Wilbanks, Smith & Thomas
ASSET MANAGEMENT, LLC

MARKET RETURNS
Year to date through March 31, 2017

Index	Return
MSCI All Country World Index	7.0%
S&P 500 Index	6.1%
Dow Jones Industrials Index	5.2%
Russell Small Cap Index	2.5%
MSCI EAFE Index	7.4%
MSCI Emerging Market Index	11.5%
Barclays Capital U.S. Aggregate Bond Index	0.8%
Merrill Lynch High Yield Index	2.7%
S&P/Citi Int'l Treasury Bond Index ex U.S.	1.7%
Merrill Lynch U.S. Treasury 1-3 Year Index	0.3%

For more information, please contact:

Wilbanks, Smith & Thomas
Asset Management, LLC
150 West Main Street, Suite 1700
Norfolk, Virginia 23510
(757) 623-3676
www.wstam.com

"When you come to a fork in the road, take it."

Yogi Berra

"The secret to success is to find the freight trains in life and get on them instead of in front of them."

Starwood Chairman Barry Sternlicht

The dictum above from the worldly philosopher Yogi Berra is relevant today for investors. After two and half months of strong gains and low volatility, stocks ended the first quarter of 2017 on a cautious note amid concern about the durability of the "Trump trade." Investors are forced to choose between remaining committed to the eight-year-old bull market, which must at some point be due for a correction, and sitting on the sidelines and risking missing out on more gains. Fundamentally the economic picture continues to improve, and the global recovery and expansion remain on track. In fact, the improving global economy was the driver of market performance in the first quarter, mitigating concerns that the Fed will overshoot in its effort to withdraw stimulus in the U.S. and offsetting investor concern about Trump's ability to implement his ambitious economic agenda. Stocks and currencies in the developing world were strong as China's recovery progressed, and momentum spread to the Eurozone, where the unemployment rate fell to its lowest level in eight years. Bullish investors believe that, barring a policy misstep by the President or the Fed, the coordinated global economic expansion will continue to "trump" politics even at a time when media coverage is focused almost entirely on day-to-day legislative wrangling in Washington. It seems the news is viewed entirely through either pro-Trump or anti-Trump lenses these days, and the administration's relative success in pushing its agenda of tax reform, deregulation, and infrastructure spending remains an important variable in the economic and market outlook. Still, as John Authors points out in the *Financial Times*, "not everything is Donald Trump's fault, and by the same token not everything that goes right in the world can be attributed to him." [1]

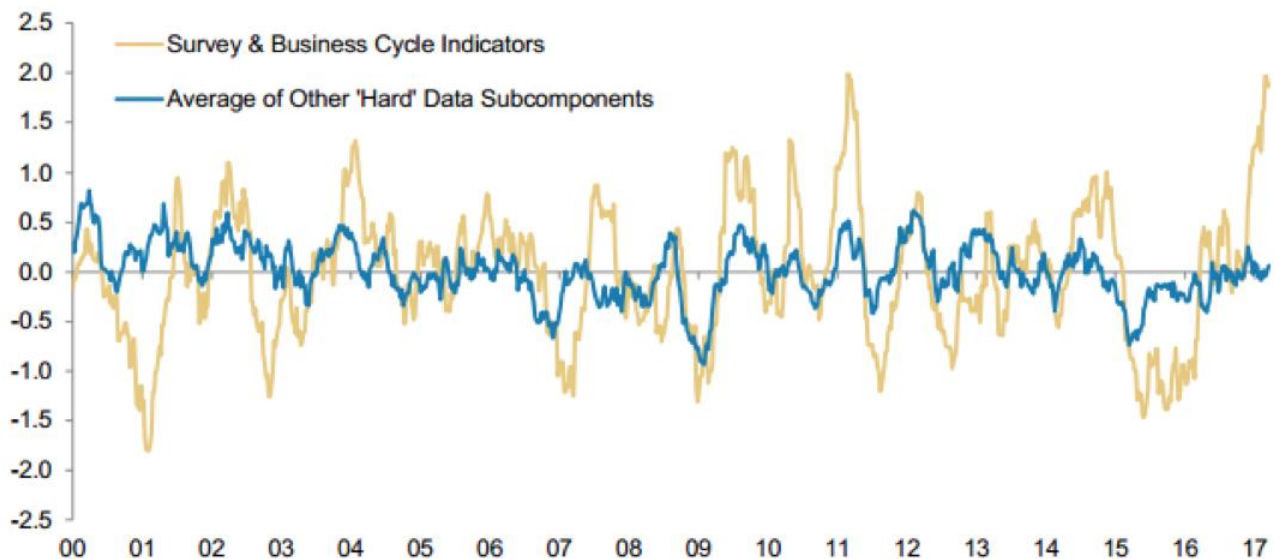
Market action over the course of the quarter indicated that at this fork in the road most investors are choosing the road most traveled: continued and increasing stock exposure. While the final tally was not available at the time of our writing this letter, CNBC pointed to record inflows of approximately $100 billion into equity ETFs in the quarter as evidence of investors' continued strong appetite for stocks.[2] These money flows reflected both the positive trajectory of the global economy and surprising insouciance to Trump's political/legislative challenges. The MSCI All-Country World Index (ACWI), a broad measure of global stock performance, gained 7.0% during the first three months of the year, extending the post-election run as most major stock indexes achieved all-time highs. The markets remained calm despite the contentious debate around the healthcare bill during the last week of March, and the S&P 500 finished just 2.2% below its record level. In fact, volatility throughout the quarter was amazingly low considering the incessant flow of news and noise from Washington. Wall Street's "fear gauge," the CBOE Volatility Index (VIX),

