Economic and Market

Overview

Third Quarter 2013

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UMB

UMB Investment Management appreciates this opportunity to present our information to you.

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Economic and Market Overview

Economics

The U.S. Federal Reserve dominated the headlines in Q3 as markets awaited word of whether the central bank would begin to end its $85 billion per month bond-buying program, the centerpiece of its efforts to stimulate the economy. The Federal Open Market Committee made the decision to forego tapering as the economic data did not warrant it. In addition, the quarter closed with the threat of a government shutdown and a potential debt limit standoff. At this time we think it will be a political event that may be a source of near-term uncertainty and not an economic event that would cause significant negative impact to economic growth. If the shutdown lasts longer than 30 days, Q4 GDP would more than likely take a hit between 0.5 and 1.0%. Our forecasted 1.8% annual growth in 2013 would be reduced to 1.7%.

The government's shutdown also has implications on the Fed's exit plan from its asset purchase program. We now believe that the Fed will begin tapering in December at the soonest, and the probability of tapering being delayed until 2014 continues to increase. Our forecast of 200,000 job growth per month is a healthy payroll number; however, we continue to have concerns over the quality of jobs given that all of the job growth in June was attributable to part-time work.

Housing comprises a mere 2.7% of GDP; however, housing starts will be a major contributor to GDP in 2013, perhaps adding 1.0% to GDP growth this year. The threat of higher mortgage rates may cool the housing market for the remainder of the year and into 2014. Housing prices are expected to bolster consumer confidence -- as of July, home prices are up 12% over the last year.

The global economy continues to be supported by accommodative monetary policy. Europe's recession has officially ended and China's economy has shown signs of improvement.

Our economic theme of "Policy Basin" remains intact, where we expect to experience positive economic growth in the 1.5% - 1.8% range. First-half economic growth has been subdued due to a drag on government spending. We anticipated more economic activity in the second-half as confidence increased; however, a prolonged government shutdown and disagreements on the debt limit may curb Q4 growth. Moderate economic growth in the U.S. will most likely support double-digit returns in the stock market.

The table below summarizes our 2013 forecasts:

	2013 Year End Target
US Real GDP Growth Rate	1.70%
Global Real GDP Growth Rate	2.80%
S&P 500 Price Target	1,700
S&P 500 Operating EPS Growth	6.00% - 8.00%
Projected 10-Year Treasury Rate	2.75%

Equity Markets

The stock market continued to climb a "wall of worry" through September as a result of improving global growth conditions, decent earnings growth and continued accommodative Fed policy. Despite some bumps in the road due to uncertainty around the Fed's Tapering plan and the conflicts over the Budget and Debt Ceiling, the market has remained somewhat resilient on hopes of continued earnings growth. Once we move beyond the political noise, the market can once again focus on corporate earnings. As "green shoots" start to arise in Europe and better Chinese economic data prevails, we expect corporate earnings to benefit from these encouraging trends.

We enter the fourth quarter facing a potentially ongoing series of government shutdowns and debt ceilings. Historically, stock market selloffs from government shutdowns have been a good buying opportunity. The most recent example was in 1995-96 when, after a 21-day shutdown, the S&P 500 rose 22% over the next year. We think this time will be no different. Once the politicians come to an agreement, the market will again focus on earnings and fundamentals.

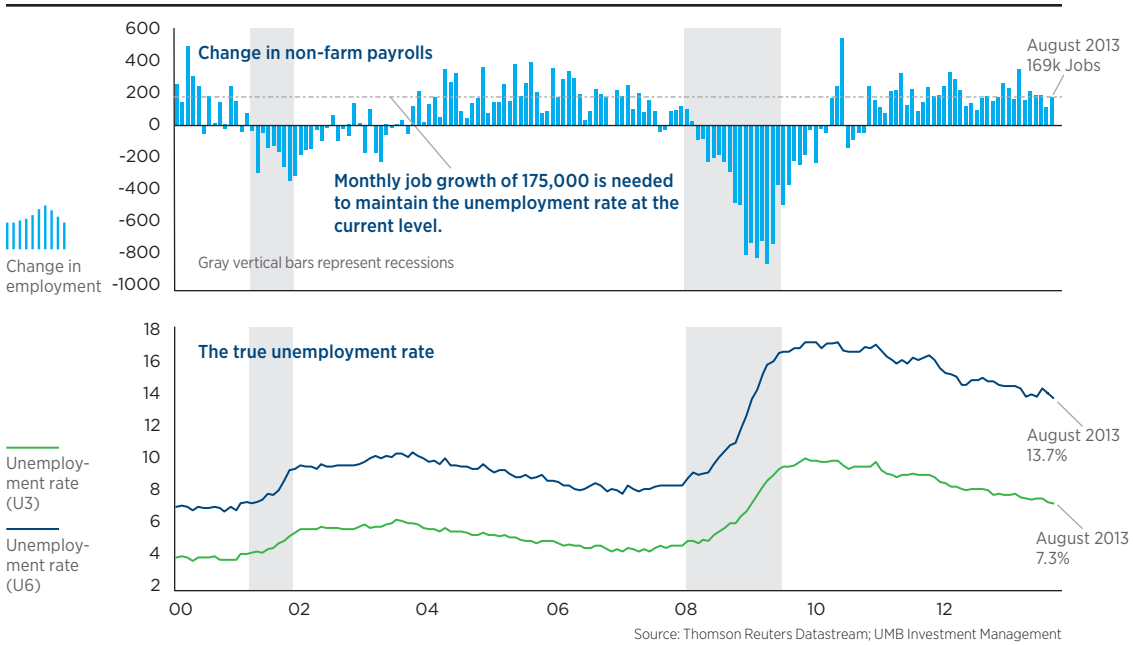
We believe the biggest short-term risk to the market is political. The government shutdown could adversely impact economic growth, depending on the length and severity of the impasse. A longer-term risk for equity markets is the regulatory environment, primarily in the financial and energy sectors. Major banks may be facing billions in fines and penalties, which could hinder the economy, as the focus of management teams is diverted from their core underlying purpose – providing credit to support economic expansion. Moreover, the Environmental Protection Agency (EPA) is implementing stringent laws that hinder growth in the energy sector. Overall, we believe these risks to be manageable for the equity markets.

