Economic and Market

Overview

It's the economy…not the election.

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2016

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

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It's the economy…not the election.

Any time we approach a presidential election, the data driving the economy and the financial markets becomes clouded. Every day, news about the election and the potential outcome moves the market. Yet as we interpret the political rhetoric, the economy continues to march along at a slow and steady pace. We don't expect the election to change the underlying fundamentals of the economy, because our political system's checks and balances will prevent any dramatic changes. Our forecast for real GDP in 2016 has not wavered; we anticipate growth between 1.5% and 1.9%. We expect approximately 2% growth in 2017.

Aggressive stimulus remains ineffective. Low interest rates, an expanded Fed balance sheet and low energy prices have failed to jumpstart economic growth. Since the great recession in 2009, the U.S. economy has averaged 2.1% real GDP growth. So far, this year won't help improve that average. In the first quarter we witnessed 0.8% growth, somewhat typical for the first quarter over the past few years. In the second quarter growth improved, posting a 1.4% increase. We expect continued improvement in the second half of the year, and are forecasting 2.5% growth in Q3 and Q4.

The labor market is the economy's shining star. The unemployment rate stands at 5%, and we think that is close to full employment. Job growth is robust and non-farm payrolls increased by 156,000 in September, supporting a moderately growing economy. But looking deeper, the following indicate a solid labor market in the near future and support GDP growth of better than 2%: the quit rate (voluntary separations/employment), the stabilization of the marginally attached (U6) and 5.4 million job openings.

The consumer continues to be in a healthy financial state. Inflation-adjusted personal consumption expenditures (PCE) climbed at a 2.1% annual rate in Q3. This is a sharp deceleration from the 4.3% pace in Q2. The presidential election may be having a short-term impact here, as consumers wait to see how fiscal policies may change. PCE growth may continue to grow at a moderate pace in Q4 as we wait for the election results.

The housing market continues to support economic growth. Housing prices are up 5.1% YoY while single family housing starts are up 5.3%. The industrial side of the economy remains somewhat weak as low oil prices and a strong dollar negatively impact investment. Anemic productivity also limits the incentive for companies to invest in their business.

We believe the economy remains on solid footing, albeit with tortoise-like growth. The consumer remains resilient while investment is somewhat weaker. We do not believe the outcome of the election will have a meaningful impact on the trajectory of economic growth here in the U.S.; however, it may create temporary uncertainty. The fundamentals — labor force growth and productivity — continue to suggest modest economic growth.

The table below summarizes our 2016 forecasts:

	2016 Year-End Target
U.S. Real GDP Growth Rate	1.5% – 1.9%
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	2.00%

Equity Markets

For the most part, this year the equity market is shaping up to look like a normal presidential election-year market. Typically, in every election year since 1928, the S&P 500 has experienced a choppy first half, then mid-year once the nominees are known, the market performs better — averaging 7% total return for the year.

While we think politics matter for sectors, history indicates there is little, if any, long-term impact to the overall economy or stock market. Therefore, we focus most of our attention in the direction of Fed policy and earnings growth, which we find *does* have an impact on the stock market. We believe the Fed will raise the federal funds rate gradually and earnings growth will improve as the economy continues to grow modestly while the drag from oil and the dollar wane. With respect to politics, however, we think gridlock is likely…and also the most market-friendly outcome to the election.

Easy Fed policy continues to support the market through low interest rates, which in turn lead to a higher valuation multiple for the market. While we think the Fed will tighten policy via gradual interest rate increases, we expect rates will remain very low for quite some time. We believe a price to earnings (P/E) multiple of 17-20x is justified in this environment, which is higher than the long-term average of 15-16x.

Earnings growth is highly correlated to the stock market. We expect earnings to grow in 2017 by mid single-digits. Earnings have been pressured the last two years as oil prices have fallen precipitously and the dollar has strengthened. We believe both of these drags to earnings growth will abate in 2017. Moreover, we expect the economy to grow by approximately 2.0% next year.

Our target price for 2016 remains 2050. However, over the next twelve months we would expect mid single-digit returns in the stock market based on a pick up in earnings growth.

Fixed Income Markets

During the third quarter, markets shifted back to a "risk on" mode, and improved sentiment helped push equity prices and bond yields higher. In response to steady/improving economic data, the FOMC reiterated its intention to move rates higher and the bond market priced in a Fed move in December. We think the 2-year Treasury most directly signals the expected direction for the fed funds rate, and it moved up 20 bps during the quarter to make room for the broadly anticipated Fed move in December.

Longer rates tend to be more reactive to long-term inflation expectations and often move in tandem with the stock markets as part of "risk-on" or "risk-off" cycles. As sentiment improved and the markets prepared for another Fed move, 10-year Treasury rates moved up 25 basis points by mid-September. However, the cycle softened late in the quarter, driving both stocks and 10-year rates lower. The net result was a very modest 12 point increase in long rates for the quarter.

