GREENLEAF TRUST

Perspectives

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William D. Johnston
Chairman, Greenleaf Trust

Economic Commentary

Fed Chair Yellen recently said "moving too quickly risks over adjusting policy to head off projected developments that may never come to pass." On the other hand, "without further modest increases in federal funds rates over time, there is a risk that the labor market would eventually become overheated, potentially creating an inflationary problem down the road that might be difficult to overcome without triggering a recession." This statement, I think, accurately defines the Federal Reserve system of governing, as well as the life of the Fed chairperson. It is precisely the balancing act of keeping interest rates low enough to spur economic growth while yet not so low that the growth in activity creates an inflationary cycle.

It is often said that the Federal Reserve Board maintains a desired inflation goal of 2% and uses that goal as an indicator of either tightening rates when the goal is achieved or easing rates when inflation falls stubbornly and consistently below the goal. Let's look at recent economic data to understand, perhaps, what the Fed is seeing and why rates aren't likely to rise very soon.

REAL GDP

The third revision of Q2 data increased the 2nd quarter estimate to + 3.1% from its previously revised estimate of 2.6%. This revision immediately had more than a few analysts suggesting that the Fed would begin a much more aggressive tightening schedule, yet the entire bandwidth of data that analyzes the condition of the economy suggests otherwise.

PERSONAL INCOME / WAGES

For the month, personal income rose 0.2% and annualized YTD at 2.8%. Wages and salaries were essentially flat and maintained the YTD average of +2.7%, while personal spending actually declined after adjusting for inflation. If the current 4.3% unemployment rate suggests to many the existence of a tight labor market, it isn't, as yet, evidenced by wage rates advancing in excess of inflation.

INFLATION

The Federal Reserve monitors the PCE Index as its inflationary benchmark. For the most recent period the index increased 0.2% and year over year rose 1.4%. When adjusted for food and energy the index increase

Commentary, continued

was nearly flat, and its year over year advance was 1.1%, well short of the Fed's goal of 2%.

CONSUMER CONFIDENCE

There are two major surveys of consumer confidence that are relied upon by economists. Each has different methodologies to collect and report data, but both are seeking the same answers to how the consumer feels about the forward period of time. The question is important and relevant, because consumer spending equates to about 70% of GDP activity, and therefore growth. So what is the consumer telling us? Both the Conference Board and University of Michigan survey declined slightly in the estimates for September. It is important to note that these slight declines do not change the overall levels of both surveys, which are at very positive levels. In other words, the slight declines are just that, slight, and the resulting composite levels suggest a fully confident consumer. Given the significant hurricane activity in the southeast impacting about 20% of our country's population, as well as the rise in geopolitical tensions with North Korea, it is not surprising to see some small reduction in confidence among consumers.

NEW AND EXISTING HOME SALES

Demand remains high across the four regions measured in the index of sales in both categories. It is the supply of homes in each category that has diminished the results in each.

MANUFACTURING / ORDERS

Both durable and non-durable goods orders rose for the month as did inventories. It is good to see consistent months of growth in the durable goods sector reflecting increased spending by business, yet the growth in inventories may be an indicator that the slight erosion in consumer confidence is actually being felt at the retail level.

"We are getting a bit more detail on the potential Republican tax proposal. In general the new level of detail, although far from transparent, suggests that the concept is to broaden the base and lower the rate."

We are getting a bit more detail on the potential Republican tax proposal. In general the new level of detail, although far from transparent, suggests that the concept is to broaden the base and lower the rate. The philosophy is present on both the personal as well as corporate side. From the very beginning of income tax history in our country — briefly during the civil war then more permanently in the 1900s and affirmed by the 16th amendment in 1913 — we have complicated the tax structure. The extent of the complications has made meaningful reform and policy realignment nearly impossible.

