Economic and Market Overview

All-Time Highs ...

Third Quarter 2018

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All-Time Highs ...

The S&P 500 hit an all-time high in Q3, supported by several economic data points that were also close to, or at all-time highs. With that in mind, our theme for the quarter is “All-Time Highs.” The U.S. economy is in transition, the underlying fundamentals remain intact, Q2 GDP posted a 4.2% gain and Q3 GDP is expected to be better than 3%. The volatility in the stock market, a leading indicator, suggests there are many headwinds that will eventually cause economic activity to slow. A trade spat with China, slowing global growth, a tight labor market and higher interest rates all are weighing on economic activity.

Labor Market

The slack in the labor market is abating. The unemployment rate stands at 3.7%, not an all-time low, but the lowest unemployment rate since 1969. Initial unemployment claims have dropped to a low of 205k in Q3, which is the lowest reading since the 1960s. This data point is a reliable indicator that the unemployment rate will remain low well into 2019. We expect unemployment to be 3.8% at the end of 2018 and in the 3.5-3.8% range by the end of 2019. The labor market is getting tight, with 71 million job openings and only 5.9 million unemployed people to fill those jobs. This is leading to wage inflation. Average hourly earnings are up 2.7%, yet our surveys suggest wage inflation is significantly higher than that. This data will support the Federal Reserve's (Fed) plan of moving short-term interest rates higher.

Confidence

Consumer confidence is close to an all-time high and when consumers feel good, they spend. This is likely to lead to a strong holiday shopping season in Q4. The labor market, wage growth, asset prices and fiscal stimulus all support robust consumer and business confidence. Businesses feel good because of tax reform and deregulation, which have caused optimism to reach near record levels. As the boost from fiscal stimulus wanes, higher interest rates increase costs, and wage growth and tariffs increase inflation, CEO confidence may fade.

Trade Negotiations – Some progress being made

A new deal with Mexico and Canada (USMCA) was reached at the end of the quarter to replace NAFTA. However, tensions with China have escalated. We do think there is a chance for progress when President Trump and China’s President Xi Jinping meet at the upcoming G20 meeting in November.

Outlook

We expect GDP growth of 3.2% in Q3, 2.5% in Q4, and 2.9% total for 2018. We think the risk is likely to the upside of our forecasts. In fact, two of the three Fed GDP tracking models we follow are signaling GDP at over 4% in Q3.

We expect GDP to slow somewhat to 2.3% – 2.7% in 2019, as the benefit of the fiscal stimulus starts to wane and it gets increasingly difficult for businesses to find qualified workers, which could begin to slow the pace of job gains. We expect the Fed to increase rates to at least 3% in 2019. Corporate earnings should see positive growth and we expect stock prices up 5-10% in 2019.

The table at right summarizes our 2018 forecasts:

<table>
<thead>
<tr>
<th>2018 Year End</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Real GDP Growth Rate</td>
<td>2.6% – 2.9%</td>
</tr>
<tr>
<td>Global Real GDP Growth Rate</td>
<td>3.6% – 4.0%</td>
</tr>
<tr>
<td>S&amp;P 500 Price Target</td>
<td>3,000</td>
</tr>
<tr>
<td>S&amp;P 500 Operating EPS Growth</td>
<td>25.00%</td>
</tr>
<tr>
<td>Federal Funds</td>
<td>2.50%</td>
</tr>
<tr>
<td>Projected 10-Year Treasury Rate</td>
<td>3.25%</td>
</tr>
</tbody>
</table>
Equity Markets

New All-Time Highs
The S&P 500 hit 2935 in Q3, an all-time high. The S&P 500 increased by 7.71% in Q3, which is the largest quarterly return since 2013. The S&P 500 is up 10.56% YTD. Strong earnings are driving stock market returns despite escalating trade tensions with China. Earnings are increasing by over 20% Y/Y so far in 2018, which has largely been driven by corporate tax reform and a strong domestic economy. The escalating trade war with China is an ongoing risk. Further trade tensions with China could reduce earnings growth by only a modest 3-5%. So, we think it’s a manageable risk to earnings.