As the short end (two years) continues to prepare for more increases from the Fed and the long end (10 years) struggles to move in tandem, we are experiencing a steady "flattening" of the Treasury yield curve. In previous cycles, steady flattening of the Treasury curve has been a signal that an economic slowdown is developing. However, this particular market cycle is unfolding in a *much* different manner than any we have experienced in the past. Recovery from the Great Recession has been extremely muted, and this modest expansion is expected to run on much longer than most previous cycles. The Fed is merely trying to get overnight rates back up to something closer to a "normal" level – they are not fighting an overheating economy or runaway inflation. Consequently, they are increasing rates at a *very* modest pace, we do not expect that they will derail our economic progress. Given low inflation rates and increasing overnight rates, it is rational to believe our yield curve can continue to flatten without signaling an impending economic slowdown.

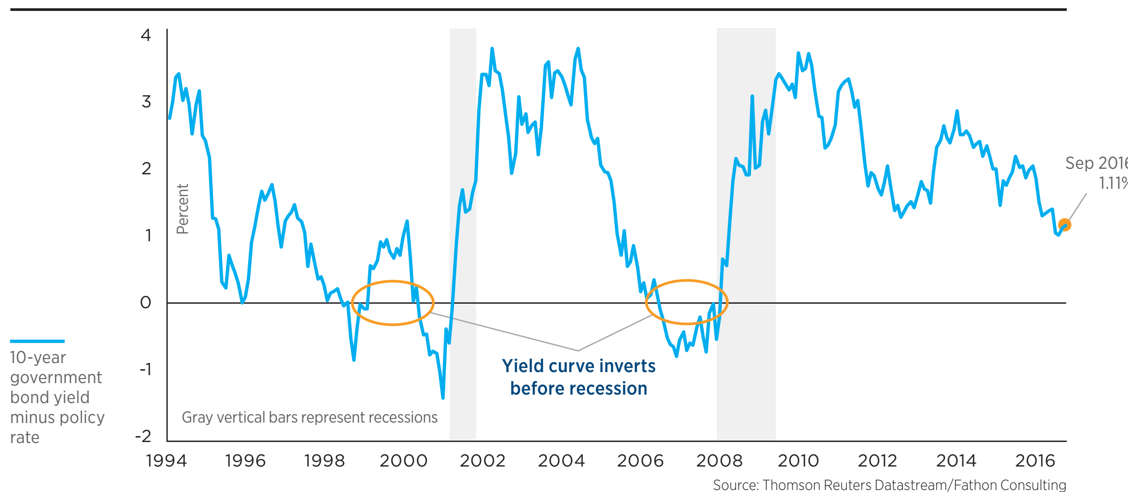
We continue to favor the credit sector, with very modest overweights in Investment Grade and low-duration High Yield. The credit cycle is likely reaching the final stages of improvement, and we are watching for signals of a reversal in broad credit quality, which would drive spreads wider and damage total returns.

The Index of Leading Economic Indicators

Source: Thomson Reuters Datastream; UMB Investment Management

- 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 2.3%, 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 1.5% in the U.S.

U.S. Yield Curve



Source: Thomson Reuters Datastream/Fathon Consulting

- 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 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.