We do have the highest corporate rate among G20 countries, that is a factual statement, and many corporations pay the full 35% corporate income tax. Many others, however, pay far less due to available deductions that are earned due to specific tax code insertions that allow for those specific expenses to be deducted against earned income. Some have suggested that the average corporate tax payment in 2015 was 18%, and thus there may not be a great appetite among business to reduce the rate while also eliminating existing deductions.

Reducing the current five tax rate categories to three may appear to lower the rates for the remaining three tax rate categories, but eliminating the deduction for state and local income taxes will be a tax increase averaging about 4.5% for citizens in all but 11 states in our country. The largest concentration of the population resides in the states with the highest state income tax rates. I wonder how well congressional representatives will be received in New York, New Jersey and California when residents in those states, who have been deducting their 11%+ state income tax from their federal income tax returns, now face the prospects of being unable to do so. On both the corporate and personal levels our current tax structure is an evolution of over 117 years, many administrations and revisions, most of which have been constructed to appeal to some specific lobby or political philosophy. To unwind any one of those preference items will be complicated and difficult to do.

What can be said with accuracy is that we have, over time, become more heavily dependent upon individual taxpayers and less dependent upon corporate tax receipts, while simultaneously reducing the numbers of income earners paying any taxes at all. Less than 20% of all tax receipts are from corporations and the balance are from individuals and nearly 84% of all personal Federal income taxes are being paid by 20% of the population. These ratios can't continue to succeed into the future. The solution to reform is comprehensive, complicated and certain to offend many. As I have suggested before, a great barometer of how good the tax reform is will be the breadth and width of those that complain about its substance.

There have been several times in my career when I have been compelled to offer thoughts on tragedies that rock our world. Man's inhumanity to man has become too common to deny. It is also insane to deny that the increase in mass shootings within our country is not real. When viewed in comparison to all other developed countries we stand in the unenviable position of having the greatest number of mass shootings. The answers are not easy, yet what we have been doing isn't working on many levels. To continue to travel the same path seems certain to assure more of the same, which is somewhat akin to the definition of insanity. We have to be able to do better.

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Who Is on Your Team?

George F. Bearup
Senior Trust Advisor

In the midst of football season a weekend does not seem to pass where a player who is interviewed does not attribute his success on the field to his teammates who work together to achieve a common goal. At Greenleaf Trust we frequently talk about working as a team with other advisors for our mutual client's benefit. But often is the case when our clients have assembled yet another team on their own, which either have been formally named as their fiduciaries or named individuals who have some control over the client's assets or their personal affairs. While it is important for a client's professional advisors to coordinate their activities and to work cooperatively with one another, it is equally important for a client to consider whether their named fiduciaries and the other 'team' members they may have inadvertently named over the years will be able to work in conjunction with one another to carry out their assigned responsibilities and efficiently share authority.

> "…there are other advisors or decision-makers that an individual may also name over the years …who control either the individual's assets or who must coordinate their delegated authority with the more commonly identified fiduciaries."

An individual's named fiduciaries are fairly obvious: Agents who act under a durable power of attorney, Personal Representatives who administer a deceased individual's probate estate and implements the directions contained in their Will, or the Trustee of an individual's Trust quickly come to mind. But there are other advisors or decision-makers that an individual may also name over the years who are sometimes overlooked, but who control either the individual's assets or who must coordinate their delegated authority with the more commonly identified fiduciaries. The assembled 'team' of decision-makers may be larger than is originally thought to be the case.

Consider the following examples where conflicting authority among or between 'team' members might arise:

- A 'signer' is named on an individual's safe deposit box, or the box is held jointly with another. The box holds valuable tangible personal property, e.g. a valuable coin collection or jewelry. Who controls those items on the box owner's death? The signer on the box who is presumed to have exclusive access to the items and who may be deemed the owner of the box contents. How does the Personal Representative of the box owner's probate estate, who must compile an inventory of the decedent's assets and carry out the directives in the decedent's Will ('Upon my death the personal representative of my estate shall distribute all of my tangible personal property wherever it is located to the following individuals…') deal with the valuable items held in the box? What if the joint owner named on the box solely 'for convenience only' purposes, claims full title to the box's contents as the surviving joint owner on the box owner's death?