Fixed Income Markets

The initial mention of Tapering of Quantitative Easing (QE) drove rates sharply higher during the second quarter, and Q3 experienced a continued steady rise in long rates. As markets were prepared for what was assumed to be the initiation of Tapering at the September FOMC meeting, the 10-year treasury pushed from 2.48% up to 3.00%. However, the markets were handed a significant surprise (again) when the Fed elected to postpone Tapering and took no action on QE. The FOMC cited weak employment and fiscal uncertainty as strong reasons to continue QE at the current pace (an outcome that we predicted in the last quarterly update). Interest rates plummeted after this surprise announcement, pushing the 10-year back down to 2.63% at quarter-end.

Given that Tapering is now clearly on the radar screen we have moved our target to 2.75% for year-end. We will likely experience a volatile new trading range around that number as the markets speculate about the precise timing of QE's wind-down. We believe the Fed will be content to keep QE fully in place until the current economic/political storm clouds dissipate – particularly given the recent announcement of Janet Yellen as Ben Bernanke's proposed replacement. We believe that political turbulence around the Budget and Debt Ceiling debates could temporarily push rates back down to 2.50% or marginally lower, but we continue to estimate that these issues will prove transient in nature.

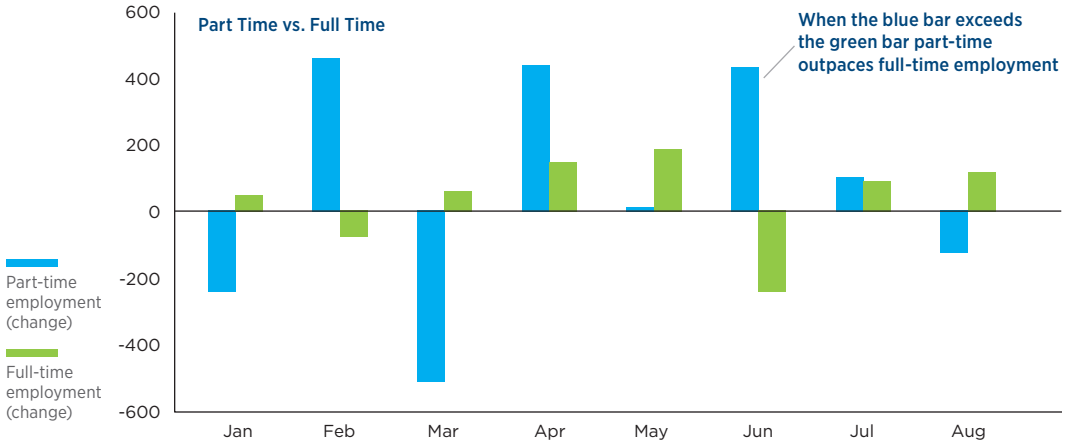
Employment



Source: Thomson Reuters Datastream; UMB Investment Management

- Headline unemployment continues to improve. We anticipate payroll growth will average 200,000 jobs per month in 2013, an increase of 10%.
- The quality of jobs remains a concern. Too many part-time jobs created. The (U6) remains stubbornly high at 13.7%.
- While the unemployment rate (U3) has been trending downward, the labor force participation rate remains at 63.5%, a 30-year low – this has contributed to the declining unemployment rate.

