ECONOMIC AND MARKET COMMENTARY

3rd Quarter 2017

SMITH SHELLNUT WILSON

OUR MISSION

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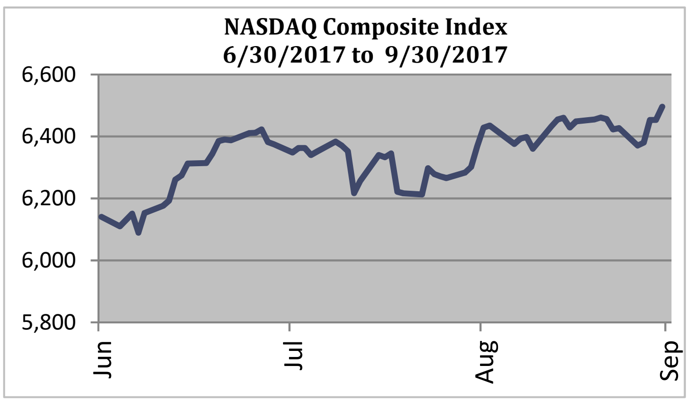
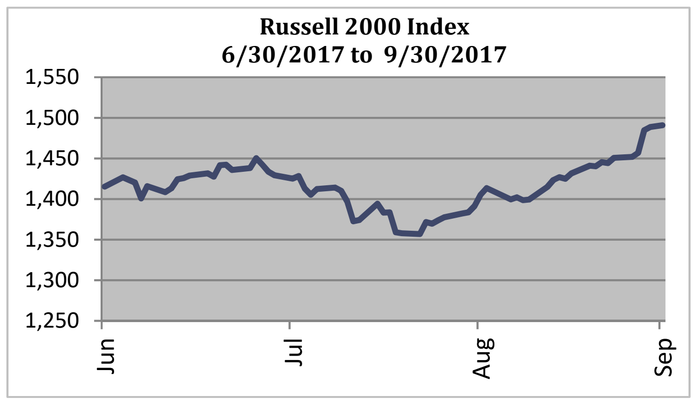
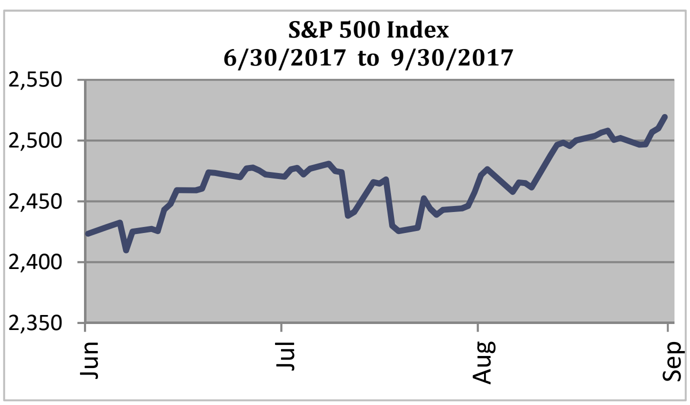
I. Third-Quarter Equity Market Recap

U.S. stocks surged to all-time highs at the end of the quarter (for the 38th time this year), as the dollar rebounded and Treasuries fell on reports that President Donald Trump is meeting with former Federal Reserve Governor Kevin Warsh to discuss the role of Fed Chair.



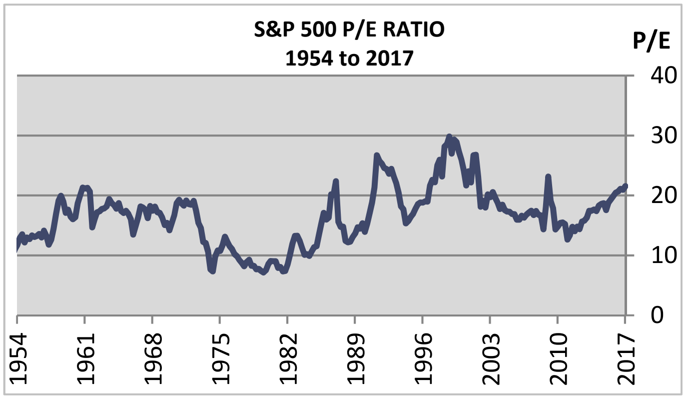




The S&P 500 Index, Nasdaq Composite Index and Russell 2000 Index all moved into record territory, with the S&P 500 benchmark notching its eighth straight quarterly gain. Financial shares helped spearhead the gains as the KBW Bank Index leaped to the highest since March. But despite the market enthusiasm, some investors predicted that Warsh's nomination would hurt stocks. Neil Dutta, head of U.S. economics at Renaissance Macro Research LLC, wrote in a note to clients: "Normally, the FRB staff assumes the chair knows the ins and outs of monetary economics at least as well as they do. Warsh would not be afforded that assumption. That is a big problem."

