be viewed as a positive development.

Capital Markets

After multiple years without a 10% correction, we have witnessed two such sell-offs since last August. While we are in the process of recovering again from the most recent sell-off, it remains that the market has made little to no progress over the last 12-18 months. Not surprisingly, a lack of corporate profit growth is the primary culprit. Corporate earnings have been more or less flat for the past 18 months. The price to earnings multiple (P/E) for the S&P 500 is only modestly above its long term average, suggesting that there is room for market gains if earnings can reaccelerate. A return to meaningful and sustainable earnings growth will undoubtedly require increased corporate investment and higher productivity than we have seen in recent years.

Developed and emerging international markets have dramatically underperformed domestic markets over the last seven years. While fundamental catalysts for a turnaround are elusive, relative valuations suggest that the risk/reward scenario is improving for these markets.

Short and longer term interest rates have come down again since the beginning of the year. For perspective, the 10-year Treasury currently sits at 1.8%, inside a range of 1.5 to 3.0% since 2012. While the 2-year Treasury rose to 1.1% at the beginning of the year, it has since fallen back to .76%. The yield curve remains positively sloped, which holds positive implications for growth going forward.

Portfolio Implications

Equity

Our primary emphasis remains on large and mid-cap domestic companies that are investing for growth in an ongoing and meaningful fashion. We also remain focused on companies with quality earnings, solid cash flow, and healthy balance sheets, while exercising sensitivity to relative valuation. We are looking for opportunities to increase international exposure modestly, as relative valuations are becoming more compelling.

Fixed Income

We continue to be focused on balancing yield generation with interest rate and credit risk by maintaining disciplined, structured portfolios with average maturities in the short-intermediate range, as well as a strong emphasis on investment grade bonds. Here we are looking for attractive relative yields in corporate bonds, as well as municipals for higher tax brackets.

April 8, 2016

Kipp Goll, CFA
kipp@autusam.com

Don Cuppy

Steve Fields, CFP®

Mark Fiedler, CFA