Economic and Market
# Overview

Fourth Quarter
2015

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UMB

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

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## Economics

The U.S. economy continued to advance in Q4, albeit at a tortoise-like pace. Economic data in the U.S. and around the world points to slowing economic conditions. Oil, China and other geopolitical tensions dominated the headlines throughout the quarter. The Federal Reserve interpreted the U.S. economy as strong enough to withstand higher interest rates and hiked short-term rates in December after seven years of a zero interest rate policy. We expect real GDP around 1.0% for the quarter, putting economic growth for 2015 at 2.4%. In 2016, we expect growth at a 2.1% pace.

Economic conditions in the U.S. have been supported by two primary tailwinds: the labor market and housing. In 2015, robust job growth (221,000 average jobs per month, clearly the brightest-shining variable) supported a very mild economic expansion. Plentiful jobs combined with a slow-growing labor force will lead to a tight labor market, and will eventually lead to wage inflation. We saw a hint of this late in the year as average hourly earnings grew at a 2.5% rate. We expect 200,000 new jobs per month to be created in 2016.

The housing market was also a tailwind, with housing starts on the rise due to an increase in household formations, an improving labor market and low interest rates.

There are numerous headwinds; the most notable of these is China. China's risks are two-fold: a slowing economy and an extremely volatile stock market.

China's economy is clearly slowing, as it naturally should since growing at a double digit rate is unsustainable. In 2010, the size of China's economy was $5 trillion and it was growing at a double-digit rate. Today its economy is the second largest in the world, at $10.5 trillion. China's stock market has spooked global markets. However, due to government regulations and intervention coupled with gross speculation, China's equity markets are not a leading indicator and do not represent the fundamentals of their economy or corporations.

Lower energy prices are a positive for consumers, but extremely low energy prices may be bad for the overall global economy. The energy sector is clearly in a recession with energy companies' revenues being slashed and costs promptly reduced by cutting employment and curbing capital expenditures. As conditions for the sector continue to worsen, the slog has trickled into the finance sector and punished banks that lend into the energy space.

We are watching for signs of the next recession in the U.S. Two of our favorite indicators suggest a low probability of a recession in 2016. The yield curve gives us signals of a looming recession. Typically the spread between the 2-year and 10-year Treasury becomes inverted prior to a recession. At this time we are not close to seeing that inversion. The six-month rate of change in the Leading Economic Index historically heads lower into negative territory prior to a recession. We remain in positive territory, again suggesting a low probability of a recession this year.

The table below summarizes our 2016 forecasts:

| | **2016 Year-End Target** |
|---|---|
| U.S. Real GDP Growth Rate | 2.0% – 2.3% |
| Global Real GDP Growth Rate | 3.3% |
| S&P 500 Price Target | 2050 |
| S&P 500 Operating EPS Growth | 4.00% |
| Projected 10-Year Treasury Rate | 2.50% |

## Equity Markets

The S&P 500 rose by 7.0% in Q4, recouping the losses seen in Q3. For 2015, the market ended up by 1.4%. Market volatility is being created by China, oil, and the Fed. The downturn in the Chinese stock market is negatively impacting sentiment in global markets. While lower oil is positive in many aspects for the consumer, it has become a headwind for the market as firms in the energy space face the threat of bankruptcy, and the drag begins to bleed over into other areas of the market (high yield/finance with exposure to oil). The Fed raised the Fed Funds rate by 25bps in December, marking the start of a tightening process while global risks are simultaneously elevated. This creates additional uncertainty and market volatility.

In 2015, earnings growth is expected to be flat, largely due to lower energy prices (energy sector profits down >50%) and a stronger dollar (approximately 35% revenue in the S&P 500 comes from international markets). For 2016, we think earnings will grow approximately 4% based on 2.1% GDP growth. We have assumed oil and the dollar are neutral to earnings in 2016. Right now, the market is discounting that either or both will continue to be a headwind in 2016. If Oil stays low and the dollar strengthens, there is a very high probability we'll see flat earnings again in 2016.

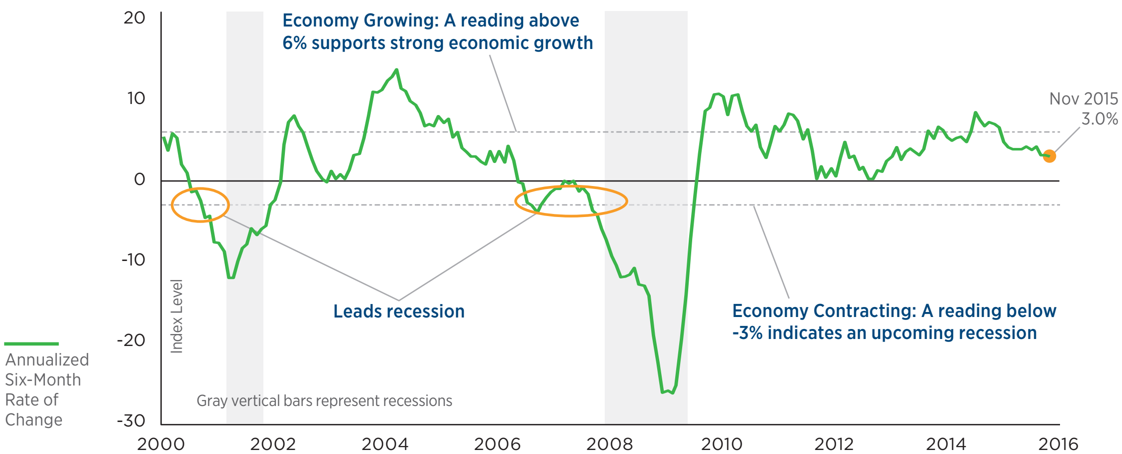
Our theme for 2016 is that 1900 is too low, and 2100 is too high on the S&P 500. Our official 2016 S&P 500 forecast is 17.1 x 120 in earnings for 2016 = 2050.