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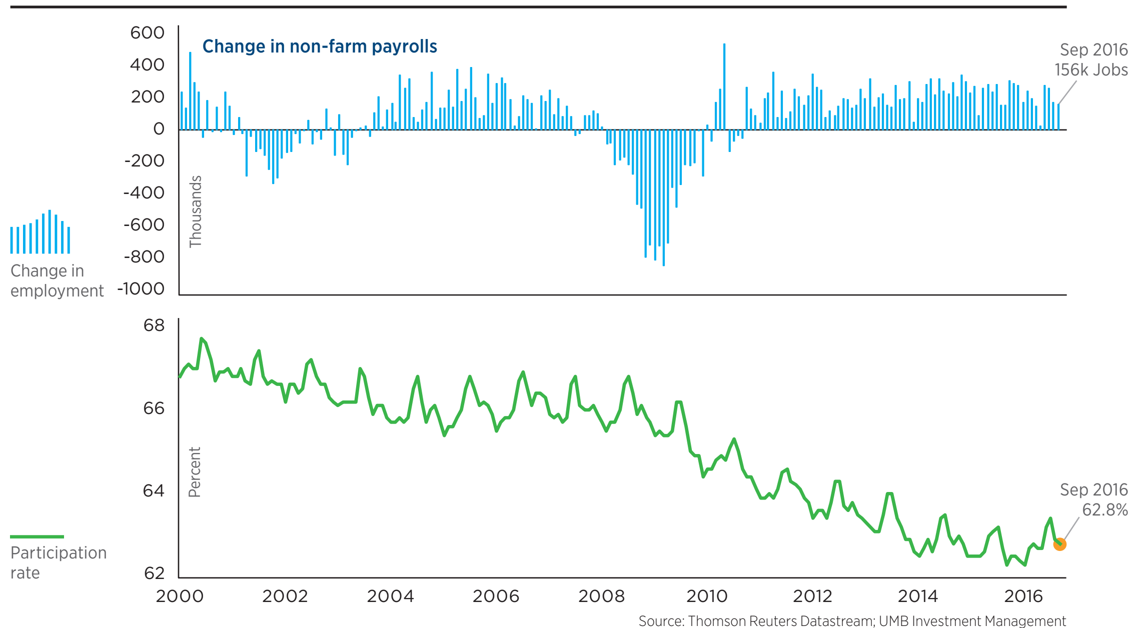
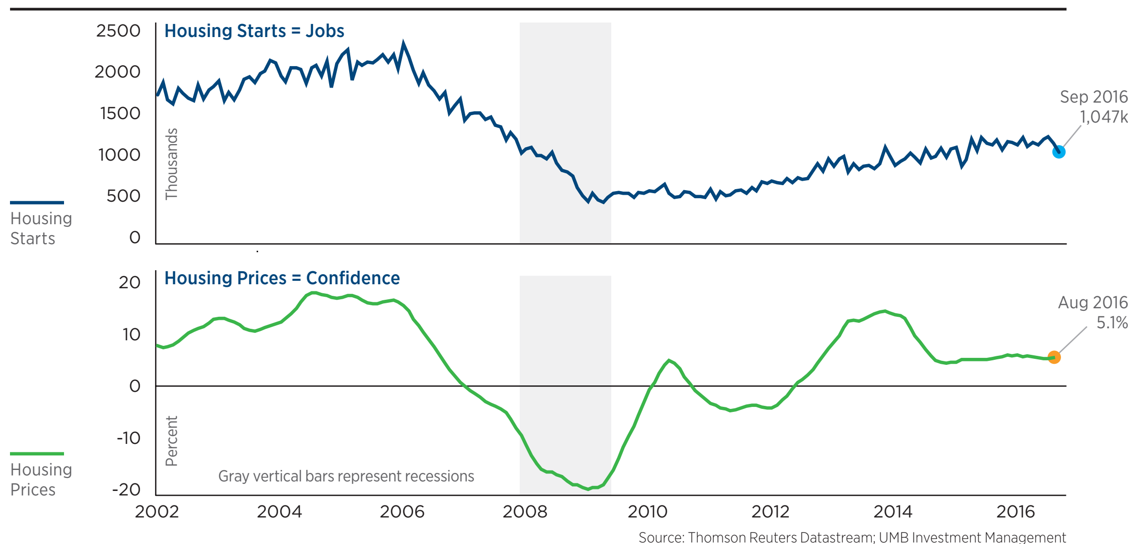
Labor Markets



- The unemployment rate stands at 5.0%. In addition to solid job gains, the historically-low participation rate is contributing to low unemployment rates.
- Job gains have averaged 178,000 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



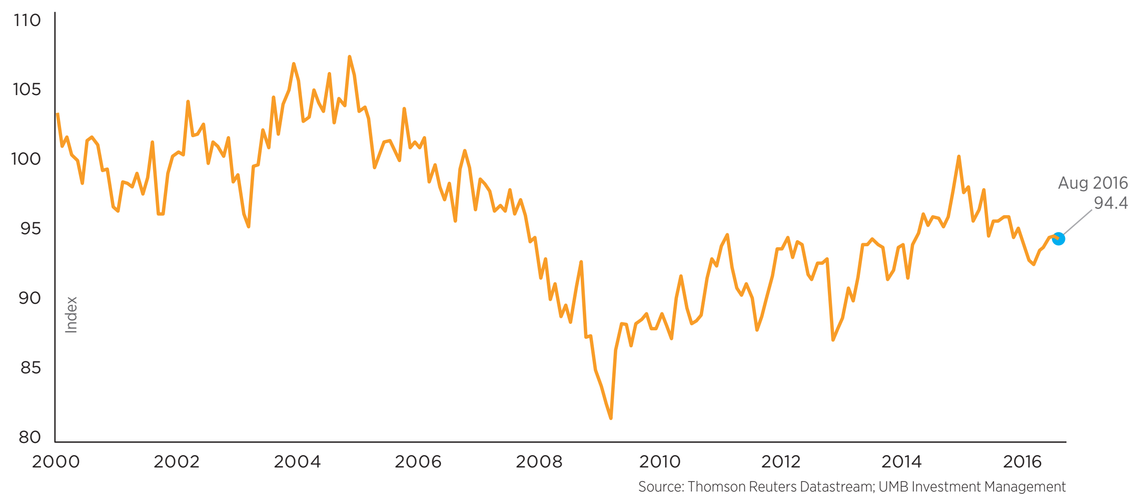
- The housing market continues to improve, giving no indication of an oncoming recession.
- Housing starts remain below normal levels of approximately 1.4 million per year. We estimate 1.2 million starts this year.
- Housing starts are being driven by an increase in household formations as a result of 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.

