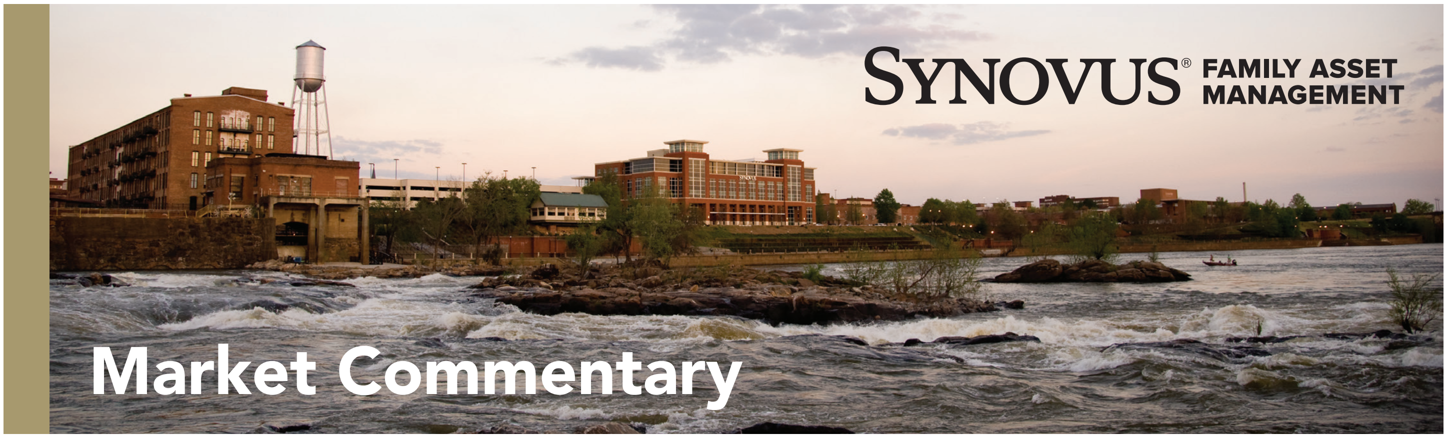
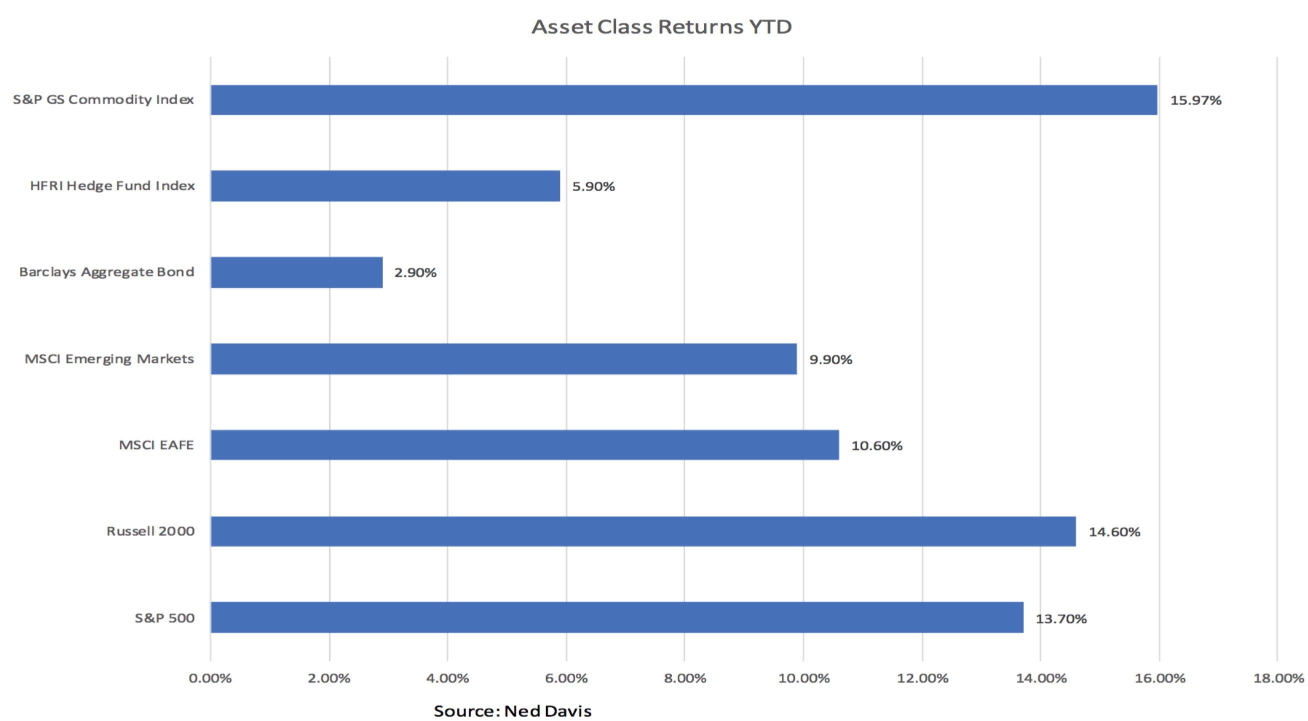