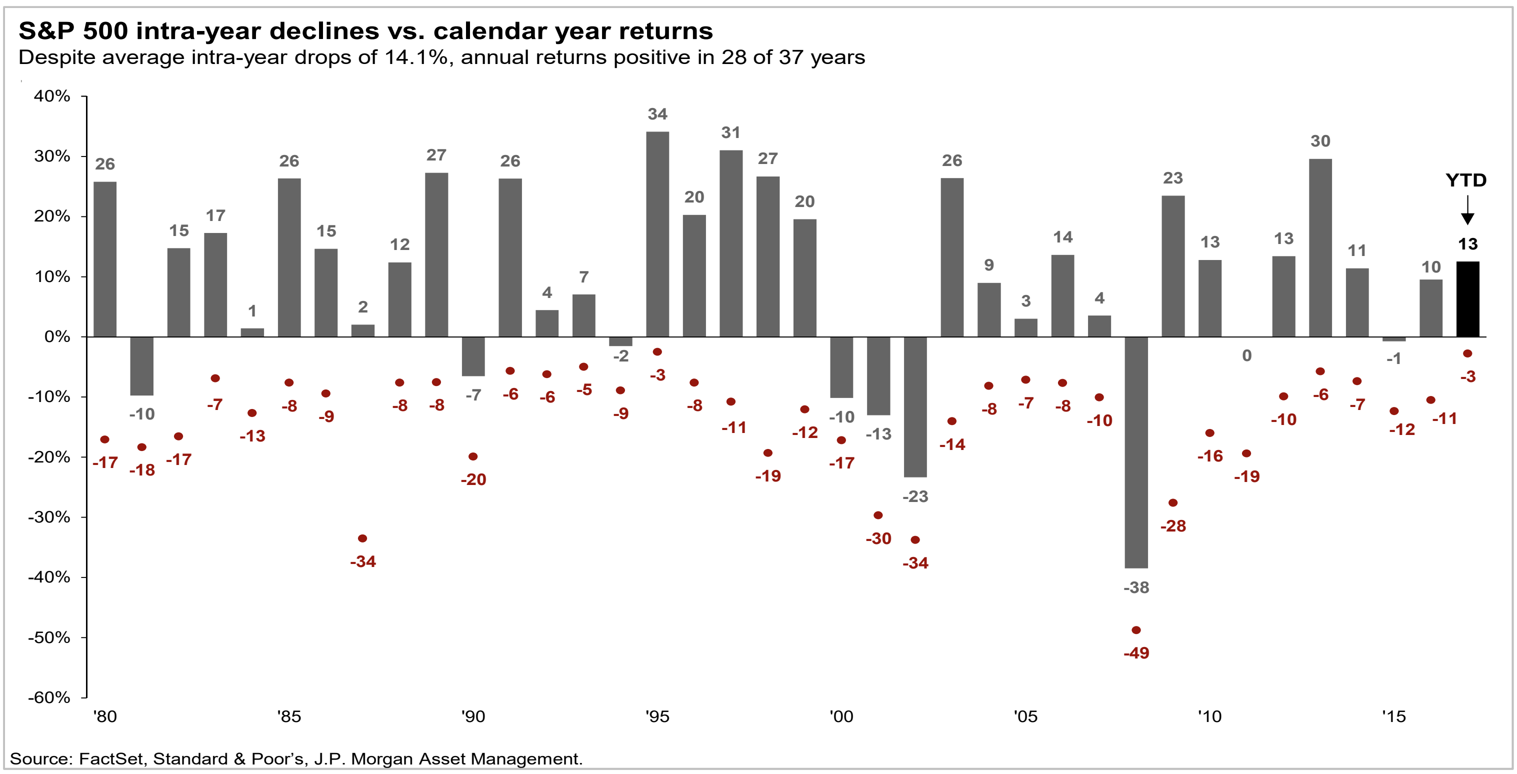
For the quarter, the S&P 500 gained just over 4% on a dividend-reinvested basis, sporting a quarter-end price-earnings multiple of 21.5x and a trailing 12-month dividend yield of 1.97%. The index's 20-plus times multiple places it at the high end of historical valuation levels (see "S&P 500 P/E Ratio" graph on page 2). Elevated market valuations, coupled with the fact that the U.S. markets have not seen even a "normal" 5% downward adjustment in over 16 months while the Fed persists in raising short-term rates despite weakening inflation statistics, suggest that stocks may be due for a correction of some sort.

*Registration of an Investment Adviser does not imply any certain level of skill or training.



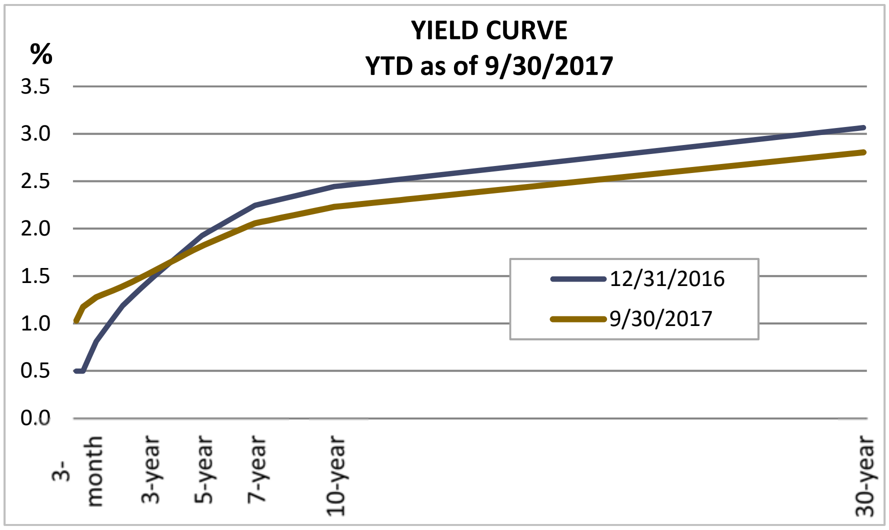
As stated on page 1, The S&P 500 index's 20-plus times P/E multiple places it at the high end of historical valuation levels.

