LEGACY

ECONOMIC AND FINANCIAL DIGEST

A NEWSLETTER FOR LEGACY INVESTORS

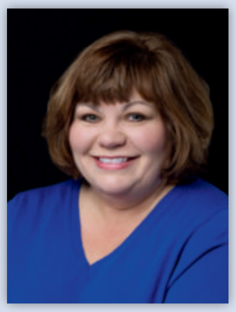
Oct 2017

The Inflation/Employment Puzzle

Mother Nature upended the economic landscape during the late summer months as Hurricanes Harvey and Irma wreaked havoc along the Gulf Coast. The humanitarian toll was the most troubling consequence of the storms; millions of Americans endured severe property damage, if not outright destruction, while countless others either perished or suffered bodily harm. While the economy also took a hit, the impact should be temporary and the recovery easier than that facing the unfortunate victims of the weather-related devastation.

The cost to the economy in terms of lost sales, output, and worker hours will not be known for some time. Private and government statisticians will probably not have a full reckoning until next year. From our lens, the storms took a meaningful bite out of the economy's growth rate in the third quarter, perhaps lowering it from a pre-hurricane consensus forecast of 2.7 percent to about 2.0 percent, with all of the damage inflicted in August and September. No doubt, some of the lost activity will never be recovered. *Continued next page*

Cybersecurity Awareness



Ranee Bahn,
Audit and
Compliance Officer
P 920.967.5073

October was National Cybersecurity Awareness Month. In this spirit, I want to share some of the ways Legacy protects client data, and provide a few helpful tips that you can use at home to protect your private information.

Over the past 18 months, our team has been working diligently to address the changing nature of network and information security. We recognized that in today's world of data breaches, basic security controls are no longer good enough. As a result, Legacy has contracted with the professional services of respected outside organizations to aid in strengthening our security posture. Legacy's ultimate goal is to protect sensitive client information.

- Our network support services partner, StrataDefense, works exclusively with financial institutions and is in tune with the rapidly changing needs in our industry. We recently implemented a virtual security analyst that monitors our network for indicators of compromise. In real-time, it can isolate a potentially compromised machine and sever its network connectivity. This proactively stops malicious activity in the early stages and prevents the loss of sensitive client information.
- In addition to the virtual security analyst, Legacy has undergone critical network infrastructure reconfiguration that better secures our internal network. As Legacy prepares to move into 2018, we plan to continue the evolution of our network security.
- In addition to the changes to our network infrastructure, we have been working with the team at Wipfli, LLP, to participate in regularly scheduled technology audits, during which Wipfli evaluates and tests our internal technology systems and policies to ensure that we are operating in a safe and secure manner. These tests include internal vulnerability scans to ensure that patching and flaw remediation are properly completed.
- Legacy participated in its first-ever penetration test this fall For this test, Legacy employed the (simulated) hacking services of SynerComm to break into our network to help expose potential weaknesses that could be exploited by actual hackers. We are happy to report Legacy's configured defenses stopped the SynerComm hackers at the gate. SynerComm was unable to gain a foothold on our network or "steal" any data.

We encourage all of our clients and friends to take an interest in their personal computer security and offer the following helpful tips:

- Use strong passphrases. Use a phrase that is easy for you to remember and something that only you would know. We suggest between 14 and 25 characters. Anything less is too easy for a hacker to crack. Never use these types of passwords: "Password" or "Winter17", "Spring18", etc. An attacker will crack these types of passwords within seconds.
- Be sure to lock the device (smartphone, tablet, etc.) when you are finished using it. This will help keep your information safe from thieves and other prying eyes. Configure the device to automatically lock out after a few minutes of inactivity.
- Install anti-malware software to protect against viruses, key loggers, phishing websites, and other malicious activity. Preferably, use a paid solution rather than a free one.
- Consider using a PIN to secure your device(s) and see if your device(s) will allow number pattern randomization.
- Stay away from using free public Wi-Fi, if possible. Public Wi-Fi can allow hackers easy access to your data.
- Secure your passwords. Do not keep them written down or use the same password for every application. Consider using a password vault application that can secure all of your passwords in one location.
- Subscribe to a credit-monitoring product for yourself, your spouse, and your children.