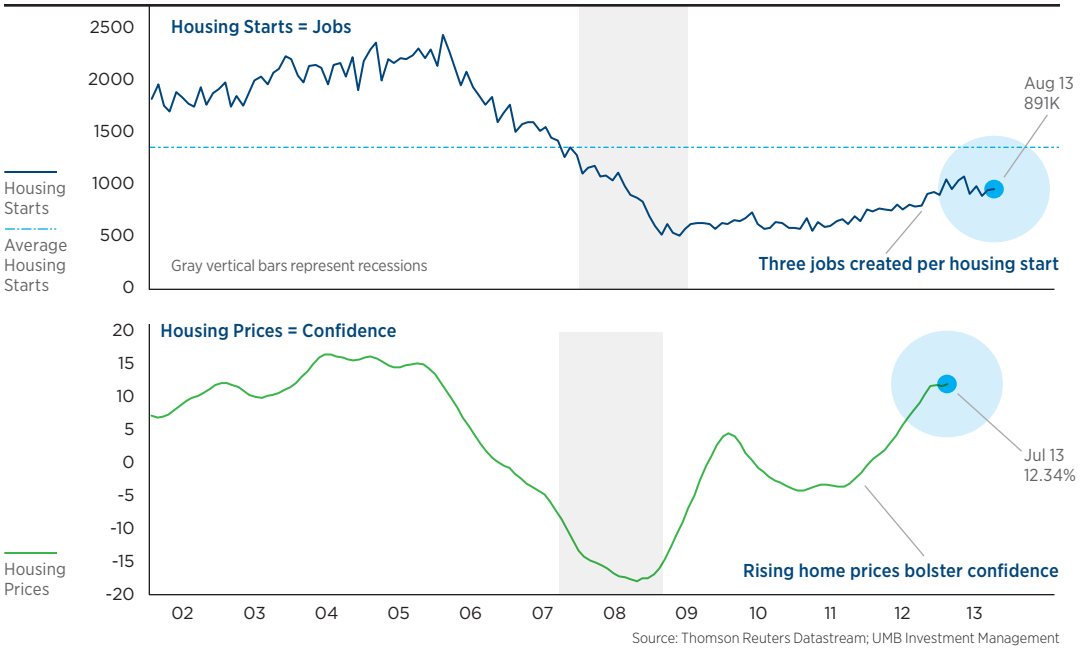
Employment Growth in 2013 Year-to-Date



Source: Thomson Reuters Datastream; UMB Investment Management

- Part-time employment growth has accounted for more than 50% of total job growth so far in 2013 according to the household survey.
- The growth in part-time work is concerning as it indicates that job growth, while strong so far in 2013, has been low quality in nature.

Housing is in Recovery Mode



Source: Thomson Reuters Datastream; UMB Investment Management

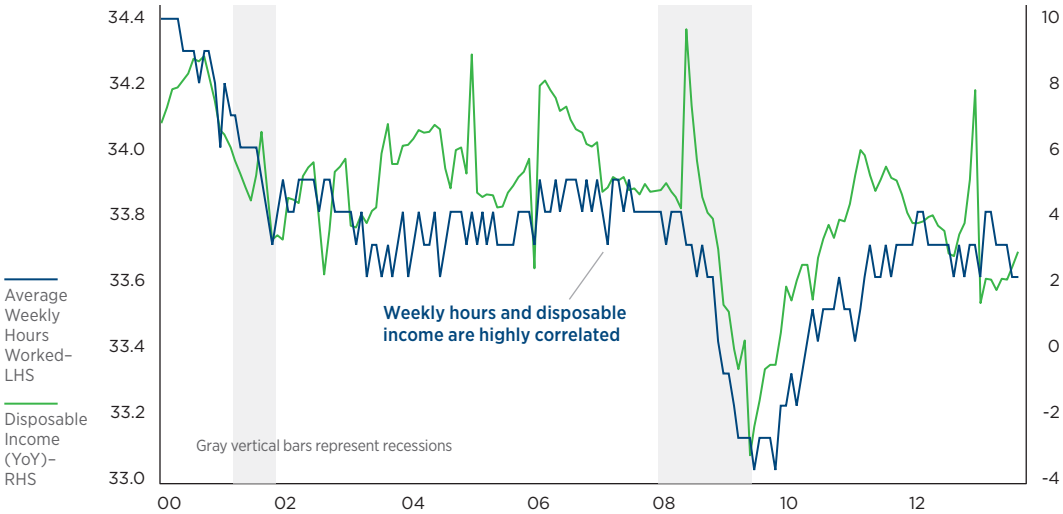
- Housing starts lead to job creation. Each new home under construction creates three new jobs. We expect roughly 900,000 new home starts in 2013.
- Housing starts have been trending very positively, showing solid recovery from the 2009 bottom. Higher mortgage rates may cool starts.
- Home prices are anticipated to be up double digits this year.
- Rising home prices is a positive for confidence; however, it reduces affordability for new purchases.

Mortgage Rates vs. Purchase Applications

Source: Thomson Reuters Datastream; UMB Investment Management

- Mortgage rates have risen sharply of late due to Fed Tapering expectations.
- Higher rates pose a threat to the still somewhat nascent housing recovery as affordability is reduced.
- On the other hand, continued improvements in the labor markets could positively impact affordability as incomes rise.

