FIRST NEBRASKA Trust COMPANY

Third Quarter 2016

Quarterly Letter to Clients

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The Third Quarter of 2016 will be unforgettable -- for so many reasons. It will be remembered for the highly unusual presidential campaign, whose nominees appeared to promise change, but undoubtedly can only promise further disappointment to a frustrated electorate. The quarter marked record lows in interest rates and record highs in stocks. It saw the highest government debt levels in our nation's history at a time when global growth trends are drifting downward. It was a quarter peppered with calamities and tragedies, both natural and man-made.

In reviewing the changes that have occurred over the past few months, it reminded me of high school chemistry class when we studied the second law of thermodynamics. The second law of thermodynamics states, "the entropy of any isolated system always increases."[1] In layman's terms, the concept is focused on how the world is constantly in a state of change, moving from a state of order to disorder, and that the trend toward disorder can only be averted by applying some form of energy to reorder it. We build stuff and Mother Nature rusts it, weathers it, removes it through natural disasters, and then we rebuild it again. We set borders and boundaries geographically, socially, economically, and politically and they become the proverbial lines in the sand that constantly have to be redrawn through negotiation, arbitration, or some other force. The wisdom of the ages and history has reminded us over and over again that change is a constant in our lives. It's reminiscent of the old quote from an unknown author, "There are three things that are certain in life: death, taxes, and change. You can't avoid change, it's mandatory. Progress however is optional."

Economic Overview

The current expansion is the fourth longest in the post WWII time frame. Yet, nowhere has change been more apparent than in the lack of vitality found in the current economic recovery - especially when compared to prior expansions. The unimpressive

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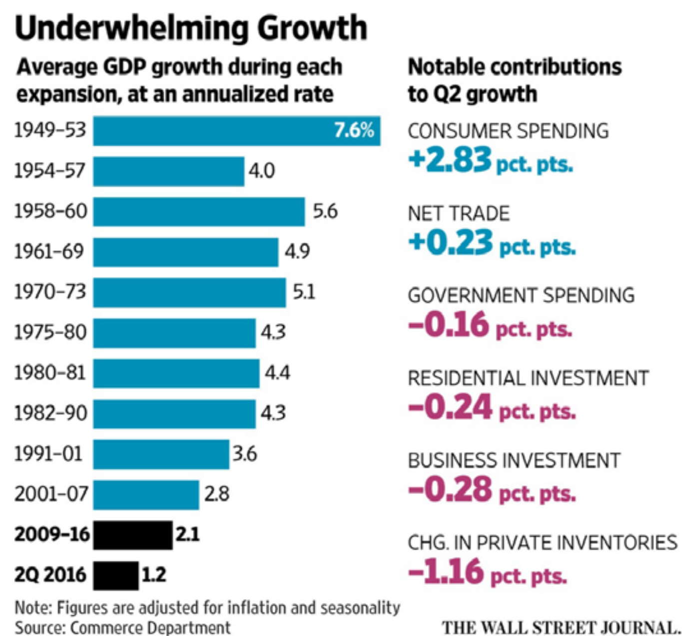
[1] "The second law of thermodynamics says that the entropy of any isolated system always increases." Source: Boundless. "The Three Laws of Thermodynamics." ***Boundless Chemistry***. Boundless, 02 Jun. 2016. https://www.boundless.com/chemistry/textbooks/boundless-chemistry-textbook/thermodynamics-17/the-laws-of-thermodynamics-123/the-three-laws-of-thermodynamics-496-3601/

rate of growth is even more surprising given the massive amounts of fiscal and monetary stimulus that have been directed toward trying to boost economic activity. U.S. deficits remain high, while more and more of these deficits are being funded by issuing U.S. Treasury Debt. U.S. Gross Domestic Product is now estimated to be about $18.5 Trillion, with the most recent estimate of the U.S. National Debt placed at $19.7 trillion. This puts the widely followed Debt to GDP ratio just over 106.5%. Because this ratio is at historically high levels, and because both the current debt levels and the future debt requirements to fund entitlement programs limit the options for significant fiscal stimulus, it is becoming an increasing concern to policymakers. The picture is similar on the monetary side of the ledger, as the Federal Reserve's extraordinary easy money policies, including keeping the Fed Funds Rate at or near 0%, has left the Federal Open Market Committee (FOMC) with little in the way of alternatives to battle the next economic downturn.

