LEGACY

ECONOMIC AND FINANCIAL DIGEST

A NEWSLETTER FOR LEGACY INVESTORS

April 2018

Consumer Retrenchment Not Alarming

As advertised, the economy is turning in an underwhelming performance in the first quarter, dragged down by soft consumer spending. Since households are the economy's main growth driver, many are fretting that the nation's third-longest expansion, about to enter its tenth year, is nearing the end of the road. There are troubling signs that typically appear at the late stages of a business cycle. The Federal Reserve is leaning against the wind, raising short-term interest rates and shrinking its balance sheet. Inflation is picking up and the job market is nearing, if not at, full employment. In addition to these time-honored cyclical markers, the economy faces risks on the policy front, particularly regarding foreign relations and trade.

Just as the administration's tax cuts last year cheered the business community and pumped more energy into stock prices, president Trump's announced tariffs on steel and aluminum had the opposite effect, drawing criticism from business leaders and wreaking havoc in financial markets. Trump softened the tariff's bite by excluding Canada and Mexico, but that has not quelled fears his policies will veer towards a more protectionist stance. Reshuffling his inner circle to include advisors with more

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Navigating Rough Waters

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A few months ago, I was on vacation with my family on the north shore of Oahu in an area known for its big wave surfing. The best surfers in the world flock to this spot every winter in hope of catching waves that may exceed 20 feet. But part of catching the perfect surfing conditions involves a lot of waiting (and wading) through imperfect conditions. Despite having tuned out from the headlines (the markets were closed that day), I had an epiphany: the markets and the ocean have a lot in common.

We had been to this same beach the day before. The weather was beautiful and the water was about as calm as it ever gets in this area. My children were complaining because the waves weren't "big enough". There were no dangerous currents in the water and we spent most of the day wading in waist-deep water. From a parent's perspective, this was about as low-risk as the ocean ever gets with kids.

But the next day was very different. The weather had changed and a big storm was brewing to the north. What seemed like a peaceful paradise less than 24 hours before had turned into a nearly unrecognizable, violent, and stormy scene. Conditions were so rough the lifeguards closed the beach. The area where we laid our towels the day before was now more than 100 yards into the surf. We had been lulled into a false sense of comfort by focusing on what was going on around us rather than looking at the weather data and tide tables that would have warned us about bigger waves to come.

The events of those contrasting days at Waimea Bay played out in the markets at the start of this year. As the calendar turned to 2018, market participants were celebrating the better-than-expected economic data, and analysts were upgrading their earnings forecasts to account for the tax law changes that were passed at the end of 2017. As equity markets rallied more than 7% in the month of January, it seemed as though risks were lower than they had been in more than a decade. However, the data we monitor at Legacy was painting a different picture.

Complacency was at extreme levels. Surveys of market participants showed a very high level of bullishness. Account values were at all-time highs. Just when things seemed "nearly perfect," the tide rose and the storm blew in. In the matter of a few days in early February, global stock markets went from "sunny and calm" conditions to "stormy with 20-foot waves".

In January, as the data started to point to riskier conditions brewing, our models correctly told us we should reduce our equity exposure and wait for better conditions before redeploying these funds. Weather events often arise quickly, and it takes time for the situation to calm down. The same is true of the markets. When data moderated and levels of complacency declined, we began to increase our equity exposures again.

We expect this year will involve more volatility than last year, especially as we approach the mid-term elections. And, while rough patches arise faster than they dissipate, we do expect this period of volatility to pass, too. Once the elections are done, the third year of a presidential term (2019, in this case) historically sees the best performance for equities of all four years. We will remain cautious while the surf is high, but believe sunny skies and calmer waters lie ahead.

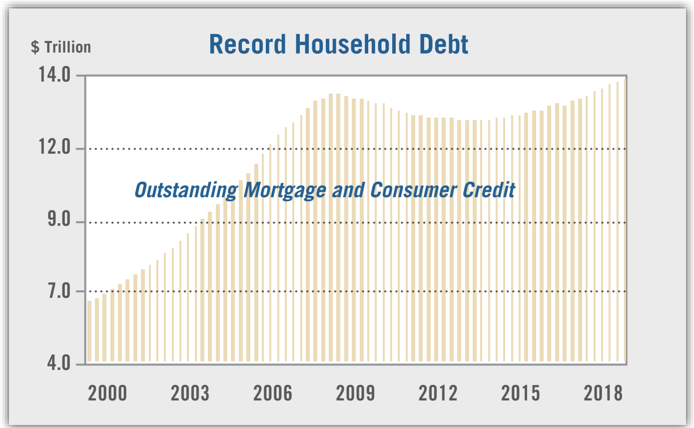
hawkish views on trade only brings the prospect of a trade war closer to reality. There are many flaws in current trade arrangements that need to be addressed, but erecting trade barriers and ramping up geopolitical tensions will do more harm than good for the economy and pose bigger threats to the growth outlook.

