FIRST NEBRASKA Trust COMPANY

# First Quarter 2017

## Quarterly Letter to Clients

**By Scott A. Wendt, CFA**

**April 20, 2017**

---

Circumstances change. In fact, identifying change, and determining whether it is permanent or temporary, is one of the primary challenges all investors face. As John F. Kennedy reminded us:

> ***Change is the law of life. And, those who look only to the past or present are certain to miss the future.***[1]

Take the first quarter of 2017 for example. The quarter began with a world watching with anticipation the inauguration of a new President of the United States, whose contentious election appeared to animate the stock market and boost business and consumer confidence to new heights. The expectation of proposed tax cuts, regulatory reform, and infrastructure spending, pushed markets upward. In fact, you could almost hear the markets humming the 1920's tune *Happy Days Are Here Again*. However, the hoped for stimulus from new government policies has yet to translate into economic activity. As the expansion approaches its ninth anniversary, the slow growth that has persisted over the last few years has not kept the economy from making progress towards becoming the third longest expansion since 1900. Nevertheless, subdued economic growth remains a challenge to policy makers, who despite extraordinary measures, have yet to see their efforts bear any real fruit.

Consumer spending has been trending downward since 2015. Not surprisingly, retail sales are also exhibiting a similar trend. Auto sales, a significant component in the composition of retail sales, have slowed; leaving auto dealers with ample inventory and waiting for manufacture incentives to spur sales. In contrast to the record high auto sales in 2016, consumers have spent less on vehicles during the quarter, according to the Commerce Department. "Even with record-high discounts, U.S. dealerships in March carried 72 days' worth of inventory based on the current sales pace, up from 66 days a year earlier."[2] The extent of the soft retail environment is becoming more

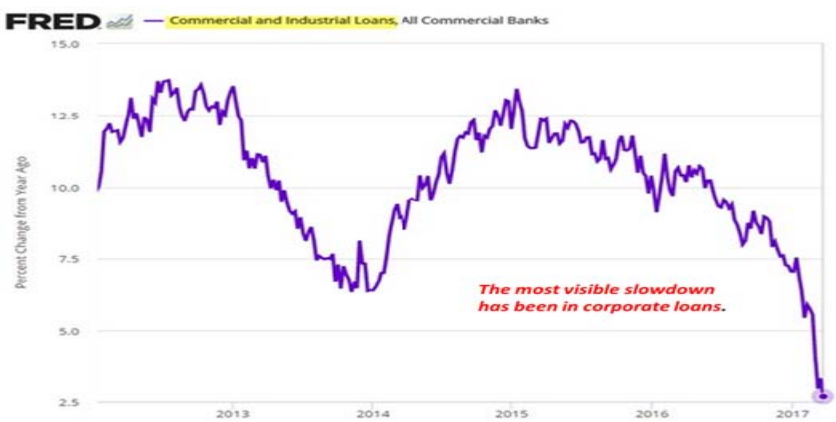
---

[1] Read more at: ttps://www.brainyquote.com/quotes/quotes/j/johnfkenn121068.html?src=t_change

[2] "Confidence Is High but Economic Gains are Elusive" by Eric Morath, **The Wall Street Journal**, April 14, 2017.

apparent, as the number of major retail chains announcing major restructuring, downsizing, or filing for bankruptcy protection is on the rise.

Another change that has given analysts pause is the abrupt slowdown in bank loan growth, with the most visible decline in the commercial and industrial segment. The graph below shows growth between 7% and 14% since 2012, then declining in 2013 in response to softer demand for direct borrowing from banking institutions. The more recent fall off has yet to be fully explained. It could be a repeat of 2013, when there was a temporary hiatus from obtaining credit from banking institutions in favor of going to the bond market. It could also be that business leaders have improved confidence in future business prospects, and are putting plans on hold until they see how Congress revises the corporate tax code. Either way, this change continues to be of interest to investors, as most manufacturing firms continue to have excess capacity to produce goods before expanding to meet current or future demand.




The elongated, disappointingly slow expansion has resulted in a similar pattern of job growth, with unemployment falling from its high of over 10% to its most recent report of 4.5 percent. The lower rate is encouraging, as the labor force participation rate has seen a small blip upward, implying that many folks who had been on the sidelines are finding jobs. Other measures of labor utilization are showing similar reductions. The widely watched U-6 unemployment rate, comprised of those workers that are discouraged or in involuntary part-time positions, was near 17% at its peak in 2009 and has dipped below 9% for the first time since 2008. However, Labor Market Flows have seen a reversal at the end of 2016, with both the Job Openings rate and the Hires rate falling slightly. Another change that seems pertinent is that since 2015, the rate of growth in the number of Job Openings has been greater than the rate of growth in the number of Hires for the first time since the turn of the millennium. This trend seems to coincide with the most recent report from small business owners, who say that they are having a more difficult time finding qualified workers.

