LEGACY

ECONOMIC AND FINANCIAL DIGEST

A NEWSLETTER FOR LEGACY INVESTORS

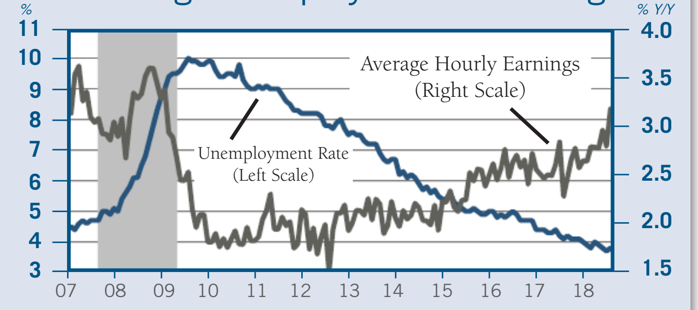
February 2019

It’s Not Just Jobs

Thanks to the government shutdown it will be a while before the data calendar returns to normal. In the meantime, economists, policymakers and investors are flying partially blind. Yet through anecdotal reports, private surveys and hard data available from government agencies that remain open, including the Labor Department and the Federal Reserve, a sense of how the economy is performing can still be had. There are still missing pieces on last year’s fourth quarter, but all the evidence suggests that the year ended on a firm note, punctuating the strongest full-year of growth since 2005.

As has been the case throughout most of the expansion, now in its tenth year, consumers were the main driving force in 2018. Business investment spending had an initial spurt, propelled by the corporate tax cuts enacted in late 2017 and other investment incentives, but that source of strength faded as the year progressed. The latest surveys of business intentions do not point to much of a rebound, if any, heading into 2019. Indeed, fiscal stimulus will be less of a tailwind this year than it was in 2018, which means the economy will have a tougher time overcoming any obstacles thrown in its way.

Declining Unemployment Lifts Wages



It does not require much guesswork to see what those impediments might be. Right out of the starting gate the partial government shutdown posed a major hurdle for the economy. Each week of the shutdown sliced an estimated 0.1 percent from GDP, which translates into a 0.5 percent haircut for the first quarter if it lasts through the end of January. Should the shutdown last through the first quarter, the bite on GDP would rise about 1-1/2 percent. Some of the economic loss will be recovered when the shutdown ends, but government dysfunction has become a fact of life in Washington. That, in itself, is a growth-retarding influence, as it adds a layer of uncertainty in the financial markets and corporate boardrooms. Another obstacle looms overseas where things are even more turbulent; the European Union is coping with the uncertain consequences of Brexit, and China is suffering its worst slowdown since 1990. The U.S. drew strength from strong global growth in recent years; it will miss that impetus this year. What will drive the economy forward in 2019?

Healthy Job Market Supports Customer Spending

Despite widespread predictions that growth will slow from the solid pace in 2018, few economists believe the second-longest expansion on record will end this year. If it lasts through mid-year, as expected, it would become the nation’s longest ever. The fuel for the growth engine will likely come from the same source as last year: consumer spending. As long as personal consumption, which accounts for about two-thirds of economic activity, remains healthy, the economy is not likely to shift gears into reverse.

With the economy still churning out jobs at a healthy pace and unemployment hovering at 50-year lows, consumers have ample ammunition to keep on spending. Following December’s blockbuster 312 thousand gain, payrolls increased for 99 consecutive months, the longest stretch of continuous job gains on record. For a big chunk of that period, wage growth was stagnant, as it took more than four years just to recover the nearly 8 million jobs lost due to the Great Recession. But once those jobs were recovered in 2015 and the unemployment rate fell below 5.0 percent, wages started to move up faster; by the end of last year, worker earnings were increasing at the fastest pace in 8 ½ years.

As the job market continued to tighten, policy makers as well as the financial markets became increasingly concerned that a breakout of wage inflation would gain traction. Bond yields, ever sensitive to inflation, rose and the Federal Reserve steadily applied the monetary brakes, hiking short-term rates by a quarter-percent every quarter and withdrawing liquidity by shrinking its balance sheet. Towards the end of the year, economic worriers saw another obstacle that the economy may have to overcome

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It's Not Just Jobs

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the prospect of the Fed tightening too aggressively and stifling the expansion.

The Fed Blinks

To its credit, the Fed acknowledged the growing concern its rate-hiking campaign was causing. The stock market's plunge during the final three months of the year, wiping out all of the year's earlier gains and then some, reflected the perception that the Fed was unwavering in its quest to bring short-term rates up to normal levels. That perception was validated at the December 18-19 policy meeting when the benchmark short-term rate was increased for the fourth time in 2018 and more importantly the Fed said it expected two more hikes in 2019.

The markets reacted violently to that meeting – with the Dow Jones Industrial average tumbling 8 percent in four days – prompting the central bank to quickly soften its stance. Virtually all key Fed officials, including Chairman Powell, made comments stating that policymakers were sensitive to the markets' concerns and that policy was not on a preset course of steadily raising rates. If economic data turn softer than expected and inflation remains tame, future rate increases would be put on hold. The onslaught of dovish comments by central bank officials calmed investor fears and stoked a major rally in the stock market that continued through most of January.

