Economic and Market

Overview

Déjà Vu

Second Quarter 2016

KC Mathews, CFA
EVP/Chief Investment Officer
kc.mathews@umb.com

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KC Mathews, CFA
EVP/Chief Investment Officer
kc.mathews@umb.com

Additional contributors:

Eric Kelley
EVP/Managing Director, Fixed Income
Investment Management

Will Reese
VP/Director of Equity Research
Investment Management

Dan Trgovich, CFA
AVP/Senior Analyst
Investment Management

Déjà vu – will the twos do?

It feels a bit like déjà vu. For the past few years, we have seen weak first quarter economic activity only to see a rebound in the second quarter and then mediocre growth for the calendar year. Déjà vu, 2016 appears to be developing the same pattern. In Q1, the economy expanded at a tortoise's pace of 1.1%. We expect real GDP to grow 2.5% in Q2 and anticipate the economy will grow 2.0% for the year.

Because of benign economic growth around the world, growth expectations and market returns all seem to land around 2%. The question at hand is: will 2% growth do? Domestically, we have seen GDP growth in the range of 1.5 to 2.5%, averaging 2.1% for the last six years — well below the historical average of 3.2%. This year we expect 2% GDP growth, an average that stands for the seventh year in a row. Our 2017 and 2018 forecasts don't improve upon that to any real extent.

Last year the stock market, represented by the S&P 500, returned 1.4%. The return in the first half of 2016 is 2.7% price appreciation plus 1.1% dividend yield for a total return of 3.8%. The yield on the 10-year Treasury at the beginning of the year was 2.3%; today it is at 1.5%. The point is that we have experienced low returns, and we expect low returns this year. Again the question arises: will a 2% return do?

We think the answer is yes; 2% growth may not be great, but it may be good enough. Much of the economic data supports our argument that the economy continues to be on solid ground. The labor market is robust with unemployment at 4.9%; one could easily argue that we are at full employment. Déjà vu, we have seen significant strength in the labor market since 2010. The strong labor market should support consumer confidence, the housing market and consumption. Other statistics such as the Manufacturing and Non-Manufacturing data trended higher in the quarter, once again supporting an economic expansion.

The market was dealt a Brexit surprise late in the quarter when the United Kingdom voted to leave the European Union (E.U.). It had been a member since 1973. The departure vote spiked uncertainty and caused a risk off ripple through the markets. However, markets recovered quickly as experts predicted minimal economic impact would be felt in the second half of the year, which calmed investors' concerns. The rise of populism around the globe will be a factor to watch over the next few years.

Will 2% do? Perhaps. Companies have found a way to make money in a 2% economic growth environment, and low returns have been tolerated considering inflation has been at bay.

The table below summarizes our 2016 forecasts:

	2016 Year-End Target
U.S. Real GDP Growth Rate	1.8% – 2.2%
Global Real GDP Growth Rate	3.3%
S&P 500 Price Target	2050
S&P 500 Operating EPS Growth	6.00%
Projected 10-Year Treasury Rate	2.00%

Equity Markets

The market continued to trade within the 2-year trading range in the second quarter. Market volatility continued as we saw a sharp rally in oil in the first part of the quarter, continuing advocacy on the part of outspoken Federal Reserve members for higher interest rates in the middle of the quarter, and a defection within the E.U. at the end of the quarter.

Oil rallied as U.S. supply continued to decline YoY, supply was disrupted in Canada/Libya/Nigeria and the U.S. dollar weakened. Oil has risen to approximately $50/barrel, which significantly reduces downside risk as it has relieved financial distress within the energy complex. Comments from a number of Federal Reserve officials created pressure for an interest rate hike sooner rather than later. Ultimately, Brexit concerns kept the Fed on hold. Volatility ensued at the end of the quarter when in a surprise move, Britain did in fact vote to leave the E.U. Interest rates continued to move lower given the uncertainty regarding the Brexit fallout. 10-year German Bond yields went negative, pushing the U.S. 10-year yields lower. Importantly, we do not believe the lower 10-year yield is a reflection on economic growth in the US. One positive takeaway from the Brexit situation is that interest rates remain low while the U.S. economy is holding up well. This has created a scenario where the valuation multiple has been able to expand. Moreover, market expectations that the Fed will raise interest rates have been pushed back. Lastly, we believe the earnings recession will come to an end in Q216. We expect earnings growth in Q3, and earnings acceleration into Q4. The catalysts for earnings growth to resume are easy comparisons, a lower dollar and stable oil year over year, and improving economic growth.

The market is currently at the high end of the trading range. We continue to think below 1900 is too low and above 2100 is too high. However, in a low interest rate and low inflation environment, higher valuation multiples can be justified. The market closed the quarter trading at 17.5x our 2017 earnings estimate of $120 per share. Historically, a range of 17-20x earnings is seen when inflation is between 1-3%, which is the current environment. As such, we could see the market trade to 2220, or 6% higher than end-of-Q2 levels, which would represent 18.5x (mid-point of the aforementioned valuation range) our 2017 earnings estimate. But once interest rates and inflation increase, the market could fall back into our 1900 – 2100 range.

Fixed Income Markets

U.S. Bond Markets were caught in the cross currents of seemingly contrasting themes during the second quarter of 2016. The turbulence that rocked riskier asset classes (stocks, high yield bonds, etc.) throughout the first quarter began to abate, and the markets settled into a nice recovery phase. Of course, the shocking outcome of the Brexit vote unleashed another wave of "flight to quality" in the bond markets, with assets flowing rapidly in the U.S. Treasury market, pushing rates down even further. The 10-year Treasury note posted a new all-time low in the days following Brexit.

