LEGACY

ECONOMIC AND FINANCIAL DIGEST

A NEWSLETTER FOR LEGACY INVESTORS

October 2018

The Road Ahead Will Get Bumpier

The economy is closing in on the best year for growth in more than a decade, and household and business spirits are understandably upbeat. Workers have enjoyed 95 consecutive months of job growth, the longest stretch on record; wages are finally starting to rise at a faster clip; and personal finances continue to improve, with the savings rate at a healthy 6.7 percent. Not surprisingly, personal consumption staged the strongest increase in nearly four years during the second quarter, and the summer season appears to have fared nearly as well. Heading into the final quarter of the year, there is no reason to think that consumers will zip up their wallets. Because consumer spending accounts for 70 percent of total output, the year should finish on a solid note.

Likewise, the business community has benefited immensely from lower taxes, deregulation, and robust financial markets that provided companies with record amounts of capital at a relatively cheap cost. They have also rewarded shareholders profusely, returning a big chunk of their cash flow in the form of dividends and share buybacks. The virtuous circle of record profits, firm consumer demand, and recycled cash flow back to shareholders have underpinned the impressive run-up in stock prices. The result is one of the longest bull markets on record. All things considered, one could say that businesses and investors have never had it better.

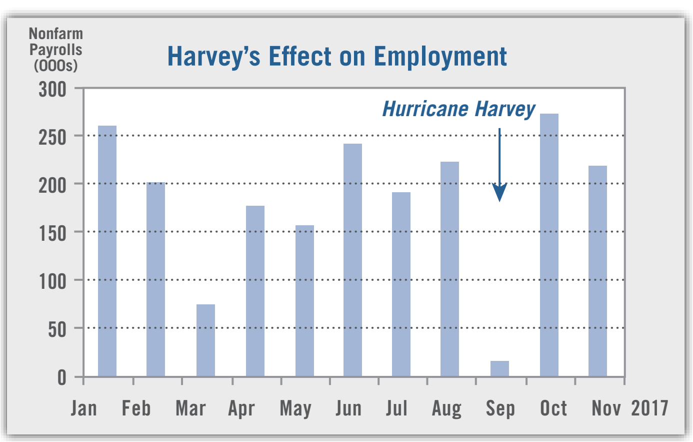
More than a handful of economists are attributing the Goldilocks moniker to the current environment, portraying an economy that is "just right"–not too hot, not too cold. It is hard to disagree, given an unemployment rate that is near the lowest since the 1960s and an inflation rate that is still historically tame. But just as trees don't grow to the skies, good times don't last forever. Make no mistake, a recession is not around the corner, barring some unforeseen shock or an egregious policy mistake by the Federal Reserve. But there is no question that the expansion, the second longest on record, is in its late stages and some signals that typically presage the endgame are starting to appear. It's not a question of whether, but when the next recession will occur.

Watch Out For Noise

During the late summer and early fall hurricane season, Mother Nature tends to have a big impact on the economy. This year is no exception. At press time, Hurricanes Florence and Michael have already destroyed lives and wealth. Like major storms that preceded them, including three devastating storms in 2017, normal activity is upended in the affected regions. Foot traffic at restaurants and department stores comes to a halt and sales are suppressed, workers can't get to their jobs and unemployment temporarily spikes, and output is lost when stores and factories are forced to close.

Past experience indicates that after a brief slowdown, activity will speed up for a while. Auto sales will get a temporary bump as households replace vehicles destroyed by storms. Post-hurricane rebuilding efforts will spur an increase in construction activity. In other words, the economic data are likely to be distorted over the next several months, making the tea leaves difficult to read and complicating the task of the Federal Reserve. Recall that the Fed hit the pause button in its tightening policy last September when activity slumped in the wake of Hurricane Harvey.

Hurricane Florence came too late to derail the Fed's rate increase this September. With other outside influences poised to muddy the economic waters, including escalating trade tensions with China and a potential debt crisis among emerging market economies, the future course of policy will be challenging. The Fed currently plans another rate hike in December, yet outside shocks or noisy data in coming months may prompt it to put things on hold.