[1] Authers, John, "The Long View," *Financial Times*, 25 March 2017.
[2] Pisani, Bob, "Money Poured Into Stocks In the First Quarter," CNBC.com March 31, 2017.

posted its second lowest quarterly level on record, and the average daily change for the Dow Jones industrial average during the quarter was the lowest since 1965.[3]

Below the calm surface interesting cross-currents are flowing. Market leadership shifted during the quarter from sectors expected to benefit most from Trump's regulatory and fiscal policies to those most driven by near-term earnings growth. Banks and infrastructure companies fell from favor in March and technology took the lead, with Apple's 25% gain for the quarter reflecting that trend. Non-U.S. stocks, which were adversely impacted late last year by fears about restrictive trade policies, rallied very strongly in the first quarter as the global growth picture improved and White House saber-rattling diminished. In fact, as we detail later in the letter, both developed and emerging market stocks outpaced U.S. equities, with emerging markets posting a particularly strong 11.5% return. One seemingly obvious Trump trade, betting against Mexico, reversed completely during the quarter. The peso was one of the best performing currencies in the first quarter and the iShares Mexico ETF which tracks publicly traded companies in Mexico was up 16%.

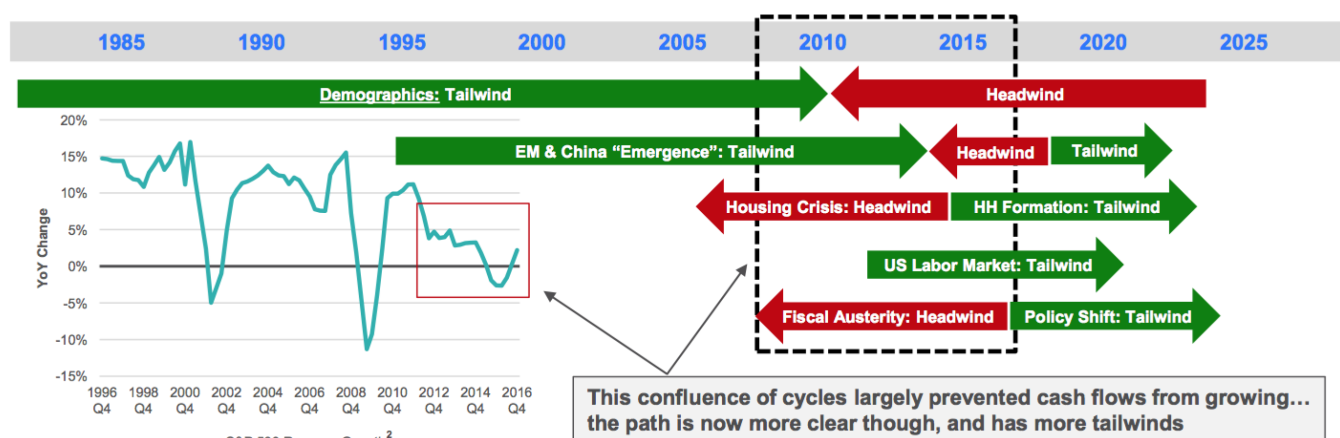
With a healthy, expanding global economy and a pro-growth President in office, why are some investors, including us, cautious about the outlook for equities? Our primary concern is market valuation. U.S. stocks are expensive, and while high valuations don't mean that a market crash is imminent, they do tilt the balance between risk and return to a less favorable position. The most accurate predictor of stock returns over a ten-year period is the valuation of the market at the beginning of the period. Investor optimism about the improving economy and the expected boost from Trump's policies has lifted U.S. equity valuations to levels where expected returns are low and risks high. The graph below from Ned Davis research shows the gap between expectations for the economy as measured by "soft" data that includes forward-looking confidence readings and business surveys, and "hard" data in the form of measured economic activity. "Hard" data translates into real GDP growth and increasing profits, and while growth looks strong expectations may be too optimistic. U.S. equities are trading at prices that reflect the market's strong optimism about future growth, so they are vulnerable to correction if growth disappoints.



