TMI Market Trax

Market Commentary Quarterly

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EXCEEDING EXPECTATIONS

IN THIS ISSUE

Exceeding Expectations

by Mark Teichner

According to the mission statement of the Heisman trust, "The winners of the (Heisman) trophy epitomize great ability combined with diligence, perseverance, and hard work." In 2017, Oklahoma Sooners quarterback, Baker Mayfield won the honors with 86% of the vote. His story is one of "diligence, perseverance, and hard work."

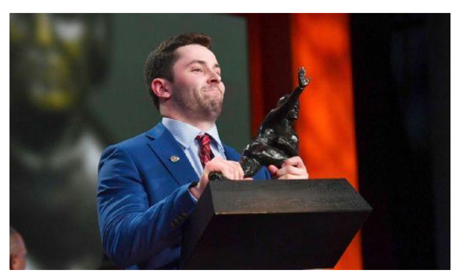
At 5'11" and 185 pounds, he was considered too small for a quarterback and not heavily recruited coming out of high school, but with determination, he walked on at Texas Tech and earned the starting role and went on to become the Big 12 freshman offensive player of the year. Following injuries, reputed scholarship problems and poor communications with the coaching staff, he transferred to Oklahoma. After sitting out a season due to NCAA rules, he again won the starting quarterback job, this time over the incumbent starter, and led the Sooners to the college football playoffs, their second time in three years.

This story parallels the events in our current econo-political environment. After beating out seasoned political contenders, first year term setbacks caused investors to question whether President Trump deserved the lead role, and whether any of his agenda would move forward. Challenges included the inability to pass his stated legislative priorities, numerous departures of senior White House administration officials, ongoing confrontations with the FBI, DOJ, and democratic party leaders, saber rattling with North Korea, as well as the media's ongoing preoccupation on the Russian investigation. Relationships inside the Republican party were also becoming strained, and the party was at risk of losing its majority during the mid-term elections, unless it could turn the program around.

Despite ongoing claims of character flaws by the main street media, arm chair political quarterbacks, and Trump adversaries, knowledgeable Wall Street

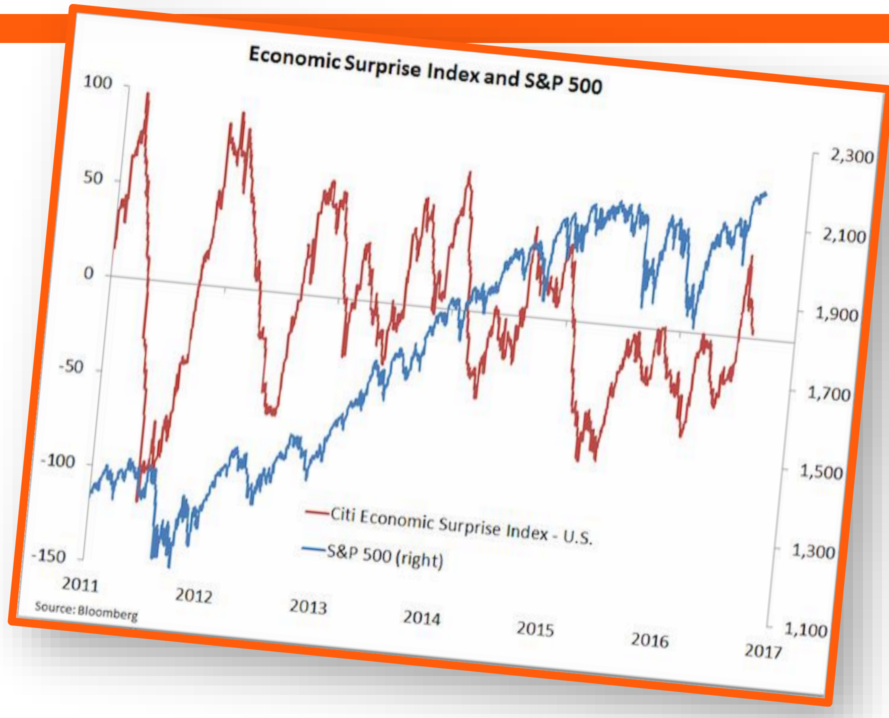
The Heisman Trophy

"The Heisman Memorial Trophy annually recognizes the outstanding college football player whose performance best exhibits the pursuit of excellence with integrity. The winners of the trophy epitomize great ability combined with diligence, perseverance, and hard work. The Heisman Trophy Trust's mission is to ensure the continuation and integrity of this award." (source: heisman.com)



