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MARKETWATCH

Deeply Rooted in the Community | Third Quarter 2017

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Current Outlook

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

We now are halfway through what we have been calling the "Year of Uncertainty." We have expected uncertainty to reign as it relates to the major drivers of economic health and investment opportunities. Some of those drivers include private sector growth, employment levels, interest rates, inflation, and sometimes most importantly, political stability and fiscal policy.

The uncertainty in many of these areas has lessened as the U.S. and global economies continue to show improved performance. Worldwide monetary policies indicate that the nearly nine-year battle to prevent a second Great Depression has succeeded. The monetary authorities are now looking for ways to return to a more normal level of interest rates after actual results showed they achieved their employment and inflation goals. The U.S. Federal Reserve Board just increased its target for short-term interest rates a full 1% since they first raised interest rates in December of 2015—which was the first increase in eight years. We expect a further increase in short-term rates of another 1% over the coming 24 months.

In addition, the Fed has outlined its plan to sell off many of the bonds it purchased beginning in 2008. Both of these tangible actions will reduce the amount of monetary accommodation. We expect the rest of the world's monetary authorities to follow the Fed by tightening money modestly in the developed world. After nine years of low interest rates and rising equity prices, we may see a reversal of these dominant trends this year. We are cautioning against too much exuberance as we are reminded of the axiom "Don't fight the Fed" – when rates are rising or falling.

As to the outlook for the private sector, uncertainty here has lessened too as economies around the world exhibit moderate growth. The U.S. economy is expected to continue the transition wherein monetary policy gradually tightens and fiscal policy might meaningfully ease. These factors will drive the real economy and asset pricing in 2017 as well as into 2018.

We have categorized the current environment as "uncertain" partly because of the tectonic shift in Washington, D.C. that took place last November. This "uncertainty" on the fiscal policy front continues as Republicans appear to be having difficulty turning words into action on tax reform, healthcare overhaul, and much needed infrastructure spending. The strong upswing in equity prices since last November has lost momentum as hoped-for fiscal policy changes have devolved into an intra-party tussle. Congressional action is being delayed, at best, or abandoned, at worst. Growth estimates have been ratcheted back slightly, making any optimistic economic projections unattainable. This specific "uncertainty" remains despite the resolution of many other macro worries. Future headline-driven "uncertainty" about the outlook remains only a "tweet" away.

Given this outlook, we again are being careful about portfolio construction. While our clients own many wonderful companies in their 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 fixed-income securities to the mix as interest rates rise.

Bonds vs. Stocks – The Next Round

Timothy P. Vick
Director of Research

Market strategists seem eminently conflicted at the moment. At a time when macroeconomic conditions are relatively benign, even upward sloping, the financial markets are throwing off mixed signals that have stock and bond investors wondering how to allocate portfolios. On the one hand, broad economic data from the U.S., Europe, and Asia continue to show that the nine-year expansion in production and lending that began in 2009 remains intact. This has pushed up equity prices to new highs. The data also show that values of U.S. businesses continue to climb due to improved sales prospects, rising returns on capital, and effective use of cash flows.

Yet, bond markets seem to portend an end to the expansion. Interest rates dropped in recent weeks, inflationary pressures that once seemed imminent have dissipated, and oil and commodity prices have retreated. Most importantly, the yield curve on government bonds has "flattened," meaning that short-term and long-term bond yields have converged – historically, that has signaled a softening economy.

These mixed signals, taken at face value, pose difficulty for managers who are trying to extend returns for clients and keep risk levels moderate. An economic slowdown would most certainly hold interest rates lower for longer, hurting both stock investors looking for growth and fixed-income investors needing higher yields. Better economic growth, however, would justify the stock market's rally and give us continued opportunities to plant higher levels of income within portfolios.

Whether you're desiring stocks or bonds, much hinges on economic growth and the movement of interest rates in 2017. The positive data – improved loan demand around the world, tighter job markets, strengthened bank balance sheets, and revived capital spending – all point to more normal economic growth going forward and continued modest increases in interest rates. But we are watching closely sluggish U.S. productivity levels and retail consumption, both of which can naturally put a ceiling on GDP growth and keep it below policy makers' 3% targets.

We'll be guided by three trends as we navigate the tradeoffs between stocks and bonds:

A return to pre-Recession yields seems very unlikely to us. Prior to 2008, money-market funds yielded more than 5%, as did corporate bonds and municipal debt. We would "lock in" such yields for many clients today if they existed, but they cannot given the "New Normal" lower levels of money demand and economic activity.

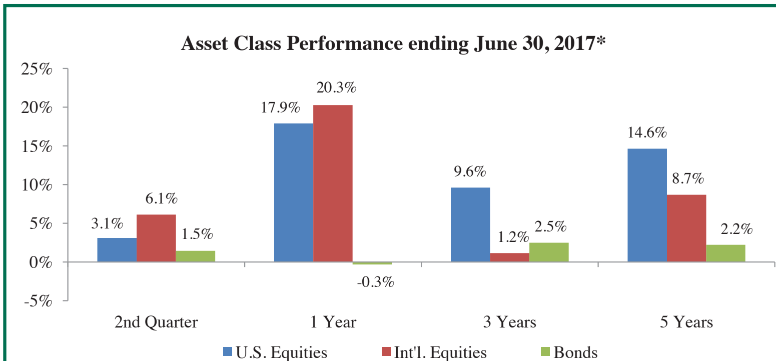
Total returns on stocks and bonds are falling after multi-year rallies in both asset classes. Stocks, however, remain the preferred investment by a longshot. An investor who buys a 5% coupon-paying bond today faces the possibility of watching the bond drop 3% a year in price until maturity, for a total return of just 2%. Equity investors should benefit from near 10% earnings growth in 2017 and 2018, but with stocks trading at cyclically high premiums to earnings and cash flows, chances are good that investors ultimately obtain returns below companies' earnings growth.

