LEGACY

ECONOMIC AND FINANCIAL DIGEST

A NEWSLETTER FOR LEGACY INVESTORS

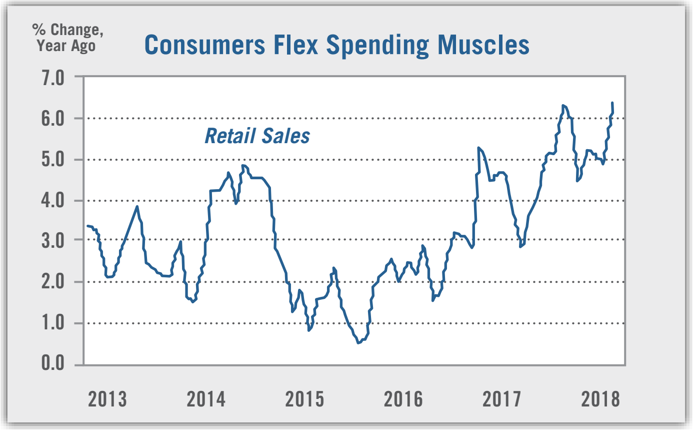
July 2018

As Good As It Gets

As expected, the U.S. central bank hiked short-term interest rates by another quarter-point at its June meeting, lifting the bellwether federal funds rate up to a range of 1.75-2.00 percent. It was the second increase so far this year, and the seventh since the Fed moved away from its lengthy zero interest-rate policy (ZIRP) of December 2015. While rates are still historically low and less than what Fed officials deem to be a neutral rate (a level that neither stimulates nor restrains economic activity), they won't be for long if the Fed follows through with its current plan. At the June meeting, most voting members of the Federal Reserve Board are expected to pull the rate trigger two more times this year, followed by three increases in 2019.

Hence, some time in 2019, the Fed will have returned rates to a neutral level, currently estimated at just under 3.0 percent, assuming its upgraded growth and inflation forecast comes to pass. That's the rub: the economy was doing fine when policy makers convened in mid-June. Unemployment had fallen to an 18-year low of 3.8 percent, growth was tracking a 4.0 percent pace or better for the second quarter (which would be the second strongest quarterly growth rate in a decade), and inflation was picking up. The Fed understandably believed that the economy no longer needed as much monetary support to keep forging ahead, so it is gently stepping on the brakes to keep the growth engine from overheating.

This approach makes sense, but the second quarter may be as good as it gets. The economy received a burst of energy this spring, fueled by massive tax cuts enacted last year and increased deficit spending. These catalysts pack a punch, but they will start to fade as time goes on. The economy will need to rely more on organic sources to sustain growth, and it is unclear how well they will hold up. The fundamental underpinnings are solid, highlighted by a robust job market. But Fed rate hikes, high debt burdens, low savings, and rising fuel prices against a backdrop of lagging wage growth are squeezing household purchasing power. Importantly, business leaders and investors are becoming increasingly concerned over heightened trade tensions and the potential disruptive effects a trade war would have on the economy and financial markets. The economy may be riding high now, but the road ahead will probably not be as smooth.



Consumers Splurge

When the Federal Reserve increased interest rates in March for the first time this year, it did so more on the basis of hope over reality. Recall that the economy was just finishing up a lackluster period of growth in the first quarter, as GDP slowed dramatically to a 2.2 percent pace from 3.0 percent or more in each of the previous three quarters. Consumers, the economy's main growth driver, were the biggest drag, as consumption expenditures slumped to a 1.1 percent rate from a robust 4.0 percent in the previous quarter. The Fed correctly believed that the slowdown from a post-hurricane influenced surge would be temporary, and that spending would pick up again in the spring.

But even the Fed could not envision the strength of the rebound that has since occurred. Following an eye-opening spike in retail sales during May, and upward revisions over the previous two months, consumption expenditures are tracking the strongest growth rate in nearly four years in the second quarter. Other sectors of the economy also contribute to growth in varying degrees, prompting widespread upward revisions to the near-term outlook. It now looks like GDP could well advance by more than a 4.0 percent annual rate in the second quarter, and may move into the white-hot zone of 5.0 percent, a rare occurrence seen in only three other quarters this century.

