

ECONOMIC AND MARKET COMMENTARY

OUR MISSION

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4th Quarter 2018

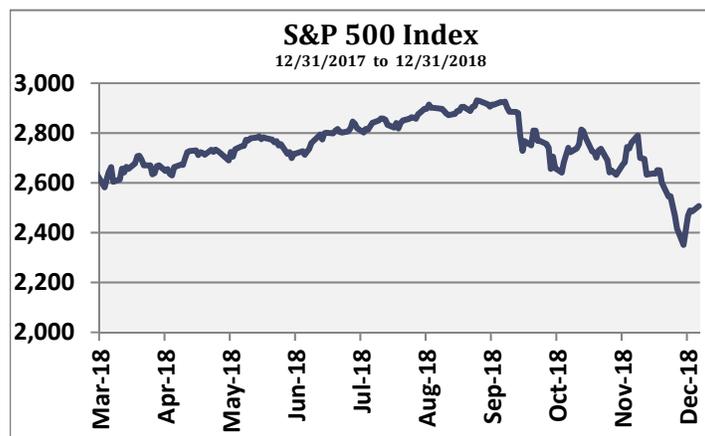
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I. 2018 Equity Market Recap

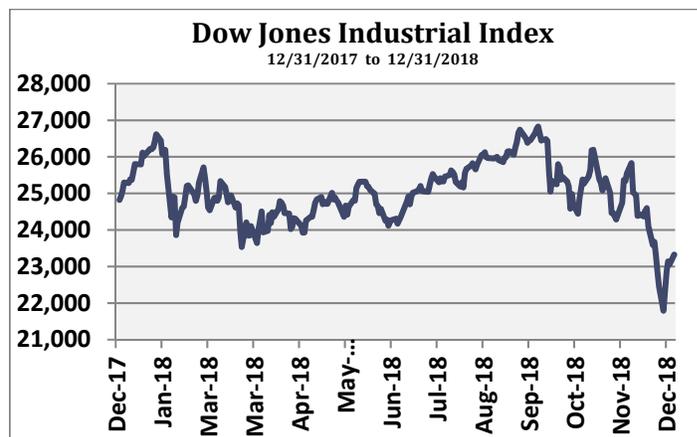
Equity markets closed out a turbulent year on a bright note on the last trading day, but still finished 2018 with the worst showing in a decade.

After setting a series of records through the late summer and early fall, major U.S. indexes fell sharply beginning in early October, leaving them in the red for the year as a whole.



The S&P 500 Index, the market's main institutional benchmark, finished the year with a loss of 6.2% (4.4% loss with dividends reinvested). The last time the Index fell for the year was in 2008 during the financial crisis. The S&P 500 posted small price losses in 2011 and 2015, but eked out small gains in both years once dividends were included.

The Dow Jones Industrial Average declined 5.6% (in price terms) for the year, while the Nasdaq composite slid 3.9%.



Major indexes in Europe also ended 2018 in the red. France's CAC 40 finished the year down 11%. Britain's FTSE 100 lost 12.5%. Germany's DAX ended the year in a bear market, down 22% from a high set in January and 18% from the start of the year. Most Asian markets likewise lost ground in 2018.

Wall Street started 2018 on a strong note, buoyed by a growing economy and corporate profits. Stocks climbed to new highs early in the year, shook off a sudden, steep drop by spring, and rode a wave of tax cut-induced corporate earnings growth to another all-time high by September. Then the jitters set in.

Investors grew worried that the testy U.S.-China trade dispute and higher interest rates would slow the economy, hurting corporate profits. A slowing U.S. housing market and forecasts of weaker global growth in 2019 stoked traders' unease.

*Registration of an Investment Adviser does not imply any certain level of skill or training.

In October, the market's gyrations grew more volatile.

The autumn sell-off knocked the benchmark S&P 500 Index into a correction, or a drop of 10 percent from its all-time high, for the second time in nine months. A Christmas Eve plunge brought the index briefly into bear market territory, or a drop of 20% from its peak, before closing the trading day just short of that threshold.

Health care stocks posted a 4.7% gain in 2018, leading all other sectors in the S&P 500. Utilities were the only other sector to eke out an annual gain, adding 0.5%.

Technology companies, a big driver of the market's gains before things deteriorated in October, ended the year with a 1.6% loss.

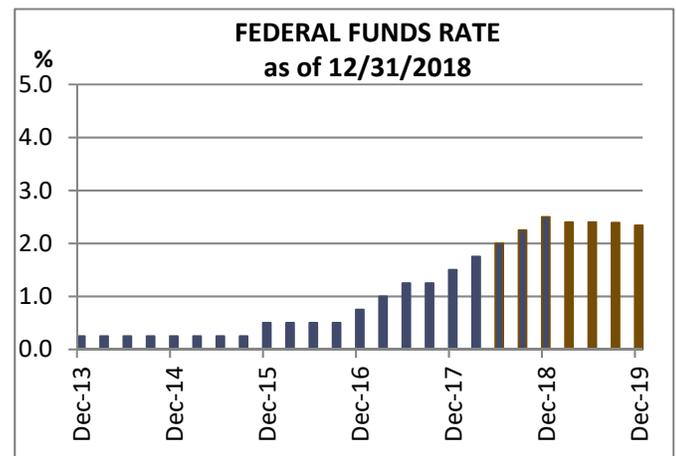
Energy companies fared the worst, plunging 20.5% for the year, as the price of U.S. crude oil tumbled 40% from a four-year peak of \$76 a barrel in October.