Baker Mayfield - Oklahoma

2017 Heisman Memorial Trophy recipient (photo: Todd J. Van Emst/USA TODAY Sports) voters, primarily institutional investment managers and strategist, were willing to overlook these accusations. Instead, they focused on the results caused by his ability to scramble, shake off tacklers, and his raw business instincts, intuition, and experience to motivate his supporters. Most importantly, in the face of these Washington, DC concerns, they focused on deregulation measures, and the ongoing domestic and global economic recovery. U.S. real economic growth passed the 3% annualized statistic for both the second and third quarters of 2017, something not witnessed in years, while the fourth quarter is again expected to be robust. Global Purchasing Manager indices remained above the neutral level of 50. Similarly, GDP growth in the Eurozone improved from 1.8% in 2016 to an estimated 2.4% in 2017, Japan showed improvement from 0.9% to 1.7% growth, and China continued to expand at slightly below 7%. U.S. economic reports were above expectations as represented by the U.S. Citigroup Economic Surprise Index (which measures actual economic reports relative to consensus expectations), which moved from a negative 78.6 in June 2017, the lowest level in over five years, to



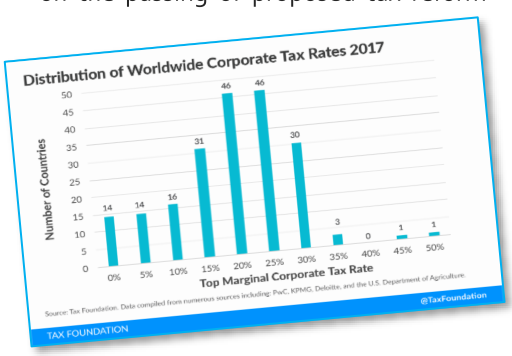
a peak of 84.5 in December, the highest level in over five years.

The equity and bond markets reacted favorably throughout the year due to the improving global economic backdrop, with market action in the fourth quarter continuing to respond to these

CITI ECONOMIC SURPRISE INDEX

This is an objective and quantifiable measure of economic news. It is defined as weighted historical standard deviations of data surprises (actual releases vs Bloomberg survey median).

encouraging trends. Investors in U.S. equities were especially encouraged as they began to place a higher probability on the passing of proposed tax reform



legislation winding its way through Congress. At the end of December, this transformative bill become the first major victory for the new administration and a wake-up call to cynics. The major components of the bill called for a permanent reduction in the corporate tax rate from 35% to 21%, a reduction in individual tax rates, a 20% deduction for pass-through businesses, and raising the threshold for the estate tax.

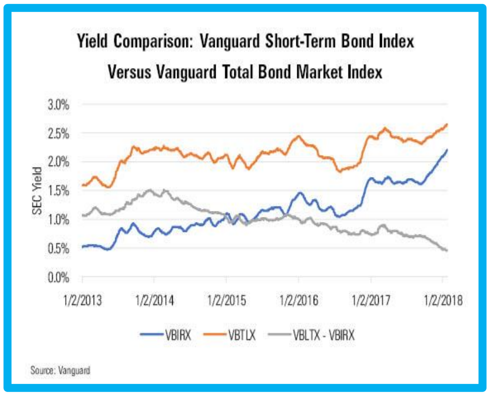
The favorable reaction to this legislation has continued into the new year, as numerous companies have announced how they plan to respond to a corporate tax rate now more competitive with foreign rates. Favorable immediate remunerations to employees announced consisted of special bonus payments to line workers, higher minimum wage rates, higher base wages, salary increases, increased 401(k) matches, and increased hiring plans. Numerous companies have announced their plans to repatriate cash held overseas, new capital investments and expansions, share repurchases, dividend increases, moving production activity back to the U.S., and even increased charitable contributions.

Individuals will begin seeing lower tax rates and withholdings in February, contrary to widespread expectations based on the ineffectual portrayal of the tax bill. . As a result, we envision the higher level of disposable income will elevate consumer sentiment and generate incremental discretionary purchasing, while helping to repair leveraged consumer balance sheets.

We also anticipate this renewed interest in domestic business expansion will eventually provide workers, who may currently be in service oriented jobs at levels below their skill set, with the opportunity to move up the value chain to higher income positions, while also bringing disenchanted workers back into the labor force. If these expectations play out, the multiplier effect on business and consumer activity should outweigh

S&P 500 4Q17 DAILY CHART

Intermediate Bond Rates



FAST FACTS

REIT

REITs, or real estate investment trusts, are companies that own or finance income-producing real estate in a range of property sectors. Most REITs trade on major stock exchanges, and offer a number of benefits to investors.

