Second Quarter 2018
Quarterly Letter to Clients
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Writing this quarterly letter for the past 18 years here at First Nebraska Trust has been both challenging and rewarding. Our goal from the start was to try to make sense of a world that appears to be going through changes of seismic proportions and put a little perspective around that change. We have not undertaken the folly of trying to forecast the future economic, interest rate, or stock market levels; but instead, to understand the major trends, to the best of our ability, and find ways to deploy your capital to achieve your financial objectives.

There is a lot of abstract thought being bantered about, which captures the imagination of many, but only adds to the difficulty of separating the signal from the noise in a world that is ever more challenging to understand, given the tumult and turmoil driven by the uncertainty of the changing social, political, and economic landscape. Trying to make sense of the world we live in may be an exercise in futility. Nevertheless, this letter will provide a brief overview of the current economic and investment environment to aid you in determining how your accounts have performed during the 2nd Quarter of 2018.

The U.S. Economy appears to be revving its engine during the 2nd Quarter of 2018, possibly making up some lost ground for the paltry performance in the prior quarter. Preliminary indications are that consumers continue to take advantage of relatively low interest rates and are taking on more debt to buy houses, cars, and other assorted goods and services. Retail sales increased 0.5% in June, which on the heels of a healthy 1.3% growth rate in May, should provide a solid foundation for Real GDP growth above the 3-year rolling average of 3 percent. Consumers are feeling the positive impact of tax cuts in their wallets, solid employment prospects, and moderate wage gains. Unemployment crept back up to 4% in June, after flirting with 3.8% in May, a level that has not been recorded since the 1960s. Businesses are hiring more workers to meet growing demand, with an impressive 213,000 jobs added during the month of June.

The manufacturing sector continued to expand at a strong pace, despite the recent threat of increased tariffs and a possible trade war. The June ISM manufacturing index increased to 60.2 and manufacturing output has been rising steadily since the 2nd quarter of 2016. Manufacturing, which was hit hard during the Great Recession, has added 1.2 million jobs since March 2010, with strength in supply deliveries and improvements in the oil patch both contributing significantly to the sector's improvement. Capacity Utilization, at 75.3%, remained well below the 85% level that is considered inflationary and a sign that businesses need to invest in additional plant and equipment to meet demand.

However, manufacturers could find a headwind in the tariff squabble if trade disputes evolve into a more aggressive exchange between the U.S. and its trading partners. Some companies may use the general concern as a chance to test higher prices in their respective markets, while others may see some margin pressures, as the higher costs of inputs get more difficult to offset with other cost containment measures. While the threat of a global trade war is at the top of almost every news source, the magnitude of this possible threat won't be known for 12 to 18 months from now. It's difficult to project the actions of companies that have several options to respond to both a temporary or more permanent impacts of retaliatory tariffs.

Many companies will consider measured responses if they believe the tariffs imposed for only a short time period. For instance, since a foreign tariff essentially increases the price of a U.S. good sold into a foreign market, a company could use the tax cut they just received to reduce their price and offset the short-term tariff impact to their profits. Some companies may shift production abroad, which could mean layoffs and plant closures, if it is believed that the trade disputes are expected to continue for the foreseeable future. Additionally, our government may respond to increased retaliatory foreign tariffs by providing domestic buyers tariff exemptions, or in the case of agriculture, increased subsidies could be added in the next farm bill to offset the negative impacts of tariffs. Finally, U.S. consumers may feel the impact of tariffs in the form of higher import prices, which could give an additional boost to the already climbing inflation numbers.

Central Bankers around the globe are beginning to reduce their accommodative monetary policy stance, which in layman's terms means that they are increasing interest rates and, in many cases, simultaneously reducing their intervention (or, if you prefer, manipulation) of the bond markets. Since 2016, the Federal Reserve has increased its short-term Fed Funds Rate from near zero to the current range of between 1.75% and 2%. The new Federal Reserve Chairman, Jerome Powell, has picked up the baton of policy transparency and measured changes from his predecessor, Janet Yellen, and has repeatedly affirmed the Fed's plan to implement future rate changes in a gradual manner. It is the Chairman's opinion that this will give the rate-setting committee ample room to negotiate the potential impacts of inflation picking up or GDP growth slowing down.

Bonds

The Fixed Income Markets have responded accordingly, with the short end of the yield curve now up over 100 basis points in the past year in response to the Fed's actions. However, the long maturity range of the yield curve is now dealing with the twin impacts of higher fiscal deficits that need to be funded with U.S. Treasury debt and the change in the Federal Reserve's Quantitative Easing (QE) policy. Funding deficits with debt means that there will be an increase in the supply of U.S. Treasuries, putting downward pressure on prices and increasing long-term interest rates. Similarly, with the Fed reversing its QE program, there will be less demand from the Fed buying long-dated U.S. Treasury Notes and Bonds, which could also depress pricing and provide another upward bump to interest rates. Obviously, this is why the Fed Chairman is an advocate of the aforementioned gradual rate increase.

Over the past quarter, interest rates remained variable, with bond investors seeing negative returns almost across the maturity and credit spectrums. Lower quality bonds underperformed higher-quality credits, as spreads widened on corporate debt and risk-aversion increased. Yields on treasury bonds continue to oscillate within a trading range. Over the past quarter, the 10-year Treasury bond traded to yield between 2.73% and 3.11%, posting a yield of 2.85% at the end of June.