But before celebrating an economy off to the races, the likelihood is that this will be as good as it gets. True, the growth engine still has plenty of fuel, thanks to a robust job market and the added boost coming from lowered taxes and increased deficit spending. The odds that the expansion will be short-circuited by a recession this

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As Good As It Gets *Continued from front page*

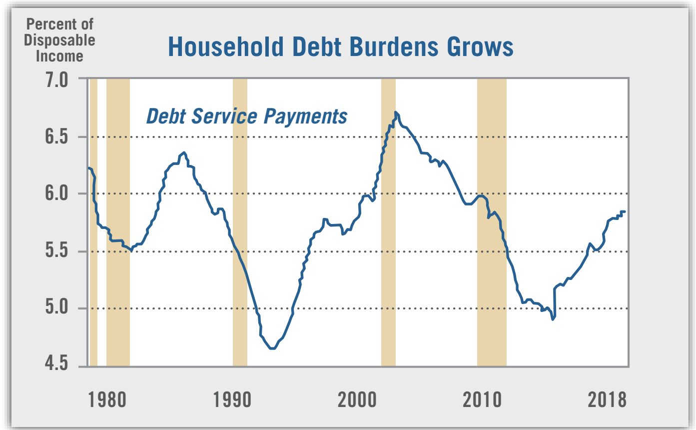
year is practically nil. A $20 trillion economy does not shift gears on the dime unless buffeted by a confidence-shattering external shock. As long as households are collecting paychecks instead of pink slips, they will have the wherewithal to sustain spending and feed the economy's growth engine.

Households Stretched

The second quarter's growth spurt should not be viewed as a template for the rest of the year. For one, household fundamentals do not justify the outsized boost from consumption that took place during the period. Personal incomes continue to grow with expanding payrolls, but the increase is not keeping up with the spending pace. As a result, households have financed some of their purchases by drawing on savings and simultaneously reduced the personal savings rate to precariously low levels. The overall rate dipped to 2.8 percent in April, one of only a small handful of times it fell below 3.0 percent during the recovery. It is the budget-strapped households on the lower end of the income ladder that are mostly forced to dip into rainy-day funds. These individuals are being squeezed by the rising costs of fuel and shelter and are prime candidates to cut back spending to replenish depleted savings.

More worrisome is that this population relies heavily on credit to support purchases and are more vulnerable to the rise in interest rates being engineered by the Federal Reserve. The strain may already be affecting their behavior, as consumers have sharply cut back their credit card borrowing this year. Through April, revolving credit, mainly credit card debt, has increased by an average of $1.5 billion a month, down from a $5 billion monthly average increase in 2017. The slowdown is highly understandable. Debt servicing charges on consumer credit increased considerably faster than incomes over the last three years. By the end of 2017, they accounted for 5.86 percent of disposable incomes, only a tad under the 6.0 percent that prevailed at the onset of the Great Recession.

Importantly, the interest rates charged on credit cards respond directly to changes in the Federal Reserve's short-term policy rate, usually with a lag of less than 60 days. Therefore, the debt-servicing ratio at the end of last year (the latest period available) does not reflect the three-quarter point rate hikes implemented in December, March, and June. With total revolving credit outstanding topping $1 trillion, a quarter-percentage point rate increase translates into roughly a $2.5 billion increase in monthly interest payments. Multiply that by three rate increases, and you would need to see a meaningful acceleration in income growth to compensate for the increased debt servicing charges. True, the tax reduction that took hold in



the first quarter boosted disposable incomes significantly. We suspect, however, that a big chunk of the tax savings was used to pay down credit card debt, which contributed to the sharp consumer spending slowdown.

Heightened Trade Anxiety

While workers are starting to see modestly stronger wage growth, so too is inflation picking up just as the positive contribution from the tax cuts are beginning to wane. Hence, households are not likely to enjoy a meaningful acceleration in purchasing power in coming months. The combination of low savings, high debt burdens, and modest income growth is a recipe for a slowdown in consumer spending from the torrid second-quarter pace.

