The AUTUS Review

(Fourth Quarter, 2019)

The Economy

The U.S. economy continued on its expansionary path in 2019, but growth was challenged by trade tensions between the U.S. and China. Business confidence was measurably impacted by ongoing tariffs and the threat of more to come. This showed up in reduced capital spending and a decided slowdown in manufacturing activity. The ISM manufacturing index fell to its lowest level since the recovery began in 2009.

The clouds on trade began to clear a bit in mid-December, when the trade delegations of the United States and China made progress and reached an agreement on "phase one" of a new trade deal. Even before this we saw capital investment and manufacturing activity start to turn up, perhaps in anticipation of this initial accord.

Consumer activity, representing around 70% of the U.S. economy, remained strong in 2019. Wages continued to grow at the fastest pace in over 10 years, while unemployment remains at record lows. All this is feeding consumer spending, showing up in healthy retail sales numbers as well as a robust housing market.

Perhaps the most significant factor that kept the economy on its growth path in 2019 was the aggressive turnaround in the Federal Reserve's monetary policy. The Fed ended 2018 with its 9th interest rate hike over four years. Perhaps one too many. The last hike brought about a very temporary yield curve inversion, a harbinger of potential recession on the horizon. To their credit, the Fed observed the error of their ways and reversed policy, cutting interest rates 3 times this year, in addition to other stimulative measures. We now observe the 2/10 year treasury yield curve spread at its highest level in 15 months - a positive message about economic growth in the months ahead.

We are closely watching the obstacles and issues that can derail the ongoing expansion. The onset of a presidential election naturally creates a level of uncertainty that is only exacerbated by the split electorate as well as the divergent platform ideas presented thus far. It goes without saying that business activity can struggle with an increased level of uncertainty. Second, a threatening resurgence of inflation is possible given the Federal Reserve's markedly more dovish stance. Also, deficit spending continues to increase and approach levels that may be unsustainable. Finally, trade negotiations are far from over and remain a potential stumbling block. All of these bear watching. Of course, geopolitical events are an ever-present concern, but always remain difficult to gauge. It is only easy to say that they will add to volatility but are unlikely to alter the trajectory of the economy without significant escalation.

Bottom line, we remain optimistic about the economy in 2020, with most indicators pointing to sustained, albeit modest growth.

Capital Markets

2019 was a banner year for equity markets around the world, with the U.S. leading the way against major market indices. In fact, this was the best year for U.S. stocks in over 20 years and the best year for global stocks in a decade. Don't forget, however, that stocks started the year from depressed levels after a sharp 20% correction in the fourth quarter of 2018.

Technology stocks led the way, followed closely by the industrial, communication, and financial sectors. Energy and utilities were the two worst sectors of the market. The leadership characteristics of the market throughout 2019 are indicative of a healthy risk appetite and a positive outlook for growth, despite the many obstacles the market faces. It should be noted that the market has been climbing a wall of worry for some time now and has been met with a constant barrage of negative forecasts suggesting the next financial crisis is right around the corner. While we are clear-eyed about potential risk factors and that market setbacks are part of investing, we also understand that there is an ongoing negative psychology that has persisted since the financial crisis that is a factor in driving the market forward. It is when psychology turns wildly positive that we should become more concerned.

After a year like 2019, market sentiment is admittedly improved. Valuation is also a bit elevated, with the S&P 500 trading at about 18x the average earnings estimate for 2020, the highest reading since early 2018, and a high point in this cycle. Perhaps near-term enthusiasm should be tempered somewhat, but with a positive backdrop for growth, we believe it remains a constructive environment for investors with an appropriate time horizon.

Bond markets around the world also rallied as interest rates moved lower in 2019. While short-term interest rates remain near lows, longer term rates found a bottom in the fourth quarter and have risen modestly, perhaps reflecting better growth or higher inflation ahead. With global central banks amplifying liquidity, long-term interest rates could continue to move higher.

Portfolio Implications

Equity

As the market progresses and divergences appear, rebalancing to maintain effective diversification is increasingly important. Among other things, we are looking closely at exposures to sector, style, size, and region to effectively balance risk and return.

Fixed Income

With interest rates low and global central banks providing concerted liquidity to markets, we remain conservative in our fixed income positioning. We continue to emphasize investment grade holdings with average durations at 5 years or less.

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