Confidence

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. It's unclear how the upcoming U.S. presidential election is influencing confidence. Several consumer discretionary companies have mentioned the election as a headwind.
- The continued strength in consumer confidence supports our view that we will see acceleration in consumption growth. This should support our GDP forecast of 1.5% growth.

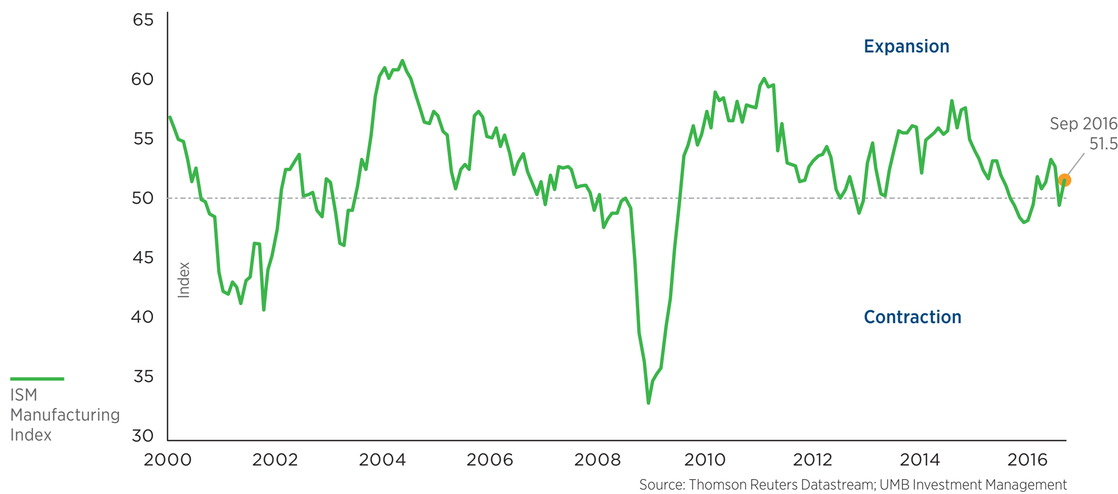
Small Business Optimism



- The NFIB Small Business Optimism Index continues to rebound from levels seen earlier this year.
- The top three most important problems of small business were taxes, government regulations and labor quality.
- Corporate spending could see somewhat of a pause due to the uncertainty of the U.S. presidential election as seen in the business optimism survey.
- Current levels support modest GDP growth.

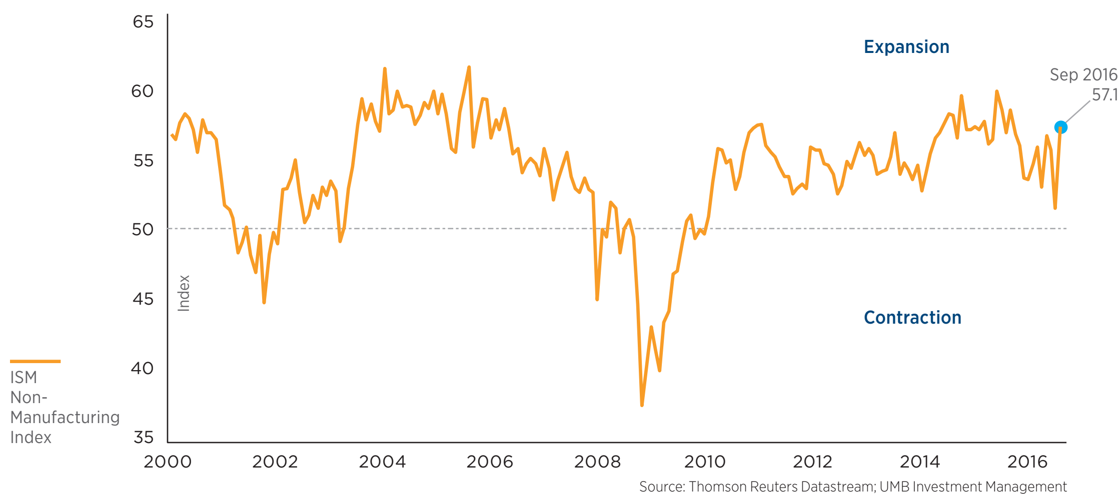
Manufacturing/Non-Manufacturing

Manufacturing



- The ISM Manufacturing Index rebounded in September after contracting in August.
- The rebound in the ISM Index reinforces our view that the economy remains on a solid foundation.
- The improvement in oil prices should help trends in the manufacturing and industrial sectors of the economy.
- The current readings are consistent with GDP growth close to 2%.

Services



- The ISM Non-manufacturing Index rebounded to a year-to-date high of 57.1 in September after the weakest reading of the year in August.
- 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.