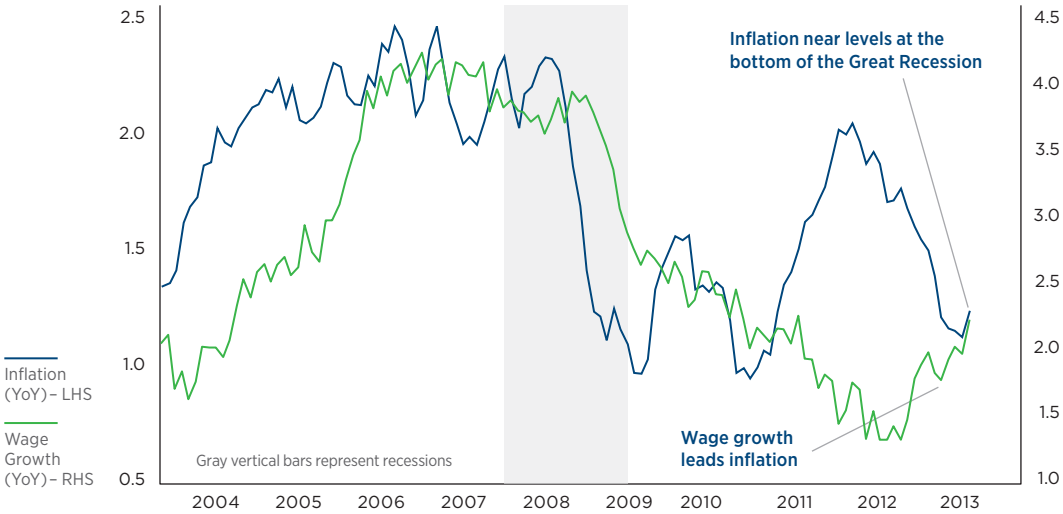
Weekly Hours Worked vs. Disposable Income



Source: Thomson Reuters Datastream; UMB Investment Management

- Government budget cuts will pare job growth, but perhaps have a more severe impact on hours worked due to government furloughs.
- The Affordable Care Act is likely negatively impacting hours worked as hours are reduced and part-time employment increases. Elements of the Act have been delayed a year, yet the uncertainty persists.
- Average hours worked have been stable over the past few years, no prevalent upward trend. Data supports moderate economic growth.

Inflation (PCE) and Wage Growth

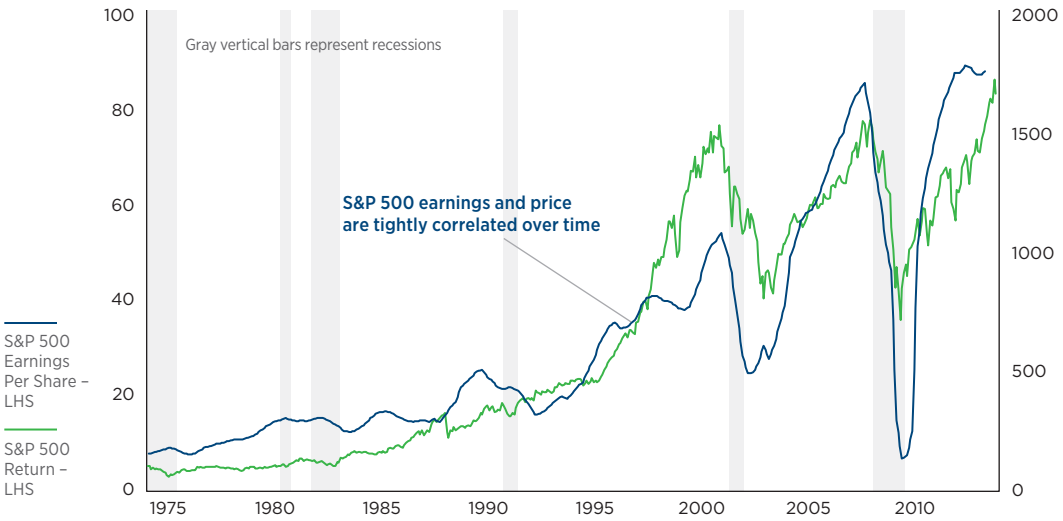


Source: Thomson Reuters Datastream; UMB Investment Management

- The Fed's measure for inflation (PCE) is well below its long-term "target" of 2%.
- PCE is in a steady downward trend since the beginning of 2012.
- Inflation is clearly not an imminent threat, leaving plenty of room for continued easing.
- Watching wage inflation, starting to tick up. Wage inflation is sustainable inflation and leads overall inflation indices.