S&P 500

The Standard & Poor's 500, often shortened to the S&P 500 (or just, the S&P), is a stock market index based on the market capitalizations of 500 large companies having their common stock listed on either the NYSE or NASDAQ.

the $1.5 trillion deficit projected over the next ten years by some economists.

In reaction to these favorable factors, corporate earnings estimates, using the S&P500 as our proxy, have exploded higher. According to Bloomberg, 2017 earnings are estimated at $120 compared to projections for 2018 currently at $151, a 25+% increase. A $2,700 value for the S&P500 derives a price to earnings (P/E) valuation multiple of 22.5x on trailing 2017 figures, certainly elevated by historical standards. More importantly, it derives a more moderate forward P/E multiple of 17.9x on 2018 earnings estimates. Only time will tell if these earnings estimates will continue to be revised upward as companies report and provide favorable guidance or revert to the normal historical pattern of gradually weakening over time. This forward multiple certainly appears reasonable given an environment of low inflation, where valuation multiples tend to be higher than long term averages. Assuming no material economic slowdown or spike in interest rates, 2019 forecasted earnings of $167 per S&P500 index value, generates a P/E of 16.2x., and provides a reasonable construct for future equity market returns.

Many argue stimulative fiscal policy (tax cuts) are unnecessary at this stage in the economic cycle and will lead to even lower unemployment rates and wage pressure, tighter capacity utilization, higher inflation, and tighter monetary policy (increases in the fed funds rate). We agree this is a risk to monitor. However, despite the anticipated three increases in the funds rate expected in 2018, monetary policy currently remains accommodative, not restrictive, and increased spending will boost near term results. Five-year forward inflation expectations, which were in the 1.8% level throughout most of the second half of 2017, are now just over 2%. Headline consumer price inflation (CPI) is expected to increase 2.3% in 2018, but core-CPI (which excludes food and energy) is estimated to increase by a more moderate 1.7%. The falling dollar is causing commodity and intermediate goods prices to rise, up 2.6% in December on a year over year basis, but tight global competition is expected to prevent companies from fully passing on these cost increases.

While intermediate bond rates have started to drift higher, they are not yet high enough to be viewed as competitive with valuation and return expectations for the equity market. We continue to evaluate which asset classes are most competitive and deserve to earn the leadership role. For now, we remain favorably positioned towards equities to maintain their winning record over the year, although corrections and greater volatility would be expected at this stage in the cycle.

Consistent with last quarter's report, winning in investing over a full market cycle requires a strong defense as well as a productive offense. At present, cyclical economic influences cause us to want our economically sensitive sectors to run with the ball, keeping our defensive players in reserve and on the sidelines. We expect bonds to generate modest to slightly negative returns in a rising rate environment. Similarly, we recommend underweighting defensive sectors including utilities, staples, REITs and telecommunications, while overweighting technology, industrials, financials, energy, materials, and

consumer cyclicals.

Being a Heisman Trophy winner does not always translate to success in the NFL. Tougher competition from a variety of influences is anticipated during the 2018 season. This will result in higher volatility, corrections, and periodic injury. We will continue to maintain perspective and look for signs of overexuberance and amateur behaviors. Additionally, we will assess whether markets are discounting excessive optimism, which would be the time to change strategy and protect the lead. For now, we believe staying with an overweight to risk assets will do a better job of helping to get closer to our financial goal line.

TMI Market Trax is written by TMI Trust Company's Mark Teichner. For questions or comments on TMI Market Trax, TMI Agency portfolios or other investment services distributed by TMI Trust Company, contact Mark Teichner at mteichner@tmico.com.

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Investing involves risks including loss of principal. Current and future portfolio holdings are subject to risks as well. International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles, or from economic or political instability in other nations. Bonds and bond funds will decrease in value as interest rates rise. Due to the speculative nature, high-yield bonds involve greater risks of default or downgrade and are more volatile than investment-grade securities. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume.

Diversification may not protect against market risk. There is no assurance the objectives discussed will be met. Past performance does not guarantee future results. Index returns are for illustrative purposes only and do not represent actual portfolio performance.

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TMI Trust Company
901 Summit Avenue
Fort Worth, TX 76102