However, as the dust settled following Britain's historic decision, equity markets began to push higher again, helped by a strong tailwind coming from ever-improving domestic economic releases. Oddly, interest rates did not follow their normal pattern — we would have expected rates to rise quite rapidly in an environment where the Brexit storm clouds cleared, the stock market was establishing new highs and the economic news was continuing to improve. However, this latest quarter has taught us the hard lesson that the U.S. Bond Market is no longer a clear barometer of the domestic economic outlook. Even as equities soared and strategists begrudgingly admitted that the economy is looking rather strong, long interest rates remained stubbornly low, mired well below the estimates of most leading forecasters.

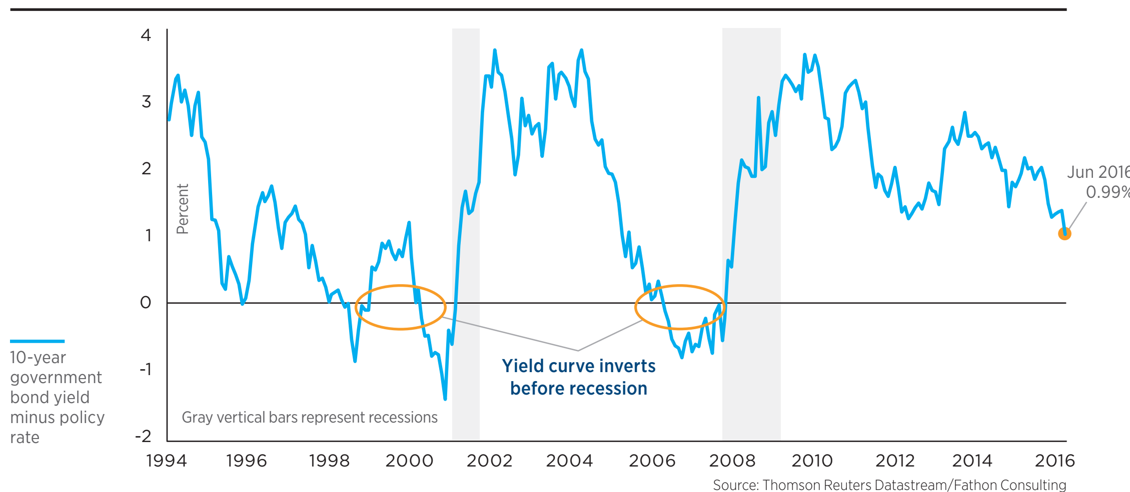
The traditionally high correlation between interest rates and stock prices appears to have been broken, or at least hobbled, during the current cycle. The massive amount of ongoing stimulus throughout Europe has pushed interest rates into negative territory in some of the key regions. This is fuelling a global search for yield that is driving global reserves into the U.S. Bond market, serving as an anchor on rates here in the U.S. huge global investors are looking to the U.S. for yields that appear to be high in comparison to European rates (see charts in the Fixed Income section).

For the time being, we are shackled to a very flat yield curve, one that is likely to flatten further as the FOMC gently moves overnight rates higher. Global reserve flows are likely to keep our long rates from moving much above 2% (10-year Treasury), which will result in a yield curve that is quite flat by historical standards. However, the traditional assumption that a flattening yield curve is signaling an impending recession will be off the mark. In fact, our yield curve is (and will continue to be) flattening as the domestic economy strengthens — counter to our historical experience. Strong recoveries in global economies, coupled with higher inflation expectations, will be needed in order to push long rates higher — a scenario that is likely to hold well into the future.

The Index of Leading Economic Indicators

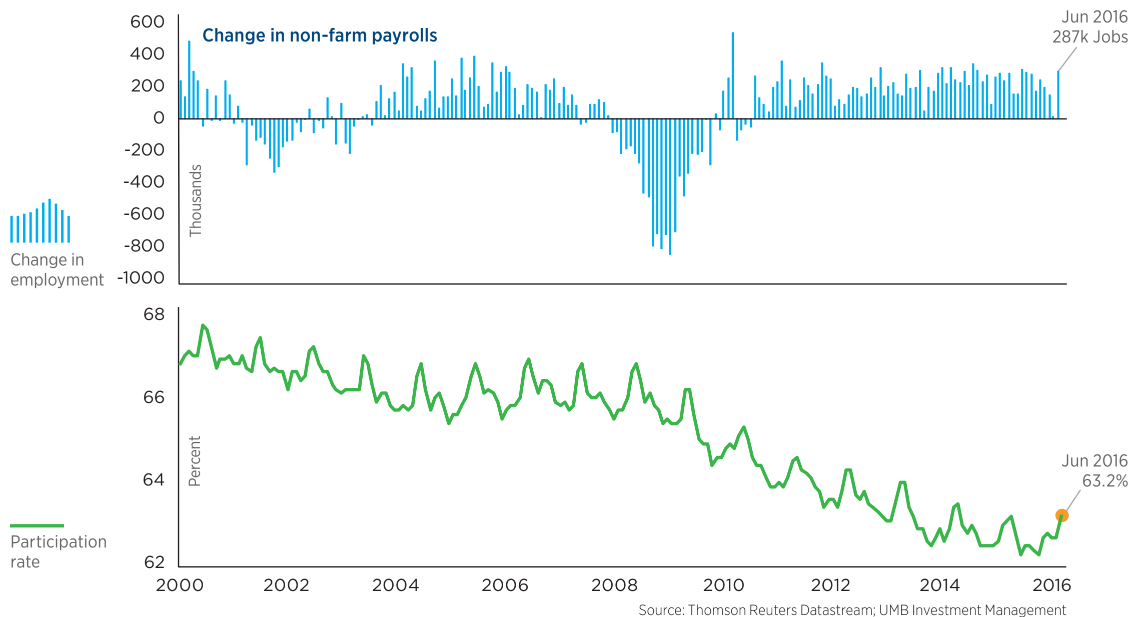
- The Index of Leading Economic Indicators (LEI) is comprised of 10 components, 7 non-financial and 3 financial.
- The indicator's six-month annualized growth rate is 0.7%, which is consistent with a moderate- to slow-growing economy.
- A -3% rate of change is normally a good precursor to an upcoming recession, which is clearly not on the horizon based on this indicator.
- The current LEI reading supports our 2016 real GDP forecast of a moderately-growing economy around 2.0% in the U.S.