## Fixed Income Markets

Volatility continues to remain elevated despite the FOMC coming through with its first rate hike in seven years late in December. Ongoing headwinds from China and the energy/commodity sectors put continued pressure on both the equity and credit markets. As stock markets sold off (the volatility spike), the high yield (HY) market continued to suffer through powerful spread widening. High yield had become overvalued in 2014, and had spent most of 2015 selling off and resetting valuations. The trend has become exacerbated by the recent trouble hounding the stock market (see above) and yield spreads have moved back to multi-year highs. Credit analysts are becoming concerned with cash flow and earnings challenges, causing the selloff to broaden from energy to encompass the entire HY market. The pressure also worked its way through the investment grade market, causing most of the credit sector to lag the government sector quite substantially.

We believe the Fed will continue to normalize rates with a small upward adjustment to Fed Funds throughout 2016. A renewed downturn in China or Europe would derail this forecast, but we do not foresee that happening at this time. Once we achieve some stability in China and have some clarity on the intentions of the Fed, the recent selloff in credit (both HY and Investment Grade) will provide an attractive re-entry point for those who followed our advice to exit the sector last year.

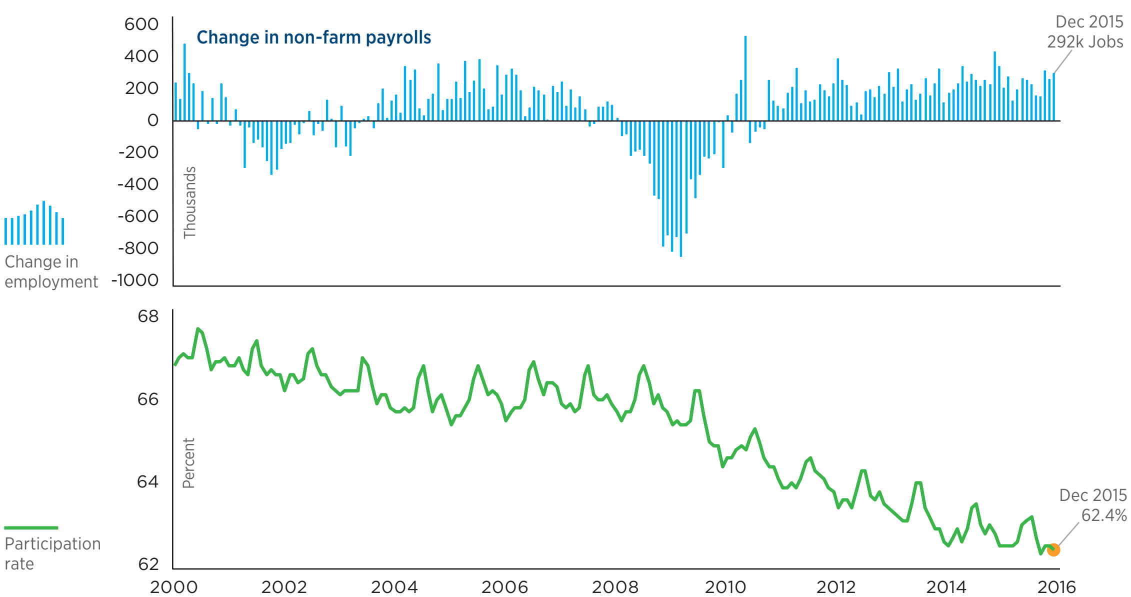
## The Index of Leading Economic Indicators




Source: Thomson Reuters Datastream; UMB Investment Management

- The Index of Leading Economic Indicators (LEI) is made up of 10 components, 7 of which are non-financial and 3 of which are financial.
- The indicator's six-month annualized growth rate is 3%, which is consistent with a moderately-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 of around 2.1% in the U.S.

