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.

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ECONOMIC & INVESTMENT SUMMARY

For Quarter Ending March 31, 2018

Economic Activity

Economic data continued to trudge along in the first quarter of 2018 as labor markets also maintained their slow improvement. The trailing three-month increase in the change in nonfarm payrolls of 242K was at its highest since September 2016 and the labor force participation rate increased to 63%—also its highest since March 2014. The larger issue in the labor markets has become the number of job openings, a shortage of quality labor to some extent, as these openings reached 6.3 million in January. This statistic, mentioned frequently by us in quarterly commentary, continues to remain at historically high levels and January's result was the highest on record. The unemployment has remained at 4.1% for five consecutive months while the underemployment rate, a much broader measure of employment in the U.S., has risen to 8.2% over the past few months as it recently bottomed out at 7.9% in October.

Inflation data has provided little surprise to the markets over the past few years until a fairly large surprise in early February. The annual increase in Average Hourly Earnings came in high at 2.9% against the forecasted 2.5%. This surprise moved Treasury yields higher and certainly was a catalyst for the stock market correction in early February. Beyond that one-time data release, inflation has continued to remain lukewarm. The core inflation that the Federal Reserve closely watches most recently read 1.6%, which is well below their 2% target for inflation. The Federal Reserve has lately been more open to giving inflation a little room to the upside without abruptly changing monetary policy.

Interest Rates

The Federal Reserve continued their gradual path of tightening monetary policy as they increased their Target Rate again to a range of 1.50% to 1.75%. This rate increase was the sixth time they have increased their Target Rate since they took it to 0% in December 2008. We expect the Federal Reserve to remain on course with their projections in 2018, which is for three total rate increases, unless they are derailed by a surprise increase in inflation.

The tougher challenge for the Federal Reserve into 2019 will be continued rate increases without longer-term bond yields rising. As the Fed has increased their Target Rate, short-term interest rates have continued to narrow the gap between the yield on short-term rates and long-term rates. The Federal Reserve would not be able to raise their Target Rate beyond the ceiling that longer-term bond yields create.

The return on traditional fixed income during the first quarter was negative as interest rates increased throughout the first quarter. Short-term interest rates reached their highest since the recession and three-month LIBOR, the global borrowing rate, reached its highest level since November 2008. If purchased at year-end 2017, the price on the 30-year Treasury bond declined by 4.9% over the quarter as the interest rate on the 30-year bond increased by 24 basis points to 2.98% while the yield on the 2-year Treasury note increased by 37 basis points to 2.26% but only lost 0.21%--we are staying short in maturity and duration with fixed income dollars.

Stock Market

In the first quarter of 2018, the equity market fell victim to a correction with the S&P 500 declining 10% in a nine-day period from late January thru early February. This was the first correction of at least 10% since February 2016. The culprit for the correction was a sharp rise in wage inflation and heightened political tensions surrounding a potential trade war. For the quarter the small caps stocks were down 1%, followed by the S&P 500 down 2%, and the Dow Jones Industrials Average down 4%. Internationally equities fared slightly better with the Emerging markets index up 1.50% and the developed international index down.

Volatility returned in the first quarter with the Vix Index (measure of volatility) spiking higher after experiencing record low levels throughout 2017. Investors have witnessed volatile swings in the market and have seen more days in 2018 in which the S&P 500 has moved 1% than all of 2017. Even with all the volatile swings in the market, the S&P 500 is still at levels seen in December of 2017. We believe increased volatility will remain as the Federal Reserve becomes less accommodative by raising interest rates and reducing the value of their balance sheet.

We are maintaining our constructive view on global economic growth and corporate earnings. Corporate America should see a windfall from recently passed tax reform and as a result S&P 500 earnings have been projected to be in a range of $155-160 per share. Solid economic growth and sharply higher earnings estimates will provide a floor for equity prices, absent an unforeseen economic event.

U.S. growth stocks which outperformed value stocks by 17% in 2017 continued outperforming U.S. value by 5% year to date with large cap technology stocks leading the way. Year to date, the technology sector is more than 10% ahead of more defensive yield oriented sectors such as staples, telecom, and utilities. On a 1-year basis the technology sector is more than 30% ahead of these same sectors. We acknowledge the long term growth and disruptive nature of technology, but are aware this has become a crowded trade in the short term.