INVESTMENT INSIGHT

2019

THIRD QUARTER

LEGACY WEALTH MANAGEMENT

Right by you.

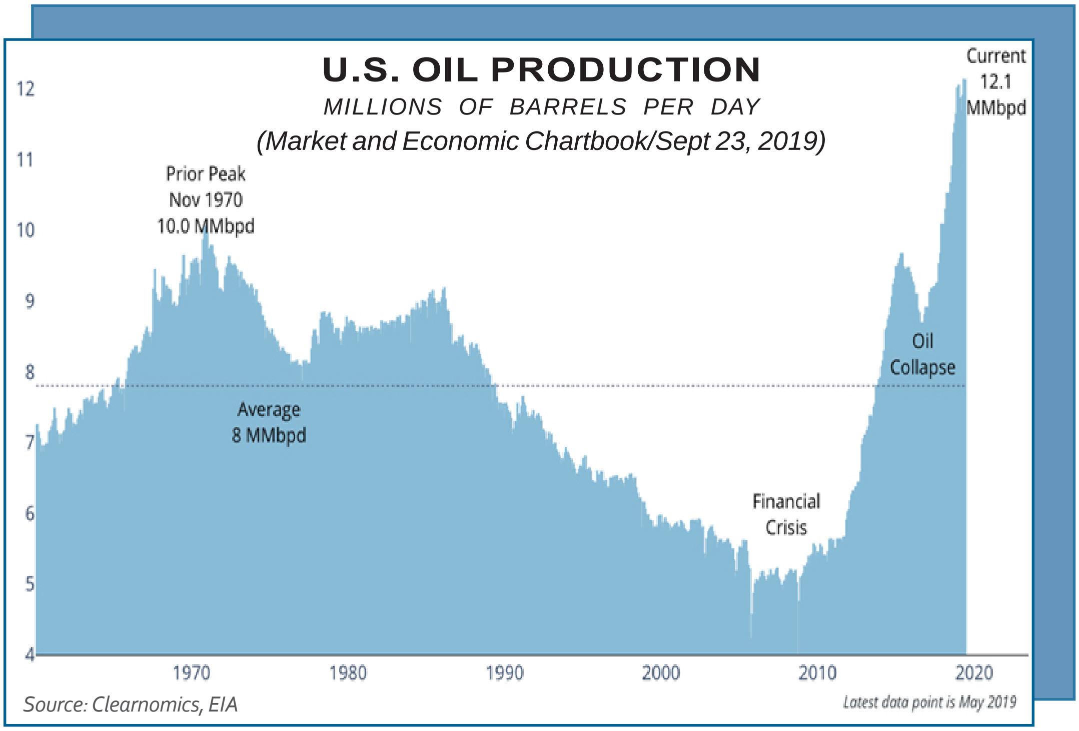
Over the last few quarters, we have written about the market gyrations of late 2018 and early 2019, the long and slow recovery of the U.S. economy and markets since 2008, warning signs about what might lie ahead, and the importance of maintaining a long-term view of the markets. This quarter we will focus on the reasons we believe any future recession should not be overly dramatic.

OIL / ENERGY

I can recall conversations not too many years ago (10?) that centered around "peak oil" and the idea that the world would run out of this critical natural resource within our lifetimes. The idea was that there were no more large discoverable reserves, and the ones we knew about were depleting at a rapid rate. The U.S. was heavily dependent on foreign oil and that meant heavily dependent on less-than-friendly parts of the world. The Middle East and oil fields in certain areas of Africa have long been unstable and uncertain areas, subject to disruptions from political problems or outright terrorism.

Then came the shale-oil revolution with new technologies such as fracking and horizontal drilling providing the opportunity to tap into oil reserves never before reached. Just as all technologies get better and cheaper over time, so have the new oil extraction technologies. The result is that the U.S. is now completely ***energy independent!*** In fact, we are now *exporters* of oil. A by-product of the new oil production is virtually unlimited natural gas production. Natural gas is a much cleaner source of energy which is an obvious benefit. It is also very hard to store or transport, so it is best used at or near the source. Cheap and readily available domestic oil and natural gas will lower energy costs for both consumers and manufacturers. This keeps consumers comfortable and businesses running without high, energy-related inflationary pressures and threats of energy shortages influenced by disruptions in other parts of the world.

