Market Review & Outlook: Tropical Disturbance

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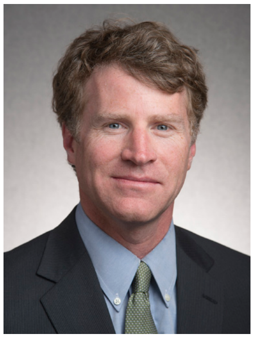

Miles T. Kirkland, CFA
Senior Vice President &
Portfolio Manager
Wealth Management Services

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Executive Summary

- *Hurricanes curtailed hiring and probably economic activity in the third quarter, but the underlying momentum appears to remain strong.*
- *Renewed energy behind tax reform is seen as a potential catalyst for faster growth, but making a deal will be difficult.*
- *Catalonian secession has introduced a new complication to EU cohesiveness, but the European economy seems to be healthy with international equity markets offering excess return potential given lower valuations and the earlier stage of the economic cycle.*
- *Domestic equities are trading at the high end of a normal range, but still offer the best potential for returns above the rate of inflation in our opinion.*

The wind and the rain set back a healthy domestic economy in the third quarter of 2017. The personal and commercial disruptions from major hurricanes hitting two heavily populated states and the Commonwealth of Puerto Rico were enough to curtail employment and probably Gross Domestic Product growth relative to healthy recent trends. The stock market seems to believe these disruptions are temporary with potential for an economic benefit from the recovery efforts. Brinkmanship between the United States and North Korea and Iran remain a concern, while European political difficulties resurfaced with Catalonia's referendum to secede from Spain. Despite all of this, third quarter equity performance was healthy across the board based on a strong response to earnings reports in July and renewed efforts to reform the tax code with the primary goal of reducing the corporate tax rate.

Following the storms, third quarter GDP estimates have been cut to 2.5 percent with the fourth quarter estimates currently at 2.7 percent. These estimates continue a healthy growth trend, but remain below what Americans are accustomed to seeing at this point in an economic cycle. The "hard data" reflects the impact of the hurricanes while the "soft data" remains very encouraging. Nonfarm payrolls (hard data) actually declined 33,000 in September breaking a trend of an average 187,000 additions per month over the last 12 months. The weak report was written off as an aberration by most. Unemployment, which comes from a different survey, actually declined to 4.22 percent. Labor force participation continues to increase and average hourly earnings saw a long

Equity Market Index Returns

As of September 30, 2017

Asset Class	Index	3Q 2017 (%)	Year-to-Date	1 year (%)	3 years (%)	5 years (%)	10 years (%)
Large Cap U.S.	S&P 500 Index	4.49	14.25	18.62	10.81	14.23	7.43
	Russell 1000 Large Growth Index	5.90	20.73	21.95	12.71	15.26	9.09
	Russell 1000 Large Value Index	3.12	7.91	15.11	8.52	13.20	5.91
	DJ US Select Dividend Index	2.47	8.71	13.21	12.26	14.28	7.50
Mid Cap U.S.	S&P 400 Mid Cap Index	3.23	9.41	17.52	11.18	14.43	9.00
Small Cap U.S.	S&P 600 Small Cap Index	5.96	8.91	21.03	14.07	15.60	9.27
Developed International	MSCI EAFE Index	5.40	19.94	19.08	5.03	8.38	1.34
Emerging Markets	MSCI Emerging Market Index	7.89	27.78	22.46	4.91	3.98	1.32
Commodities	Bloomberg Commodity Total Return Index	2.52	-2.86	-0.29	-10.41	-10.47	-6.83
Real Estate	NAREIT Equity Index	0.94	3.66	0.65	9.85	9.68	5.82
Global Market Cap Weighted	MSCI World Index*	4.83	16.00	18.64	7.68	10.98	4.21

**The U.S. represents about 51% of the MSCI World Index.*
All returns greater than one year are annualized.
Source: Greenhill Market Index Review as of September 30, 2017

awaited improvement from 2.5 percent to 2.9 percent. The ISM Manufacturing Purchasing Managers Index (soft data) rose to 60.8 from 58.8. The survey tends to be a relatively accurate predictor of future activity and the levels and the trend are both strong.

