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

# The Fed in the Crosshairs

The Federal Reserve, as expected, raised its bellwether policy rate again at its September meeting, bringing it to a range of 2 to 2-1/4 percent. That's still low by historical standards, but a fair distance away from the near zero level in effect from December 2008 through December 2015. If all goes according to plan, another hike - the fourth this year -should be put into place at the December meeting and three more in 2019. When all is said and done, the central bank hopes to bring rates up to 3.4 percent in 2020, which would be about half percent above the level it considers neutral, i.e., one that keep the economy growing at its maximum speed without stoking higher inflation.

Some experts feel that the Fed is going too fast and too far, claiming that the economy's trajectory does not warrant a persistent stepping on the monetary brakes. Even with the faster growth underway this year, the expansion is hardly a barn-burner, tracking a 2. 3 percent growth rate on average since it began in mid-2009, about half the average pace during previous postwar upturns. What's more, they argue that this year's pick-up is about to hit a speed bump; once the sugar-high of last year's tax cuts evaporates the economy will return to its much-lower growth potential in 2019 and 2020. Higher rates in the Fed's playbook may well turn that speed bump into a recession.

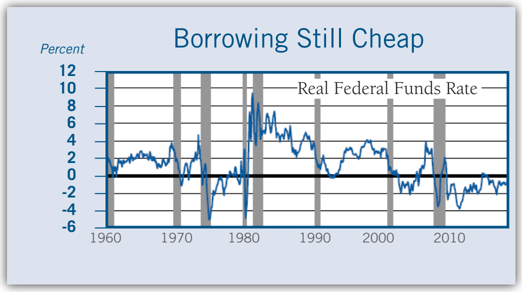
But others wonder why the Fed is taking so long to bring rates up to normal levels. The job market is red hot, featuring the lowest unemployment rate in nearly 40 years. A growing scarcity of workers is putting upward pressure on wages, lifting labor costs for companies. Higher labor costs, in turn, puts pressure on firms to boost prices, leading to more inflation. If the Fed waits too long and allows this wage-price cycle to gain traction, it will be forced to take harsher, growth-retarding measures later on, ushering in a recession sooner rather than later. Simply put, the central bank is in the crosshairs, caught between the hawks who want it to move more aggressively to stave off an inflation outbreak and the doves who believe that a gradual approach is more appropriate. Complicating matters even more is a president who falls squarely in the dovish, low-rate, camp and is not shy about criticizing the Fed. At this juncture, whatever the Fed decides to do at the December policy meeting, not everyone will greet it with good tidings during the holiday season.

### Borrowing Still Cheap

The central bank looks at an array of economic and financial indicators in formulating monetary policy. At the present time most are flashing green, pointing to further rate hikes in coming months. Indeed, the statement following the September 25-26 policy meeting explicitly said … "further gradual increases in the federal funds rate will be consistent with sustained expansion in economic activity." Unlike previous meetings, the latest statement did not describe policy as still being "accommodative' a sign the Fed believes the economy no longer needs the helping hand provided by ultra-low interest rates.

That said, it is hard to describe the current level of rates as anything but accommodative. At 2-2-1/4 percent, the federal funds rate does not even cover the 2.3 percent annual inflation rate recorded in September, meaning the real cost of borrowing money is still free. Even after another hike in December, the real cost of borrowing money will still be cheap, much less a big obstacle for the economy to surmount. Prior to every post war recession, real short-term interest rates climbed to at least 4 percent before pushing the economy into a downturn.

To be sure, long-term interest rates are as important , if not more so, than short-term rates in influencing economic activity and it is the market, not the Fed, that determines movements in bond yields. But despite a rise to around 3.2 percent from 2.40 percent at the start of the year, long-term rates are still historically low relative to inflation. While the rise has boosted mortgage rates and added to the woes of an already-struggling housing market, it does not appear to be a significant drag on overall growth.




### Justifying Rate Hikes

Simply put, the economy is still running on a full head of steam. Following the second quarter's robust 4.2

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percent growth rate, the third quarter is not losing much momentum, tracking a pace of more than 3 percent. Consumer confidence is high, job growth remains strong and households are still spending freely. Manufacturers are ramping up output, driving production in September up for the fourth month in a row for the first time since 2011.

Barring some external shock, the handoff to the fourth quarter will probably be sturdy as well, pointing to only a gradual slowdown from the previous six months. For the year as a whole, the economy is poised to grow by 3 percent for the first time in over a decade. And, following six years of persistently low inflation, the Fed's preferred measure of prices is on the cusp of its 2 percent target and should exceed it next year. Taken together, these ingredients constitute a recipe for another rate hike at the December policy meeting, something that the financial markets have fully priced in.

