Investment Market Update

March 31, 2017

The optimism reflected in the equity market's early quarter performance is beginning to fade as investors impatiently await details of a revised tax plan and infrastructure-spending program. The pro-business Trump administration is battling, rather than skillfully negotiating, political resistance. Investors are questioning if the Washington political theater will become a reality show comedy, tragedy or popular hit. Healthcare reform, trade debates, and immigration issues are postponing progress on advancing tax reform, which threatens any acceleration in the economy.

During the quarter, many economic signals and monetary policy messages were mixed and contradictory. While soft data like consumer confidence and sentiment are peaking, the real data reveal only moderate economic growth. In a visibly conflicting sign, the Federal Reserve Bank of Atlanta revised down its 2017 GDP growth estimate from 3.5% to 1.3%, while the overly optimistic Federal Open Market Committee (FOMC) in Washington, D.C., raised interest rates 25 basis points. The FOMC reacted to the recent 1.9% inflation rate, while the Atlanta Fed sees larger trends in aging demographics, low wage growth, disruptive technological advances, and potential disinflation in commodities, as growth hindering. Even though the interest rate increase was expected, the market responded counterintuitively with short-term rates rising but long-term yields falling. This flattening yield curve is usually a sign that economic growth is moderating.

Index	First Quarter Total Return
S&P 500 Index	5.5%
Mid-Cap 400 Index	3.5%
MSCI International EAFE	6.5%

The equity markets will trade in a range until there is further evidence of corporate earnings growth or new fiscal policy implementation. With a corporate tax rate reduction from 35% to 20%, S&P 500 earnings would be estimated to grow 9.1% in 2017. Without reduced tax rates, earnings would be anticipated to grow only 6.6%. In either case, domestic equity market valuations are in their median trading range. We believe the U.S. will provide more stable returns than foreign equities with significantly less political, currency, commodity and economic risk. The best-performing sectors to date have been in information technology, healthcare and consumer discretionary companies. The best of these -- like Apple, Facebook, Amgen, Amazon, and Home Depot -- are innovating new products, investing in new processes and improving enhancements and services to become more efficient.

Best Always,

Michael Aloian - ***President, Trust & Investment Management Services, Chief Investment Officer***

941-624-5400

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A Big Meaningless Milestone

By Samuel A. Kiburz, Portfolio Manager

Exchange-traded funds (ETFs) are just one of the many types of investments available, but they have some qualities that set them apart. ETFs are securities that attempt to track all types of indexes, industries, or commodities. For example, an ETF might be made up of securities representative of the technological industry or the S&P 500.*

Some may choose ETFs because they combine the diversification of a mutual fund with the flexibility of stocks. ETFs net asset values are not calculated daily, as are typical mutual funds, rather their prices may fluctuate throughout the day based on market demand.

Exchange-traded funds were created in the 1990s, and their number recently surpassed 2,000. While that may seem impressive, it actually is a meaningless milestone. It does, however, provide a benchmark at which to examine the industry.

The number of ETFs is growing, though at a decreasing rate. More funds creates more competition manifesting in fee wars amongst the funds, challenging profitability. In fact, there were 128 closures in 2016, a record high, tripling the number in 2008.

I believe there is a limit to the number of legitimate and feasible indexes to track when creating new ETFs. At the most recent ETF conference I attended, I was inundated with numerous off–the-wall ideas as companies reached for new ETF products. A recent study of 1,000 active investors indicated they are starting to feel overwhelmed with the number of ETFs available and feel that the performance of some ETFs may differ from expectations due to the complexity of the funds' strategy.

It should also be noted that closed ETFs do not merge with more successful sister funds as do mutual funds. Rather, they either are liquidated or delisted, which presents a new type of risk to investors. Either type of closing can be costly, especially liquidations, since they can cause an unexpected taxable gain or loss. To add insult to injury, the ETF can pass the cost of closing onto investors, which may be as high as 3%. If a fund is delisted, that can make selling it difficult.

What types of ETFs close? In general, they are funds that have not attracted sufficient investment interest to reach the industry minimum of $25 million.

Does this mean ETFs are risky investments as compared to mutual funds? Not in our opinion. Our Trust and Investment Management Services division significantly researches and monitors all available ETFs. In addition, we thoroughly analyze the underlying investments. We also consider factors such as the asset size, how long it has been in existence, its daily and monthly trading volume, its expense ratio, how well it tracks its respective indexes and the reputation of its issuers.

When all of these factors are considered, we narrow the 2,000+ ETF universe down to the "best of the best" and use those products exclusively.

Here are some facts regarding exchange-traded funds:

1. The SPDR S&P 500 Index ETF is the largest fund (including mutual funds) in the world with more than $212 billion in assets. It trades over $18 billion a day.
2. $572 billion has flowed into ETFs since 2009, and it is projected that ETFs will have more invested in them than in mutual funds by 2025. The industry had the best quarter ever during the first quarter of 2017, with more than $130 billion invested into ETFs.
3. ETF trading makes up over 35% of all the daily trading volume on the stock exchange.
4. The money invested in ETFs grew by $284 billion during 2016, while mutual funds shrank by $187 billion.

So, while the ETF industry is growing, the number of indexes upon which they can be based is limited. We therefore will probably not see them grow to 3,000 (the next big, meaningless milestone) as fast as we saw them grow to 2,000.

** The S&P 500 is an unmanaged group of securities that is widely recognized as being representative of the U.S. stock market in general. The performance of an unmanaged index is not indicative of the performance of any specific investment. Individuals cannot invest directly in an index.*

A Team You Can Trust

Samuel Kiburz
Christine Hause
Michael Aloian
Lory Weisensee
Angie Misner
Cindee Murphy
Francine Wargo
Martha Dyer
Terri Griffith
Brittney Seymour

Charlotte Harbor Office
23112 Harborview Road
941-255-5235

Murdock Office
1100 Tamiami Trail
941-624-5400

North Port Office
4300 Aidan Lane
941-777-6100

Parkside Office
3002 Tamiami Trail
941-235-4444

Peachland Office
24163 Peachland Boulevard
941-627-0038

Punta Gorda Office
2331 Tamiami Trail
941-639-2511

www.charlottestatebankandtrust.com