THE
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ADVISOR
MANAGING WEALTH. SECURING LEGACIES.

Please join us for our upcoming Quarterly Investment Briefings.

Wednesday, November 16th, 2016
and Thursday, February 2nd, 2017
4:00 p.m. to 6:00 p.m.
Windsor Park Conference Center
4020 Edison Lakes Parkway
Mishawaka, IN 46545

Founded in 1988, Indiana Trust and Investment Management Company is an independent trust company chartered under the Indiana banking statutes. It is a single purpose financial institution dedicated exclusively to providing investment management and trust services to individuals, trusts, employee benefit plans, corporations, and not-for-profit organizations.

MANAGING WEALTH. SECURING LEGACIES.

Election anxiety? The market looks well past November

In June, when U.K. voters approved a referendum to leave the European Union, equity markets around the world shook. Solemn pronouncements from talking heads on cable news and media coverage elicited a negative emotional response. This emotional response obscured the immediate reality of Brexit, which is nuanced; and the long-term effects are still not entirely clear. Subsequent to the few days of stock market volatility, markets rallied sharply, particularly in emerging markets and the U.K.

The referendum in the U.K. provides a very recent example of the fleeting short-term impact political elections have upon markets. Elections matter to people's lives. They have long-lasting effects. Yet, evidence shows that the stock market cares little for one political party versus another.

Nevertheless, investors often draw investment conclusions from closely-held political views. These conclusions tend to suffer from confirmation bias: it is human instinct to search solely for evidence which supports our preferred theories while ignoring facts to the contrary. When political views inform investment decision-making, investors can stray from achieving their long-term goals.

The reason that elections ultimately result in only a temporary bumpy ride is that the stock market looks ahead at years – even decades – of future corporate earnings. Will the U.K. referendum ultimately impact how many iPhones Apple will sell in the U.K. over the next ten years? Will the U.S. presidential election determine how many cars Ford will sell in California over the next twenty years? This is the long-term investor perspective and this is why event-driven markets are usually replaced by markets focused on corporate earnings and equity valuations.

In 2016, the U.S. stock market has rallied in the face of percolating risks: Brexit, low oil prices, and a slower-growth economy in China. Emerging market stocks have also performed very well and had their best quarter

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RETURNS AS OF 9/30/2016

ASSET CLASS	3Q 2016	2016 YTD
EQUITIES		
Large Cap US Equities (S&P 500)	3.9%	7.8%
Mid/Small Cap US Equities (Russell 2000)	9.1%	11.5%
International Developed Market Equities (MSCI EAFE)	6.4%	1.7%
Emerging Market Equities (MSCI Emerging Markets)	9.0%	16.0%
FIXED INCOME		
Barclays Capital US Aggregate Bond Index	0.5%	5.8%
BofA Merrill Lynch Municipals, 3-7 years	0.0%	2.4%
ALTERNATIVES		
Real Estate (FTSE EPRA/NAREIT Developed Index)	1.5%	11.0%

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since 2012. These market rallies continue to be aided by the ongoing global interest rate environment. Expectations are for rates to stay low and trend even lower in many countries. Because of the continued ultra-low interest rate conditions, investors continue to seek opportunities for yield around the globe.

The S&P 500 is up 7.8% calendar year-to-date. Part of the market's resilience is certainly attributable to the low interest rate environment. However, corporate earnings have helped as well. Several large tech sector companies (Apple, Facebook, Microsoft) have posted better-than-expected earnings and fundamentals, and shares of tech companies have pushed higher. Conversely, dividend-paying sectors of the market, which were very much in-vogue earlier this year, lagged during the third quarter. Utilities were down 6%. U.S. REITs were also down for the quarter, despite having grown to the point where they were broken out from other financial stocks in the S&P 500 and now command their own sector.

The mosaic of U.S. market valuations continues to hover above long-term averages, but valuations overall remain in a fairly-valued range. These elevated valuation measures of the stock market are not unusual in comparison to valuations during similar low inflation and low interest rate environments in the past.

Developed markets outside the U.S. had a very good quarter, up 6.4%. Large global banks make up a substantial part of developed foreign markets. The big banks had a good third quarter, despite the news that the U.S. levied a multibillion-dollar fine on Deutsche Bank for its role in the 2008 financial crisis. Stocks in Japan rose by 7% during the quarter while the yen has appreciated by 19% so far in 2016.

Emerging markets have had a tremendous 2016 and the third quarter was one of their best quarters in several years. Brazil's market has rebounded strongly this year as a new political regime appears to be committed to fiscal reform. Even Russia's market has performed well as oil prices have rebounded.

