INVESTMENT INSIGHT

2019
FIRST QUARTER

LEGACY WEALTH MANAGEMENT
Right by you.

Last quarter we wrote about the roller coaster that was the stock market in 2018, running nicely up through the first three quarters of the year only to go flying down one of those scream-inducing declines in the fourth quarter. As quickly as it declined in the fourth quarter, it hit bottom on December 24th and started shooting back up, turning investor screams back into smiles! But what in the world should we expect from here?

Investment markets are influenced by many things at once all the time. You can never rely on a single factor to predict the market's next move. Here are a few things that we believe are influencing the markets and our take on what they could mean for future returns.

Interest Rates and Inflation

The Federal Reserve (Fed) met on March 20 and decided to leave short-term interest rates unchanged. The Fed's Congressionally-mandated dual goal is to work toward full employment and low inflation (price stability). The unemployment rate is 3.8%, lower than it has been since the late 1960's (50 years), and inflation is hovering around the Fed's stated target of 2%. If I'm the Fed, I would say that is mission accomplished! The challenge that they have in front of them is to maintain these very good numbers. Past Federal Reserve policy-makers have often missed the mark, moving interest rates up or down for too long, producing unintended results in the economy. This Fed is seemingly being much more patient about any moves they make, leading us to conclude that interest rates and inflation will remain low for the foreseeable future. Unemployment should remain low, and wages should continue to rise (wage growth is approximately 3% year-over-year), allowing the consumer to continue driving the economy in a positive direction. Consumer spending makes up roughly 70% of the economy (as measured by gross domestic product, or GDP), so a healthy consumer is very important.

Corporate Earnings Growth

Corporate earnings grew at a fantastic rate in 2018, boosted as one would expect by the reduction in corporate tax rates from 35% to 21%. The impact of the tax cuts is wearing off, and the global economy is slowing down, so corporate earnings growth for 2019 will be much lower than for 2018. Most financial market experts that we follow are still calling for earnings growth this year of +4%, just much slower growth than last year's +20%. That means that the likelihood of a recession in 2019 (or even 2020) is relatively low. However, since earnings are expected to grow more slowly, investors will have to determine what they are willing to pay for this new pace of future earnings. If one expects earnings to grow quickly, they are willing to pay more for those future earnings than if they expect earnings to grow slowly. The most common way to view this is through a price-to-earnings ratio, or P/E ratio. This ratio reflects the price per share of a company stock (P) to the earnings per share of the company (E). The higher the ratio, the more investors are willing to pay for future earnings. Viewing this measure over time allows one to see whether investors are despondent about the future (low P/E) or overly exuberant (high P/E). Since 1985, P/E ratios for the S&P 500 stock index have averaged 15.1x, while the latest reading is 16.4x. Investors are more optimistic about the future than their average expectations over the last 30+ years but are not "irrationally exuberant" (to use former Fed Chairman Alan Greenspan's term). To some degree, investors are being "pushed" into equity investments to try to earn a better return than they can on cash or bonds, so a slightly elevated P/E is not surprising. And if the P/E ratio returned to its long-term average, it would not portend doom for the markets or client portfolios.

The Yield Curve versus Other Leading Indicators

A much-discussed and watched topic of late has been the shape or slope of the yield curve. Typically, it is cheaper to borrow money for two years than it is to borrow the same amount for ten years. There is simply more risk that the loan won't be repaid in ten years, so the lender charges more to be compensated for that additional risk. The cost (or yield) on a two-year loan might be 2%, while the cost (yield) on a ten-year loan might be 3.5%. In this situation, the yield curve is said to be "normal" or slopes up and to the right. An "inverted" yield curve is just the opposite – the two-year loan earns more than the ten-year, meaning that the yield curve slopes down and to the right.

Accepting a lower rate for longer-term debt doesn't make any sense unless the investor believes that there is more risk in the near-term; that is, they are pessimistic about short-term economic or market opportunities. If one is concerned that the economy/market is going to decline in the near-term, accepting a lower long-term rate may make sense simply to lock in an acceptable rate through the bad times. The thought is, "I'm okay earning 1.9% on my ten-year loan instead of making a two-year loan at 2% only to find rates have dropped significantly when I have to reinvest the loan in two years." When the yield curve inverts (short rates are higher than long rates), it is often seen as a precursor to an economic slowdown or recession. Yield curve inversion has been a very good predictor (leading indicator) of coming recessions, but studies have shown that the curve actually has to invert (not just get close to inversion) and that even once it does invert, the timing of a pending recession could be anywhere from six to thirty-six months away. Today's yield curve as measured by the two-year Treasury bond versus the ten-year Treasury bond is very flat, but as of this writing has not inverted.

Another important leading indicator tool is the Leading Economic Index (LEI) published by The Conference Board, a think tank that was founded in 1916. The LEI is made up of ten different economic indicators such as average weekly hours, manufacturers' new orders, building permits, etc. Positive index numbers indicate continued economic growth, while negative index numbers provide an indication that the economy is slowing and will likely enter recession. The LEI index usually turns negative several months before a recession, but current readings are still positive. The index actually increased slightly in February, yet "[d]espite the latest results, the US LEI's growth rate has slowed over the past six months, suggesting that while the economy will continue to expand in the near-term, its pace of growth could decelerate by year end." (https://www.conference-board.org/data/bcicountry.cfm?cid=1)

What Does All This Mean?

On balance, the news for the U.S. economy is still good. Growth here at home is not as strong as it was, but even slower growth continues to support workers, consumers, and investors. Global growth is also slowing and could get worse, depending on events like Brexit and trade negotiations with China. Should we see continued deterioration in international economies, that could certainly feed back into the U.S. economy and markets. A trade deal with China could ease trade tensions and bring some support back to economies around the world, so slowing global growth bears watching, but does not lead us to any immediate concern and action.

The yield curve is getting close to its warning point but is not quite there yet. Again, this bears watching, and we are watching closely but are comforted by the fact that the Conference Board's LEI indicator is still positive. Balancing these two leading indicators against one another allows us to take a patient approach to developments in the economy and markets. Even if the yield curve inverted tomorrow and warned of a coming recession, it could be anywhere from six to thirty-six months away. Market returns between the time of an inversion and an actual recession have often been positive, so patience is warranted.

Given the different topics discussed in this *Insight*, cautiously optimistic would be the summary of our view of the future. Since growth is not as strong as it has been, markets should be expected to be more volatile as investors figure out whether they are paying the right price today for future earnings. Continued growth in the economy that supports low unemployment and rising wages with low borrowing costs and low inflation should all be good for consumers and investors. We have appropriate allocations in place implemented by good managers. Those clients who have developed a financial plan with their Legacy Team can be assured their plan is designed to accommodate market volatility. (If you need to work on a Financial Plan, please contact your Relationship Manager at Legacy.) The roller coaster is still on the tracks. As we said in the conclusion to our last *Insight*, hang on for the ride, and know that you will arrive at your final destination intact!

This First Quarter
Investment Insight
has been written by Legacy's
Managing Director
Duncan Miller.

The views of this commentary are not intended to be a forecast of future events, a guarantee of future results, or investment advice. We do not undertake to advise you of any changes in the views expressed herein. Investors should not use this information as the sole basis for investment decisions. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index. Past performance is no guarantee of future results. Any statistics have been obtained from sources believed to be reliable, but the accuracy and completeness of the information cannot be guaranteed.