LEGACY
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The Income Spending Gap

While the political version of the "theater of the absurd" continues to run its course, the economy remains in a state of sublime detachment. By now, more than eight months into the Trump administration, it is almost certain that its ambitious tax and spending agenda will either be extremely watered down or fail to see the light of day this year. The White House, with its rotating cast of advisors, has failed to put forward a cohesive, much less detailed fiscal plan, while a deeply polarized Congress is at loggerheads over what policies to pursue and which should take priority. After wasting months in a failed attempt to repeal the Affordable Care Act, lawmakers are running out of time to come up with a tax reform bill, the cornerstone of its pro-business agenda that promised to jump-start the economy's growth engine.

Before tackling tax reform, Congress had to first pass legislation to fund the government past September, or risk a shutdown. Even though President Trump signed a bill on September 8th increasing the debt ceiling through December 8th, the holidays are fast approaching, and it's unlikely that squabbling legislators will have either the will or the time to agree on a complex tax reform package. Instead, the grand tax reform plan will probably convert into a modest tax cut plan, which would not go into effect until 2018. And remember infrastructure – President Trump's signature campaign promise? That appears to have fallen off policymakers' radar screen, dashing any hope of legislation this year that would impart the most powerful direct boost to economic growth.

With the growth-stimulating fiscal prospects now deflated, the main catalyst of the surge in household and business confidence has likewise fallen by the wayside. Yet, spirits remain high, the stock market is still bullish, and the economy is cruising in the same gear as it was before the election. This lack of response to broken fiscal promises may not hold for long if it turns out that the economy needs government support to keep it afloat. But the fundamentals that prevailed before the election remain mostly in place today. They generated 2 percent growth then and are still generating the same growth rate now. We suspect that dynamic will continue for the foreseeable future, although the main growth driver – households – may need some fuel to sustain its momentum.

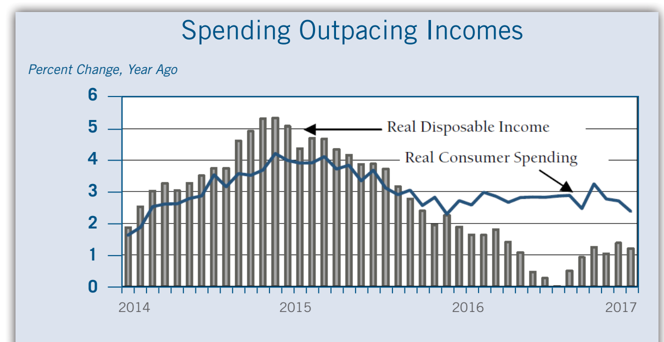
An Unsettling Divergence

As expected, the economy rebounded from the tepid 1.2 percent growth rate in the first quarter, increasing by a more respectable 2.6 percent pace in the April-June period. What's more, recent revised data on consumer spending suggest that second-quarter growth was a tad stronger than initially estimated. Importantly, consumers flexed their spending muscles to start the third quarter, as July retail sales were much stronger than expected, powered by hefty gains in most retail categories.

The recent strength in consumer spending may be a belated response to the surge in household confidence following the election. For months, economists wondered why the optimistic mood of households had not translated into more vigorous spending. Growth in personal consumption expenditures, which account for about 70 percent of gross domestic product, decelerated sharply in the first quarter, to a 1.9 percent annual rate from 2.9 percent in the fourth quarter of 2016, even as confidence surged. As it turned out, expenditures rebounded in the second quarter to a more robust 2.8 percent pace and that momentum, as noted, carried over into the start of the third quarter.

Overall, households maintained a steady spending pace of around 2.5 percent over the first half of the year, almost spot-on with the average since the end of the Great Recession. But while households have largely lived within their means throughout the first six years of the recovery, a disturbing pattern has emerged since the end of 2015. In 2016 growth in incomes and spending diverged sharply, with real disposable incomes slowing dramatically even as spending held at the 2.5 percent pace. That divergence has continued this year. Over the past 1-1/2 years, incomes have increased at a 1.2 percent average annual rate, more than a full percentage point less than spending growth.