The graph below illustrates, 5-10% intra-year stock market dips are the norm, not the exception, in the stock markets and can serve to provide a healthy springboard for the continuation of cyclical bull markets.



II. Third-Quarter Bond Market Recap

U.S. Treasury yields rose a slight 2-7 basis points on a net basis during the quarter, masking a dramatic 35 basis-point drop in the yield on ten-year Treasury notes within the quarter, which was precipitated by North Korean sabre rattling and market concerns over low inflation readings and hurricane-related economic disruptions.

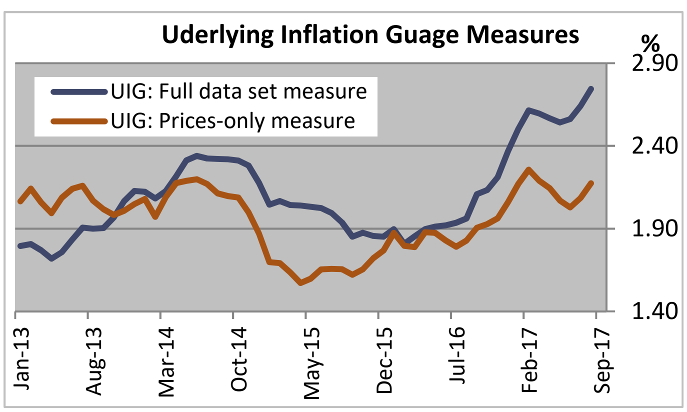


During the quarter the yield curve flattened as it has done on a year-to-date basis, also. Flattening yield curves historically have presaged economic downturns, but the scope, scale and tools of current monetary policy have distorted the predictive power and reliability of this indicator during the current credit cycle.

The ten-year Treasury ended the quarter at a 2.34% yield, down 10 basis points on a year-to-date basis, while two-year notes closed at a yield of 1.48%, up approximately 30 basis points during the first three quarters of the year.

III. Volcker Redux

The Federal Reserve Bank of New York's first release of its new measure to track underlying inflation -- called, appropriately enough, the Underlying Inflation Gauge -- shows prices behaving quite differently from traditional indexes this year. The UIG's broad measure registered a 2.74% reading for August, the highest since November 2007, according to historical data from the Fed. That compares with a 1.9% annual change in the Labor Department's consumer-price index and a 1.4% July gain in the year-over-year Personal Consumption Expenditure Core Price Index, the preferred gauge of Fed policy makers, which matched the lowest since September 2016.



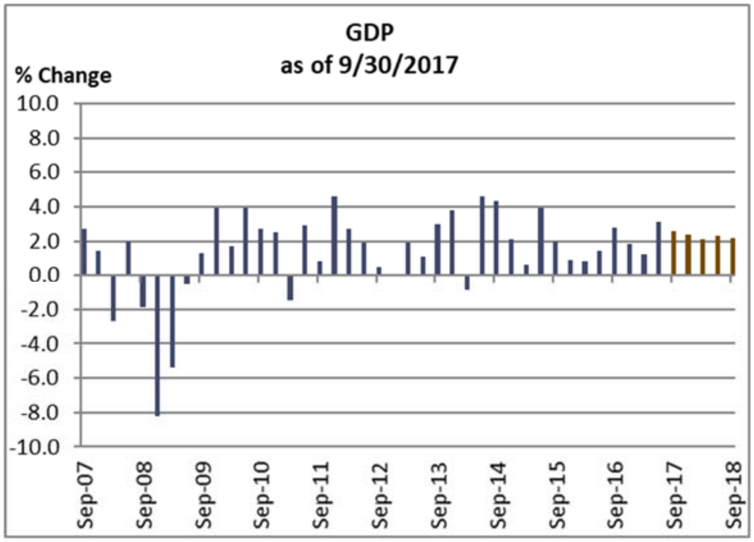
Why the gap? The UIG incorporates dozens of additional variables outside of prices, including the unemployment rate, stock prices, bond yields and purchasing managers' indexes. A second, "prices-only" version of the UIG is derived from CPI data. That gauge advanced 2.2% in August. The New York Fed says the UIG "has shown more accurate forecasts of inflation compared with core inflation measures," and the two UIG measures indicate that "trend CPI inflation" is currently in a range of 2.2% to 2.7%, rather than the sub-2% readings from the traditional inflation measures that are confounding Fed policy makers.

