LEGACY

ECONOMIC AND FINANCIAL DIGEST

A NEWSLETTER FOR LEGACY INVESTORS

June 2018

Recession Watch

At 107 months and counting, the U.S. expansion is now the second longest on record, topping the 106 months from 1961 to 1969. Not surprisingly, the "recession watch" is on for economists, investors and policymakers. Some, of course, firmly believe that trees grow to the sky and the current upturn can continue forever. That illusion comes with complacency, which is nurtured by time. No one expected a recession in the 91st month of the 92-month upturn that ended in 1999; nor did they in the 119th month of the record 120-month expansion that ushered in the Great Recession in December 2007. The longer a familiar trend is in place, the greater is the conviction that "this time is different". Of course, astute observers of history know that this notion is false. They are the sleuths who look for patterns that in the past have foreshadowed the onset of recessions.

The problem is that downturns can occur for uniquely different reasons. The dot.com bust brought the economy to its knees in 2000 and the collapse of another asset bubble, this time in housing, caused the financial crisis and the Great Recession in 2007-2009. In the 1970s, oil shocks played a key role bringing two expansions to an abrupt halt during that decade. But as former Fed chairmen, Alan Greenspan, once said, it is almost impossible to identify a bubble until it bursts. His view was that policy makers are better equipped to deal with the consequences of a bust than to stop a bubble from developing.

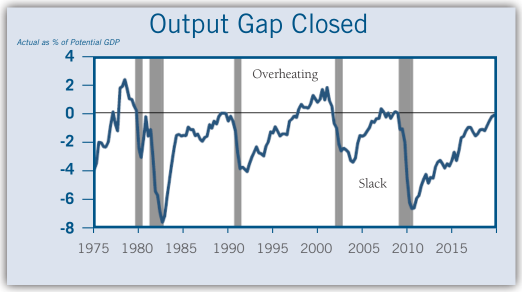
While a bubble may be developing under our noses, it is more likely that some other external shock - such as a global trade war or geopolitical event - would bring the current expansion to an unnatural end. But like bubbles, such shocks are almost impossible to identify in advance, and guarding against them is not the purview of the Federal Reserve. The more difficult challenge is to identify organic pressures that may be building and to calibrate policy accordingly. So far, the Fed's gradual rate-hiking strategy seems appropriate for an economy that is steadily improving and showing no apparent imbalances. But there is little doubt that the economy is in the late stages of the expansion. Make no mistake: a recession is on the way. The only question is, when will it start?

Running on Full

After stumbling in the first quarter, the economy regained its footing early in the second. Indeed, all cylinders of the growth engine are kicking in. Consumers are once again flexing their spending muscles, businesses are stepping up investment spending and housing is firmly on the comeback trail. The advances in the private sector are getting a helping hand from the government. Not only are the effects of the $1.5 trillion tax cut gaining traction, but state and local governments are enjoying a revenue windfall that will find its way into the spending stream one way or another.

Simply put, the lackluster 2.3 percent growth rate in the first quarter is being left in the dust, supplanted by a more vigorous spring quarter that is on track to post at least a 3.0 percent gain according to the Atlanta Fed's GDPNow forecast. With inflation hugging the Federal Reserve's 2 percent target and the job market close to, if not at, full employment, the Fed has enough ammunition to pull the interest-rate trigger at its upcoming June policy meeting. What comes after that, however, is less certain.

The current plan is for one more increase after June, but recent events have raised the odds of a second rate increase before the end of the year. The reason: the economy is running close to its full capacity, and continued above-trend growth heightens the risk of an inflation breakout. With the unemployment rate now at 3.8 percent in May, virtually all slack has been taken out of the labor market. Likewise, the nation's output in the first quarter hit the upper limit of its productive capacity, meaning there is no gap left between actual and potential output, known as the output gap. When supply fails to keep up with demand - either for workers or for goods and services - the recipe for higher inflation is in place.



Continued next page

Fiscal Stimulus: Too Much Of A Good Thing?

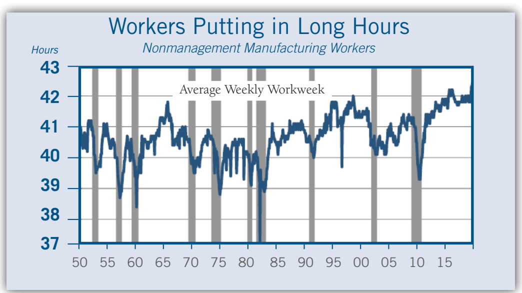
Continued from front page

External Versus Internal Forces

Adding fuel to the fire, the inflation trend is finally moving up after years of languishing at stubbornly low levels. There is a strong possibility that the Fed's preferred inflation gauge will move above its 2 percent target fairly soon, emboldening the more hawkish Fed officials to argue for a faster pace of rate increases. However, there is some question as to how sustainable the inflation pickup is and how much of it is due to external causes rather than to a buildup of organic inflationary pressures.