Market & Economic Review | Second Quarter 2019

Q1 2019 Review

In the first quarter, we saw financial markets gain back much of what was lost in the fourth quarter. The energy heavy S&P GSCI index gained nearly 16% with U.S. stocks leading the global equity markets. The catalyst for the resuming rally was the U.S. Federal Reserve indicating they would likely take a patient approach to monetary policy leaving interest rates unchanged during the quarter. Negotiations resumed with China on trade, which pushed off any new tariffs. U.S. GDP grew 3% during the fourth quarter, while inflation has stayed at or below 2%. The environment is conducive to asset prices getting bid up.

Asset class returns for the first quarter contrasted with the fourth quarter, as nearly everything was down in the fourth quarter and nearly everything was up during the first quarter. The S&P 500 saw its best start to the year in over 20 years. Global equity markets saw its best start going all the way back to 1998. Bond markets rallied significantly as the Fed is likely to stop raising rates and economic growth is expected to moderate.



Economic Outlook

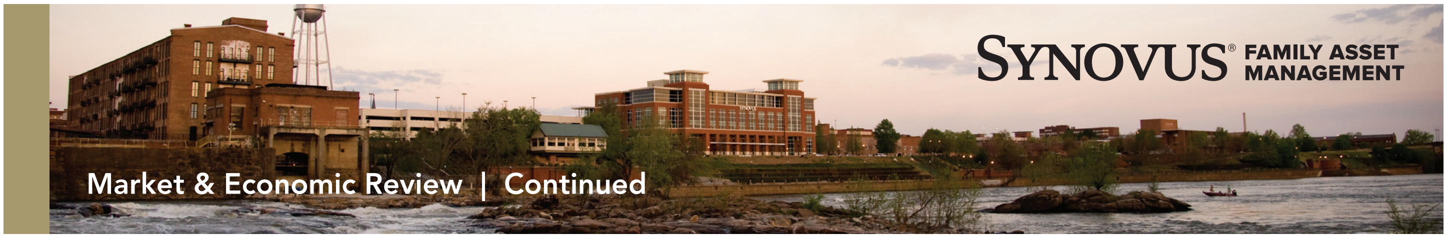
All indications are that global economic growth will slow but still be positive. We are expecting U.S. GDP for 2019 to grow between 1.8%-2.5%. Inflation continues to be under control as wages are growing just fast enough to not heat up prices and businesses are not forced to raise prices to pay for them. Based on demographics and technology continuing to lower costs and increase efficiencies, we continue to take the stance that inflation will be on the lower end of most forecasts. The chart below lists out the measures we follow to determine if economic growth will slow down enough to trigger a recession. Every economic indicator and financial stress indicator we follow is not at a level where they typically would be just prior to a recession. The only indicators that are cause for concern are the bottom two, which indicate that asset levels are at extremes similar to where they have been prior to the past couple of recession. Taking everything into account, we estimate the risk of a recession over the next 12 months at less than 25%.