Escalating Risks
There are three important risks to the market. The first risk is interest rates. Rising rates can be negative for stocks as bonds compete with stocks for assets. Additionally, higher interest expenses for companies represent a slight headwind to earnings. Secondly, the ongoing trade spat between the U.S. and China is a risk. While the direct impact to earnings is small, the indirect impact through lower confidence and delayed investment is more uncertain and perhaps more consequential to markets. Lastly, rising input costs have the potential to put downward pressure on margins and, thus, earnings. Several companies have discussed higher input costs related to not only the trade spat with China but also other general inflationary pressures such as rising wages and higher freight costs, among other things.

Mid-Term Election
Typically, the market shows strong seasonality in the November and December months going into the all-important holiday shopping season. Moreover, this is especially true in mid-term election years like this one. We do not expect the outcome of the mid-term elections to have a meaningful impact on markets over the long-term. The expected outcome of the mid-term elections may result in political gridlock, which is historically good for markets. Additionally, the market typically rallies following the mid-term elections into the end of the year.

Outlook
We forecast the S&P 500 to end the year at 3,000, which would represent a low double-digit return for the year. Our 3,000 forecast on the S&P 500 is based on 18.75 X $160 in 2018 earnings. Our initial forecast range for 2019 is 3,000-3,300. At the midpoint this would represent 18 times our 2019 earnings forecast of $175. We expect an environment where valuation multiples compress due to higher rates, but earnings growth remains strong.
Fixed Income - Treasury Rates Grinding Higher

During Q3, the bond markets continued to push rates modestly higher, as economic data remained robust and the FOMC continued to telegraph a plan for ongoing increases in overnight rates. The fed funds rate was nudged up to 2.00% in September, and follow-up commentary clearly pointed towards additional upward movements in coming quarters. Treasury rates moved higher, as would be expected. The 10-year Treasury moved up to 3.05%, its highest level since early in the decade. Shorter rates had moved up slightly more than the 10-year, which meant that the slope of the Treasury curve had flattened further. At quarter end, the 2-10 slope was only 24 basis points, a reading that would historically be considered very “flat” and a signal that we might be nearing the end of an economic cycle.

Flattening Yield Curve – The 2-10 Slope

We have regularly emphasized that the slope of the yield curve is an important leading indicator for a slowdown in the economy. If the 2-10 year slope becomes completely flat or inverted, this usually signals an oncoming recession. Over recent quarters, the slope has ground steadily lower, with the last figure of 24 marking the lowest slope in more than a decade (since before the Great Recession). However, we do not believe that the yield curve will invert this year. Labor shortages should push wages and inflation higher, which will most likely force long rates higher. We are forecasting that the 10-year Treasury will reach 3.50% by the end of 2019.

High-Yield Spreads

As highlighted in our last update, there is another important indicator that we believe should be paired with the Treasury slope to provide the best indicator of impending weakness in the economy and markets – high-yield spreads. Typically, the combination of an inverted Treasury curve and a widening of high-yield spreads provides the best indicator of broad-based turbulence.

At quarter-end, the high-yield market was quite strong, with yield spreads very near their cyclical lows, but volatility was increasing. We will keep a very close watch on both of these indicators as we believe that yield curve inversion, followed by a widening of high-yield spreads (in the neighborhood of 100 basis points), will be a critical signal for a change in outlook.

Summary

We have been forecasting that the fed funds rate will reach 2.50% and the 10-year Treasury yield will hit 3.25% by the end of 2018, and we maintain those targets for year-end. Total return expectations for the year continue to be very modest. Improving economics should continue to be supportive of corporate and high yield bonds as long as earnings hold steady. However, we are very late in the credit cycle and high-yield spreads are very low, so caution is warranted.
U.S. Equity Markets - All-time Highs

S&P 500

- Our original forecast for the S&P 500 at the beginning of 2018 was 3,000, which represented a 12% price return and 14% total return.
- Our forecast was based on a 18.75x valuation multiple and $160 in earnings for 2018.
- Our target for earnings of $160 was conservative, as we have seen valuation multiple contraction due to stronger-than-expected earnings growth and higher interest rates.
- Our current 2018 forecast remains at 3,000, which represents 8% upside from current levels.
- For 2019 we are forecasting a range on the S&P 500 between 3,000 and 3,300, based on 18 x $175 EPS for 2019.

