MARKET TRAX

MARKET COMMENTARY QUARTERLY

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The Calm Before the Storm

WEATHERING THE STORM

While down in the Bahamas this summer on vacation, a friend posted a series of pictures on social media. The scenes were rather idyllic and alluring, with images of beautiful white sandy beaches, sunbathing vacationers on poolside lounge chairs, reeling in billfish off the side of a deep-sea fishing boat in calm, blue ocean waters, and sipping from colorful icy drinks with little umbrellas and a slice of dripping pineapple hanging from the rim. I was envious and happy for them as they enjoyed their time away, but at the same time becoming concerned. Watching the weather updates and projected "spaghetti model" future paths of hurricanes Harvey and Irma, these tranquil paradises were in line and at risk of being hit by the powerful effects of mother nature, with the potential loss of life, damage to property, and these seemingly carefree living conditions.

While certain areas of the hurricane prone regions were spared due to a last-minute turn in direction, others were less fortunate, and the post storm images became front page headlines soon thereafter. For those areas hardest hit the results were major power outages, widespread flooding, submerged cars, blown off rooftops and severely damaged structures, and the underbelly of boats washed up on shore, well away from the water's normal edge. Those on the periphery of the storm were mostly spared but received collateral

damage with blown over signs, downed trees, and debris fields of leaves and branches. While modern technology including satellite imagery, and statistical and dynamic modeling has improved hurricane forecasts, their unpredictable character provides limited certainty towards the eventual path and outcome.

Economists, market strategists, and meteorologists have often been associated with each other and at times lampooned for their imprecision of forecasts. While weathermen use measurements of wind, barometric pressure, temperature, precipitation, and cloud movement to forecast where a storm may go, economists and strategists similarly utilize a wide range of economic and behavioral variables to estimate the future direction of markets. These include traditional and non-traditional variables such as growth and productivity, money velocity, relative momentum, net positioning, short interest, market sentiment, margin balances, interest rate curves, yield spreads, economic surprises and earnings beats, to name just a handful of the endless data available. It is the mosaic of factors, time horizons, and embedded biases which determines each investor's outlook, while the weight investors place on these factors, and frequent shifts in weighting preferences, heightens the unpredictable nature of financial markets.

Just as meteorologists utilize a "cone graphic" to represent the potential path of a hurricane, future market and security values also reflect a range of outcomes. Extreme outcomes, positive and negative, have low probabilities, but probabilities nonetheless. The predicted number publicized simply represents a highest probability or a probability distribution weighted outcome. A turn of events consisting of a surprise election result, a military event (or even threats of one), a change in tax or spending policies, results of trade negotiations, a blowout economic or earnings report, or even a natural disaster like a hurricane, can change the probabilities and outlook, either favorably or unfavorably. It is simply the difference and randomness of a storm making landfall or turning out to sea. Portfolios positioned towards extreme outcomes will benefit or be harmed greatly by what actually takes place, while a diversified portfolio helps to smooth the results, although may still realize collateral damage.

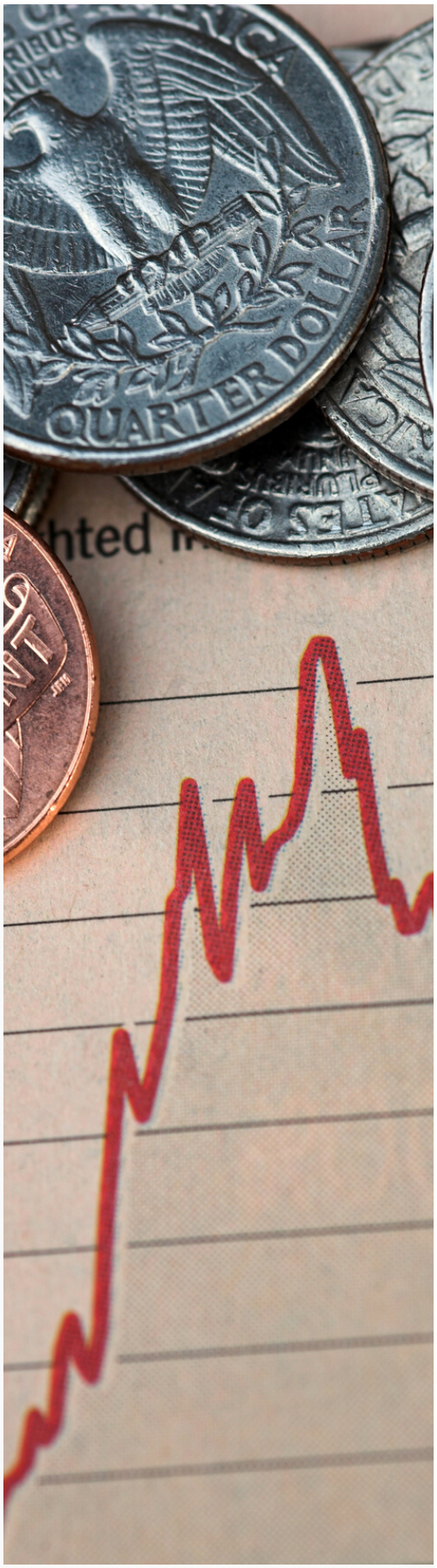
All asset pricing begins by using a risk-free rate, generally a U.S. Government security like