U.S. Yield Curve



- Historically the shape (slope) of the yield curve gives us clues to the health of the U.S. economy. A positively shaped curve indicates economic growth and a flat or negative slope signals an oncoming recession.
- Today, due to the Central Bank action around the world, there is pressure to keep longer-term interest rates low. At the same time the Fed is attempting to raise short-term rates.
- Quantitative Easing might be artificially impacting the slope of the curve, which is a risk. The efficacy of this recession indicator may be hindered.

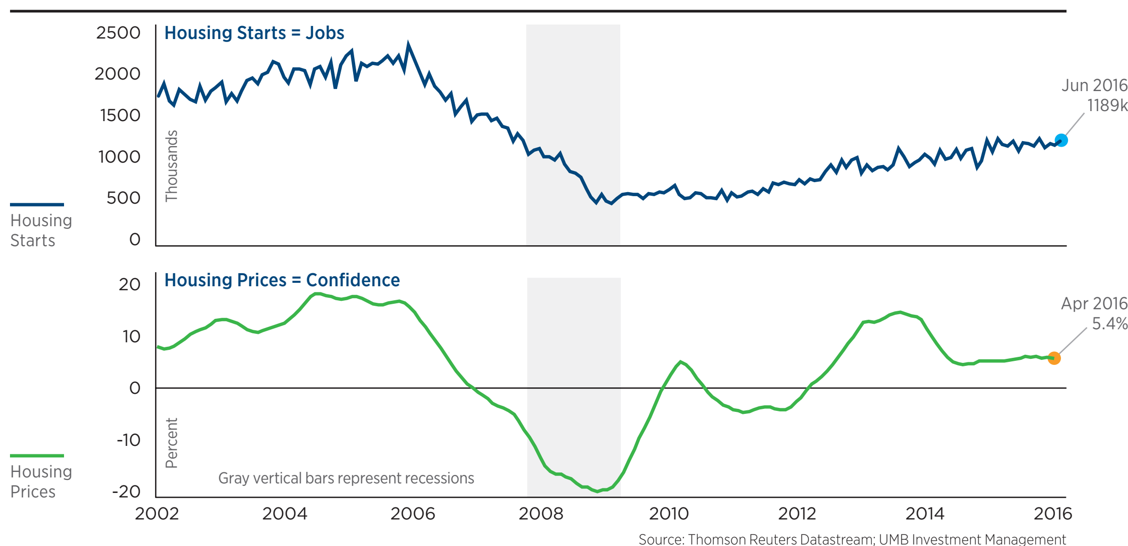
Labor Markets



Source: Thomson Reuters Datastream; UMB Investment Management

- The unemployment rate stands at 4.9%. In addition to solid job gains, the historically-low participation rate is contributing to low unemployment rates.
- Job gains have averaged 172,000 per month YTD. Historically, job growth of this magnitude has indicated moderate GDP growth.
- We expect payroll growth will average 170,000 jobs per month in 2016. While job growth has slowed, this is still a healthy level. Job gains since WWII have averaged approximately 120,000 per month.
- Our forecast indicates an unemployment rate of 4.9% by the end of 2016, driven by continued job gains and a slightly improving participation rate.
- The improved employment landscape will support consumer confidence and in turn, consumer spending.