S&P 500 intra-year declines vs. calendar year returns

- Equity market volatility has increased in 2018. Importantly, volatility is not to be feared. It is a normal part of equity markets.
- In fact, the average intra-year, peak to trough, decline in the S&P 500 is 13.8% per year. For 2018, our intra-year drop has been 10%.
- We continue to expect the markets to remain volatile as we transition away from accommodative central bank support and as fiscal stimulus wanes.
The U.S. labor market remains extraordinarily healthy. The unemployment rate (U-3) fell to 3.7% in September, which is the lowest level since the 1960s. The marginally attached unemployment rate (U-6) continues to fall as well, reaching 7.5% in September.

Finding qualified labor is becoming a problem for firms, which could somewhat slow job gains over the next couple years.

Initial unemployment claims remain historically low, at close to 200k. This suggests the unemployment rate will remain fairly low as we move into 2019.

We expect the unemployment rate to end 2018 at 3.8% and end 2019 around 3.5-3.8%.

The labor market is tightening. The scarcity of labor is a common theme among small business owners.

There are 7.1 million job openings but only 5.9 million unemployed people to fill those jobs. In other words, there are more jobs available than people to fill those jobs, which is rare to see and signals the labor market is tight.

We believe that as the labor market continues to tighten, wages will start to pick up. Average Hourly Earnings and the Employment Cost Index both remain largely range-bound at 2.8% y/y.

Faster wage growth could lead to inflationary pressures in the economy. We are monitoring wage growth closely.
Supporting Economic Evidence - Confidence

**Consumer Confidence - Conference Board**

- The Conference Board Consumer Confidence Index has increased sharply over the last year, remaining near a 15-year high. The recent surge in consumer confidence has largely been driven by a robust labor market.
- Consumers are in sound financial health with a 6.6% savings rate. This buffer can help withstand an unexpected shock. The strength in consumer confidence supports our view that we will continue to see solid consumption growth.

**NFIB Small Business Optimism**

- Business confidence - NFIB Small Business Optimism and CEO Confidence - are both also at near-record levels. Corporate tax reform and deregulation have boosted business confidence as earnings have increased.
- When businesses feel good, just like consumers, they spend or invest back into the business. This leads to capex growth and, over time, productivity gains.

**CEO Confidence**

- CEO Confidence has recently hooked lower. The CEO Confidence survey is geared toward large, Fortune 500 companies. Weaker international trends and trade disputes may be starting to impact confidence.

Source for all: Thomson Reuters Datastream; UMB Investment Management
Third Quarter, 2018

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Manufacturing

- The Manufacturing PMI continues to trend higher, reaching 59.8 in September and signaling robust manufacturing activity in the U.S. The Manufacturing PMI is near all-time highs.

- Typically, when the Manufacturing PMI reaches these levels, it slows over the coming years. We would expect some slowing into 2019.

- The forward-looking new orders component of the index remained elevated, at 61.8, in September. Impressively, new orders have been over 60 for 17 consecutive months.

- The new orders data suggests the manufacturing economy will remain strong for several future quarters.

Services

- The ISM Non-Manufacturing Index, or services, remained at a healthy level over the key expansion/contraction level of 50, coming in at 61.6 in September.

- 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 are confident in our 2.9% GDP forecast for 2018.
• Trade tensions between the U.S. and China escalated in Q3. A further escalation in the trade negotiations with China is a risk because a trade war is one of the factors that prolonged the Great Depression in the early 1930s.

• However, things look much different today than in the 1930s in terms of global trade. The tariff rate in the 1930s increased to nearly 60%. Today, the tariff rate is under 3%.

• The Dow Jones fell sharply during this period, before recovering when globalization began in the 1940s.

• We believe the probability of a full-blown trade war that significantly disrupts markets is fairly low. Moreover, the market can likely handle a modest increase in the tariff rate.

• The market gives us a second opinion on how the trade negotiations with China are going to play out. Clearly the market performance, a leading indicator, believes that the U.S. has the upper hand in the trade spat with China.