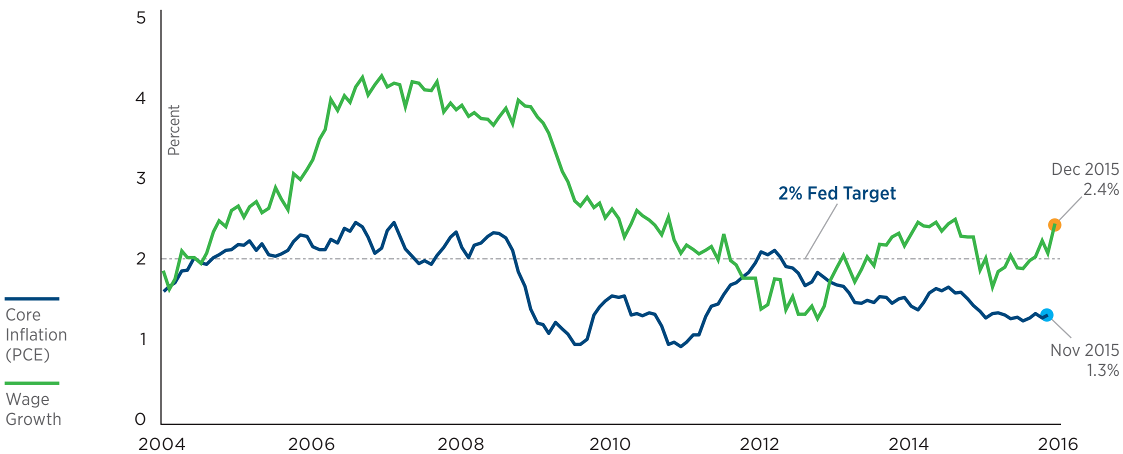
## Labor Markets




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 helping drive the unemployment rate lower.
- Payroll growth has averaged 221,000 jobs per month in 2015. Historically, job growth of this magnitude indicated GDP growth higher than 2.5%.
- We expect payroll growth will average 200,000 jobs per month in 2016. This is a healthy level. Job gains since WWII have averaged approximately 120,000 per month.
- Our forecast indicates an unemployment rate of 4.7% 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.

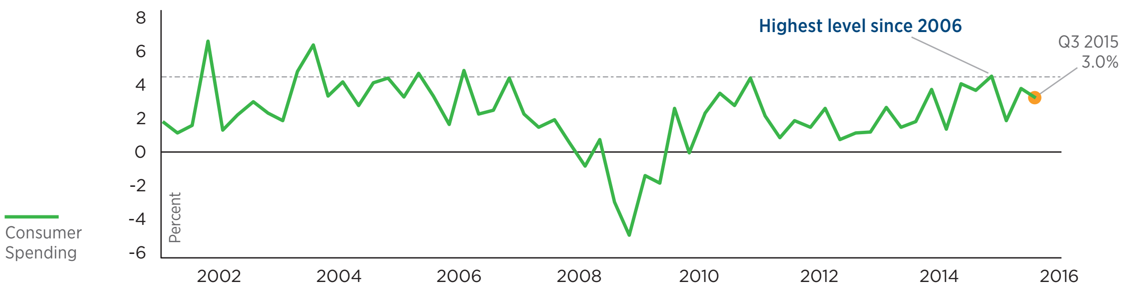
## Core Inflation (PCE) and Wage Growth

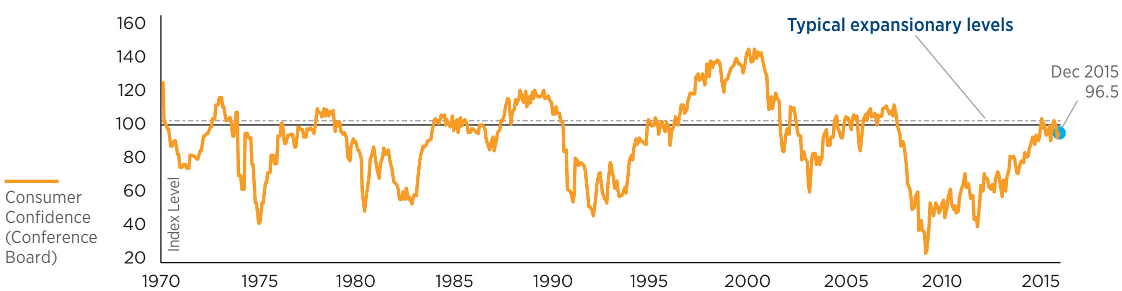



Source: Thomson Reuters Datastream; UMB Investment Management

- The Fed's measure for Inflation (core PCE) is well below its long-term "target" of 2%. Current core PCE, which excludes food and energy, is at 1.3%. Core CPI, which has a heavier weight toward housing, is at 2%.
- Lower energy prices are putting some downward pressure on core inflation as energy is a significant input cost for many goods and services.
- We believe meaningful wage growth is necessary for sustainable inflation. Wages have been increasing at a moderate pace since the recovery began. Average hourly earnings increased 2.4% y/y in December.
- Headline inflation should remain below 2% in 2016 due to lower energy prices.

## Consumer

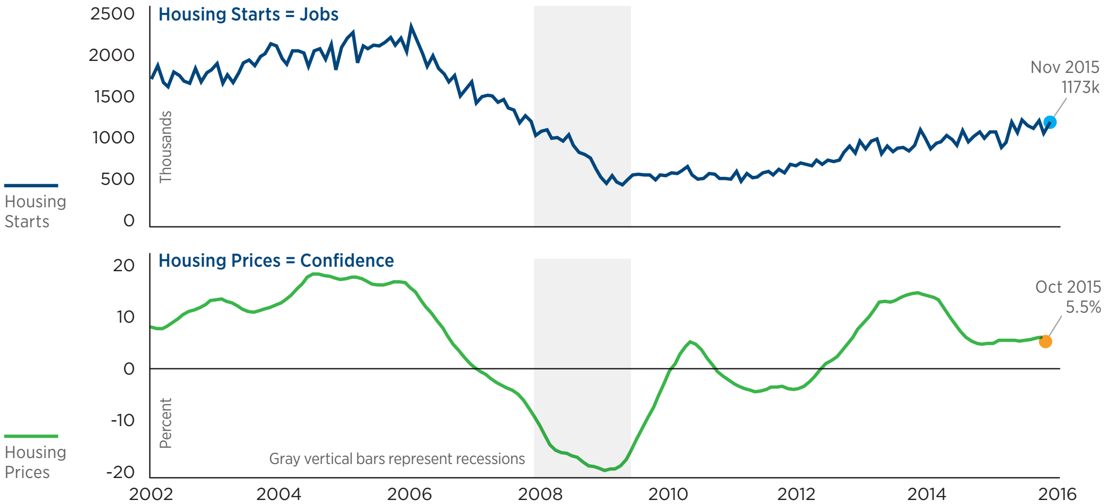



Source: Thomson Reuters Datastream; UMB Investment Management

- We expect consumption expenditures to remain healthy in 2016 as the consumer is in a solid economic position due to lower debt burdens, reduced energy prices, and better job prospects.
- Consumer confidence is just approaching normal expansionary levels. We believe improved consumer confidence will translate into higher spending and less saving as the year progresses.
- The volatility in the financial markets is a risk to our forecast to the extent consumers respond to market volatility by holding off on big ticket item spending. However, we view this as a manageable risk.
- We believe consumer spending will increase by approximately 3% in 2016, which supports our forecast of moderate economic growth.