The risks confronting investors have market strategists on Wall Street forecasting another turbulent year for stocks in 2019, with wide discrepancies in projected year-end S&P 500 price targets, implying price returns ranging from 6% (Wells Fargo) to 25-30% (UBS, Deutsche Bank, JPMorgan).

II. 2018 Bond Market Recap

U.S. Treasury debt produced its fifth straight annual gain in 2018 as a December rally, fueled by falling U.S. stocks and fading expectations for Fed rate increases in 2019, erased losses posted earlier in the year that were driven by increased issuance, strong employment data and equity market gains.

Treasuries began the year with their biggest January loss since 2009, anticipating auction size increases that began in February and brought net issuance during the year to \$688 billion versus \$399 billion in 2017. Treasuries ended the year with their biggest monthly gain since June 2016, as equity benchmarks and oil fell to intra-year lows and short-term rate futures all but priced out a Fed rate increase in 2019.



Bar chart data in brown indicates projections implied by fed funds futures.

During the year, benchmark yields mostly tracked higher through the first three calendar quarters, reaching multiyear highs in November. They began to retreat after the U.S. midterm elections transferred control of the House to the Democrats, and as stocks and oil slumped.

The Bloomberg Barclays U.S. Treasury Index returned 0.86% for the year, as coupon income offset price declines; the index's full-year gain was the smallest since 2015. For the year as a whole, two-year Treasury yields rose by 60 basis points, while five- and ten-year Treasury yields increased by approximately 30 basis points.

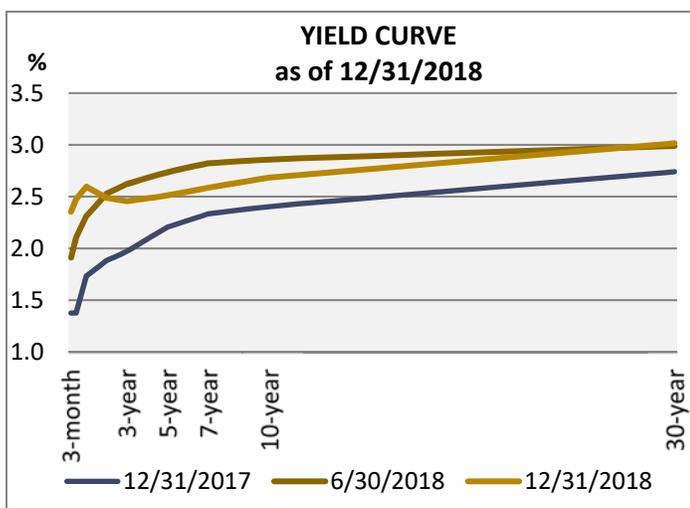
As short-maturity yields rose more than long-maturity yields, the spread between ten-year and two-year yields reached a low of 11 basis points in mid-December, the lowest since 2007. Segments of

the curve inverted, including 5s/2s and 5s/3s; at year-end, only 3s/2s remained inverted.

Jerome Powell succeeded Janet Yellen as Fed chair in February, and the central bank raised rates once per quarter, as expected, taking the target range for fed funds from 1.25%-1.50% at the start of the year to 2.25%-2.5% by year end. Announcing its final move of the year on December 19th, the FOMC scaled back its median forecast for increases in 2019 to two from three and said global economic and financial developments will dictate the course of U.S. monetary policy in 2019.

Breakeven rates on Treasury inflation protected securities (reflecting market-based inflation expectations) were buoyed to multiyear highs in February by larger-than-forecasted increases in wages and CPI, then slumped to the lowest levels in more than a year in December, exacerbated by a 40% decline in oil prices during the fourth quarter.

Across other fixed-income markets, European government bonds ended little changed as measured by Bloomberg Barclays Pan-European Aggregate, while U.S. corporate bonds lost 2.5%, as credit spreads widened for the first time since 2015.



III. Why We Should Indeed Worry About The U.S. Treasury Yield Curve Inverting

by Frances Coppola, Senior Contributor, Forbes Magazine

An inverted U.S. Treasury yield curve is widely thought to signal an impending economic downturn. Every recession since World War II has been preceded by an inverted yield curve. Of course, an inverted yield curve is only an expression of investors' views of the economic outlook, and, as we all know, investors can be wrong. In addition, since the financial crisis, markets have been so distorted by central bank policy that an inverted yield curve perhaps doesn't signal quite what it used to. So, maybe we shouldn't worry about the yield curve inverting.

Or - should we? A new post by the St. Louis Federal Reserve suggests that people might be right to be worried about yield curve inversion. And the reason lies in the behavior of banks.

The U.S. Treasury yield curve is said to be "inverted" when the yield on short-term bonds is higher than that on long-term bonds. Normally, investors expect higher returns on longer-dated bonds to compensate them for higher interest-rate and liquidity risks on such bonds. But if investors think the short-term economic outlook is poor, they may sell off shorter-term bonds while holding on to longer-term ones, raising the yield on shorter-term bonds relative to that on longer-term bonds. This is the reason an inverted yield curve is often seen as an indicator of a forthcoming recession.