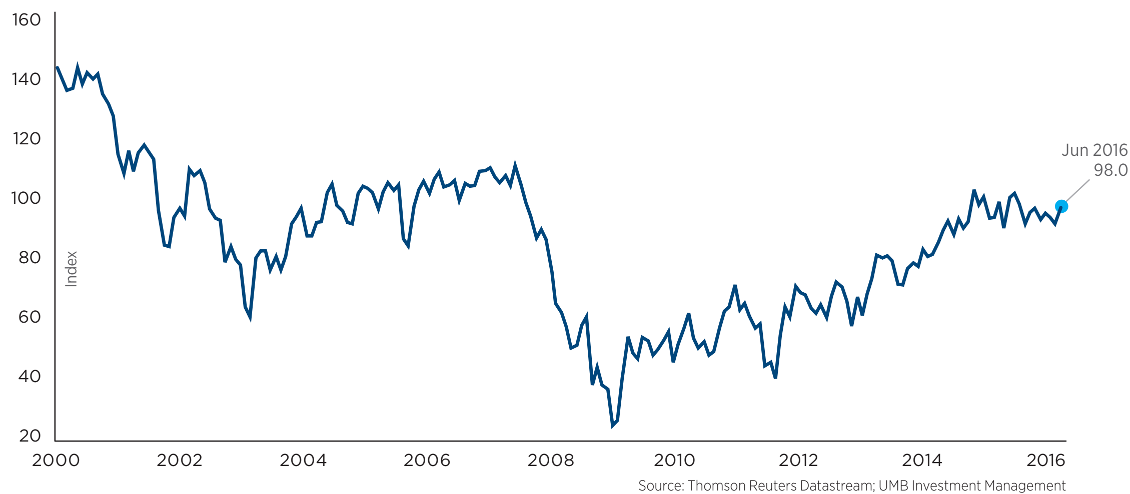
Housing is in Recovery Mode



Source: Thomson Reuters Datastream; UMB Investment Management

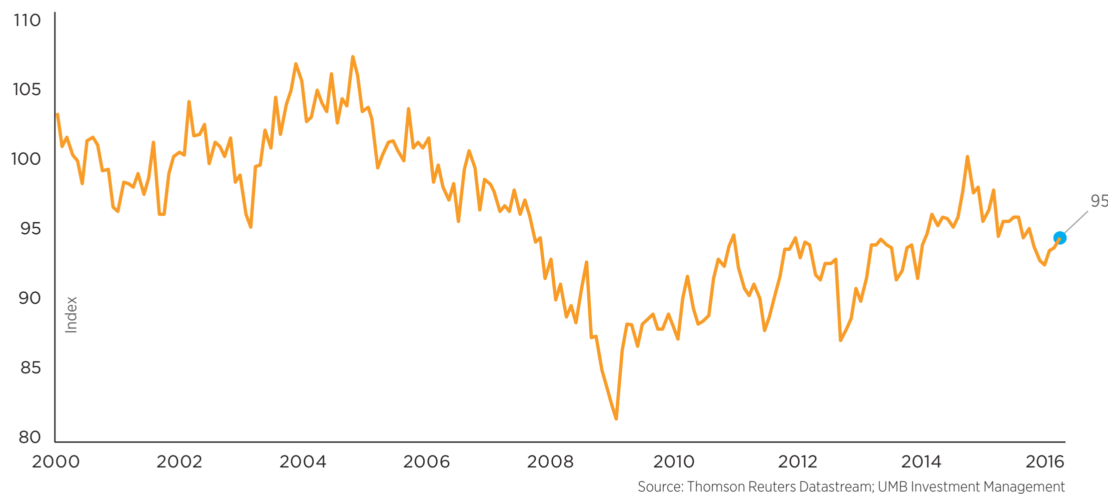
- The housing market continues to improve, giving no indication of an oncoming recession.
- Housing starts remain below normal levels of approximately 1.4 million per year. We estimate 1.2 million starts this year.
- Housing starts are being driven by an increase in household formations as a result of the strong labor market and increasing wages.
- Home prices continue to increase at a moderate pace, which supports the wealth effect.
- We believe the state of the housing market continues to support a moderate growth economy.

Consumer Confidence



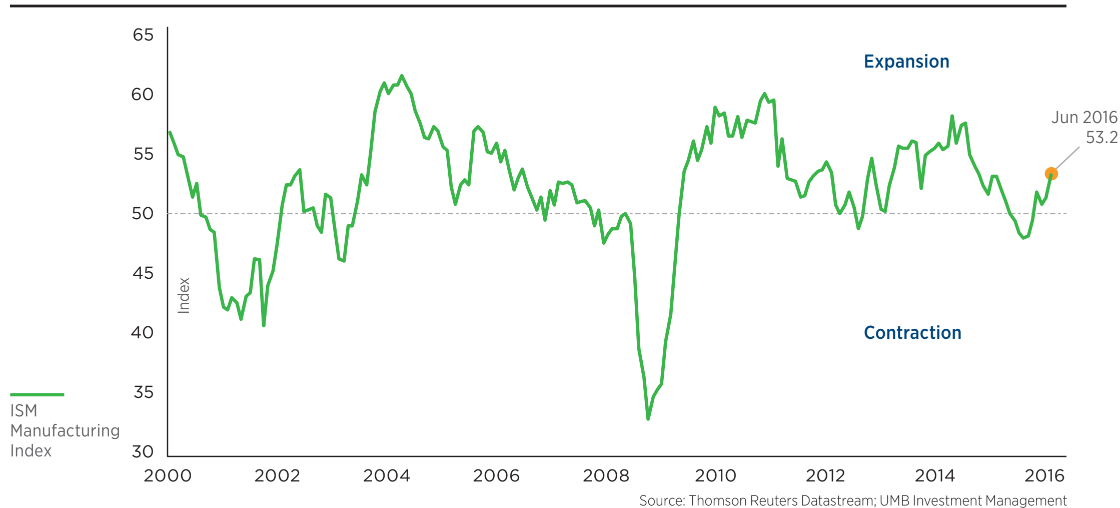
- Consumer confidence remains at a high level by historical standards.
- Confidence has been driven by a robust labor market, low interest rates and an upward-trending stock market.
- The continued strength in consumer confidence supports our view that we will see acceleration in consumption growth. This should support our GDP forecast of 2% growth.

Small Business Optimism



- The NFIB Small Business Optimism Index rose 0.7 points in June, its third straight gain, reaching its highest level this year.
- The index was led by a four-point gain in the outlook for the economy over the next six months.
- Current job openings rose two points, matching the highest level since April 2006.
- The top three most important problems of small business were taxes, government regulations and labor quality.
- Current levels support 2% GDP.