The effects of the U.S.'s energy independence are significant. For example, the recent attack on the Saudi oil production facility reportedly wiped out half of Saudi production and five percent of daily global production, yet oil markets remained reasonably calm, with oil prices rising only slightly and quickly declining again. The Saudis appear to be getting production back on line fairly quickly, but even if they did not, it would not be a dire situation for the U.S. In fact, higher energy prices should benefit U.S. energy companies, and the new technology could be employed to increase production, offsetting the loss of production overseas. Our energy independence also helps us avoid foreign entanglements. Had this attack on Saudi production happened 10 years ago, the U.S. may have felt greater pressure to react militarily to protect our energy interests; however, now our response can be more measured.

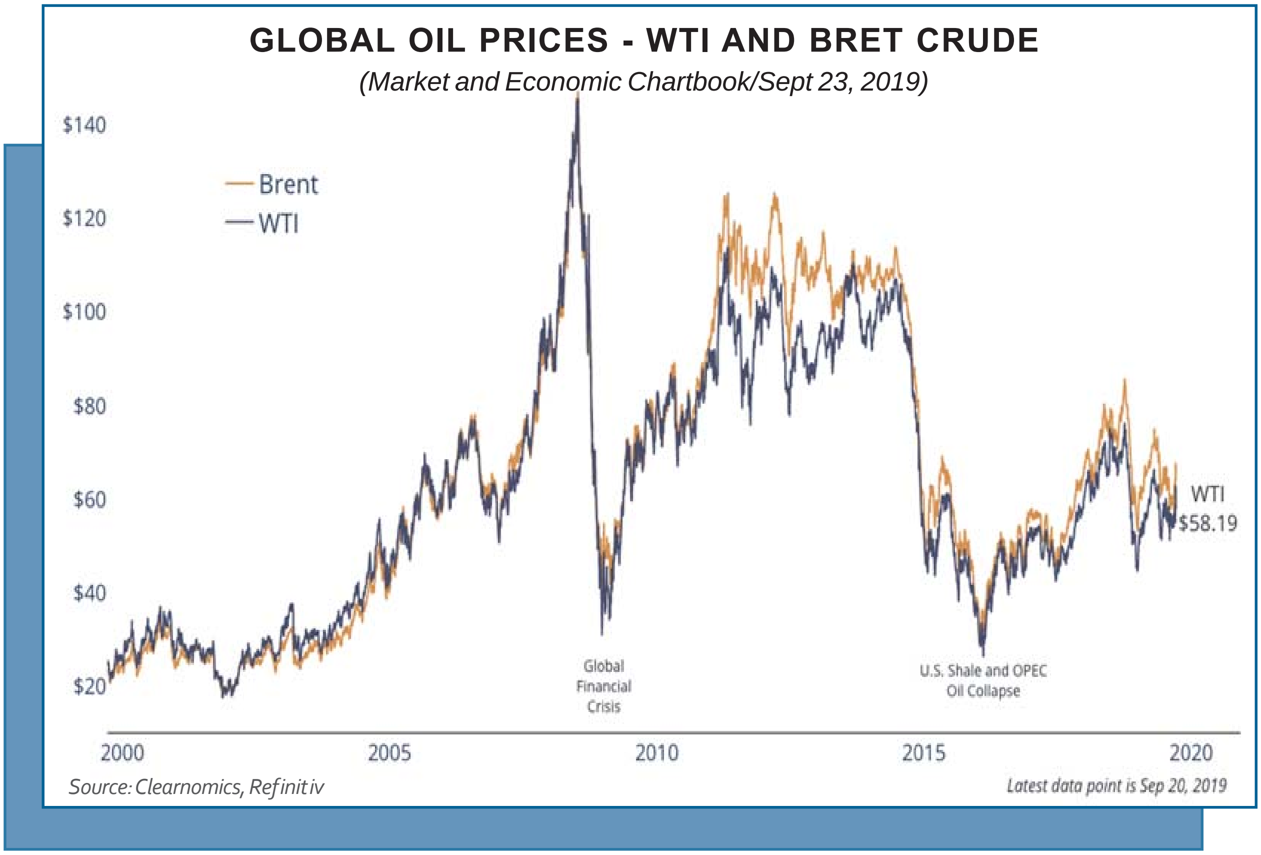

U.S. OIL PRODUCTION

MILLIONS OF BARRELS PER DAY

(Market and Economic Chartbook/Sept 23, 2019)