There might be more bark than bite behind the administration's tough messages to trading partners, so we will have to see how things actually play out. The risk is that the process could be unwieldy and create more uncertainty in the financial markets, leading to heightened volatility—if not severe market corrections—that could have a negative effect on the economy. While not a trivial probability, the odds are that congressional pressure ahead of the midterm elections will force the administration to temper its more strident growth-stifling policies and not undercut the economy's solid fundamentals. If so, the momentum that was interrupted in the first quarter should resume as the tax cuts find their way into the spending stream and businesses continue to ramp up investment.

Consumers Borrowing Again: Should We Worry?

Households spent a good part of the recovery working off the excessive debt burden acquired prior to the Great Recession. Many of the paydowns were involuntary, reflecting a tidal wave of defaults, foreclosures, and short sales stemming from massive layoffs during the downturn and the housing bust that forced millions of people to lose their homes or sell them at a deep discount. As well, lenders closed the credit spigot for several years to restore battered balance sheets and comply with tougher regulations mandated by Congress. On the other side of the ledger, the demand for loans shriveled as consumers, fearful of job security and whose nest eggs were decimated by the plunge in stock prices and housing values, refrained from taking on new debt.

Deprived of the fuel that borrowing provides, consumer spending recovered much more slowly from the Great Recession than normally occurs during cyclical upturns. But the deleveraging process ended in 2014. Slowly but surely, the credit spigot reopened as lender balance sheets returned to health. Meanwhile, buoyed by the lengthening recovery and accelerating job growth, households regained both the confidence and wherewithal to start borrowing again. By late 2016, outstanding household debt exceeded the previous peak set in 2008 and continued to set new records through the end of 2017.



Some feel that consumers dove back into the borrowing pool too rapidly and are ill-equipped to handle the mountain of new debt created over the past two years. That's particularly the case with interest rates rising and incomes lagging below the growth in spending, resulting in a much lower savings rate than a few years ago. Should the job market sputter and/or asset values fall, households might be hard pressed to service their debts, leading to an abrupt spending cutback that sets the stage for the next recession. In this context, the slump in retail sales over the past three months sounds an ominous note.

No Alarm Bells Yet

The increase in consumer debt in recent years has generated pockets of distress. In particular, the delinquency rate is rising on new credit card borrowing, and the share of delinquent auto loans is higher now than before the financial crisis. These trends certainly need careful monitoring; however, relative to incomes, households have hardly embarked on a reckless borrowing binge. Nor have lenders ignored the lessons of the financial crisis, extending credit to just about anyone with a heartbeat, as was the case in the run-up to that unfortunate episode.

To gauge the distress level of consumer debt, it is best to view the borrowing trend in the broader context of a rising population, higher asset values, and stronger incomes. Relative to incomes, total household debt remains 15 percent smaller than in the run-up to the financial crisis, and 20 percent below the peak distress level during the crises–107 percent of disposable income versus 135 percent in 2007. With interest rates on both mortgages and other consumer loans remaining well below pre-recession levels, households are devoting a much smaller share of income to debt repayments than was the case a decade ago. They also have more collateral to back up their loans. At $114 trillion, total household assets are nearly 10 times larger than liabilities, the largest coverage since 1989.

True, the remarkable 10-year rally in stock prices has underpinned the appreciation in asset values, with most of the gains accruing to wealthier households. These individuals had little trouble servicing debt before the bull market began. However, the squeeze on the middle class has also eased considerably, thanks to the run-up in home values in recent years. Whereas 11.9 million homeowners were underwater in their mortgages in the fourth quarter of 2009, or 26 percent of all mortgaged properties, only 2.5 million are stuck with negative equity today, less than five percent of the total. Looked at another way, households in the aggregate have recovered all of the home equity lost during the housing bust, having nearly a 60 percent equity stake in their properties in the fourth quarter of last year.

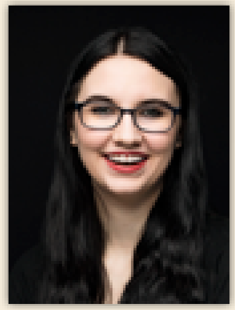
Taking a Breather

Simply put, households have stepped up borrowing in recent years, but, by most yardsticks, they are not overextended. That's important, because consumer willingness to borrow plays a critical role in spending behavior. For example, in the final quarter of 2017, roughly 27 percent of total consumer purchases (excluding home purchases) were financed by credit, the largest share of credit-financed spending since the financial crisis. Not surprisingly, the 3.8 percent growth rate in personal consumption expenditures during that period was the strongest in three years.

While first-quarter borrowing figures are not yet available, consumer credit slowed considerably in January, coincident with the pullback in consumer spending. As noted, retail sales slumped in February, too, which may also be linked to weaker credit-financed purchases, particularly since auto sales were a big drag that month. On the surface, these are ominous signs, signifying that households are once again abstaining from taking on new debt. If that's the case, consumers could be a significant drag on growth for the rest of the year.