The bonds most widely used to measure the slope of the yield curve are 2-year and 10-year Treasury notes. So far, the 10-year versus 2-year portion of the curve has not inverted, though it is extremely flat (the spread between the Treasury

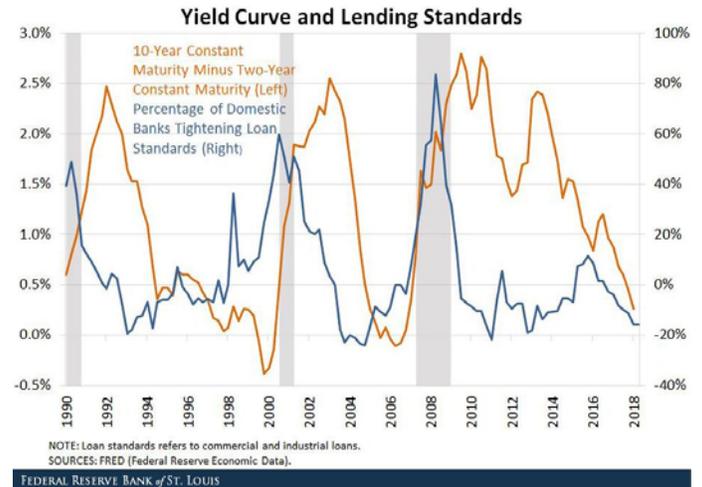
notes was only 19 basis points at the end of the year).

An inverted yield curve is problematic for banks because banks earn profits on the spread between their funding cost and their return on lending. When the yield curve is upwards sloping, it is in banks' best interests to borrow short-term funds and lend long-term. This is known as "maturity transformation." Maturity transformation has always been at the heart of simple "boring" banking, as exemplified in the traditional bank manager's adage: "Borrow at 3%, lend at 6%, be on the golf course by 3." But if short-term funds become more expensive than long-term funds, then banks can see their spread profits evaporate, especially if they have kept longer-term loans on their books instead of securitizing them.

It's not just commercial banks that can be hurt when short-term interest rates rise above long-term ones. Between 1980 and 1995, a third of U.S. savings & loan associations failed because the Fed's high interest rates at the time raised their cost of funds above the fixed interest rates on the long-term mortgage loans on their books.

When lending becomes less profitable, banks tend to reduce overall lending. Typically, they do this by tightening credit standards, making it harder for borrowers to obtain loans. So, if an inverted yield curve means they actually lose money on lending, banks might tighten lending standards considerably. The chart from the St. Louis Fed's post duplicated below suggests that this is exactly the way banks behave. For example, in 2000, when the yield curve sank to minus 0.3%, the proportion of banks tightening lending standards rose from less than 10% to 60%.

The source of the information in this commentary is SSW and Bloomberg Research unless otherwise noted.



UST yield curve and bank lending standards ST. LOUIS FEDERAL RESERVE

Of course, this chart doesn't tell us whether the tightening was due to the inverted yield curve itself or to general economic factors. So, the St. Louis Fed directly questioned banks as to how they would respond to a moderately inverted yield curve. The answer was eye-opening:

"Many of those surveyed indicated that they would tighten lending standards or price terms on every major loan category."

If the responses to the survey are to be believed, the correlation between an inverted yield curve and tightening bank lending standards shown in the chart above is causative. Banks respond to an inverted yield curve by cutting lending. And if banks cut lending, the economy tends to slow.

But an inverted yield curve is itself an indicator that the economy is slowing. So, if banks reduce their lending in response to an inverted yield curve, the slowdown is amplified. Thus, in the words of the St. Louis Fed:

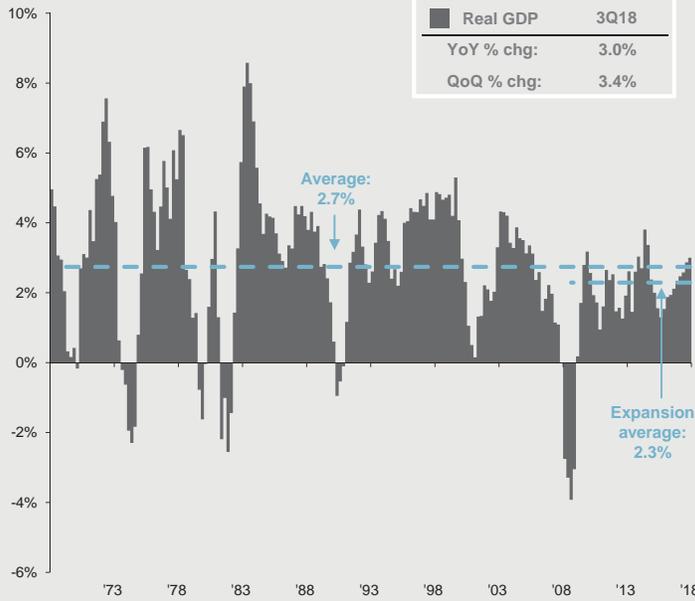
"An inverted yield curve might do more than predict a recession: it might actually cause one."

Investors, therefore, would do well to consider the possibility that the U.S. Treasury yield curve might soon invert.