Earnings and Spending Drive the Stock Market

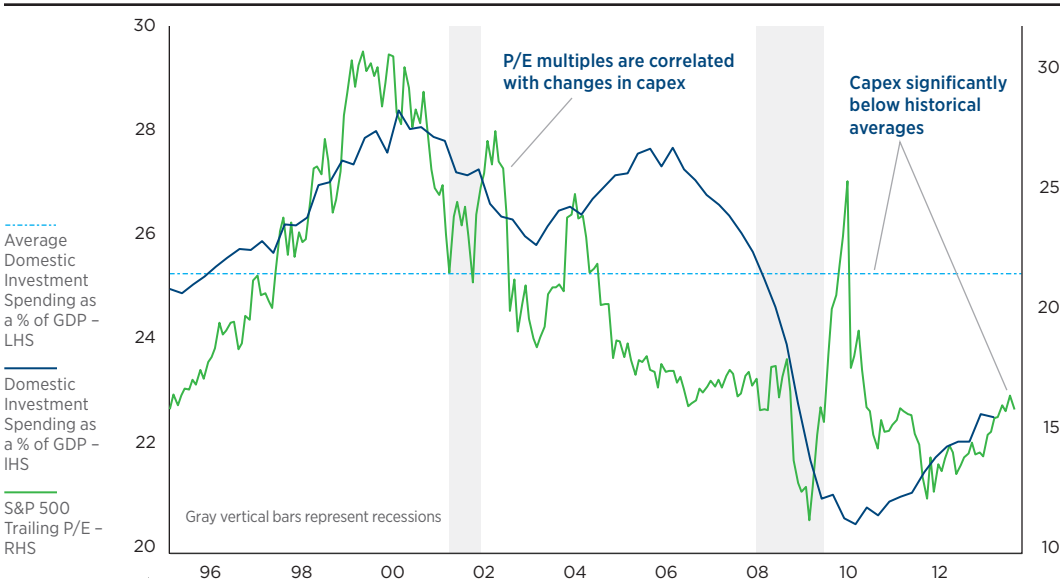
S&P 500 Earnings vs. S&P 500 Returns



Source: Thomson Reuters Datastream; UMB Investment Management

- Over the long term, the direction of earnings is highly correlated with the movement of stock prices.
- We experienced low-single digit earnings growth in 2012 and expect mid-single digit earnings growth in 2013, even in a sluggish GDP environment.
- A significant portion of S&P 500 earnings stems from international activity. The weakness in international economies appears to be abating. This potentially provides a tailwind to earnings growth.

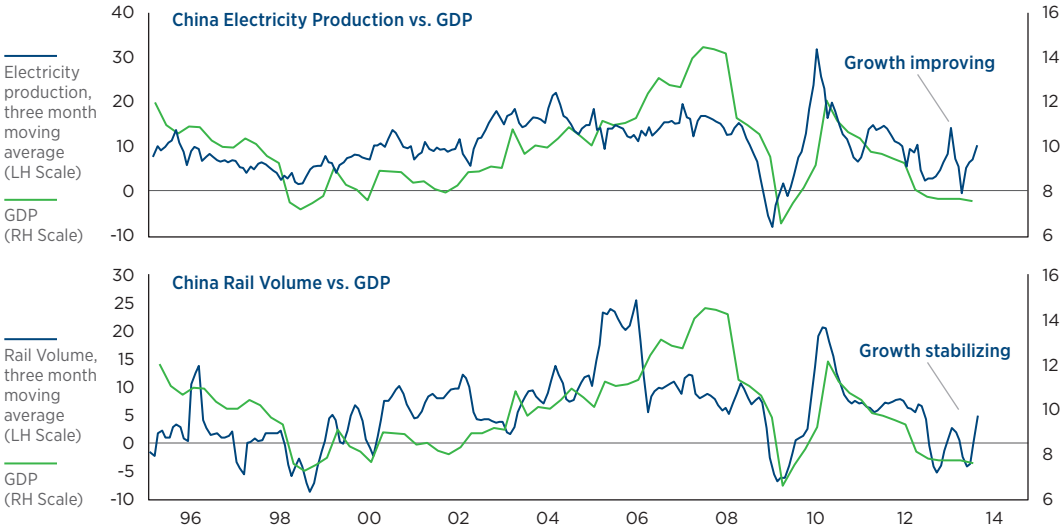
Capital Expenditures (% of GDP) and S&P 500 P/E Multiples



Source: Thomson Reuters Datastream; UMB Investment Management

- We anticipate a recovery in capital expenditures over the coming years.
- Historically, rising capital outlays translate into higher stock market returns through multiple expansion.
- Growth in capital spending is driven by improving aggregate demand, CEO confidence and record corporate earnings, and exacerbated by low interest rates.

