The AUTUS Review

(Third Quarter, 2016)

The Economy

In spite of all the election year noise, it is economics, not politics, that really matters. This has certainly been the strangest political season in memory, with constant talk about email scandals, tax returns, shady activities by candidates' charitable foundations, building a wall along our border, not allowing Muslims into the country, and even a war of words with a former beauty contestant. Strange times indeed. But ultimately, if history is any guide, the real driver of asset values is the economic environment, and not the senseless political bantering or a shift in power in Washington.

In the four presidential elections from 1968 to 1980, the markets performed poorly in each year following the election. But this was attributed to weakness in the overall economy, not who won. In 2001, the bursting of the dot-com bubble was largely responsible for the negative stock market, not the outcome of the election. On the flip side, the last two elections in the 1980s were followed by strong stock market performance, not due to a shift in political power, but rather a rebound in asset prices coming from improving economic fortunes. And the strength in 2009 had nothing to do with politics; it was a recovery from the depths of the financial crisis.

We've seen no evidence that this election has yet impacted the domestic economy. Growth in final sales to domestic purchasers, which would logically be hit by election uncertainty, has been significantly stronger. Consumer confidence is close to a nine-year high. The stock market has largely shrugged off the political rhetoric. And overall economic growth in the 3rd quarter has picked up.

The Federal Reserve is walking a thin line. Interest rates remain near "emergency" levels, despite the fact that the recovery is in its seventh year. A normalization of interest rates at this point in the cycle makes sense, given that the severe structural imbalances have largely been repaired. But when the Fed raised rates from 0% to 0.25% last December, the stock market corrected by 12% over the next two months. And so much of our economy is now dependent on low interest rates, from home mortgages, to business spending, to the cost of the government's own debt. Indeed, navigating a path toward higher rates without upsetting the financial markets and derailing the expansion will be a tricky maneuver for the Fed.

When unanticipated events occur, their impact tends to be short-lived and the focus usually returns quickly to the broader economic fundamentals. The Brexit outcome was certainly unexpected. But once the dust settled, markets quickly perceived the real impact to be muted and not immediate. Perhaps the U.S. elections will fall similarly. Any result that creates a market reaction should soon be overshadowed by the true implications of economic realities.

The Capital Markets

The current bull market is now 7 ½ years old, making it one of the longest in history. Stocks have risen by 3.2 times, or around 17% per annum, since early 2009. This is the third strongest gain ever among bull markets. At this stage, careful attention should be paid to valuations. The U.S. market is trading at a PE of 16x next year's expected earnings. While not overly expensive, the market could certainly be considered fully valued, with further gains not likely coming from multiple expansion. More plausibly, we'd have to see earnings re-accelerate in order for stocks to move higher. While challenging, perhaps this will occur in the 4th quarter, when energy and the strong dollar present less of a headwind.

If indeed the Fed embarks on a campaign to normalize interest rates, stock investors would naturally be concerned. Higher rates can pose several impediments to rising asset values. But if interest rates are rising because economic growth is strong, that can actually be good for stocks. Historically, the stock market has done fine when earnings growth rates have exceeded yields on Treasuries. With the 10-year around 1.7%, this is a pretty low bar.

Portfolio Implications

Equity

We've seen some healthy rotation occurring in equity markets this year, with small-caps, mid-caps, value stocks, and emerging markets all having a turn at outperformance. We think high-quality dividend payers make sense in this low-rate, late-cycle phase. We're also seeking earnings consistency, and find the Health Care and Technology sectors to be relatively attractive. We remain underweight Energy, but with oil prices stabilizing and earnings bottoming, we may start to see some value in the group.

Fixed Income

We've been cautious in our approach toward managing bond portfolios, focusing on short- and intermediate maturities. Corporate bonds offer some value, as yield spreads still look attractive versus Treasuries.

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Don Cuppy
don@autusam.com

Mark Fiedler, CFA

Steve Fields, CFP®

Kipp Goll, CFA