The AUTUS Review

(Third Quarter, 2019)

The Economy

After a decade of expansion, the economic outlook is becoming somewhat less clear. Trade wars, waning confidence, and political uncertainty have dampened the prospects for robust growth. Essentially, the current environment can be characterized as "more of the same;" that is, slow growth, low interest rates, low inflation, gradually improving employment, and lots of uncertainty.

The consumer, which represents roughly 70% of the U.S. economy, remains strong. Retail sales and personal consumption expenditures rose for the sixth consecutive month in August, to new highs. Consumer confidence has been steady, buoyed by a solid employment picture. At 3.5%, unemployment is at a 50-year low, and wage gains are above trend.

Business sentiment is being negatively impacted by political uncertainty. CEO confidence declined for the sixth straight quarter, and Small Business Optimism is weakening. We'll need to see business confidence improve in order for capital spending to pick up and help reaccelerate economic growth. The trade dispute with China is damaging the manufacturing sector. The ISM manufacturing PMI declined for the fifth month in August, and industrial production growth is slowing.

Interest rates around the globe remain extraordinarily low. In the U.S., the Federal Reserve reduced the Fed Funds rate by another ¼ point in September and has now undone the last two rate hikes from last year. They will likely cut at least one more time in 2019. The Administration continues to verbally pressure the Fed, believing they need to become even more accommodative. Lower interest rates have certainly helped mitigate concerns about relatively high debt levels.

Overall, the pace of growth in economic activity has slowed, but our base case forecast does not suggest that a recession in the next year is imminent. This has been a long economic cycle, but a slow, moderate one. The Fed is accommodative, the U.S. tax cuts have helped, the consumer is healthy, and the tariffs are thus far only impacting selected industries.

The Capital Markets

Because the bull market began over 10 years ago, many investors worry that we may be near a top. We've been reviewing several factors that were common in past market peaks, and still believe the cyclical excesses that defined those periods do not exist as yet. Valuations are not stretched, and net inflows into equity funds have been underwhelming. Earnings expectations have stabilized at lower growth levels, and we're not seeing a shift into more defensive sectors. Credit spreads have not been widening, and interest rates, which were rising in past cycle peaks, have been declining this year. IPO and M&A activity remain lackluster. And finally, we're not seeing a blow-off top, where investors are paying peak multiples for peak earnings. As we've observed in the past, this has been the least joyful bull market in memory. Skepticism remains, and that's likely a healthy sign.

Volatility has picked up, as much of Wall Street's focus has been on trade. The markets seem to hang on every pronouncement from our president and from China. We'd expect this volatility to continue, especially as we enter earnings season. We'll be focusing on companies' comments about the impact of tariffs on their bottom lines.

Clients have asked about the expected impact on the markets should impeachment become a reality. So far, the issue has been shrugged off by investors. Our sense is there could be some short-term impact, but longer-term will depend on broader economic factors. In the Watergate scandal, stocks were already under pressure because the economy was in recession, oil prices had spiked, and inflation was rampant. And in the Clinton impeachment proceedings, the stock market actually rallied, because the economy was strong, and the scandal was deemed not to be impactful to the healthy backdrop. In the end, we'll be focused more on economic policies than on politics.

Portfolio Implications

Equity

Our sector positioning is relatively neutral, and we've looked to rotate out of some highly appreciated stocks that appear expensive, and into growth names that are more reasonably valued. We've been reluctant to increase exposure to international equities until the impact of issues like trade and Brexit become more clear.

Fixed Income

As interest rates have declined, overall bond returns have been strong this year. We've been rather cautious, building portfolios with laddered maturity structures and a duration less than five years. We're focusing on high-quality corporates and avoiding Treasuries.

October 4, 2019

Don Cuppy — don@autusam.com

Mark Fiedler, CFA

John Stull, CFA, CPA

Kipp Goll, CFA