TMI Trust Company
Specialized Trust Services

MARKET TRAX

MARKET COMMENTARY QUARTERLY

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INSPIRING POTENTIAL

This past February I was fortunate to attend an annual father-son dinner at my son'sigh school where the keynote speaker was Dick Hoyt. While not the star power of past presenters, such as Archie Manning and Vince Dooley, his personal account was as inspiring a story as one could hear. Hoyt spoke of his dedication to give his quadriplegic and cerebral palsy afflicted son (due to complications at birth) the opportunity to experience a full and meaningful life, contrary to doctors' recommendations to institutionalize him. Together, Team Hoyt not only participated, but also competed, in marathons and triathlons via Dick's own grueling physical effort, by running while pushing a wheelchair, towing a raft while swimming, and carting his son on a special two seat bicycle. Hoyt accomplished these feats without previously being much of a training enthusiast.

Of equal amazement was the narrative of Dick's son, Rick, developing his own capabilities by learning to communicate one letter at a time via an interactive computer, graduating from Boston University with a degree in Special Education, and later working to help create communication systems for those with disabilities. His own meaningful story was his transformation from being once considered a "vegetable" by supposed experts, to becoming an active, contributing member of the community, himself an inspiration to many.

Just as most expectant parents are excited by the opportunities of welcoming a new child into the

world, and high expectations of what they might become, investors enter into markets and securities with high hopes for the possible returns those investments might generate. With reasonable expectations, those prospects have a high probability of being realized. However, within any normal probability distribution, some investments will far exceed expectations generating outsized gains, while some will significantly disappoint, have ongoing challenges and potentially a material loss.

Timing, a change in fundamentals, and/or unforeseen or unexpected random events could alter the anticipated course, both favorable or unfavorable. Despite best efforts, all investors will have experienced this broad range of scenarios, and periodic setbacks should not cause one to give up.

Influenced by lower corporate and individual tax rates and global economic expansion, investors entered the New Year with highly favorable expectations. Based on this promising outlook and favorable views on corporate sales, earnings, and shareholder friendly actions, the S&P500 advance by 5.7% in January. In an associated move, the Bloomberg Barclays Aggregate Bond benchmark declined by 1.15%, reflecting rising inflationary expectations and interest rates (the 10-year Treasury yield rose from 2.4% to 2.7% during this period).

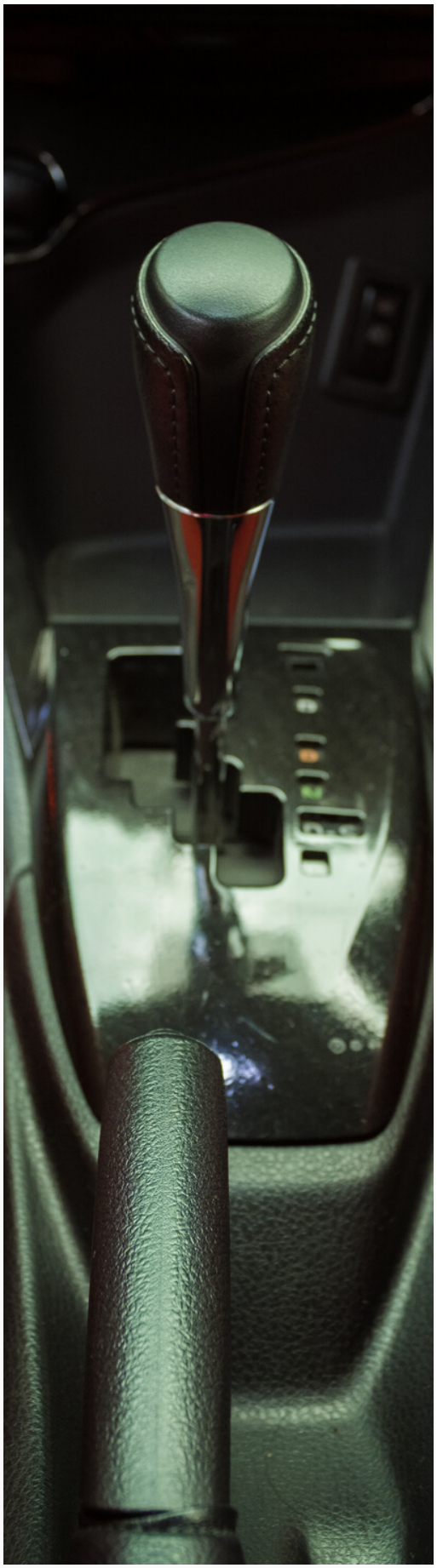
Shortly thereafter, however, with harsh winter weather conditions, ongoing Washington D.C. political unrest (including additional departures of White House staff, investigations of election meddling, and alleged hush money payoffs), combined with the uncertain outcome of aggressive trade proposals business sentiment turned more cautious. Economic numbers, in turn, were reported slightly less favorable, witnessed by the U.S. Citigroup Economic Surprise Index falling from 75 at year end to under 50 at the first quarter's end. Similarly, the Atlanta Fed's "GDPNow" estimate, which started the quarter predicting first quarter GDP growth at over 4%, has since declined to 2%. This caused returns for the S&P500 and Aggregate bond indices to decline for the remainder of the quarter by 6.1% and 0.3%, respectively, and in turn, generated negative total returns of 0.76% and 1.46% for the quarter overall.

