LEGACY

ECONOMIC AND FINANCIAL DIGEST

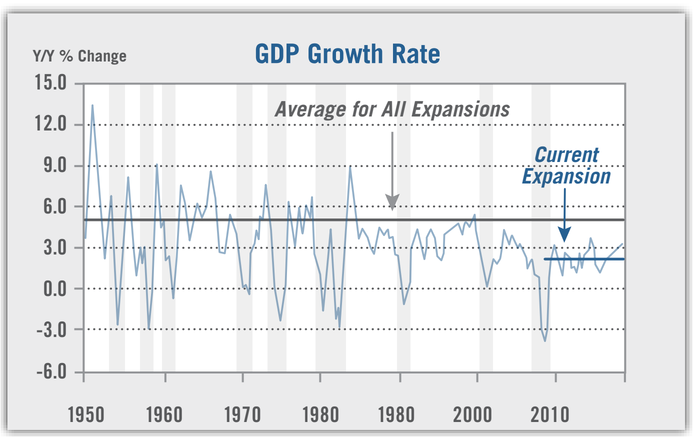
A NEWSLETTER FOR LEGACY INVESTORS

April 2019

Back to the Future: 2% Growth

As advertised, the brutal headwinds that buffeted the U.S. economy late last year are having knock-on effects in the early months of 2019. The economy's performance in the closing quarter of 2018 did not look bad at all as GDP advanced by a respectable 2.6 percent annual rate, according to the government's preliminary estimate That capped a full-year growth rate of 2.9 percent, which ties for the fastest pace since 2005. But the year ended on a downbeat amid escalating trade tensions; the start of a 35-day government shutdown; a debilitating plunge in stock prices that wiped out nearly $4 trillion in household net worth; and rising interest rates, fueled by fears that the Federal Reserve was tightening policy too aggressively.

Those headwinds took a severe toll on activity in the final month of 2018, highlighted by a sharp drop in consumer spending and a plunge in factory output. As a result, the economy had to climb out of a deep hole to start the new year even as it struggled to overcome the government shutdown, which didn't end until the final week of January. Not surprisingly, the first quarter tracked a lackluster path, with growth hovering under 1 percent. By any yardstick, that is perilously close to stall speed. An increasing number of economists, including the Federal Reserve, are marking down their growth outlook for the year and the financial markets in late March priced in a 40 percent chance that the Fed's next move will be to cut rates, more than double the odds of a month earlier.



Just as the fourth quarter ended on a weaker note, the first quarter should provide a stronger hand-off to the summer months. Amid the darker clouds overhanging the economy earlier in the year, some promising signs were already shining through. Consumers reopened their wallets and purses in January; workers received fatter paychecks; negotiations with China showed promise of a deal, easing trade tensions; and the late-year spike in interest rates was entirely erased, brightening prospects for home sales. A lethargic winter should be followed by a spring bounce–but don't expect another year of growth like 2018.

Rosy Outlook

In its latest economic projections released with the new budget for fiscal year 2020, the Trump administration expects the economy to at least match last year's stellar performance, pegging a growth rate of about 3 percent over the next five years and even stronger both this year and next. Most economists, however, scoff at that rosy outlook, noting that the economy just doesn't have the structural capacity to meet that rate of growth. Both the Federal Reserve and the Congressional Budget Office expect growth this year to wind up closer to 2 percent and stay there over the next five years.

We concur with that more modest outlook, which is consistent with the downshift in the economy's growth potential. Over the 10 previous postwar expansions, the economy grew on average 5 percent a year. But the average pace slowed over the last three upturns – to 3.6 percent in the 1990s and to 2.8 percent during the 2001-2007 expansion. The current upturn, set to become the longest on record, has also been the weakest in the postwar era, averaging a 2.2 percent growth rate over its nearly 10-year span.

No doubt, the Great Recession's broad and devastating impact had lingering effects that contributed to the current expansion's relatively weak performance. But those effects dissipated years ago, as unemployment steadily fell, the financial system returned to health, corporate profits roared ahead, and the astonishing rally in stock prices and housing

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Back to the Future: 2% Growth

