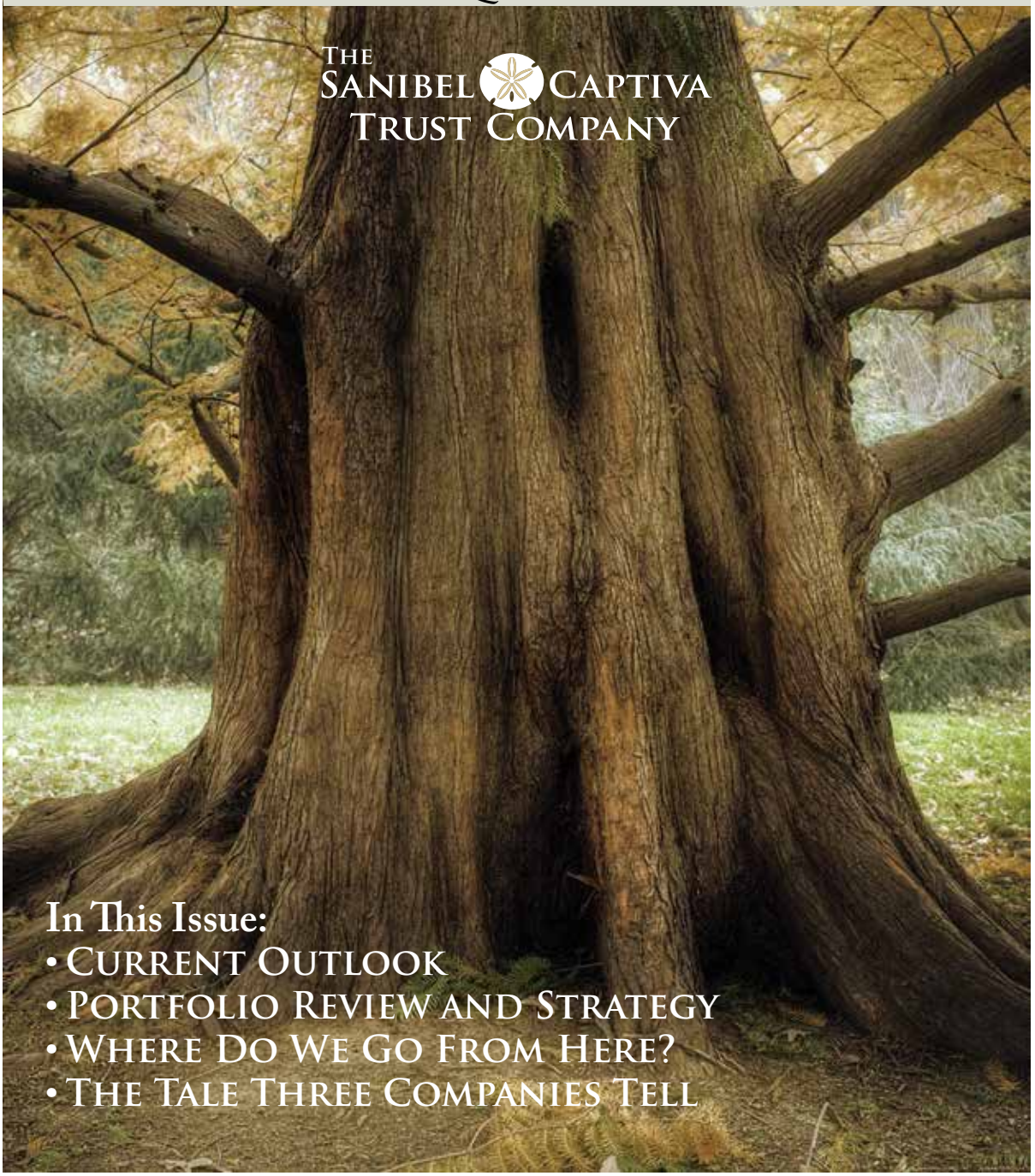
Market Watch

First Quarter 2014

The Sanibel Captiva Trust Company



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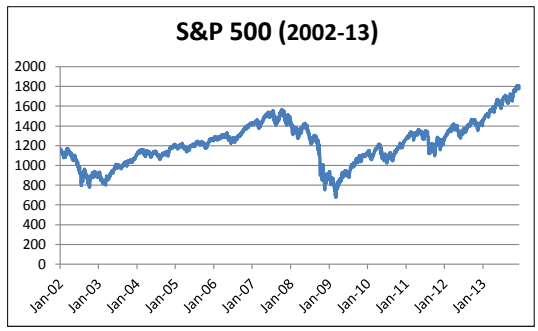
Current Outlook