Source: Clearnomics, EIA

Latest data point is May 2019


GLOBAL OIL PRICES - WTI AND BRET CRUDE

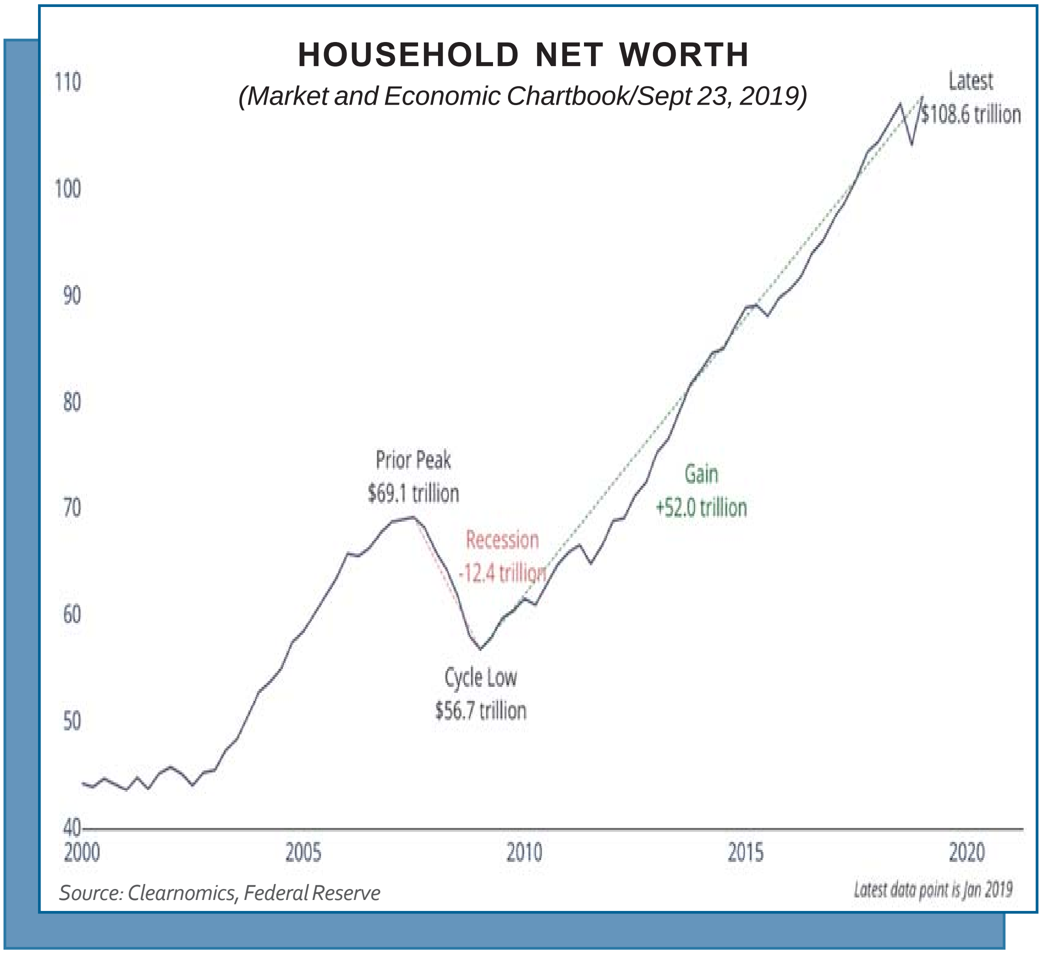
(Market and Economic Chartbook/Sept 23, 2019)

Source: Clearnomics, Refinitiv

Latest data point is Sep 20, 2019

BANK BALANCE SHEETS AND CONSUMER DEBT

In the 2008 financial crisis, there was significant concern about the ability of major banks in the U.S. and around the world to survive. The fear that another Bear Stearns or Lehman Brothers collapse would happen caused liquidity markets to disappear, meaning that neither consumers nor businesses could obtain credit. Since the crisis, new laws have been enacted requiring banks to hold much more capital in reserve to guard against adverse financial conditions. Banks are regularly subjected to a "stress test" by their regulators to see how they would fare in the event of a severe economic downturn. Banks in the most recent stress tests were found to be on sound financial footing, leading regulators to conclude that the U.S. banking system is on solid ground and could withstand an economic downturn.


HOUSEHOLD NET WORTH

(Market and Economic Chartbook/Sept 23, 2019)

Source: Clearnomics, Federal Reserve

Similarly, the U.S. consumer is in good financial shape right now. The chart above shows household net worth has nearly doubled since the lows of 2009. Consumer spending makes up approximately 70% of U.S. economic activity (Gross Domestic Product, or GDP), so a healthy consumer is very important. Interest rates (particularly mortgage rates) are very low; inflation is low, allowing consumers to continue buying goods and services at reasonable prices; unemployment is at a 50-year low; and wages are rising. JP Morgan reports that debt payments as a percentage of disposable income are below 10%, meaning that households are only spending ten cents of every dollar earned in order to stay current on their debt payments.