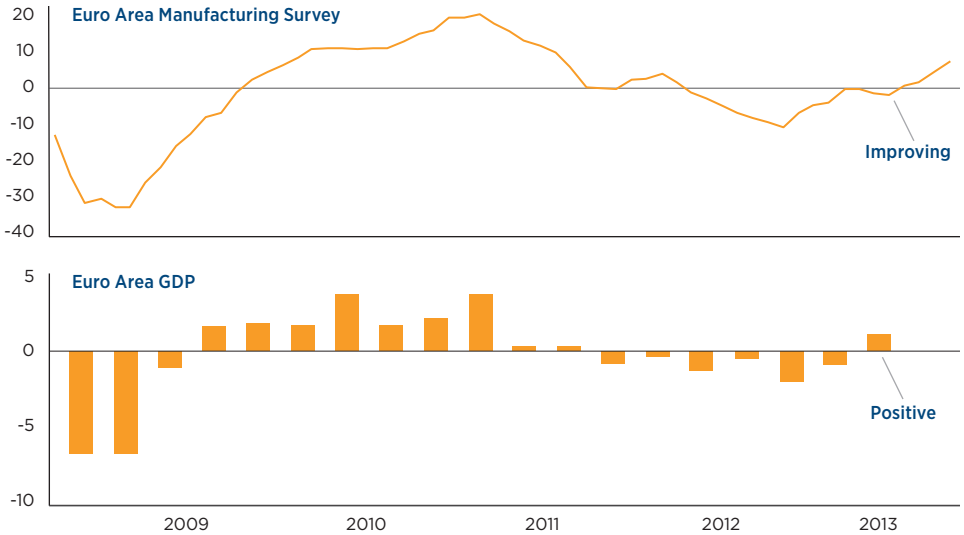
China Economic Data



Source: Thomson Reuters Datastream; UMB Investment Management

- China's electricity production is signaling stronger economic growth in the quarters ahead.
- Rail volumes in China suggest economic activity is in the process of bottoming.
- Despite the better economic activity, sentiment surrounding China is very negative.
- An acceleration in China's economy should benefit the cyclical sectors in the S&P 500.

Euro Area Economic Data



Source: Thomson Reuters Datastream; UMB Investment Management

- The recession in Europe officially ended in the second quarter of 2013.
- Leading indicators from Europe suggest continued economic improvement.
- As European economic weakness has depressed earnings for several years, a positive economic turn could provide a tailwind for multinational companies.

U.S. Equity Sector Performance and Valuation

S&P 500 Year-to-Date Return

	Total Return % as of 09/30/13					
Index followed by sectors	1 Month	3 Month	YTD	1 Year	3 Year	5 Year
S&P 500	3.14	5.24	19.79	19.34	16.24	10.00
Consumer Discretionary	5.44	7.79	29.12	31.84	24.11	18.76
Health Care	3.16	6.82	28.45	28.55	20.93	13.06
Industrials	5.68	8.90	23.91	28.46	16.65	10.60
Materials	4.43	10.30	13.5	16.55	11.90	8.15
Financials	2.76	2.87	22.93	30.19	13.55	1.69
Consumer Staples	1.33	0.80	16.08	14.05	15.84	10.86
Energy	1.77	5.15	15.41	12.24	15.34	6.57
Information Technology	2.88	6.62	13.39	6.91	13.68	12.02
Utilities	1.13	0.19	10.14	6.99	10.58	7.06
Telecom	-0.47	-4.40	5.69	-0.68	12.55	11.17

Source: Bloomberg

- The S&P 500 YTD return of 19.79% was led by Consumer Discretionary and Health Care. The consumer has received a large boost in confidence from the housing market recovery which has boosted spending. In Health Care, revolutionary drug discoveries have propelled this group higher.
- Going forward, we favor industrials because that group should benefit from a reacceleration of cap-ex as global growth picks up.

Valuation

	Current Valuation vs. Historical Valuation		
Index followed by sectors	Current P/E	Historical P/E	*Disc./Prem
S&P 500	15.9	16.0	-0.6%
Industrials	17.1	17.3	-1.1%
Information Technology	14.8	18.8	-27.0%
Financials	13.0	13.2	-1.5%
Consumer Staples	18.5	18.4	+0.5%
Consumer Discretionary	20.6	20.0	+2.9%
Health Care	16.8	15.4	+8.3%
Telecom	21.1	16.8	+20.3%
Utilities	15.3	14.8	+3.2%
Energy	13.3	12.3	+7.5%
Materials	18.4	16.5	+10.3%

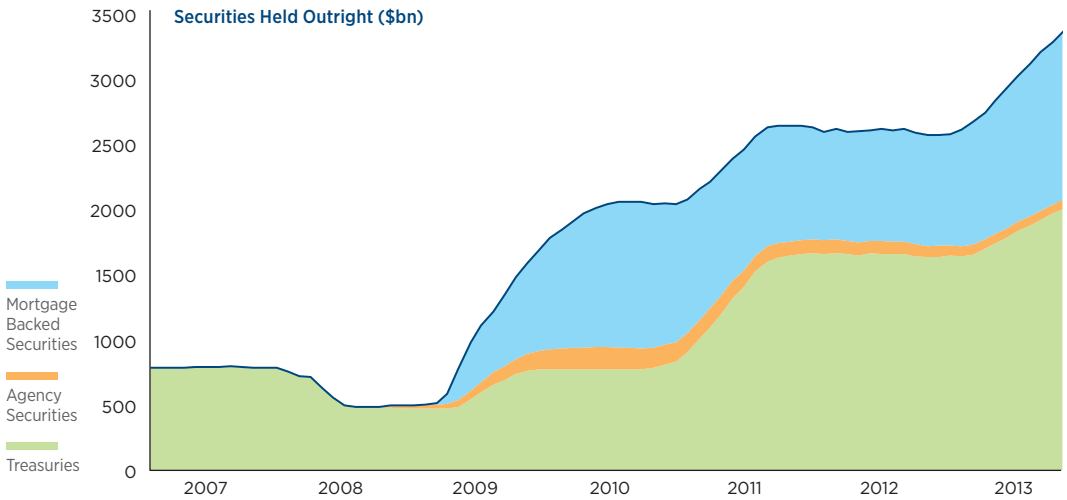
*Discount/Premium to historical P/E

Source: Thomson Reuters Baseline

- From a "top-down" approach, we monitor sector valuations alongside our proprietary company specific valuation models.
- Industrials, financials and information technology are the only sectors that trade at a discount versus historical valuation.
- The combination of global growth recovering and attractive valuation makes industrials one of our favorite sectors as it has meaningful international exposure.