Nor is it just to prevent the economy from overheating that underpins the central bank's gradual rate-hiking plan. In addition to its twin objective of attaining full employment and price stability, the Fed wants to minimize the risk that asset bubbles pose to the economy.  That risk was painfully evident during the last two recessions, which were kicked off by the bursting of the dot.com bubble in early 2000 and, most dramatically, by the collapse of the housing bubble in 2006 that ushered in the 2007-2009 financial crisis and deep recession. Many experts believe that the extended period of low interest rates is promoting a bubble in the stock market, where prices have soared by over 300 percent since mid-2009, raising concerns that a steep market correction and wealth destruction could bring the economy to its knees. The stock market may or may not be too richly valued – opinions vary widely – but by gradually lifting interest rates the Fed is reducing the incentive of investors to rely as heavily on the risky stock market for income and potentially push prices up into bubble territory.


### No Change In Potential

With three pillars justifying the current Fed policy – solid growth, rising inflation and the avoidance of financial instability – firmly in place, the question is, how far up can rates be lifted before they do crippling damage to the economy? This is where the rubber meets the road for Fed policymakers and a lot depends on what they view as the tipping point for some key indicators. They must determine, for example, how low to allow the unemployment rate to fall before it stokes an undesirable pickup in wage and price inflation. Likewise, it is important to know at what point does the economy become overheated. Is the noninflationary speed limit 2, 3 or 4 percent? The lower it is, the faster the Fed needs to raise interest rates to bring growth down to its potential cruising rate.

Despite the administration's claim that tax reform kicked up the economy's growth potential from the long-standing 2 percent to at least 3 or (in Trump's estimation) 4 percent, there is little evidence that the new tax regime has provided the supply-side uplift promised by the bill. For sure, the fiscal stimulus gave the economy a big demand boost, which propelled growth this year beyond its 2.3 percent trend over the first eight years of the recovery. But as the saying goes, past performance is no guarantee of the future. Indeed, outside of the White House, few believe that the economy can sustain the current pace much beyond the current quarter.

One reason: there is little evidence that growth in the economy's output capacity has picked up meaningfully. For that to happen, either the labor force or worker productivity would need to grow faster than it has. If the tax cuts – which mainly benefited corporations – jump-start a sustained pick-up in investment spending, that would boost productivity growth. But what the tax cut gave with one hand – contributing to stronger capital spending early in the year — the escalating trade war with China and increased tariffs are taking with the other, prompting many business leaders to put new spending plans on hold. It's premature to assume that productivity growth will strengthen from the lackluster 1 to 1.5 percent annual growth rate over the past several years.

### Fed Can Be Patient

Meanwhile, growth in the labor force is clearly slowing, thanks largely to an aging population that is generating a wave of retirements each year. With 10 thousand individuals turning 65 every day, that trend is destined to continue, despite the fact that an increasing share of older workers

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are staying on the job. The slowdown could be arrested somewhat by encouraging more immigrants to enter the country. But the current administration is more inclined to toughen immigration policy, not loosen it.

To be sure, a tightening labor market combined with rising labor costs is a time-honored spur to productivity, as businesses strive to invest in more labor-saving equipment and software to generate output. However, labor cost pressures is hardly forcing companies' backs to the wall. Yes, the lowest unemployment rate in nearly 40 years has stoked a modest acceleration in wage growth this year, with average hourly earnings rising about a half percent to the 2.5-3.0 percent range compared to two years ago. But with inflation running at 2.0 percent and productivity growth at 1.5 percent, wage growth would have to exceed 3.5 percent before labor costs start to take a toll on profit margins.

The question is, why are wages responding so tepidly to the lowest jobless rate since the 1960s, when workers were getting pay raises at more than twice the rate as now? The search for answers has created a cottage industry of economists offering varying explanations. But most agree that when inflation and inflationary expectations are high and rising, workers demand bigger raises to keep up. That was the case in the 1960s and for the next 20 years. But it's not the case now, as inflation and inflation expectations are well contained. For that the Fed deserves much of the credit, forging policies over the past two decades that built up its inflation-fighting credibility.

One benefit of that accomplishment is that the Fed can let the economy run hotter and the jobless rate drift lower than otherwise without having to step on the monetary brakes as aggressively as they would have in the past. But since it is unclear how low the jobless rate can go or what the economy's actual speed limit is, the central bank will be looking closely at inflation and inflationary expectations as main guides to policy next year. ■

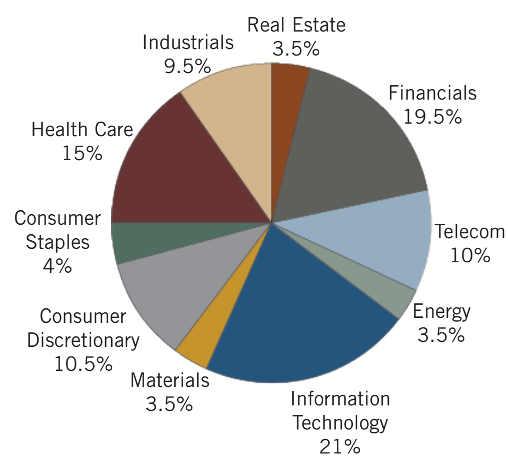
## Legacy's Core Equity Portfolio

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 to the right shows the sector weightings in the Core Portfolio as of November 2018.



Core Equity Portfolio Composition

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