Economic growth and the composition of GDP

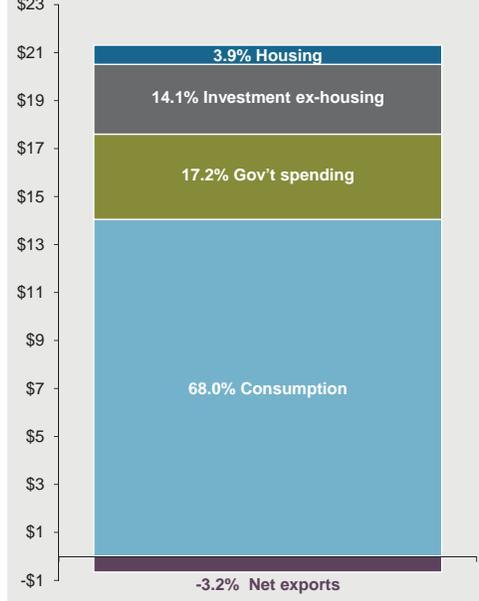
Real GDP

Year-over-year % change



Components of GDP

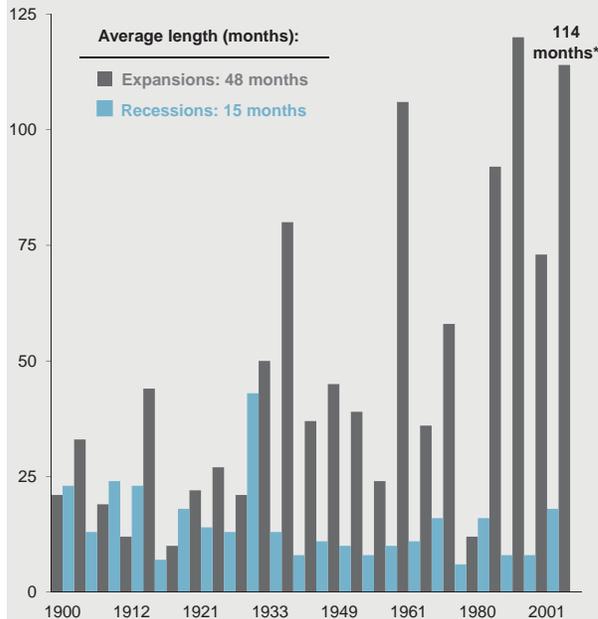
3Q18 nominal GDP, USD trillions



Source: BEA, FactSet, J.P. Morgan Asset Management.
 Values may not sum to 100% due to rounding. Quarter-over-quarter percent changes are at an annualized rate. Average represents the annualized growth rate for the full period. Expansion average refers to the period starting in the third quarter of 2009.
 Guide to the Markets – U.S. Data are as of December 31, 2018.

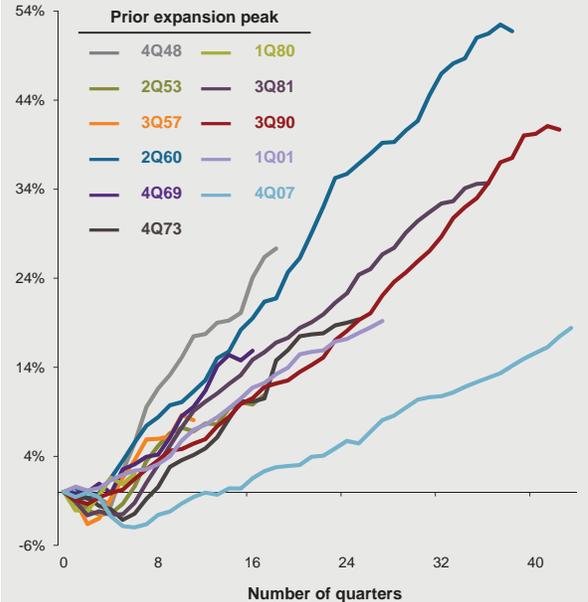
The length and strength of expansions

Length of economic expansions and recessions



Strength of economic expansions

Cumulative real GDP growth since prior peak, percent



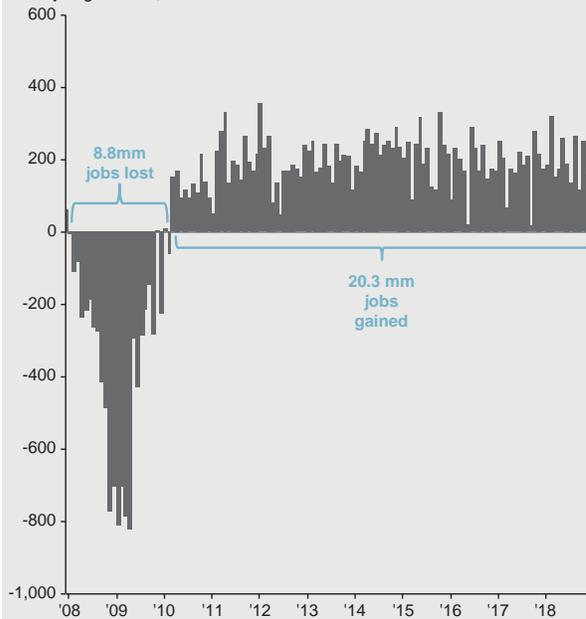
Source: BEA, NBER, J.P. Morgan Asset Management. *Chart assumes current expansion started in July 2009 and continued through December 2018, lasting 114 months so far. Data for length of economic expansions and recessions obtained from the National Bureau of Economic Research (NBER). These data can be found at www.nber.org/cycles/ and reflect information through December 2018. Past performance is not a reliable indicator of current and future results.
 Guide to the Markets – U.S. Data are as of December 31, 2018.

