The Trust Company of Virginia

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EQUITY MARKET COMMENTARY

Despite headwinds of rising interest rates, a decreasing likelihood of fiscal stimulus and high valuations, U.S. equity markets keep climbing. The S&P 500 returned 3.1% in the quarter, is up 9.3% in 2017 and increased 17.9% in the past year. The U.S. economy continues to grow slowly, though not spectacularly, at a 2.1% annualized pace in the first quarter, matching the post-recession average. Unemployment is a low 4.3%, wages are growing at 2.4%, energy prices remain low, housing prices are rising and consumer confidence is high. Inflation remains close to the Fed's 2% target, a level of inflation that historically supports average valuations of 17.6x forward earnings, close to where the S&P 500 traded at the end of June.

The S&P 500 was led higher by Healthcare, the best performing sector advanced 7.1% in the quarter and trails only Technology as the top sector through the first half of 2017. Within Technology we initiated a position in electronic payments processor Visa. Processing 60% more transactions than its closest competitor, Visa has strong pricing power and brand value along with a solid financial position. About 85% of global retail transactions are still done with cash or a check, suggesting the electronic payment industry has the opportunity for continued growth. Financials outperformed in the quarter but are trailing the broader index in 2017. Though tax reform, or a tax cut, may be delayed or never materialize, there is much the Trump Administration can do to promote growth through deregulation that will benefit the Financial sector. Regional banks in particular stand to benefit from lower regulations, higher interest rates and increased loan activity. We initiated a position in the SPDR S&P Regional Banking ETF to gain low cost exposure to the industry.

Telecom and Energy were the only sectors posting a negative return in the quarter and are the only negative sectors for the year. Energy has fallen 12.6% in 2017 while Telecom has declined 10.7%. The development of economical fracking technology in the U.S. over the last few years increased the supply of oil and natural gas. Concurrently, improved energy efficiency decreased demand and led to lower prices. Telecom, the smallest sector by number of constituents, is facing competitive pressure from voice-over-Internet protocol (VoIP) and bundling packages from cable companies.

S&P Forward Inflation Valuation **1958 — 2016**

Inflation	Average P/E	Highest P/E	Lowest P/E
0—1%	16.3	20.9	11.7
1—2%	17.0	20.6	13.1
2—3%	17.6	26.7	10.8
3—4%	16.0	20.7	10.1
4—5%	14.0	21.0	9.5
5—6%	14.9	20.2	8.2
6—7%	11.6	17.9	7.2
>7%	8.4	11.5	6.6

Source: Charles Schwab, Bureau of Labor Statistics and FactSet

Internationally, a decent cyclical recovery is underway in most countries, developed and emerging alike. The populist movements in Europe remain at bay following the French elections and the underperformance of the anti-Euro Five Star candidates in Italy's municipal elections. The European Central Bank, seeing a strengthening in the economy, removed language about further interest rate cuts at their most recent meeting. The British election added some uncertainty but international stocks outperformed U.S. stocks over a 12 month period for the first time in 3 years and have returned 13.8% in 2017. International equities trade at more attractive valuations than the U.S. and we will be disciplined about increasing exposure as the uncertainty recedes.

Stretching into its 100 month of growth, many are skeptical of the U.S. economy and equity market. Volatility, low for the past year, will return though the timing is unknown. Even in a steadily rising market, significant pullbacks of 10% or more are common; the last occurring nearly a year and a half ago in early 2016 suggests we are overdue. We remain steadfast in our approach: investing in companies generating positive cash flow, maintaining manageable debt levels, with sound management teams and rewarding shareholders through dividends and share buybacks.

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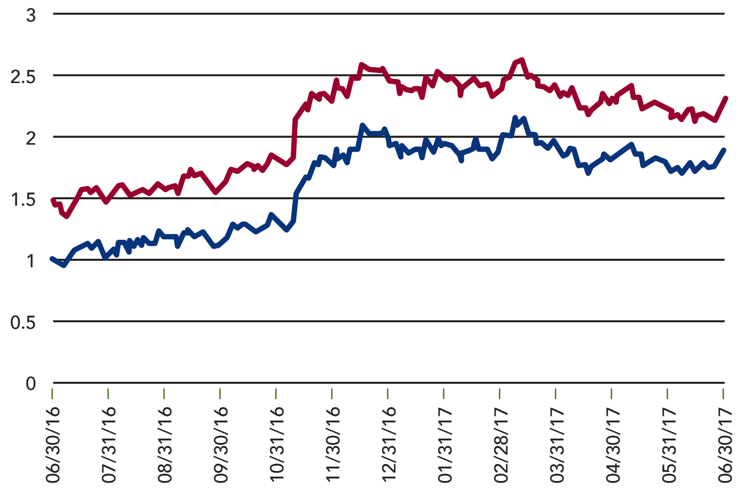
FIXED INCOME COMMENTARY

