LEGACY

ECONOMIC AND FINANCIAL DIGEST

A NEWSLETTER FOR LEGACY INVESTORS

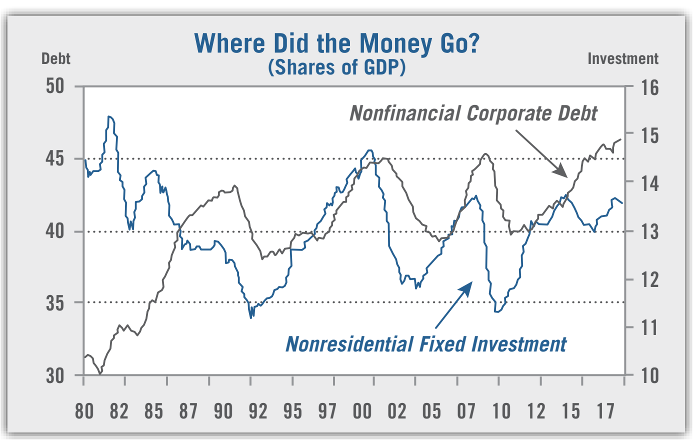
January 2019

# Bubble Bubble Toil and Trouble

There's an old adage that Wall Street likes to climb a wall of worry. In the first quarter of 2019, that wall keeps getting higher, resulting in one of the most tumultuous market environments in years. The question is, will that wall come tumbling down or pose a formidable barrier for the economy to surmount in the coming year? The expansion is getting long in the tooth and showing distinct signs of fatigue. A recent Duke University poll revealed that 50 percent of chief financial officers expect the economy to fall into a recession in 2019. That's more pessimistic than the view held by the majority of economists, but even they are upping the odds of a downturn this year. The latest poll puts the odds at over 20 percent, still low but up about five percentage points from a few months ago.

Paradoxically, the deepening sense of pessimism reflects a drumbeat of headline-grabbing "what-ifs" rather than what's actually happening. What if trade tensions with China escalate to the point of no return, resulting in onerous tariffs and other trade barriers? What if the Federal Reserve makes a policy mistake that cuts short the expansion? What if corporations ran up too much debt and households filled their portfolios with too many risky stocks, making them vulnerable to higher interest rates or a steep market correction? These and other questions battered investor psyches in the waning months of 2018 and start of 2019.

In reality, the economy resembles more of a Goldilocks environment than the bearish sentiment in corporate boardrooms and on trading floors. Following sturdy growth rates in the second and third quarters, the economy appears to have delivered another solid performance in the fourth quarter of 2019, punctuating the strongest growth for a full year since 2005. Meanwhile, inflation ended the year on a tame note, erasing fears that the tightening labor market would stoke wage and price increases. Sturdy growth, full employment, and tame inflation are not ingredients that would normally be associated with mounting pessimism. The question is, will the "what-ifs" that are spooking investors and corporate leaders come to pass?




### Fact Versus Fiction

The divergence between perception and reality is not something new. For about three years through mid-2017, consumer and business confidence surged even as their actual spending lagged. Throughout the period, the so-called "soft data" portrayed a substantially brighter picture of an economy that was slogging along at a lackluster two-percent pace. However, since that time, that gap has steadily closed. Economic growth accelerated and surveys of households and business sentiment have leveled off, although at high levels.

More recently, the trend lines have moved in the opposite direction. The economy has continued to forge ahead at a speedier pace than in earlier years of the recovery, but worries over global growth and rising trade tensions have taken a toll, particularly among large corporations whose fortunes are deeply tied to global developments. Consumers are still upbeat and spending accordingly, as evidenced by the recent strength in retail sales. But even that reality is being contradicted on Wall Street. Despite a festive holiday shopping season, retail stocks are on track to suffer their biggest losses in the fourth quarter since the financial crisis.

