LEGACY
WEALTH ADVISORS

Executive Summary

Legacy Update — December 2018

As expected, markets continue to struggle with the divergence between continued strong economic data and expectations of a growth slowdown in 2019. Valuations, once stretched, have come in some as market selling expanded from Emerging Markets, EU and small caps to all of the major US indices over the last several months.

As we forecast in October, the bounce-back rally failed as investors caught in the initial sell-off cut positions, which led to an expanding cycle of de-risking as the decline accelerated. As a result, the selloff was deeper than we had initially expected, and it will now likely take longer to repair before the next move up.

The Economy

While interest rate sensitive areas like housing and autos have seen significant weakness, other economic factors remain strong. Unemployment remains near historical lows, job creation remains solid, wage and income gains are picking up, manufacturing and consumer confidence remain near the highs, and Christmas sales just rose over 5%, well above expectations.

The GDP final Q3 revision came in at 3.4% , bolstered by a larger than expected increase in inventories. However, we expected as much as businesses tried to onboard as much inventory as possible before the coming implementation of tariffs on goods from China, and others.

Despite headlines about the Dollar collapsing, it's oddly still within 1% of the 18-month highs, and about 10% above the January lows. We expect continued dollar strength as US growth remains comparatively strong.

The Fed

We observe that the Fed continues its deliberate, well considered approach to gradually increasing the benchmark rate, having again raised rates by 25 bp (nine increases since 2015). We have had concerns all year that the Fed was the biggest risk to the financial markets by staying too tight, too long. The recent selloff has validated our concerns, but has also (so far) relieved our concern that a "Powell Put" would replace prior Fed puts. True "price discovery" in the markets, despite the current volatility, will be much more healthy in the long run.

As we expected, rather than moving up to 3.5-4%, the 10 year bond has dropped significantly below 3% as investors begin to embrace our outlook for a slowing economy into 2019. While some headlines blare "Recession!" we feel a "Growth Recession" (<2.5% GDP growth) is a far more likely outcome.

Politics

We expect the current shutdown to last well into January, depending on how the polls go. Both sides are working their narrative for the 2020 election cycle, and setting the stage for the new Congress. Dems will likely hold out until January when the House will be less willing to pass any "Wall" attachment to the CR. However, R's will have a stronger core in the Senate to resist the House, having gotten rid of a handful of "Never-Trumpers". Negotiations will have to start all over again.

Trump and Schumer have drawn lines in the sand, which will be difficult to walk back. We expect Trump to show more public flexibility, while privately holding the line. If he caves, his base will be furious (see GHW Bush's "No New Taxes" pledge that cost him his re-election in 1992). We currently expect the Dems to take the brunt of criticism as the shutdown drags on, leading to some sort of compromise by month's end.

The Markets

Markets continue to try to reconcile the domestic and global economic slowdown we expect in 2019 with the ongoing strength in employment, continuing wage gains and a lack of interest rate pressures. That said, insider buying recently surged to the highest levels in eight years. The last time insider buying rose as much was in August 2011, when the S&P 500 was in the middle of a similar 19% retreat, before staging a 10% rally in each of the next two quarters. We expect a similar rebound.

Keep in mind that one of the reasons we have been defensively positioned for most of this year is because we have expecting this type of selloff to occur ever since we bottomed in February. Any time you transition from a strong-growth economy (3-4%) to a steady state economy (2-2.5%) you get these kinds of market adjustments as expectations come down.