# The AUTUS Review

***(Fourth Quarter, 2016)***

### The Economy

With an extraordinary and surprising election behind us, attention has now shifted to the potential policy changes that the new administration will bring to the economic scene. The good news of the last seven plus years is that the economy has been in expansion mode. The bad news is that real GDP growth has averaged just around 2%, leaving a massive $3 trillion output gap in its wake, relative to getting back to long-term trend line growth of 3%.

The stated goal of the incoming administration and its team of economic advisors is to fill this gap through pro-growth policies that include more balanced regulations, tax reform, updated trade policy, and more efficient government spending, leading to higher levels of business investment and productivity.

Markets have responded favorably thus far, at least to the idea of these changes. Lasting success will of course be measured by the effective and balanced implementation of these policies, and it would be unwise to downplay the risks associated with this process. There are obstacles to long-term economic growth that are more intractable in nature, including the high level of government debt, as well as current demographic trends. That said, an acceleration to 3% growth is possible with reasonable policy changes and is the reason for the current enthusiasm.

While real GDP growth will again average somewhere around 2% in 2016, there was a meaningful uptick in the 3rd quarter of the year. Also, with the economy near full-employment, inflation has been rising. Accordingly, the Fed decided to increase the fed funds rate in December, following an ill-timed hike one year earlier. The bond market has thus far affirmed the Fed's most recent move with a continuation of yield curve steepening, suggesting better economic growth ahead.

The potential change in the direction of economic policy offers the opportunity to shift from an economy that has been focused on monetary stimulus to one that is focused on increased investment and higher productivity. While not without risks, it represents a sensible pivot and a much more sustainable path.

### Capital Markets

Domestic equity markets were up nicely in 2016. The market's ascent was not equally favorable to all sectors, as is usually the case. Post-election, the market has been led in dramatic fashion by financial, energy, and industrial sectors, on the hopes of a more favorable regulatory environment as well as a cyclical growth revival. More staid and consistent sectors such as consumer staples and health care are flat to down since the election. International equity markets were also flat to down in the wake of the election.

The move in stocks does have some tangible backing in the form of an acceleration in earnings growth in the 3rd quarter of 2016. At 17x forward earnings expectations, the market is not cheap, but neither is it wildly expensive.

Short and longer term interest rates have spiked since the election following an acceleration in recent and expected growth and inflation. For perspective, the 10-year Treasury has risen from an all-time low of 1.4% to around 2.5%. This is roughly equivalent to an 8% drop in price. The 10-year has traded in a range from 1.4% to 3% over the last 5 years. The yield curve (represented by the spread between the 2-year Treasury and the 10-year Treasury) remains positively sloped, which holds positive implications for economic growth going forward.

### Portfolio Implications

#### Equity

With a potentially changing landscape, we are evaluating a marginal shift to more pro-cyclical exposure. As always, we will remain disciplined in maintaining effective diversification and focusing on companies exhibiting solid return on invested capital, high quality earnings, healthy cash flow, and sound balance sheets. We will continue to emphasize companies that are consistently and materially reinvesting for growth.

#### 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. This approach has muted the downside in fixed income portfolios compared to an extended maturity portfolio, which some investors find themselves with if they've "reached for yield."

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