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MANAGING WEALTH. SECURING LEGACIES.

U.S. stock market shows impressive resilience in 2016

The year 2016 was a perfect case-in-point as to the unpredictability of geopolitical events and their short-term impact on markets. At the beginning of 2016, not a single economist or market guru predicted the stock market and oil selloff in January, the U.K.'s vote to leave the European Union ("Brexit") in June, or the Presidential election of Donald Trump in November. If someone had predicted these events, would they have also predicted that the U.S. stock market would be up 12% for the year? Or that emerging stock markets would be up over 11%? Not likely.

Elections matter. They have important social and business ramifications, but elections have virtually no lasting impact on markets. The reason that markets care little for electoral politics is that long-term cash flows are what drive stock market returns over time. The intrinsic value of those cash flows does not change as dramatically as the day-to-day gyrations of the market indicate. The noise in the financial media and our human instinct to protect against loss can obscure that underlying truth and can lead to poor investment decision making. This is also why, given thoughtful consideration, our clients' goals rarely change as a result of a political election.

From an investment perspective, it is important to remain objective despite the polarized U.S. political climate. Some investors who are now optimistic for stocks based on the Trump victory were skittish in 2009 after the Obama inauguration. The U.S. market is up over 200% cumulatively since that time. Other investors are now squeamish at the thought of market volatility during a Trump presidency, yet early on, the market has embraced the business-friendly tone of the Trump administration.

The presidential election was a good example of how events may have unpredictable impact on markets. Despite the election-night hand-wringing, the S&P 500 rallied in November and December, ending the year up 12%. Small company stocks had a tremendous end to the year – the Russell 2000 Index of small cap stocks was up over 20% in 2016. Most other major asset classes, however, were down for the quarter.

Dollar strength in 2016 was a drag on returns once again for dollar-based investors in foreign developed markets. Emerging markets were hurt in the fourth quarter (down 4%) by higher U.S. interest rates which make emerging markets less attractive. As a result, returns for well-diversified portfolios for the three months ending 2016 were mixed.

> **2017**
>
> *Please join us for our upcoming Quarterly Investment Briefings*
>
> **Wednesday, May 3rd**
> **Wednesday, August 2nd**
> **Wednesday, November 1st**
>
> 4:00 p.m. to 6:00 p.m.
> Windsor Park Conference Center
> 4000 Edison Lakes Parkway
> Mishawaka, IN 46545
>
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RETURNS AS OF 12/31/2016

ASSET CLASS	Q4 2016	2016 YTD
EQUITIES		
Large Cap US Equities (S&P 500)	3.8%	12.0%
Mid/Small Cap US Equities (Russell 2000)	8.8%	21.3%
International Developed Market Equities (MSCI EAFE)	-0.7%	1.0%
Emerging Market Equities (MSCI Emerging Markets)	-4.2%	11.2%
FIXED INCOME		
Barclays Capital US Aggregate Bond Index	-3.0%	2.7%
[illegible] Municipals, 7 Years	-3.2%	-0.3%
ALTERNATIVES		
Real Estate (FTSE EPRA/NAREIT Developed Index)	-5.4%	5.0%

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U.S. stock market shows impressive resilience in 2016

In the fourth quarter, enthusiasm for political change towards lower taxes and a looser regulatory business environment boosted the U.S. stock market. Financial stocks surged as the Federal Reserve raised its target interest rate for only the second time in a decade. Higher rates help banks' net interest margins. Financials have also been strong since the election due to expectations for less onerous regulations. President Trump has maintained that he will target Dodd-Frank reforms which have increased banking compliance costs since 2010. Goldman Sachs and Bank of America were up over 30% in the fourth quarter. Market expectations are for a strong rebound in corporate earnings in 2017 and 2018, particularly if corporate tax reform takes hold.

The Russell 2000 Index of small cap stocks rose by over 20% in 2016. These smaller firms have more exposure to the U.S. economy and its tax rates than do global corporations, which are impacted more by currency exchange rates and global economic conditions. The potential for a substantial business tax cut could be a great boost to small cap stocks' earnings growth in the coming years.

Outside the U.S., foreign developed markets were slightly negative in the fourth quarter. Dollar strength in 2016, in particular relative to the U.K. pound, was a drag on returns once again for dollar-based investors in foreign developed markets. The U.K. market was up 19% in local currency terms but was flat in dollar terms as the weakening of the pound due to the Brexit event negated the market return. Currency trends are notoriously unpredictable and over the long-term tend to wash out as a component of foreign stock market returns.

Emerging markets were hurt in the fourth quarter (down 4%) by higher U.S. interest rates and a stronger dollar. However, emerging markets had a solid 2016 (up 11%). The rebound of Brazil in 2016 – up 67% in dollar terms – was a major factor for the asset class. Russian stocks, with a high concentration in the energy sector, were up 55%.

