LEGACY
ECONOMIC AND FINANCIAL DIGEST
A NEWSLETTER FOR LEGACY INVESTORS
March 2017

No Winter Blues

Economists have a habit of downplaying the significance of data for a single month, famously noting that one-month does not make a trend. Investors, of course, do not always heed that warning, as they just as famously tend to overreact, particularly when incoming data either exceed or fall short of expectations. That divergent response has been clearly evident in the beginning of this year. Most data for January have come in above expectations, fueling the post-election euphoria that is driving equity prices to new highs. Economists, however, have been more guarded; some have upgraded the near-term outlook but most remain skeptical that the early momentum will be sustained over the rest of the year.

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This winter, exceptionally favorable weather is encouraging more trips to the malls and restaurants, as well as other forms of activity, such as construction. Time will tell if the strength in January borrowed activities from future months, resulting in a payback that validates the skeptical view. Aside the weathers' boost to activity, some long entrenched impediments are turning positive, such as energy-related spending and business investment. There is no question that this year is getting off on a better footing that last year.

But while there are compelling reasons to be cautiously optimistic about this year's prospects, it's doubtful that the economy will live up to the elevated expectations reflected in the financial markets as well as in household and business surveys. For the most part, these expectations are based on the growth-boost that the new administration will bring about through tax cuts and increased government spending. It will take more time to find out if reality will live up to the hype. President Trump is painfully finding out what many presidents before him have experienced: winning the election was the easy part, governing is the hard part. The time it takes to implement the expected growth-inducing policies could test the patience of businesses and households.

Broadening Improvement

Given the drama that is buffeting the administration's first 100 days in office, it is easy to overlook a development that is critical to the lives of all Americans. The economy is not only cruising through its eighth year of expansion, it is showing signs of picking up momentum. True, as noted above, some of the recent improvement may be due to a seasonal quirk related to the exceptionally warm and calm winter now unfolding. But while that may be temporarily pumping up some weather-sensitive sectors, the gains are being spread across a broad swath of activity.

Factories, for example, are ramping up production, topping year-earlier output levels for the third consecutive month in January. The manufacturing sector had been in the doldrums for much of 2016, dragged down by a strong dollar, which makes manufactured goods more expensive to foreign customers, and the slump in oil prices that decimated oil drilling and exploration as well as energy-related equipment spending. Those headwinds have either faded or are having less of an impact. The dollar, while not rising since late last year, is still up 25 percent from the spring of 2014. Yet, export orders increased 16 percent in January from year-earlier levels, according to the latest ISM Survey of Manufacturers. Meanwhile, oil prices have recovered from under $30 a barrel at the trough in January 2016 to the $50-55 range so far this year. As a result, hundreds of oil rigs have been brought back to life, and mining output has increased in three of the last four months.

Meanwhile, one of the laggards in the economy's growth engine, capital spending, is turning the corner. Data from the fourth quarter showed companies increased outlays on equipment for the first time in over a year. Although most of the increase was for software and research and development, capital goods are picking up the pace. Machinery output registered a solid increase for the second consecutive month in January in response to rising orders.

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In the previous month, bookings for new machines jumped 5.3 percent above the year-earlier pace, the biggest annual increase in more than two years. A capital-spending boom is not in the cards by any means, but business investment is morphing from a headwind into a modest tailwind, broadening the base of support for growth early in the new year.

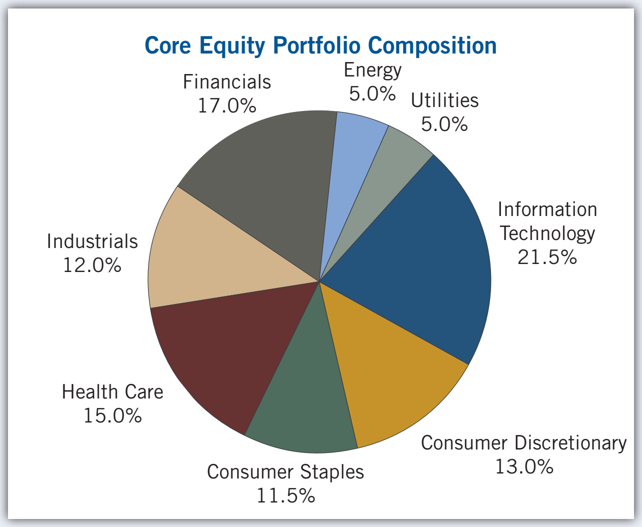
Helping Hand from Housing

Like capital spending, residential outlays emerged from a two-quarter setback and contributed positively to growth in last year's fourth quarter. By all accounts, that trend is continuing. Housing starts spiked by 10 percent in the fourth quarter from a year earlier, averaging a 1.25 million annual rate. Homebuilders maintained that pace in January, as starts continued to run more than 10 percent ahead of the previous year. What's more, building permits for new construction jumped 4.6 percent during the month, which means that residential outlays will likely boost economic growth at least through the first quarter.

Legacy's Core Equity Portfolio

The Core Equity Portfolio is designed to ensure broad participation in the equity market, with less than average market volatility, while producing a meaningful performance edge for our clients. Our active valuation strategy and analysis focuses on individual stock selection in conjunction with economic sector discipline that looks beyond mainstream consensus to construct customized client portfolios.

The graphic below shows the sector weightings in the Core Portfolio as of February 28, 2017.



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There are headwinds that could restrain the housing market going forward. The increase in long-term interest rates has pushed up mortgage rates by about a half-percentage point, and further increases may well be in the cards. Higher financing costs along with hefty home price increases will no doubt shut marginal homebuyers out of the market, crimping sales. But mortgage rates are still at historically low levels and homebuilders need to sustain construction to beef up inventory, as the number of homes for sale hovers near all-time lows.