Fed Quantitative Easing Resulting in Ballooning Portfolio — Will Pressure Yields

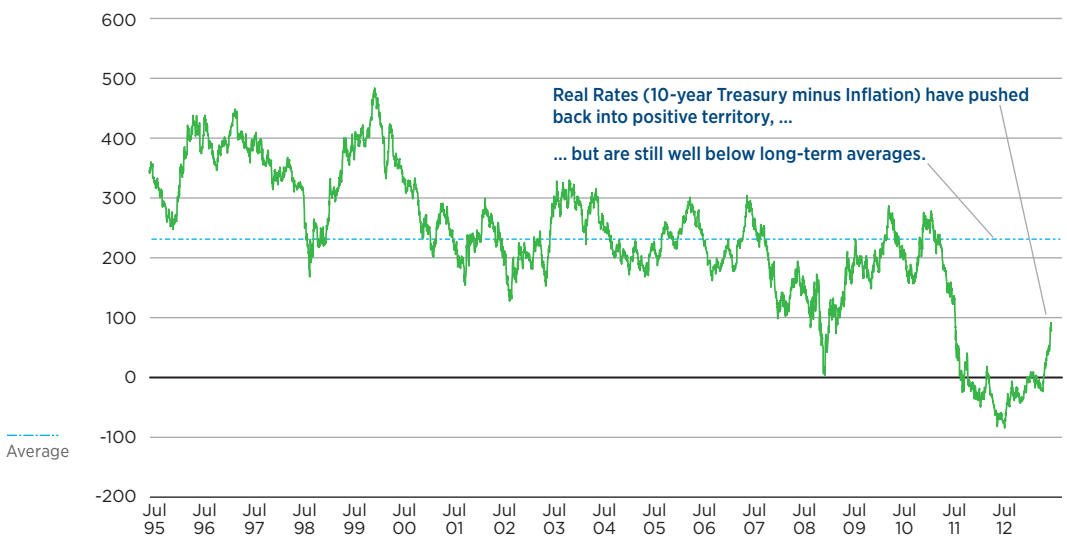
Federal Reserve Assets



Source: Thomson Reuters Datastream; UMB Investment Management

- The Fed bond portfolio has reached approximately $3 trillion. Unwinding these holdings will have impacts on the bond market and could push rates upward more rapidly.
- As the economy moves into stronger territory, the end of QE activities has come into play.
- The discussion of the ending of this multi-trillion dollar purchase program has shifted rates upward, as participants prepare for "normalization" of the Treasury yield curve.

10-Year Treasury Real Yield



Source: Thomson Reuters Datastream; UMB Investment Management

- Real Treasury rates are well below fundamental averages, relative to typical benchmarks.
- Now that "tapering" of QE is being discussed, rates have begun to re-trace the path back to "normalized" levels. The target for year-end 2013 is 2.50%
- The Fed will likely succeed in ensuring that the move is somewhat orderly, but ultimately rates will move up to at least 3.50 – 4.00% (nominal).
- Investors must beware of holding long maturities.

U.S. Fixed Income Sector Performance and Weightings

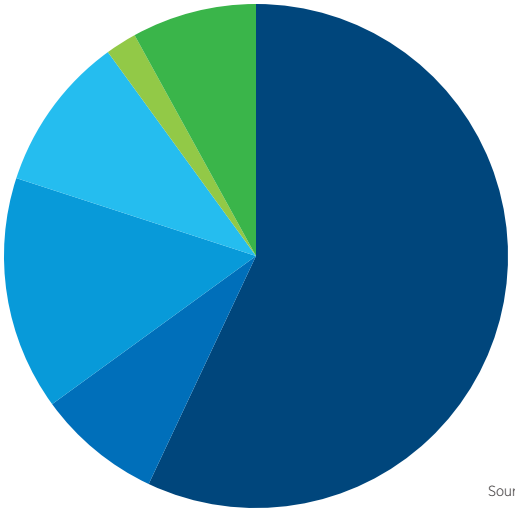
Performance

Index/Sector	MTD Return	YTD Return
Gov 1-3 Yr	-0.07	0.02
ABS	-0.57	-0.76
US Agency Intermediate	-0.68	-0.88
U.S. MBS	-0.96	-2.01
US Aaa Credit	-1.05	-2.02
US Agg Intermediate	-1.12	-1.63
G/C Intermediate	-1.20	-1.45
U.S. Aggregate	-1.55	-2.44
Credit Intermediate	-1.91	-1.84
US High Yield Intermediate	-2.52	1.43
US High Yield	-2.62	1.42
U.S. Credit	-2.85	-3.60
UST Long	-3.17	-7.83
US Baa Credit	-3.41	-4.01
US Agency Long	-4.77	-7.97
Credit Long	-5.26	-8.01

Source: Thomson Reuters Datastream; UMB Investment Management

- May and June returns were severely negative due to the rise in Treasury rates. This pushed YTD returns into negative territory for all but the High Yield sector.
- Talk of Tapering QE put pressure on all spread sectors, with lower credit quality sectors giving back some of the incremental performance they've generated over the last year.
- The Treasury curve steepened, as markets responded to Fed talk of Tapering QE.
- The long end of the market suffered. All long indices posted negative returns, severely lagging intermediate/short assets.

