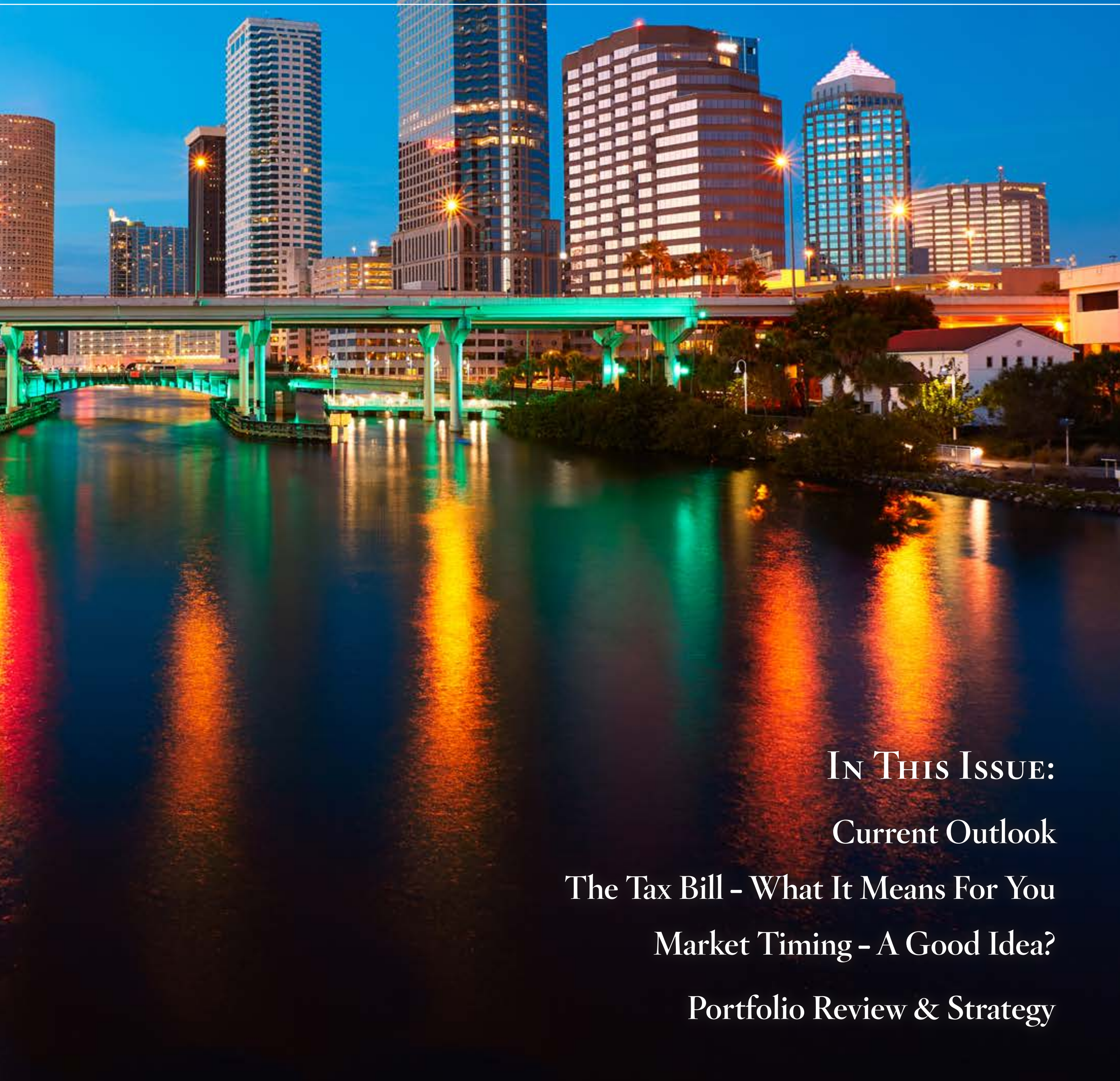
THE SANIBEL CAPTIVA TRUST COMPANY | THE NAPLES TRUST COMPANY | THE TAMPA BAY TRUST COMPANY

MARKETWATCH

DEEPLY ROOTED IN THE COMMUNITY | FIRST QUARTER 2018



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Current Outlook

Richard E. Pyle, CFA
President, The Sanibel Captiva Trust Company

The new year started on a strong note with consumers and businesses both showing high levels of confidence and hope. As we are fond of saying, however, "Hope is not a strategy." The question is, what strategy should investors adopt to make the most of this year's opportunities?