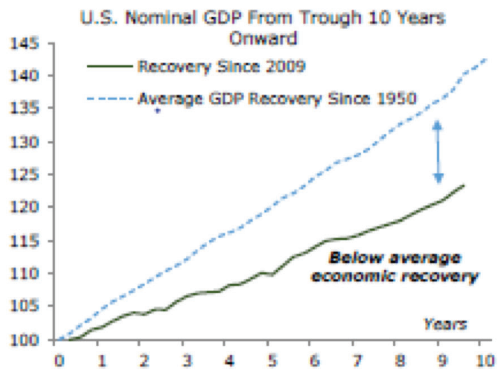
Indicator	Value
Yield Curve Inverted	No
Money Supply growing faster than 5%	No
Employment Costs as % of GDP Rising	No
US Avg. Hourly Earnings Growing more than 3.5%	No
Corporate Profits as % of GDP Falling more than 2 Percentage points	No
CorporateProfit Margins down 1 Percentage Point from peak	No
U.S. PMI below 50	No
NAHB/WF Housing Market Index below 50	No
TED Spread up over 100% in past year	No
LIBOR-OIS Spread over 50 bps	No
High Yield Bonds spread to Treasuries over 700 bps	No
Buffett Indicator(U.S. Equity Market Cap/GDP) above 100%	Yes
Household Net worth as % of Disposable Income above 6x	Yes
Probability of Recession next 12 Mo.'s	25%

Equities

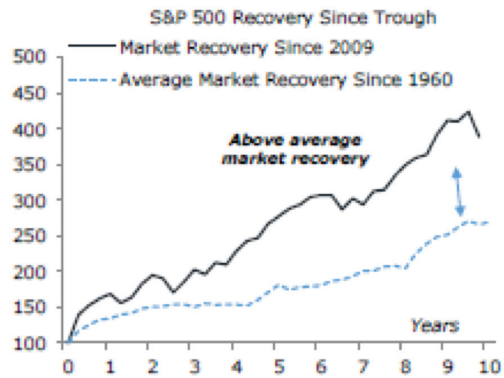
All major stock indices were positive for the quarter as the tech heavy NASDAQ was up 16.5% and the S&P 500 was up 13.7%. International stocks were up, but continued to trail the United States. Growth continued to outperform value, while small cap and mid cap indices outperformed large cap. In the fourth quarter the attitude was one of higher interest rates slowing growth down considerably. In the first quarter of 2019, the attitude was that lower growth and inflation would keep the Fed on the sidelines and thus allow room for financial assets to increase in value. The cyclical sectors led the way in the U.S. with industrials and technology leading, and defensive sectors such as utilities, healthcare and consumer staples lagging. After bottoming out at around 14x forward P/E ratio, the S&P 500 currently stands around 16.5x forward P/E ratio which is around the average for the past 5 years. While not cheap, U.S. equity markets have a pretty strong tailwind with low interest rates and positive economic growth.

Asset prices have benefited tremendously from global central bank monetary policy. In the right-hand side of the chart above we see that the S&P 500 has recovered significantly more than the typical market recovery since 2009, while U.S. Nominal GDP has recovered significantly less. Going forward, one thing we continue to look out for, is better than expected economic growth that doesn't translate into a rally in equity markets. It is quite possible that the very thing that would get the Fed to start raising rates again would be a stronger than expected economy. Higher rates would be a headwind that would weaken equity markets.





Data as at November 26, 2018. Source: Haver Analytics, Datastream, and Goldman Sachs Global Investment Research.



Data as at November 26, 2018. Source: Haver Analytics, Datastream, and Goldman Sachs Global Investment Research.