• The S&P 500 is up nearly 10% since April 2018, in contrast to the Shanghai Index, which is down 15%.

• The U.S. exports only $130bn to China, while China exports over $500bn to the U.S. The risk to Chinese growth is significant.

• If the trade spat lingers, S&P 500 EPS growth may be curtailed by 3-5%, which we view as manageable.
• Several variables are not hitting all-time highs, which supports further stock market gains.

• Oil, while significantly off its lows seen in 2016, is still well off its highs from 2008.

• We think WTI oil between $60-80 per barrel is a sweet spot for equities. If oil trades over $100 it could alter our outlook.

• Valuation of the S&P 500 is not near all-time highs as measured by the forward P/E ratio.

• Low interest rates and inflation support higher-than-average valuation multiples.

• We think current valuations at 16-17x are reasonable, with total returns coming from earnings growth and dividends.

• Core inflation has been moving higher lately but has generally been low for the past several decades.

• Inflation should continue to move modestly higher due to the tightening labor market and wage growth.
Wages have steadily moved higher over the past several years. Generational lows for unemployment and tight labor markets are driving expectations for ongoing wage pressure.

In a 70% service-based economy, wage pressure is expected to push inflation measures higher.

If inflation continues to build, expectations will increase and Treasury rates should shift upwards.

Inflation has finally migrated higher. Both measures of CPI are above the 2.00% target that the FOMC seeks.

With inflation above the FOMC target and seemingly poised to push higher, the FOMC is projecting that it will remain on the path towards higher rates.

Runaway inflation is not expected, but the inflationary impulse is strong enough to keep the Fed moving rates higher for several more quarters.
The bond market has been forced to adjust for the FOMC commentary pointing towards ongoing increases in rates.

The steady march higher for fed funds rates is expected to continue well into 2019. We expect quarterly adjustments through at least Q2 2019.

Economic strength will be sufficient to keep the Treasury curve positively sloped. We expect the 10-year to move up largely in tandem with fed funds rate adjustments, ending 2019 at 3.5%.

The slope of the yield curve, which is the difference between long-term and short-term rates, has a near-perfect track record of predicting recessions.

When the yield curve inverts (short rates higher than long rates), a recession typically ensues within the next 12-24 months. See the red circles at left.

While the yield curve has flattened over the past few years, we believe the slope will remain positive for several more quarters.

Moreover, even when the yield curve inverts, there is significant time to react before a recession starts.
Equity Market Performance

<table>
<thead>
<tr>
<th>Index/Sector</th>
<th>Total Return % as of 9/30/18</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3 Month</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>7.71</td>
</tr>
<tr>
<td>Technology</td>
<td>8.80</td>
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<tr>
<td>Consumer Discretionary</td>
<td>8.18</td>
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<tr>
<td>Health Care</td>
<td>14.53</td>
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<tr>
<td>Energy</td>
<td>0.61</td>
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<tr>
<td>Industrials</td>
<td>10.00</td>
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<tr>
<td>Utilities</td>
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<tr>
<td>Real Estate</td>
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<tr>
<td>Communication Services</td>
<td>9.94</td>
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<tr>
<td>Financials</td>
<td>4.36</td>
</tr>
<tr>
<td>Materials</td>
<td>0.36</td>
</tr>
<tr>
<td>Consumer Staples</td>
<td>5.69</td>
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</tbody>
</table>

For the quarter, rising rates again drove returns down close to zero for the broad Intermediate indices.

Corporate bonds (the Credit sector) recovered somewhat, leading all other sectors for the quarter.

We expect rates to drift modestly higher for the remainder of the year. Returns are likely to be near zero or possibly negative for the calendar year.