The offshore Chinese market was up 13% in the third quarter, its best performance since 2013. The Chinese currency, the renminbi, was added on October 1 as a currency in the IMF's Special Drawing Rights (SDR) reserve asset. The SDR is a basket of currencies comprised of the U.S. dollar (which is 42% of the SDR basket), the euro, the renminbi, the Japanese yen, and the U.K. pound. Only central banks, such as the Federal Reserve, can hold SDRs which are used as foreign currency reserves alongside U.S. dollars and euros. In the larger picture of total reserves, SDRs play a small role and the inclusion of the renminbi as 10% of the SDR basket is mainly symbolic of China's ascendancy in the global economy. The inclusion of the renminbi to the SDR basket will have little impact on global investors.

Fixed Income Markets

The Bloomberg Barclays U.S. Aggregate Index, a wide barometer of the U.S. investment-grade bond market, nudged upward 0.50% in the third quarter as interest rates basically held steady. The 10-year U.S. Treasury note began the quarter at 1.5% and ended at 1.6%. The Federal Reserve continues to search for the right time to further bump up its short-term target rate. Some of the Fed's caution is likely attributable to the strength of the dollar in recent years. The Fed is also cognizant of the low level of inflation. While nominal interest rates are near all-time lows, real rates (nominal rates minus inflation) are not at all-time lows.

Corporate bonds and high yield bonds, which have credit risk components not found in U.S. Treasury bonds, have performed well this year. Investors continue to search for incremental income opportunities in riskier segments of capital markets.

Given that interest rates have declined over the last two years, bond investors have some concern about the prospect of higher rates. It is worth considering the forces which would push rates higher and the likelihood for those situations to occur. First, there is speculation that the Fed will move its overnight target rate upward more quickly than expected. The counterargument to this is that the Fed is attempting to be more transparent than in the past and will do everything possible to communicate its intentions. Should the Fed raise its short-term target rate, the entire yield curve will not necessarily shift higher as a result. This is because the market still has a tepid long-term outlook on inflation and economic growth. Strong foreign demand for U.S. bonds is also helping to keep rates here at bay.

Portfolio Management Comments

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. Our goal is to combine multiple asset classes to generate returns with the most efficient level of risk across a spectrum of asset allocations. In these strategic asset allocations, as fixed income levels are decreased and equities are increased, expected portfolio returns rise and the associated risk also rises.

Every year, the investment committee at Indiana Trust holds a day-long meeting to focus solely on long-term capital market risk and return expectations for each major asset class. This year, as a result of this analysis we have increased our long-term target weights for emerging markets equities by 1% to 2% in most asset allocation strategies. In order to make this change, we will reduce developed market equity exposure. So, while the overall mix of U.S. and international equity will not change, the composition of non-U.S. equities will see an increase to emerging markets.

While there is still country risk that is unique to emerging markets, many companies in this asset class have become more mature. Over 10% of the global stock market is in emerging markets and its weight in the global market continues to rise. Valuations in emerging markets are compelling versus their history, as well as versus U.S. and developed markets around the world. This translates into a brighter picture of future potential return for emerging markets stocks versus the return outlook in developed markets.

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Gifting and Tax Update for 2016

If gifting is on the horizon for 2016, the IRA charitable rollover can help manage the tax impact resulting from Required Minimum Distributions. The IRA charitable rollover permits IRA owners who are age 70½ or older to make a tax-free distribution to a qualified charity of up to $100,000 per taxpayer, per taxable year. A distribution made directly to a qualified charity any time prior to December 31, 2016 can be treated as a qualified charitable distribution for the 2016 tax year and will be excluded from the taxpayer's adjusted gross income.

The provision can benefit donors who itemize deductions and whose charitable contributions are reduced by the percentage of income limitation. Because donors exclude this contribution from their gross income, they cannot take a charitable contribution deduction for the contribution; to do so would result in a double benefit for donors and is prohibited. Most contributions to public charities are qualified.

Additionally, as a reminder, the annual gift tax exclusion for 2016 is $14,000 per individual.

A brief tax update: mutual funds must distribute any realized net capital gains every year. As mutual funds can carry forward losses, in recent years, mutual funds have had fairly limited distributions of capital gains. Indiana Trust often looks to harvest losses to offset capital gains in taxable accounts. This year may see a bit of an uptick in gains distributed from funds, particularly U.S. equity mutual funds, and Indiana Trust's ability to offset those gains may be more limited this year because we have harvested losses in the past. While we cannot know for certain what gains will be passed out to investors, we can make estimates to help our clients understand their year-end tax picture.

As we near year end and questions on gifting or investment taxes arise, contact your Wealth Advisor at Indiana Trust. As always, if you have more detailed questions on the tax implications of any strategy, we can be part of the dialogue with you and your tax advisor.