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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1st Source Corporation Investment Advisors, Inc.

ECONOMIC & INVESTMENT SUMMARY

For Quarter Ending December 31, 2017

Economic Activity

Labor market data continued to show strength in the fourth quarter as even the destructive aftermath of the hurricanes could not turn the change in monthly payrolls negative. During the fourth quarter, the unemployment rate declined from 4.4% to 4.1% and JOLTS (Job Openings & Labor Turnover Survey) stayed above five million for the 34th consecutive month—prior to this streak, job vacancies had not reached five million since January 2001. We continue to believe a tight labor market and higher than average job vacancies should slowly move wages higher.

The domestic housing market continues to grow in the U.S. as home prices increased year-over-year (“YoY”), for the month ending October 31, by the largest amount (6.38% YoY) since July 2014. The increase in home prices has been driven by low inventories and high demand as existing home sales and new home sales in November reached their highest levels since December 2006 and July 2007. A few headwinds for home sales and values are the recently lowered tax deduction homeowners can take from their mortgage interest paid and rising interest rates, though we believe the strong economy and labor markets will continue to outweigh those.

The U.S. Congress passed the Tax Cuts & Jobs Act bill (the “tax bill”) and was signed by President Trump on December 22. The primary elements to the tax bill are a permanent reduction in the corporate income tax rate from 35% to 21%, majority marginal tax rates declining, and the estate tax exemption increasing from $5.6 million to $11.2 million (expires December 2025). The tax bill should be a positive for economic growth but it will add a significant amount to the U.S. deficit and debt unless there is a substantial increase in U.S. economic growth.

Interest Rates

Short-term rates had another quarter of reaching longer-term highs as the two-year U.S. Treasury note reached its highest yield since October 2008 and three-month LIBOR reached its highest rate since December 2008. Short-term rates should continue to increase in 2018 as the Federal Reserve is forecasting three rate hikes during the year and the economy continues to grow. Longer-term rates have barely changed since the end of 2016 as they are more correlated with inflation and inflation expectations, but as short-term rates move higher it should begin to push longer-term rates higher. We do expect a slight uptick in inflation—thus pushing longer-term bond yields higher.

More clarity has been brought to the future of the Federal Reserve as the nomination of Randal Quarles for Vice Chairman of Supervision has been confirmed and Jerome Powell will most likely be the new Chairperson of the Federal Reserve when Janet Yellen’s term ends in February 2018. There will still be additional appointees to the Fed in 2018 as three vacancies remain beyond the first two appointees aforementioned—though there has been one nomination recently and if approved it would bring the vacancies to two.

The more credit risk one took in 2017, the more return one earned. This additional return came from high yield bonds and preferred stocks. We expect 2018 to have a similar pattern, though the return difference to be smaller, as the economy continues to expand and at least remain stable.

Stock Market

The fourth quarter of 2017 continued the strong performance in the equity markets with the Dow Jones Industrials Average, S&P 500, and the Nasdaq all hitting new records. It was the 63rd record high for the S&P 500 this year. Equity markets gained in the fourth quarter as expectations surrounding tax reform drove the latest leg of the bull market. For the year the Dow gained 28.1%, the S&P 500 21.8%, and the Nasdaq 29.7% on the strength of the technology sector. International equities outperformed the S&P 500 for the first time since 2012 with the MSCI EFA (developed international) up 25.2% and the MSCI EM 36.9% (emerging markets).

The catalyst behind this equity market – synchronized global growth, strong corporate earnings, and low inflation should continue into 2018. Tax reform will be an additional boost to corporate earnings, but the corporate tax cut is likely to vary by sector. Industries such as financial, retail, and telecom pay some of the highest effective tax rates and will benefit more than those with a lower effective tax rate, such as technology. Tax reform could provide upside of $10 to $15 in S&P 500 earnings, which would increase consensus earnings estimates to $150 per share. At an elevated 20x earnings this would yield a S&P 500 of 3000.

The current bull market has extended its streak of positive annual returns to nine years and has almost quadrupled since the bottom in March 2009. The current trailing price to earnings ratio for the S&P 500 is 21 and above historical levels, but below those seen in 1999-2000. One major risk for the equity market is the Federal Reserve and their pace of raising interest rates. Currently the market is expecting three interest rates hikes from the Fed, but if inflation were to spike the Fed may have to raise interest rates faster than expected. We do believe the equity bull market will continue in 2018, but with reduced expectations, increased volatility, and more corrections which would represent an opportunity to buy at lower prices.