The AUTUS Review

(First Quarter, 2018)

The Economy

The economy appears to be building momentum as we enter April. For the most part, economic policies coming out of Washington are broadly consistent with an acceleration in nominal GDP. The stimulative effects of tax reform, combined with other forms of fiscal stimulus and deregulation, are beginning to gain traction. Clearly, talk of trade wars is becoming a major concern. Hopefully calmer voices will prevail, allowing the bluster and posturing to gradually subside before any real damage to the global economy can be done.

People are beginning to feel the impact of lower tax-withholdings from their paychecks and a strong jobs market. Consumer confidence and sentiment are holding at high levels, with the recent gains tied directly to lower income households. Corporations are also benefiting from tax reform. Lower corporate tax rates that encourage repatriation of foreign reserves, paired with immediate expensing of capital investments are providing financial flexibility. Companies are increasingly using these new-found funds to pay employee bonuses, expand operations, bolster capital structures and increase share buy-backs and dividends.

Both domestic services and manufacturing indices are in expansionary territory. The Institute for Supply Management Index (ISM) is showing durable strength and is near a 14-year high. The Purchasing Managers' Manufacturing Index (PMI) is not far behind, supporting the notion that domestic manufacturing is doing very well and should continue to do so for the foreseeable future.

Wages and inflation expectations are moving higher and are consistent with moderate economic growth and the gradual removal of monetary stimulus by the Fed. Capacity stresses are evident with lengthening delivery times, tighter labor markets and rising input costs due to tariffs and increasing raw material costs. Eventually, these higher costs will be pushed through to the consumer and inflation pressures will build. For now, inflation is inching higher in an orderly fashion and any softness in retail spending is being offset by strength in wages. The measured increase in inflation expectations is allowing the Fed to gradually normalize monetary policy, giving investors time to adjust to this new stage of the business cycle. From a historical perspective, we are late in the current cycle. However, barring a policy misstep or a geopolitical shock to the system, the current cycle appears to still have room to run.

Capital Markets

While it is natural for an economy supported by monetary stimulus to transition to a self-sustaining economy supported by healthy consumers and businesses, the transition can bring increased uncertainty and volatility. During the 1st quarter, the S&P 500 saw 23 daily moves of +/- 1%, compared to only 8 days in all of 2017. Investor complacency brought on by the steady, smooth rise in the broader indices over the last several years is being tested.

Rising real GDP growth is leading to increased earnings and inflation expectations and rising interest rates. The time of easy monetary policy and artificially low interest rates is slowly coming to an end and capital market participants must adjust. Moving forward, capital appreciation through multiple expansion will become more difficult to achieve. "Lower quality" companies that are heavily dependent on debt will find navigating this new reality significantly more difficult as the real economy siphons money away from financial assets.

The Fed is committed to a gradual path of monetary policy normalization as they ween investors off easy money. Rates remain relatively low but are starting to drift higher. For now, the positively sloped yield curve bodes well for continued economic expansion.

Portfolio Implications

Equity

As we transition from monetary stimulus and easy money is slowly removed from capital markets, growth and strong fundamentals become ever more important. Broad diversification across sub-asset classes and economic sectors is also critical at this stage of the business cycle.

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 corporate bonds.

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