Following through after aggressive efforts by various members to prepare the markets for future rate hikes, the Federal Reserve raised rates on June 14th. The Fed funds target range was raised 25bps from 0.75-1.00% to 1.00-1.25%. This was the fourth increase by the Federal Reserve since the Financial Collapse of 2008/09. Equally as significant was the decision to move forward with the "normalization" of its $4.5 trillion balance sheet consisting of Treasury and mortgage-backed securities. Current plans suggest a $10 billion per month reduction, perhaps starting as soon as September. Formal announcement of the Fed's intention to reduce its balance combined with their intention to continue to raise short-term rates appears to have convinced the market that the extended period of accommodative monetary policy is ending. Accordingly, in the last week of the quarter, the US 10yr Treasury yield climbed 27bps from 2.14% to 2.31% reversing the downward trend in yields (10yr yield at the beginning of the quarter was 2.39%). Yields on the US 5yr Treasury bond started Q2'17 at 1.92% and finished only down 3ps (1.89%).

Fixed income securities largely generated positive returns during Q2'17 with the Bloomberg Barclays Aggregate index returning +1.45%. The Bloomberg Barclay's Treasury Index gained +1.19% during the quarter



Source: Bloomberg Financial

but is down 2.32% over the past year. The Bloomberg Barclay's Intermediate Govt/Credit advanced 0.94% over the past three months. Municipals, as measured by the Bloomberg Barclay's 5yr Index climbed 1.25% which follows a 1.90% gain the first quarter. However, performance over the last twelve months (+0.44%) was negatively impacted by a 2.6% decline in Q4'16. High yield delivered a 2.17% gain and has returned nearly 13% over the last twelve months.

Bloomberg Barclay's Fixed Income Indices

6/30/2017	Last Qtr	YTD Total Return (%)	12 Month	YTW (%)	Duration	Wtd Avg Maturity
US Aggregate	1.45	2.27	-0.31	2.55	6.2	8.3
US Intermediate Aggregate	0.92	1.61	-0.16	2.35	4.5	5.3
US Intermediate Government/Credit	0.94	1.73	-0.21	2.08	4.1	4.4
US Intermediate Corporate	1.49	2.67	1.68	2.72	4.5	5.1
By Rating						
US Aggregate Aaa	1.06	1.67	-1.26	2.30	5.7	7.3
US Aggregate Aa	1.64	2.61	-0.15	2.56	6.2	9.2
US Aggregate A	2.43	3.48	1.12	2.98	7.5	10.8
US Aggregate Baa	2.68	4.44	3.54	3.55	7.5	11.4
US High Yield	2.17	4.93	12.70	5.62	3.9	6.3
US Municipal (4-6yr)	1.25	3.17	0.44	1.64	3.9	4.9
US Treasury	1.19	1.87	-2.32	1.90	6.2	7.6