Some of the slack should be taken up by business investment spending, which the Fed sees as a critical source propelling the economy forward. However, business leaders are already expressing concern over the administration's increasingly protectionist trade policy which is drawing stern reactions from our trading partners. There is little sign that the Trump administration is backing down. Instead, it is ramping up the bellicose trade rhetoric, particularly against China, with threats of increasing tariffs on virtually all of the $500 billion in Chinese imports.

More broadly, it is also threatening to pull out of NAFTA, the long-standing pact with Canada and Mexico that involves $1.1 trillion in trade and $840 billion of cross-border investments. This would not only disrupt supply chains of U.S. companies, but also push prices higher on goods for consumers and inputs for businesses. The uncertainty may prompt companies to rethink their investment decisions, a direct threat to growth.

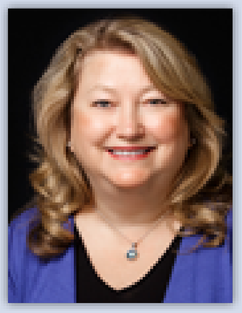
Markets React

Until recently, the financial markets have taken the trade spats in stride, as has the Federal Reserve. After the June policy meeting, Chairman Powell acknowledged the risk of a trade war, but said that so far it has not impacted economic data. The implication is that the Fed will continue on its rate-hiking course until some negative effects become visible. Given the economy's robust performance in the second quarter and rising inflation pressures, there is justification for that position. The central bank does not seem overly concerned with the potential growth-dampening impact of trade tensions; instead, it is more concerned with preventing the economy from overheating.

The impact of a trade war would be more pronounced if the second quarter marked peak growth for the economy and momentum slows in coming quarters. The risk is that the Fed would be tightening policy into a slowing economy, and the lagged effects of higher short-term interest rates would hasten the onset of a recession. Investors are forward looking, and the combined effect of a tightening policy and heightened trade tensions is starting to weigh on the financial markets. Stock prices, have become more volatile, and long-term interest rates are lagging behind the upward climb in short-term rates. That lag reflects many factors, including a flight to quality by investors into U.S. Treasury bonds seeking refuge from trade tensions. It is also a sign that bond investors see weaker growth ahead than does the Federal Reserve. Time will tell who is right, but we believe the spring surge in activity is about to cool off as the summer heats up. ■

When Seconds Count

Why it's important to name a contingent beneficiary



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I always recommend that you name at least two beneficiaries for your accounts, and it's particularly important for IRAs and retirement plans. Generally, IRA owners assume they can name their children or another contingent beneficiary at a later date if something happens to their spouse, but that is not always the case. Here are 10 reasons why you should always name at least two beneficiaries on your retirement accounts:

1. You will help your heirs minimize income taxes the same way you did. For many, their IRA and retirement accounts are some of their largest assets. If you work hard to maximize your contributions (and minimize your income taxes) through your retirement plan or IRA, you will also give your named heirs the ability to minimize income tax on those assets when they are eventually distributed.

2. Spreading IRA distributions over the beneficiary's lifetime saves money. It makes a significant difference in the income tax rate, the income taxes paid, and the remaining after-tax amount that your heirs eventually receive from your IRA. However, if a beneficiary is not designated on the IRA itself, the entire IRA may have to be distributed within a year or two after the owner's death, and IRA distributions are taxed as ordinary income. Also, your IRA's eventual beneficiaries may not be able to rollover or transfer the distribution from your IRA into another IRA unless they are listed on the beneficiary designation. The same rules apply for retirement plans like 401k and 403b accounts.

3. If you become incapacitated over time, you may lose the ability to add another beneficiary at a later date. Financial power of attorney documents generally do not, and should not, allow for another person to name a beneficiary for you on your IRA or retirement plan. This can become a problem as a person ages and may begin to experience cognitive decline.

4. Incapacity can be sudden and irrevocable, as in cases of health emergencies or accidents. In cases like these, you may not recover sufficiently to be competent enough to designate an additional beneficiary.