Great Savings Dip



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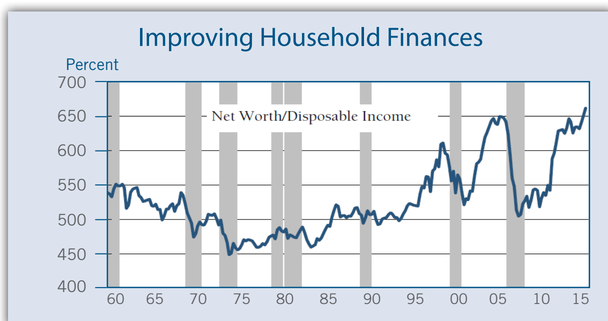
Simply put, households have been financing spending by dipping into savings. The personal savings rate, at 3.8 percent in June, is down 2 percentage points since the end of 2015 and well off the 5.5 percent average over the past twenty-five years. Significantly, the entire decline occurred before the election, as the savings rate hit 3.7 percent in November. That, in turn, rules out the notion that the confidence boost following the election somehow made households more willing live with a smaller savings cushion. The so-called "Trump Bump" did contribute to post-election euphoria on Wall Street and Main Street, but the change in consumer spending and savings habits took place well before the election.

No doubt, the willingness of households to draw down savings would not have happened if they felt insecure about job and income prospects. But consumer confidence increased steadily in 2014 and 2015 as the jobs engine shifted into a higher gear. It took time for households to shake off the insecurity from the Great Recession, which decimated 8.7 million jobs and vaporized the balance sheets of millions of Americans. But by the start of 2016, companies had increased payrolls for 63 consecutive months, driving the unemployment rate down to under 5 percent from a 10 percent peak and instilling workers with a greater sense of job security. Meanwhile, households made huge strides towards restoring their finances.

At the start of 2016, household net worth had soared to new highs, thanks to steep debt reductions and rebounding stock and real estate values. The rebuilding of balance sheet health has since continued, more than compensating for the slowdown in income growth. Indeed, aggregate household wealth hit a post-World War 11 record of 6.61 times annual disposable incomes in the first quarter of this year, topping the previous peaks of 6.59 in 2006 and 6.24 in 1999. In both of those periods, the personal savings rate was just as low or even lower than it is now, suggesting that households are more willing to live with a smaller savings cushion when they feel secure in their finances underpinned by a strong job market.

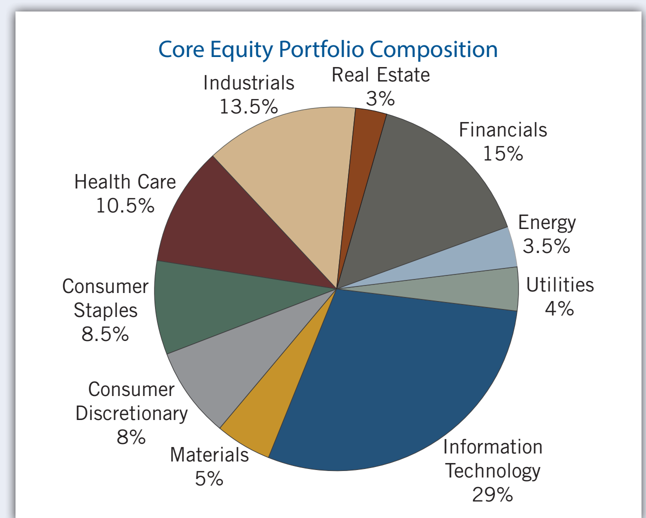
Not Sustainable



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 below shows the sector weightings in the Core Portfolio as of August 2016.



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But it is questionable if consumers can outspend income growth for much longer. In both 1999 and 2006, the previous periods of peak net worth and low savings rates, events did not end well. In those episodes, asset values were crushed by the dot-com bust in 2000 and housing collapse in 2007-2009. Households responded quickly to those events, reining in spending and pushing the savings rate back up. Not surprisingly, that behavior ushered in recessions, a mild one in 2001 and the Great Recession later on as household finances were further battered by the huge mortgage debts that fueled the housing boom.