As the chart below shows, the most recent recovery pales in comparison to the average growth experienced over the past 67 years. In fact, the recovery growth rates have steadily declined since the 1990's, causing many economists to suggest that the combination of demographic, educational changes, and productivity have resulted in a "new normal" growth rate for the U.S. economy of between 1½% and 1¾%, noticeably slower than the levels seen since World War II.[2]



Source: **The Wall Street Journal** July 31, 2016[3]

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[2] "What is the New Normal for U.S. Growth?" by John Fernald **FRBSF Economic Letter** 2016-30 October 11, 2016.

[3] "U.S. in Weakest Recovery Since '49" **The Wall Street Journal**, July 30, 2016, Pg. A1. https://si.wsj.net/public/resources/images/NA-CL082_GDP_fr_16U_20160729182742.jpg

Growth can remedy a multitude of problems. It provides additional jobs, which in turn offer the opportunity for an improved standard of living. Growth allows tax receipts to increase, providing governments with the resources to fund programs deemed to be in the interest of the public good and necessity. Growth can provide the cushion to the shocks of natural disasters. Growth can buffer the negative impacts of policy or strategy mistakes by corporations or governments. Growth can absorb the extra costs that result from changing competitive or regulatory costs, allowing the organization to continue to compete, albeit at a lower profit level. Conversely, slow growth provides little cushion to the vagaries and uncertainties that business and government face. Slow growth does not deflect the headwinds of increased taxes, increased cost inflation, excess capacity, or increased regulation. Slow growth results in a higher probability of underperforming or being unable to sustain the organization for the future. Of course, the possibility of an economic slowdown, or outright recession, could mean economic disaster for those that need the cushion that higher economic growth would normally provide them.

The current low growth environment is further sullied by high levels of government debt and increasing deficit spending, which limits the options for fiscal policy to provide meaningful stimulus and jump-start any slowing or recessionary economy. As such, politicians have looked to the Central Bankers to provide *any* necessary stimulus. Under normal circumstances, the world central bankers have a difficult job. However, we are not in normal times. Consider how extraordinary the policy actions have been over the past 8 years to generate the subpar economic growth levels reported around the globe. In Japan and Europe, Central Bankers have pushed monetary policy into realms not previously considered feasible, instituting a Negative Interest Rate Policy (NIRP) in hopes of stimulating consumers to spend more. While the results have not been encouraging, this has not stopped the European Central Bank (ECB) from drastically expanding their Quantitative Easing programs. As sovereign debt is becoming scarcer, the ECB has turned to the corporate bond market. To influence rates to ever-lower levels, the ECB is currently holding close to 30% of the region's investment-grade corporate bonds – all of which are now trading at negative yields. The Bank of Japan (JCB) has spent the past year buying government bonds and Japanese stocks to prop up financial assets and keep interest rates in negative territory. The JCB now owns close to 50% of all Japanese government bonds. It is estimated that between 20% and 25% of global sovereign debt now trades with a negative yield. "Global central bank balance sheets are up from $6 trillion in 2007, to $21 trillion today, and they are still being expanded at the pace of $200 billion each and every month."[4] If a little works a

[4] "The Coming Bond Bubble Collapse" **PeakProsperity** September 18, 2016.

little bit, then a lot should work even better, right? Given the atypical conditions central bankers face, a slowdown or recession now would greatly reduce their chances of engineering a satisfactory outcome.

