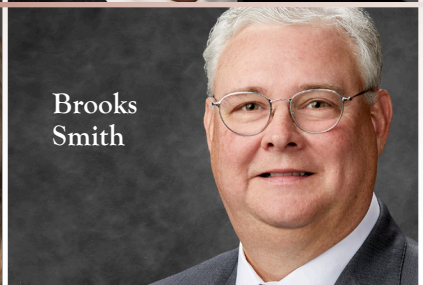
A Matter of Trust

First Quarter 2019



First Quarter Investment Update

Todd Wetsel
Senior Vice President
Senior Trust Portfolio Manager

Todd has 16 years of trust and banking experience. He began his career with Bank of America while attending West Texas A&M University. After graduating with a Bachelor of Business Administration, he went to work for the trust department at Herring Bank where he served as an assistant trust administrator. Todd enlisted in the United States Army in 2005 and served two tours of duty in Iraq. In 2010, he joined HAPPY STATE BANK where his principal duties include market research and portfolio management. Todd has attended the Texas Trust School and Texas Graduate Trust School offered by the Texas Bankers Association. He is a member of the Amarillo East Rotary Club and serves on the board of the Wesley Community Center Foundation.

We can all breathe a big sigh of relief. The Federal Reserve has stopped raising rates! Maybe. At least for now. We will have to wait and see. In all seriousness though, the Fed is now taking a pause on raising rates, which is the best news we could receive as far as the equity markets are concerned. You will remember that as 2018 drew to a close, the Fed continued to raise rates, seemingly on auto-pilot, and the markets were in a state of panic. In January they changed course, prompting a relief rally in the markets. The theme for the first quarter was very much a "wait and see" approach, but it appears unlikely they will raise rates again this year. Let's see where this takes us.

Economy

The trend of the U.S. outperforming global economies, as measured by gross domestic product, continued in the first quarter. U.S. GDP growth was 3.2%, beating economists' estimates of 2.5%. The U.S. economy grew at a 2.9% clip for the full calendar year of 2018. As you can see in Exhibit 1, there was a boost in economic growth in the second quarter of 2018 due to the effect of the tax cuts, however the growth rate has since been slowing. Expectations for GDP growth for the rest of the year are generally in the 2% to 2.5% range. Consumer confidence has rebounded since the government shutdown with inflation recently hitting 2%, excluding food and energy, for the first time since 2012.

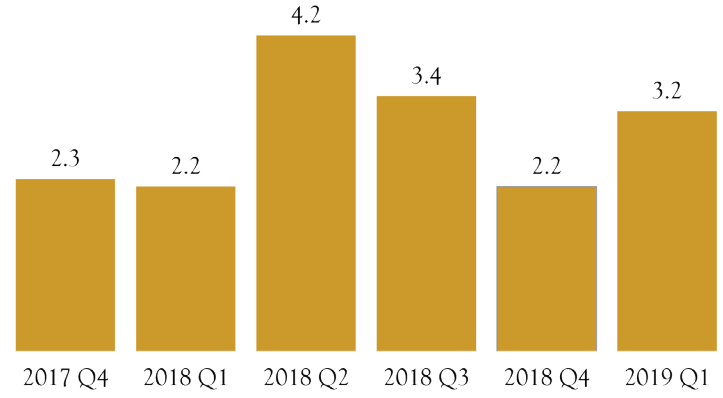
According to the Labor Department, multifactor productivity, an approximate measure for innovation, hit 1% in 2018. This was the highest increase since 2010. Over the past decade, productivity, a measurement of output per unit of labor, has seen paltry increases with an average rate of only 0.4% since 2007. A portion of the slowing productivity gains in the past few years are attributed to the aging U.S. population and fewer individuals entering the workforce as the baby boomer generation retires. Improvement in productivity is vital for the economy to experience significant and sustained growth and increase the living standards of American workers.

The labor market has had a very long stretch of adding jobs with unemployment now at 3.8%. The Federal Reserve continues to lower their official estimates of the level of unemployment the economy can sustain without causing inflation (4.3% vs 4.8% in 2016). Nonetheless, wage growth in the first quarter at 4.2%, was slightly lower than we saw through most of 2018.