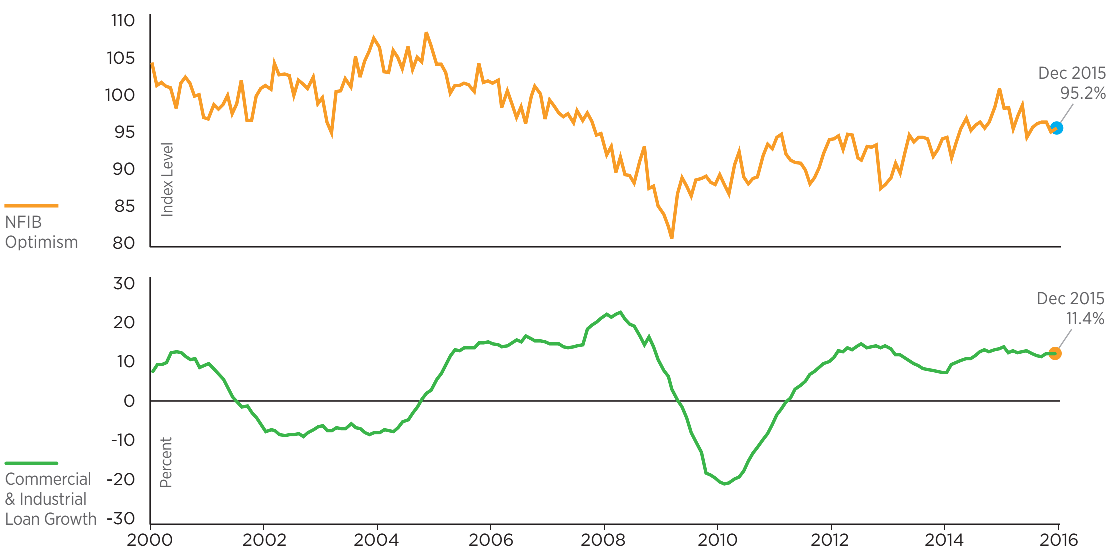
## Housing is in Recovery Mode




Source: Thomson Reuters Datastream; UMB Investment Management

- The housing market is a bright spot in the U.S. economy.
- Household formations have begun to tick higher as the labor market has improved, causing pent up demand to be unleashed. This leads to housing starts.
- We are calling for 1.2 million starts in 2016. Housing starts lead to job growth.
- Housing prices have slowed recently as comparisons over the last few years have been difficult. We expect 3-5% home price growth over the next several years. This should support the wealth effect.
- We expect housing to add 0.25% to 0.5% to GDP in 2016.

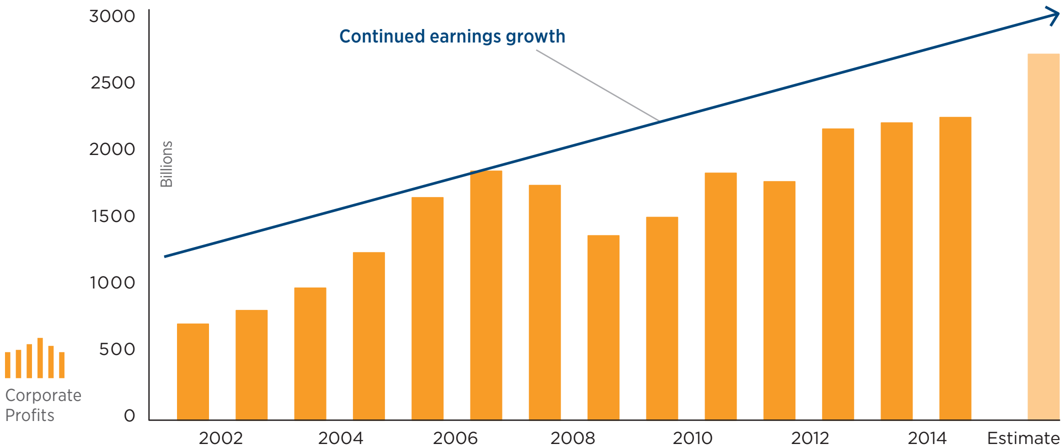
## Corporate Health




Source: Thomson Reuters Datastream; UMB Investment Management

- Corporate America remains healthy. The NFIB optimism index has come off its highs due to slowing profit growth and market volatility.
- We believe the slowdown in profit growth is temporary. As a result, we expect businesses to continue to invest in labor and capital to facilitate growth.
- Commercial and Industrial (C&I) loan growth remains stable, which indicates firms are reinvesting in their businesses.
- The improved health of corporate America supports our forecast of an improving economy.