Here in the U.S., Federal Reserve Chair Yellen recently mentioned at the annual Jackson Hole, Wyoming Federal Reserve Conference that she would keep all options on the table, including considering purchase of common stocks if the conditions warrant such actions. Whether trial balloons, or actions that are truly under consideration, the current rhetoric reflects the most difficult of tradeoffs that the Federal Reserve currently faces. First, they must slowly change policy to remove the extraordinary accommodations, while not becoming responsible for shocking the system into a slowdown or recession. Next, they must simultaneously put as many arrows back in the quiver as possible, to provide them the flexibility to reverse their course should there be a contraction in economic activity during the next few years.

Capital Markets

Capital markets continue to be hypnotized by the Central Bank's extremely accommodative policy, with Wall Street pundits and strategists readily proclaiming that fundamentals just do not matter anymore. They say "It's all about the Fed" or "Don't fight the Fed" as justification for the momentum in financial assets that has pushed yields on the highest quality credits to record lows, while supporting stock valuation metrics that are significantly above average.

More investors are starting to understand the potentially disturbing impact of dealing with low rates that last for long periods of time. The vast majority of folks approaching retirement age have not saved enough. Near 0% rates have a direct impact on their ability to save for the future. Low rates mean it takes longer to reach the level of savings required to fund any given retirement lifestyle. Low rates also mean that retirees may have to dip into principal funds sooner than they expect to meet their spending needs. For the pension funds that many folks depend on, low rates mean that actuarially determined future liabilities are much larger than previously thought. In addition, the expected returns used to estimate the future value of pension assets are also lower, which results in the need for higher employer contributions to avoid the possibility of larger unfunded liabilities. For retirees especially, this policy acts like a hidden tax, which requires a higher level of retirement savings to fund a given level of future income. It also increases the likelihood that many retirees will outlive their financial resources – especially if future taxes and inflation are significantly higher than they are currently. Finally, the negative market reaction to last December's Fed Funds rate increase of 25 basis points was not encouraging. For those investors that have focused solely on their return ***on*** investment by reaching for higher yields to the

exclusion of considering the return ***of*** their investment, rising interest rates could be an unwelcome surprise.

The quirks of the bond market were demonstrated again during the quarter just past. Bond yields on the 10-Year U.S. Treasury hit an all-time low of 1.366%, as European investors migrated into higher-quality bonds in the wake of the British vote to exit the European Union. The bond markets overall posted unexceptional returns for the quarter. As the performance chart below demonstrates, intermediate corporate bonds gained 1.2% for the quarter, while intermediate government bonds posted a -0.3% quarterly loss. Continuing the trend of the 2nd quarter, longer maturity bonds performed better than shorter ones, while poor quality (riskier credits) outperformed the higher quality paper.

Morningstar Bond Indexes — **As of 9-30-2016**

Broad Market	Quarter	1-Year	3-Year	5-Year
US Inter Core Bd TR Bond	0.51	4.31	3.90	3.27
US Lng Core Bd TR Bond	1.02	11.92	8.37	5.67
US Shrt Core Bd TR Bond	0.06	1.77	1.39	1.33
Corporate				
US Inter Corp Bd TR Bond	1.22	6.52	4.61	5.17
US Lng Corp Bd TR Bond	2.35	13.84	8.33	6.93
US Shrt Corp Bd TR Bond	0.44	2.99	2.18	2.79
Government				
US Inter Gov Bd TR Bond	(0.31)	3.32	3.02	2.17
US Lng Gov Bd TR Bond	(0.45)	9.93	8.78	4.72
US Shrt Gov Bd TR Bond	(0.12)	1.20	1.08	0.86

Corporate debt is now approaching record levels, as companies around the country have taken advantage of the interest rate environment to borrow low cost funds. However, as corporate chief financial officers (CFOs) are leveraging up their balance sheets, inquiring bondholders want to know where the cash to pay them is going to come from and what the borrowed money is going to be used for. Increasingly over the past few years, profit shortfalls have meant that companies have to borrow to fund maintenance capital expenditures or to provide working capital to cover rising operating costs. A number of companies have borrowed funds to maintain their high dividend

payouts. Still others have had to borrow to fund dividend payouts that otherwise would not be funded without repatriating funds from offshore subsidiaries and incurring high income taxes in the process. Finally, with earnings trending downward, companies have used various financial engineering methods, including stock buybacks using funds from issuing additional debt, to maintain reported earnings per share growth. Most analysts would agree that the increase use of debt to buy back stocks is a tax efficient way to return capital from the business to shareholders. However, there is a point where the increased financial leverage has a greater negative impact than the positive results of manufacturing additional earnings per share growth. Historically that point transpires as the company experiences a business slowdown, or an outright recession occurs, causing credit downgrades at a time when revenues and earnings are not adequate to cover the increased debt burden.