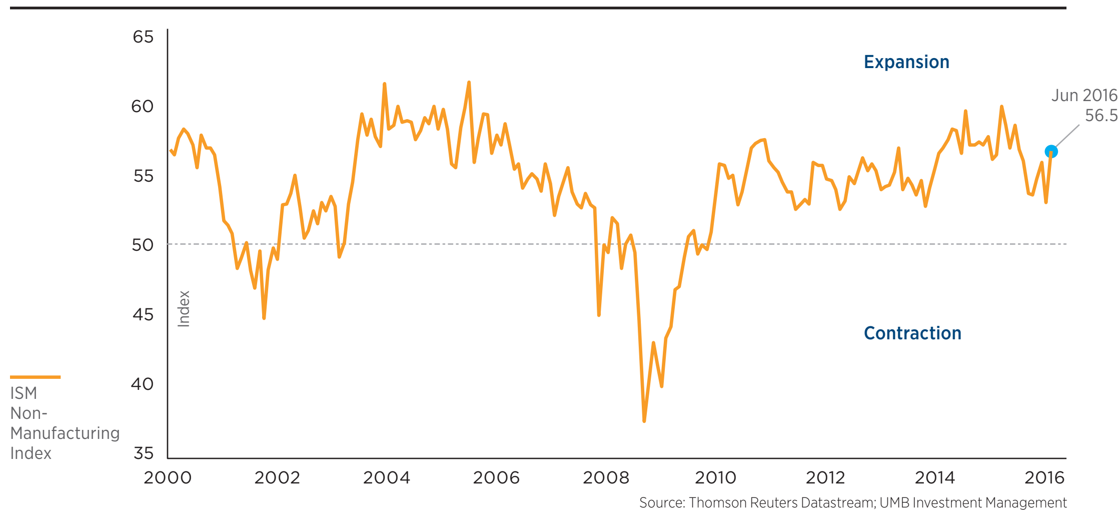
Manufacturing



Source: Thomson Reuters Datastream; UMB Investment Management

- The ISM Manufacturing Index rose 1.9 points in June, its fifth increase in the past six months. The index is at its highest level since February 2015.
- All index components increased and nearly all, excluding inventories, were above the break-even level of 50. New Orders, a leading indicator, accelerated.
- The rebound in the ISM Index reinforces our view that the economy remains on a solid foundation.
- The current readings are consistent with GDP growth close to 3%.

Services



Source: Thomson Reuters Datastream; UMB Investment Management

- The ISM Non-Manufacturing Index rose to a seven-month high of 56.5 in June.
- Given strong consumer confidence and a robust labor market, we expect continued strength in the service sector.
- As the service sector represents nearly 50% of economic activity in the U.S., we have a high degree of confidence in our modest GDP growth forecast for 2016.

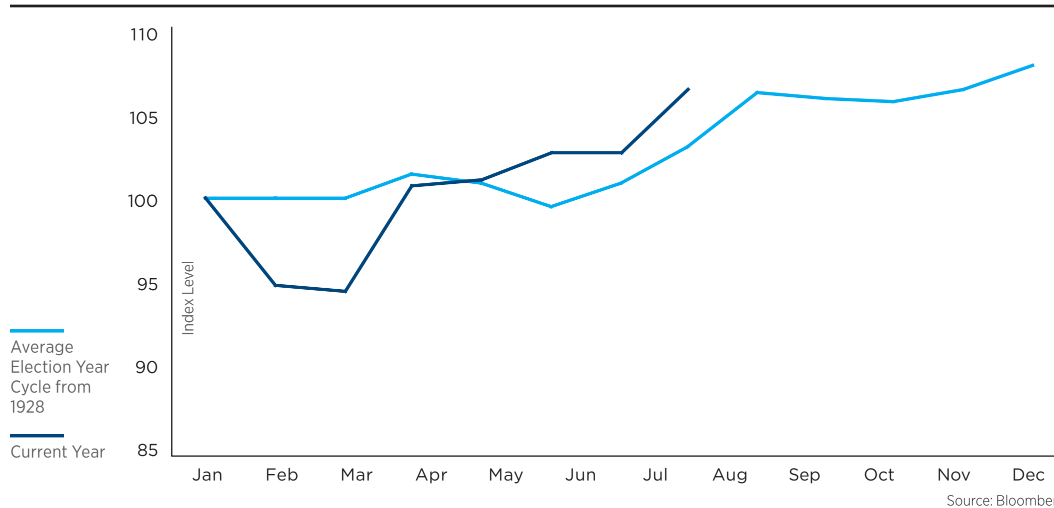
S&P 500 Presidential Cycle Return Averages, 1928–Present

	1st Year	2nd Year	3rd Year	4th Year (Election Year)
Average Return per Year	5.1%	4.8%	12.8%	**7.0%**
Median Return per Year	5.0%	6.2%	16.8%	**10.4%**
Percent Positive Return Years	55%	59%	77%	**73%**

Source: Bloomberg

Presidential Election Year Cycle

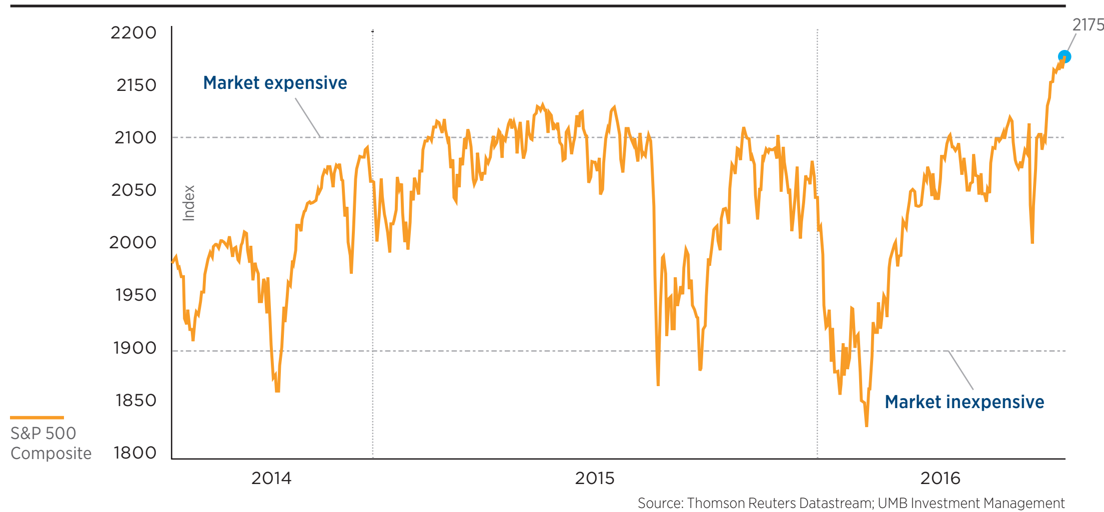
S&P 500 Average Performance in Elections Years Since 1928