After multiple failed efforts to overturn the Affordable Care Act, President Trump and Congress appear to have moved on to tax reform. Tax reform is among the issues that we believe market participants anticipate with a high degree of optimism. It will not be easy. The tax code is extremely complicated for a reason; a variety of interests are represented. If the net result of a cleaner and more pro-growth tax code is higher taxes for any specific group, these constituencies will use political influence to maintain a lower burden. The stated goal is lower taxes on businesses. The United States has a relatively high corporate tax rate (35 percent). Proponents of tax reform believe that the high corporate tax rate drives businesses to invest less, invest elsewhere and invest in the wrong things due to distortions. All good thoughts, but the United States has a lot of debt and forecast deficits ad infinitum. So we cannot just lower the corporate tax rate. Also, many businesses are pass-through entities, for which taxes are paid by the owners based on an individual's ownership and marginal rate. Here reform gets very complex. Everybody wants to help "small business," but the definition is not universally agreed upon and there are an enormous number of tax returns at stake. Individual income tax is a much greater revenue contributor to the Federal Treasury than corporate taxes and taxes on pass-through income are significant contributors to individual income taxes. In order to remove bad incentives and drive growth through greater investment in the US economy, many believe these pass-through dollars need to be taxed at a significantly lower rate also. All else equal, this leaves a very large gap to fill to meet many Republican deficit hawks' requirement that reform be "revenue neutral." Something has to give because there is no indication that Democrats want to participate at all. Increasing the amount of income subject to the lower rates (in order to keep revenue the same) basically comes down to two things: debt and state and local taxes. Deducting interest expense offers higher returns to equity investors (assuming the whole enterprise does not go to the bank). Everybody pays different levels of state and local taxes and elected representatives will defend the tax deduction for concerned citizens. Both sound like non-starters. Our guess is that we get a lower corporate tax rate assuming that growth, taxes on repatriated funds held abroad and a more surgical approach to limiting deductions can limit the lost revenue. The rest might be noise this time, but a lower corporate tax rate could be enough to drive economic growth a little higher by making more money available for investment.

The re-emergence of tax reform has had a significant impact on interest rates with the 10-year treasury yield rising from a little over 2 percent to 2.44 percent as of October 25, 2017. Despite low inflation readings, the Federal Reserve seems committed to steady increases in the Fed funds rate. The probability of a December rate increase has risen from very low to almost certain following Fed commentary and continued economic momentum. Much of this seems to be a program to maintain credibility and provide some options in the event that accommodative monetary policy is needed as a tool for the next recession. So short-term rates are going to increase. Long-term rates are more difficult to handicap with stubbornly low inflation and the beginning of the Fed's balance sheet normalization program. We believe the wise approach to bonds in this environment is to maintain high credit quality, limit the length of maturities and stagger maturities so that there is an opportunity to reinvest maturities consistently at higher prevailing rates. This is a dangerous time to reach for yield, but we do believe that investment grade bonds remain the most economical and time-tested means of managing total portfolio risk.

Eurozone economies are battling a number of headwinds: aging populations, heavy indebtedness, rigid labor and regulatory regimes, a largely unassimilated immigrant population, political schisms and a high level of exposure to terrorists. That said, the economies are doing relatively well and we believe they will continue to do well. Real Gross Domestic Product is running at about 2 percent growth, which is a good level for the Eurozone as a whole. Unemployment has declined to 9.2 percent and is forecast to continue to decline. These are very large and sophisticated markets and the health of these markets impacts many other countries' potential for growth. Since the Great Recession, there has always been a weak link somewhere in the world. We are encouraged to see nearly all regions of the world growing.

At the end of the third quarter, the S&P 500 traded at 18 times next 12 months earnings estimates versus 14.6 times the 15-year average. Equities are