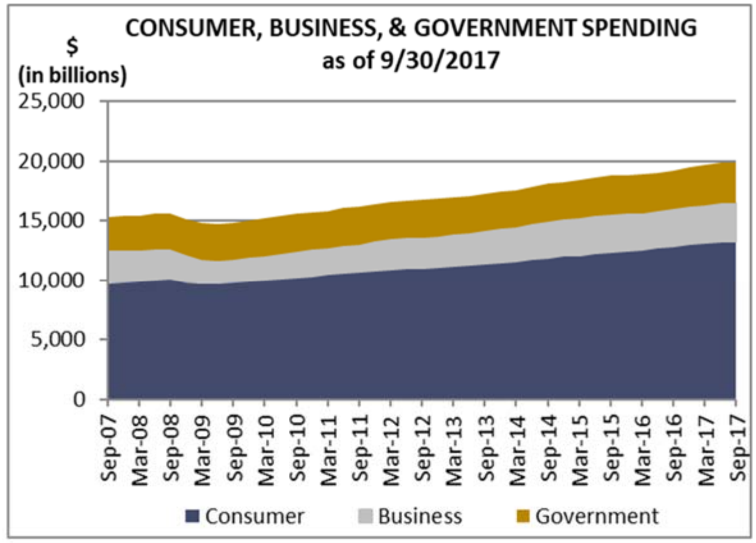
All of this is rather reminiscent of the Volcker era, when the notion of "core" inflation was first introduced into the monetary policy realm. Paul Volcker was chairman of the Federal Reserve under Presidents Jimmy Carter and Ronald Reagan from August 1979 to August 1987. Volcker is widely credited with ending the high level of inflation seen in the United States during the 1970s and early 1980's by switching Fed policy from targeting interest rates to targeting the money supply. U.S. inflation, which peaked at 14.8% in March 1980, fell below 3% by 1983 under the Volcker Fed's tight money policies.

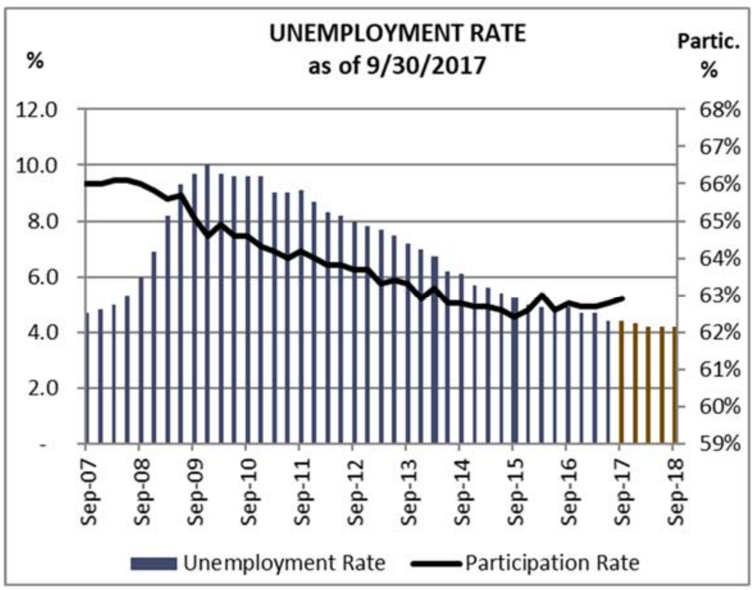
What has largely escaped the history books is an anecdotal tale that in order to underscore his success on the inflation front, Volcker changed the way "success" was measured. Questioning Fed staffers as to what components of the inflation calculation were the most volatile in skewing headline inflation numbers higher, inevitably the answer would come back: food and energy prices. To which the Chairman replied: "then leave them out." And hence was born the "core" consumer price index - - inflation had indeed been conquered, policy-wise and statistically.

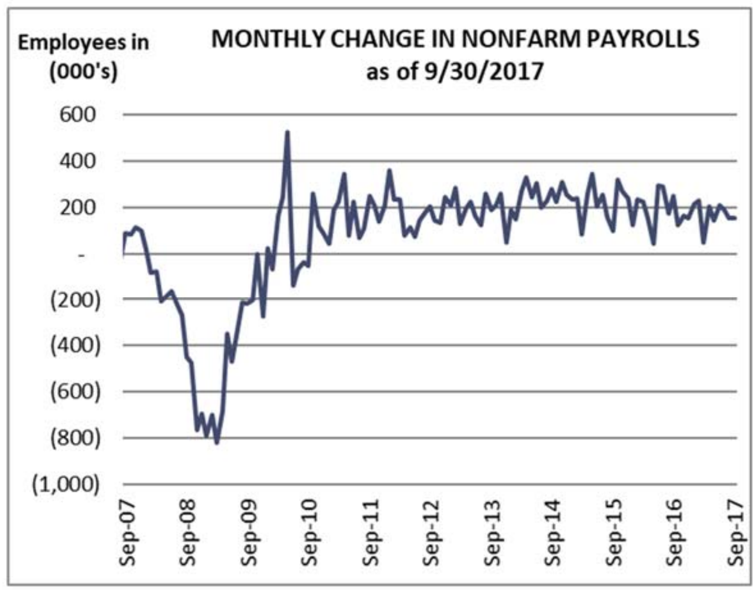
The source of the information in this commentary is SSW and Bloomberg Research unless otherwise noted.