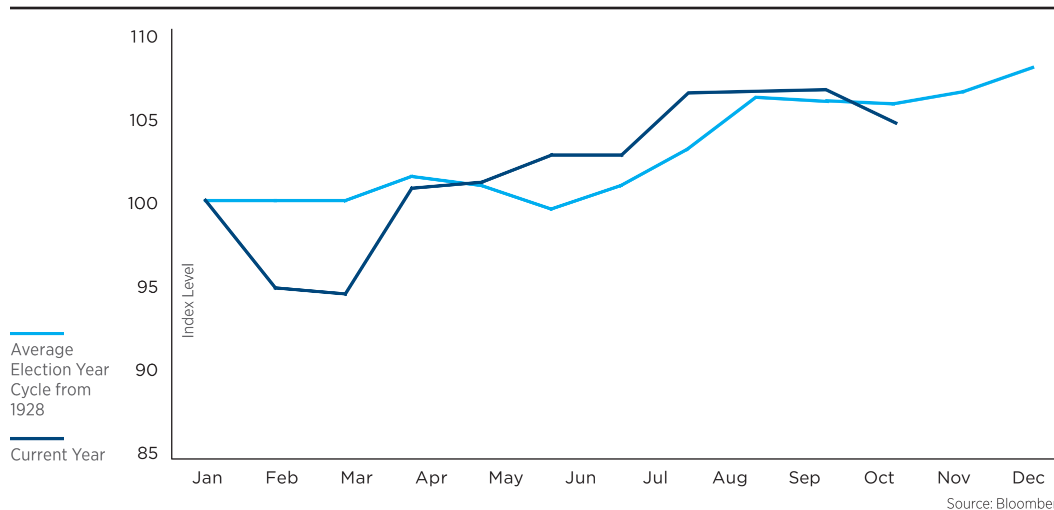
S&P 500 Presidential Cycle Return Averages, 1928–Present

	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%	**9.0%**
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 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 of 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.

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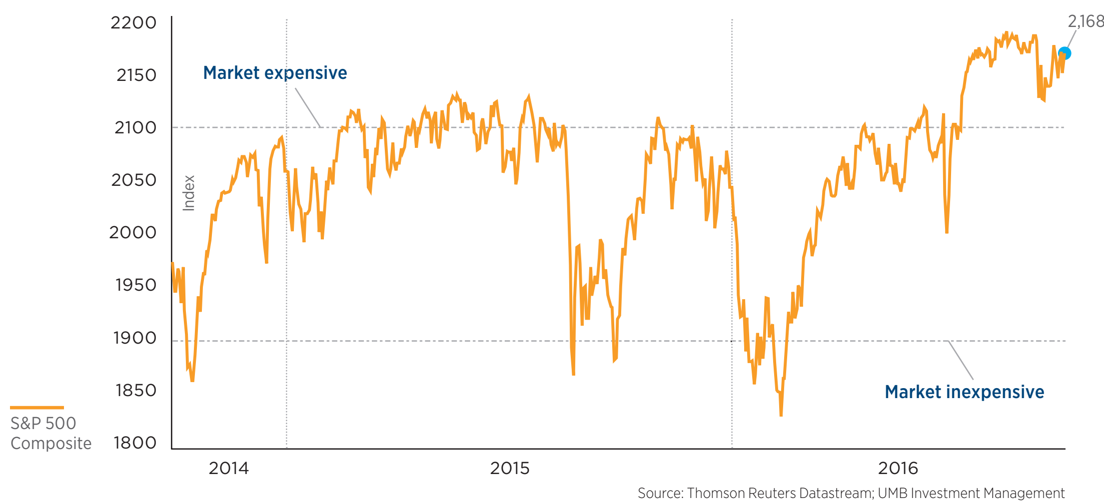
Stock Market

S&P 500



- The stock market broke out of its trading range in 3Q.
- Importantly, oil has likely bottomed, which significantly reduces downside risk to the market and also makes it highly likely earnings will grow nicely in 2017.
- Near term the U.S. presidential election, upcoming Federal Reserve meetings in November and December, and earnings reports will dictate the direction of the market.

S&P 500 Valuation

- The market is fairly valued at 17x forward earnings, in our view.
- However, we would not be surprised to see the market trading at a higher valuation given the low interest rate environment and the prospects for a pickup in earnings growth in 2017.
- Typically a low interest rate and low inflation environment results in price to earnings (P/E) multiples of 17-20x.
- Over the next twelve months, we expect the market to provide mid single digit returns based on our earnings growth forecast of 4-6% and a dividend yield of 2.2% on the S&P 500.