Over the past couple of years, measures of housing, labor, retail sales, and industrial production have ebbed and flowed, causing the Federal Reserve to fall short of its 2016 goal to raise rates and reduce the extreme levels of monetary stimulus.  The Federal Reserve position has been to error on the side of slow rate hikes in light of the modest economic recovery and the excess supply of labor.  With three 25 basis point increases under their belt, the Federal Open Market Committee (FOMC) has raised the Fed Funds rate to 75 basis points.  But they still have a long way to go to reach the approximately 3% Fed Funds Rate that Fed Chair Yellen recently implied was the most likely "normal" rate.  Without a more robust level of economic growth and continued improvements on the labor front, the Fed most likely will take until 2019 or 2020 to return the Fed Funds rate to that "normal" level.

Another change confronting investors is the possibility that fiscal stimulus in the form of tax cuts and increased government spending on infrastructure and defense may provide increased jobs and add to GDP growth.  In a perfect world, this would provide the Fed with a much-needed respite, and allow them to stay on plan for raising interest rates over the next 2 years.  The key here is how quickly things will be able to change. However, as the Trump administration found out with their attempt to repeal and replace the Affordable Care Act (ACA), things in Washington take much longer to change than first anticipated.  Likewise, tax reductions and regulatory reform will most likely not happen within the first 180 days of the new administration.  There's always the chance that the *expected benefits* of the proposed changes are offset by the negative impacts of increased deficits that have to be funded by increasing the amount of outstanding Federal Treasury Debt.  This in turn will mean taxpayers will have to pay more in future taxes due to both the higher debt level *and* the increase in interest rates due to the expected Fed Fund rate hikes.

## Bonds & Stocks

With inflation remaining tame and market participants in a wait-and-see mode regarding the speed of Fed policy implementation, interest rates become the next focus of change facing investors.  After a 35-year period in which the predominate trend in interest rates was down, it appears that rates may be ready to reverse direction.  Given the multi-decade trend, it is sobering to contemplate that only those folks over age 60 have ever experienced double-digit interest rates.  Likewise, folks over age 85 have seen rates nearly this low in the 1940's, as well as the peak levels in the 1980's, when lenders loaned money with rates hovering around 20 percent.  Now that was significant change!

Bond investors invest in bonds to keep what they have. Those investors that experienced the late 1970's, know how the combination of increased inflation and rising interest rates caused bond mutual funds to lose a significant portion of their principal. The temporary loss became permanent when bond fund managers sold bonds at a loss to meet the redemption requests of their mutual fund holders. Significant, but unanticipated events (i.e. the OPEC Oil Embargo) in the economic environment at that particular point in time drove these changes in interest rates. A different set of factors will most likely drive the reversal in the interest rate trend today, which depending on the rate of change, could have similar results.

Bond investors should be wary of trying to guess when and how quickly rates will begin their ascent. There are numerous reasons why this interest-rate cycle may be very different. Rising rates may attract money into shorter bonds, as investors breathe a sigh of relief that the Zero Interest Rate Policy (ZIRP) is behind them and they can once again earn something on safe investments. Investors may favor bonds if the proposed fiscal stimulus falls short and the economy continues its slow-growth track. In addition, the twin structural headwinds of an aging population (older folks consume less) and technology substituted for labor, both place a drag on future economic activity.

The bond market appeared to be absorbing the impact of the stock market rally, while keeping an eye on the Fed, during the first quarter. The result was that the bond market traded within a narrow range. The 10-Year U.S. Treasury bond began the quarter at 2.45%, declining to a low of 2.31% and then recovering to a high of 2.62%, before finishing the quarter at 2.40%. In the past quarter, corporate bonds performed slightly better than high quality government bonds. Bonds with longer maturities performed better than shorter-dated credits. Results for a cross section of bond indices are show in the table below.

