LEGACY

ECONOMIC AND FINANCIAL DIGEST

A NEWSLETTER FOR LEGACY INVESTORS

December 2017

The 2 Percent Solution

For the first time since 2014, the U.S. economy grew by 3.0 percent or better for two consecutive quarters. According to the Government's first estimate released in October, GDP increased by a 3.0 percent annual rate in the third quarter, following a 3.1 percent advance in the second. Either the devastating hurricanes in August and September had a much more modest impact on activity than thought, or the economy rebounded more swiftly than expected. Most forecasters had estimated the storms would slice about half-percent from the third quarter's growth rate, lowering it to 2.5 percent or less. To some, the surprising outcome together with the sturdy pace of job creation has underpinned hopes that the expansion has finally broken out of the prolonged lackluster 2 percent growth trajectory, which many respected economists viewed as the "new normal" for the economy.

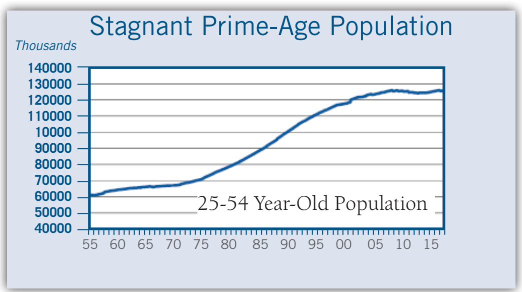
But before cracking open the champagne, a note of caution is in order. An outsize contribution to third quarter's growth came from business spending on inventories, an expenditure that may leave firms with more merchandise on shelves than desired; that, in turn, could lead to a swift pullback in orders – crimping production and dragging down growth – if the overhang is not quickly absorbed by higher sales. Indeed, final sales slumped in the third quarter, as growth in consumer spending slowed to a 2.4 percent annual rate from 3.3 percent in the second. And while job growth was robust, wages still lagged, depriving workers of the income needed to pick up the spending pace.

None of these caveats is meant to throw cold water on positive news. The economy is outperforming expectations on many fronts, and it appears to be sustaining momentum heading into the final months of the year. If growth hits 3.0 percent again in the fourth quarter – a distinct possibility – it would mark the longest stretch of consecutive gains at that pace in more than a decade, dating back to 2004- 2005. But as encouraging as that sounds, don't assume that the 2 percent growth barrier has been broken. To exceed that threshold for a sustained period without stoking inflation would require faster labor force growth than is indicated by demographic trends along with a pick- up in productivity growth, which would reverse a declining trend over the past decade. Since neither is expected over the near term, a continuation of the current growth pace into 2018 is likely to result in higher inflation and increasing interest rates.

Slowing Population Growth

The resilient behavior of the U.S. economy through the third quarter has taken a further bite out unemployment, as the jobless rate in October fell to a 17-year low of 4.1 percent. With job openings at record highs and initial claims for unemployment benefits low, the rate could well go lower, dropping below 4.0 percent for only the first time since 2000 and the second since 1969. The first benchmark is remembered fondly as it punctuated five years of strong growth, low inflation and rising real incomes until the dot-com bust ushered in a mild recession in 2001. Remembrances of the earlier benchmark are less pleasant. The jobless rate then was driven down by an unchecked war-fueled expansion in the late 1960s that ignited a decade of spiraling inflation, lowered living standards and skyrocketing interest rates.

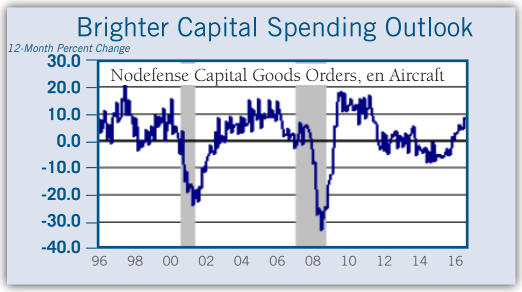
Despite their differences, both episodes had one thing in common that nurtured the economy's growth potential: an expanding labor force fueled by population growth. In the 1960s and 1970s, the baby boomers entered their prime working age and continued to swell the labor force through the early years of the 21st century. The labor force grew even faster than the prime-age population during the 60s, 70s and 80s due to the increase in participation by women. Hence, even though productivity languished during that period, the 3-4 percent annual increases in the labor force kept the economy growing. Conversely, labor force growth slowed in the late 1990s as the participation of women had peaked and the population was aging; but the slack was taken up by a spurt in productivity that underpinned a five-year stretch of GDP growth far stronger than anything seen since.