5. You and your primary beneficiary may be involved in a common accident. This would be another time when you may not be able to add another beneficiary.

6. You might inadvertently cause a costly administrative problem or family conflict after your death. Unless you review your beneficiary designations annually and upon all major life events, you may forget to update your beneficiary designation. A contingency beneficiary ensures your funds stay with a person of your choosing if the primary beneficiary is no longer alive.

7. A listed contingent beneficiary allows your primary beneficiary to disclaim all or a portion of his or her share of your IRA to the contingent beneficiary. Your contingent beneficiary would be able to spread out the distributions and taxation from your IRA over his or her lifetime.

8. Beneficiary designations take precedent over your will for your IRA and retirement plans. Listing your heirs in your will is not an effective way to designate people as beneficiaries of your retirement accounts. Your IRA may end up being distributed to your estate and your estate may end up paying income tax on the IRA distribution with just the after-tax proceeds being paid out to your children. The after-tax proceeds could be almost half of your IRA or retirement plan balance!

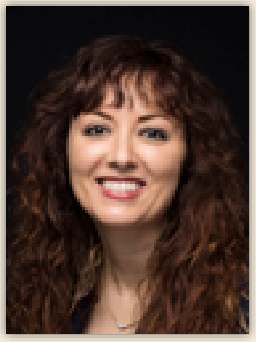
9. You can take the opportunity to also arrange for a trust or a Uniform Transfers to Minors (UTMA) if one or more of your beneficiaries are minors.

10. It's simple and easy to do. Generally, you must use the financial institution's beneficiary designation form and send the signed form to the financial organization for the designation to be effective.

Please note, designating two primary beneficiaries can work the same as having a contingent beneficiary. Remember to read the terms of the beneficiary designation to make sure that your designations will distribute your IRA or retirement funds in the manner you desire.

Legacy Team Spotlight

Meet Robyn Metko



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Robyn Metko joined Legacy in 2017 as a Client Representative. Prior to joining Legacy's team, Robyn worked extensively in the music and entertainment industry. She spent several years as a writer for a music business publication, a session singer and studio musician, a private lesson teacher, a promotions director, and the owner of her own entertainment marketing firm. She attended Lawrence University for vocal performance and the Berklee College of Music to become a music business specialist before earning her associate's degree in paralegal studies from Northeast Wisconsin Technical College.

Robyn's coworkers value her eagerness to fully grasp the reasoning behind every process and procedure. She asks intelligent questions and strives to develop a deeper understanding of how and why systems operate as they do. At Legacy, Robyn assists Marta O'Brien with trust administration and account management. Though relatively new to our team, Robyn uses her positive attitude to build strong, helpful relationships with her clients and coworkers.

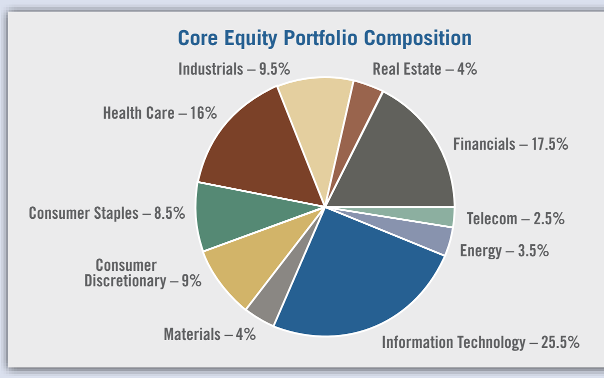
In her free time, Robyn is a classroom facilitator and mentor for Junior Achievement, a volunteer spokesperson who traveled to Washington D.C. to meet with lawmakers on behalf of the American Cancer Society, and a marathon runner who raises funds to benefit the Leukemia & Lymphoma Society. Robyn also enjoys knitting, oil pastels, yoga, and hiking, and visiting her family's farm in Readfield, Wisconsin, a town which Robyn affectionately says is home to more cows than people.

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 June 30, 2018.



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