Interest Rates

The Fed now appears to consider its Fed Funds rate in the range of 2.25% to 2.5% to be at the level of "neutral" siting increased market volatility, mild inflation and threats to U.S. economic growth. We find this somewhat worrisome as rates are still very low, particularly when adjusted for inflation. The balance sheet is still very large in relation to the size of the economy and when compared to historical standards as well. The question must be asked: if the economy cannot handle higher rates, how healthy is it really? Or have we truly

Exhibit 1. **U.S. GDP Growth**



Source: Bureau of Economic Analysis

Index Returns

	U.S. Stock Market	International Developed	Emerging Markets	Global Real Estate		U.S. Bond Market	Global Bond ex U.S.
Q1 2019	STOCKS					BONDS	
	14.04%	10.45%	9.92%	14.07%		2.94%	2.96%
1 YEAR	STOCKS					BONDS	
	8.77%	-3.14%	-7.41%	13.93%		4.48%	5.23%

entered into a "new normal" where rates will be low for a much longer timeframe than we thought possible.

While the shape of the yield curve did not change significantly from the beginning of the quarter, it did shift downward with rates declining across the board. The yield curve has technically inverted as the 10-year Treasury yield fell slightly below both the three and six-month yield. For more information on the yield curve, possible connection to recessions and how it might affect your investment approach, please take a look at the article titled "The Flat-Out Truth" on our publications page at www.happytrust.com.

Trade/International

News on the U.S. vs China tariff war has receded from the headlines, but realistically very little has been resolved. The market seems to be pricing in an amicable resolution, but time will tell. China's GDP growth in the first quarter of 6.4% was higher than expected and has helped to alleviate some concerns about global growth. The bulk of the increase appears to be spurred by tax cuts and de-regulation implemented by the Chinese government in response to recent slowing economic growth.

Brexit continues to pose problems for Great Britain as parliament has not been able to agree on an exit deal from the European Union after several attempts. Overall, Europe is struggling with slowing economic growth. The European Central Bank has been unsuccessful in raising rates and recently committed to keeping them below zero. Eurozone growth is expected to be around 1%, a level it has struggled to rise above now for several years.

Markets

All major asset classes had positive performance around the globe, ranging on the low end with bonds at nearly 3% to the U.S. equity markets just over 14%. The majority of the equity moves came in the first half of the quarter in response to the change in tone from the Federal Reserve. Some of the strongest performing segments of the U.S. market included the energy, technology and communication services sectors. REITs, particularly here in the U.S., experienced the biggest rebound after the fourth quarter sell-off. Healthcare and Financial services ranked at the bottom with banks being hurt by the Fed's decision to no longer raise rates.

Commodities generally did well, with the exception of grains, as oil rose to over $60 per barrel from $45 at the beginning of the year. Recent OPEC productions cuts have helped to offset the growth in U.S. oil production.

Credit spreads, the difference in yield between highly rated and lower rated bonds, narrowed in reaction to the Fed's dovish language. Put simply, lower-quality bonds outperformed higher-quality bonds. Investment grade corporate bonds led the fixed income class with a 5.1% return while U.S. Treasuries gained just over 2%.

At the end of the fourth quarter there was much concern that the Fed was going to raise rates too far and push the economy into a recession. Those fears have been largely alleviated and the markets have rebounded accordingly. However, angst still remains, particularly regarding the inversion of the yield curve. As pointed out in "The Flat-Out Truth" article on our website, there is no reliable way to attempt to time the market around interest rate moves and yield curve inversions. Our approach remains steadfast to our guiding principles, including: Stay Focused on the Long-Term. Tune out the short-term noise and don't attempt to time the market. As human beings, we are terrible at predicting the future. This strategy has stood the test of time and we believe it will bring the best results going forward.

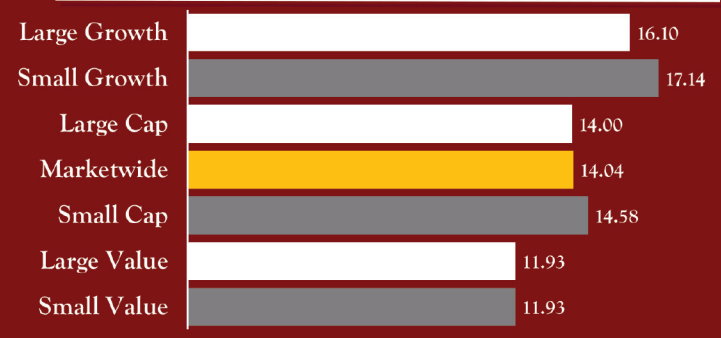
HAPPY Investing!

