ECONOMIC & INVESTMENT SUMMARY

For Quarter Ending June 30, 2017

Economic Activity

Retail sales continue to be a disappointment as they have experienced negative monthly changes for two out of the past four months. The decline in retail sales can be attributed to the decline in automobile sales and gasoline. Automobile sales have reported a monthly decline four of the five past months. Despite declines in retail sales, personal consumption has been the driver in quarterly growth of U.S. gross domestic product ("GDP"). Consumption of services, largely health care, has accounted for more than 50% of total personal consumption over the past few quarters and in the first quarter of 2017 it accounted for 85% of total personal consumption.

The slowing of the change in nonfarm payrolls increases has continued for four consecutive months and the three-month average increase for the change in nonfarm payrolls has reached its lowest level since the three-month period ending July 2012. This has not come as a surprise as the U.S. economy has appeared to reach full employment or very near it as the U.S. business cycle matures. The unemployment rate is currently at 4.3%, but there still remains structural unemployment in the U.S. as the underemployment rate, commonly referred to as U6, is at 8.4%. Even the U6 rate has experienced strong declines over the past few months as it has gone from 9.2% in December to the 8.4% today.

Inflation data on goods continues to soften and come in below expectations, but can be primarily attributed to the decline in energy prices. Most recently the core personal consumption expenditure, the Fed's primary gauge for inflation, reported only a 1.4% year-over-year increase. We do believe wage inflation will continue to take hold as personal income has been increasing at healthy levels over the past three months—averaging a 0.3% monthly increase and the labor markets remain incredibly tight.

Interest Rates

The Federal Reserve (the "Fed") increased their target rate, the benchmark for short-term interest rates, through the first half of the year and in December 2016. The Fed increased their target rate by .25% in March and June with the current range at 1.00% - 1.25%. They have also laid out a plan for shrinking their balance sheet that has grown to $4.5 trillion from $1 trillion pre-financial crisis. Three-month LIBOR, the globally used short-term borrowing rate, reached 1.298% on June 30—its highest level since March 2009.

The early reaction to such changes has been muted. As we would expect, the yield on treasury notes maturing in less than 3 years have moved higher. Despite the Fed's increase in their target rate, the yield on longer maturities, 3+ years, has dropped. We do not believe that the bond market is ignoring the Fed's recently-founded monetary policy but that the driver in lower long-term bond yields has come from inflation expectations that are stable, lower energy prices, a continual glut of negative yields globally, and that the Fed will move methodically and with much advanced notice of any changes. The Fed's communication at their June meeting provided a good back drop on how they would reduce the balance sheet possibly starting later this year.

Stock Market

The second quarter of 2017 continued the positive momentum in the equity markets with the Dow Jones Industrials Average, S&P 500, and the Nasdaq all hitting record highs. For the quarter, the Dow gained 3.96%, the S&P 500 3.09%, and the technology heavy Nasdaq 4.21 %. Smaller capitalization equities measured by the Russell 2000 underperformed their larger brethren and finished the quarter up 2.76%. Developed markets measured by the MSCI EFA were up a strong 7.02% for the quarter as the French presidential victory by Emmanuel Macron gave much needed support to the European Union.

The market advance was bolstered by the strongest corporate earnings growth in 22 quarters with first quarter earnings up 14% year over year driven by 8% revenue growth. For the full year, analysts now expect earnings growth of 10% on mid – single digit revenue growth. In Europe first quarter earnings growth was even stronger with earnings per share up 26% year over year, the fastest in 7 years. Revenue growth has improved from last year with 63% of companies in the S&P 500 exceeding their revenue estimates, and a continuation of the weakening dollar could drive revenue and earnings revisions higher. The strongest sales growth was seen in the energy sector based on a rise in year over year energy prices in the first quarter. Energy prices have since declined significantly and prices were set for their worst first half performance since 1997 as increased shale oil production offset cuts from OPEC.

The upward bias in the equity markets has been concentrated in the large cap growth asset class with year to date returns of 4.59% versus the 1.30% returns of large cap value. Through May 31st, the Russell 1000 Growth/Value ratio surged 11.5%, the second-biggest gain since data began in 1979. More specifically, large capitalization technology equities such as Facebook, Amazon, and Google are responsible for the majority of the S&P 500 return on a year to date basis. Though, these companies have outstanding growth prospects and are forecasted to growth earnings north of 20% for the current year.

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.

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