Source: Bloomberg

- The market tends to exhibit common trading patterns around a Presidential Election Cycle.
- An election year tends to be the second best in terms of market performance in the four-year election cycle.
- In an election year, the market tends to be a tale of two halves.
- The first half of the year tends to be highly volatile due to uncertainty around the presidential candidates.
- As the field of candidates thins and more certainty is gained, the market tends to rally.
- In the second half of an election year, the equity markets typically improve due to dissipating uncertainty.
- So far, 2016 is following a similar pattern.

S&P 500



- The stock market has been range bound for nearly two years as volatility has increased.
- However, recently in the third quarter, low interest rates combined with improving economic growth trends have caused the market to break out of its two-year long range, at least temporarily.
- We think earnings will return to growth as the oil and dollar headwinds from the past few quarters reverse and the economy continues to grow at a modest pace.

S&P 500 Valuation

- Fair value of the market is valued at 17x forward earnings, today the market trades at 18x.
- Recent multiple expansion has been driven by a decline in U.S. interest rates without a deterioration in economic growth prospects.
- In our view, to see a sustainable stock market rally, we need to see an acceleration in the global economy and earnings to drive the valuation of the market higher.
- As the market is trading above the higher end of our forecast for 2016, we would look to be tactically bullish on market pullbacks or a reacceleration of the global economy.

U.S. Equity Sector Performance

S&P 500 Year-to-Date Return

	Total Return % as of 6/30/16					
Index/Sector	1 Month	3 Month	YTD	1 Year	3 Year	5 Year
S&P 500	0.26	2.46	3.84	3.98	11.64	12.08
Telecommunication	9.34	7.06	24.85	25.14	10.25	11.70
Utilities	7.81	6.79	23.41	31.47	15.96	13.80
Energy	3.28	11.62	16.10	-3.92	-1.28	0.75
Consumer Staples	5.18	4.63	10.46	18.66	14.35	15.03
Materials	-0.89	3.71	7.46	-2.04	8.70	5.76
Industrials	0.99	1.40	6.46	7.01	12.07	11.18
Consumer Discretionary	-1.18	-0.91	0.68	3.78	13.23	16.11
Health Care	1.02	6.27	0.42	-2.02	16.52	17.27
Technology	-2.76	-2.84	-0.32	4.79	15.25	13.40
Financials	-3.21	2.12	-3.05	-4.21	7.63	10.41

Source: Bloomberg

- The S&P 500 rose 2.46% in a volatile Q2.
- The Telecommunication and Utility sectors continue to lead the market due to the search for yield in the current low interest rate environment.
- We continue to believe the strong returns seen in the Telecommunications and Utilities sectors are not sustainable.
- The Financial sector has lagged the market as consensus Fed rate hike expectations have been significantly pushed out.

TINA is the Latest Acronym

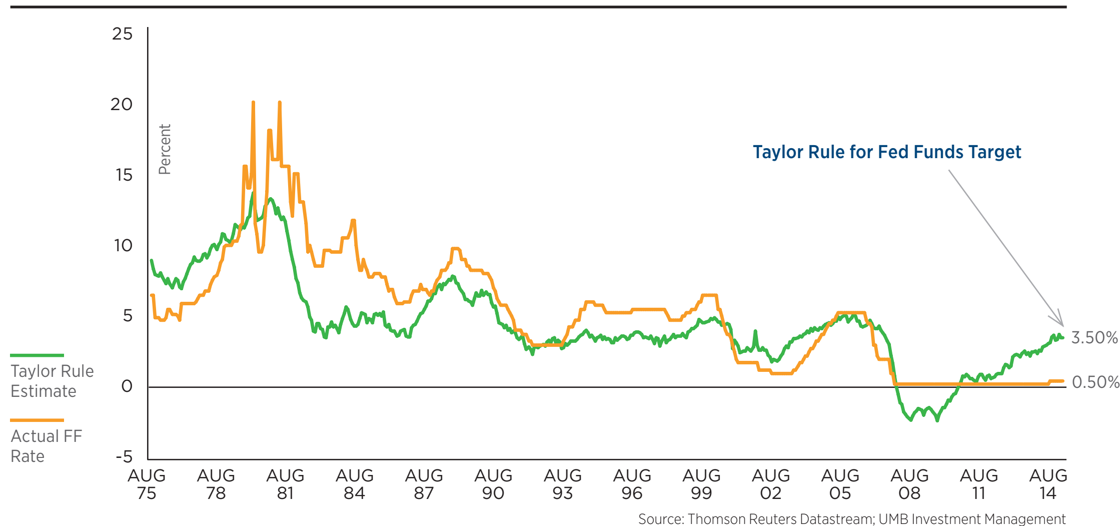
FANG	2015 Return	2016 YTD Return
Facebook	34%	9%
Amazon	118%	6%
Netflix	134%	-20%
Google	47%	-10%
TINA		
AT&T	2%	26%
Verizon	-1%	21%
Duke Energy	-15%	20%
Kimco Realty	5%	19%

Source: Bloomberg

- In the stock market, 2015 was the year of the FANG stocks. FANG is an acronym which represented the leading stocks of 2015 (Facebook, Amazon, Netflix, and Google).
- In 2016, we have a new acronym to describe the leading stocks. It is called TINA (there is no alternative). TINA represents the search for yield. That is, interest rates on bonds are not attractive so it is pushing investors into equities to get yield.
- In 2015, FANG stocks led the market. Now in 2016, TINA stocks lead the market.