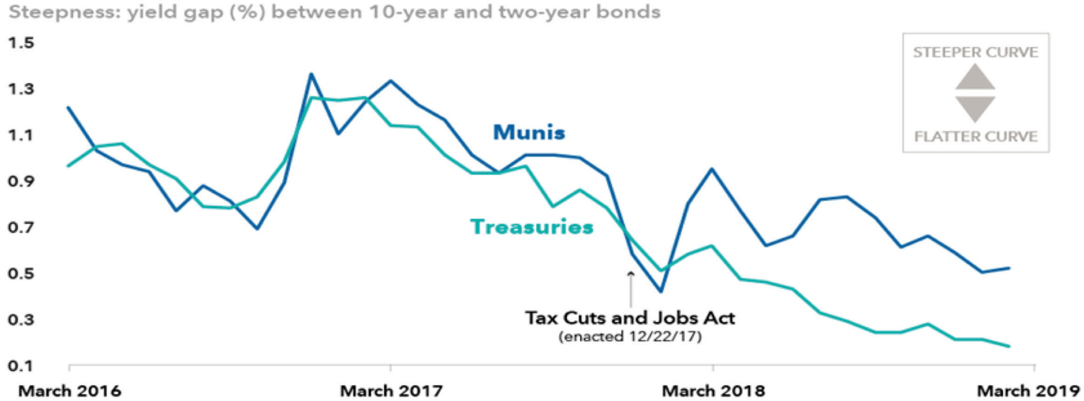
We continue to monitor the dynamics between U.S. versus international equity market returns. As we have mentioned in previous letters, we see international markets as fundamentally cheaper than the U.S. but have not seen monetary conditions loose enough in those markets relative to the U.S. to make a meaningful shift towards international markets. China is beginning to ease, to offset a slowdown, while Europe is likely to start soon. When we see signs of loose policy in these markets relative to the U.S. and the dollar begin to weaken, that is the time we look to make the shift.

Fixed Income

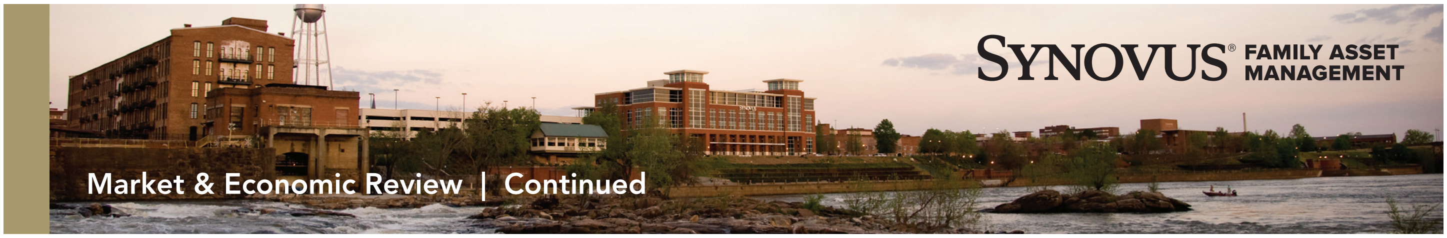
It appears that rates will remain lower for longer after the Fed's March meeting. Inflation and wage growth, while higher is only rising at moderate levels. Economic growth, while positive, is likely to be in the 2%-2.5% range for 2019. Bond markets rallied with equities during the quarter with the U.S. aggregate bond index up 2.94% for the quarter. The U.S. Treasury yield curve flattened during the quarter as the spread between the 10-year Treasury Bond and the 2-year Treasury Note settled below 16 basis points. As indicated in the chart below, municipal bonds provide a bit more spread between 10-year and 2-year maturities. In our allocations we are staying shorter in duration with treasuries and corporates and being a little bit longer with municipal bonds. The goal is to target an overall duration between 4 and 5 years.

Despite flattening, the muni curve is unusually steep compared to Treasuries

Steepness: yield gap (%) between 10-year and two-year bonds



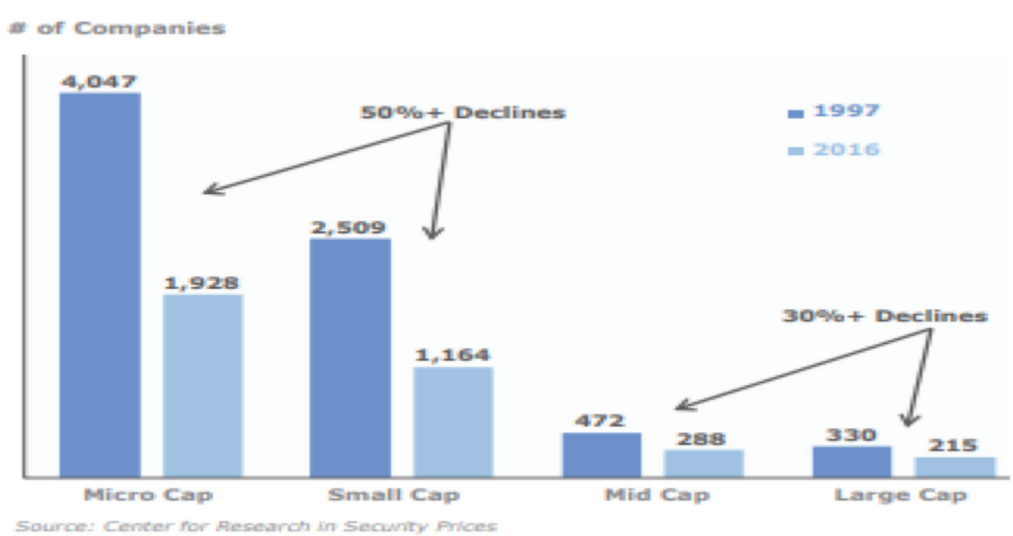
Sources: Bloomberg Index Services Ltd., Thomson Reuters. Month-end data through 1/31/19.



