The AUTUS Review

(Third Quarter, 2018)

The Economy

Nine years into the expansion, the economy is only now really starting to ramp. For most of the recovery, real GDP growth was rather stagnant, at 1%-2%. But a combination of fiscal stimulus, softening regulatory policies, and heightened business and consumer confidence have led to an acceleration, with real GDP growth now running at around 4%. Good times indeed.

Last year's tax cuts will amount to $120 billion in individual and small business savings, and $80 billion in corporate tax reductions. Congress passed a meaningful budget deal this year that will increase spending by $100 billion. That's $300 billion in fiscal stimulus. We should also see upwards of $700 billion of repatriated profits coming back into the economy, as companies bring back overseas cash.

Confidence is running high at this point in the cycle. The Conference Board's Consumer Confidence Index rose to a new cycle high last month. Full employment, rising wages, and firming home values have emboldened consumer optimism. Small business confidence also surged to new highs in August. And we're finally seeing evidence of increased capital spending amongst large U.S. corporations, owing to tax relief and record profit levels.

The employment picture is very healthy. September's unemployment rate was 3.7%, the lowest level since 1969. The 134,000 jobs added made it the 96th consecutive month of growth — eight full years, double the previous record. Employers have added close to 20 million jobs during that streak. Wage gains have not yet accelerated, but we'll be be watching this measure as a potential predictor of rising inflation.

Longer-term interest rates have lately been on the rise. For the full duration of the recovery up to this point, rates have remained stubbornly low, despite the fact that the economy has been expanding and we're so far removed from the crisis environment of a decade ago. The Federal Reserve has now raised short rates eight times; they'll likely boost rates one more time in 2018, and perhaps two or three times next year. At this point, we're closely watching the shape of the yield curve. An inverted curve (when short rates are higher than long rates) almost always warns of an impending recession. If the yield curve were to invert, it would likely be the result of Fed policy that is overly restrictive, which would certainly lead us to be much more cautious in our outlook.

Overall, we expect to see elevated GDP growth over the next several quarters, with inflation generally remaining in check and the threat of trade wars unlikely to diminish growth prospects. Further out, we'll be monitoring the potential catalysts for slowdown. Recessions are typically caused by a policy mistake (fiscal, regulatory, trade), inflation at levels that leads the Fed to tighten too much, or an exogenous event such as a supply shock.

The Capital Markets

It's been said that this is perhaps the most "joyless" bull market in memory. Investors have remained skeptical, aware of the risks facing them at this stage of the cycle. Concerns about trade wars, "peak earnings," inflation, an inverted yield curve, the Fed, and the midterm elections are all "bricks" in the so-called Wall of Worry. But we believe the fact that investors are so aware of these risks actually bodes well for the sustainability of the bull market. There's no sense of euphoria that was evident in past cycles, and we don't yet see an obvious asset bubble building. Corporate profits remain robust, and the Tax Cut & Jobs Act has provided ample cash for many companies to spend as they wish – capital investment, share repurchases, dividend payments, debt restructuring, etc. Higher interest rates might change capital allocation behavior, but with robust growth as the driver of higher rates, we can only be constructive in our outlook for risk assets.

Portfolio Implications

Equity

The historical resilience of equities and the importance of a long-term viewpoint have certainly been made clear by the market's behavior over the last decade or so. The S&P 500 experienced a painful 57% decline in 17 months beginning in the fall of 2007. But an investor who bought into the market at the very peak *before* the crisis, and held on, has experienced a 137% return in the 11 years since. That's an average annual return of 8.2% for those who stayed the course and did not panic sell. This certainly reinforces our approach of investing in high-quality companies, building diversified portfolios, and sticking to a disciplined long-term time horizon.

Fixed Income

We've long been cautious in our outlook for the bond market, expecting interest rates to eventually "normalize" at higher levels. Therefore, our average portfolio duration targets have been less than five years. We're finding value in investment grade corporate bonds, and are remaining underexposed to Treasuries.

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