U.S. Equity Sector Performance

S&P 500 Year-to-Date Return

	Total Return % as of 9/30/16					
Index/Sector	1 Month	3 Month	YTD	1 Year	3 Year	5 Year
S&P 500	0.02	3.85	7.84	15.42	11.14	16.35
Energy	3.08	2.26	18.72	18.96	-2.19	5.94
Telecommunication	-0.93	-5.60	17.86	26.82	9.79	12.28
Utilities	0.39	-5.91	16.13	17.37	13.56	12.08
Technology	2.44	12.86	12.51	22.82	17.46	18.05
Materials	-1.25	3.71	11.45	22.25	6.50	12.69
Industrials	-0.11	4.14	10.87	19.70	10.41	17.50
Consumer Staples	-1.46	-2.63	7.55	15.77	13.04	15.40
Real Estate	-1.62	-2.68	5.78	13.83	10.24	12.17
Consumer Discretionary	-0.31	2.94	3.64	9.64	11.51	20.07
Financials	-2.72	4.59	1.40	7.40	8.23	17.31
Health Care	-0.51	0.94	1.37	10.71	14.34	20.00

Source: Bloomberg

- The S&P 500 rose 3.85% in 3Q.
- The technology sector lead the market advance in 3Q.
- The safety sectors lagged the market in the quarter as interest rates moved higher.

Sector Comparison

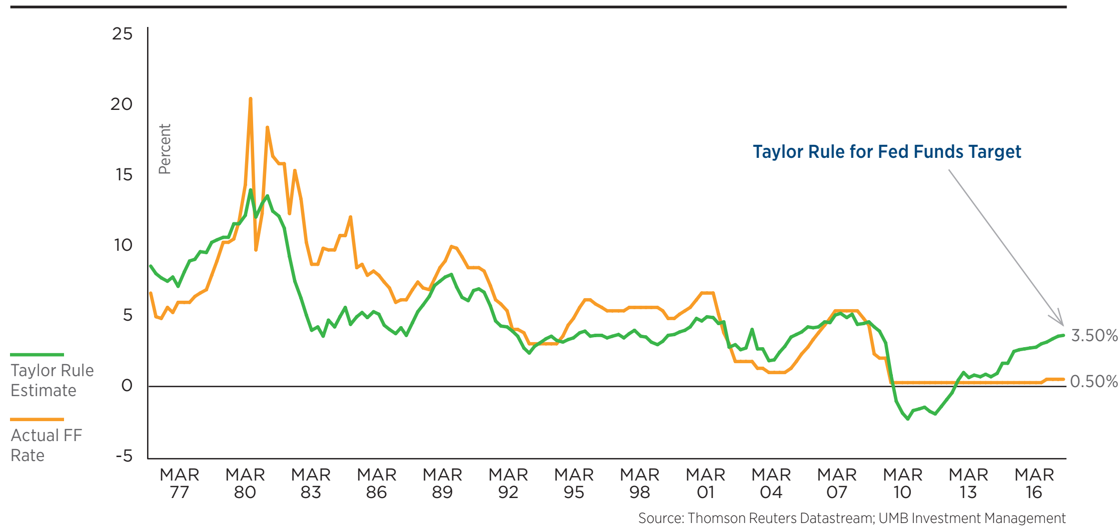
Industry/Sector	12/31/2015 to 7/6/2016	7/6/2016 to 10/4/2017	P/E	Historical P/E	Dividend Yield
S&P 500	4%	3%	18x	15x	2.2%
Utilities	25%	-10%	17x	15x	3.6%
Telecom	26%	-9%	14x	15x	4.7%
Regional Banks	-4%	12%	16x	15x	2.4%

Source: Bloomberg

- So far this year has been a tale of two halves in terms of sector performance.
- In the first half of the year, the market was led by stocks with high dividend yields such as utilities, telecoms, and REITs.
- In the second half of the year, so far, the market has been led by regional banks.
- If interest rates continue to rise, high dividend yield stocks may experience continued downward pressure.
- Regional banks offer a good combination of dividend yield support, earnings upside, and attractive relative valuations.