Portfolio Management Comments

A common question on most clients' minds is why portfolio returns have not surged as dramatically as the U.S. stock market. Certainly U.S. stocks have performed very well for the last ten years relative to every other asset class. The short answer to this question is that our client portfolios hold more than just U.S. stocks. Every client portfolio at Indiana Trust has a target asset allocation, which determines the percentage of the portfolio to be allocated to each asset class (i.e., U.S. stocks, international stocks, bonds). This strategic asset allocation is the primary driver of returns over time.

A disciplined allocation to a diversified set of asset classes means that our portfolios will have components which outperform others, sometimes for long periods. The fourth quarter was a case study in the pain that diversified portfolios can sometimes inflict. U.S. stocks were up over 4%, yet a balanced portfolio including bonds and international stocks resulted in a portfolio return of close to zero.

Bonds act as an important shock-absorber to stock market volatility. However, given the return disparity with the U.S. market, why do we continue to include international and emerging markets stocks in portfolios? First, there are compelling

long-term investment opportunities outside the U.S. Nestlé, Toyota, and Daimler are a few examples of global companies which have generated high returns on capital over time. Second, non-U.S. stocks make up over almost half of global stock market value. Excluding them would essentially cut the global stock universe in half. Additionally, the number of stock market listings in the U.S. is essentially the same as it was in 1972. U.S. companies are older and much bigger than they once were, and this is not necessarily the case overseas. Given these market dynamics, international and emerging markets are an important opportunity set for capital growth.

It is fruitless to attempt to time when one asset class (i.e., U.S. stocks) will outperform another asset class (i.e., international stocks). One does not need to go too far back in history to find periods when international and emerging markets were contributing more than U.S. stocks to total portfolio returns. It is always hard to see when the turning point will be, however, our diversified approach ensures that we will have our clients' portfolios positioned to take advantage when it does.

Fixed Income Markets

After the presidential election in November, interest rates in the U.S. moved sharply higher. Investors assigned a higher probability of stronger economic growth and higher future inflation. These new expectations centered on both broad tax reform, which will reduce personal and business taxes, as well as fiscal stimulus in the form of infrastructure spending by the incoming Trump administration. This could be interpreted as a blueprint for higher budget deficits in the short-term and increased bond issuance by the U.S. Treasury – a possibility which may have helped push rates higher. The outcome of higher deficits and higher bond issuance is far from certain, given the makeup of Congress and its relationship with the Trump administration. One piece of this puzzle does have a very high likelihood of coming to fruition: tax reform.

As a result of the sell-off in the bond market, the Bloomberg Barclays U.S. Aggregate Index, a wide barometer of the U.S. investment grade bond market, fell 3% in the fourth quarter. The last quarterly return worse than that was in 1981. While it was a historically bad quarter for the U.S. bond market, the total return was 2.7% for the full calendar year – not far off its current yield. Corporate bonds, which have a credit risk component, fared better than government bonds in the fourth quarter and for the year. High yield bonds had a tremendous 2016 – some high yield indexes were up over 14% – as investors continued to search for income opportunities in riskier segments of capital markets.

While many in the prediction business are beginning to claim that the bond market is headed for higher rates, there are still many reasons why rates may remain in a low range. One key reason is that many central banks outside the U.S. still have accommodative policies in place. The global low interest rate environment makes the U.S. market relatively attractive to those sovereign bond markets, and investors continue to scour the globe for income. Interest rates in the U.S. may have risen a bit faster than events justified. So far in the first quarter of 2017, rates have stabilized.

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IRS, Security Summit Partners, Remind Taxpayers to Protect Themselves Online*

WASHINGTON – The Internal Revenue Service, the states and the tax industry today urged taxpayers to take steps to protect themselves online to help in the fight against identity theft.

Scammers, hackers and identity thieves are looking to steal taxpayers' personal information and ultimately their money. But, there are simple steps taxpayers can take to help protect themselves, like keeping computer software up-to-date and being cautious about giving out their personal information.

Here are some best practices taxpayers can follow to protect their tax and financial information:

Understand and Use Security Software. Security software helps protect computers against the digital threats that are prevalent online. Do not buy security software offered as an unexpected pop-up ad on your computer or email.
It's likely from a scammer.

Look for the "S." When shopping or banking online, always look to see that the site uses encryption to protect your information. Look for "https" at the beginning of the web address. The "s" is for secure.

Use Strong Passwords. Use passwords of eight or more characters, mixing letters, numbers and special characters. Don't use your name, birthdate or common words. Don't use the same password for several accounts. Don't share passwords with anyone. Calls, texts or emails pretending to be from legitimate companies or the IRS asking to update accounts or seeking personal financial information are almost always scams.

Be Cautious When Using Public Wireless Networks. Public Wi-Fi hotspots are convenient but often not secure. Remember, if you are transmitting sensitive information, look for the "s" in https in the website address to ensure that the information will be secure.

Avoid E-mail Phishing Attempts. Never reply to emails, texts or pop-up messages asking for your personal, tax or financial information. Never click on links even if they seem to be from organizations you trust. Go directly to the organization's website. Legitimate businesses don't ask you to send sensitive information through unsecured channels.

To learn more on protecting your personal and financial data, visit www.irs.gov/individuals/taxes-security-together

*[illegible]

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