The FOMC — the struggle between a stronger economy and global QE

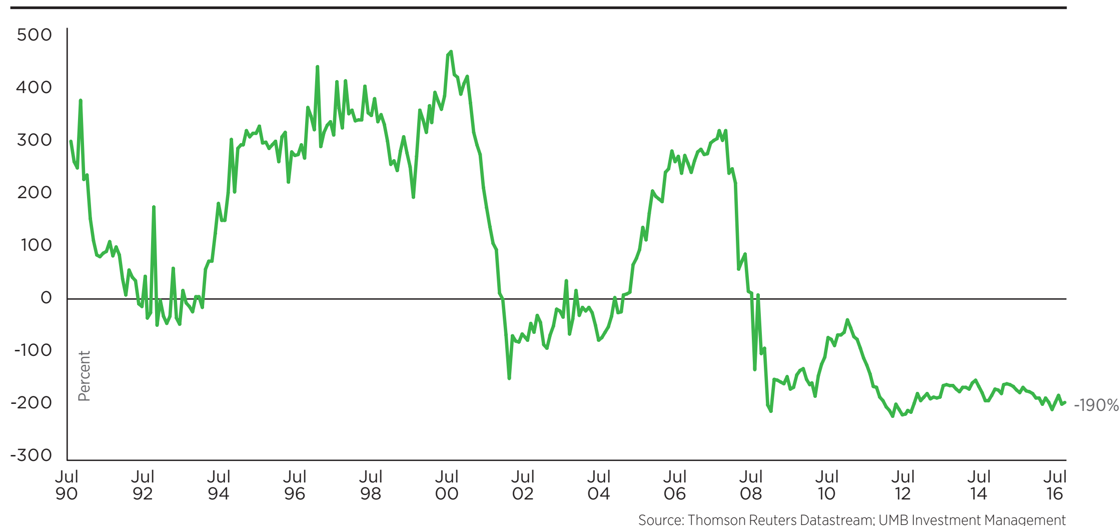
Taylor Rule for Fed Funds Target



Source: Thomson Reuters Datastream; UMB Investment Management

- The FOMC's traditional econometric model for interest rates, the Taylor Rule, currently indicates that Fed Funds could be in the 3.5% range, given the current basket of economic indicators.
- Global Quantitative Easing is keeping rates meaningfully below historical norms.
- Domestic economic strength is giving the Fed plenty of ammunition for moving rates modestly higher.

Real Fed Funds Rate**

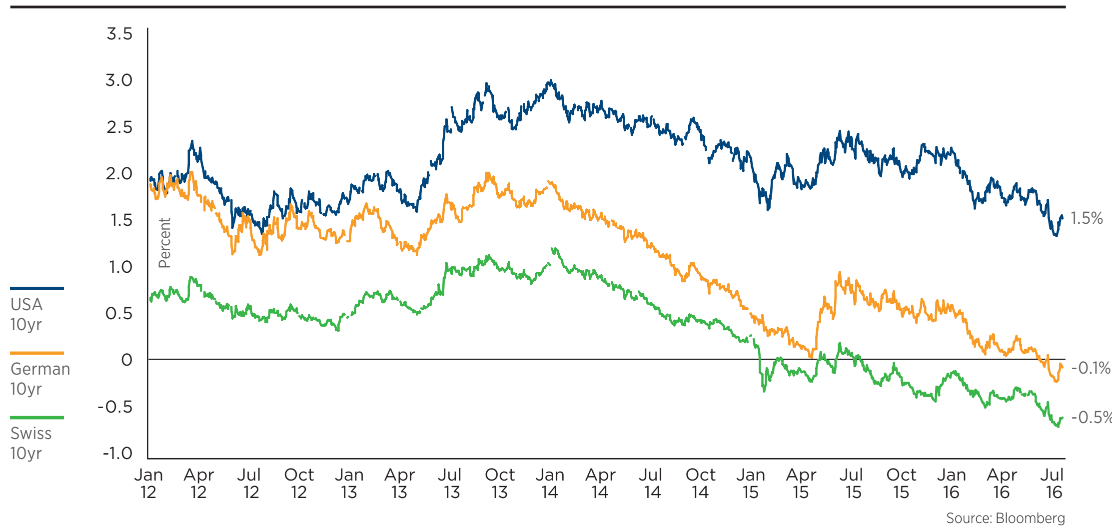


Source: Thomson Reuters Datastream; UMB Investment Management

- The Real Fed Funds rate has been mired in deeply negative territory for nearly a decade.
- An improving economic picture makes it difficult to continue rationalizing such deeply negative real rates.
- The Fed will continue to signal a modest movement towards more neutral rates.

** Effective Fed Funds rate minus Core CPI

Global Yields



Source: Bloomberg

Stubbornly Low Government Bond Rates Despite Improving Economics

- Eurozone QE has pushed rates lower across the developed markets, with the U.S. posting new all-time lows in mid-June.
- The global search for yield will mute any rise in long rates associated with increasing overnight rates.
- Global QE and a glut of excess reserves will result in flatter yield curves until there is a marked improvement in global growth and/or a meaningful upward push in Inflation.