Our fixed-income strategy will have to stay nimble and evolve as we look for the best lower-risk income opportunities available at a given moment. Since 2008, we have ignored traditional government debt (where yields have nosedived well below 3%) and have alternately taken advantage of oversold corporate bonds, high-yield bonds, utilities, preferred stocks, REITs, oil and gas partnerships, and high-dividend paying blue-chip stocks. We will keep fishing these ponds until government debt offers adequate yields to compensate clients for the price risks.

Portfolio Review & Strategy

Ian N. Breusch, CFA
Chief Investment Officer

U.S. equities continued their upward trajectory throughout the second quarter of 2017. However, the boilerplate new items that seemingly propelled stock markets higher post-election have subsided. Healthcare reform, corporate and individual tax reform, and infrastructure spending (i.e. fiscal stimulus) remain on the horizon, but certainly are far from imminent. Other than a more forgiving regulatory environment, we are dealing with an economic backdrop that is largely unchanged. GDP has been predictable, corporate earnings have been solid, unemployment continues to improve, and the Federal Reserve Board has felt comfortable raising interest rates twice this year – with potentially more rate increases to come. As it relates to our portfolio of investments, the first-quarter earnings results we reviewed in April and May were positive.



**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.*

On June 14th, the Fed decided to raise the federal funds rate by another 0.25%. This follows the same decision made last December and in March. In just a few months, short-term borrowing rates have risen, and more rate hikes are expected this year and next. However, let's remember the Fed only impacts the short end of the yield curve. All other interest rates are set by market participants; therefore, the full spectrum of interest rates behaves differently than the Fed's desired outcome. We have noticed a slight flattening of the yield curve take place, meaning longer-term rates are not increasing as a result of Fed action. Flat or "inverted" yield curves can be a sign of impending recession. However, the Fed is acutely aware of this and can adjust their path toward interest rate normalization based on how the broader market reacts. This is one major reason why we believe achieving the target federal funds rate may take a bit longer than expected.

We continue to favor a combination of growth and dividend-paying stocks spread across several market sectors for the core portion of client portfolios. Income needs continue to be met by using high-quality income stocks (utilities), preferred stock, REITs, and master limited partnerships. Corporate and municipal bonds will be used more as interest rates rise and bond valuations look more attractive.

International stocks have performed rather well through 2017. While we have limited our direct exposure to international markets, we do own several individual companies headquartered abroad and many more that have revenue streams all over the world. As the economic landscape improves across Europe and other developed regions, we will consider more opportunities there.

Family Vacation Homes – Blessings or Curses

Robin L. Cook
Wealth Services Advisor

Leaving a vacation home to your children is one of the most sentimental thoughts in estate planning. Many years of fond memories and family gatherings are contained within the walls of that home, and it seems a great way to leave a legacy that will remind your children of those wonderful times. But without proper planning, those sentimental thoughts can quickly give way to painful discord, financial burdens, and even resentment after your death.

The first step that many parents overlook before leaving that legacy is to determine whether it makes financial sense to keep the home in the family. In most cases, the answer is yes, but liquidating that second home has become a necessity for some parents who are living off their assets and need all their assets to generate a return. When in doubt, parents should take care of their financial needs first.

The next step is to find out whether your children actually want the home and will equally share in the use and enjoyment of the property. Some children may have to travel much farther to visit the home, and some may not be equally able to pay for taxes, upkeep, insurance, repairs, maintenance or unexpected damage. If the value of the vacation home makes up a substantial portion of your overall estate, some of your children might prefer a more liquid inheritance that can make a difference in their day-to-day ability to support and enhance their family lifestyle.

If you leave your children as equal owners, they will have to agree on all decisions regarding the home, including when each of them can use it, whether to rent it out when not being used, whether to sell it (and at what price), and what repairs or maintenance will be needed. There may also be concerns that a child's share in the vacation home could pass outside the existing family through death, divorce or creditor claims.

So, if you are thinking of leaving a vacation home to your children, the first step is to talk to them individually and be open and direct about your goals and intentions. Ask them how they honestly feel about the idea and outline the obligations and financial responsibilities that accompany such a gift. You may uncover some attitudes, as well as personal situations, that could affect how you would set up this joint ownership - or whether to do it at all.

If those discussions still lead you to believe you want to continue down that path, the next step is to seek the guidance of an estate planning professional who can discuss various forms of shared ownership that can potentially minimize future conflicts. Placing the home into a limited liability company, a family partnership, or into a trust and appointing an independent trustee to be responsible for making all decisions may help alleviate some of the tensions caused by direct ownership. You will have to include money in your estate to cover the carrying costs of the home for a reasonable period of time. You may also want to give your children a right of first refusal to purchase the home in the event of a future sale.

Your vacation home may have been a place that held your family together for many years. Insightful forethought, professional planning and proper documentation can help conserve the property and strengthen family bonds for the next generation.

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