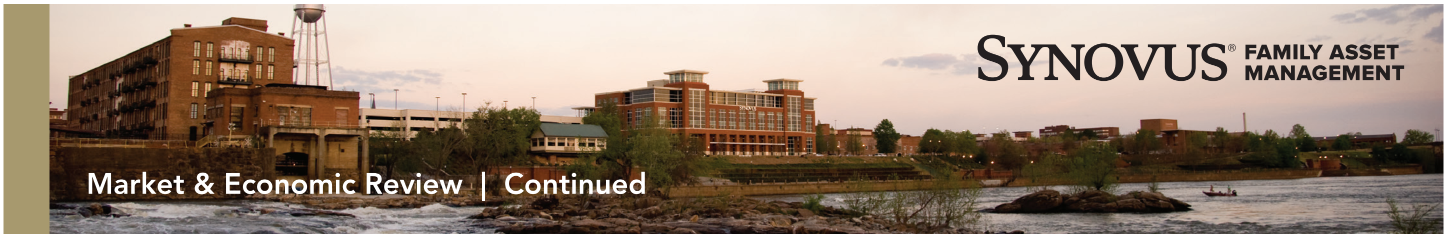
Interest rates in the U.S. continue to be anchored by low rates around the globe. At last count there was around $10tn of debt that trades at negative interest rates. While rates in the U.S. are low by historical standards they are attractive to investors globally. Demographics are a powerful force that plays out in a country's interest rate level. The U.S. has entered a phase where population growth is slowing. In looking at Japan, we get a glimpse of what is possible in our future. Japan has experienced a major slowdown in population growth and actual decline in the recent past and near future. We don't necessarily see the U.S. following the exact trajectory of Japan, but we expect slower population growth which does influence GDP growth and inflation. Until we see a significant change, we continue to be in the lower for longer camp.

Alternatives

Money continues to flow into the private equity space which has generated some debate around if there is too much capital flowing into the space and thus lower future returns. What we have seen is that money continues to go into the largest funds. This is the area where the large institutional investors must invest due to their size. Over the past decade the amount of capital going into private equity for funds $100mm and less has been steady. Growth has primarily been in the $1bn+ funds, which we tend to invest less in. Our sweet spot is in funds up to $500mm in commitments. The below chart shows not only why we have been underweight small cap stocks but why we gravitate toward smaller private equity funds. The number of publicly traded companies has continued to shrink especially in the micro and small cap space. Regulations have been a contributer but also the fact that private companies are staying private longer. What this means to us is that the pool of quality publicly traded small cap growth companies has shrunk considerably. To get the returns that were possible in the past requires being invested while they are still private. Lyft just went public with a market cap of around $26bn which would put it near the middle of the S&P 500 in regards to size. In the past, Amazon went public at a market cap less than $500mm. Netflix went public around $200mm and Salesforce went public around $1bn. All three of these would have been categorized in the small cap space. If this is a structural change, then it is likey that private equity has not grown beyond its ability to deliver historical returns.



Source: Gresham Partners



Synovus Family Asset Management Investment Team
Michael S. Sluder, Chief Investment Officer & Sr. Portfolio Manager
Scott Bowen, Director of Portfolio Management
Andrea R. Parker, Senior Portfolio Manager
Zachary D. Farmer, Senior Portfolio Manager

Comments and questions can be directed to michaelsluder@synovus.com

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