## Corporate Profits




Source: Thomson Reuters Datastream; UMB Investment Management

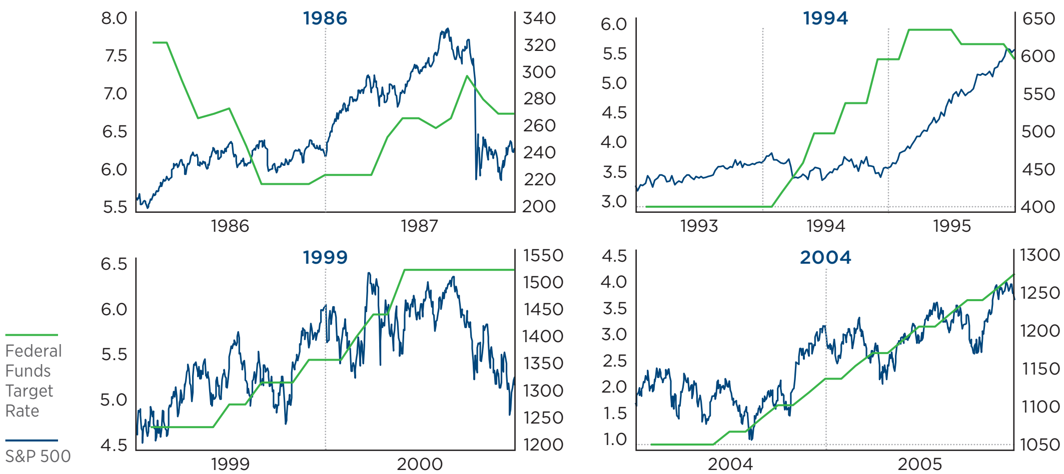
- The stock market is highly correlated to corporate earnings growth. Economic conditions are unfavorable for a few sectors — we think less than 10% of the market.
- Earnings growth has been under pressure due to the energy sector and foreign exchange effects.
- We expect 4% earnings growth in 2016, driven by 3% revenue growth, lower input costs, and share repurchases.
- The biggest risks to our earnings forecast are a stronger dollar and a global economic slowdown.
- Overall, the earnings backdrop supports a challenging market environment for stocks in 2016.

## Crude Oil, WTI


Source: Thomson Reuters Datastream; UMB Investment Management

- There are three factors driving the price of oil lower. First, there is an abundant supply of oil. Second, OPEC/Saudi Arabia have decided not to stabilize the price of oil through production cuts. Third, the dollar continues to strengthen.
- Two things we are looking for in order to call a bottom are production cuts from individual shale producers in the U.S. and oil producing countries, and M&A activity.
- While lower oil is positive economically, we believe it hurts the market as firms may go bankrupt and emerging markets will continue to struggle.
- Banks also have exposure to energy firms, which creates additional uncertainty. Importantly, however, we do not think banks' exposure represents a systemic risk to the financial system.

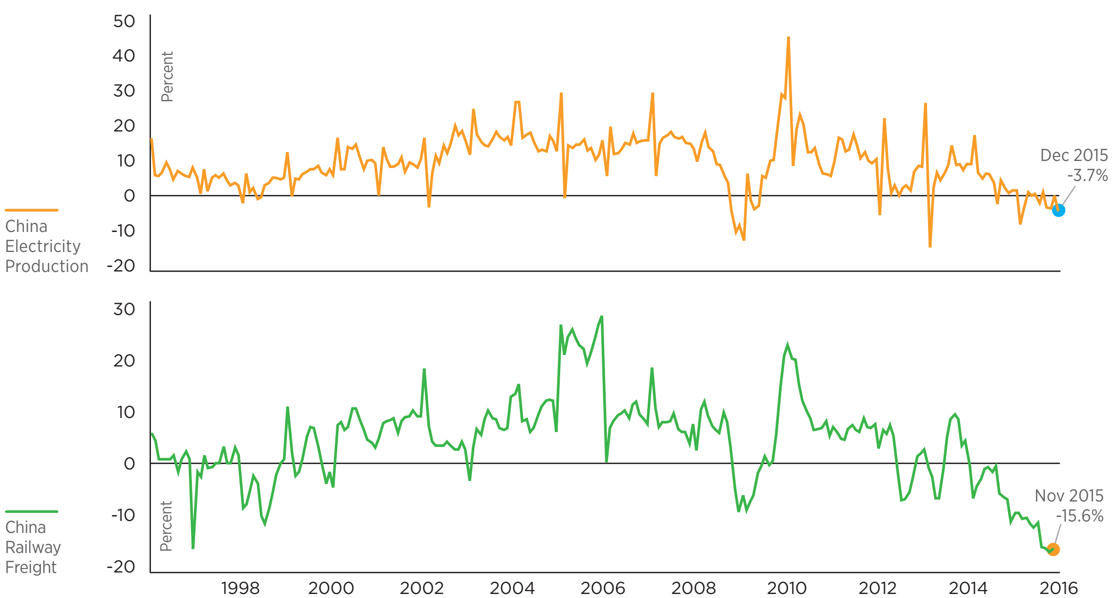
## Rate Hike Cycles




Source: Thomson Reuters Datastream; UMB Investment Management

- The Fed has begun the tightening process by raising Fed funds by 25bps in December; however, Fed uncertainty remains and is negatively impacting stock market valuation.
- The market wants the Fed to proceed at a very slow rate — raising Fed funds by 50bps in 2016. The Fed appears to be on a more aggressive rate path — driven by the robust employment outlook — than what the market expects.
- An inconsistent Fed policy message, as evidenced by mixed commentary from Fed governors, is creating volatility in the markets.