Wall Street is fretting over an array of potential trouble spots that underpinned a dramatic slide in stock prices in the final two months of 2018. Trade policy topped the list, but analysts that dig deeply into corporate balance sheets are finding some disturbing developments with potentially dire consequences. Most troublesome is the huge volume of debt that corporations have taken on during the expansion. Total non-financial corporate debt has grown by an impressive 58

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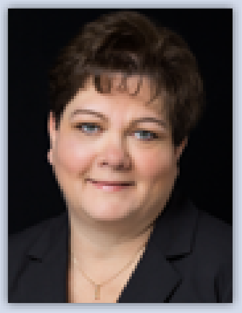
# Born Before 1954?

## Consider This Social Security Strategy



Rachel K. Wolf,
Trust Tax and Financial Planning Officer
920.967.5056
rwolf@lptrust.com

If you or your spouse were born <u>before</u> January 2, 1954, you may still be eligible to take advantage of the restricted application filing strategy for Social Security retirement benefits. The strategy is limited and expires at the end of 2019.

The strategy allows one spouse who has reached full retirement age (FRA) and who is eligible to collect retirement benefits on his or her own record, to collect only a spousal benefit while deferring collection of his or her own retirement benefit in order to accrue delayed retirement credits (DRCs). DRCs increase the deferring spouse's retirement benefits at a rate of 8% for each year of delay up to a maximum of four years. This allows the deferring spouse to not only draw current spousal benefits while increasing his or her own benefits through DRC, but also to increase survivor benefits for the long term.

**DO YOU MAY QUALIFY IF:**

- If you were born before January 2, 1954, and are at or older than your FRA.
- You have not filed for retirement benefits on your own record.
- Your spouse has filed for his or her own benefits.
- Only one spouse may file a restricted application.

**EXAMPLE 1:** Fred and Wilma are both at FRA (age 66) this year. Fred filed to receive his retirement benefit in the amount of $2,000/month. Wilma's benefit, if she filed now, would be $1,000/month, but she chooses to delay her own benefit until she reaches age 70, thereby taking full advantage of DRCs. Because Fred filed for his retirement benefit and Wilma is at FRA, Wilma is eligible to restrict her application to spousal benefit only and will receive $1,000/month (50% of Fred's benefit at age 66) while her own retirement benefit is accruing DRCs. Wilma's benefit with the DRCs at age 70 would then be $1,320/month.

**EXAMPLE 2:** Barney is 67 years old and has not filed for retirement benefits because he intends to file at age 70 to receive his full DRCs. Barney's wife, Betty, will be 63 this year. Betty just retired and files for retirement benefits on her own record. Barney's age 66 benefit would have been $2,000/month and Betty's would be $1,000/month. (Betty's retirement benefit will be reduced for filing prior to her FRA.) However, because Betty is filing on her own record and Barney is older than his FRA and has not filed on his own record, Barney is eligible to file a restricted application for spousal benefits based upon Betty's record. Barney will receive $500/month (50% of Betty's benefit at age 66) for the next three years until he attains age 70, at which time he will file for his own retirement benefit that has increased to $2,640/month because of his DRCs.

**PLEASE NOTE:**

- Beginning with the month you attain FRA, if you continue to work, your earnings do not reduce your benefit, no matter how much you earn.
- If you are divorced, you may qualify for this strategy but this article does not address the specific requirements for your circumstance.
- How to apply for a restricted application:
  - If you are applying in person at an SSA office and are told that this option is no longer available, you may need to speak with a supervisor. You can also make an appointment with your local SSA office if you want help to make a restricted application, or contact the SSA at 1-800-772-1213.
  - If you are applying online, you will be asked a series of questions about when you want your retirement benefits to start. Respond that you do not want your retirement benefits to begin with the month of filing, and that if eligible for both retirement and spousal benefits, that you wish to delay retirement benefits. In the comments portion of the application, you must type a statement informing the SSA that you are restricting your application to spousal benefits only. For example, "I am not applying for retirement benefits on my own record but wish to earn delayed retirement credits. I am filing a restricted application for spousal benefits only."