However, that prospect is inconsistent with the positive fundamentals underpinning household behavior. Aside from the healthy financial yardsticks noted above, the robust job market, rising incomes, and elevated confidence strongly indicate that consumers should regain their spending mojo in coming months. Disposable incomes will also be getting an extra boost from last year's tax cuts, which are just finding their way into worker paychecks through lower withholding. A delay in the disbursements of earned income tax credits to lower income households probably took a bite out of spending in February. *Continued next page*

Legacy Team Spotlight



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Meet Olivia Will

Olivia Will joined Legacy in summer 2016 as a part-time Project Worker, completed a Hospitality and Marketing Internship with the company in summer 2017, and has since accepted the position of part-time Communication Design Specialist. She currently attends the University of Wisconsin-Stout where she is studying hotel, restaurant, and tourism management with a concentration in event and meeting management.

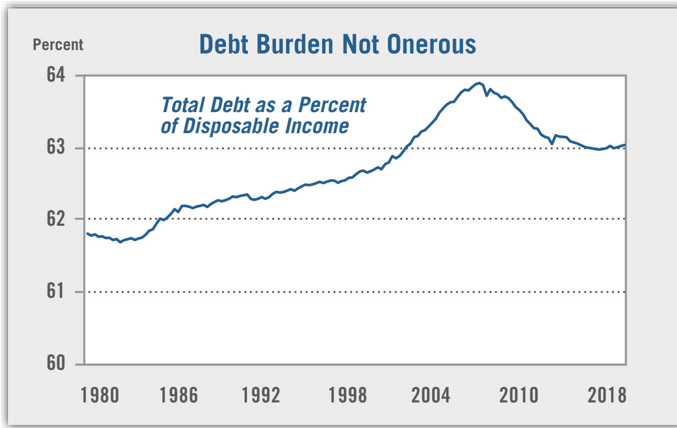
Olivia's coworkers enjoy her fresh perspective and ideas, her eagerness to learn, and her willingness to help out with any and all projects, no matter the department. As a member of the corporate services department, Olivia also often works closely with the administrative team at Legacy and the trust operations department in which her mother, Angel Will, is an employee. Design and print contractors appreciate Olivia's positive attitude, accessibility, and quick responses.

Olivia interacts with our clients through the planning and execution of Legacy's social events, such as the Summer Soiree, and through the creation and distribution of the firm's Economic and Financial Digest and Econtrarian commentary. She loves working for Legacy because she experiences and learns about the corporate side of event planning and marketing.

Olivia has been a resident of Neenah, Wisconsin, for most of her life. She graduated with honors from Neenah High School and returns from college to spend summers with her parents and two younger siblings. A self-proclaimed foodie, Olivia enjoys attending the local farmer's market each week, visiting restaurants in the Fox Cities, creating new recipes, or testing tried and true favorites.

Modest Rebound Ahead

The growth slowdown in the first quarter, led by the pullback in consumer borrowing and spending, is not particularly worrisome. Temporary setbacks are common in recoveries. All the signs point to a rebound in consumer spending reinforced by strengthening business investment and increased fiscal stimulus. However, don't expect households to go on a spending and borrowing binge.



While consumer fundamentals are sound, households are saddled with some restraints. For one, spending has outpaced income growth over the past two years. In large part, savings, not more borrowing, have financed the spending excess. As a result, the personal savings rate has declined to just over three percent, about half the level of two years ago. This is an unsustainably low level that leaves households with little in the way of reserves. The last time the savings rate was this low were the years leading up to the financial crisis.

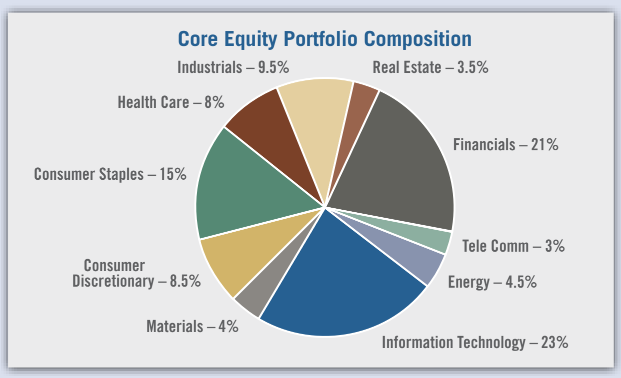
For another, the Federal Reserve is lifting interest rates, highlighted by the sixth quarter-point increase at the policy meeting on March 20-21. This will immediately boost borrowing costs on credit cards and auto loans, the two areas that are already showing signs of distress. Not only will the increase in debt servicing charges discourage some credit-financed purchases. Banks are also tightening lending standards where loan performance quality is deteriorating indicating that the supply of credit for auto and credit card purchases will not be as abundant in the future. This "composed caution" on the part of banks, expressed in the Federal Reserve's latest Senior Loan Officer Opinion Survey, will put a check on the reckless type of lending that precipitated the financial crisis. While that also moderates growth prospects, it keeps the economy and banking system on a sound footing and enhances the prospects for a longer expansion. ■

Featured Legacy Investment Portfolio

Core Equity

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 shows the sector weightings in the Core Portfolio as of March 31, 2018.



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

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