This Third Quarter
Investment Insight
has been written by Legacy's
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Duncan Miller.

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CONCLUSION

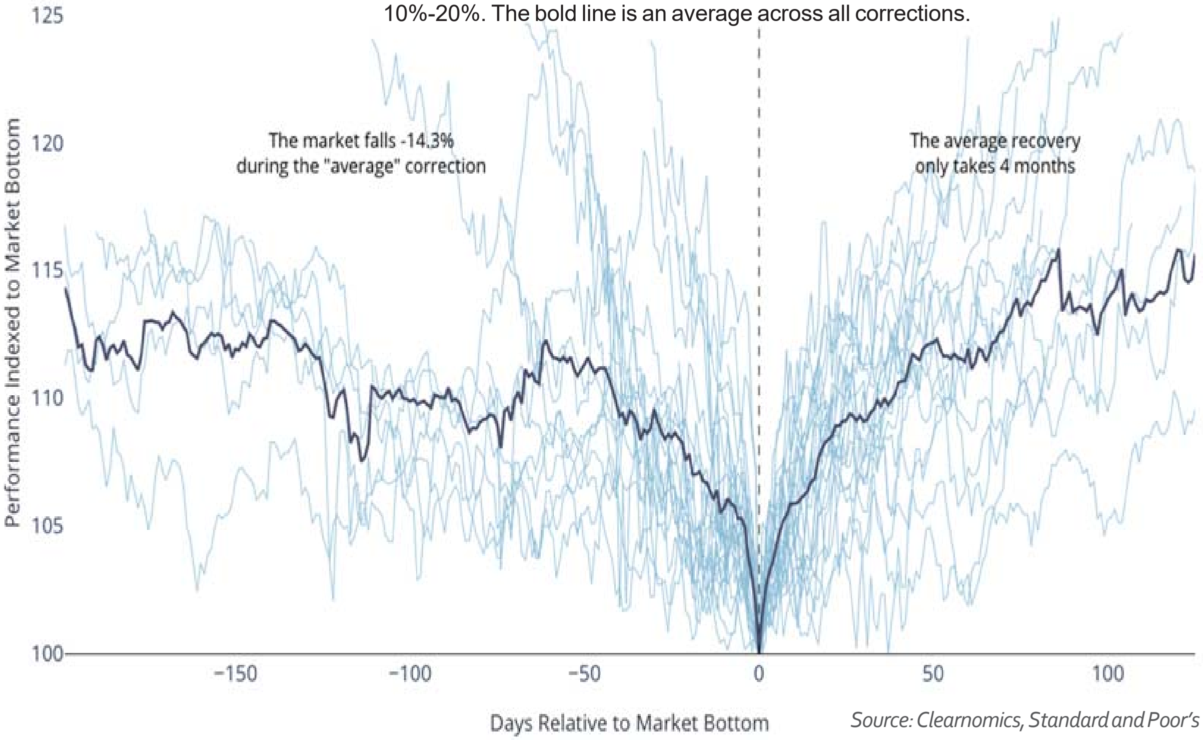
As we listen to the prognosticators and read commentaries from experts, some are calling for a recession in the next year or so, while others are saying that the economy will slow but will not go into recession. We know that a recession *will occur* sometime since all economic expansions come to an end, but also know that it is very difficult to predict when a downturn might happen. The average market correction sees a market decline of -14.3% while the average recovery takes only four months.

Based on the ideas outlined in this *Insight*, we believe that the next recession will be an average one (or better), not a severe one. Energy is cheap and abundant. Our financial system is sound. Consumers are healthy and jobs are plentiful. We have adjusted most client portfolios over the past several months to an allocation heavily weighted to the U.S.— roughly 85% of our stock allocation is to the U.S. We believe those adjustments will provide opportunities for portfolio growth, while also providing portfolio protection in the event of a market downturn.

MARKET CORRECTIONS AND RECOVERIES

(Market and Economic Chartbook/Sept 23, 2019)

S&P 500 Total Returns Since World War II. Market corrections are peak-to-trough declines of 10%-20%. The bold line is an average across all corrections.



Source: Clearnomics, Standard and Poor's

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