The Inflation/Employment Puzzle

Continued from front page

That is, a haircut not taken in late August is unlikely to be replaced by two visits to the barber in September.

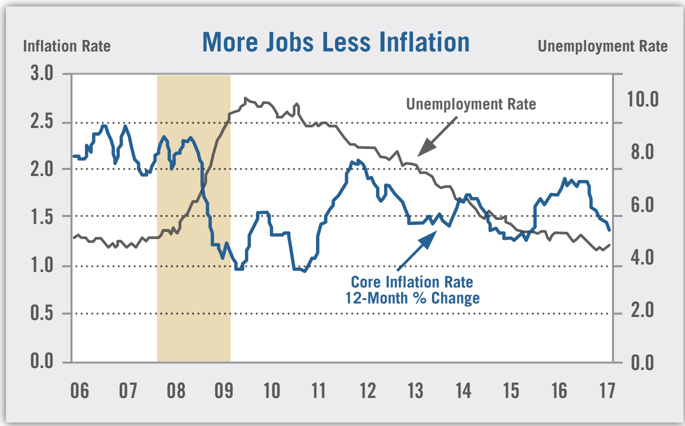
The vast majority of lost sales and output will be made up in coming months. The rebuilding efforts, in turn, will add strength to the economy's growth rate in the fourth quarter, boosting the demand for construction materials and workers and for goods and services from an array of related industries supporting the rebuilding process. Even the auto industry, which has seen sales languish this year, will get a boost as owners replace the estimated half million vehicles wiped out by the hurricanes. It remains to be seen if the rebound from the weather-related setback is strong enough for the Federal Reserve to pull the rate-trigger in December, fulfilling its planned three hikes this year. Assuming that growth does accelerate, the Fed will still need evidence that inflation is moving higher to justify an increase. Despite the recent inflation lift from a temporary storm-induced spike in gasoline prices, that prospect remains more of a hope than reality.

Hawks Versus Doves

The recently released minutes of the Federal Reserve's September 19-20 policy setting committee indicate there was considerable discussion about why inflation has remained persistently low in the face of an ever-tightening job market. The issue has been a major point of contention between Fed officials who want to keep rates low and those favoring preemptive rate increases to stave off an inflation flare-up down the road. The inflation hawks believe it is only a matter of time before the tight labor market stokes wage and price inflation. Their view is based on a time-honored relationship, known popularly as the Phillips Curve, in which inflation rises as the unemployment rate declines and vice versa.

The doves, however, argue that the historical pattern has broken down. They point to the fact that inflation has not only failed to increase in the face of declining unemployment, but has actually receded in recent months, almost a year after the jobless rate fell to a level widely considered to be consistent with full employment. That rate, which the Federal Reserve pegs at 4.6-4.8 percent, was initially hit in October 2016; this August, the jobless rate stood at 4.4 percent. Yet core inflation, as measured by the Fed's preferred gauge, the personal consumption deflator excluding food and energy prices, has fallen from an annual rate of 1.9 percent last October to 1.4 percent this summer. The rate remained below the Fed's inflation target of 2 percent in every month since April 2012.

The doves believe that continuing to raise rates in a misguided attempt to stifle future inflation only risks choking off the



recovery. Their view, supported by some notable Fed officials, is that inflation may have been driven permanently lower due to forces that are not fully understood and, hence, there is little harm in letting the economy run hotter for a while longer. Some also believe there is still considerable slack in the labor market despite the low unemployment rate, which does not capture the millions of workers who dropped out of the workforce but might want a job. The hawks, however, assert that inflation's rise to the 2 percent target is just being temporarily delayed by some transitory factors, such as declining prices on cell phone plans. They are concerned that maintaining ultralow rates for too long is sowing the seeds of even more virulent inflation that will require harsher growth-stifling interest rate increases later on.

No Wage Inflation

At this point, it is a toss-up as to whether the Fed will pull the rate trigger in December. As noted, the hurricanes are distorting the economic data, making it difficult to interpret the fundamental trends in growth and inflation at least through October. Still, by the December meeting, the noise in the data will have mostly subsided and the Fed should have a better sense of where the economy stands. One thing is clear: the Fed is strongly committed to normalizing monetary policy by unwinding the extraordinary measures taken to lift the economy out of the Great Recession and financial crisis. At the September meeting it announced that beginning in October it would start reducing its massive $4.2 trillion portfolio of securities accumulated since the depths of the recession in 2008.