- A Funeral Representative is named under Michigan's new statute that makes the Funeral Representative a fiduciary. That Representative incurs expenses for the decedent's funeral and burial arrangements. But the Personal Representative charged with paying the decedent's final expenses balks at paying those funeral bills incurred by the Funeral Representative, claiming those funeral expenses are either extravagant or a needless dissipation of the decedent's estate that the Personal Representative is required to preserve. Who pays the funeral bill and in what amount?
- A social security 'Representative Payee' is named on the Social Security Administration's form that is authorized to receive the recipient's social security monthly check. Another individual is named to act as the recipient's Agent under their durable power of attorney. The Agent needs access to those social security benefits in order to pay the disabled recipient's monthly expenses, but the Representative Payee refuses to turn over the funds. Who wins that battle between the fiduciary and the ancillary 'team' member?
- A long-term care contract holder names a 'Lapsed Policy Designee' to receive notice of non-payment of the long-term care contract premium if the contract holder later becomes incapacitated when another premium payment comes due. Yet another individual is named Agent under the contract holder's durable power of attorney and who is authorized to pay all of the disabled contract holder's bills. What happens when the Lapsed Policy Designee receives notice of premium nonpayment and fails to timely report that fact to the Agent? Who is liable when the long term care policy lapses and the contract holder later needs long term care?
- A Patient Advocate is named under a durable power of attorney for health care that makes the decision to incur an elective and expensive medical procedure for the patient that is not covered by Medicare. Another individual is named as Agent under the patient's durable power of attorney for financial decision-making. The Agent objects to paying for the expensive elective medical procedure. Whose authority controls?
- A successor account owner is named under an individual's 529 higher education expense account purchased for their grandchild. That designated successor account owner is not named as the Agent under the account owner's durable power of attorney. Funds are now needed by the Agent to pay for the disabled account owner's assisted living expenses. The designated successor 529 account owner, as the only individual who can access the funds, refuses to withdraw the funds from the 529 account. Must the Agent go to court to compel access to the 529 account funds?

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Who Is on Your Team?, continued

- A child is named as a joint bank account owner with their parent. Other family members are told that the child's name was added to the account 'for convenience purposes.' The parent names another individual to act as their Agent under their durable power of attorney. The Agent needs access to the joint bank account funds to pay the parent's bills, yet the joint account balance is withdrawn by the joint owner child before the Agent can access the account. Does the Agent get the money back from the child?
- An Agent who is appointed under a durable power of attorney is not the same individual who is named as the Successor Trustee of a Trust to which the settlor has transferred all of his or her assets. There is an overlapping delegation of responsibilities assigned to both the Agent and to the Successor Trustee under their respective fiduciary instruments. It is impossible to ascertain which of the two fiduciaries' shared authority prevails in a dispute over managing the settlor's assets. What if the durable power of attorney gives to the Agent the right to terminate the settlor's trust?

"The last thing an individual and his or her fiduciaries want is confusion as to who has final authority to make decisions, or who controls assets, or what assets can be accessed to pay the individual's bills..."

There can also be revocations of designated fiduciaries of which individuals may not even be aware. Some banks require their customers to sign limited durable powers of attorney on the bank's preprinted form which has the effect of limiting, or replacing, the individual's designated Agent made in an earlier durable power of attorney. Or loan documents required by lending institutions include a loan covenant that limits the authority previously given to the borrower's Agent. Many partnership or operating agreements that are signed in connection with the owner holding a membership interest in a limited liability company (LLC) contain provisions that either override the member's earlier delegation of authority to an Agent, or which sometimes gives to the LLC manager the legal authority which has the effect of replacing the Agent with regard to either voting that membership interest or controlling the cash distributions associated with that membership interest. In short, there are instances where a fiduciary that originally possessed the authority to handle or manage an individual's assets or business interest is dispossessed of that authority. These 'replacement' provisions frequently are found in business and loan documents that are either overlooked, i.e. the fine print at the back of the document, or they are forgotten over time, but they nonetheless disrupt or cause confusion to the individual's 'team' of fiduciaries.