Labor market perspectives

Economy

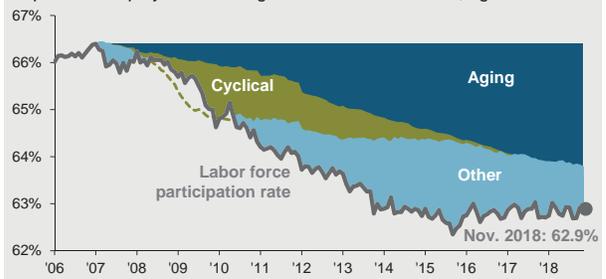
Employment – Total private payroll

Total job gain/loss, thousands



Labor force participation rate decline since 2007 peak*

Population employed or looking for work as a % of total, ages 16+



Net job creation since February 2010

Millions of jobs



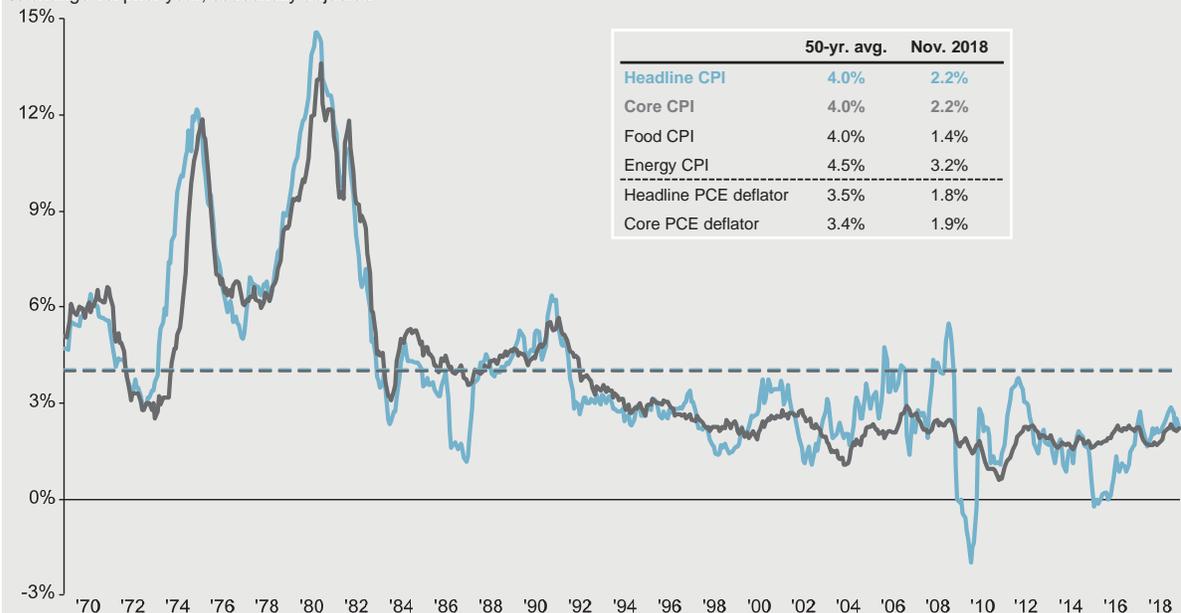
Source: BLS, FactSet, J.P. Morgan Asset Management. (Bottom right) Info. fin. & bus. svcs. = Information, financial activities and professional and business services; Mfg. trade & trans. = Manufacturing, trade, transportation and utilities; Leisure, hosp. & other svcs. = Leisure, hospitality and other services; Educ. & health svcs. = Education & health services; Mining & construct. = Natural resources mining and construction; Gov't = Government. *Aging effect on the labor force participation rate is the estimated number of people who are no longer employed or looking for work because they are retired. Cyclical effect is the estimated number of people who lose their jobs and stop looking for work or do not look for work because of the economic conditions. Other represents the drop in labor force participation from the prior expansion peak that cannot be explained by age or cyclical effects. Estimates for reason of decline in labor force participation rate are made by J.P. Morgan Asset Management. *Guide to the Markets – U.S. Data* are as of December 31, 2018.

Inflation

Economy

CPI and core CPI

% change vs. prior year, seasonally adjusted

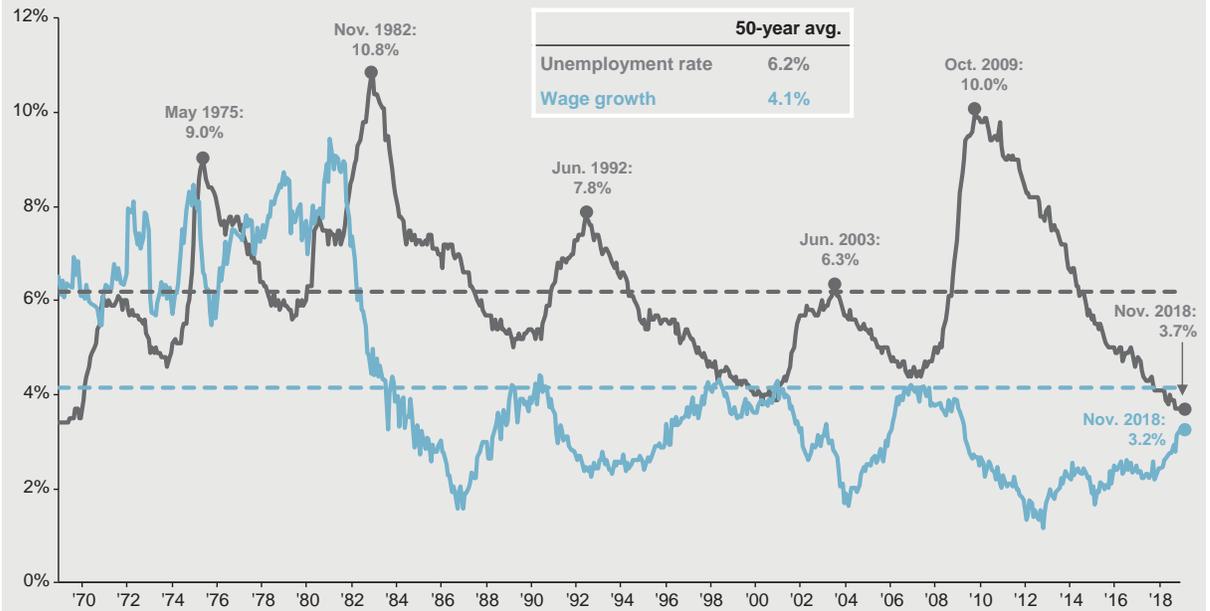


Source: BLS, FactSet, J.P. Morgan Asset Management. CPI used is CPI-U and values shown are % change vs. one year ago. Core CPI is defined as CPI excluding food and energy prices. The Personal Consumption Expenditure (PCE) deflator employs an evolving chain-weighted basket of consumer expenditures instead of the fixed-weight basket used in CPI calculations. *Guide to the Markets – U.S. Data* are as of December 31, 2018.

