The AUTUS Review

1st Quarter, 2017

The Economy

The winds of change are blowing as we move further into 2017. A new political party has taken up residence in the White House, as control of the executive branch changed hands for the first time in 8 years. With it brings new policy direction surrounding social welfare, foreign policy, taxation, regulation and fiscal spending. While it's difficult to predict with confidence exactly how things will eventually unfold, change appears inevitable.

Momentum in the economy is beginning to build. 4th quarter GDP was revised up to 2.1%, while 2017 and 2018 forecasts have been steadily rising, despite a traditionally weak first quarter. Consumer sentiment remains healthy, thanks to the improving labor market and growing wages. Corporations are starting to spend on capital projects again, buoyed by the potential for tax relief, fiscal stimulus and deregulation. Reflation is finally beginning to take hold after years of low inflation both domestically and abroad.

Change is also taking place at the Federal Reserve, as members undertake the tenuous process of normalizing monetary policy. In late March, the Fed raised rates by a quarter point for only the 3rd time since before the 2008 financial crisis. Furthermore, the FOMC has communicated the potential for as many as three additional rate hikes later this year. In addition, the Federal Reserve has floated the idea that they could soon begin reducing the size of their balance sheet as part of the normalization process.

Traditionally, any monetary tightening by the Fed has been viewed with skepticism by capital market participants. However, the gradual shift from excessively accommodative monetary policy appears to have been interpreted positively by investors, given the rise in equity markets and the steepening yield curve. Moving from negative real rates to modestly positive rates can be healthy and supportive of the economy and markets by allowing the financial system to function more efficiently. Also promising is the possibility of fiscal stimulus supporting economic growth, which would relieve some of the burden monetary policy has had to bear alone for the past several years.

Capital Markets

Equity markets began the New Year on a strong note. Investors seem reenergized by the potential combination of pro-business policy changes. While we've been in a corporate profit recession for nearly two years now, it finally appears to be over. The final revision of 4th quarter GDP showed that economy-wide, corporate profits have grown in back-to-back quarters for the first time since the second half of 2014. While the actual number was relatively small, the trend bodes well for the private sector's ability to invest capital in labor, equipment and structures in the near to medium term.

Several factors are supporting the profit reacceleration, including stronger economic growth, a resurgence in the energy sector and stabilizing foreign currency markets. The prospects of corporate tax reform, combined with industry deregulation, are inspiring confidence in company board rooms. Collectively, these should encourage continued private-sector investment and activity, which will strengthen the virtuous loop of economic expansion.

Undoubtedly, there are risks to this narrative. Expectations and optimism are running high regarding policy changes, so any perceived disappointment could shake investors' confidence and derail the rally. There are also risks to the markets playing out in Europe as pivotal elections take place in France, Germany and Italy, and the UK begins the process of pulling out of the European Union. Not to mention other geopolitical hot spots around the globe. But for now, the economic cycle that began nearly nine years ago seems to have found a second wind.

Portfolio Implications

Equity

While talk of policy changes is encouraging, the implementation could prove to be more difficult than many believe. Richly valued stocks are more susceptible to market risk in the form of policy execution disappointment. Now, as is always the case, it is important that portfolios remain broadly diversified across economic sectors and sub-asset classes. Attractive valuations are harder to uncover, but can still be found in both domestic and international equities.

Fixed Income

For the most part, rates have held the gains achieved over the last couple of quarters. Inflation is slowly starting to pick up and we are seeing these revised expectations play out in the steeper yield curve. We are maintaining an average duration of below five years, but will adjust this tactical stance if rates continue to rise. *March 31, 2017*

Mark Fiedler, CFA
mark@autusam.com

Don Cuppy

Steve Fields, CFP®

Kipp Goll, CFA