[3] Macintosh, James, "What Comes After the Trump Trade? *Wall Street Journal*, April 1, 2017.

Economic Overview - “Making America Reflate Again”

Despite the risk that expectations may be too high, first-quarter data generally supported the bullish economic outlook shared by most commentators at the beginning of the year. In Blackrock’s March economic commentary Rick Rieder discusses the synchronized tailwinds from the labor market, housing trends, emerging market recovery, and U.S. fiscal policy. For the first time in over a decade these forces are acting in concert, and Reider suggests in the chart below that the outcome will be positive for corporate revenue and earnings growth. Fourth quarter 2016 U.S. GDP growth was revised upward to 2.1% in March and the preliminary data for the first quarter of 2017 indicate a similar trajectory. The U.S. economy reached another important milestone when the February CPI reading exceeded the Fed’s 2% target for the first time in five years. That achievement suggests that economic activity is growing at a healthy enough pace to remove slack in the labor force and plant capacity, which bodes well for wage growth and corporate investments in plant and equipment.



Source: Blackrock

The U.S. consumer sector has benefitted from gains in employment and wages, and family balance sheets are in better shape than at any time since before the housing crisis. Given that strength consumer spending continued to lead last quarter while corporate investments in plant and equipment, which tend to follow a longer cycle, were relatively weak. Companies remain in a holding pattern awaiting confirmation of the direction and timing of the policies that they hope will lead to lower corporate tax rates, less regulation, and the repatriation of over $1 trillion of cash held abroad by American corporations. If those pieces of the economic puzzle fall together they could fuel a boom in business investment, but even so those investments are a year or more down the road. Barclays Capital capital-goods analyst James Stettler covers industrial companies and notes that “no one’s really pushing the button on capex yet.” Heavy equipment maker Caterpillar told analysts that while tax reform and infrastructure spending would be good for its businesses, it would not expect to see large benefits until at least 2018.[4] The lag between policy implementation and economic impact, as well as the possibility that Trump’s agenda isn’t implemented at all, are risk factors worth watching. The President’s pro-growth policy troika of tax reform, deregulation, and infrastructure spending remains in focus but the failed effort at healthcare reform revealed the challenges that the administration faces in pushing the various policy planks through Congress.

Outside the U.S. the turnaround in China was a crucial driver of the global economic resurgence. Just a year ago we were writing about the risk of a "hard landing" and currency devaluation in China; now the International Institute of Finance reports that China enjoyed net inflows of capital in March for the first time in three years. While China dominates the inflows to emerging markets, the positive sentiment about the Chinese economy has lifted all boats. Emerging market equities are up 41% since last January’s lows and EM bond issuance hit an all-time record last quarter.[5] Few doubt the long-term growth potential of China's economy, but many worry that the transition from an

[4] “The World Economy, From Deprivation to Daffodils,” *The Economist,* March 18, 2017.
[5] “Emerging Market Bulls Charge Back Into The China Shop*,” Financial Times*, April 2, 2017.

underdeveloped, communist economy to a consumer-driven capitalist regime will be a bumpy one. The Eurozone is also enjoying a strong resurgence after years of financial and political crisis. With key elections ahead in several of the 19-country currency bloc's member nations the solid economic data and improving political mood are timely. Factories in the euro zone reported their highest levels of activity since 2011 and economic growth in general appears to have recovered finally from the sovereign debt crisis of 2010. Most importantly the job market recovery should help stabilize the political situation and, hopefully, mitigate the market's response to Brexit.