## China Economic Data




Source: Thomson Reuters Datastream; UMB Investment Management

- China accounts for approximately 15% of global GDP and most of the incremental economic growth around the world.
- China's economy is slowing substantially, as evidenced by electricity production and freight volumes. We view additional fiscal and monetary policy as likely.
- We believe China's direct economic impact on the U.S. is manageable. Only approximately 7% of our exports go to China and most of this product is re-exported out of China to its final destination.
- The Shanghai Index, China's stock market, has been very volatile due to speculation, China's slowing economy, and policy missteps. This has driven sentiment in the U.S. markets.

# U.S. Equity Sector Performance and Currency versus Commodities

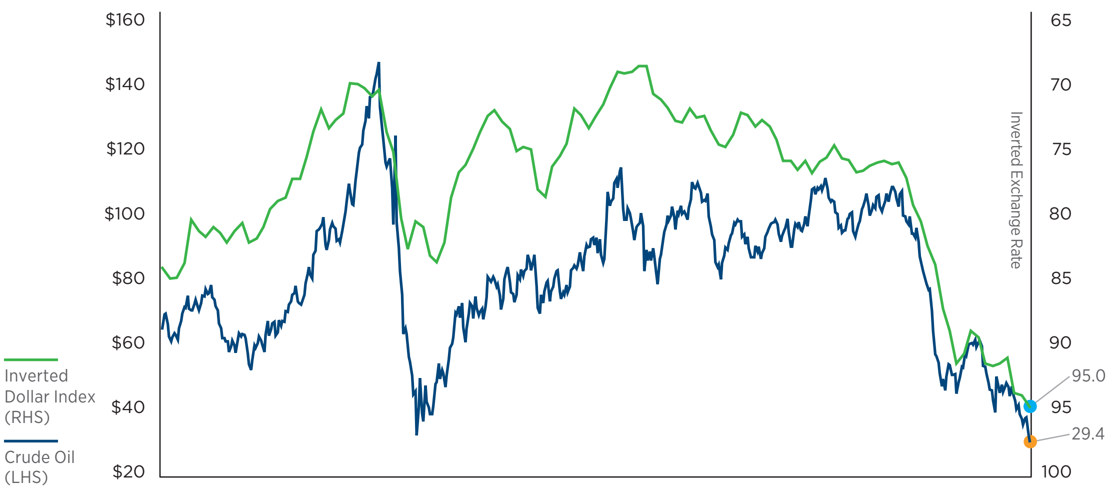
## S&P 500 Year-to-Date Return

| Index followed by sectors | Total Return % as of 12/31/15 1 Month | 3 Month | YTD | 3 Year | 5 Year |
|---|---|---|---|---|---|
| S&P 500 | -1.59 | 7.03 | 1.37 | 15.12 | 12.55 |
| Consumer Discretionary | -2.78 | 5.79 | 10.11 | 20.00 | 17.83 |
| Health Care | 1.78 | 9.22 | 6.89 | 23.75 | 20.28 |
| Consumer Staples | 2.86 | 7.64 | 6.60 | 15.96 | 14.50 |
| Technology | -2.29 | 9.17 | 5.92 | 17.78 | 13.94 |
| Telecommunication | 1.75 | 7.61 | 3.40 | 5.88 | 8.33 |
| Financials | -2.16 | 5.92 | -1.56 | 15.41 | 10.41 |
| Industrials | -2.03 | 7.97 | -2.56 | 14.59 | 11.51 |
| Utilities | 2.17 | 1.07 | -4.84 | 11.59 | 11.03 |
| Materials | -4.16 | 9.69 | -8.38 | 7.15 | 5.00 |
| Energy | -9.87 | 0.20 | -21.12 | -3.11 | -0.08 |

Source: Bloomberg

- The S&P 500 rose 7.03% in Q4, gaining back the ground it lost in the previous quarter.
- For 2015, the market gained 1.37%. The consumer sectors were two of the best-performing sectors in 2015 as they have been aided by lower oil prices and the improved financial health of the consumer.
- Energy and materials were the two worst-performing sectors in 2015 as commodity prices languished.
- In 2016, we expect China, Fed policy, energy, and politics to play a critical role in the direction of the market.