Unemployment and wages

Civilian unemployment rate and year-over-year wage growth for private production and non-supervisory workers

Seasonally adjusted, percent

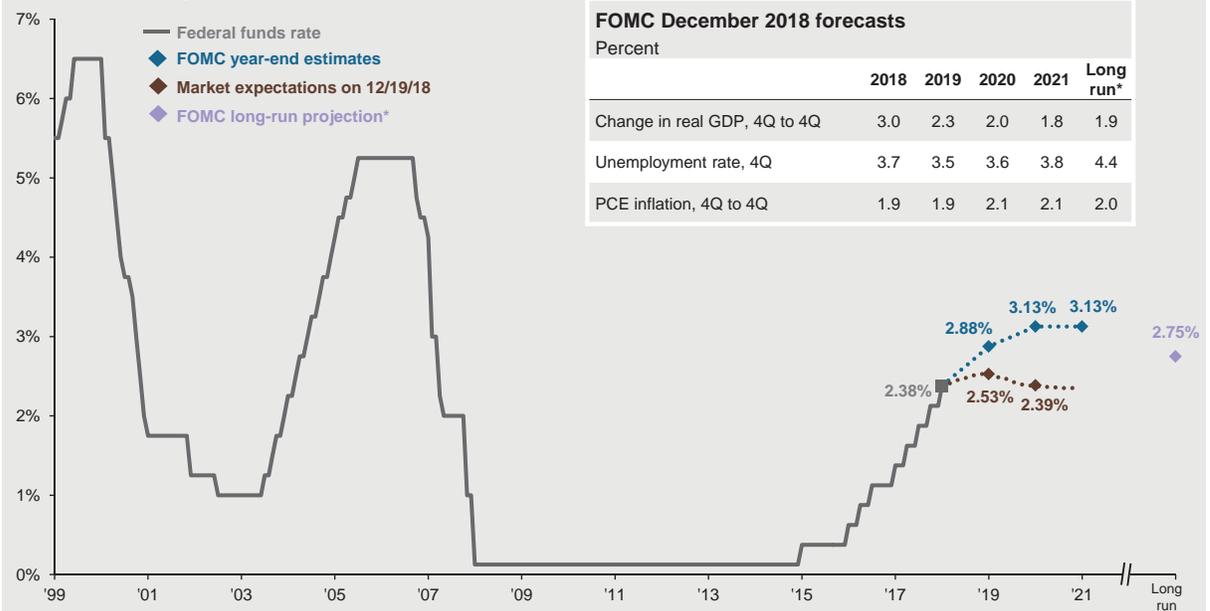


Source: BLS, FactSet, J.P. Morgan Asset Management.
 Guide to the Markets – U.S. Data are as of December 31, 2018.

The Fed and interest rates

Federal funds rate expectations

FOMC and market expectations for the federal funds rate



Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Asset Management.
 Market expectations are the federal funds rates priced into the fed futures market as of the date of the December 2018 FOMC meeting and are through November 2021. *Long-run projections are the rates of growth, unemployment and inflation to which a policymaker expects the economy to converge over the next five to six years in absence of further shocks and under appropriate monetary policy.
 Guide to the Markets – U.S. Data are as of December 31, 2018.