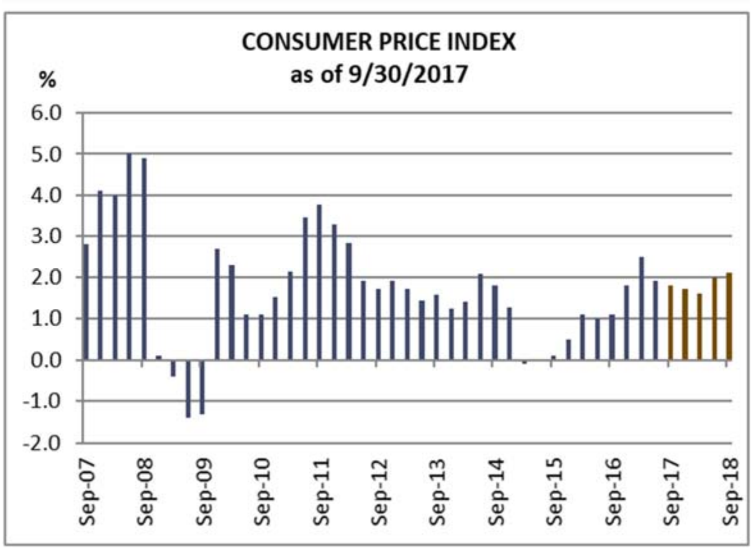
CHART BOOK

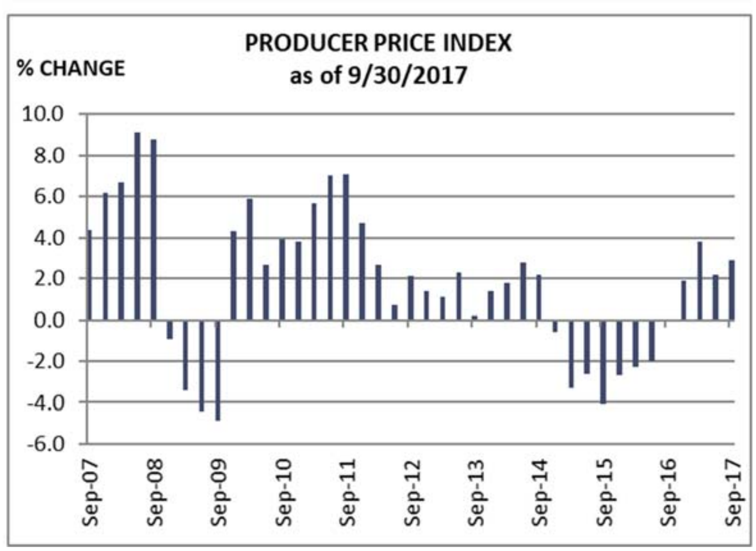




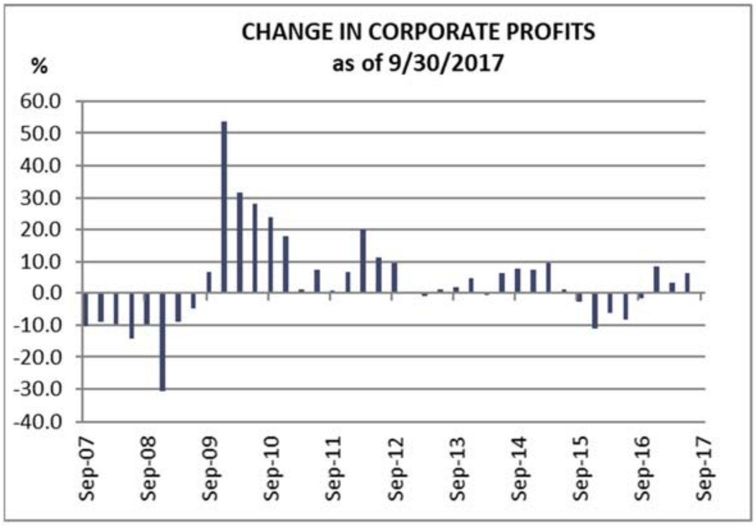


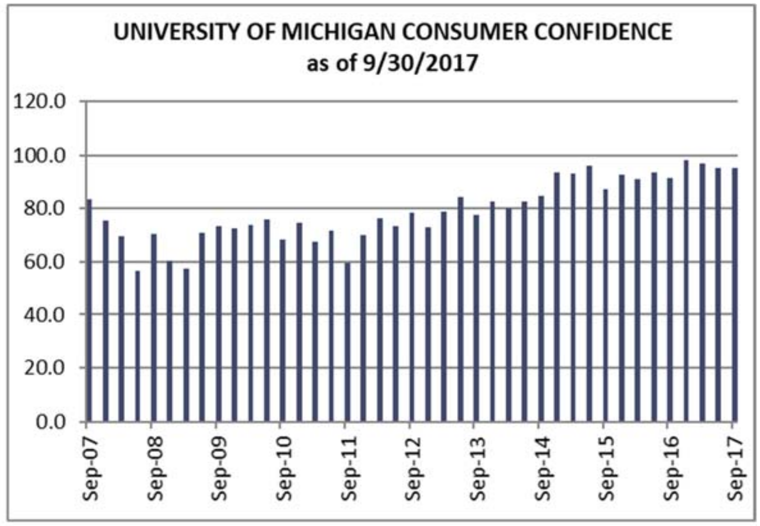


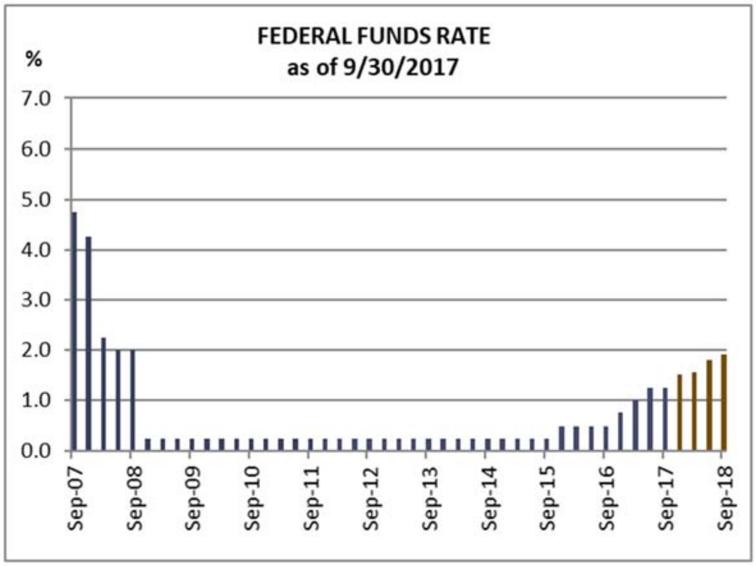