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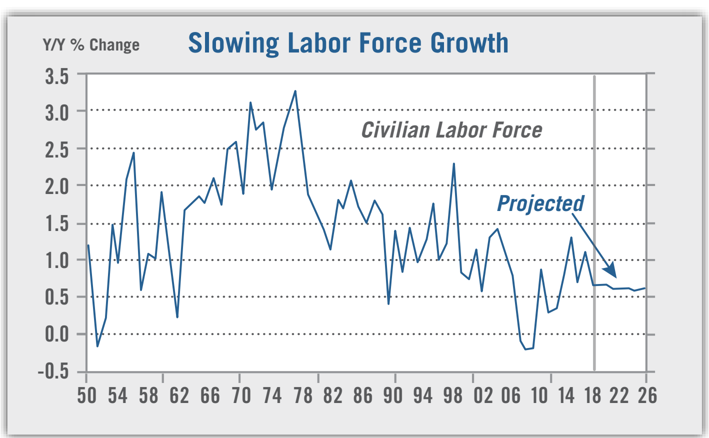
values restored household wealth. By the start of 2015, consumer confidence had returned to prerecession levels and has continued to climb. After spiking to above 4 percent in the second quarter of 2018, the economy's growth rate receded to 3.4 percent and 2.6 percent over the next two quarters and, as noted, slowed considerably further in the first quarter of this year.

Lack of Specifics

The administration, of course, is undaunted by the slowing trend and believes that the economy can sustain the 3 percent growth rate established in 2018 over the foreseeable future. Unfortunately, the assumptions in the budget document provide few specifics on how that goal would be achieved. The only explanation given for the administration's above-consensus economic forecast is that it assumes the policies put in place and the proposals made in the budget will lift the long-run output potential of the economy. It goes on to say that "…other forecasters are unlikely to be operating under the same assumptions."

More than likely, those policies, particularly the Tax Cut and Jobs Act enacted in late 2017 and the budget-spending bill passed in early 2018, provided a temporary sugar high that juiced the economy's growth rate in 2018. It is hard to see how the proposals in the new budget, which includes nondefense spending cuts, would sustain that improvement or increase the output potential of the U.S. economy.

Keep in mind that the reasons causing the nation's lowered growth potential are not easily reversible. For one, the population is aging and spurring an ever-rising tide of retiring baby boomers, which is restraining labor force growth. True, older workers are staying on the job longer than in earlier decades, but that is only slowing the inevitable decline in the labor force participation rate, not reversing it. For another, productivity growth has declined significantly in recent decades, and it is unclear if or how it can return to its earlier pace. With the labor force growing around 0.5 percent a year and productivity at 1.5 percent, the administration would have to provide more compelling evidence that the economy can sustain growth above 2.0 percent.



Not Stall Speed

It is also necessary to view a 2 percent growth rate in a different light than in the past. Throughout most of the postwar period, the economy's growth potential was considerably higher, ranging between 3 and 4 percent. Following the Second World War, the labor force expanded briskly as soldiers returned to civilian life seeking jobs, and their services were eagerly sought after by companies facing a huge pent-up demand for goods and services. In the 1960s and 1970s, growth in the labor force was fueled by the surging postwar birth rate and the influx of women into the workforce.

From 1949 through the 1980s, the labor force increased by an annual rate of just under 2 percent, a period that included seven recessions. Growth slowed to 1.2 percent in the 1990s and to 0.8 percent since the turn of the century. The Labor Department expects the labor force to continue slowing to a 0.6 percent growth rate through 2026. Simply put, the slower growth in the labor force alone has sliced the economy's potential growth rate by more than a full percentage point compared to earlier decades.

That largely explains why the majority of economists believe 2 percent growth is the "new normal" for the U.S. economy. In the past, that would have been referred to a stall speed, a pace that is so slow that any adverse event would tip the economy over into a recession. Indeed, in every postwar cycle when the annual growth slipped to that threshold for more than a quarter, a recession soon followed. Soft landings are historically rare occurrences.

Meet Sarah Brown

Sarah Brown,
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Legacy Team Spotlight

Sarah Brown joined Legacy in 2012 as a trust support services assistant. As a member of Legacy's trust operations department, Sarah works closely with her team to efficiently process daily operations tasks. Sarah also assists Ranee Bahn, Legacy's audit and compliance officer, to gather information and review reports that require intense attention to detail. Sarah earned her associate's degree in the administrative assistant program at Fox Valley Technical College.

Outside of work, Sarah is very active, and spends much of her time outdoors. She loves to travel, hike, and spend time with her three children. Her youngest son is a hockey player, and Sarah goes to every game. Sarah also loves live music and enjoys attending concerts.

At Legacy, Sarah has many different responsibilities ranging from daily operations to client tech support for our online portal and some receptionist duties. At Legacy, we appreciate her outgoing nature and the service that she provides to our clients and visitors.