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

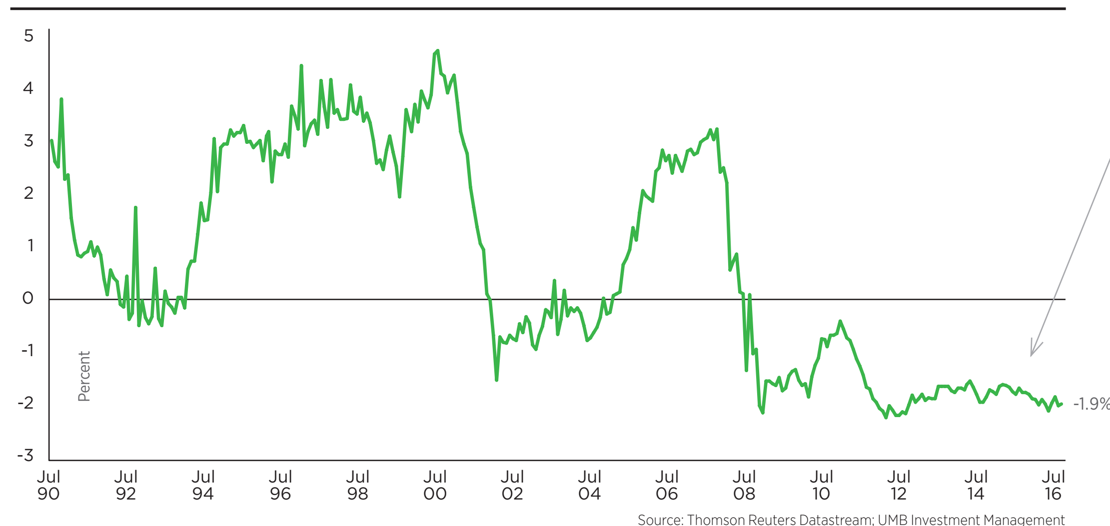
Taylor Rule for Fed Funds Target



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**

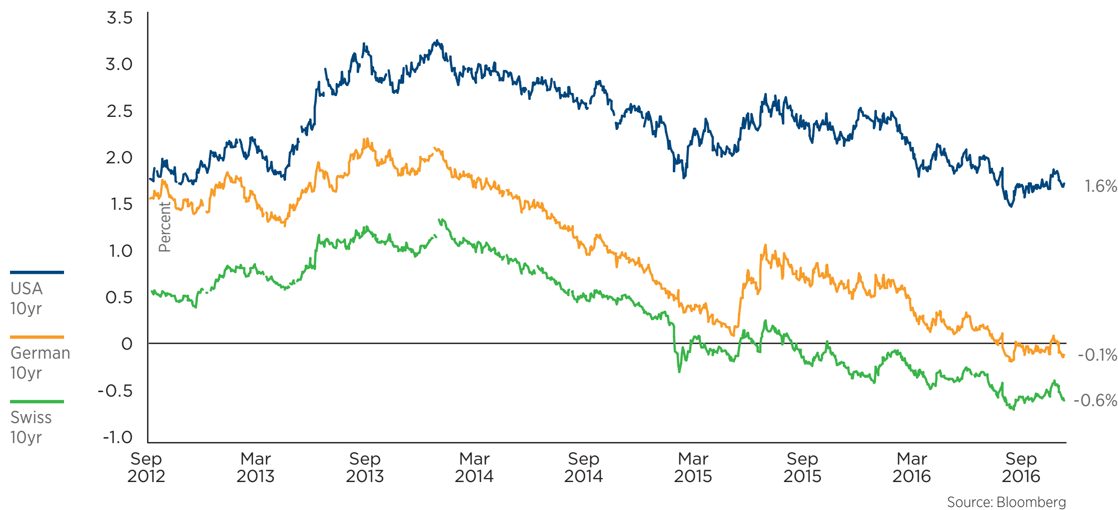


Source: Thomson Reuters Datastream; UMB Investment Management

- 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

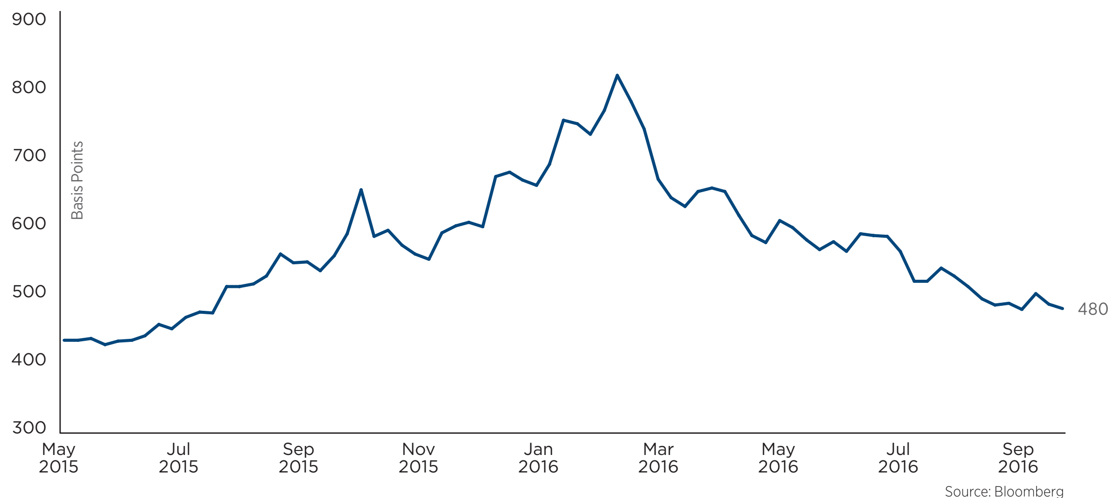


Source: Bloomberg

Global Rates Signaling a Modest Shift

- Hints of tapering Quantitative Easing caused global rates to drift modestly higher at quarter end.
- Rates are still negative in developed European markets, but appear to be poised to follow U.S. rates gently higher.
- Global softness and a glut of excess reserves will still 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 continued to grind lower, in tandem with steady improvements in economic data.
- 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 — trends beginning to change