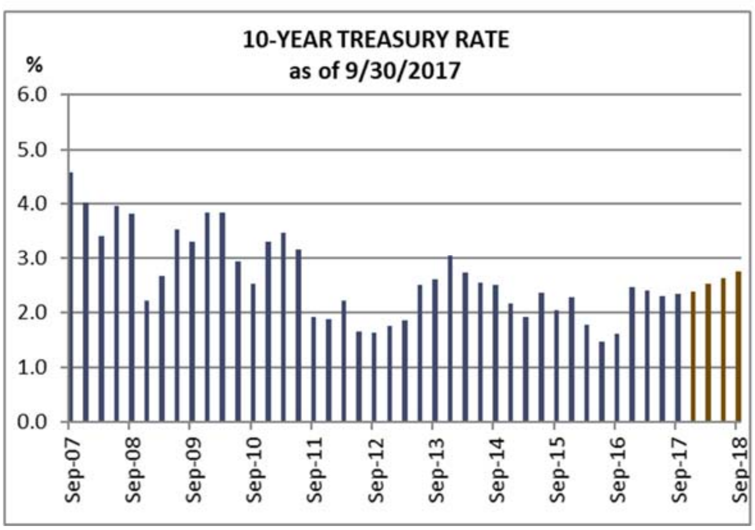


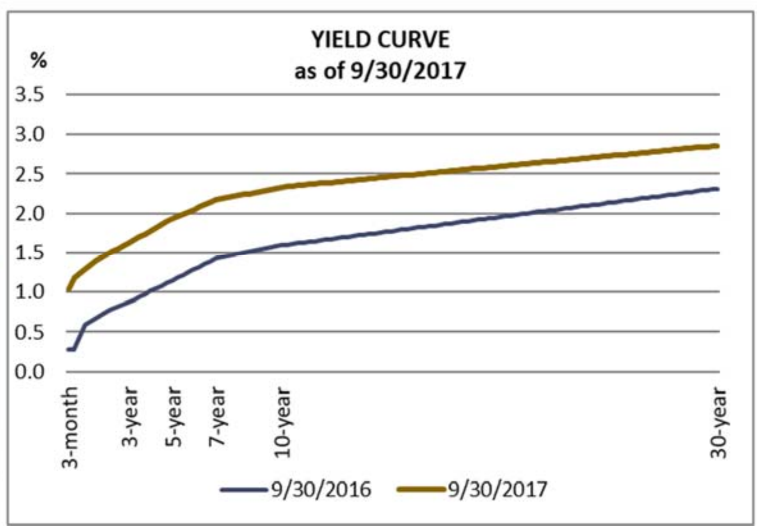
Note: Bar chart data in brown are estimates from a Bloomberg® composite of market participants