Equity Market Overview

Continuing the trends established last year global equity benchmarks recorded new highs during the first quarter. The Dow Jones Industrial Average gained 5.2% for the quarter bringing its one-year return to 19.9%. As we've discussed equities were supported by the momentum of the U.S. economy, a turnaround in the global economy including both Europe and China, and expectations about supportive fiscal policy.

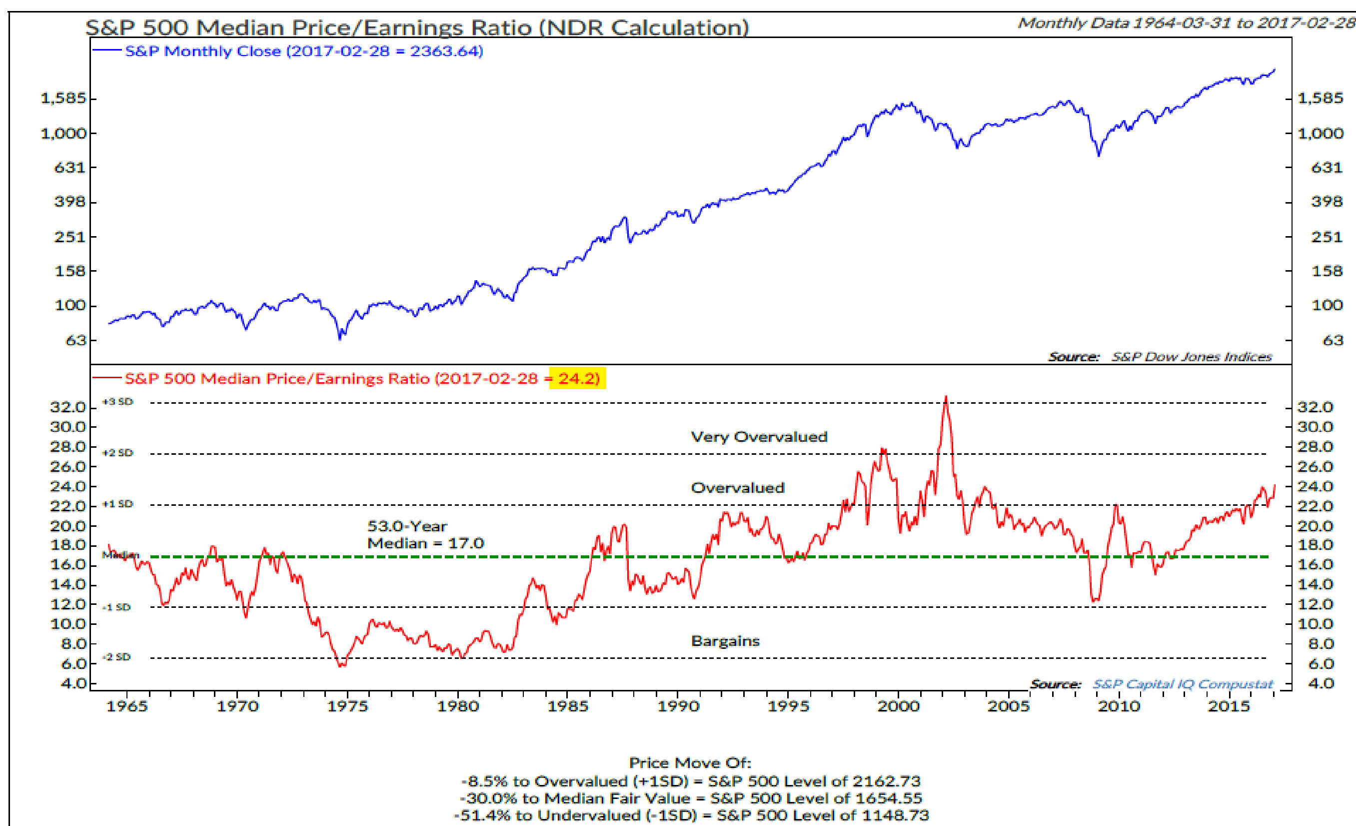
Equity Index	1Q 2017	1 Year	3 Year
Dow Jones Industrial Average	5.2	19.9	10.6
Large Cap Stocks (Russell 1000)	6.0	17.4	9.9
Growth	8.9	15.8	11.2
Value	3.3	19.2	8.6
Small Cap Stocks (Russell 2000)	2.5	26.2	7.2
Growth	5.3	23.0	6.7
Value	-0.1	29.4	7.6
MSCI All Country World Index	7.0	15.7	5.6
International Stocks (MSCI EAFE)	7.4	12.2	1.0
Growth	8.6	7.9	1.9
Value	6.2	16.7	-0.1
Emerging Markets Stocks (MSCI EM)	11.5	17.7	1.5