The champagne corks were popping and the strains of "Happy Days Are Here Again" could be heard across the nation as U.S. equity markets finished their best year since 1997. The good times were driven by an economy awash in liquidity, thanks to the Federal Reserve Board's decisions to continue to buy Treasury and mortgage securities at a record pace. This unprecedented creation of money has caused both optimism and concerns as we struggle with sub-par world economic growth and below-average inflation. While we continue to see signs of sustainable growth in the U.S., an end to the Euro-Zone's recession, as well as a synchronized global expansion, market participants are wondering what impact will be seen on securities valuations when more-normal central bank activities resume.

The Federal Reserve Board has stated that monetary easing in the U.S., through its purchase activities, would begin to end (the so-called "taper") when economic data indicated that the employment situation and economic growth appeared sustainable. However, the Fed has also stated that an accommodative stance may be necessary as long as the risk of future government shut-downs was high. Within the past two months, economic growth has risen above 4% for the first time in more than 5 years, the unemployment rate fell dramatically to 7%, and the U.S. Congress has managed to approve a budget for both fiscal 2014 (ending this September) and fiscal 2015. This "dual budget approval" hasn't happened for five years, and avoids the near-term possibility of a shut-down. Thus the announcement in the middle of December that the Fed will be cutting back its purchases of Treasury securities should not have been a surprise.



The Fed likewise has said that interest rates would begin to move back to a "normal" level once it has completely finished its securities purchases. The stated goal is to get the unemployment rate sustainably below 6.5% before the Fed would even consider raising short-term interest rates. We do not expect an increase in short-term rates until mid-to late 2014, so investors looking for a decent return on their money-market funds may have a long time to wait.

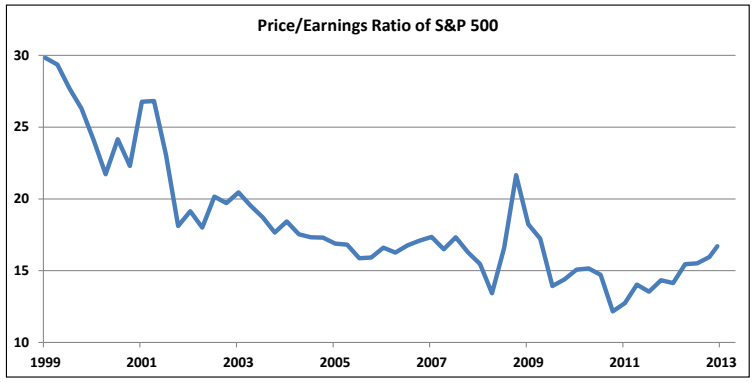
What will a "normal" economic environment look like down the road? We believe we will continue to struggle with nominal growth (inflation plus real economic growth) below the historic average of 5%-7% per year in the U.S. due to the effects of the financial crisis and its aftermath. In this type of environment, interest rates are unlikely to return to a comparable 5%-7% level unless inflation becomes unhinged from the current reality. Obviously, this will depend importantly on the ability of the central bank to reduce unnecessary liquidity from the financial system in a timely and effective manner without causing a jarring spike in the entire interest rate spectrum. This is a great unknown at the present time, but we are diligent in our efforts to analyze upcoming data for any signs that the most-likely scenario of continued stable economic growth and inflation proves optimistic.

Where Do We Go From Here?

The stellar performance of the U.S. equity market over the past year has created more worry than optimism among many of our clients. This is an understandable reaction – after enduring two bear markets in less than a decade, many equity investors are understandably skittish.

At the trust company, we are approaching the market more cautiously than we did a year or two ago, but we are not heading for the fallout shelter just yet. Extended bear markets are generally caused by either rampant speculation that drives valuations to unsustainable levels, or economic dislocation that undermines the health of corporate earnings, and we don't see either of these two issues affecting the market just now.