Slow But Steady

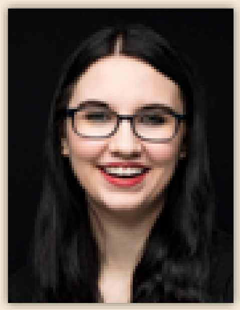
This pattern was broken during the current expansion, as the annual growth rate slipped below 2.0 percent in 16 of the 37 quarters since the recession. Yet one of the outstanding features of the upturn, besides its lackluster pace, is that it has been the least volatile of the postwar cycles. The standard deviation, a common measure used to quantify the amount of variation in a series, shows that volatility in the current expansion has been a third lower than the average of previous postwar cycles. Slow and steady growth has extended the life of the expansion.

However, the slower an economy grows, the more vulnerable it is to external shock, which is why economists place more than trivial odds that a recession will take place within the next year or two. And it is not hard to find potential sources that could tip the economy into a downturn. While reports of progress on trade negotiations with China are hopeful, nothing concrete has yet emerged and an outright trade war could still erupt. Global growth slowed significantly in the second half of last year; if the struggles of overseas economies worsen, the U.S. would feel the pain through lower exports and corporate profits. On the home front, lawmakers will be confronting a debt-ceiling battle later this year, which raises the prospect of another confidence-shattering government shutdown.

These and other unforeseen developments could trigger a recession sooner than later. But the economy has absorbed several shocks during the expansion–a sovereign debt crisis, a plunge in oil prices, and two government shutdowns–which have not derailed the expansion even as it barely maintained a 2 percent growth rate. A key reason for this resilience is that the main culprit behind previous recessions, excessive policy tightening, has been absent this time. The Fed has been accommodative throughout the expansion, increasing rates only gradually from the emergency-era zero bound as the expansion matured.

Of the eight rate increases since December 2015, four came last year as the fiscal stimulus gave a temporary jolt to growth. With that stimulus fading, inflation remaining bottled up, and growth slowing back towards 2 percent, the Fed put rate hikes on hold at levels that are far below the peaks that prevailed prior to past recessions. At the March 19-20 policy meeting, the majority of Fed officials signaled that they might not raise rates at all this year. As long as this economic and policy backdrop remains in effect, there is every reason to believe that the expansion still has a way to go, even at the new normal growth rate of 2 percent. Should the administration's above-trend growth forecast for this year come to pass, the risk of excessive policy tightening would increase, as would the odds of a more imminent recession. ■

Social Media Safety



Olivia Will,
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Social media is a great tool for individuals and businesses, offering ways to connect with family, friends and customers. However, social media platforms also have some drawbacks. Almost two-thirds of social media-using adults in the U.S. report their accounts have been hacked. These attacks put users at risk of having personal information stolen and used maliciously.

Although most social media sites are making improvements to their security systems, there are still some personal measures you can take to protect yourself:

1. *Keep your security software up-to-date. Make sure your web browsers and device operating systems are running the latest versions to help make you less susceptible to viruses and malware.*
2. *Update your privacy settings. Many social media sites have optional settings to help protect your privacy. These optional settings offer strengthened protections over default settings.*
3. *Use strong and unique passwords. Passwords should include more than one word. It helps to use a phrase that is easy to remember. You should also include numbers and symbols. Always use a different password for each social media account.*
4. *Know your connections and friends. If you do not recognize the requester when you receive a request to connect, it is not a good idea to accept. Avoid connecting with strangers and impersonators.*
5. *Beware of links. If you do not trust the sender or the source of the link, delete it. Clicking unsafe links makes you vulnerable to scams, viruses,and ransomware.*
6. *View your profile from a different perspective. To verify that your privacy settings are achieving your desired results, try looking at your profile as an outsider. Logging out and searching for yourself can help determine what other people are able to view. It may also allow you to discover if there are any false accounts made in your name.*
7. *Limit sharing of personal information. Your personal information can be collected and used for malicious purposes. Post only what is necessary.*

There is no surefire way to completely shield yourself from the risks of social media, but these tips can help.

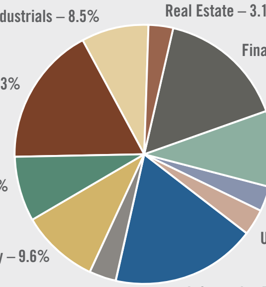
Featured Legacy Investment Portfolio

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, 2019.

Core Equity Portfolio Composition



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