We project continued growth in not only the U.S. economy but an awakening in the rest of the world as a synchronized global expansion takes hold. World central bankers, represented mainly by the U.S., Europe, the U.K. and Japan, had continued to expand the money supply and foster "easy money" to revive economic growth after the financial crisis of 2008-09. It is our opinion that these efforts are coming to an end and that less easy money lies ahead. We also expect a slow revival of inflation expectations and gradually rising interest rates. We expect the Federal Reserve Board to increase its short-term interest rate target from 1.5% currently to at least 2.25% by the end of 2018. The U.S. 10-year Treasury note could yield as high as 3.5% during the same time period from the current 2.4%.

We project a transition toward monetary policy tightening at the same time that fiscal policy is meaningfully eased to drive the real economy and asset pricing well into 2018. We categorize the current environment as "uncertain" because of the tectonic shift in Washington, D.C. that took place last year. Interest rates around most of the world now look poised to rise from the unusual negative rates that have been experienced the past two years. Indeed, after nine years of low interest rates and rising equity prices, we may see a reversal of these dominant trends. Adding to the uncertainty, the make-up of the Federal Reserve Board will see turn-over of six of the seven members since June, 2014. Board members serve 12-year terms. This creates a relatively inexperienced Board overall.

Given this outlook, we again are being careful about portfolio construction. While we own many wonderful companies in our client portfolios, we are ever mindful that the valuations of many asset classes are closer to cyclical highs rather than lows. We look forward to the opportunity to add more fixed-income securities to the mix as interest rates rise. We still expect moderate economic and profit growth around the world this year with relatively low inflation. Stabilization in the value of the U.S. dollar and the price of oil will go far to act as a tailwind to profit growth after their negative effects in 2015 and 2016. Recently passed corporate tax reform could meaningfully benefit profit growth as well in the years ahead – a fact not lost on equity market participants.

With the U.S. economy expected to grow for at least the next 24 months as inflation and interest rates move inexorably higher, risks to the investor class appear containable. Despite the headline news bombardment, there is more opportunity for wealth creation. A rebound in capital spending and consolidation opportunities amongst some of the multi-national companies is also at play. The recently concluded federal tax reform efforts will also act as a stimulus to the world's capitalists. Funds previously held in foreign domiciles can now be used to expand opportunities here in the U.S. – whether it be for acquisitions, capital spending, dividends or share buybacks. All of these options represent cause for dynamic economic activity.

We remain positive regarding the long-term return potential of the world economy and expect a continuation of relative prosperity for some time to come.

The Tax Bill—What It Means For You

Michael R. Dreyer, CPA
President, The Tampa Bay Trust Company

In late December, the President signed into law The Tax Cuts and Jobs Act, with sweeping provisions that will affect individuals. While most experts expect the bill to provide relief for the majority of taxpayers, some will no doubt be adversely affected depending on their individual situation. The discussion below highlights the bill's major features, but in no way is meant to be a comprehensive analysis. There are a number of other provisions that affect individuals but are beyond the scope of this article. As such, we strongly suggest you discuss your personal situation with your tax advisor.

Tax rates: The bill retains seven tax brackets, but the rates and the income levels that apply to each are changing modestly. In general, the marginal rate will decrease for most taxpayers. Most notably, the highest rate, currently 39.6%, will be reduced to 37%. That marginal rate applies to single individuals with taxable income of more than $500,000 and married filers with taxable income of more than $600,000. The marginal tax rate will actually increase from 33% to 35% for single taxpayers with taxable income between $200,000 and $424,950 and married couples filing jointly with incomes between $400,000 and $424,950.

Dividend and Capital Gains Tax: The favorable tax rates for qualified dividends and long-term capital gains remain unchanged at 0%, 15% and 20%. Gains subject to the additional investment income tax will still be subject to the 3.8% add-on rate.

Standard deduction: The bill nearly doubles the standard deduction for individual taxpayers to $24,000 for married filing jointly, $18,000 for heads of households, and $12,000 for all others. The additional standard deduction for the elderly and blind does not change.