| **Morningstar Bond Indexes** | | | | *As of 3-31-2017* |
|---|---|---|---|---|
| **Broad Market** | **Quarter** | **1-Year** | **3-Year** | **5-Year** |
| US Core Bd TR Bond | 0.85 | 0.43 | 2.87 | 2.52 |
| US Lng Core Bd TR Bond | 1.5 | 0.5 | 4.9 | 4.3 |
| **US Shrt Core Bd TR Bond** | **0.5** | **0.7** | **1.2** | **1.1** |
| **Corporate** | | | | |
| US Corp Bd TR Bond | 1.4 | 3.3 | 3.6 | 4.0 |
| US Lng Corp Bd TR Bond | 1.7 | 4.6 | 4.9 | 5.2 |
| **US Shrt Corp Bd TR Bond** | **0.9** | **1.9** | **1.8** | **2.2** |
| **Government** | | | | |
| US Gov Bd TR Bond | 0.7 | (1.4) | 2.1 | 1.6 |
| US Lng Gov Bd TR Bond | 1.4 | (3.9) | 4.9 | 3.4 |
| **US Shrt Gov Bd TR Bond** | **0.3** | **0.1** | **0.9** | **0.7** |

In spite of the unusual times we are living in, the stock market provided satisfactory results for the quarter. The table below displays the range of returns earned by mutual fund managers during both this past quarter and the 1-year, 5-year, and 10-year time periods. For the first quarter of 2017, the table illustrates that larger capitalization stocks performed better than smaller capitalization stocks. In addition, lower quality stocks outperformed their higher quality counterparts. On a total return basis for the quarter, the Dow Jones Industrial Average (DJIA) increased +5.2%, while the S&P 500 was up +6.1%. The tech-heavy NASDAQ posted a gain of +9.9%. The average mutual fund, represented as General Equity in the Lipper Table, saw a gain of +4.8% for the quarter. International stock funds appreciated +7.2%.

## LIPPER MUTUAL FUND INVESTMENT PERFORMANCE AVERAGES

**MONDAY, APRIL 17, 2017**

| | Qtr | 1 year | 5 year | 10 year |
|---|---|---|---|---|
| S&P 500 | 5.9 | 16.6 | 12.7 | 6.9 |
| S&P 500 Index P | 5.5 | 14.7 | 10.9 | 5.2 |
| Dow Jones Ind. Average P | 4.6 | 16.8 | 9.4 | 5.3 |
| NYSE Composite P | 3.9 | 12.6 | 7.0 | 2.2 |
| General Equity | 4.8 | 16.5 | 10.4 | 6.0 |
| Equity Income | 3.9 | 15.0 | 10.4 | 6.1 |
| Large-Cap Growth | 9.3 | 14.6 | 11.6 | 7.9 |
| Large-Cap Value | 3.6 | 18.7 | 11.6 | 5.3 |
| Mid-Cap Growth | 7.4 | 16.0 | 10.4 | 7.2 |
| Mid-Cap Value | 3.2 | 18.5 | 11.9 | 6.3 |

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

While bond investors focus on keeping what they have, stock investors focus on growth--both the growth of their underlying businesses and the corresponding growth in their investment portfolio. In a slow growth economic environment, growth is scarce, which in turn causes many investors to chase growth and pay a higher price than they might otherwise in a more normal investment environment. They would do well to heed the sage advice of Warren Buffett in the following quote:

> ***Most people get interested in stocks when everyone else is. The time to get interested is when no one else is. You cannot buy what is popular and do well.***[3]

The current stock market is expensive by most valuation measures, making it vulnerable to shocks that might change the underlying growth trends of the companies investors own. At the end of the 1st Quarter, the S&P 500 Median Price / Earnings (P/E)

[3] The Quotations Page -- http://www.quotationspage.com/quote/39123.html

Ratio was 24.1 X, significantly above the 50-year median P/E of 17.0 X. Similarly, the Shiller P/E ratio ended the quarter at 28.9 X, also significantly above the its average level of 16.7 X. As the chart below suggests, many stock market investors recognize this higher-than-normal valuation. The graphic shows that the percentage of stock market investors who see the U.S. Stock market as overvalued has reached its highest level in the past 17 years.


Experience tells us that when stocks are as expensive as they are today, eventually something will change which will return valuations to a more normal level. The euphoria cannot last forever. The world can change on a dime. Yet, our long-term investment philosophy will remain constant. While change is all around us, we believe sound investment principles, consistently applied, will allow us to navigate successfully the vagaries of the capital markets. We will strive to find investments that will allow us to achieve your long-term investment goals by utilizing a custom-tailored portfolio. We will make every effort through this process to minimize the risks of permanent capital loss. The undertaking of discovering reasonably priced stocks, without sacrificing quality in a high and rising valuation environment, makes the task even more challenging. Nevertheless, we will continue to adhere to our investment discipline, regardless of the market's undulations.