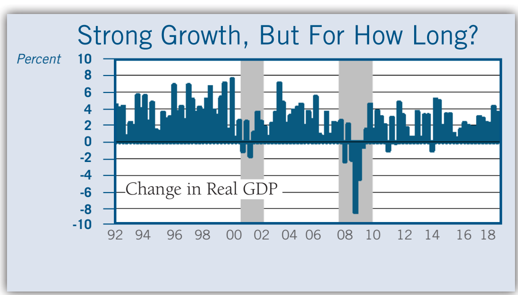
LEGACY
ECONOMIC AND FINANCIAL DIGEST
A NEWSLETTER FOR LEGACY INVESTORS
December 2018

Gathering Headwinds

With the midterm elections behind us, the pollsters can breath a sigh of relief that the outcome was generally consistent with their predictions, unlike the embarrassing misses in the 2016 election. For the most part, economists can also pat themselves on their collective backs for correctly predicting the economy's performance this year. Most saw a pick-up in growth, thanks largely to the massive tax cuts enacted last year and the spending bill passed early this year. Although many questioned whether the economy, in the late stage of a business cycle and already near full-employment, needed such a jolt of fiscal stimulus, there was little doubt that it would be a powerful growth catalyst.

But the low-hanging fruit for predictions, like the elections, is now behind us. Looking ahead, the task becomes much more challenging. To be sure, there is a chance that another dose of fiscal stimulus will be forthcoming, as both the Democrats and the Trump administration favor increased spending on the nation's infrastructure. Odds are, however, any legislation will get bogged down by disputes over how to pay for it. As it is, Congress already has a lot on its plate to consider, including approving President Trump's trade bill that overhauls NAFTA, raising the debt ceiling and passing another government budget that will require lifting spending caps to avoid deep cuts from the elevated levels temporarily allowed this year. Given the split majority in the House and Senate amid a highly polarized political climate, it will not be a walk in the park for Congress to navigate these legislative imperatives in the coming year.



Assuming no additional fiscal impetus, the economy will be facing more headwinds than tailwinds in 2019. The tax cuts will still be juicing growth, but their positive impact is already starting to fade and will continue to diminish as the year progresses. Meanwhile, the other policy lever managed by the Federal Reserve is pulling in the opposite direction. The Fed is poised to raise its short-term policy rate in mid-December for the fourth time this year and expects three more hikes in 2019. Other policy decisions may also present headwinds. Trade tensions with China remain high and unresolved issues with Europe may result in tariffs on autos, which would invite retaliation and impair global trade, stoke inflation and lower global growth. While we don't have the predictive backing that the fiscal stimulus provided last year, it is a pretty safe bet that the economy is set to slow in 2019.

Déjà Vu?

The economy delivered another solid performance in the third quarter, posting a 3.5 percent growth rate, following an even sturdier 4.2 percent pace in the second quarter. It was the strongest back-to-back increases in four years, underpinned by a robust job market and vigorous consumer spending. It is still early, but momentum appeared to be strong heading into the fourth quarter as retailers ramped up seasonal hiring and inventories in anticipation of strong holiday sales. The year may well end with another solid growth rate close to 3.0 percent in the fourth quarter, punctuating the strongest full-year expansion since 2005.

But the global economic and financial backdrop contains some disturbing similarities to the period just prior to 2015-2016, when GDP growth abruptly downshifted to less than a 1 percent average annual rate for three consecutive quarters. Recall that back then global growth was slowing, highlighted by widespread fears of a hard landing in China; oil prices were plunging; and the dollar was climbing, sapping exports. Meanwhile, the Federal Reserve had just embarked on its campaign to bring short-term interest rates up to normal levels, executing its first rate hike in December 2015 since the fall of 2006.

All of those influences are present now, raising fears that the U.S. setback in 2015-2016 could recur as the curtain rises on 2019. While that's possible, it is not likely. For one, the earlier external shocks were more severe than they are now. The global economy was much more fragile, with Europe struggling to emerge from a 2011-2013 debt crisis that threw it into a recession, the oil shock was greater, with crude prices plunging by 70 percent compared to the 25 percent decline over the past month, and the dollar's

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climb was much steeper – 25 percent compared to the recent 10 percent advance. To be sure, the rate-hiking campaign is more advanced now, but the withdrawal of monetary accommodation has been more than offset by fiscal stimulus, which is still boosting growth in the U.S.

Divergent Growth

But it would be a mistake to assume that the U.S. can continue to forge ahead as it has in the face of those tailwinds. This year has been somewhat of an anomaly. In 2017, virtually all regions of the world grew simultaneously, supported by central bank easing, strong trade flows and pent-up demand. But the synchronized growth story fell apart this year as Europe and developing nations struggled while growth in the U.S. accelerated. That divergence in performance led to diverging policies, with the U.S. Fed raising rates to prevent the economy from overheating while the central banks of Europe, Japan and China kept interest rates low.