The point is that an individual assembles their own 'team' over a period of years in multiple legal documents and contracts to manage many of their business or financial interests or to make personal decisions and to incur expenses on their behalf. This 'team' may hold authority that frequently conflicts with the authority given to the fiduciaries that are named in more formal estate planning documents. The last thing an individual and his or her fiduciaries want is confusion as to who has final authority to make decisions, or who controls assets, or what assets can be accessed to pay the individual's bills, or the expensive and protracted litigation will be required to resolve disputed grants of authority and access to assets and bank accounts. Thought needs to be given to who is named as a 'team' member, what role they are expected to play in the management of an individual's financial affairs, and what authority each 'team' member should hold. Naming 'team' players who do not get along with each other to these various roles or positions surely will invite needless conflict, cause delay in managing assets and paying bills, and increase the expenses associated with the administration of an individual's business or financial affairs. Do you know who is on your 'team?' Have you inadvertently named a 'team of rivals?'

Your Credit and Options to Protect Your Identity

Lauree K. VanderVeen, CTFA
Vice President
Trust Relationship Officer

Last month, Greenleaf Trust sent correspondence to clients in response to the Equifax breach in which hackers were able to obtain personal information of 143 million Americans. The information exposed included names, addresses, birthdates, Social Security numbers, and driver's license numbers. The correspondence highlighted steps to take to check to see if you had been affected and if so, what to do about the breach. We have had numerous inquiries as to how to protect identity and the best course of action going forward. The specific recommendation depends on your situation. Even if you are not affected by the latest loss of confidential information, identity theft is a constant threat. Understanding your credit report and monitoring your financial accounts regularly is critical to protect your own identity and credit information.

"Even if you are not affected by the latest loss of confidential information, identity theft is a constant threat."

Understanding Credit Score vs. Credit Report

Your credit score is an important number organizations use to determine your creditworthiness and to determine the price you will pay to use their services. Credit agencies use information from your credit report and a complex mathematical equation to calculate your credit score. Scores range from 300 to 850. A higher score often translates to paying less for loans, credit, insurance and phone services. Your score can be different depending on which credit reporting agency provided the information.

Often only credit scores are reviewed. If a score is high, it may be

Your Credit and Options to Protect Your Identity, continued

assumed there are no credit issues. A credit score, however, does not tell the entire story. The score alone will not identify if someone has stolen your personal information and obtained credit in your name. Also, errors within your report will impact your score. Since your credit score is derived from your credit report, it is wise to carefully review your credit report often.

It has become common for credit card companies to offer customers free credit scores. While this is helpful to be notified if your score changes, it is important to understand not all companies calculate the scores the same and some may assess your score differently when lending to you.

Your credit report is a record of how you manage money. The report details current and past information about your borrowing and payment history. It also lists past and present employers and residences. It is not uncommon to have errors in your report. According to a Credit.com survey, 1 in 5 Americans have incorrect information on their credit reports. These errors can be related to incorrect details about your personal information, late payments or judgments against you.

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At your request, under the Fair Credit Reporting Act (FCRA), the three national credit agencies, TransUnion, Equifax and Experian, are required to provide you with your credit report every 12 months. AnnualCreditReport.com is the only legitimate source authorized by Federal Law to provide you annual free credit reports. You may also contact the service by calling 877-322-8228 or by writing to Annual Credit Report, Request Services, P.O. Box 105281, Atlanta, GA 30348. Additionally, if a company denies you credit, a report must be provided to you along with an explanation of why you were denied.

