The AUTUS Review

2nd Quarter, 2017

The Economy

Economic growth accelerated a bit in the second quarter from the first quarter, but still remains in the mid 2% range. One of the economists we follow refers to the economy as a "plow horse" versus a race horse and another refers to it as a pontoon boat instead of speed boat. Regardless of the temptation to apply a name, the important takeaway is it appears the economy is gaining traction and we may see faster growth in the future. Furthermore, the global economy is having a strong year, with all of the world's top 20 economies growing at a pace we haven't seen since 2010.

Several leading indicators point to faster economic growth in the second half of 2017. Positives supporting this forecast include a strong labor market, improving consumer sentiment (as measured by the University of Michigan Consumer Sentiment Index), strong corporate earnings, and a wealth effect as a result of improving real estate valuations. There is a concern of over-optimism in the market in anticipation of potential healthcare reform, infrastructure spending, deregulation, and lower taxes. The risks to improving economic growth include the debt limit issue that is expected to come up in Congress sometime this summer or early fall, geopolitical unrest, and economic policy uncertainty in general.

The Federal Reserve continues working towards normalizing monetary policy. The Fed intends to continue to push rates higher (albeit at a slow, deliberate pace) combined with balance sheet reductions. We believe this combination will eventually be a positive in the event inflation picks up steam. In the short run, given the somewhat mixed economic picture and the recent slowdown in some inflation measures, predicting future Federal Reserve action is more difficult.

Capital Markets

During the first six weeks of 2016, the market experienced a technical correction, i.e. a decline of 10%. After digging this hole to start off last year, the S&P 500 posted a positive return of almost 12% for 2016. The market has remained strong and has posted solid returns thus far this year. The strong first half may be attributed to improving fundamentals, in the form of the fastest earnings growth in five years that has resulted in benchmark indices setting several record highs. For the first time in several years, international markets are up more than domestic markets in the first half of 2017.

Expectations are high for earnings growth and disappointing results are a risk to the market. Slowing economic growth, restrictive government policy, and/or a retreat in the high level of optimism add to the risks in the equity markets.

"Lower for longer" has been used to describe the current interest rate environment and that term is appropriate. While the Federal Reserve is, as mentioned earlier, normalizing monetary policy via small rate hikes over time and shrinking its balance sheet, a tightening labor market may pose the greatest threat to higher inflation.

Portfolio Implications

Equity

While conditions currently appear to be positive for stocks, earnings growth expectations are very high. As always, maintaining a diversified portfolio of high quality stocks is important, especially in light of the risks in the market, which include geopolitical uncertainty, monetary policy error by the Federal Reserve, and disappointing news from Washington. The international exposure in our client portfolios has shown nice appreciation this year and has provided enhanced diversification.

Looking forward, we do not see an obvious catalyst for higher oil prices, so that sector may continue to be a market laggard; however, this may also lead to an opportunity to invest based on valuation. It appears consumer consumption and capital investment will be key themes to keep an eye on. We will continue to search the economic sectors and sub-asset classes for valuation opportunities.

Fixed Income

Continued patience and duration management have added value for our clients' fixed income exposure. After moving meaningfully higher in the second half of 2016, 10-year Treasury yields have been range-bound thus far in 2017. The Federal Reserve has signaled its intention of another 25 basis point increase in the fed funds rate and a gradual reduction in its balance sheet for the remainder of 2017. Of course, a surprise in inflation could change that stance. In general, we are maintaining an average duration in our client portfolios of less than five years, which should provide downside protection in the event of an interest rate spike.

July 10, 2017

John Stull, CFA, CPA
john@autusam.com

Mark Fiedler, CFA ***Don Cuppy***

Steve Fields, CFP® ***Kipp Goll, CFA***