These diverging policies and relative outperformance of the American economy made the U.S. a more attractive destination for foreign funds. The surge in capital inflows, in turn, drove up the dollar, which makes American goods more expensive in the global market place, thus threatening exports and manufacturing activity. Indeed, the strengthening dollar has reinforced the tightening of financial conditions being engineered by the Federal Reserve. And while the stronger dollar should be a positive force for our trading partners, stimulating their exports and cushioning the global slowdown, increased tariffs and ongoing trade tensions with China are wiping away that impetus. The recent Asia-Pacific summit failed to mend any fences between the U.S. and China, raising the odds that the Trump administration will follow through with its plan to hike tariffs from 10 percent to 25 percent on $250 billion of Chinese goods beginning in January.

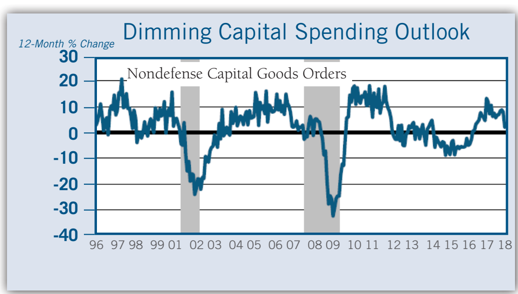
The U.S., of course, is less dependent on trade as a growth driver than most other nations, so it should be less affected by global developments. But the spillover effects from trade barriers and overseas adversity could be damaging. The S&P 500 companies derive about 50 percent of their revenues from foreign operations, making profits and the stock market vulnerable to a global slowdown. The recent upsurge in market volatility may be a sign that investors are losing faith that trade tensions will abate. Should the long bull rally in stock prices come to an end, the positive wealth boost that supported household spending would also vanish, removing another tailwind that propelled the economy forward in recent years.

Signs of Stress

While the economy entered the fourth quarter with a good deal of momentum, signs of a slowdown are already appearing. The headwinds in the housing market are becoming fierce, with builder sentiment plunging in November and affordability being eroded by higher mortgage rates and rising home prices. Business investment spending continues to slow from the robust pace over the first half of the year, even as corporate debt is piling up. If profits sag under the weight of a global slowdown, debt servicing issues will become a problem for a growing swath of companies.

But these drags should be more than offset by the ongoing strength of the job market, which is lifting incomes and sustaining a high level of household confidence. So far, consumers are showing little sign of zipping up their wallets and purses, and retailers are expecting a festive shopping season over the holidays. That said, holiday sales are not expected to be as frothy as last year, when they grew by an outsized 5.7 percent over the previous year. Keep in mind too that retail inflation is rising, so the real value of consumption in the current quarter will register a far slower growth rate than the eye-opening 4.0 percent increase in the third quarter.

Hence, the economy's growth engine will be running on fewer cylinders heading into 2019 than was the case entering this year. Global growth is slowing, business investment is stagnating, housing is in the doldrums and inflation is eroding consumer purchasing power. Another deficit spending jolt could jump-start growth and an easing of trade friction could lift business confidence as well as stock prices, but those catalysts are anything but certain to occur.



More Difficult Policy Choices

Despite these slowing portents, the Federal Reserve is expected to pull the rate trigger at the mid-December policy meeting. Indeed, the prospective slowdown is just what the policy doctor ordered, as the economy has been growing

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well above its potential this year and inflation has final moved up to the Fed's two percent target. With the job market continuing to tighten, wage growth is accelerating and putting upward pressure on prices. As long as actual and expected growth exceeds the economy's potential growth rate of roughly two percent, the Fed has sufficient reason to stay on the path of gradually raising short-term rates to preempt an inflation outbreak.

At the September meeting, Fed officials predicted that the economy would grow by 2.5 percent in 2019, which is still handily above the economy's potential pace and validating the rate hike expected next month. But at the upcoming policy meeting on December 18-19, Fed officials will also be updating their economic and interest rate projections for next year and 2020. It will be interesting to see if the recent market turmoil and slowdown overseas causes them to scale back their outlook. Whether or not they do, the financial markets have turned more skeptical that the Fed will follow through with the three rate increases planned for next year at the September meeting.

As long as growth appears to be tracking close to the Fed's 2.5 percent expected pace, they will continue to press gingerly on the monetary brakes to keep inflation and inflationary expectations in check. Conversely, an abrupt slowdown, similar to 2015-2016 could well put the rate-hiking plans on pause, as the Fed assesses the impact that previous increases are having on the economy. Simply put, the Fed faces more difficult policy choices next year and will have to be more nimble than this year, ready to move in either direction. The wrong turn could prevent the expansion from lasting past mid-2019 and set a record for longevity. ■

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 shows the sector weightings in the Core Portfolio as of December 2018.

Core Equity Portfolio Composition