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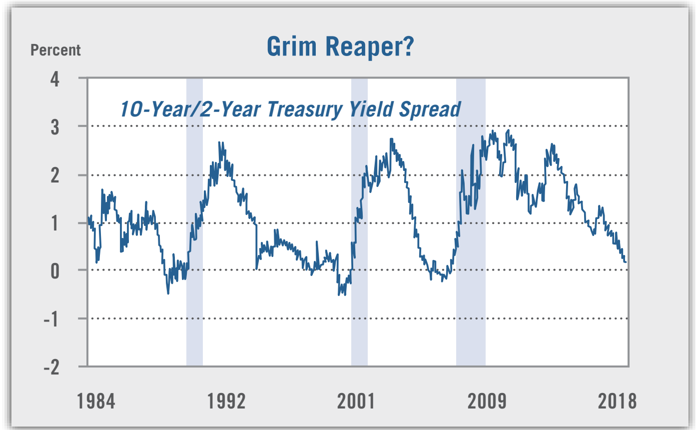
Recession Signal: Inverted Yield Curve

Assuming outside influences do not throw incoming data completely off-kilter, the stage should be set for another rate increase in December, the ninth since The Fed abandoned its post-recession zero rate policy in December 2015. The fundamental underpinnings driving growth remain solid. Job growth is outstripping the increase in the working age population, sending unemployment down to historically low levels. Wages are starting to pick up, with average hourly earnings in August rising at the fastest clip– 2.9 percent– in more than a decade. Rising labor costs combined with above-trend growth is putting upward pressure on prices.

Against this backdrop, the Fed is striving to bring short-term interest rates up to a neutral level, one that neither stimulates nor inhibits growth, hoping to sustain a balance of full employment and stable inflation. It currently sees that rate at just under 3 percent, so at the 2.00-2.25 percent range after the September increase, it is still about three quarter-point steps away from the target. Unless the economy falters, the bias among Fed officials will be slanted towards lifting rates three more times next year.

The problem is that the next increase may bring about a time-honored recession indicator, the dreaded yield- curve inversion, which occurs when short-term rates rise above long-term rates. Recently, the spread between 10-year and 2-year Treasury yields has narrowed significantly, as long-term rates have not increased as fast as the Fed-induced increases in short-term rates. Some, including several Fed officials, believe the yield curve is not as meaningful a recession indicator as in the past. They argue that special factors have been depressing long-term interest rates, including strong foreign demand for U.S. bonds, which offer higher yields and safety than available elsewhere; an unprecedented volume of purchases by central banks; and the reduced risk perceived by investors in tying up funds for longer periods. Hence, the mantra of these nonbelievers in the yield curve is that "this time is different." They may turn out to be correct. However, an inverted yield curve has been a precursor of past recessions, so it should not be dismissed as trivial.



How Will The Fed React?

If the yield curve inverts, there will be louder voices within the Fed to move more cautiously. The fear is that the central bank might repeat the mistakes of earlier cycles, when it moved too aggressively to stave off inflation and instead sent the economy into a recession. That's the message of an inverted yield curve, wherein bond investors accept lower long-term yields than they can obtain from short-term securities because they expect the economy to slow and inflation–and, hence, rates– to fall.

However, there is enough credibility behind the "this time is different" view that the Fed will not blindly change its policy course if a yield curve inversion occurs. Instead, it will monitor incoming data more closely as it pushes short-term rates up to a neutral level. The neutral level itself is not a fixed target; if the economy continues to grow strongly without stoking an upsurge in inflation when that target is reached, the Fed could decide that policy is still too accommodative and continue raising rates until growth slows.

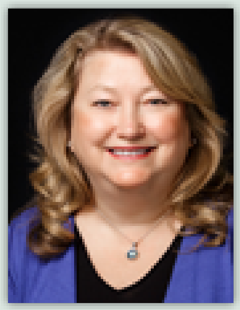
One attention-getting feature of the current expansion is that inflation has remained so tame even as the economy is near full employment and growing. Some believe the traditional relationships that have underpinned inflation in the past have broken down. For example, in previous expansions when the unemployment rate was as low as it is now, both wages and prices were rising at a faster pace. And while wages are picking up, there is some question as to how much power companies have to pass on higher labor costs to consumers in the form of higher prices. According to the latest survey of small businesses by the National Federation of Independent Business (NFIB) a record share of firms plans to increase labor compensation in coming months, but a much smaller share plans to increase prices.

The Ugly Effects of Tariffs

Rising labor costs are not the only threat to stoke inflation. On September 24, the U.S. imposed 10 percent tariffs on $200 billion of imports from China, just three months after the administration announced 25 percent duties on $50 billion of Chinese imports. If China retaliates, Trump threatens to expand tariffs on an additional $267 billion of goods, covering all

"Rather than focusing on having enough money to 'retire', consider having enough money to be 'financially independent' – to have enough money to do what you want, when you want, with whom you chose, at the pace you're comfortable with." *Mitch Anthony.*

Three Questions



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I talk to a lot of people about what they want to do with their lives. For those who are still working, it usually becomes a discussion of what they want to do when they retire. My friends, our clients, my family—people in their 40s, 50s and early 60s all want to know if they have enough money to retire. But whether or not you have enough assets to retire really depends on what you plan to do in retirement. Not surprisingly, everyone's vision for their retirement is unique; that is, assuming they've given it some thought.