How To Dispute an Error on Your Report

You have the right to dispute any information that is inaccurate on your report. The agencies are required to investigate your claim. To start the dispute, explain in writing what is incorrect. The credit agencies will investigate the discrepancy and communicate back to you the results. The company that reported the incorrect information must correct the error and notify all consumer reporting companies. When the investigation is complete, the company must provide you with a free copy of your report to show the change. Keep good records of any disputes including dates of inquiries and details of correspondence. Be cautious and avoid companies that claim they have the ability to remove derogatory items from your report for a fee. If the information is accurate and negative, it cannot be removed and will remain on your report for seven to 10 years.

If you need additional information or are having difficulty getting your credit report corrected, contact the Consumer Financial Protection Bureau (CFPB) at consumerfinance.gov. This agency is also a good resource if you have questions about credit reports.

How to Protect Your Identity

Regularly monitoring your credit report is the best way to spot signs someone is using your information. Consider requesting credit reports from the three agencies separately throughout the year. This way, you are continually reviewing your information for free every three to four months. Consider reviewing one of your credit reports during your annual relationship review meetings with your Greenleaf Trust client centric team.

Be cautious of phishing attempts. Scammers may send you emails which look like an authentic company or government agency in hopes that you will provide additional personal information. You may also experience phone or "vishing" attempts to gain more information from you. If you are suspicious, call the company directly.

In addition to self-monitoring, there are other options to consider. One or several of these options may be best for you:

- Credit Monitoring – Equifax is offering free credit monitoring for a year by enrolling in their TrustedID Premier program (normally $27.99/mo). There are other companies that offer credit monitoring for a fee. Greenleaf Trust Technology team recommends top rated firms including: Identity Guard (www.identityguard.com); Lifelock (www.lifelock.com); or Identity Force (www.identityforce.com). Many financial organizations offer free alerts if unusual activity or changes in your accounts happen. This could help notify you quickly if there is fraudulent activity on your accounts.
- Fraud Alert - If you have been a victim of identity theft, consider placing a fraud alert on your file. A fraud alert is a type of notice put in your credit report that lets lenders know you have been a victim of identity theft and to use extreme caution to confirm it is actually you applying for credit. Placing a fraud alert on your credit file is easy. Notify one of the reporting agencies of your potential breach and they will report this information to the other agencies. A fraud alert is typically set up for 90 days, but it can be extended to 7 years. Consumer Reports suggests opting for the 90 day alert and renewing your alert every 90 days. With each renewal, you are provided a free copy of your credit report. In addition to the three free reports you are already allowed, you could receive up to 20 free credit reports for the year. The fraud alert or credit lock will require you to provide a phone number where you can be reached and before any credit is obtained on your behalf, you will be contacted to confirm the authenticity of the request. You can decide whether to provide information for the credit or not.
- Security Freeze - A security freeze will prevent anyone from obtaining access to your credit file. If no one is able to access your credit file, no credit should be issued in your name. This is the best way to protect

"A security freeze will prevent anyone from obtaining access to your credit file. If no one is able to access your credit file, no credit should be issued in your name. This is the best way to protect your credit but can have drawbacks."

Your Credit and Options to Protect Your Identity, continued

"Once your personal identification information (PII) is exposed, identity thieves can impersonate you and potentially open credit, gain access to your bank accounts, contract rental agreements and make purchases in your name."

your credit but can have drawbacks. If there are new loans or services you want, you will have to unfreeze your account each time. There can be costs associated with freezing and unfreezing your account. If you intend to freeze your information, you must contact each of the three agencies separately.

If you have children under age 16, given the severity of the recent Equifax breach, you might consider placing a security freeze on their credit. Currently, Michigan allows parents to request security freeze on a child's credit report.

Once your personal identification information (PII) is exposed, identity thieves can impersonate you and potentially open credit, gain access to your bank accounts, contract rental agreements and make purchases in your name. With the stolen Social Security numbers, there is a greater risk of a fraudulent personal tax return being filed in your name. If you have been a victim, visit IdentityTheft.gov to report the incident to the Federal Trade Commission. They will also provide you with a personal recovery plan.