## Bubble, Bubble, Toil, and Trouble

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percent since 2010, reaching a record, both in nominal terms ($9.3 trillion) and as a share of GDP (45 percent). The outsize increase has been encouraged by an extremely easy monetary policy, the increased risk appetite of investors, and the desire to obtain higher yields on corporate bonds in a prevailing low-rate environment.

### A Corporate Debt Bubble

The favorable backdrop encouraging the debt buildup is in the process of reversing. Monetary policy is tightening, interest rates are rising, and investors are becoming more discerning, as evidenced by the recent sharp widening of yield spreads between lower and higher-rated bonds. If profits sag under the weight of a growth slowdown and rising cost pressures, debt-servicing issues will become a problem for a growing swath of borrowers.

What's worse, the proceeds from borrowing have been mostly channeled into nonproductive uses, namely to finance mergers and acquisitions, stock buybacks, and dividend payments to shareholders. Normally corporations turn to the capital markets to finance capital spending, something that lifts productivity and enhances the long-run growth prospects for the economy. But business investment spending never exceeded the 13.7 percent share of GDP reached four years ago, and is not likely to do so in the near future.

Many analysts are increasingly concerned about the financial health of the business sector and its vulnerability to rising interest rates. They fear that a corporate debt bubble has emerged and could be the catalyst for the next recession. Recall the catalysts of the last two recessions were the bursting of the dot.com bubble in 2000 and the collapse of the speculative housing bubble in 2007. In fact, the Federal Reserve in its first-ever Financial Stability Report, highlighted worries about the elevated level of corporate debt, with special focus on the rapid growth of leveraged loans.

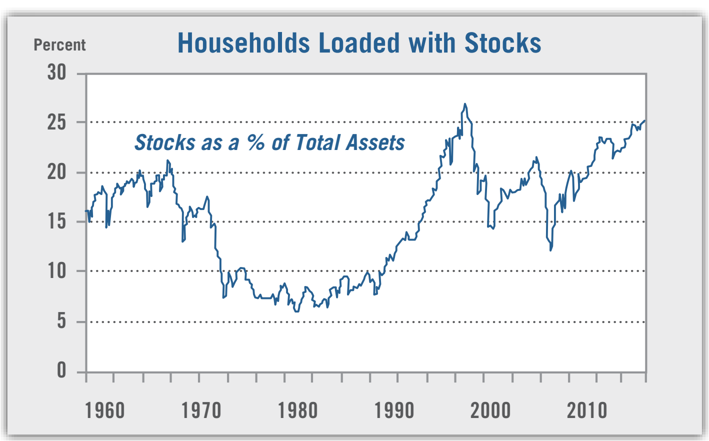
## Household Vulnerability

Even as corporations have built up enormous amounts of debt, households have enjoyed astonishing asset appreciation since the end of the recession. Equity holdings have accounted for 40 percent of the increase, thanks to the surge in stock prices, and they now account for 25.2 percent of total household assets, only a tad below the 27 percent record high seen at the height of the dot.com bubble in 2000. The good news for the economy is that when households feel wealthier they tend to spend more. The potential bad news is that the outsize share of stocks on household balance sheets leaves them more vulnerable to market correction. The 14 percent tumble in stock prices from early October to mid-December wiped out about $4 trillion of equity wealth. The period is probably too short to have a meaningful near-term impact on consumption, but if the wealth destruction is not recovered over the next six months or so, households will feel poorer and likely pull in their horns.

There's some evidence that the negative reaction to a market downturn is greater than the positive reaction to a market upturn, reflecting the notion that people derive more pain from a loss than enjoyment from a gain. Time and the direction of stock prices will determine if that is the case in this cycle. The more important trends to watch are the fundamental underpinnings that move the markets. Our sense is that investors are sounding a more pessimistic note than is warranted by actual and prospective events.