For example, the administration's decision to increase tariffs has led to higher input prices on steel, aluminum and lumber and that is increasing the cost of producing autos, homes and many durable goods. This is a one-off increase that does not generate sustained cost pressures on businesses. While the higher costs of raw materials may lead to an immediate boost in the price level, it does not result in a higher inflation rate, which would require larger price increases month after month. Likewise, oil prices have spiked in recent months, lifting prices for regular gas at the pump to close to $3 a gallon for the first time since 2014. Unlike tariffs, gas prices have been steadily rising this year, boosting the overall inflation rate. But like tariffs, higher gas prices are largely a product of external forces, most notably OPEC production cutbacks as well as heightened geopolitical tensions in the Middle East.

That said, it would be a mistake to conclude that only external forces are responsible for the pick-up in inflation. Nor is it certain that price pressures would subside if, or when, those forces abate. With the economy's resources stretched to the limit, supply constraints in both the labor and product markets will soon kick in. These constraints represent forces that are generated internally and have a more sustained influence on inflation; they are also the forces that should guide the Federal Reserve in formulating a policy response. After all, Fed policy has little influence on tariffs or OPEC oil decisions, but it can offset pressures that originate from internal sources, such as rising labor costs or excessive demand.



Labor Costs Poised to Rise

No doubt, the ever-tightening labor market has been a key influence behind the Fed's decision to gradually remove the punch bowl of ultra-low interest rates in effect since the financial crisis. Historically, as companies run out of workers to hire, they are forced to pay higher wages, both to retain existing workers and to lure those away from other companies or from the sidelines. For the first six years of the recovery, wage growth remained in the doldrums, as job growth only gradually offset the massive layoffs during the Great Recession. Even as unemployment steadily declined in the post-recession years, the memory of those layoffs sustained worker anxiety over job security, undercutting their willingness to bargain aggressively for higher wages.

As those memories faded over time, wage growth has picked up, but by far less than would be expected given the plunge in the unemployment rate to an 18-year low of 3.8 percent. At 2.6 percent in April, the annual increase in hourly earnings is well below the 4 percent-plus gains seen the last time the jobless rate was this low. But pipeline pressures are building and it is only a matter of time before wage growth accelerates. Indeed, while the pace of increases for all workers has been lackluster, it has accelerated in sectors where labor is in short supply.

In manufacturing, for example, the number of unfilled job openings is 25 percent higher than at the peak of the last expansion. As result, factories have had to push existing workers harder. In April, production and nonsupervisory manufacturing workers logged an average of 42.4 hours a week, the longest workweek in the postwar period. Asking workers to put in longer hours is exacting a price. Average hourly earnings for these blue collar manufacturing workers increased 3.0 percent in April from a year earlier; that's up more than a full percentage point from last summer, which is a far stronger pick-up than for the typical worker in the private sector.

The Fed Challenge

Simply put, the relationship between unemployment and wages is not broken, as many have come to believe. That said, even where worker shortages appear to be severe, the increase in wages has been quite manageable. One reason, modestly higher wages may be luring workers off of the sidelines. Manufacturing jobs increased by 245 thousand over the past year, the largest annual increase since 1998. Yet there are more than a million fewer factory workers holding jobs than at the start of the Great Recession. Hence, there is a large pool of potential workers that can still be brought back to the manufacturing workforce, which indicates that there is more slack in the job market than meets the eye.

Continued next page

Fiscal Stimulus: Too Much Of A Good Thing?

Continued from previous page

The challenge of the Federal Reserve is to strike a balance between allowing progress on the wage front for workers long left behind while keeping labor cost pressures from stoking an inflation breakout. Historically, the Fed has not been successful in engineering such a soft landing, as ten of the past thirteen recessions have followed a tightening Fed policy. A big part of that challenge will be to identify how low the unemployment rate can fall before it triggers a wage-price spiral that would cause a growth-killing policy response.

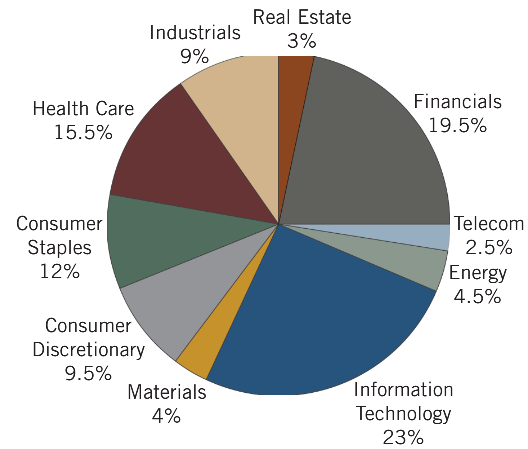
In light of the modest wage increases seen so far - and still tame inflation - the Fed seems willing to tolerate a further tightening of the job market. It also recognizes that certain temporary factors may push inflation above the 2 percent target for a while. Hence, there is a good chance that the most common recession catalyst, an overly tight monetary policy, will not derail the economic expansion over the foreseeable future. If that's the case, there is a good chance the current upturn will last beyond July 2019, which would make it the longest in U.S. history. But other threats to the expansion are still on the radar screen for those on the recession watch. Two of the more visible are a global trade war, accompanied by a severe market correction, and a sustained oil-price surge that saps household purchasing power and kills the economy's main growth driver. While neither is an imminent threat, an external shock is more likely than a policy mistake to bring the expansion to an unceremonious end. ■

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 June 2018.

Core Equity Portfolio Composition



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.