The AUTUS Review

(Fourth Quarter, 2018)

The Economy

A combination of tighter monetary policy and trade tensions set the stage for slower economic growth expectations in 2019 and a significant revaluation in global equity markets since the end of last quarter. This is not to ignore other factors that undoubtedly include dysfunction in Washington, as well as geopolitical tensions, but these two issues are the driving forces of the recent disruption. We'll try to address each independently.

First, we'll discuss monetary policy. We've previously made the point that economic expansions don't die of old age alone, but very often are precipitated by a monetary policy mistake. While the Fed can be forgiven for its concerns about recently rising inflation (particularly wage inflation), and their pursuit of "normalizing" interest rates, it seems that they became too aggressive in their efforts. While a 2.5% fed funds rate does not seem restrictive in a historical sense, credit market indicators, not to mention the stock market, have been sending a different message. Of note is the flattening yield curve, with the 2 to 10-year Treasury spread very close to inversion. The Fed ignored these messages in their December meeting, raising rates and indicating an expectation for two more rate hikes in 2019. The markets reacted violently to the perceived tone-deaf assessment of economic and market conditions. The good news is that it seems the Fed is now finally getting the message. Indeed, market expectations for any rate hike in 2019 have fallen below 30% as of this writing.

Trade and tariffs are certainly more of a wild card given the current administration's unorthodox and unpredictable approach to negotiations and messaging. While the existing level of tariffs do not represent a significant threat to ongoing economic growth, the uncertainty about the ultimate outcome is beginning to have an impact on confidence and business decisions in corporate America. There is little doubt that trade reform, particularly with China, is a necessary endeavor, but the ongoing nature of the struggle acts as sand in the gears of global trade and growth. While it is difficult to predict the ultimate outcome or its timing, it may be fair to say that the direction of talks has taken a more constructive tone since the G20 meeting in December. With negative market signals, leaders of both countries have newfound motivation to resolve differences and complete a deal.

These issues aside, most measures of economic growth and stability remain healthy heading into the new year. Unemployment is near 50-year lows at 3.9%, wages are rising at about 3.2%, while core inflation remains contained at 2.2%. These factors in tandem with lower oil prices are a strong foundation for consumer spending, the largest part of the U.S economy.

With a potentially improved environment for interest rates and trade in 2019, alongside still solid fundamentals, it is our view that the economic expansion that began in March 2009 will continue despite some near term slowing.

Capital Markets

Global equity markets have been severely disrupted since the end of the 3rd quarter, with the S&P 500 falling about 20% from high to low, and small cap stocks off by almost 30%. 2018 was the first negative year for the S&P 500 in the last ten years. There were few places to hide as the pain was felt across most asset classes. Tighter monetary policy and trade tensions turned out to be too much for the market to bear right now. Market psychology was also at play. When optimism reaches elevated levels as in September of last year, the market has a way of swinging the pendulum in the other direction. It seems now that negativity rules the day. While more volatility is likely in the script, there is good value in the broader market, with the S&P 500 trading around 14x expected earnings for 2019.

Interest rates may have found a near term high in the 4th quarter, with the 10-year Treasury falling from 3.25% to 2.70%. Despite a very flat yield curve, the 2-10 year spread avoided inversion, an important indicator for continued economic growth. With the Fed likely on pause early in 2019, interest rates may be range bound in the first half of the year.

Portfolio Implications

Equity

While stocks remain under pressure, there is good value across many sectors for investors with patience and discipline. Many high-quality names that were previously out of reach for new investment are offering another opportunity. As has been the case through difficult markets in the past, sound portfolio construction is the key to building durable and resilient portfolios. To that end, we are focused on maintaining effective diversification while investing in companies exhibiting solid return on invested capital, healthy cash flow, sound balance sheets, and positioning themselves for long-term growth.

Fixed Income

With interest rates coming off recent highs and likely range bound for the time being, we are maintaining average maturities in the short-intermediate range with a heavy emphasis on investment-grade credit. Any meaningful resumption of higher interest rates may offer the opportunity to extend average maturities, but we do not expect this to arise in the near-term.

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