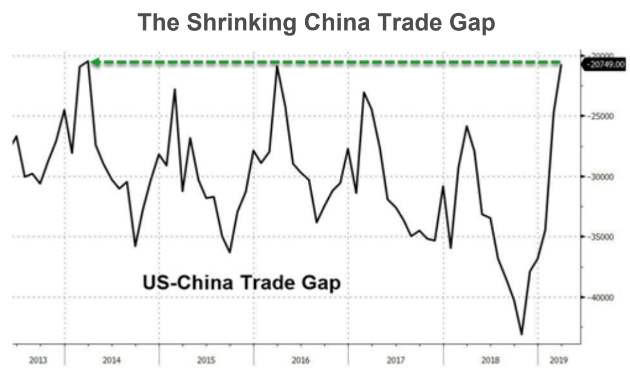
Executive Summary

Legacy Update — May 2019

In December we wrote, "the selloff was deeper than we had initially expected, and it will now likely take longer to repair before the next move up." The following explosion to the upside took many, including us, by surprise. The market now looks like it is ready to correct for some of that excess, in reaction to the China trade time-out.

With the Fed now on hold, and global economies slowing, markets have reacted negatively to the "unexpected" unwinding of the China trade deal. We view the setback as very typical of President Trump's "Art of the Deal" negotiating style, and China's misreading of his commitment to changing the status quo.



US Trade Gap with China Tumbles to a Five Year Low

The Economy

While the recent GDP report came in well above expectations at 3.2%, we are reminded that such metrics are "backward-looking". More concurrent measures continue to show the arrival of the global and U.S slowdowns that we have been expecting.

China's recent backpedaling on commitments in the new trade deal have prompted President Trump to announce an increase from 10% to 25% on existing tariffs, and indicate an additional $300B will now be subject to tariffs. China has announced additional retaliatory tariffs of up to 25% on about $110 billion of U.S. goods.

China can not afford a prolonged trade war with the U.S.; the balances are far too lopsided in our favor. We expect "progress is being made" will be the next announcement, as the impact on China's exporters and supply chains continues to take a bite.

The Fed

As we forecasted last fall, the Fed has indeed entered a "pause", if not an outright end to the recent tightening cycle. Market expectations have now shifted to the possibility of at least one interest rate cut before year-end. While we think it is possible, we are not yet convinced.

Interest rates are mirroring the continued low inflation rates we have expected, despite widespread market concerns that the first round of China tariffs would bring with it inflation. We have not been in that camp, believing instead that the developing global slowdown in growth would offset any impact from such tariffs.

We expect the Fed will continue to stand pat, monitoring the economic impact of the ongoing trade spat and growth recession, and will adjust policy slowly based upon developing metrics over the summer.

Politics

Most well designed polls show voters now oppose impeaching the President, often by a large margin. As a result, Speaker Pelosi has beaten back demands by more fervent members of the House to pursue it. The prevailing strategy is to overwhelm Trump with subpoenas from multiple House committees looking into various aspects of Trump's businesses, taxes, family entanglements, and emoluments charges, not to mention the Mueller findings. In our opinion, impeachment would be a colossal mistake ahead of a bruising 2020 primary election season for the Dems.

We also believe that as the summer unfolds, Dems will have their hands full as Connecticut U.S. Attorney John Durham reviews evidence related to the FISA warrants that opened the FBI counter-intelligence investigation of Trump leading to the Mueller Special Counsel.

The Markets

Markets rallied more aggressively off the December lows than we had expected, as investor fears of an impending recession receded. As markets moved higher, we expressed concerns that stocks were overvalued based upon our thesis of a "growth recession/earnings recession" in 2019, and expectations that a China trade deal was "baked in" to the markets. The recent setback in trade negotiations proved to be a catalyst to trigger the selloff/re-test that we have been expecting.

We published a graphic in the October 2018 Monthly Outlook, and updated it in December, showing we expected a market correction to develop running through June or July of 2019. Heading into the summer months, our base case has not changed as we continue to see earnings and trade expectations reset asset values.