Supply, as much as demand, will determine how much of a contribution to growth the housing sector can provide in coming months. The industry shrank considerably during the 2007-2009 housing bust, and now accounts for 3.5 percent of GDP compared to over 6.5 percent prior to the Great Recession. One consequence of this reduction is that millions of construction workers left the industry for other pursuits, leaving homebuilders with a shortage of workers to complete projects. Even now, eight years into the recovery, there are almost one million fewer construction workers drawing paychecks than at the peak in 2006. It has never taken that long to fully replenish the labor pool in past postwar expansions.

Nonworking Population Swells

Which brings us to the broader question of just how tight is the labor market? As was the case in construction, the Great Recession wiped out 8 million jobs in the U.S. economy, sending the unemployment rate up to a peak of 10 percent in 2009. Unlike the pattern in construction, however, the recovery has restored all of those jobs and then some. As of January, total employment exceeded its prerecession peak by 5.5 million and the unemployment rate has been driven down to under 5 percent, a rate usually deemed consistent with full employment.

The problem is that the population has grown faster than the work force, which means that the pool of workers not in the labor force has expanded by nearly 16 million since the recession. If that segment of the population were to be counted as unemployed, the jobless rate would be considerably higher. Of course, the lion's share of the increase in the nonworking population consists of retiring baby boomers that have no intention of returning to the labor force. Hence, their exclusion from both the jobless numbers as well as other measures that depict labor force slack is justified. If anything, an ever-larger share of the older population is staying in the job market, reflecting better health and other factors, such as the need to supplement inadequate retirement savings.

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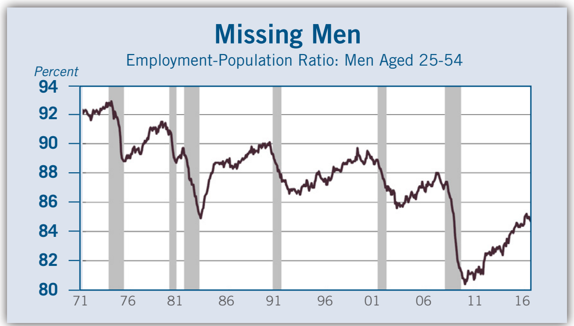
But more troublesome and less understood is the decline in the share of prime-age men, those who fall in the 25-54 year old category, that are gainfully employed. This trend, which removes retirees from the picture, has been on a downward trend for decades, reflecting broader access to government disability insurance programs and the proliferation of two-income earners in households, among other reasons. Still, there is a cyclical component to the trend, wherein the decline accelerates during recessions and recovers most of the way back during recoveries. This time, however, prime-age men have only clawed back about two-thirds of the jobs lost during the recession, a much smaller rebound than in past recoveries. This suggests that at least some of the prime-age workers on the sidelines, particularly low-skilled workers, would return to the labor force if growth were stronger.

The Fed's Dilemma

With the economy now well into its eighth year of recovery from the Great Recession, the labor market has moved closer to full employment and inflation is starting to pick up. This has enabled the Federal Reserve to gradually lift interest rates, including the second quarter-point increase last December. Barring an unexpected setback in the economy, more increases are coming. Recent economic indicators have exceeded expectations, putting pressure on the Fed to speed up the rate-hiking process.

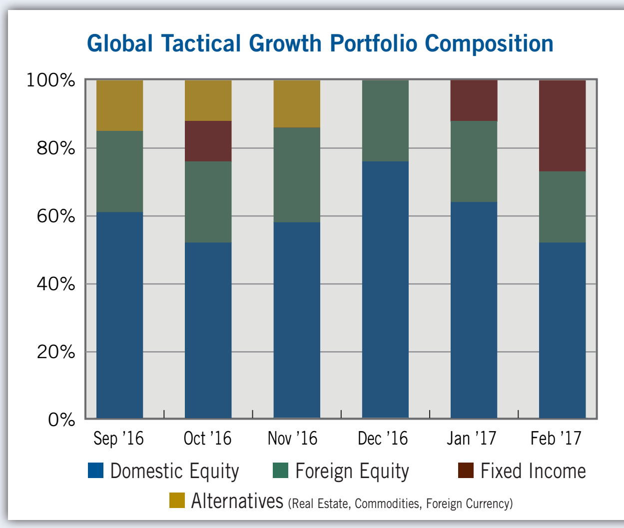


While the Fed does not want to fall behind the inflation curve—forcing it to overreact with harsher rate hikes down the road—it is also concerned about stifling growth if it moves too swiftly. The uncertainty regarding fiscal policy and other controversial proposals of the administration that might affect the economy further complicate the Fed's decision. Last year, the decision to put off the first of four planned rate increases was an easy call since the economy hit the skids and inflation remained dormant. This time, the decision to move so soon after the December hike is a close call. The minutes from the recent policy meeting suggest that an increase at the mid-March meeting is on the table, particularly if upcoming data on employment and inflation again exceed expectations. That said, there seems to be little risk of waiting a little longer, since growth and inflation have come in under expectations for so long and the labor market still appears to have some slack. ■

Legacy's Global Tactical Growth Portfolio

The Global Tactical Growth (GTG) Portfolio is a disciplined, proprietary investment solution designed to maximize long-term investment returns with moderate risk. Legacy's goal is to position the GTG portfolio in the best performing asset classes (domestic equity, fixed income, foreign equity, foreign and domestic real estate, commodities and currencies) using all Exchange Traded Products.

The chart to the right shows the GTG asset allocation mix across the four major asset classes over the past six months.



To learn more about Legacy and our services, call 920.967.5020.

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