Mid and small-cap stocks lagged large companies in the quarter, taking a breather after the relative strength they demonstrated at the end of 2016. The Russell Mid-Cap Index still rose a respectable 5.2% and the Russell 2000 Index of small stocks rose 2.5%. While small and mid-cap stocks have outperformed big companies over the past 12 months their lower relative returns over three to five years and lower valuations suggest that there is still room for those segments of portfolios to add value. Growth stocks regained the momentum over Value stocks in early 2017. The Russell 1000 Growth Index climbed over 8.9% while the Russell 1000 Value Index came in under 3.3% for the quarter. Similar margins were seen within the Russell Mid Cap and Russell Small Cap Growth and Value segments. Sector performance was the primary driver of this divergence as growth stocks were aided by strong results in Technology, Health Care and Consumer Discretionary stocks. Financials make up a large share of the value universe and this sector stalled after the strong gains enjoyed at the end of last year.

Developed markets outside the U.S. posted good results to kick off 2017, besting domestic indexes after lagging for several years. The MSCI EAFE rose 7.3% for the quarter and the MSCI ACWI ex U.S. Index (an index that includes more emerging markets exposure) was up 7.9%. Foreign stocks began the year amid uncertainty about upcoming elections, particularly in Europe. Concerns that a populist takeover of the continent would lead to the demise of the European Union have abated in light of the stronger economic footing in Europe this quarter. Declining unemployment and better overall economic conditions will dampen the enthusiasm for sweeping populist change. The obvious outlier risk is in Great Britain where the initial response to the Article 50 trigger of the Brexit process was muted. The best case scenario regarding Brexit is that the status quo in terms of trade and business policy is maintained, but that outcome seems unlikely as details emerge about the challenges that British companies doing business on the continent will face, and vice versa. As the two-year process begins no one knows how it will play out, and it represents a significant risk to the health of the European economy.

Emerging markets were the star of the quarter as China recovered, commodity prices firmed, and fears about Trump trade policies abated. The MSCI EM Index rose 11.5%, best among all equity and fixed income asset classes. Cash flows into ETFs again offer a window into investor sentiment. According to the *Wall Street Journal* exchange traded funds investing in emerging markets took in $10.5 billion in new money during the quarter compared with $130 billion in existing assets, so about 8% of total fund assets came in during the first three months of this year. Assets in other types of funds (including conventional open-end funds) are not included in these figures so they don't reflect total investor exposure to the segment, but certainly they are representative of the direction and magnitude of cash flows.

Despite the strong returns last quarter emerging markets equities remain inexpensive relative to U.S. stocks. The chart below from Ned Davis Research reveals that at its current level of around 25 times trailing earnings the S&P 500 is trading in its top decile of valuation as measured by P/E ratio, which means that stocks have been less expensive 90% of the time.



Source: Ned Davis Research

By comparison emerging-market companies are trading at an average of 12.2 times their expected profits over the next year, a little higher than their long term historical average of 11 times earnings but about half as expensive as U.S. stocks.[6] As the *Wall Street Journal* points out relative cheapness does not equate to safety, and emerging economies by definition are risky and prone to crises resulting from commodity prices, currency risk, and political turmoil. Still, at today's valuations we believe that emerging market equities continue to represent a good opportunity in the spectrum of asset classes. While recognizing their risks we are maintaining a meaningful allocation in portfolios.

