The AUTUS Review

(Third Quarter, 2017)

The Economy

The stock market continues to grind higher, closing at record levels on almost a daily basis, despite several potential headwinds. Gridlock in Washington, constant sniping among politicians, three major hurricanes, escalating tensions with North Korea, the possibility of a trade war with China, and a more restrictive Federal Reserve have all essentially been shrugged off by a resilient stock market.

The economic expansion continues on the same sluggish, choppy trajectory that it has since the recovery began more than eight years ago. After an uneven and somewhat disappointing 2016, growth began to pick up this spring, with gains in consumer spending, confidence, business investment, government spending, and exports. GDP growth in the first quarter was an anemic 1.2%, but accelerated to 3.1% in the second quarter.

The labor market in the U.S. is running at "full employment," with the jobless rate at 4.4%. Consumers are in good shape, and even though shopping habits are changing (i.e. more online, less mall), consumption expenditures are up a healthy 3.3%. Confidence is at the highest level in seventeen years. Housing remains on an uptrend, although disruptions from hurricanes Harvey and Irma are expected.

Inflation remains benign, with the rate continuing to trend below 2%. This is due to plentiful raw material supplies, adequate manufacturing capacity, large sources of labor, and uneven economic activity. Persistently low inflation certainly makes the Fed's efforts to normalize interest rates a delicate balance. So far in this cycle, the Fed has raised interest rates four times, with the current Fed Funds target at 1.25%, and has begun reducing its balance sheet. But the pace and consistency of these efforts will be tested if economic growth remains uneven and inflation low.

With the failure to bring changes to healthcare law, tax reform is now front and center on the Republican agenda. The White House needs a legislative victory, and the Republican-controlled Congress has made tax policy it's top priority. Investors remain skeptical. While lots could change in the coming months, the focus clearly is on lowering corporate tax rates, pass-through rates, reducing individual tax rates, as well as compressing the number of tax brackets. Also on the table is a plan to drastically lower the tax on companies repatriating foreign profits. And the estate tax is once again being debated. The White House is pushing for elimination of the estate tax, although this seems unlikely.

Overall, we believe the economic expansion will continue for the foreseeable future, and do not yet see signs of excess. Low interest rates, a healthy consumer, and strong business confidence should continue to drive growth. And tax cuts, for which many economists and investors are not particularly optimistic, could provide an additional tailwind.

The Capital Markets

The U.S. stock market is up 20% since the elections last November. The current bull market is in its ninth year, and we haven't seen a meaningful shakeout in several years. Investors have been emboldened by the pro-growth rhetoric of the Trump Administration, focusing on infrastructure build-out, less regulation, and tax cuts. Also driving the market has been a reacceleration in corporate earnings growth, largely driven by a bounce in the Energy sector. Many have worried that valuations are stretched. Currently, the market trades at a PE multiple of nearly 18x next year's expected earnings. While this is near the upper end of the long-term range, with interest rates and inflation low and profits still healthy, we wouldn't say the market is significantly *overvalued.* Bull markets don't tend to die of old age, nor of inflated valuations; typically, economic excesses, policy errors, or exogenous events lead to the end.

Portfolio Implications

Equity

The benefits of portfolio diversification have become even more evident this year, as international and emerging markets have greatly outperformed domestic equities. Small- and mid-caps have also done well. Despite extended valuations, equities are still exhibiting fundamental advantages over other asset classes, and we're inclined to maintain exposure at or even slightly above strategic targets. For sectors, we continue to favor Technology, Industrials, and Consumer Discretionary, where we're seeing strong earnings growth.

Fixed Income

Interest rates remain stubbornly low, despite steady economic growth and the Fed's tightening program. This low rate environment could persist for a while, with inflation expectations remaining modest. We continue to be cautious in constructing bond portfolios, focusing on investment grade corporates, avoiding Treasuries, and keeping average durations shorter than five years.

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