the T-bill or 10-year Treasury. Valuing an investment is then estimated by projecting the future cash flow expected to be generated by the asset, and bringing back those future cash flows to the present ("present value").

This is done by using a risk based interest rate, with a Treasury rate as the floor and an excess return premium as consideration for the higher uncertainty. All else being the same, a lower interest rate causes the value of an asset to increase, while a higher interest rate causes the value to decline. Due to the Federal Reserve and other central banks suppressing the risk-free rate through a low fed funds rate and quantitative easing (QE) bond purchases, traditional pricing models have been distorted, leading these models to derive a higher than normal value.

In the current environment, investors and strategists are paying close attention to statements by the Federal Reserve regarding the pace of rate hikes and unwinding of QE, and the outlook for inflation. A low inflation environment causes rates to stay down, while rising inflation requires a higher interest rate to be compensated for increasing costs. Fortunately, global competitive forces and slow economic growth have helped restrain inflation for many years. However, these forces may be changing, although gradually. Improved employment and economic growth trends have caused wage pressures to moderately increase, industrial commodities to rise, corporate earnings to improve, and bond yields to start moving higher. The Fed remains accommodative, as the funds rate remains low and QE related bond holdings are to be rolled off gradually. We now, however, expect the Fed to raise rates in December, consistent with their stated normalization policy.

Although valuation on the benchmark



indices are certainly above long-term averages, averages which include both high and low inflation as well as strong and weak economic environments, they are historically consistent with low inflation, low interest rate environments. Additionally, the index's constituents have transformed over time, now represented by a large weight in financials, which have much stronger balance sheets than in the past, and technology companies, having faster growth and higher return potential. As a result, historical measures of value may not fully reflect these differences.

We remain favorably disposed to equities, specifically those area benefiting from the improvement in global growth. Sectors of greatest interest include financials, which benefit from higher interest rates and reduced regulatory burden, and technology, industrials, and materials which all benefit from improved cyclical growth. Those more defensive and yield oriented sectors including utilities, telecommunications, REITs, and consumer staples are likely to continue to under perform, especially should interest rates drift higher. These various sectors can be found spread out across asset classes and benchmarks, so performance will be dependent on their relative weights in those indices and/or active managers' positioning relative to their respective benchmark.

The VIX Index (a measure of risk based on volatility) is near all-time lows, yield spreads reflect both a search for yield and low default risk, earnings are being reported above expectations, and equity markets are reaching all-time highs in this improved setting. While agreeable and peaceful now, this idyllic backdrop won't last forever and we warn against excessive complacency caused by the current warm sun and easy tropical breezes. Just as we've seen concentrations of wealth along the coastlines, institutional money managers are buying larger capitalization companies as the number of public stocks available for purchase have declined. While this leads to faster price gains on the way up, it will lead to greater losses when hurricanes hit and the economic backdrop becomes more challenging.

In our opinion, there is no immediate need to batten down the hatches or seek immediate shelter, although permanent preparation for hurricanes and market corrections are always important for survival. Water, food, battery supplies, cash, and ample liquidity from which to draw in case of emergency, while closely monitoring the potential range of outcomes for the right time to flee inland.

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TMI Market Trax is written by TMI Trust Company's Mark Teichner. Questions or comments on TMI Market Trax, contact Mark Teichner at mteichner@tmico.com. The material herein is based on data from sources considered to be reliable, but it is not guaranteed as to accuracy, does not purport to be complete and is subject to change without notice. This communication is for informational purposes only. Use by other than intended recipients is only allowed prior to TMI Trust Company's consent. Sender accepts no liability for any errors or omissions arising as a result of transmission. Any comments or statements made herein do not necessarily reflect those of TMI Trust Company or its affiliates.