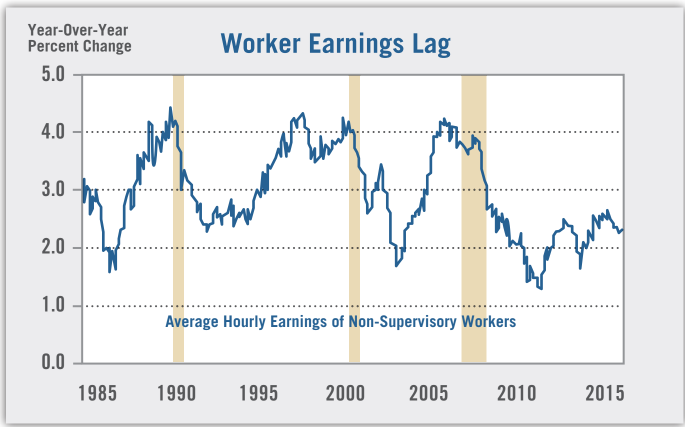
The balance sheet reduction had been telegraphed well in advance and came as no surprise to the financial markets. The process is intended to be gradual and predictable and designed to have a minimal impact on the markets. But predicting the timing of the next Fed rate increase is more of a challenge because the main sticking point, anemic inflation, remains a divisive influence among policy makers. At the core of the dispute is whether the historical trade-off between low unemployment and inflation is still relevant, given the breakdown in the relationship in recent years.

Perhaps the first place to look for answers is labor costs, which have been unusually restrained throughout the recovery. For the past 5 months, the annual increase in worker earnings has been stuck at 2.5 percent; slightly higher than earlier in the recovery but well below the 4.0 percent increases seen at this late stage of the last three business cycles. Historically, wage and price inflation go hand-in-hand, as labor costs are the biggest expense of employers. The more workers get paid and assuming their productivity does not increase, the more companies need to lift prices to protect profits. Not coincidentally, the 2.5 percent increase in workers earnings less 1.1 percent trend productivity growth since the recession translates into a 1.4 percent inflation rate, which is virtually spot-on with the current rate.

A Truck Full of Reasons

The biggest puzzle is why wage inflation has not gained traction in the face of an ever-tightening job market. While there are many theories, all have their critics. The argument that the 4.4 percent unemployment rate overstates the tightness in the labor market because it doesn't count workers on the sidelines has some credibility. But it also flies in the face of widespread labor shortages reported by a growing number of companies. Both arguments may be valid, as the dichotomy may simply be that the sidelined workers do not have the skills demanded by employers.

Evolving demographics could also explain the sluggish wage growth. The workforce is aging, and retiring baby boomers, who are in their peak earning years, are being replaced by younger workers who are less well compensated. This



compositional change is dragging down the growth in average wages for all workers. Indeed, another measure compiled by the Federal Reserve Bank of Atlanta that tracks wages for the same worker over a 12-month period shows that earnings have increased by a more robust 3.5 percent through August, a full percentage point higher than for average wages.

Finally, with inflation remaining low, worker paychecks are going a longer way. Hence, while nominal wage growth has been stuck at 2.5 percent over the past five months, the annual growth rate in real wages has doubled, from 0.3 percent to 0.6 percent. If, in fact, workers expect inflation to stay low or even recede further, they would conceivably be more content with slimmer wage increases than if inflation was taking a bigger bite out of their purchasing power. One Fed official strongly believes that declining inflation expectations has tilted the inflation trend lower.

Danger Zone

There is nothing inherently wrong with a 1.5 percent inflation rate that remains stable in the face of a tightening labor market. However, that happy confluence is not likely to persist. One danger is that the persistence of low inflation will drive inflation expectations lower and cause a change in spending behavior. Consumers would then withhold purchases in anticipation of lower prices, which not only lowers growth but heightens the risk that a deflationary spiral would gain traction. With interest rates still historically low, the Fed would have little ammunition to fight that threat. This prospect, of course, argues for a continued easy policy until inflation and inflation expectations show clear signs of increasing.