Understandably, there are some who view the current upbeat measures of balance sheet health as a negative omen of things to come. After all, the higher asset values are, the more vulnerable they are to a collapse that could once again bring the economy to its knees. Many analysts do believe the stock market is overvalued, ripe for a correction, and that home prices have increased too high too fast, pricing many

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buyers out of the market. Time will tell if those judgements are correct. The good news, however, is that households are not as vulnerable to a correction in either the stock or housing markets as they were in 1999 or 2006.

While the equity share of household assets is higher than normal, it is well below the peak reached in 2009. Besides, stock-market corrections have not deeply impacted the economy in the past, if only because wealthier individuals hold most stocks whose spending patterns do not change much. The dot-com bust was an exception, but that was probably because the dot-com craze lured many ordinary citizens to the stock market who were less prepared to handle a downturn in their stock holdings. The other major asset class, real estate, is hardly a threat to blow up balance sheets. Not only is the housing share of total assets well within the normal range, mortgage debt is historically low relative to both incomes and assets Hence, a housing correction is not likely to result in the wave of foreclosures, bankruptcies and bank failures that ushered in the financial crisis in 2008.

Income Squeeze

A more worrisome development is the downshifting of income growth since 2015. Our concern is two-fold. First the slowdown in real incomes has occurred despite low inflation – the core inflation rate, which excludes volatile food and energy prices – is running at a 10-month low of 1.5 percent. The risk is that inflation will pick up in coming months, as the drag from some idiosyncratic price declines – such as plunging prices of cell phone plans – eases. If inflation picks up faster than incomes, the squeeze on household budgets would intensify, raising the odds of a cutback in consumer spending.

Second, the savings drawdown is not sustainable. The current savings rate is already near a historic low, so households would need to rely on other sources to sustain spending at the current pace. These include credit or assets. But households are reluctant to ramp up borrowing for a variety of reasons, including the still-raw scars from the financial crisis as well as the tougher standards they face from lenders. While appreciated asset values do instill more confidence and, hence, willingness to spend, most of the stock gains, as noted earlier, accrue to upper-income individuals who are not likely to change spending patterns.

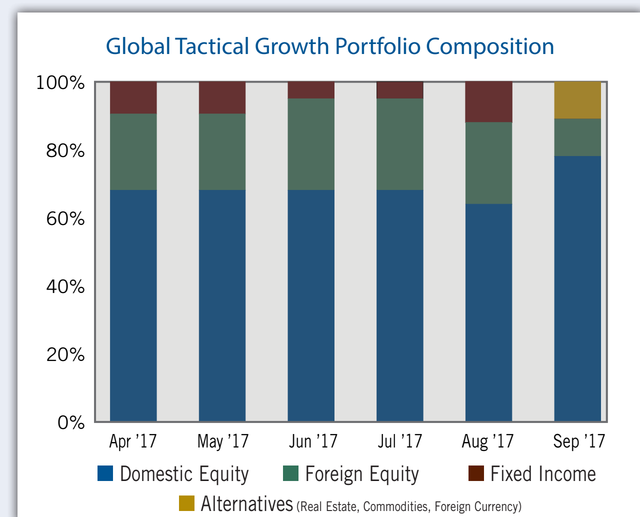
Rising property values do benefit a broader segment of the population, but homeowners are more inclined to rebuild housing equity than use it as cash-dispensing machines as was the case during the housing boom of the early 2000s.

Looking ahead, consumers should support spending the old fashion way – by aligning purchases with income growth. With the job market steadily tightening and the competition for workers heating up, the odds are that income growth will speed up at least enough to sustain spending at a modest 2-2.5 percent pace. If a tax cut package does see the light of day by the end of the year, it would inject some much-needed oomph to the spending stream and brighten growth prospects in 2018.

Legacy's Global Tactical Growth Portfolio

The The Global Tactical Growth (GTG) Portfolio is a disciplined, proprietary investment solution designed to maximize long-term investment returns with moderate risk. Legacy's goal is to position the GTG portfolio in the best performing asset classes (domestic equity, fixed income, foreign equity, foreign and domestic real estate, commodities and currencies) using all Exchange Traded Products.

The chart below shows the GTG asset allocation mix across the four major asset classes over the past six months.



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PRIVATE TRUST COMPANY

Two Neenah Center | Suite 501 | Neenah, WI 54956 | 920-967-5020 | www.lptrust.com

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