The AUTUS Review

2nd Quarter, 2018

The Economy

Economic growth accelerated a bit in the second quarter from the first quarter annualized rate of 2.2%, and some economic pundits are predicting an annualized rate of more than 3% GDP growth for the balance of the year. It appears that the potential improvement in economic growth will be accompanied by increased stock market volatility.

Although the threat of trade wars seem to be dominating the headlines recently, there are several positives that forecast a continued favorable environment for the markets. Tax cuts and reforms, including the full expensing of capital spending, seem to be enticing corporations to invest. On the personal side, many taxpayers are seeing the benefits of lower taxes and bonuses in their paychecks. In addition, due to their lack of exposure to international tax policies, small and midsize corporations tend to benefit from lower taxes to a greater extent than larger companies.

Confidence remains strong, as measured by The Institute for Supply Management (ISM), The Purchasing Mangers' Manufacturing Index (PMI), and Michigan Consumer Sentiment Index (MSCI). It appears all are benefiting from favorable fiscal stimulus and deregulation, as well as planned increased spending on infrastructure and defense. We have seen a rebound in consumer spending, and factory orders are strong. The increase in consumer spending may be reflective of an improvement in employment rates and a sustained increase in residential property valuations. In addition, there has been an improvement in housing starts, and permits continue to trend higher.

While several positive themes seem to support the premise of a continuation of favorable market conditions for investors, contrarians may have some concern over the still elevated confidence measures and potential over-optimism. The risk of a potential trade war is real and some of the consequences could include a slowdown in both domestic and global GDP, higher input costs, and increased consumer prices. There is also a risk of wage inflation as the employment picture continues to improve. Geopolitical risks and economic policy uncertainty are constant potential stumbling blocks as well.

We expect the Federal Reserve to cautiously continue to normalize interest rates via a series of small (most likely 25 basis point) quarterly increases in the fed funds rate, as well as to gradually shrink the size of its balance sheet.

Inflation has nudged a bit higher but still remains at modest levels. In addition, at least for the present time, wage increases remain modest despite the historically low unemployment rate.

GDP growth may reach 3-4% for the balance of this year, following the 2.3% GDP growth the economy experienced last year. The current expansion is now the second-longest in history; however, in many ways it has also been the weakest expansion in U.S. history. One outcome from this slow, but long, recovery is that many of the excesses that tend to build and have caused recessions in the past have not yet materialized.

Capital Markets

There has been a recent, modest pullback in U.S. stocks as well as a sharper retreat in international markets. One may recall 2017 marked the first year in recent memory the international markets outperformed the domestic markets. Although trade tensions have risen, we believe it is premature to predict a full-blown trade war. It appears the health of the U.S. economy is strong enough to offset those growing worries and a positive resolution may lead to a tailwind for equities.

Interest rates remain at low levels but are slowly moving higher due to an uptick in GDP growth and inflation. The current positively shaped yield curve is favorable for incremental economic growth.

Portfolio Implications

Equity

We continue to focus on broad diversification among sectors as well as other asset classes. As Warren Buffet has been quoted, "In the short term the market is a popularity contest; in the long term it is a weighing machine." We agree with Mr. Buffet's observation and, as a result, we remain disciplined to invest in companies with solid fundamentals, such as strong returns on equity and assets, consistent quality earnings, solid balance sheets, and sustainable cash flows.

Fixed Income

Our approach of a disciplined focus on valuation and diversification for stocks also applies to our approach to building bond portfolios. We continue to focus on bonds that offer returns with commensurate interest rate risk and credit risk. We are maintaining structured portfolios with short to intermediate average maturities, with an emphasis on investment grade corporate bonds.

July 3, 2018

John Stull, CFA, CPA
john@autusam.com

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

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