The concern of bondholders should also be a concern of stockholders. U.S. corporations are in a profit slump. If the 3rd quarter earnings results come in as expected, it will be the sixth straight quarter of year-over-year earnings declines for the S&P 500 companies. With margins and profits under pressure, and stock prices still trending upward, valuation measures are, by most measures, extended to the high side and well above their long-term averages. These two trends cannot be sustained. Either stock prices will have to correct, or earnings will have to reverse course and begin growing significantly. The change will eventually take place, in spite of the strategists' siren song to solely focus on the Fed and ignore the fundamentals. Eventually the fundamentals always have their day of reckoning. It's just that no one knows when that day of reckoning will occur. As such, investors should heed the wise advice from the great investors of the past when they caution that the market can remain irrational longer than you expect.[5] This really implies that timing the market is all but impossible.

Looking back over the past year, the stock market saw two separate corrections of over 10%. One of these occurred during February 2016, with the other occurring one year ago in September of 2015, providing a favorable comparison for the 1-year performance results shown in the Lipper Mutual Fund table on the next page. The table displays the wide range of returns posted by mutual fund managers during the past quarter. In addition, it shows that larger capitalization stocks performed slightly better than smaller capitalization stocks. The average mutual fund, represented as General Equity, saw a gain of +4.8%. On a total return basis for the quarter, the Dow Jones

[5] "The market can remain irrational longer than you can remain solvent." Generally attributed to A. Gary Schilling or John Maynard Keyes – See: http://quoteinvestigator.com/2011/08/09/remain-solvent/

Industrial Average increased +2.7%, while the S&P 500 was up +3.7%. The tech-heavy NASDAQ posted a gain of 9.6%. International stock funds appreciated 6.4%.

LIPPER MUTUAL FUND INVESTMENT PERFORMANCE AVERAGES

MONDAY, OCTOBER 10, 2016

	Qtr	1 year	5 year	10 year
S&P 500	3.7	14.6	15.7	6.7
S&P 500 Index P	3.3	12.9	13.9	5.0
S&P Industrials P	3.4	14.7	14.0	6.9
Dow Jones Ind. Average P	2.1	12.4	10.9	4.6
Russell 2000 IX P	8.7	13.7	14.2	5.6
NYSE Composite P	2.2	9.4	9.6	2.4
General Equity	4.8	10.7	13.5	6.1
Equity Income	2.5	14.1	13.0	6.1
Large-Cap Growth	5.7	10.8	15.3	7.7
Large-Cap Value	4.2	12.8	14.4	5.2
Mid-Cap Core	4.8	11.6	14.7	7.1
Mid-Cap Growth	4.7	8.1	14.0	7.4
Mid-Cap Value	5.5	13.6	15.2	6.6

P-Price only index. Calculated without reinvestment of dividends. Source: Lipper

It is always a challenge to find new ideas to add to portfolios. However, our strategy remains consistent with our disciplined process of purchasing stocks that can be bought at prices that meet our investment standards, while still providing an acceptable margin-of-safety. Our desire is to find those companies that will be suitable additions in the process of custom tailoring your portfolio to meet your long-term goals, while minimizing risks of permanent capital loss. The task of finding inexpensive stocks, without sacrificing quality in a high and rising valuation environment, makes the challenge even more difficult. However, we will continue to be disciplined in our process, purchasing those stocks that can be bought at prices that meet our investment criteria while selling those stocks that exceed our estimate of fair value, irrespective of the market's gyrations.