[6] Zweig, Jason, "Emerging Markets Are On A Tear, But Tread Carefully," Wall Street Journal, April 1, 2017

We're cautious about the valuations of U.S. equities, but we're encouraged by earnings trends. Corporate earnings are the transmission between economic growth and stock market returns, and for the most part the earnings picture looks good. In January consensus estimates for S&P 500 earnings for 2017 stood at $131, 20% higher than 2016. The fourth-quarter of 2016 marked a resumption of earnings growth for U.S. blue chips after an energy-lead decline in the past several quarters. With a more favorable outlook for the energy sector, hopes run high for continued strength for overall earnings growth for the rest of 2017. At this point most earnings estimates do not include any projected bump from regulatory, tax or fiscal policy changes, so if progress is made on those fronts there could be upside from the current estimates. Higher earnings would, of course, mitigate the valuation challenges, so the market will be watching closely as first quarter results are announced.

Bond Market Overview

After rising sharply in the second half of 2016 on expectations of faster growth and higher inflation, bond yields traded in a tight range during the first quarter. The tightening labor market and higher commodity prices boosted inflation and led the Federal Reserve to implement a 25-basis point rate hike in March, when Fed officials took on a decidedly more hawkish tone. New York Fed President Bill Dudley contends that "the case for monetary policy tightening has become much more compelling. Since the election, we've seen very large increases in household and business confidence, we've seen very buoyant financial markets — the stock market is up, credit spreads are narrow, and we have the expectation that fiscal policy will probably move in a more simulative direction."[7]

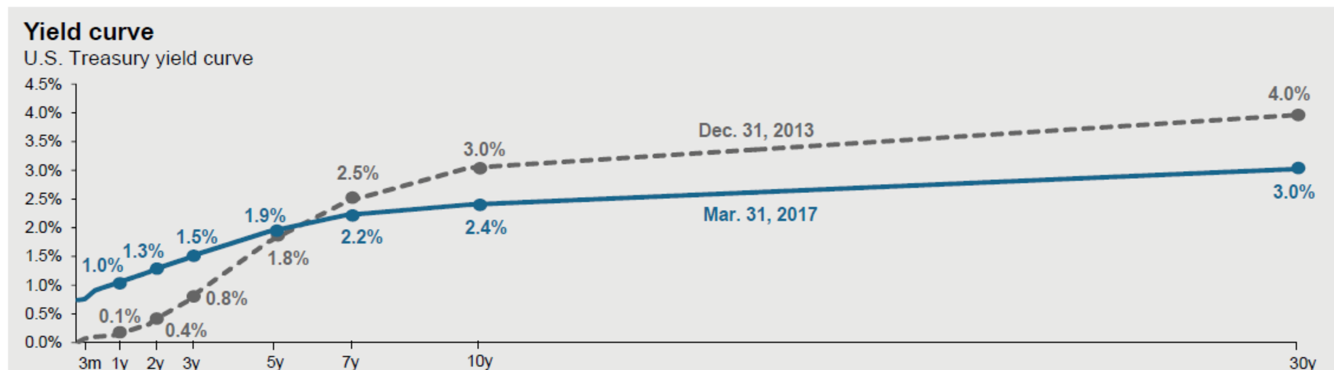
The Fed's rate increase and new guidance actually drove the yield on the U.S. 10-year Treasury note lower, and it closed the quarter at 2.39%, down from 2.45% at year-end. The flattening yield curve reflects concern that the Fed will be too aggressive in normalizing policy after eight years of unprecedented accommodation and indicates that the bond market is not as convinced as the stock market about the strength and durability of the economic expansion. The Barclays U.S. Aggregate Bond Index rose 0.8% for the quarter. High yield bonds continued to enjoy solid investor demand and the Barclays High Yield Corporate Index was up 2.7%, partially because of stabilizing energy markets. Income-oriented investors continue to find the corporate sector attractive based upon their expectation of improving profitability and lower default risk. Outside of the U.S. returns were strong as the credit component of sovereign bond returns overwhelmed the threat of higher yields and the dollar generally weakened versus the basket of global currencies. The Barclays Global Aggregate ex U.S. index rose 2.5% and emerging market bonds performed even better. Barring any major downside economic surprise we expect domestic investment grade and high yield credit to remain attractive.