Source: Bloomberg Financial

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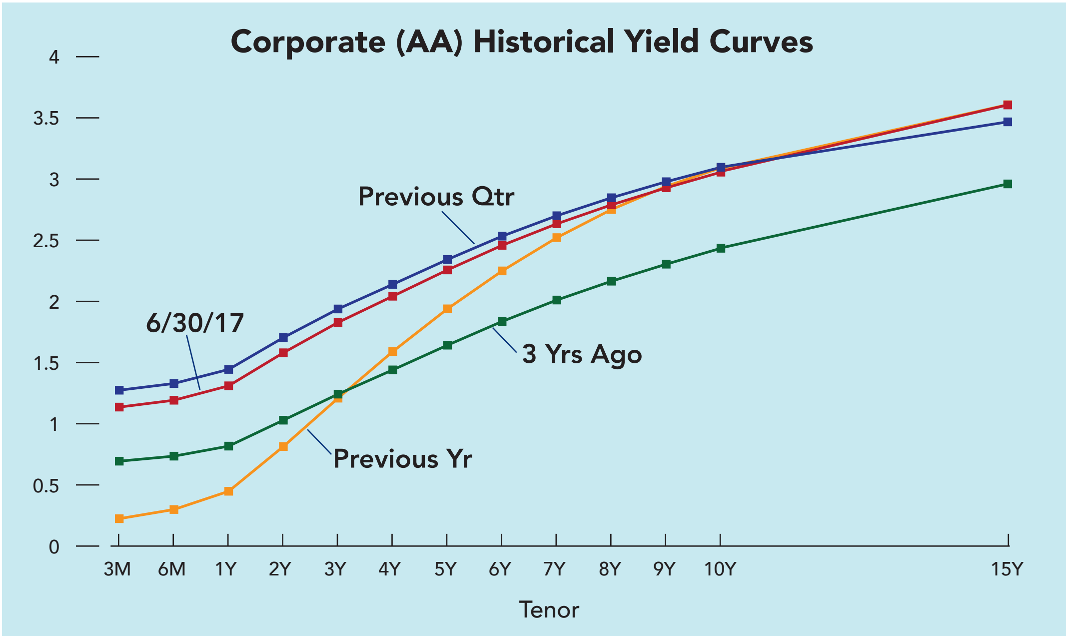
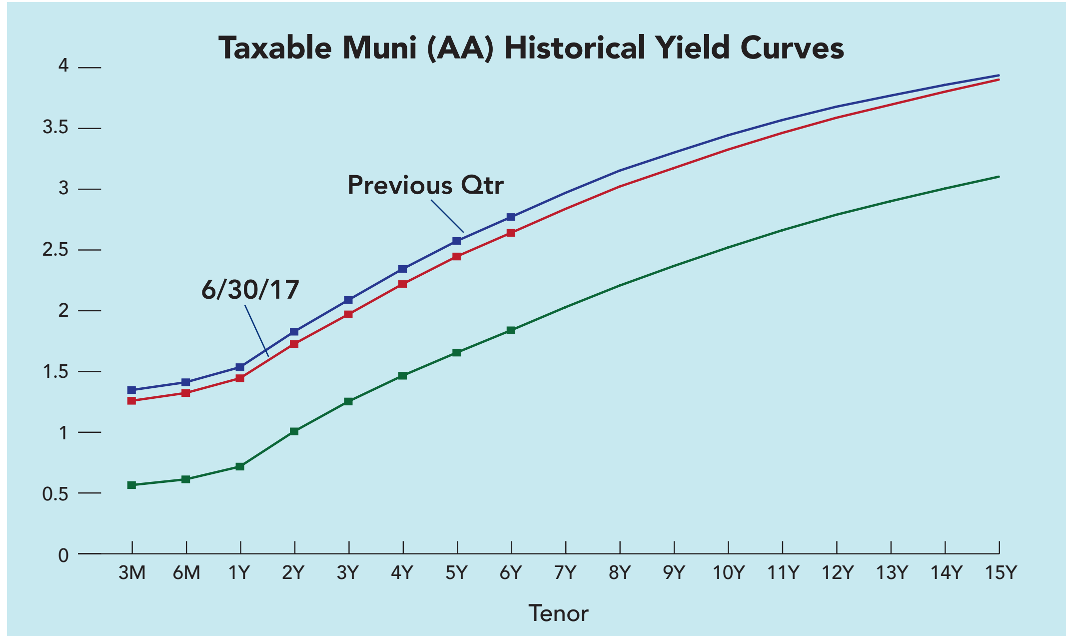
FIXED INCOME COMMENTARY

Taxable Fixed Income Performance Composite

The TCVA taxable fixed income composite (inclusive of cash holdings) returned 0.70% for the quarter ended June 30, 2017, compared to 0.94% for the Bloomberg Barclay's Intermediate Government / Credit Index. The composite duration stands around 3.3 years compared to the benchmark's duration of 4.1 years. The overall conservative maturity profile of the composite, in addition to cash holdings were the primary drivers of the unfavorable relative return comparison. Compared to the benchmark, the composite remains underweight BBB credits (2% vs 19%). Much of the disparity is due to the composites strong allocation to taxable muni credits. Although we continue to find modest value in select taxable municipal securities, we expect over time to increase our exposure to high-quality corporate bonds.





Source: Bloomberg Financial