Finally, in a Wall Street Journal article on September 27th, the interim CEO of Equifax stated the following, "By January 31st, Equifax will offer a new service allowing all customers the option of controlling access to their personal credit data. The service we are developing will let consumers easily lock and unlock access to their Equifax credit files. You will be able to do this at will. It will be reliable, safe and simple. Most significantly, the service will be offered free, for life." Given the scope of this breach, there will likely be more changes in the near future. Your client centric team will work to keep you updated and assist you in understanding and protecting your credit.

If you have questions about your credit report or would like a copy of the information our company sent on September 17th, please don't hesitate to contact me or a member of your client centric team.


Crain's Detroit Business just named
Greenleaf Trust a 2017 Cool Place to Work.
(Not that we noticed...)
GREENLEAF TRUST®
Financial Security from Generation to Generation

Steven P. Phillips, CFP®
Wealth Management Advisor

Nationalism, Globalism, and Everything in Between

"We are now seeing hints of fractures in the traditional post-war [international] structure."

As a general rule, the post-World War II era has been one of unprecedented peace and economic security. It is an age that has witnessed huge technological innovations and resulting economic growth and opportunities for expanding numbers of people. Politically, we have witnessed the fall of the Berlin Wall, the demise of communism in the former Soviet Union, the creation and expansion of the European Union, the adoption of a single currency for Eurozone members, and the spread of democracy, particularly in Eastern Europe and Asia. We have seen a profound shift away from nationalism as more emphasis was placed on collective security through international cooperation, as evidenced by the founding of the United Nations, NATO, and other international organizations. This military and peacekeeping cooperation coincided with more liberal trade policies, as economies historically dependent on tariffs shifted to policies of increased free trade, most notably evident in the creation of the North Atlantic Free Trade Agreement (NAFTA). It seemed the course of the future was increased cooperation along military, diplomatic, and economic lines.

We are now seeing hints of fractures in the traditional post-war structure. Concerns over income inequality, economic disparity among nations within the Eurozone, lack of national sovereignty within the European Union, and debates over immigration have fueled headlines and political elections across the globe. The continued wars in the Middle East, particularly in Syria, have displaced millions of refugees seeking safety and shelter in neighboring countries, Europe, and to a much lesser extent, the United States.

The German election on September 24, 2017 highlighted many of these issues. While Angela Merkel's Christian Democratic Union (CDU) won the majority of votes, all but guaranteeing she will see her fourth term as Chancellor, the election was historic for the German republic. The CDU received 33% of the votes, the lowest amount since 1949, while the other mainstream party in Germany, the Social Democratic Party (SPD), received 20.5%, their lowest amount since the pre-war era. Most notably, the far-right Alternative for Germany (AfD), which campaigned on a Eurosceptic, anti-immigration platform, won 12.6% of the votes, winning an estimated 94 seats in the German Bundestag. This marks the first time a far-right party has won seats in Germany's parliament since the World War II era. Given that the SDU, Merkel's main coalition partner since 2013, has indicated they will go into opposition, Angela Merkel will now be forced to form a ragtag coalition with smaller parties, notably looking to the business friendly Free Democratic Party (FDP) and the Greens for cooperation. The opposing views within these parties will likely make the future German government much less united compared to years past.

Much of the rise of the AfD within Germany came in the eastern part of the country, where concerns over the more than 1.1 million refugees allowed into the country since 2015 stirred domestic debate. We have seen much of these debates around immigration and economic policies rage within other European nations recently as well. The Netherlands more centrist leader, Mark Rutte, was able to solidify a win over the anti-immigrant Party for Freedom (PVV) and its leader, Geert Wilders. The same situation occurred in France, when Emmanual Macron's newly formed En Marche! defeated the far-right National Front led by Marine Le Pen. While the Netherlands and France saw more centrist leaders elected, the PVV and the National Front both came in second in each election, earning 13.1% and 13.2% of the votes, respectively. There has also been an upsurge in far-right parties recently within Eastern Europe, most notably in Poland, Austria, and Hungary.