Fixed Income Index/ETF	1Q 2017	1 Year	3 Year
Barclays U.S. Aggregate Bond Index	0.8	0.4	2.7
iShares 1-3 Year Treasury Bond ETF	0.2	0.1	0.6
iShares 3-7 Year Treasury Bond ETF	0.7	-1.0	2.0
iShares 20+ Year Treasury Bond ETF	1.7	-5.3	6.1
iShares TIPS Bond ETF	1.3	1.5	1.9
SPDR Barclays Mortgage Backed Bond ETF	0.7	-0.3	2.5
iShares National AMT-Free Municipal Bond ETF	1.1	-0.3	3.1
SPDR Barclays Intermediate Term Corporate Bond ETF	1.1	2.3	2.8
SPDR Barclays High Yield Bond ETF	2.3	14.6	2.2
PowerShares Senior Loan ETF	0.4	7.0	2.0
SPDR Barclays International Treasury Bond ETF	2.5	-4.4	-3.0
iShares JPM USD Emerging Market Bond ETF	4.0	8.0	5.4

From this point on the Fed's path and the direction of interest rates will be dependent upon the success of the Trump economic agenda and the evolution of the economy. The timing of fiscal stimulus will be an important factor, and

[7] De Costa, Pedro, "The Fed Could Be On The Verge Of Making A Big Mistake," BusinessInsider.com, March, 2017.

the upward pressure on interest rates from higher growth and expectations about government stimulus will be balanced by uncertainty about the timing and success of the agenda. With the Fed seemingly set on withdrawing stimulus from the economy, it has two tools at its disposal. Its conventional tool is the Fed funds rate, which determines short-term interest rates, and it also can steer longer term rates by managing the size and make-up of its balance sheet. The Federal Reserve owns $2.4 trillion of U.S. Treasuries and $1.8 trillion in mortgage-backed bonds purchased under its quantitative easing program, and its decisions about whether and how to reinvest the proceeds of those bonds will affect the supply and demand balance of the bond market and influence longer-term rates. The flattening yield curve demonstrated in the chart below was driven by Fed tightening on the short end and continued accommodation on the long end. Now the Fed is signaling a move away from rate hikes as their preferred method of removing accommodation and toward a gradual wind-down of their balance sheet, which should cause longer-term rates to drift higher and the yield curve to steepen.



