The AUTUS Review

(First Quarter, 2019)

The Economy

The U.S. economy appears to have transitioned to a period of moderate economic growth when compared to the lofty numbers of last summer. In 2018, the economy expanded at an average annual rate of nearly 3.0%, but GDP growth this year looks more likely to end up somewhere near 2.0%. While the pace has clearly slowed, the expansion seems to be on reasonably sound footing, and we feel there is little danger of entering a recession in the near-term.

From a historical perspective, the current economic cycle seems a bit long in the tooth. In fact, if the expansion lasts one more quarter, it will reign as the longest in U.S. history. However, it is important to keep in mind that the end of an economic expansion is normally caused by policy errors, asset bubbles or geopolitical shocks rather than being defined by length of time.

Lingering effects of the longest government shutdown on record, combined with weaker global economies and unresolved trade negotiations with China, have softened the resolve of the Federal Reserve. For now, the Fed has communicated that they will cease tightening monetary policy until additional data justifies higher rates. This policy shift is also occurring in several foreign economies where central bankers are attempting to counteract sluggish economic growth.

Recently, we have seen a rebound in U.S. manufacturing activity as production, new orders and hiring have all picked up. Construction spending has also trended higher for the third straight month as both private and public construction projects increased during the quarter. Business confidence took a hit during the market volatility of last December but is gradually recovering. Consumer confidence has remained relatively high due to the strong jobs market and the rise in average hourly earnings.

While these are encouraging signs of economic stability, at some point rising wage growth could negatively impact corporate profit margins and lead to broader inflation concerns. If this trend persists, we will eventually see the Fed adopt a more hawkish stance, but for now monetary policy remains neutral and fiscal and regulatory policy remain broadly accommodative.

From our perspective, the U.S. economy is likely to remain range bound in this sluggish growth phase for the foreseeable future. However, a reacceleration in global growth and/or a resolution to the trade negotiations with China could have a positive impact on domestic economic growth in the second half of the year.

Capital Markets

U.S. equity markets fell dramatically during the last few weeks of 2018 but rebounded sharply during the first quarter. The Fed's pivot to a more data dependent posture and encouraging movement on the China trade front appear to have bolstered confidence enough for investors to deliver the market's strongest calendar start since 1991. Coupled with the recent improvement in economic data, the consensus looks to have shifted back to "no imminent signs of recession."

In the first quarter, broad large-cap equity indexes were up over 13% with mid- and small-cap equities performing even better. For the quarter, both developed and emerging international equity markets trailed their U.S. counterparts but still provided investors with returns approaching 10%. Even real estate and commodities joined the party with strong performances. With the Fed stepping to the sidelines, bonds also had a relatively strong quarter as yields pulled back from their highs.

Corporate profits are decelerating as revenue growth moderates and margins tighten, but earnings are still expected to grow in the mid-single digits during 2019. With the price/earnings multiple at 16.5x 2019 earnings estimates, valuations appear reasonable in this low interest rate environment. However, due to the likelihood of marginally lower corporate earnings and the recent strong market performance, it would not surprise us to see a short-term pull-back over the next few months.

Portfolio Implications

Equity

We are using the recent market strength to broaden our equity holdings and improve portfolio diversification. At the same time, we are purposefully improving the overall quality of our holdings by focusing on companies with strong capital structures and robust cash flow, while remaining sensitive to valuation.

Fixed Income

We continue to focus on investment grade corporate bonds issued by companies with dominating market positions and strong cash flow. Our target duration remains in the 4 to 6-year range. We believe this part of the yield curve provides the best risk/return characteristics in the current environment.

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