## Oil & the Dollar



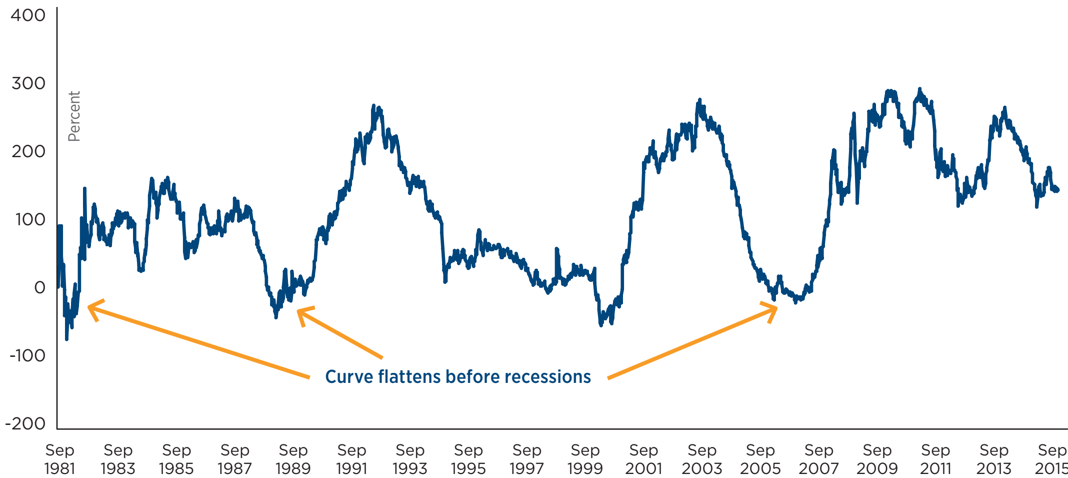

Source: Thomson Reuters Datastream; UMB Investment Management

- The dollar is near its highest level in a decade due to relative economic strength in the U.S. and the prospect of the beginning of the Fed tightening cycle.
- The direction of the dollar is highly inversely correlated with commodity prices.
- The decline in commodities is putting several large companies at risk of bankruptcy.

# Less Clarity from the FOMC Led to Increased Volatility



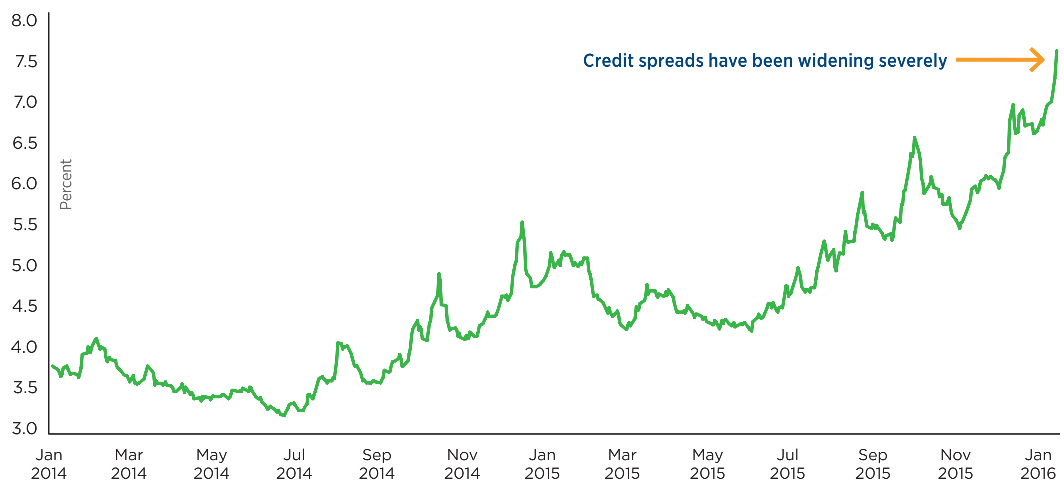
## Slope of Yield Curve — 2 Year to 10 Year




Source: Thomson Reuters Datastream; UMB Investment Management

- The Treasury Yield Curve has a perfect track record of flattening before the onset of recessions.
- The current spread between the 2 year and 10 year Treasury is roughly 115 basis points — the slope of the curve is not currently indicating a threat of recession.
- The bond market is not anticipating a meaningful slowdown in the U.S. economy in the next 12-24 months.

## High Yield Spreads




Source: Thomson Reuters Datastream; UMB Investment Management

- Energy market turbulence continues to feed the HY selloff.
- Valuation questions and global weakness caused the selloff to spread through the other HY sectors.
- Yields have hit cyclical highs.
- Global stability and some clarity from the Fed could provide an outstanding re-entry point for the HY sector at some point during 2016. At this time, it is still too early to re-enter.