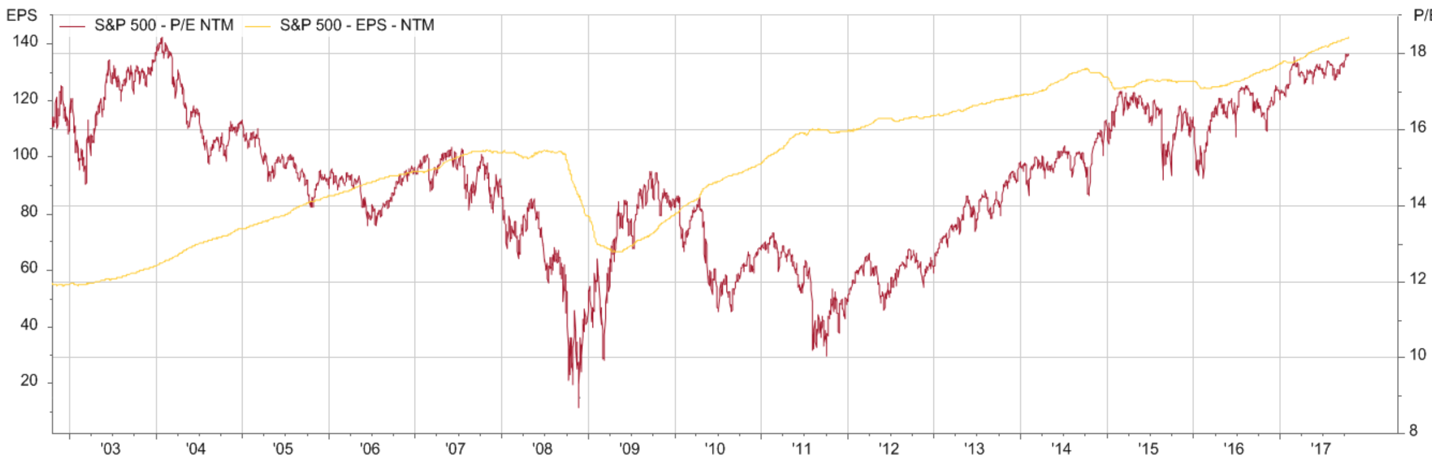
Fixed Income Market Index Returns

As of September 30, 2017

Asset Class	Index	3Q 2017 (%)	Year-to-Date	1 year (%)	3 years (%)	5 years (%)	10 years (%)
U.S. Taxable Bonds	BC Aggregate	0.85	3.14	0.07	2.71	2.06	4.28
	BC Intermediate Government Credit	0.34	1.55	-0.66	1.58	1.01	3.08
	BC US Intermediate Credit	0.99	3.55	1.58	2.98	2.60	4.77
U.S. Municipal Bonds	BC Municipal Bond (5 Years)	0.68	3.87	1.14	1.98	1.93	3.81
International Bonds	Citigroup Non-US Government Bond	2.57	8.63	-3.14	0.47	-1.07	2.67

All returns greater than one year are annualized.
Source: Greenhill Market Index Review as of September 30, 2017

S&P 500 EPS and Price/Earnings Multiple



Source: FactSet as of September 30, 2017

not inexpensive. We believe that valuations reflect two issues; one is good; one is debatable. The good news is that earnings are growing after a period of stagnation caused by declining oil prices, the rising dollar and a mid-cycle correction in industrial activity. Equities are generally compelling investments because capital and ingenuity are able to produce a growing series of cash flows over the long-term that are unmatched by other investment options. Therefore, earnings growth reaccelerating is a good thing. S&P 500 earnings are forecast to grow 10 percent for 2017 and 11.5 percent for 2018. The more concerning news is that there really are not many alternatives to investing in equities right now. Bond yields are so low that it will be mathematically impossible for bonds to deliver returns comparable to the history that most of today's investors recall. Beyond the simple math of higher yields reducing bond prices, investors in riskier bonds are not being adequately compensated for the risk that they are taking in our opinion. Real estate prices are high reflecting the asset's natural status as first substitute for bonds. There is little evidence that investors are pouring money into equities at an unreasonable pace right now so we do not see signs of euphoria. Equity holders' open ended claim on earnings power is not a bad place to be when a world awash in capital has limited the return potential of so many asset classes. It is wise to assume that returns will run below the long-term average for US equities for the near-future, but ultimately stock prices follow earnings. We do not believe that the higher valuations reflected in stock prices today equate to significantly higher risk, but we do believe that appropriate perspective requires a longer history than the last five years. The premium return to equity holders is compensation for the additional risks that are taken.

We enter the fourth quarter with clear economic momentum, a bias toward positive earnings reports and a lot of things that could go wrong. Front pages are full of doomsday scenarios that tell us equity prices are way too high and must come down or bond yields are way too low and must go up. We believe this is a time for discipline. Get the allocations right on the front end and rely primarily on time and earnings power to achieve your financial goals. International equities are an important portfolio component in our opinion given higher expected returns from lower valuations and the relatively early phase of the economic cycle.

We wish you well.