Morningstar Bond Indexes *As of 6-30-2018*

	Quarter	1-Year	3-Year	5-Year
US Inter Core Bd TR Bond	0.1	(0.4)	1.6	2.4
US Lng Core Bd TR Bond	(1.1)	(1.3)	3.5	4.2
Corporate				
US Corp Bd TR Bond	**(1.0)**	**(0.9)**	**3.0**	**3.5**
US Inter Corp Bd TR Bond	(0.3)	(0.8)	2.3	3.1
US Lng Corp Bd TR Bond	(2.2)	(1.7)	4.3	4.8
Government				
US Gov Bd TR Bond	**0.1**	**(0.7)**	**1.0**	**1.5**
US Inter Gov Bd TR Bond	(0.1)	(1.3)	0.8	1.3
US Lng Gov Bd TR Bond	0.1	(0.9)	2.5	3.6

We believe that it will be nearly impossible to predict the future level of interest rates. However, there continues to be a reasonably decent chance that rates will move higher over our investment horizon. Thus, we maintain our recommendation that new investments in the fixed income arena be made with a *bias towards* capital preservation and with an emphasis on purchasing higher-quality credits. Our preference will be to maintain existing (or construct new) fixed income portfolios with a target average maturity in the 5 to 7 year range, to reduce the potential adverse impacts of a large increase in interest rates in the next couple of years.

Stocks

Stock market valuations continue to be strained, while performance continues to be driven by just a few technology stocks. The zeal for these top performers carried over from last year into the first half of this year. As the table on the next page demonstrates, Amazon, Alphabet, Apple, Microsoft and Facebook accounting for 98% of the S&P 500's year-to-date advance. [1] Likewise, these same stocks provided over 100% of the Nasdaq's YTD return. Overall, the technology sector continues to be the largest weighting in the S&P 500 Index, making up almost 26% of the index. This outpaces the second place financial sector, whose components make up 14% of the index. As stated in last quarter's letter, "With two-fifths of the index returns coming from these two econcomically sensitive sectors, investors should take note on just how much reported returns are dominated by an ever smaller number of companies."[2]

	% of S&P 500's YTD Returns	% of Nasdaq 100's YTD Returns	YTD Change
Amazon	35%	41%	49%
Netflix	21%	21%	117%
Microsoft	15%	15%	19%
Apple	12%	12%	13%
Alphabet	8%	8%	11%
Facebook	8%	8%	16%
Top 3	**71%**	**78%**	
Top 4	**83%**	**90%**	
Top 6	**98%**	**105%**	

The Lipper Performance table on the next page 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 second quarter of 2018, the table illustrates that smaller capitalization stocks underperformed again when compared to larger capitalization stocks. In addition, for the sixth quarter in a row, lower-quality stocks outperformed their higher-quality counterparts. On a total return basis for the quarter, the Dow Jones Industrial Average (DJIA) increased +1.3%, while the S&P 500 was up 3.4%. The tech-heavy NASDAQ posted a gain of +6.6%, outpacing

[1] Hat Tip: @carlquintanilla – July 9, 2018

[2] This concentration of returns is reminicient of the pattern seen 18 years ago, just prior to the peak in the stock market, when it appeared there was no stopping the upward, gravity-defying trend of technology and telecommuncations Dot.com stocks.

most other major indices. The average mutual fund, represented as Equity Income Fund in the table, saw an increase of +2.0% for the quarter. International funds faired much worse, declining -2.1% for the quarter, providing additional evidence of the wide dispersion of returns over this past quarter.

LIPPER MUTUAL FUND INVESTMENT

Performance Averages

Friday, July 06, 2018

Investment Objective	2nd qtr	YTD	1-year	3-year	5-year
S&P 500 Daily Reinv IX	3.4	2.7	14.4	11.9	13.4
DJ Ind Dly Reinv Avg IX	1.3	(0.7)	16.3	14.1	13.0
Multi-Cap Value Funds	1.5	(1.1)	8.4	7.7	9.7
Equity Income Funds	2.0	(0.5)	8.8	8.4	9.4
Large-Cap Core Funds	2.8	1.7	12.7	10.0	11.9
Large-Cap Growth Funds	5.7	9.0	22.4	13.3	15.3
Large-Cap Value Funds	1.2	(1.3)	8.3	8.0	9.9
Mid-Cap Core Funds	2.9	1.6	10.4	7.8	10.4
Mid-Cap Growth Funds	4.4	7.5	19.2	10.0	12.7
Mid-Cap Value Funds	2.2	(0.1)	8.0	7.3	9.9
International Stock Funds	(2.1)	(2.7)	7.1	4.9	6.2

Sources: Lipper; WSJ Market Data Group

High quality new ideas appear to be in short supply at the present time. Thus, we continue to search out situations where we believe a company is undervalued relative to *our* estimate of its worth. Likewise, we will continue to trim or sell those stocks that exceed our estimate of value, irrespective of the gymnastics of the general markets. Our investment horizon continues to be long-term, with a focus on buying companies that appear to provide an acceptable risk/return tradeoff. Our preference continues to be to assemble and maintain a well-diversified portfolio of companies with a history of earnings, dividends, and cash flow growth that can provide us with exposure to most economic sectors of the economy.