Source: JPMorgan

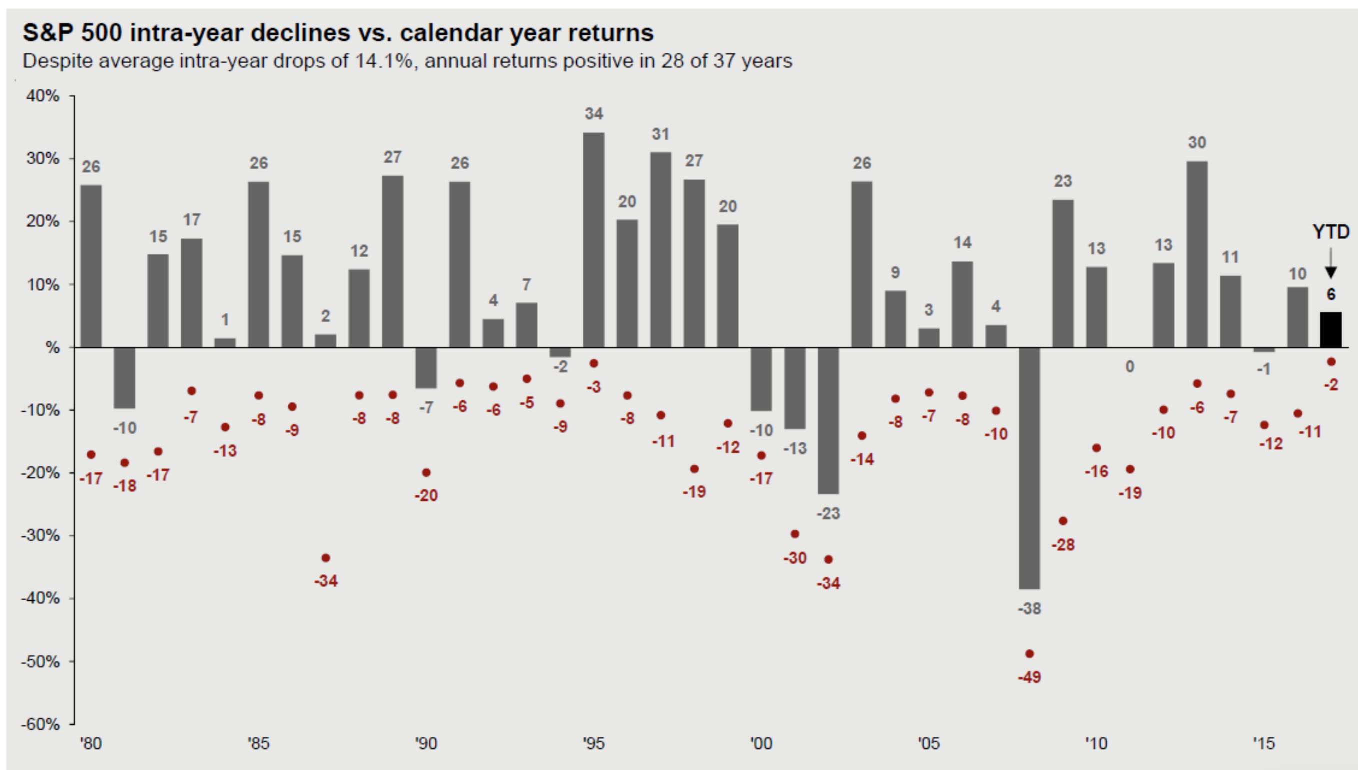
Concerns about rising rates have led us to remain underweight interest rate sensitivity (duration) relative to the Barclays Aggregate Bond Index for the past several years, and this positioning remains a prudent strategy given the improving economic backdrop. In a flat yield curve environment like today's the incremental return for taking an extra year of duration risk is meager, and the risks associated with adding duration are high. Our portfolios have achieved reasonable income and total returns by focusing on credit exposure rather than duration risk, and in both taxable and non-taxable accounts that strategy remains appropriate.

Summary

In conclusion, we return to the most important choice facing investors today, and as always that decision boils down to how much risk to take and what level of returns to pursue. The correct answer for any individual, family, or institution requires an understanding of available resources, short and long-term objectives, risk tolerance, and preferences. Those client-specific factors drive investment policy decisions including asset allocation ranges and return targets, and our job is to understand our clients well enough to implement investment strategies that meet their needs. Our allocation to equities within any specific client portfolio reflects not only our views on the market but also the client's required rate of return and ability to tolerate risk.

Our portfolio positioning as we enter the second quarter reflects both the opportunities and risks that we see in stocks and bonds. Stocks remain the asset class of choice for long-term growth, and as we've discussed the global economy is healthy. Still, valuations and years of low volatility leave equities vulnerable to correction, in our view. Investors may be underestimating the risks associated with the implementation of the Trump economic agenda and the transition in Federal Reserve policy in the U.S., and the volatile progress of the Chinese economy and unpredictable impact of Brexit on foreign markets. Where appropriate we're rebalancing portfolios to bring allocations back in line with long-term targets, and within equity portfolios we continue to emphasize diversification by size, style, and geography.
The unusually low market volatility in recent years makes it easy to forget that stock market corrections are a normal part of the process, and as this chart demonstrates the S&P 500 hasn't endured even a single 20% decline during the recovery from the 2008 bear market. The most important takeaway is that a properly allocated portfolio gives an

investor the confidence to ride through corrections and enjoy the long term returns that the market provides. Confidence is the product of good planning and efficient implementation.



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1980 to 2016, over which time period the average annual return was 8.5%. The 2017 bar represents the year-to-date return and is not included in the average annual return calculation.
Guide to the Markets – U.S. Data are as of March 31, 2017.

The best way to ensure that our strategy and allocations meet your needs and have your confidence is communication, and to that end we look forward to a talk or visit soon! Have a great spring!

Wayne F. Wilbanks, CFA
Lawrence A. Bernert III, CFA
D.J. Kyle Elliott, CFP
Mark R. Warden
Roger H. Scheffel Jr., CPA, PFS
Thomas F. X. McNally, CMT, CFA
Wade A. Monroe, CIMA
Paul A. Ferwerda, CFA
Dan F. Powell, CFA, AIF

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