Barclays Intermediate Government/Credit Sector Weights

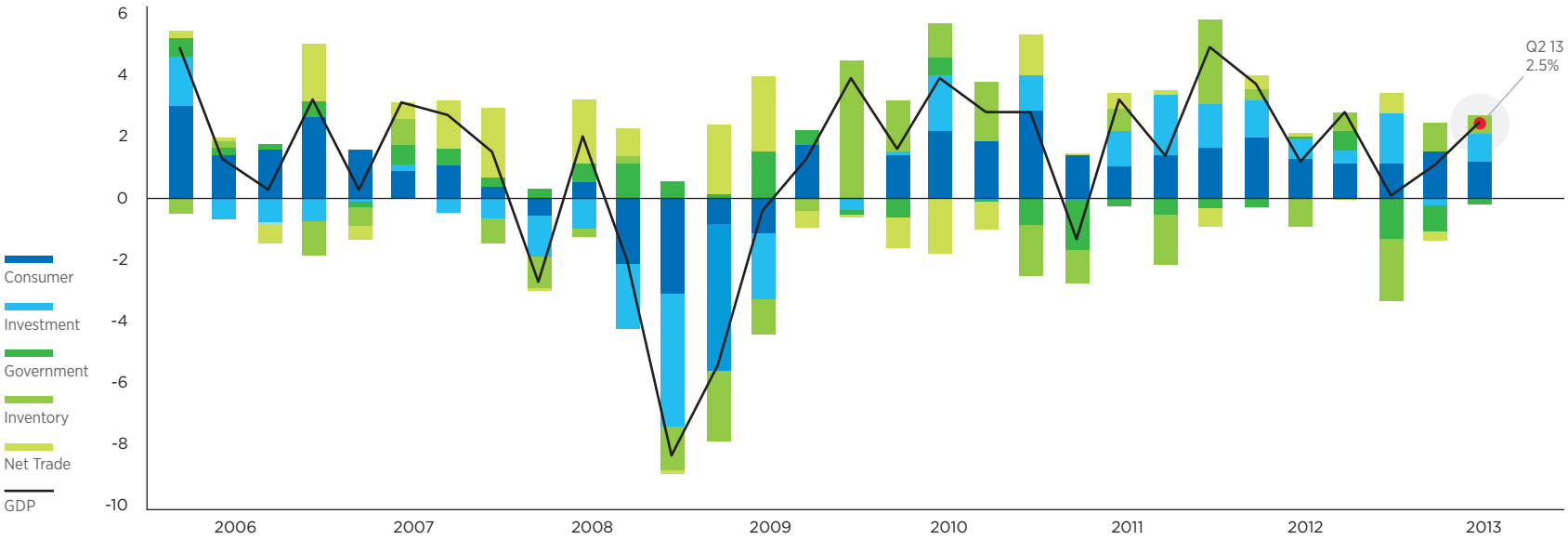


Source: Thomson Reuters Datastream; UMB Investment Management

- The performance of long-duration Treasuries will dominate the returns of the broad index – damaging returns. Yields are coming off of multi-decade lows, ensuring that this portion of the market has value only as a deflation hedge.
- Given attractive relative yields in portions of the corporate (and high yield) sector, a strong overweight is likely to help bolster incremental returns throughout the upcoming cycle.
- Mortgage backed securities can be used as a substitute for a portion of the Treasury/agency exposure, helping to enhance yields and dampen volatility.

Real Gross Domestic Product (GDP)

Contributions to GDP Growth



Source: Thomson Reuters Datastream; UMB Investment Management

% Contribution to GDP by Quarter

Component	Mar-12	Jun-12	Sep-12	Dec-12	Mar-12	Jun-13
Consumption (C)	2.0	1.3	1.2	1.1	1.5	1.2
Investment (I)	1.6	-0.2	0.9	-0.4	0.7	1.5
Government (G)	-0.3	0.1	0.7	-1.3	-0.8	-0.2
Imports (X)	-0.1	-0.4	-0.1	0.5	-0.1	-1.1
Exports (X)	0.5	0.4	0.1	0.2	-0.2	1.1
Total	**3.7**	**1.2**	**2.8**	**0.1**	**1.1**	**2.5**

Source: Thomson Reuters Datastream; UMB Investment Management

GDP Forecast

	Q1	Q2	Q3	Q4	Year
2011	0.1 (A)	2.5 (A)	1.3 (A)	4.1 (A)	1.8 (A)
2012	2.0 (A)	1.3 (A)	3.1 (A)	0.4 (A)	2.2 (A)
2013	1.1 (A)	2.5 (A)	2.2 (E)	2.0 (E)	1.7 (E)

Source: UMB Investment Management

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