Bond Market Performance

<table>
<thead>
<tr>
<th>Sector</th>
<th>Total Return % as of 9/30/18</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>3 Month</td>
</tr>
<tr>
<td>Intermediate Aggregate</td>
<td>0.11</td>
</tr>
<tr>
<td>Intermediate Gov Credit</td>
<td>0.21</td>
</tr>
<tr>
<td>US Agency Intermediate</td>
<td>0.20</td>
</tr>
<tr>
<td>US Treasury Intermediate</td>
<td>-0.12</td>
</tr>
<tr>
<td>MBS Fixed Rate</td>
<td>-0.12</td>
</tr>
<tr>
<td>Aa</td>
<td>0.34</td>
</tr>
<tr>
<td>U.S. Aggregate</td>
<td>0.02</td>
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<tr>
<td>U.S. Treasury</td>
<td>-1.59</td>
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<tr>
<td>U.S. Gov/Crfr4drt</td>
<td>0.06</td>
</tr>
<tr>
<td>Baa</td>
<td>1.35</td>
</tr>
<tr>
<td>A</td>
<td>0.68</td>
</tr>
<tr>
<td>Corporate Long</td>
<td>1.32</td>
</tr>
<tr>
<td>Us Treasury Long</td>
<td>-2.88</td>
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Green = YTD outperformance  
Blue = YTD underperformance
Real Gross Domestic Product (GDP)

U.S. Contributions to GDP Growth

<table>
<thead>
<tr>
<th>Component</th>
<th>Mar-17</th>
<th>Jun-17</th>
<th>Sep-17</th>
<th>Dec-17</th>
<th>Mar-18</th>
<th>Jun-18</th>
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<tbody>
<tr>
<td>Consumption</td>
<td>1.2</td>
<td>2.0</td>
<td>1.5</td>
<td>2.7</td>
<td>0.4</td>
<td>2.6</td>
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<tr>
<td>Investment</td>
<td>0.8</td>
<td>1.0</td>
<td>1.5</td>
<td>0.1</td>
<td>1.6</td>
<td>0.0</td>
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<tr>
<td>Net Exports</td>
<td>-0.1</td>
<td>0.0</td>
<td>0.0</td>
<td>-0.9</td>
<td>0.0</td>
<td>1.2</td>
</tr>
<tr>
<td>Government</td>
<td>-0.1</td>
<td>0.0</td>
<td>-0.2</td>
<td>0.4</td>
<td>0.2</td>
<td>0.4</td>
</tr>
<tr>
<td>Total</td>
<td>1.8</td>
<td>3.0</td>
<td>2.8</td>
<td>2.3</td>
<td>2.2</td>
<td>4.2</td>
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% Contribution to GDP by Quarter

Source: Thomson Reuters Datastream; UMB Investment Management

Source: Thomson Reuters Datastream; UMB Investment Management

UMB GDP Forecast*

<table>
<thead>
<tr>
<th>Year</th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>Year</th>
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<tbody>
<tr>
<td>2015</td>
<td>3.3</td>
<td>3.3</td>
<td>1.0</td>
<td>0.4</td>
<td>2.9</td>
</tr>
<tr>
<td>(A)</td>
<td>(A)</td>
<td>(A)</td>
<td>(A)</td>
<td>(A)</td>
<td>(A)</td>
</tr>
<tr>
<td>2016</td>
<td>1.5</td>
<td>2.3</td>
<td>1.9</td>
<td>1.8</td>
<td>1.5</td>
</tr>
<tr>
<td>(A)</td>
<td>(A)</td>
<td>(A)</td>
<td>(A)</td>
<td>(A)</td>
<td>(A)</td>
</tr>
<tr>
<td>2017</td>
<td>1.8</td>
<td>3.0</td>
<td>2.8</td>
<td>2.3</td>
<td>2.2</td>
</tr>
<tr>
<td>(A)</td>
<td>(A)</td>
<td>(A)</td>
<td>(A)</td>
<td>(A)</td>
<td>(A)</td>
</tr>
<tr>
<td>2018</td>
<td>2.2</td>
<td>4.2</td>
<td>3.2</td>
<td>2.5</td>
<td>2.9</td>
</tr>
<tr>
<td>(A)</td>
<td>(A)</td>
<td>(E)</td>
<td>(E)</td>
<td>(E)</td>
<td>(E)</td>
</tr>
</tbody>
</table>

(A) = Actual, (E) = Estimate

*Quarter over Quarter Seasonally Adjusted Annual Rate

Source: UMB Investment Management
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