Although equity indices are hitting all-time highs, and pockets of froth are certainly apparent in some areas – we doubt Tesla is really worth $20 billion, for example – the broad equity market is currently valued at about 17 times earnings. This level is roughly in line with the long-time average valuation of the market, and far lower than the peak of 30 times earnings reached in 1999-2000. As you can see in the chart at right, valuations are considerably lower today than during the late-90s equity mania.



Moreover, the current context of low interest rates and low inflation provides further support for valuations. Low interest rates make it cheaper for companies to borrow, and increase the value of dividends relative to bond coupons. Low inflation helps companies to maintain solid profit margins, since cost inputs rise at a manageable rate.

As for corporate fundamentals, earnings growth has been quite robust over the past few years, and should be solid in 2014. The housing recovery is a welcome tailwind for the economy, and both consumers and corporations continue to reduce debt – U.S. households are currently in their best financial shape in more than 30 years. Outside the U.S., Europe is starting to grow (slowly) again, and emerging markets continue to be additive to global GDP growth.

The bottom line is that equities are not cheap, but neither are they anywhere close to "bubble" territory. And while the U.S. economy does face some long-run challenges – primarily, its unsustainable fiscal situation – corporate America continues to crank out good returns on capital, and balance sheets are broadly speaking in excellent shape. Absent a sharp decline in valuations, equity returns in line with mid-to-high single-digit earnings growth seems like a reasonable expectation to us. While this is lower than the 16% annual return of the market over the past five years, it's certainly nothing to turn up one's nose at.

The Tale Three Companies Tell

Since the beginning of 2009, Wells Fargo has earned $50 billion in profits and taken in $229 billion in new deposits. But it has lent out only $50 billion of the additional money at its disposal. The rest was used to reduce debt, pay dividends, and to buy low-yielding government bonds. Apple Computer continues to hoard cash, and at present pace would hold more than $200 per share in cash by the end of 2014, after paying dividends. By this time next year, cash could constitute 70% of Apple's assets and almost 140% of shareholder's equity. Meanwhile, General Electric is shedding its lowest-margin industrial and financial businesses, raising its dividend in quantum leaps, and trying to reduce its shares outstanding to below 10 billion.

Each of these world-class companies has strong competitive advantages and solid management. Yet, each in its own way is sending a strong message to outside investors: returns on capital around the world are low, and being fully invested in all their markets isn't paying off. You can sense the conundrum: While equity investors clamor for higher returns and showed signs of heightened enthusiasm in 2013, the very companies they invested in remain cautious.

Companies, by and large, are not maximizing their growth potential at the moment – and growth is what is ultimately needed to support higher valuations. For investors, 2013 was marked by a lot of contrasts – chief among them was that equity prices surged while corporate growth rates rose only modestly. This will be a theme to watch in 2014, for stock prices are already anticipating a surge in business momentum that has not yet surfaced across the board.

Corporate investment in fixed assets and intellectual property swelled after the 2008-09 recession, but peaked in 2011 and dropped sharply at a time when the economy was building momentum. As a result, industrial production has just now rebounded to 2007 levels, and capacity utilization is still several percentage points below previous cyclical peaks. Strip away the oil, gas, and mining industries, in fact, and the rest of corporate America is barely investing in its productive capacity.