The other danger is with the labor market close to, if not at, full employment, the seeds of an inflation outbreak have already been sown. Fed officials like to say that monetary policy affects the economy with a lag. That means preemptive rate increases are required now to short-circuit inflation before it becomes too virulent to contain without bringing on a recession. The Fed has a history of overstaying an easy policy, stoking an inflation upsurge that forced it to come down heavily on the monetary brakes. Indeed, eight of the last 11 recessions have been preceded by catch-up rate increases that eventually stifled growth. No doubt, the economy would survive another quarter-point rate increase in December. But if the low inflation/low unemployment puzzle is not resolved soon, the risk is that policy decisions in 2018 will veer in the wrong direction with harmful consequences for the U.S. economy. ■

Legacy Team Spotlight

Lisa Bergan, Senior Client Representative
P 920.967.5064

Meet Lisa Bergan

Lisa Bergan joined Legacy in September 2010 as a Senior Client Representative. She holds a bachelor's degree from the University of Wisconsin-Stevens Point, has more than 18 years of trust experience, and holds a Certified Trust Financial Advisor (CTFA) designation. Lisa has a distinctive position within our Legacy office, which allows her to interact with many different clients and internal departments on a daily basis.

Lisa's coworkers love working with her, and many of them express how helpful and dedicated she is. It's been said around the office that if Lisa doesn't know the answer to a question, it's guaranteed that she knows who will have the answer. She never leaves a problem unsolved.

Our clients appreciate the relationships Lisa builds with them. She enjoys speaking with our clients, and takes the time to individually assist them with questions or concerns. She likes that Legacy is a small, local company, which affords her the opportunity to work as a team with other employees to care for clients.

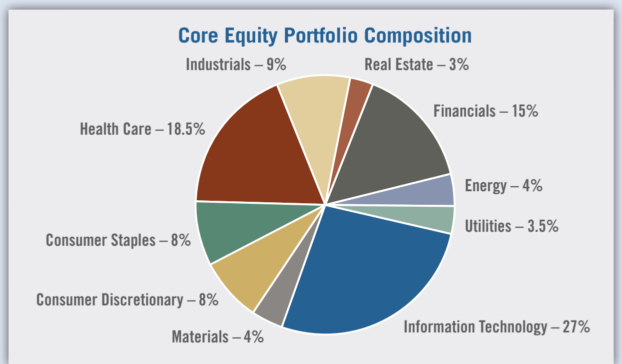
Lisa also enjoys the area in which she works. The Fox Cities provides much cultural diversity to celebrate and enjoy, and Legacy and its employees are lucky to be a part of that. Outside of work, Lisa and her husband take advantage of the area by biking on state trails, and in the spring they enjoy vacationing in Phoenix, Arizona. Lisa loves to participate in any and all activities with her nieces and nephews.

Featured Legacy Investment Portfolios

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 achieving investment goals 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.

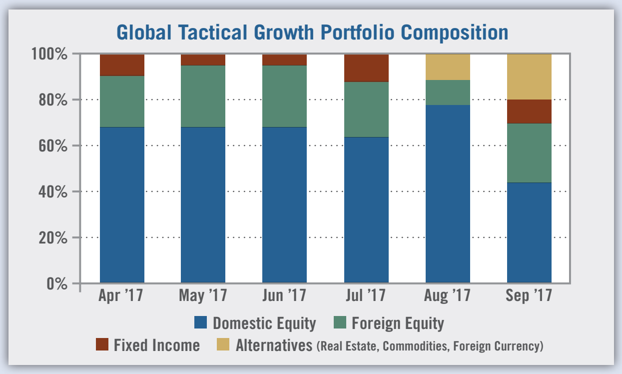
The chart below shows the sector weightings in the Core Portfolio as of September 30, 2017.



Global Tactical Growth Portfolio

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 four major asset classes over the past six months.



Past performance does not predict future results. Current and future results may be lower or higher than those referenced in this newsletter. Investments are not FDIC-insured, nor are they deposits of or guaranteed by a bank or any other entity. Investment return and principal value will fluctuate and investments may lose value.

To learn more, call us or visit www.lptrust.com.

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