The current low unemployment environment differs in some key respects from the two earlier ones. Unlike 1969, the tightening of the labor market has not stoked virulent inflation or spiraling interest rates that undercut living standards. Nor has it been associated with speculative asset bubbles that are ready to burst and short-circuit the expansion, as was the case with the dot-com bust in 2000. That's the good part. The bad news is that the population increases that underpinned growth in earlier decades is missing and not being offset by stronger productivity growth that propelled the economy forward in the 1990s. The prime-age working population hit a peak in 2007 and gradually declined over the next five years before bottoming out in 2012. As of October of this year, there are fewer workers in this age group than there were at the peak in 2007.

Double Trouble

Not only is the prime-age population stagnating, a smaller percentage of people in that age group is either looking for a job or currently holds one than was the case in 2007. For men, the drop-off is twice as large as it is for the group as a whole. To some extent, older workers are making up the difference, as both the number and the participation rate for workers over age 55 have increased significantly since 2007. That's not surprising considering the aging of the population, the better health of older workers and the financial imperatives to work longer, given the inadequacy of retirement savings and the battered nest eggs that have not fully recovered from the financial crisis.



But even with the offsetting boost from older workers, the labor force has grown at an average rate of 0.5 percent a year over the past decade, less than half the 1.2 percent annual rate over the previous twenty years. That alone explains a big part of the slowdown in economic growth during this period. What's more, the outlook is for more of the same. As the population continues to age and enter retirement, organic growth in the labor force is not expected to speed up over the foreseeable future. Indeed, the Census Bureau is projecting the resident population aged 16-64 to grow at about half the current pace over the next ten years, averaging slightly over 0.25 percent a year.

But while powerful demographic forces are at play, the pace of labor force slowing can be altered somewhat. One possibility is to increase the labor force participation rate either by slowing the exodus of older workers or, more beneficially, by getting sidelined prime-age workers to reenter the labor force. To some extent, the ongoing robust pace of job growth is accomplishing the latter as the decades-long decline in the labor force participation rate hit bottom in late 2015 and has since edged slightly higher. At best, however, the participation rate is expected to stabilize over the near term and then resume its decline as demographic forces gain traction. The second possibility would be to relax immigration policy. But that prospect seems unlikely under the current administration, which is pursuing a tougher stance towards immigrants.

Brighter Productivity Prospects

With the labor force set to grow more slowly in coming years, so too will the economy's output potential unless stronger productivity growth kicks in. The slowing growth in both the labor force and productivity explains the

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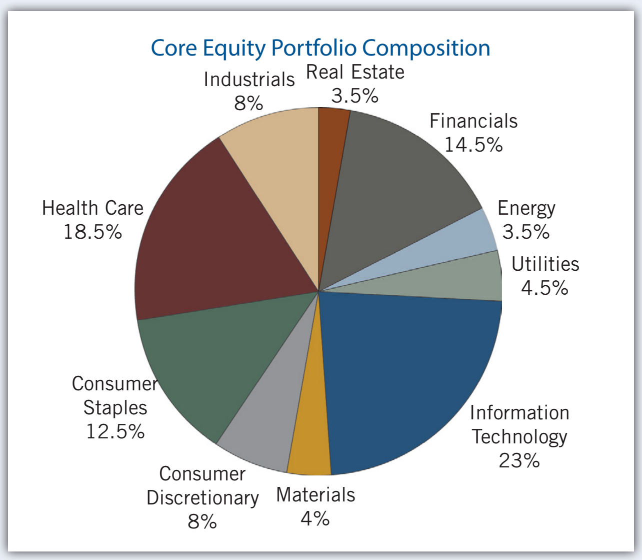
Legacy's Core Equity Portfolio

The Core Equity Portfolio is designed to ensure broad participation in the equity market, with less than average market volatility, while effectively 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 December 2017.