Personal exemptions: The bill repeals all personal exemptions for the taxpayer, his/her spouse, and dependents. Previously the exemptions were $4,050.

Itemized deductions: The bill repeals the overall limitation on itemized deductions. Previously up to 80% of deductions could be phased out for high-income filers.

Mortgage interest: The bill reduces the amount deductible on personal residence debt to $750,000 (from $1 million). Any taxpayer who owned their home prior to 2018 or who had a binding contract on Dec. 31, 2017 and purchases the home prior to April 1, 2018, will be allowed the $1 million limitation.

Home equity loans: Home equity loan interest will no longer be deductible, unless the funds are used to acquire a home (and are within the $750,000 indebtedness limitation) or are used for home improvements.

State and local taxes: The bill limits the allowable deduction for state and local income taxes and property taxes to $10,000.

Pass-through Entities: Under the bill, 20% of "qualified business income" from a partnership, S-Corporation or sole proprietorship may be deducted from gross income, subject to certain limitations. The balance of any pass-through income will be subject to normal individual rates. For individuals in certain specified service businesses (such as accounting, health, law, and financial services), this deduction is phased out beginning at $157,500 of taxable income ($315,000 for married filing joint).

Alternative minimum tax: The bill did not eliminate the alternative minimum tax (AMT). However, the exemption amount for married couples increased to $109,400 and the phase-out threshold increased to $1 million. For all other taxpayers (except estates and trusts) the exemption is $70,300, with the phase-out threshold increasing to $500,000. The exemption and threshold amounts are indexed for inflation.

Estate, gift and generation-skipping transfer taxes: The estate and gift tax exclusion is doubled to $11.2 million per person, or $22.4 million for a married couple. The generation-skipping transfer tax exemption doubles as well.

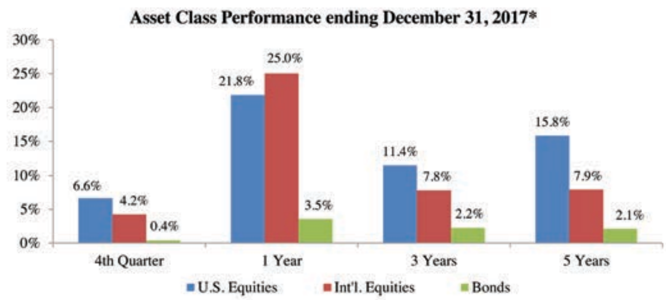
Unless a future Congress extends the bill's provisions, all of the changes affecting individuals will expire after 2025 and revert to 2017 rules and schedules, with the exception of the repeal of the individual mandate of the Affordable Care Act.

Portfolio Review & Strategy

Andrew Vanderhorst, CFA, CFP®, CLU®
Senior Portfolio Manager

The U.S. stock market continued moving higher with subdued volatility during an eventful quarter of fiscal and monetary policy action along with strong corporate earnings growth. U.S. stocks (S&P 500) moved up slowly and steadily for a 6.7% return, while not experiencing a greater than 1% daily decrease or increase for the first time this year. Breaking down the performance attribution, most of the continued rally was due to large-cap growth stocks returning 8.2% in the quarter and a late surge by large-cap value stocks, which returned 4.8%. International developed stocks rose 2.4%, while emerging market stocks rose 3.2%. Meanwhile, U.S. bonds eked out a 0.5% return.

The Republican-controlled Congress finally passed corporate tax reform and reduced the statutory corporate tax rate from 35% to 21%. In addition to experiencing a lower U.S. tax rate, many of the high-quality domestic companies that we own will benefit from a change in how their overseas profits will be taxed. The overall impact would increase many companies' profits while also allowing multinational companies to bring overseas cash home (repatriation) to the U.S. for investment, dividends, and share repurchases. While the longer-term economic impact of these tax provisions is unclear, equity investors will most certainly benefit from this portion of the tax plan (the details of which we review elsewhere in this issue).



**The S&P 500, MSCI EAFE, and Barclays US Agg Bond are used as proxies for broader market performance. Three and five year figures are annualized.*

As expected, the Federal Reserve Board increased short-term interest rates in December to a range of 1.25% - 1.50%. Janet Yellen's parting farewell as Federal Reserve Chairman highlighted the continued economic recovery in both the U.S. and the rest of the world. While inflation has continued to fall short of the Fed's 2% target, economic indicators remain positive and do not suggest an imminent recession.

