The AUTUS Review

(Fourth Quarter, 2017)

The Economy

The end of 2017 marked the 8th consecutive year of expansion for the U.S. economy, and while the song continues, the beat is starting to change. Real GDP growth averaged about 2.1 percent from 2010 to 2016, and the best year of growth during that period was 2.6%. Using current estimates for fourth quarter growth, 2017 is expected to be the best year yet in the current expansion with an estimated growth rate of 2.7%. Further acceleration to 3% growth is currently expected for 2018.

We think this acceleration is indicative of a changing dynamic in the economic cycle. It seems that a more favorable regulatory environment, as well as the expectation and now reality of tax reform, are having a meaningful impact on growth. Indeed, small business optimism is at its highest level since late 2004, and consumer confidence is at 15-year highs. This is a clear shift from the monetary stimulus driven growth prior to 2017. We wrote about the possibility of such a shift in our January 2017 newsletter, stating that *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 this transition is constructive, it is important to understand the implications for the economic cycle. While below average growth in this cycle has led to an unusually long recovery to this point, it has also created a massive output gap that has left trillions of dollars of opportunity cost on the table. With the possibility of faster, more organic growth, we may now be on the path of a "real" business cycle. With that, we will be watchful for an uptick in inflation and the excesses that gradually build, eventually leading to a more vigilant Fed and the tight monetary policy that typically defines the end of an expansionary cycle.

To be clear, we are encouraged that the economy is very much on solid footing at this time. We do not see the conditions in place that are the precursors to the end of an economic expansion, but we have a heightened sense of awareness given the changing dynamics and the new phase we have entered.

Capital Markets

Domestic equity markets had a robust year in 2017. The move was broad-based and driven by double-digit earnings growth as well as modest multiple expansion. With better growth at hand, sectors like technology, industrials, health care, and financials led the move. Less economically sensitive areas like consumer staple stocks were underperformers. For the first time in many years, international markets outperformed domestic markets, with investors finding valuations attractive against a back-drop of resurgent growth.

At 18.5x next year's earnings estimates, the market is not cheap, but we wouldn't say it's wildly expensive either given the current interest rate and inflation environment. This bull market has been surrounded by a level of skepticism that developed in the wake of the financial crisis that continues to feed the market and defy pessimists. That said, with the S&P 500 having gone over a year without even a 4% correction, it is possible that some optimism is building, and we wouldn't be surprised to see a more meaningful market correction in 2018 to moderate recent enthusiasm. At this point, we would view such an event as an opportunity and not the end of the bull market.

Interest rates are moving modestly higher in the wake of stronger economic data and an uptick in inflation. The yield curve remains upwardly sloped, with positive implications for further economic growth.

Portfolio Implications

Equity

While maintaining balance, we are tilted in the direction of 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, while investing for long-term growth.

Fixed Income

With accelerating growth and the potential for an uptick in inflation, we remain 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 an emphasis on investment grade bonds.

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