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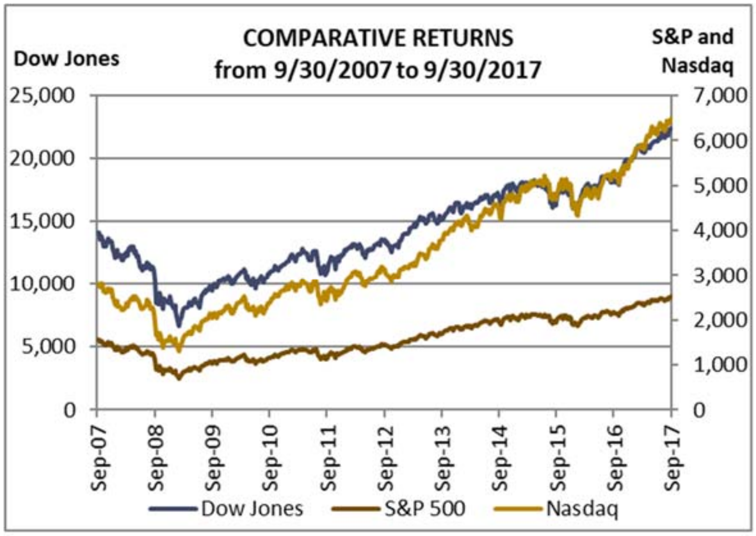
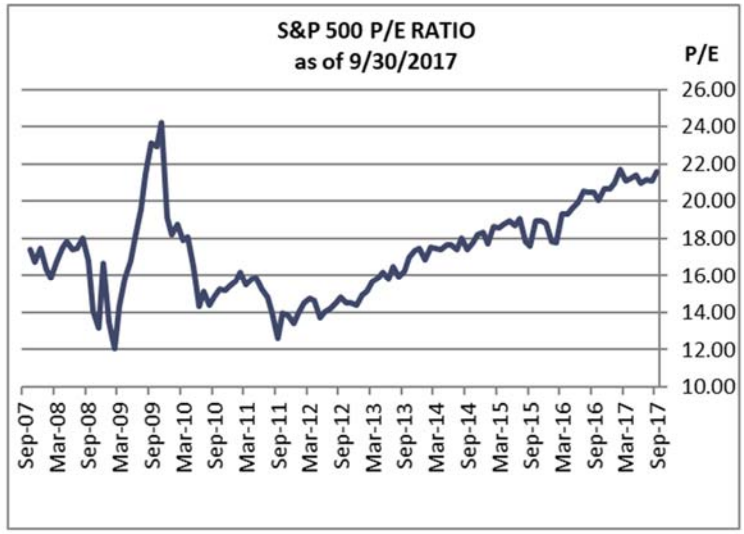
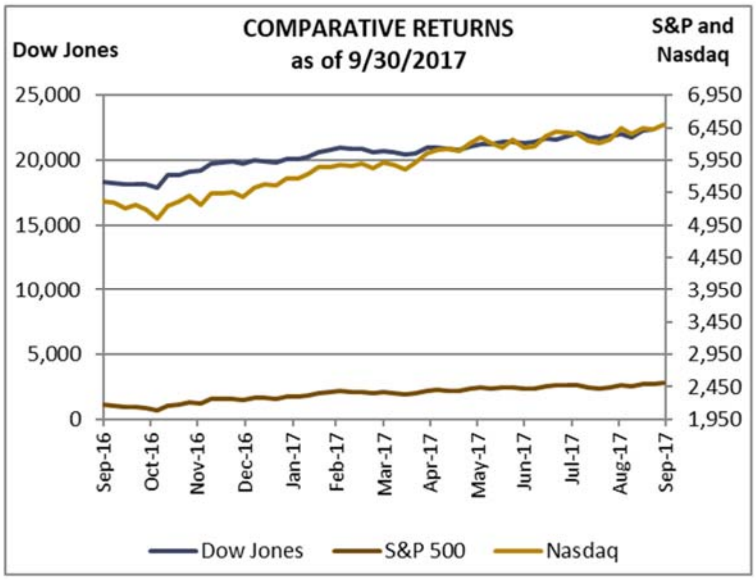
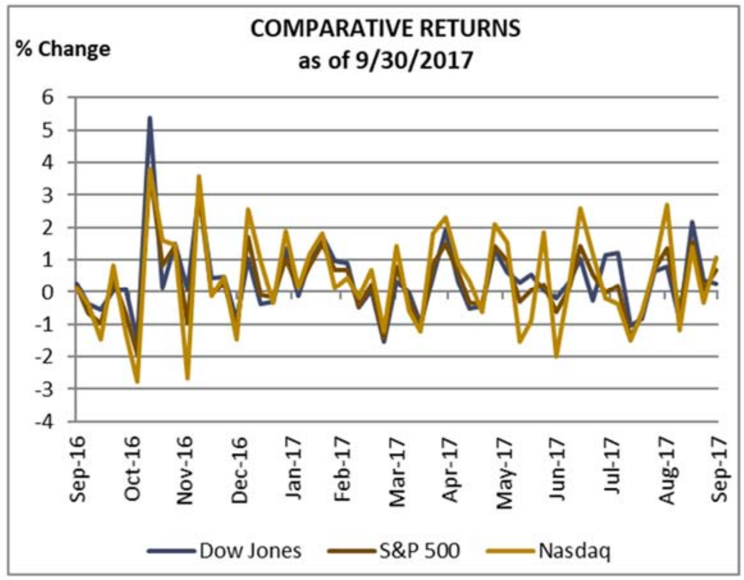
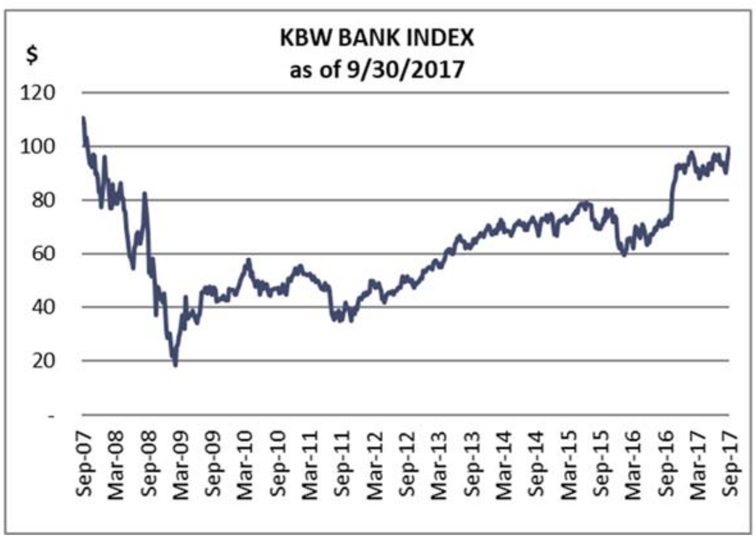
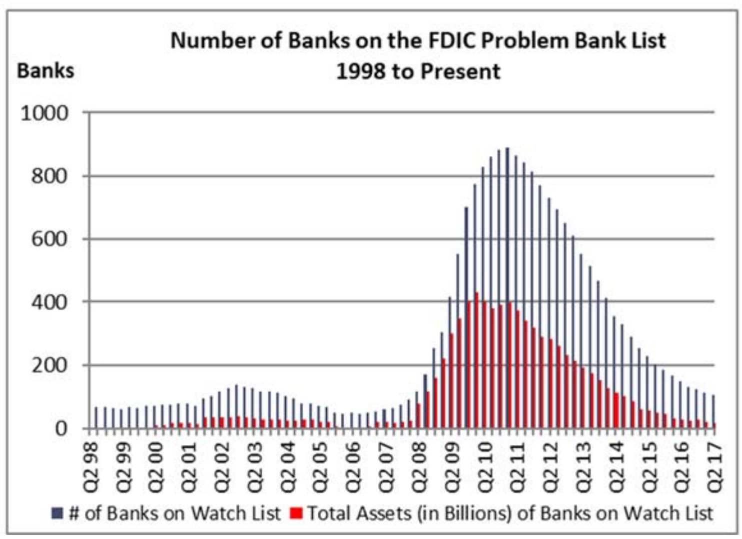