Much has already been made about Brexit, Britain's historic vote to exit the European Union, as well as the election of US President Donald Trump, who campaigned on a platform of more protectionist economic policies and greater national security measures, including a proposed wall on our southern border and a temporary travel ban on nations deemed to have a greater risk for terror. President Trump has also been consistently critical of trade imbalances, calling out China in particular, as well as threatening to scrap NAFTA if a better deal for the United States cannot be renegotiated. One of the most notable and somewhat ironic signs of the shift in economic sentiment came during the 2016 election, when Donald Trump and Hillary Clinton, forced by voter sentiment to reverse her earlier support, were unified in publicly opposing the Trans-Pacific Partnership (TPP), a trade agreement meant to reduce tariffs and increase trade that was supported by then President Barack Obama, as well as many Republican congressmen.

Fractures heal, and most likely the current economic and political landscape does not represent a complete break with the post-war order, but rather reflects the very real challenges of maintaining peace and economic security in a world of competing interests that is rapidly changing. Despite all of the global headlines, the US economy remains strong. Unemployment continues to be low, currently at 4.3%, while the US stock market continues to hover around all-time highs. While inflation has remained stubbornly low, the Federal Reserve has seen enough strength in the US economy to raise interest rates four times since December 2015 and, as of October, will begin to gradually shrink their balance sheet. There has also been stronger than expected economic numbers coming out of China and Europe, propelling emerging and developed markets to be the highest performing assets classes so far in 2017.

Here at Greenleaf Trust, we continue to monitor markets and the potential impact proposed legislation may have on our clients. Most importantly, we continue to implement holistic planning strategies on behalf of our clients, build custom-tailored portfolios that are fully diversified across multiple asset classes, and remain focused on helping our clients use their wealth to attain their long-term goals and objectives. We will continue to do so for our clients, regardless of which way the political winds may blow in the United States, Europe, and around the globe.

Dave P. Mange, CFA
Vice President
Senior Research Analyst

Will Rising Inflation Derail US Stocks?

Most of you have heard some variation of this theory lately in popular media: US stocks are at an all-time high, low bond yields have pushed investors into equities, and when the Federal Reserve raises interest rates or downsizes its balance sheet, the valuation (price to earnings ratio or P/E multiple) of the S&P 500 will fall. If corporate earnings don't rise fast enough to compensate for lower valuations, the eight-year-old stock market rally will end. That argument relies on at least two conditions: that interest rates/inflation will indeed rise meaningfully and that investors will respond by assigning lower valuation multiples to stocks. In this article, we offer perspective on this theory and some color on our approach to stock selection.

"First and foremost, the Fed is targeting and the market is expecting a moderate level of inflation over the next decade."

First and foremost, the Fed is targeting and the market is expecting a moderate level of inflation over the next decade. The Federal Reserve targets inflation of 2% in its dual mandate to control inflation while attempting to achieve full employment. In the period following 2008, inflation has consistently tracked below the Fed's long term target, which makes sense given accommodative posturing. However, even amid full employment more recently, inflation remains below target, registering just 1.9% according to September data. We (and the Fed) would typically expect full employment to drive wages, and therefore inflation, higher… and the absence of this dynamic, primarily attributed to nuances in the unemployment data (discouraged workers re-entering may mean employment is not as full as it appears, etc.) has caused a cautious Fed to tap the brakes on planned rate hikes in 2017. The market's expectations for future inflation are also muted as indicated by breakeven inflation rates. According to the Federal Reserve, the ten year breakeven rate as of September 15, 2017 was 1.85% — a reasonable proxy for what bond investors expect for average inflation over the next ten years.

