ECONOMIC & INVESTMENT SUMMARY

For Quarter Ending June 30, 2018

ABOUT THE INVESTMENT ADVISORS

1st Source Bank has been providing comprehensive financial planning and wealth management services since 1936 and currently manages over $3.5 billion in assets.

1st Source Corporation Investment Advisors, Inc. (1st Source Investment Advisors) is contained in the 1st Source Corporation holding company, and provides investment management services to 1st Source Bank.

1st Source Investment Advisors is regulated by the Securities and Exchange Commission (SEC), and is a wholly owned subsidiary of 1st Source Bank.

PORTFOLIO MANAGERS

Paul W. Gifford, Jr., CFA

Jason W. Cooper

Randall E. Thornton

Robert E. Romano, CFA

Noreen A. Kazi

Christopher M. Davis

Erik D. Clapsaddle CFA, CFP

Jackie A. Kronewitter

1st Source Corporation Investment Advisors, Inc.

Economic Activity

First quarter economic growth increased at its fastest pace since 2015 as GDP rose by 2% despite personal consumption increasing at its slowest pace since the second quarter of 2013. Consumer spending is the largest driver of economic activity in the United States as it currently accounts for more than two-thirds of GDP. We expect personal consumption to certainly pick up in the second quarter as the tax bill continues to have its rippling effects throughout the economy along with labor markets being incredibly strong, consumer confidence remains high, and wages are rising. First quarter growth was largely driven by a 10.4% increase in nonresidential fixed income investment. Expectations for growth in the second quarter have been increased over the past few months and the reliable Atlanta Federal Reserve forecasts second quarter growth to be around 4.5%.

Housing prices have continued their almost six-year ascent in the face of mortgage rates rising by 55 basis points since the beginning of the year. The most recent release from the S&P Case-Shiller home price index showed that home prices increased by 6.6% year-over-year while building permits remained well above their five-year average and housing starts reached their highest level in more than a decade. Despite the aforementioned increase in mortgage rates, the overwhelmingly strong labor markets, rising wages, and a notable shortage of housing inventory (inventory available properties for the month of May was at its lowest on record for that month) will continue to push housing prices higher nationwide.

Interest Rates

The Federal Reserve (the “Fed”) increased their target rate for the second time this year in June to a range of 1.75% to 2% and increased their rate hike outlook for 2018 from three hikes to 3-4 hikes. We expect four hikes to be difficult with inflation lukewarm at best and the difference between the 10-year and 2-year treasury notes only being around 35 basis points. There would need to be steepening in the yield curve (a greater difference between 10-year and 2-year Treasury yields) and an unexpected uptick of inflation on goods to warrant the Federal Reserve to raise rates two more times this year. Multiple members of the Fed have spoken to their concerns over the shape of the yield curve this year and the constraints it may add to monetary policy—not matching the increase of their rate hike forecast.

One of the challenges this year has been the widening of corporate credit spreads, the yield difference between a corporate bond and its comparable U.S. Treasury, as fixed income investors are demanding more yield from corporate bond issuers. Despite the weaker performance year-to-date in fixed income, the positive has been the recent ability to pick up an additional amount of yield this year along with Treasury yields that have continued to rise over the past 9 months. Company fundamentals are good and will be the driving force longer-term—the recent volatility has presented good buying opportunities.

Stock Market

Equity markets rebounded in the second quarter of 2018 from declines seen in the first quarter of this year. For the quarter the equity markets were led by the Russell 2000 (small caps) which were up 7.8%, followed by S&P 500 up 3.4%, and the narrower Dow Industrials ended up 1.2%. International markets underperformed domestic markets on concerns in Italy with the increasing popularity of the anti – establishment 5 Star political party. Also, the escalating trade rhetoric and additional tariffs announced by the U.S. and China increased the possibility of an unpleasant outcome. The tariffs may be a negotiating tool by both countries, but nevertheless developed international markets declined -3.2% and emerging markets were down -10.5%.

Small cap equities underperformed throughout 2017, but have rebounded strongly in Q2 2018 on the benefits of a stronger domestic economy versus the global economy, lower corporate tax rates from the recently passed tax reform, and smaller caps being insulated from the trade headlines. On tax reform, small cap companies will receive a much larger benefit than large caps as the majority of small companies were paying tax rates closer to 35% and will now have effective tax rates of around 22%. The tensions surrounding trade will have a much greater impact on large cap companies versus small cap companies as larger cap companies generate a greater percentage of revenue and earnings from overseas markets.

The difference in performance between growth and value equities over the past year has been staggering with growth equities up 21.4% versus the return in value equities of 4.6%. Year to date the outperformance by growth has continued with growth equities outperforming by 9.0%. The outperformance in growth equities is a result of the technology sector which is responsible for almost half of the total return in the S&P 500 over the last two years. Technology’s stronger organic growth is being fueled by secular trends in cloud computing, artificial intelligence, and increased semiconductor content in a number of new industries. The underperformance in value can be attributed to the interest rate sensitive sectors of real estate, utilities, staples, and telecom which suffer in a rising interest rate environment. For the second half of the year we expect the volatility to remain and the financial markets to remain range bound as mid-term elections come into focus.