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downshifting of the economy's output potential over the past decade. Indeed, the slowdown has been even more pronounced for productivity than for the labor force. Over the past decade, productivity growth has slowed to an annual rate of 1.0 percent compared to 2.1 percent over the previous 25 years. Over the past three years, it slipped even further, to 0.6 percent a year.

It is unclear why productivity has downshifted so dramatically. Some believe that the boost imparted by the hi-tech revolution in the 1990s has run its course while new productivity-enhancing innovations have been stifled by government policies (regulations) and the legacy of the Great Recession (cheap labor and weak demand). However, most economists link the productivity slowdown to the weak recovery in capital spending since the recession, exacerbated by the collapse in energy-related investment spending following the plunge in oil prices in 2014 and 2015.

However, capital spending turned around about the middle of last year, sparked by a rebound in oil prices and energy-related investment spending. What's more, the revival is gaining momentum, thanks to stronger global growth and improvement in business optimism. By many measures – new orders for capital goods, the ISM survey of manufacturers and industrial production – the spending revival is poised to continue and significantly contribute to economic growth next year. Importantly, more capital per worker should give a lift to productivity and increase the economy's output potential.

Getting It Right

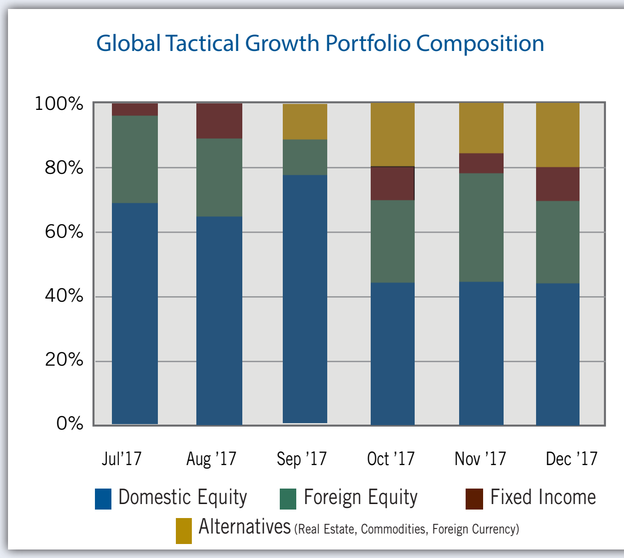
Although there is a widespread perception that the low productivity growth seen in recent years is here to stay, history suggests otherwise. The U.S. economy is continually reinventing itself, as new innovations enhance the ability of workers to turn out product, new industries replace older less efficient ones and workers move from low productivity to higher productivity jobs. The shift takes time, but odds are the seeds are being sown for stronger productivity growth in coming years.

Over the next year or so, however, the output potential of the U.S. economy will not change much; hence, if growth continues to exceed 2.0 percent, as expected, the nation's labor and productive resources will be further stretched, leading to upward pressure on wages and prices. The fact that the historically low unemployment rate hasn't yet generated the wage pressures indicated by conventional models, such as the Phillips curve, is perplexing even as it complicates the course of monetary policy. That said, wage growth has started to accelerate, albeit modestly, as has the inflation rate. The Federal Reserve is responding appropriately, gradually raising interest rates, because it recognizes that monetary policy affects the economy with a lag of six months or so. Hence, it needs to be forward-looking, leaning against the inflationary winds now to preempt a harsher response that might choke off growth later on. More often than not, the Fed failed to read the tea leaves correctly and the economy suffered. So far, it seems to be getting off on the right foot. ■

Legacy's Global Tactical Growth Portfolio

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



Past performance does not predict future results. Current and future results may be lower or higher than those referenced in this newsletter. Investments are not FDIC-insured, nor are they deposits of or guaranteed by a bank or any other entity. Investment return and principal value will fluctuate and investments may lose value.

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