Performance

Index	3 Mo Tot Return	YTD Tot Return	MTD Tot Return
U.S. Credit Long	2.26	16.50	-1.06
Baa	1.94	10.92	-0.19
U.S. Gov/Credit Long	1.24	15.74	-1.26
U.S. Credit	1.23	8.86	-0.28
U.S. Agency Long	1.15	12.86	-0.62
Corporate Intermediate	0.89	5.99	0.08
U.S. MBS	0.6	3.72	0.28
U.S. Gov/Credit	0.4	6.66	-0.19
U.S. Aggregate Intermediate	0.31	4.10	0.17
U.S. Gov/Credit Intermediate	0.16	4.24	0.13
U.S. Agency	0.14	3.42	0.09
Aaa	0.1	4.48	0.04
1-3 Yr	0.03	1.69	0.12
U.S. Agency Intermediate	0	2.26	0.18
U.S. Treasury Intermediate	-0.26	3.39	0.17
U.S. Treasury	-0.28	5.07	-0.13
U.S. Treasury Long	-0.36	14.71	-1.61

Source: Thomson Reuters Datastream; UMB Investment Management

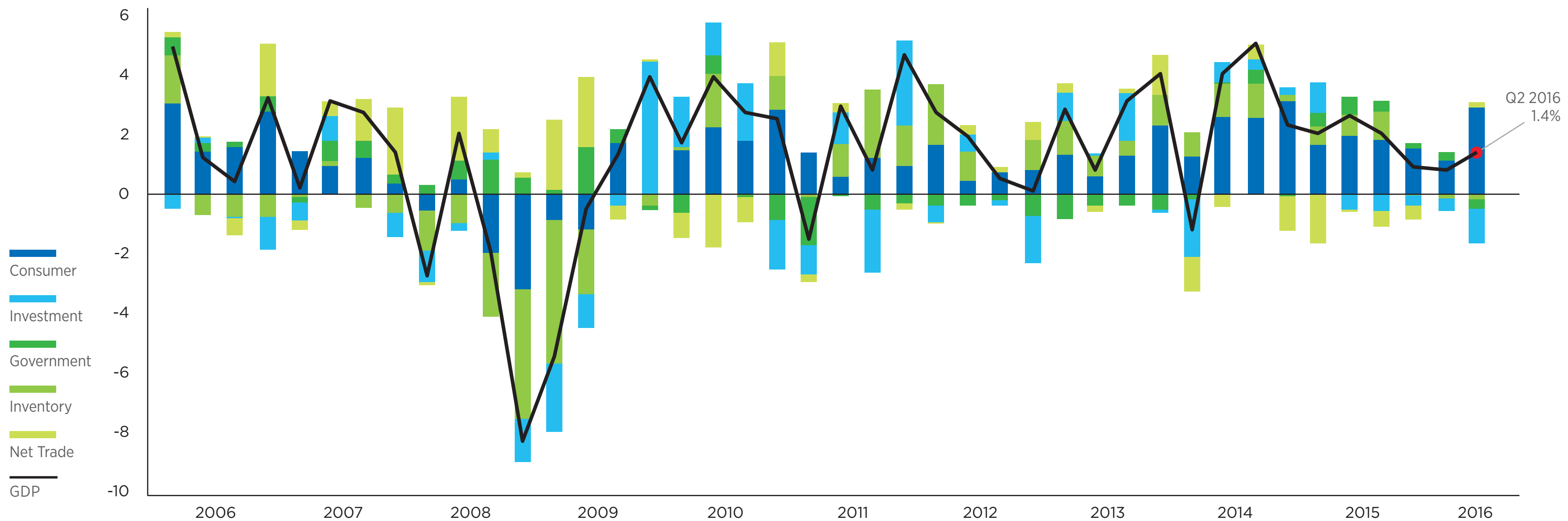
Performance

- Long rates nudged up slightly as markets began to prepare for modest increases from the FOMC.
- Long Treasuries indices underperformed due to slightly rising rates.
- Credit indices continued their strong rally, following the global push into "risk assets."
- Ongoing compression of yield spreads pushed Long Credit and lower rated indices into the leading positions for the quarter.

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 over the upcoming year.
- We anticipate rates flattening in the 2% range.

Real Gross Domestic Product (GDP)



Source: Thomson Reuters Datastream; UMB Investment Management

% Contribution to GDP by Quarter

Component	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16
Consumption	2.4	2.1	1.7	1.1	2.9
Investment	0.9	-0.1	-0.2	-0.6	-1.4
Net Exports	0.2	-0.3	-0.1	0.0	0.2
Government	0.4	0.3	0.0	0.3	-0.3
Total	**3.9**	**2.0**	**1.4**	**0.8**	**1.4**

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	0.8 (A)	1.4 (A)	2.5 (E)	2.5 (E)	1.5 (E)

(A) = Actual, (E) = Estimate

Source: UMB Investment Management

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