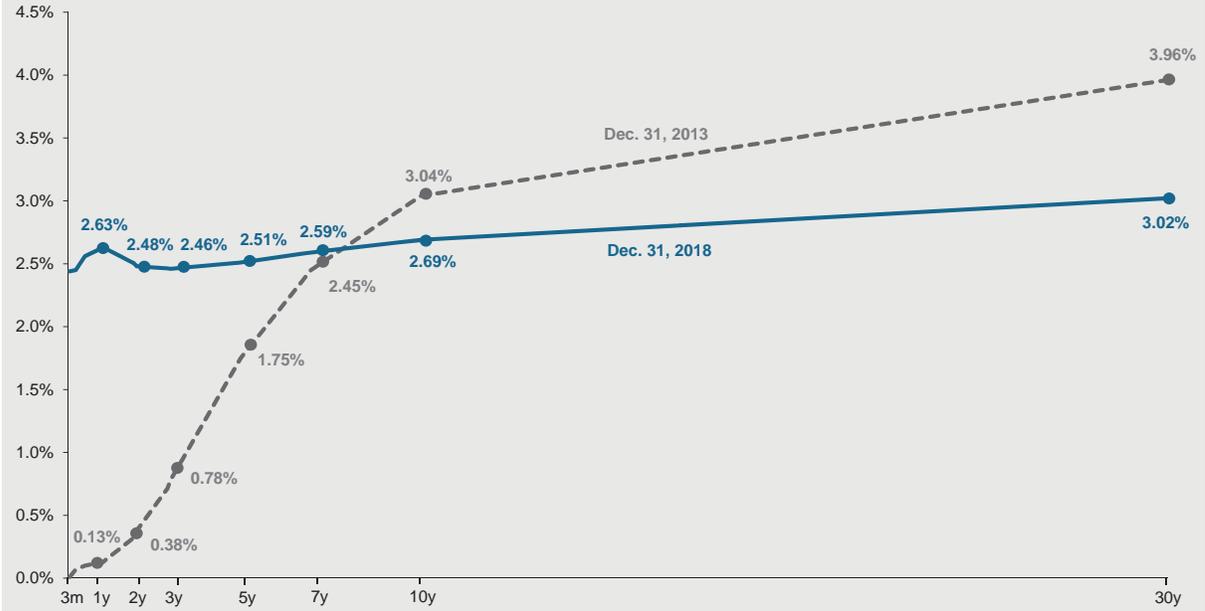
Economy

Fixed income

Yield curve

Yield curve

U.S. Treasury yield curve



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management. Guide to the Markets – U.S. Data are as of December 31, 2018.

Fixed income

U.S. yield curve inversion and recessions

U.S. yield curve steepness

Short-term yield versus long-term yield spread*



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management. *From January 1962 to May 1976 short-term bond is U.S. 1-year bond. Short-dated bond is 2-year from June 1976. Time to recession is calculated as the time between the final sustained inversion of the yield curve prior to recession, and the onset of recession. Guide to the Markets – U.S. Data are as of December 31, 2018.

Fixed income

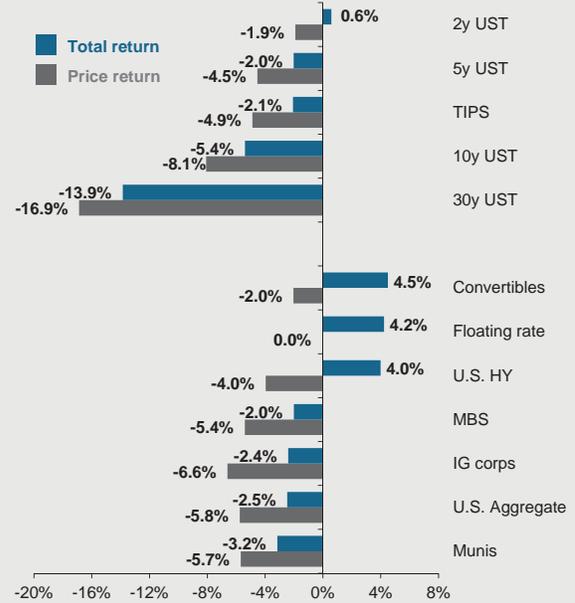
Fixed income yields and returns

Fixed income

	Yield			Return		
	12/31/2018	12/31/2017	2018	Avg. Maturity	Correlation to 10-year	Correlation to S&P 500
U.S. Treasuries						
2-Year	2.48%	1.89%	1.40%	2 years	0.72	-0.17
5-Year	2.51%	2.20%	1.42%	5	0.92	-0.23
TIPS	0.98%	0.44%	-1.26%	10	0.62	0.07
10-Year	2.69%	2.40%	0.00%	10	1.00	-0.31
30-Year	3.02%	2.74%	-2.72%	30	0.92	-0.32
Sector						
Convertibles	6.54%	6.35%	-2.03%	-	-0.35	0.88
Floating Rate	4.26%	2.05%	0.92%	3.0	-0.42	0.35
High Yield	7.95%	5.72%	-2.08%	5.8	-0.27	0.63
MBS	3.39%	2.91%	0.99%	7.2	0.77	-0.14
Broad Market	3.28%	2.71%	0.01%	8.2	0.87	-0.06
Corporates	4.20%	3.25%	-2.51%	10.7	0.46	0.23
Municipals	2.53%	2.26%	1.41%	10.0	0.56	-0.13

Impact of a 1% rise in interest rates

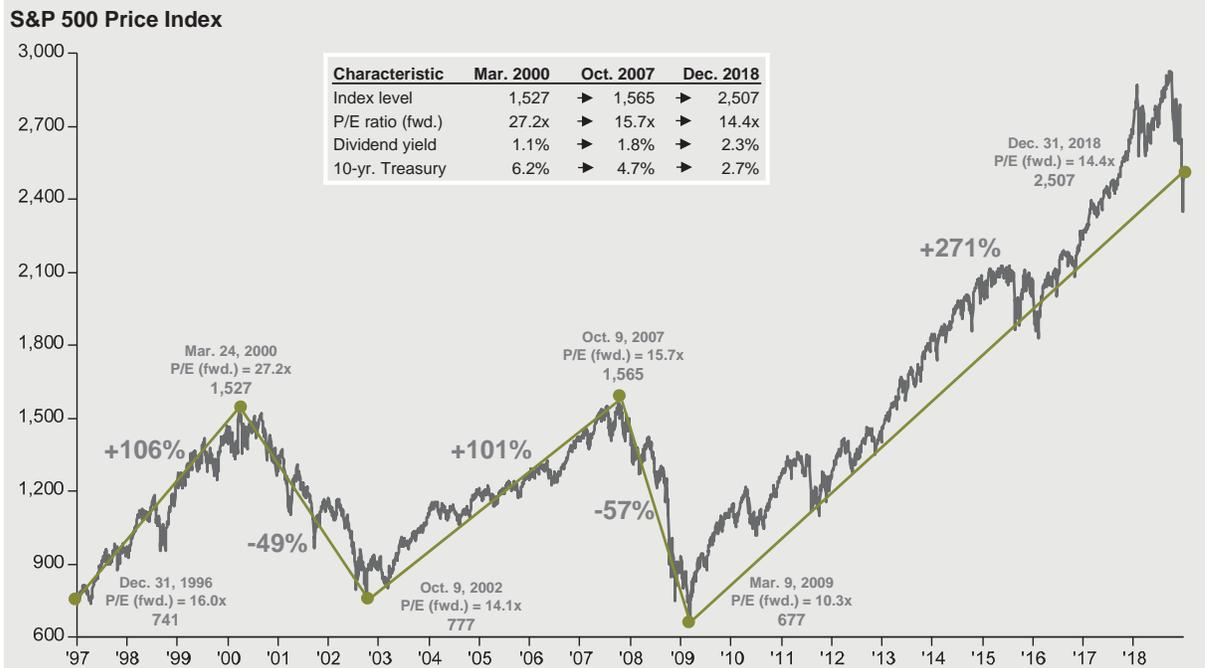
Assumes a parallel shift in the yield curve and steady spreads