Similar to children periodically challenging their parents,markets have a history of testing

the incoming Federal Reserve Chair with volatility tantrums and corrections around the time of handoff of Central Bank oversight responsibilities. Looking back at Federal Chair turnover history, this includes equity pullbacks when Volcker took the helm in August 1979, Greenspan in August 1987, Bernanke in February 2006, and Yellen in February 2014. Jerome Powell taking over the Chair role from Janet Yellen was no different, even though their views are similar. Consistent with the Fed's anticipated normalization schedule, the funds rate was indeed hiked in March, to the level of 1.75%. The futures market is currently estimating the Fed Funds rate will be raised two more times in 2018, ending the year at 2.25%.

Although still viewed as accommodative, the Fed Funds rate is gradually moving towards "neutral", causing unease from some market experts. While tightening has not yet "hit the wall", conditions could certainly become more challenging should the Federal Reserve move too aggressively. Historically, a flat or inverted yield curve (short rates higher than intermediate and long rates) has been viewed as a precursor to a slowing economy or recession, although imprecise. This factor has been cited by some economists as reasoning we may be entering a similar economic pattern, although premature to make a definitive claim. Like nervous new mothers who fear a common cold may turn into pneumonia, Wall Street tends to extrapolate short term news, leading to greater volatility than appropriate for most circumstances. While generating short-term corrections and nervous trading, those with proper perspective and longer-term investment horizons can benefit from these overreactions, by buying into the weakness.

This quarter was no different, as Trump's use of extreme positions and hyperbole in



his attempts to renegotiate trade agreements caused some investors to ominously predict a global trade war. Efforts to obtain a more "fair" agreement on trade with China certainly has the potential to escalate into something more extreme, but it is important to maintain perspective. The tariff "threats" were, according to Trump, the first in the negotiating process, and an effort to protect intellectual capital and prevent further technology transfer. Although domestic industries targeted by China would potentially suffer some revenue and margin declines, the broad U.S. economy is unlikely to be damaged. Tariffs of $150 billion, if that becomes the actual figure, pales in comparison to total U.S. economic output in 2017 of over $77.5 trillion (represents less than 0.20% of GDP), while tariffs on $150 billion would be even less. Tariffs, if enacted, would be a partial offset to the economic benefit of the recent tax cut.

Looking out over the year, we remain constructive. Despite debates on the efficacy of the tax cuts on economic activity, our view is the multiplier effect from the tax cuts, including higher capital spending, consumer spending, and wealth effect from shareholder friendly actions, will far exceed the potential 0.20% economic hit from tariffs. We also expect trade negotiations would ultimately result in improved long-term benefit to U.S. industries, not a trade war, which would then be in an improved position to compete in China and other protected markets.

After years of low market volatility, a result of the Federal Reserve providing ongoing monetary support to stabilize the economy and markets, normalization of monetary policy through raising rates and QE bond maturities is causing volatility to move back toward long-term average levels. Volatility appears high, but only relative to recent experience. Rising rates and increased volatility is not, in our opinion, a sign of a trend change, but reflective of underlying economic strength and willingness for the Central Bank to allow markets to price discover on its own, rather than being influenced by Fed policy. Leading Economic Indicators, corporate revenue and earnings estimates, and underlying market trends remain favorable, and in our opinion, the recent equity market pullback has improved the outlook for future returns. The Price/Earnings ratio on one-year forward S&P500 earnings projections has compressed to a more reasonable level of 15.5x.

When comparing equities to fixed income, despite near term uncertainties, we view the

risk/reward as more favorable for equities. In normal periods, yields on the 10-year Treasury are usually in line with nominal GDP, or roughly 4.0-4.5% today. Treasury yields of under 3% implies Treasury bond investors are not earning sufficient real returns to offset current or anticipated future inflation, although do usually provide diversification benefits and steady income. We also view the S&P500's forward "earnings yield" (inverse of the P/E ratio) of 6.1% to be attractive relative to the 10-year Treasury of 2.75%. We believe most fundamentally strong businesses have prepared for rising rates by having hydrated appropriately, getting their balance sheets in order by refinancing at lower interest rates, and should not be materially affected by rising rates.

To quote an overused analogy, investing is like a marathon, or a triathlon, requiring dedication and determination. It also requires faith in the process, trusting corporate management and portfolio managers to make intelligent decisions, while accepting periodic setbacks. Those willing to sacrifice during their early years, at times doing things when they have no formal training, are more likely to have a full and rewarding experience, with sufficient resources to utilize later in life, perhaps accomplishing what may have once been viewed as inconceivable.

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