Secondly, historical data suggests that equities tend to perform reasonably well in periods of moderate inflation. We ran an analysis of a series of five year rolling annualized returns for the S&P 500 from 1952 to the present, and parsed those returns into bins of five year rolling returns of inflation as measured by the Consumer Price Index (CPI). We calculated the inflation-adjusted real return by subtracting the mid-point of each rolling five year inflation band from the return of the S&P 500 Index over the same period with the following results:

Inflation	Avg. Return S&P 500 Index	#Observations	Average Real Return
0-2%	13.5%	65	12.5
2-4%	12.1%	120	9.1
4-6%	9.5%	34	4.5
6-8%	4.3%	21	-2.7
8-10%	11.9%	20	2.9
10+%	7.7%	2	-2.3

The data set is far from perfect as accounting rules, demographics, productivity and tax law have all changed dramatically over the observation period, but with that grain of salt taken, our simple analysis clearly shows that real returns from large cap US stocks have generally been attractive when inflation rates are below 5%. The relationship between inflation rates and real returns isn't perfectly monotonic as inflation rates increase, though we clearly see weaker returns at inflation rates over 6%. Maybe more importantly, we can also see that inflation has been more often contained below 4% than the number of cases in which inflation has been higher.

In the end, while it may not be a foregone conclusion that the stock market is poised for a severe re-rating due to inflation, it remains difficult to know what the future may bring. We believe the investment process for our internally managed US equity strategy — the Intrinsic Value strategy — is quite adaptable to a potential increase in interest rates and inflation. In general, we seek to own high quality companies generally characterized as market leaders with distinct competitive advantages and strong balance sheets. A flexible investment mandate increases our opportunity set while decreasing risk and our bias for high-quality businesses provides a natural hedge against many financial and fundamental business risks.

"We believe the investment process for our internally managed US equity strategy… is quite adaptable to a potential increase in interest rates and inflation."

Stock Market Pulse

Index	9/30/17	Total Return Since 12/31/2016
S&P 1500	583.83	13.70%
Dow Jones Industrials	22,405.09	15.45%
NASDAQ	6,495.96	21.73%
S&P 500	2,519.36	14.24%
S&P 400	1,795.94	9.40%
S&P 600	903.98	8.90%
NYSE Composite	12,209.16	12.65%
Dow Jones Utilities	723.60	12.53%
Barclays Aggregate Bond	109.59	3.12%

P/E Multiples	9/30/17
S&P 1500	21.9x
Dow Jones Industrials	19.1x
NASDAQ	24.3x
S&P 500	21.6x
S&P 400	24.5x
S&P 600	28.3x

Key Rates

Fed Funds Rate	1.00% to 1.25%
T Bill 90 Days	0.99%
T Bond 30 Yr	2.86%
Prime Rate	4.25%

Current Valuations

Index	Aggregate	P/E	Div. Yield
S&P 1500	583.83	21.9x	1.97%
S&P 500	2,519.36	21.6x	2.03%
Dow Jones Industrials	22,405.09	19.1x	2.45%
Dow Jones Utilities	723.60	NA	3.45%

Spread Between 30 Year Government Yields and Market Dividend Yields:0.89%

MAIN OFFICE:
211 South Rose Street
Kalamazoo, MI 49007
office: 269.388.9800
toll free: 800.416.4555

TRAVERSE CITY OFFICE:
125 Park Street, Suite 495
Traverse City, MI 49684
office: 231.922.1428

GRAND RAPIDS OFFICE:
25 Ottawa Avenue SW, Suite 110
Grand Rapids, MI 49503
office: 616.888.3210

BIRMINGHAM OFFICE:
34977 Woodward Ave., Suite 200
Birmingham, MI 48009
office: 248.530.6202

PETOSKEY OFFICE:
331 Bay Street
Petoskey, MI 49770
office: 231.439.5016

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e-mail: trust@greenleaftrust.com
www.greenleaftrust.com