# U.S. Fixed Income Sector Performance and Weightings

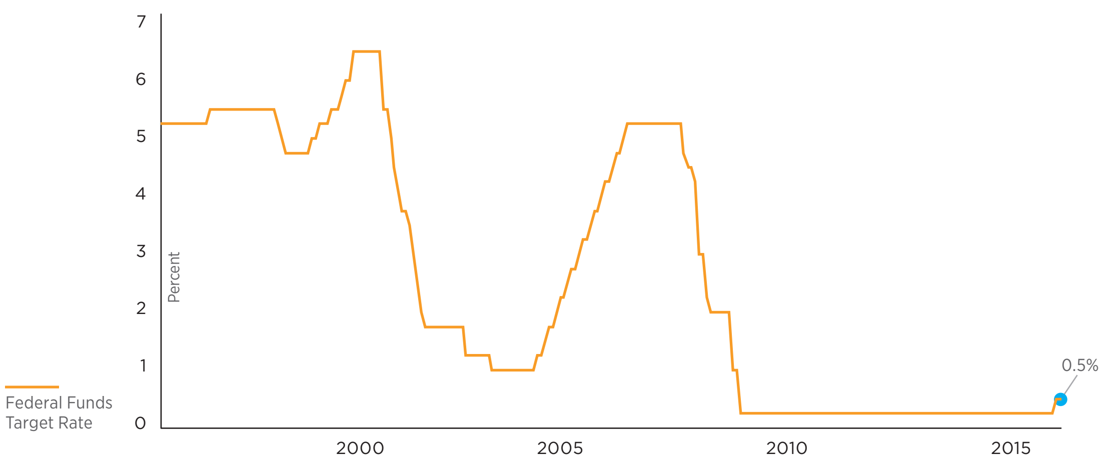
## Performance

| Index/Sector | 3 Month Return | YTD Return |
|---|---|---|
| Finance Intermediate | 0.12 | 1.98 |
| MBS Fixed Rate | -0.10 | 1.51 |
| Financial Institutions | 0.14 | 1.51 |
| U.S. MBS | -0.10 | 1.51 |
| FNMA 15 Year | -0.26 | 1.29 |
| Agg Intermediate | -0.51 | 1.21 |
| Treasury Intermediate | -0.86 | 1.18 |
| Aaa | -0.59 | 1.12 |
| Corp Intermediate | -0.42 | 1.08 |
| Gov/Cred Intermediate | -0.69 | 1.07 |
| GNMA 15 Year | -0.16 | 0.81 |
| U.S. Aggregate | -0.57 | 0.55 |
| A | -0.10 | 0.55 |
| Gov/Credit | -0.74 | 0.15 |
| Finance Long | 0.22 | -0.49 |
| Treasury Long | -1.38 | -1.21 |
| Baa | -1.01 | -2.71 |
| Gov/Cred Long | -0.94 | -3.30 |
| Corp Long | -0.97 | -4.61 |

Source: Thomson Reuters Datastream; UMB Investment Management

- Modestly rising rates eroded returns, pushing them into negative territory for the quarter, and to nearly zero for the calendar year.
- Longer maturities and lower credit quality suffered severely during the year, as the market entered a "risk off" phase near year end.
- Markets were preparing for a liftoff in the Fed funds rate, which occurred near the end of the year. The period of time during and after the initiation of a Fed tightening cycle can often be challenging for the bond markets.

## Federal Funds Rate

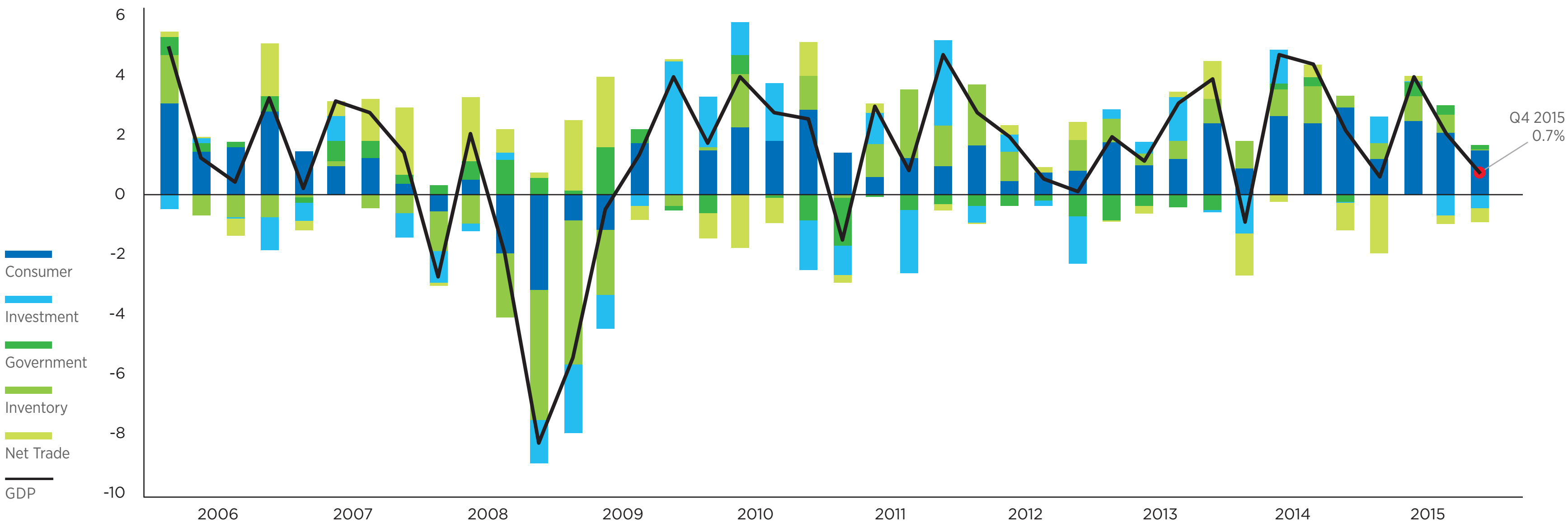



Source: Thomson Reuters Datastream; UMB Investment Management

- The FOMC initiated an initial rate hike in December, but will likely to take several years to normalize the Fed funds rate.
- The Fed is not fighting an inflation problem, but simply moving off of zero, which is no longer necessary.

# Real Gross Domestic Product (GDP)

## Contributions to GDP Growth




Source: Thomson Reuters Datastream; UMB Investment Management

## % Contribution to GDP by Quarter

| **Component** | **Dec-14** | **Mar-15** | **Jun-15** | **Sep-15** | **Dec-15** |
|---|---|---|---|---|---|
| Consumption | 3.0 | 1.2 | 2.4 | 2.1 | 1.5 |
| Investment | 0.6 | 1.3 | 0.9 | -0.1 | -0.4 |
| Net Exports | -1.0 | -1.9 | 0.2 | -0.3 | -0.5 |
| Government | -0.4 | 0.0 | 0.4 | 0.3 | 0.1 |
| **Total** | **2.2** | **0.6** | **3.9** | **2.0** | **0.7** |

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) | 2.2 (A) | 2.4 (A) |
| 2015 | 0.6 (A) | 3.9 (A) | 2.0 (A) | 0.7 (A) | 2.4 (A) |
| 2016 | 1.9 (E) | 2.2 (E) | 2.2 (E) | 2.7 (E) | 2.1 (E) |

(A) = Actual, (E) = Estimate

Source: UMB Investment Management

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