Market Summary

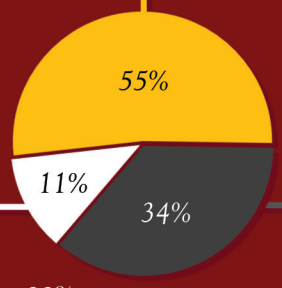
In the first quarter, all major global equity indices advanced. Small cap stocks outperformed in the U.S. and the international developed markets while underperforming in the emerging markets. Growth stocks fared better than value across the board. Bond markets, real estate and commodities were all positive for the quarter. For a more detailed quarterly report please see the publications tab at www.happytrust.com.

US Stocks

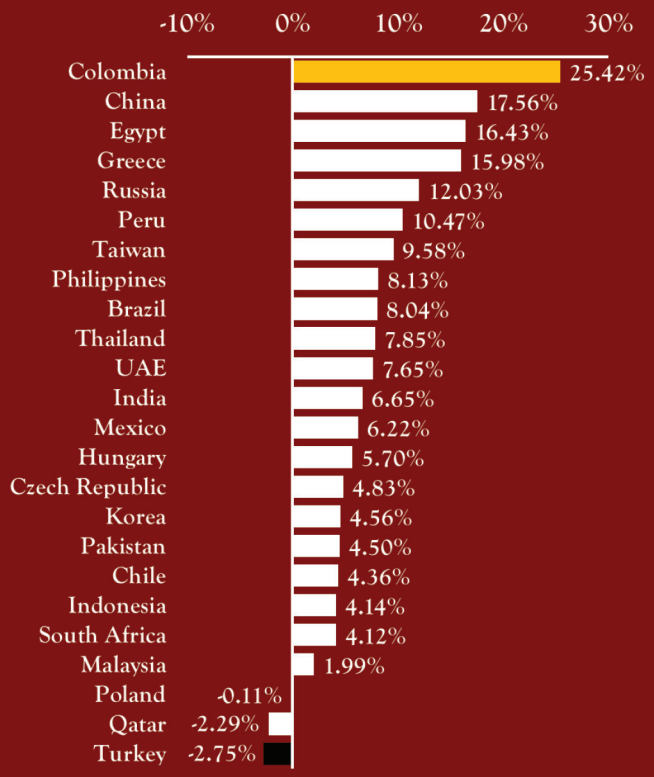
Ranked Returns for the Quarter (%)



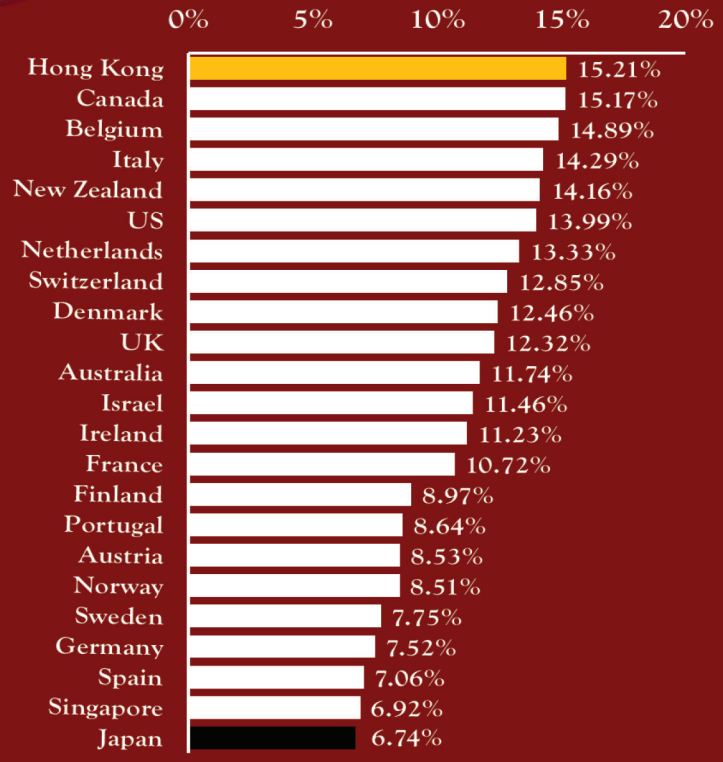
World Market Capitalization



Emerging Markets Stocks



International Developed Stocks



Meet the Team

Joby Mills

Senior Vice President
Director Of Trust Services

Joby Mills has 18 years of experience in the trust industry as an in-house attorney, trust administrator, and department manager. Joby's primary responsibility is the overall management of Happy State Bank's Trust Department. He earned his B.A. in Finance from the University of Northern Iowa and his Juris Doctor from Baylor University School of Law.