High Yield Spreads

Source: Bloomberg

Spread Compression calls for Caution

- Credit spreads have moved sharply lower, in tandem with record highs in the stock markets.
- Spread compression has occurred despite steady deterioration in overall balance sheet health.
- Leverage ratios have been increasing, accompanied by muted growth in earnings.
- Caution is warranted in the Corporate Bond market.

U.S. Bond Market Performance — surprisingly strong through the 1st half of 2016

Performance

Index	3 Mo Return	YTD Return
Credit Long	6.65	13.92
Gov Cred Long	6.55	14.33
Tsy Long	6.44	15.12
Agency Long	4.87	11.59
Baa	4.30	8.80
U.S. Credit	3.48	7.54
A	3.11	7.09
U.S. Gov/Credit	2.67	6.23
Aa	2.61	5.96
U.S. Aggregate	2.21	5.31
Gov Cred Intermediate	1.59	4.07
Agg Intermediate	1.44	3.78
Tsy Intermediate	1.28	3.66
U.S. Agency	1.22	3.28
U.S. MBS	1.11	3.10
GNMA	0.90	2.67
Agency Intermediate	0.75	2.27
1-3 Yr	0.68	1.66

Source: Thomson Reuters Datastream; UMB Investment Management

Performance

- Long rates continued their downward plunge, pushed by global QE (see previous section). U.S. 10-year rates briefly touched a new all-time low in mid June.
- Long-dated indices have dominated returns for the year.
- Credit indices have staged a strong rally on the year, following the global push into “risk assets.”
- Valuations appear to be “stretched” throughout the bond market.

Outlook

- We expect rates to drift modestly higher as global economic stability allows the Fed to continue normalizing rates.
- Some of the exceptional returns generated by long-dated bonds are likely to be given back as the year progresses.
- We anticipate rates flattening in the 2% range.

Real Gross Domestic Product (GDP)

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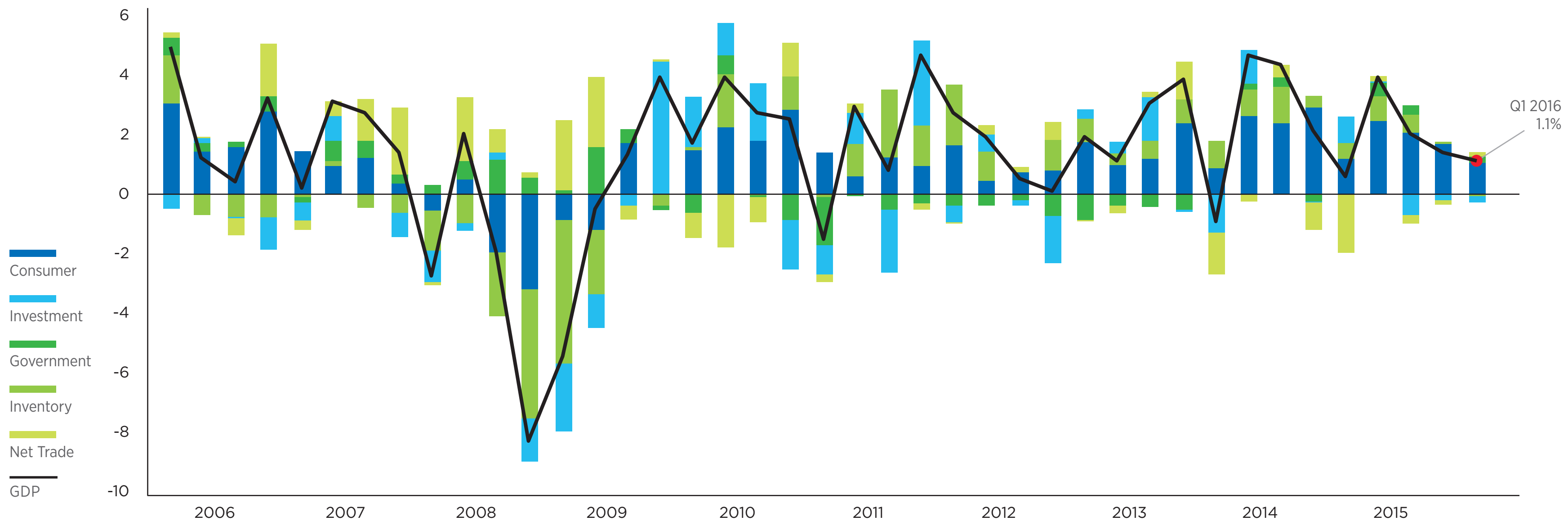

Source: Thomson Reuters Datastream; UMB Investment Management

% Contribution to GDP by Quarter

Component	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
Consumption	1.2	2.4	2.1	1.7	1.0
Investment	1.3	0.9	-0.1	-0.2	-0.3
Net Exports	-1.9	0.2	-0.3	-0.1	0.1
Government	0.0	0.4	0.3	0.0	0.3
Total	**0.6**	**3.9**	**2.0**	**1.4**	**1.1**

Source: Thomson Reuters Datastream; UMB Investment Management

UMB GDP Forecast

Year	Q1	Q2	Q3	Q4	Year
2013	2.7 (A)	1.8 (A)	4.5 (A)	3.5 (A)	2.2 (A)
2014	-2.1 (A)	4.6 (A)	5.0 (A)	2.1 (A)	2.4 (A)
2015	0.6 (A)	3.9 (A)	2.0 (A)	1.4 (A)	2.4 (A)
2016	1.1 (E)	2.5 (E)	2.4 (E)	2.5 (E)	2.0 (E)

(A) = Actual, (E) = Estimate

Source: UMB Investment Management

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