I'm consistently surprised by how many people haven't seriously considered what they want to do with the rest of their lives. It's difficult to figure out whether you have enough money if you don't know what you want to do or what it will cost. Therefore, I've started asking my clients the following three questions:

1. *If money was no object, how would you live your life? Would you change anything? Let yourself brainstorm. What does your dream look like?*
2. *Now imagine that your doctor tells you that you have 5-10 years left to live. You will never feel sick, but will have no notice of the moment of your death. What will you do in the time you have remaining?*
3. *Lastly, imagine that your doctor tells you that you only have one day left to live. Ask yourself: What did I miss? Who did I not get to be? What did I not get to do? What do I regret?*

Give these questions some thought and write down your answers, and you will uncover what is really important to you, regardless of your age. Whether it's exploring a second career, spending your free time in meaningful ways, or planning your legacy, the answers to these questions can help you decide how you want to live the rest of your life. Then we can work with you to design a plan to use your assets and investments to support your goals and dreams.

Legacy offers financial planning services at no cost to our clients. When you are thinking about retiring, wondering if your money will last as long as you do, planning a large purchase, or are concerned about your estate plan being up to date, we can help you. Call your account administrator to get started.

imports from that country. Hence, U.S. households will soon face higher prices on a litany of common Chinese goods.

Businesses will also feel the impact, as the tariffs will be applied on a wide range of supplies and materials that are critical to the production of goods sold in the U.S. Since the U.S. production apparatus is not geared towards producing most goods imported from China, import substitution is not a readily available solution. U.S. companies will either have to absorb the higher cost of foreign-bought inputs and accept lower profits, or pass the tariffs on to consumers.

Consumers, of course, have many more options than businesses to shop for cheaper goods, thanks to the rapid growth of online commerce which greatly reduces the pricing power of companies. What's more, wage growth is barely outstripping inflation, so tariff-induced higher prices will eat into household purchasing power and restrict the volume of goods purchased. Hence, higher tariffs are likely to have more of a negative impact on output than inflation.

A trade war, which is now well underway, results in the worst of both possible worlds: it stokes higher inflation and lowers growth. Over the near-term, the economy's growth engine has enough fuel to overcome the growth-retarding protectionist measures of the administration. But with fiscal stimulus from tax cuts set to fade next year, moderation in global growth, rising inflation, and tightening monetary policy, the escalation of trade tensions adds an unwelcome threat to the expansion. Depending on how the financial markets– and the Federal Reserve– react to this growing threat, the endgame may come sooner rather than later. ■

Legacy Team Spotlight

Meet Angel Will

Angel Will,
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and Retention Coordinator
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Angel joined Legacy in June 2013 as a documentation security and retention coordinator. Prior to working at Legacy, she worked in circulation at the Neenah Public Library, as an educational assistant for the Neenah Joint School District, and a stay-at-home mom who actively volunteered at her children's schools. She started as part time, and has since expanded her hours and areas of expertise.

Angel was born and raised in Neenah, though she left the Fox Valley for several years after she married her husband, a now-retired member of the United States Air Force. Together they and their three children lived all over the country and globe, including Michigan, Florida, Idaho, and Germany. The couple's daughter Olivia, who works in communications and event planning at Legacy, was born in Germany. Outside of work, Angel enjoys walking her dog, scrapbooking, and visiting her children at college.

Angel's initial role at Legacy was to further organize, archive, and secure Legacy's long-term physical and electronic files to keep pace with industry best practices. She also completes special projects for the tax and operations departments and has learned the responsibilities of the front desk. Angel's co-workers appreciate that she learns quickly, is an eager team member, and excels at precise, detail-oriented work. "Legacy is just the right size," Angel said. "I like that I can interact with everyone here and understand so many different parts of what we do for our clients."

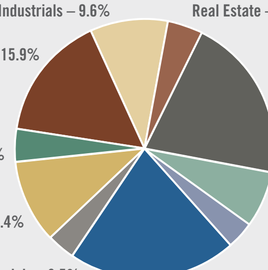
Featured Legacy Investment Portfolio

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 September 30, 2018.

Core Equity Portfolio Composition



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.

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