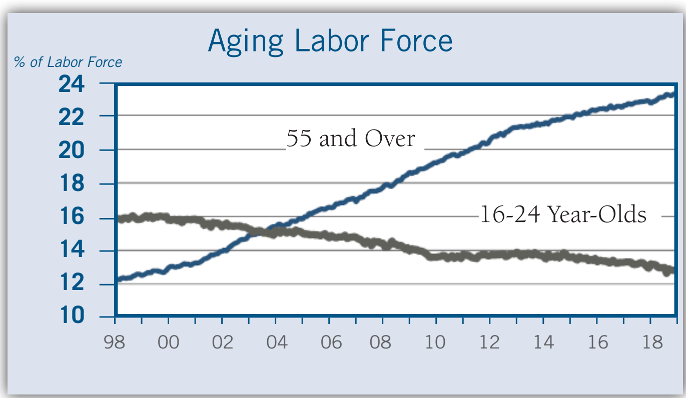
But despite the Fed's assurances – and the prediction by many that the Fed would move to the sidelines this year – it is premature to conclude that future rate increases have been taken off the table. For one, the data available prior to the government shutdown do not justify that conclusion. Yes, there were some weak readings, particularly regarding housing activity and surveys showing that manufacturing conditions were deteriorating. But those surveys were overshadowed later on by hard data on industrial production, revealing a much stronger increase in manufacturing output in December than thought. Even more damaging to the dovish camp's argument was the December jobs report featuring the eye-opening increase in payrolls noted earlier as well as the sturdy increase in wage growth.

Patience - For Now

As the new year gets underway, the Fed is faced with the same dilemma that has bedeviled it throughout 2018. While the job market continues to tighten and wage growth is picking up, inflation has remained tame; in fact, it even receded towards the end of last year, moving below the Fed's 2 percent target. Those conflicting trends, while welcome, are not sustainable over the long run. At some point wage increases should put upward pressure on prices; if the wage –price cycle becomes firmly entrenched, the Fed will be forced to pull the rate hiking trigger much more forcefully than otherwise to prevent runaway inflation. Hence, by waiting too long to apply the brakes the Fed runs the risk of having to overreact later on, which inevitably brings on a recession.

Conversely, if the Fed steadily raises rates before inflation gains traction, as it is now, it risks choking off a wage recovery that has been long delayed and still has not filtered down to all workers. Worse, by potentially causing a recession the very workers whose earnings have lagged behind would be the first to be laid off. The Fed, of course, is acutely aware of this threat, which is why it is more inclined to run the risk of higher inflation than a recession. Hence, given the tame inflation backdrop as well as low inflation expectations on both Wall Street and Main Street, the odds are that the central bank will be more patient before slamming on the brakes in the face of a tightening labor market.

But that leaves the question: how long should the Fed wait? After all, the reduced slack in the labor market and widespread reports of worker shortages are already speeding up wage growth. What's more, surveys reveal that an increasing share of businesses, both large and small, plan to pass on higher labor costs to customers in coming months. Simply put, the Fed's balancing act in which it is walking the tightrope of risking a recession on the one side and undesirable inflation on the other is becoming ever-more precarious.



How Low Can Unemployment Go?

Throughout most of the postwar period, whenever the jobless rate fell to between 4 and 5 percent, inflation picked up considerably, forcing the Fed's hand. Since the start of this century, however, the linkage between unemployment

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and inflation has been far weaker. Economists have come up with a host of possible explanations for this change, including globalization, the decline in union membership, the impact of the Internet and a shift in worker preferences towards job security over higher wages, particularly since the financial crisis. All have no doubt played a role in suppressing prices.

But the one point that most economists agree on is that the current low unemployment rate overstates the tightness in the labor market. For one, there is a huge pool of unemployed workers outside of the labor force and, hence, are not counted as unemployed; many of these workers can be lured from the sidelines to fill job openings. For another, the jobless rate itself is skewed lower by the aging of the workforce; the share of the labor force represented by workers age 55 and over has nearly doubled over the past 20 years, and this group has a much lower unemployment rate than younger workers. According to the Federal Reserve Bank of Atlanta, this shift in demographics alone has lowered the unemployment rate by almost half-percent. By the same token, older workers earn more than younger ones, so the demographic shift may also translate into a faster increase in average wages than is actually taking place among most workers.

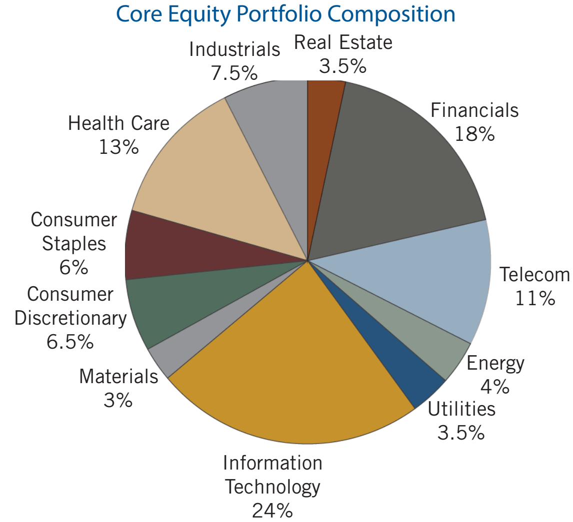
All things considered, the Fed is justified in leaning against potential inflationary winds generated by a tightening job market; but the resistance needs to be tempered by the weaker link between unemployment and inflation. Fortunately, that more cautious and patient approach appears to be the Fed's current strategy. Instead of a knee-jerk reaction to a time-honored inflation catalyst – a low unemployment rate and signs of faster wage growth – policy makers are looking at a range of indicators to guide their next moves. In 2018, the indicators were almost universally supportive of the gradual and steady interest rate hikes taken throughout the year. That's not the case now. Worse, a data-dependant Fed has little data to depend on thanks to the government shutdown. Hopefully, that obstacle will soon be removed. ■

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 January 31, 2019.

Core Equity Portfolio Composition



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