## Contained Risks

The expansion, now in its tenth year, could become the longest on record if it lasts through the middle of 2019. However, as economists are quick to note, expansions do not die of old age, but rather by some external event or a policy mistake. The bursting of a corporate debt bubble would certainly qualify as such an event. But unlike the mortgage-related bust that ushered in the financial crisis and Great Recession, the corporate debt build-up is not nearly as dire. For one, corporate balance sheets are in relatively good shape, as assets have increased faster than liabilities since 2008 and include a sizeable liquidity buffer available to repay short-term debt. For another, profits are still growing and bolstering cash flow to service debts, although the gain this year is expected to be smaller than 2018.




Likewise, household balance sheets may have taken a hit from the recent slide in stock prices, but the damage to the economy would be greater if the wealth destruction occurred alongside weak job and income prospects. That's not the case now, as the labor market remains strong and wage growth is picking up. Like corporations, households also have a sizeable cushion of savings to insulate them from a temporary setback in their stock portfolios. Thus far, the setback has not made a meaningful dent in consumer confidence, which remains near an all-time high. The risk is that a sustained market correction might undermine household confidence and cause a spending pullback that would morph into the self-fulfilling recession feared by investors.

Perhaps the biggest concern, amplified by President Trump, is that the Federal Reserve will misjudge the strength of the economy and push interest rates up too far. That's a nontrivial risk, as the Fed has a poor forecasting record and its rate hikes have tipped the economy into 7 of the last 10 recessions. Despite Trump's criticisms, the central bank has moved much more gradually in this cycle than in past ones. Following the latest quarter-point increase, the Fed raised rates nine times over the past three years for a sum total of 2.25 percentage points. By contrast, in the two-year 2004-2006 cycle, the Fed lifted rates 17 times, for a cumulative rise of 4.25 percentage points. At the December policy meeting, the Fed scaled back the number of increases expected in 2019 from three to two in recognition of slower prospective growth and still-tame inflation, and it seems ready to ease back further if justified by incoming data. That doesn't sound like a Fed about to make a policy mistake. ■

# Legacy Team Spotlight

Susan M. Hickey,
Vice President, Senior Relationship Manager
262.468.7614
shickey@lptrust.com

## Meet Susan Hickey

Susan Hickey joined the Oconomowoc office of Legacy Private Trust Company in October 2018 as vice president and senior relationship manager. She has more than 25 years of trust and financial planning experience, most recently with Johnson Financial Group. Susan is a graduate of Marquette University, where she earned a bachelor's degree in liberal arts, and a graduate of Cannon Trust School where she earned her Certified Trust and Financial Advisor (CTFA) designation. Susan is a sought-after speaker on issues of estate and financial planning and is past-president of the Milwaukee Estate Planning Forum, where she remains an active member.

Outside of work, Susan a current board member for both the Saint Joan Antida High School and The Neighborhood House of Milwaukee. She is a former board chairperson for the Women's Fund of Greater Milwaukee and a member of Impact 100 Milwaukee. She also enjoys spending time with her family, running, reading, and traveling.

At Legacy, Susan is responsible for managing large family and individual relationships in the Greater Milwaukee and Waukesha area. She works with both internal and external professional partners to assist clients in estate, financial, and business succession planning. Susan enjoys working at Legacy because of the firm's strong focus on trusts and investments rather than banking services, and because she has qualified and committed coworkers.

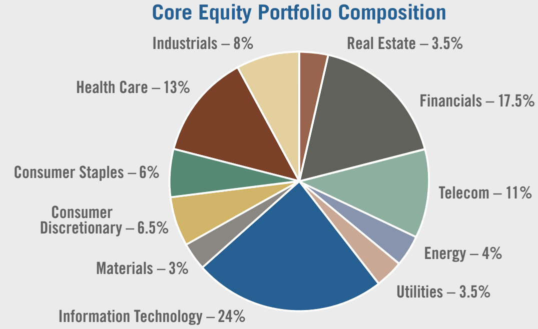
# Featured Legacy Investment Portfolio

## 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 December 31, 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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Two Neenah Center, Suite 501, Neenah, WI 54956 | 35303 Pabst Road, Oconomowoc, WI 53066
920-967-5020 or 866-811-1500