COMPARATIVE RETURNS
from 9/30/2007 to 9/30/2017
Dow Jones
S&P and Nasdaq
25,000
20,000
15,000
10,000
5,000
0
7,000
6,000
5,000
4,000
3,000
2,000
1,000
0
Sep-07 Sep-08 Sep-09 Sep-10 Sep-11 Sep-12 Sep-13 Sep-14 Sep-15 Sep-16 Sep-17
Dow Jones
S&P 500
Nasdaq


S&P 500 P/E RATIO
as of 9/30/2017
P/E
26.00
24.00
22.00
20.00
18.00
16.00
14.00
12.00
10.00
Sep-07 Mar-08 Sep-08 Mar-09 Sep-09 Mar-10 Sep-10 Mar-11 Sep-11 Mar-12 Sep-12 Mar-13 Sep-13 Mar-14 Sep-14 Mar-15 Sep-15 Mar-16 Sep-16 Mar-17 Sep-17


COMPARATIVE RETURNS
as of 9/30/2017
Dow Jones
S&P and Nasdaq
25,000
20,000
15,000
10,000
5,000
0
6,950
6,450
5,950
5,450
4,950
4,450
3,950
3,450
2,950
2,450
1,950
Sep-16 Oct-16 Nov-16 Dec-16 Jan-17 Feb-17 Mar-17 Apr-17 May-17 Jun-17 Jul-17 Aug-17 Sep-17
Dow Jones
S&P 500
Nasdaq


COMPARATIVE RETURNS
as of 9/30/2017
% Change
6
5
4
3
2
1
0
-1
-2
-3
-4
Sep-16 Oct-16 Nov-16 Dec-16 Jan-17 Feb-17 Mar-17 Apr-17 May-17 Jun-17 Jul-17 Aug-17 Sep-17
Dow Jones
S&P 500
Nasdaq


KBW BANK INDEX
as of 9/30/2017
$
120
100
80
60
40
20
-
Sep-07 Mar-08 Sep-08 Mar-09 Sep-09 Mar-10 Sep-10 Mar-11 Sep-11 Mar-12 Sep-12 Mar-13 Sep-13 Mar-14 Sep-14 Mar-15 Sep-15 Mar-16 Sep-16 Mar-17 Sep-17


Number of Banks on the FDIC Problem Bank List
1998 to Present
Banks
1000
800
600
400
200
0
Q2 98 Q2 99 Q2 00 Q2 01 Q2 02 Q2 03 Q2 04 Q2 05 Q2 06 Q2 07 Q2 08 Q2 09 Q2 10 Q2 11 Q2 12 Q2 13 Q2 14 Q2 15 Q2 16 Q2 17
# of Banks on Watch List
Total Assets (in Billions) of Banks on Watch List