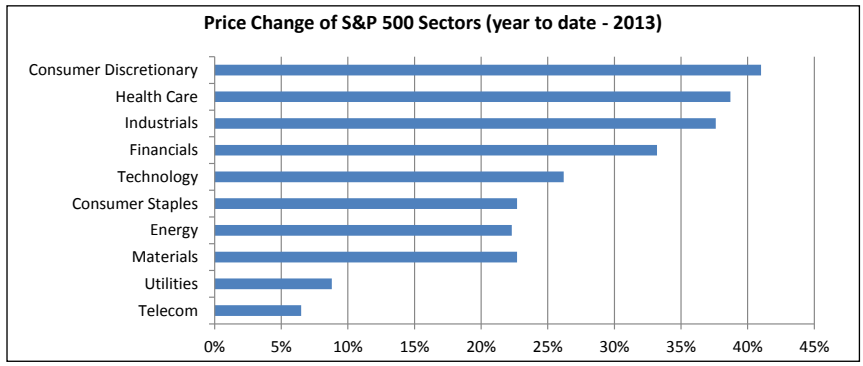
Two chief reasons account for the decline: Industries are still experiencing overcapacity and are experiencing lower returns on new capital. Banks, for example, are more leery of making new loans at today's low rates to businesses that possess the same credit risks as before. Industries, meanwhile, see the slowdowns in emerging market growth rates as an excuse to curtail expansion outside the U.S. In the absence of capital investment, corporate America has instead latched onto the "New Normal" allocation models of Apple, Wells Fargo, and GE. They are doubling down on their strongest markets (such as GE going "all in" on the oil, gas, and aviation businesses), while discontinuing product lines and spinning-off or selling weaker, non-core divisions. And with the cost of debt well below the costs of equity capital, companies are finding they can easily enhance per-share earnings (and sometimes returns to shareholders) by issuing debt to finance share buybacks and dividend hikes.

Something must give. A tech company like Apple can't continue to satisfy investors obtaining less than a 1% return on the majority of its asset base. We think the first half of 2014 will reveal whether companies are starting the transition back to traditional growth. The signs point to continued caution, but recent data points (such as increasing production in the auto industry and the buildup of inventories that led to an upward revision to GDP) tell us some corporate purse strings are opening.

Portfolio Review and Strategy

Performance among various asset classes continued to improve throughout the fourth quarter of 2013, capping off an outstanding year – particularly for equity investors. Regardless of market capitalization or investment style, equity investors were rewarded with 20%+ gains in 2013. The only discernible difference among performance was found at the sector/industry level shown in the chart below. Consumer discretionary businesses (retail, housing, autos, etc.) led the way. While it is conceivable that these businesses may have overachieved this year, it is worth noting that unemployment and housing continues to improve, perhaps providing a tailwind for these businesses into 2014. Although Telecom and Utilities broadly underperformed this year as investors flocked to investments with higher growth potential, these companies still provide excellent dividend income for conservative investors.

With no notable interest rate movements during the fourth quarter, fixed-income investments generally moved higher as well. For the year, however, fixed income was a mixed bag with shorter maturity investments performing as expected and lengthier maturity investments (longer duration) performing poorly – largely due to the Fed hinting at "tapering" their bond purchases earlier this year. Though the timing is difficult to predict, it remains inevitable that interest rates will rise. It is also inevitable that when (not if) interest rates rise, fixed-income investments will move lower in price. For example, as a result of the movement in interest rates earlier this year, the Barclays Aggregate Bond Index declined nearly 2% year to date. We expect fixed-income investors will find themselves earning meager (if not negative) real rates of return for the foreseeable future. For this reason, we have largely avoided fixed-income investments and will continue to do so until the inherent price risk lessens.



International equities moved modestly higher during the fourth quarter. Performance was also solid for the full year particularly among developed nations, but emerging markets struggled. As international equities have largely underperformed U.S. equities, we see good value among international equities and have been increasing our allocation to client accounts where appropriate.

Following a year in which U.S. equities almost indiscriminately moved higher, it is easy to extrapolate the near-term achievements as "normal" and use it as a basis for comparison going forward. It is important that we temper our expectations. For example, while we remain confident in U.S. equity markets going forward, we also expect a reversion to long-run averages, with stocks providing high single-digit returns, as opposed to the above-average returns we were pleased to earn this year.

Dear Investors,

As the largest independent trust company serving Southwest Florida, we combine personal service with world-class investment management to create a superior client experience. The Sanibel Captiva Trust Company seeks consistently to provide our clients with experience and vision grounded in results. Preserving and building wealth are fundamental to our investment philosophy and process. We know that your portfolio should be as individual as you are. That is why each portfolio is separately managed and uniquely tailored to meet the total return and cash flow requirement for each of our clients.

Every Thursday, The Trust Company's Asset Management Committee (AMC) meets to discuss investment strategy and how current events may be affecting the securities we own in our client portfolios.

If you would like to learn more about our investment approach and/or would like to attend one of our AMC meetings, we welcome your call at (239) 472-8300.

Warm Regards,

S. Albert D. Hanser
Founder and Co-Chairman

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