On the other hand, we remain vigilant as the yield curve continues to flatten. As short-term interest rates increase faster than long-term rates, the Fed must be careful to avoid creating an inverted yield curve wherein short-term borrowing rates are higher than long-term borrowing rates. That would discourage some investors from making long-term investments and discourage banks from injecting loans into the economy, thus slowing down GDP. Should that situation arise, the incoming Fed chairman, Jerome Powell, will have to pull levers to help control the yield curve, likely by trading some of the long-term bonds held on the Fed's $4+ trillion balance sheet.

The appeal of fixed-income investments has improved with the recent interest rate increases. At this time, however, we still believe equities offer better risk-adjusted returns than bonds. Furthermore, we find that clients' current income needs can still be met with investments in high-quality dividend stocks, preferred equity, real estate investment trusts (REITs), and master limited partnerships (MLPs). As interest rates continue their slow climb back to a normal range, we will monitor bonds for favorable investment opportunities. While we may remain some time away from favoring bonds, we are starting to see light at the end of the tunnel.

Market Timing—A Good Idea?

Ian N. Breusch, CFA
Chief Investment Officer

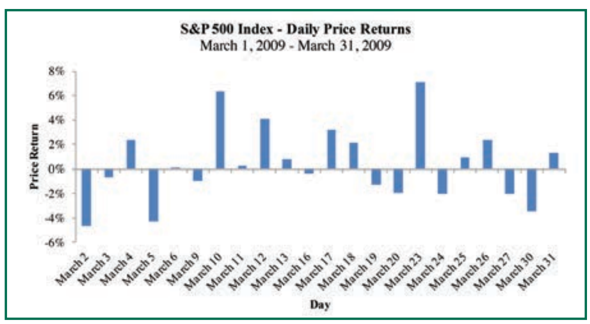
When markets become volatile or perform exceedingly well in the short term, there is a natural desire among investors to either limit the downside and/or take profits. Among practitioners in our industry, there has been much emphasis of late on investor psychology – and for good reason. Human beings, investors among them, are inherently emotional; therefore, our decision-making can often be illogical despite our best intentions.

Much of market timing stems from a very real emotional bias known as *recency bias*, which simply means evaluating a portfolio based on recent results and making incorrect conclusions about how the markets are going to behave as a result. A few real world examples of this behavior include:

- Purchasing investments after they've appreciated considerably – believing the upswing will never end
- Selling investments following a few extremely volatile days – believing the worst is around the corner
- Selling investments after a great year of performance – believing the market must be overvalued

In all three examples conclusions are reached based on what recently occurred without any consideration of fundamentals that have proven to be important determinants of success over longer periods of time.

There are other practical problems that market timing creates. If you sell to avoid losses or take profits, when do you repurchase? Let's consider the Great Recession of 2008-09 to clarify the point. Though an extreme example, March 2009 highlights the importance of staying the course particularly during volatile periods of time. Most of us agree intellectually that it is futile to perfectly time the movement in and out of equity markets. However, this chart reveals that perfection is often required for success.



If an investor in 2008 or early 2009 chose to sell their stocks to avoid volatility, would they have chosen the correct day (March 9, 2009) to reinvest? Almost assuredly not. The investor who stayed the course actually earned more than 8.5% during March of 2009. Similar volatility ensued during April, ultimately leading to another 9.4% in price gains. Investors who sold their stock to avoid volatility would have missed out on price appreciation of 18.7% in just two months. Considering the S&P 500 rose 26.5% during the whole year, if you were not invested in March or April, you missed out on the overwhelming majority of the rebound experienced in 2009.

So, how and when do we adjust portfolios given changing market conditions? Very simply, we focus on fundamentals, starting with the sales and profit prospects for each portfolio company. Given the above mental exercise, it is very rare that we would advocate for a large and hasty asset-allocation change simply because of volatile stock prices. Instead we manage portfolios according to the long-term goals of our clients and reposition at the margin, taking into consideration market dynamics, company specific fundamentals, and clients' cash needs.

The next time that markets seem too high to last or threaten to take us on a roller-coaster ride, take a moment to ask whether your desire to make changes is based on fundamentals or on the more human emotional response. We are here to assist you through those challenging moments.

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