Source: Barclays, Bloomberg, FactSet, Standard & Poor's, U.S. Treasury, J.P. Morgan Asset Management. Sectors shown above are provided by Bloomberg and are represented by – Broad Market: U.S. Aggregate; MBS: U.S. Aggregate Securitized - MBS; Corporate: U.S. Corporates; Municipals: Muni Bond 10-year; High Yield: Corporate High Yield; TIPS: Treasury Inflation-Protection Securities (TIPS); Floating Rate: FRN (BBB); Convertibles: U.S. Convertibles Composite. Yield and return information based on bellwethers for Treasury securities. Sector yields reflect yield to worst. Convertibles yield is based on US portion of Bloomberg Barclays Global Convertibles. Correlations are based on 10-years of monthly returns for all sectors. Change in bond price is calculated using both duration and convexity according to the following formula: $New\ Price = (Price + (Price * Duration * Change\ in\ Interest\ Rates)) + (0.5 * Price * Convexity * (Change\ in\ Interest\ Rates)^2)$. Chart is for illustrative purposes only. Past performance is not indicative of future results.
Guide to the Markets – U.S. Data are as of December 31, 2018.

S&P 500 Index at inflection points

Equities



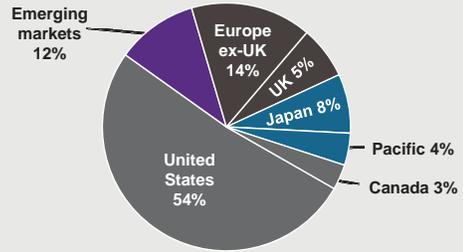
Source: Compustat, FactSet, Federal Reserve, Standard & Poor's, J.P. Morgan Asset Management. Dividend yield is calculated as consensus estimates of dividends for the next 12 months, divided by most recent price, as provided by Compustat. Forward price to earnings ratio is a bottom-up calculation based on the most recent S&P 500 Index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates. Returns are cumulative and based on S&P 500 Index price movement only, and do not include the reinvestment of dividends. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of December 31, 2018.

Global equity markets

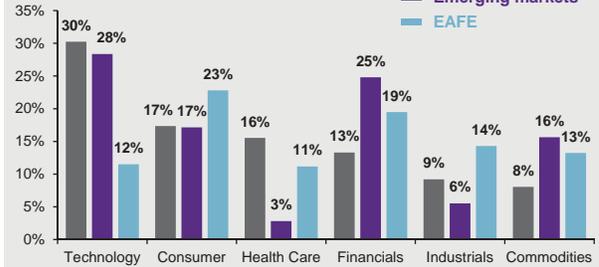
International

Returns	2018		2017		15-years	
	Local	USD	Local	USD	Ann.	Beta
Regions						
U.S. (S&P 500)	-	-4.4	-	21.8	7.8	0.86
AC World ex-U.S.	-10.2	-13.8	18.8	27.8	5.7	1.11
EAFE	-10.5	-13.4	15.8	25.6	5.2	1.07
Europe ex-UK	-10.6	-14.4	14.5	27.8	5.7	1.22
Emerging markets	-9.7	-14.2	31.0	37.8	8.3	1.28
Selected Countries						
United Kingdom	-8.8	-14.1	11.8	22.4	4.1	1.01
France	-7.5	-11.9	14.1	29.9	5.4	1.23
Germany	-17.7	-21.6	12.9	28.5	6.1	1.34
Japan	-14.9	-12.6	20.1	24.4	4.0	0.76
China	-18.6	-18.7	55.3	54.3	9.9	1.25
India	1.4	-7.3	30.5	38.8	10.0	1.37
Brazil	16.7	-0.1	26.9	24.5	10.0	1.51
Russia	17.8	0.2	1.2	6.1	4.8	1.54

Weights in MSCI All Country World Index
% global market capitalization, float adjusted



Global equities by sector
% of index market capitalization



Source: FactSet, Federal Reserve, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
All return values are MSCI Gross Index (official) data. 15-year history based on U.S. dollar returns. 15-year return and beta figures are calculated for the time period 12/31/03-12/31/18. Beta is for monthly returns relative to the MSCI AC World Index. Chart is for illustrative purposes only. Please see disclosure page for index definitions. Past performance is not a reliable indicator of current and future results.
Sector breakdown includes the following aggregates: Technology (communication services and technology), consumer (consumer discretionary and staples), and commodities (energy and materials). The graph excludes the utilities and real estate sectors for illustrative purposes.
Guide to the Markets – U.S. Data are as of December 31, 2018.