He serves as the Vice Chairman of the Administrative Council of the Texas Bankers Association Wealth Management & Trust Division, President-Elect of the Amarillo Area Bar Association, Vice President of Endowments for the Golden Spread Council of the Boy Scouts of America, and Immediate Past President of the Amarillo Area Estate Planning Council.

Terri Wright

Vice President and
Trust Officer

Terri Wright, Vice President and Trust Officer, joined Happy State Bank and Trust Company in April of 2015. Terri was born and raised in Amarillo and began her banking career with Texas American Bank in Amarillo, Texas in 1987. She has been involved in various aspects such as investments, administration and operations of a Trust Department during the past 31 years. She currently serves as an administrator for agencies for individuals and non-profits, IRA's and trusts.

Terri attended Amarillo College and is a 2000 graduate of the Texas Trust School offered by the Texas Bankers Association. Terri is a member of the Amarillo Area Estate Planning Council. Terri volunteers her time and services to several charities in Amarillo. Terri and her husband, Terry, have one daughter, Kristen, and a son-in-law, Butler. They have recently been blessed with a new grandson, Quint. In her free time, Terri enjoys cooking, reading, sports and traveling.

Diversification, Lessons Learned

Scott Richardson
Vice President and Trust Investment Officer

Scott has been in the financial services industry for over 15 years. He has a Bachelor of Business Administration from Texas Tech University. He has spent the last 13 years as a financial planner helping clients meet their financial goals. He serves as a volunteer with the Cub Scout pack at Windsor Elementary and also assists as the District Chairman for the Golden Eagle District of the Golden Spread Council BSA.

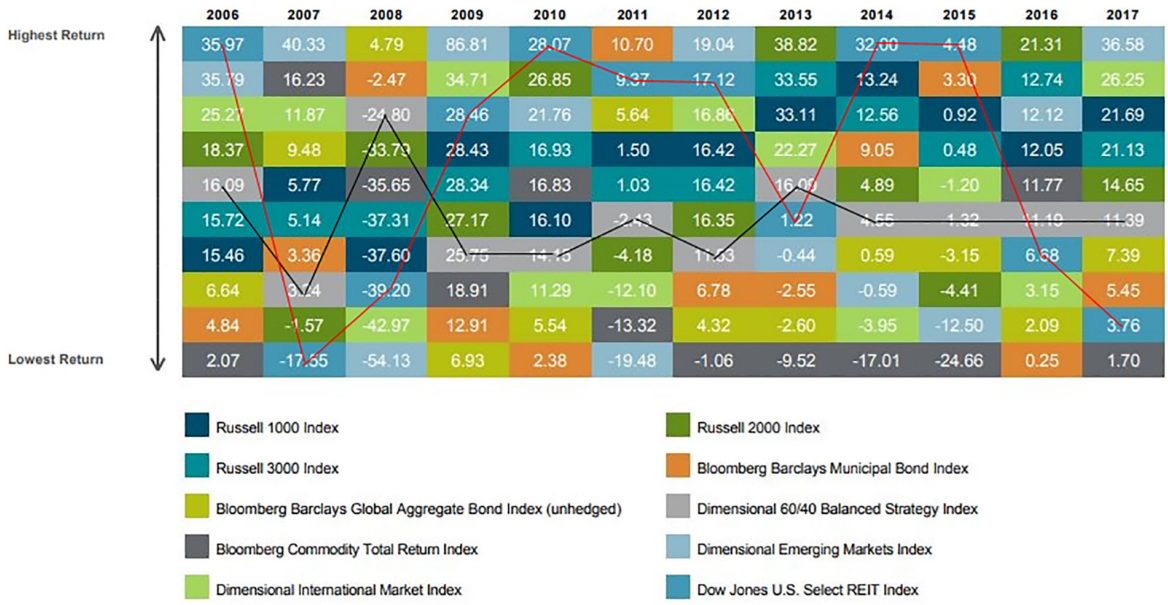
"Markets are unpredictable. That's why we preach putting your money in many buckets, or diversification. Like the Ferris wheel if one bucket happens to turn upside down, all the other buckets you've invested in are still upright. What kind of shape would you be in if all your money were in that one bucket? If one bucket goes upside down, you'd better be in the others". (West & Anthony, 2000) Don Connelly, a 40 year financial industry professional, wrote these words to describe diversification.

The Ferris wheel illustration is an interesting one because most of the time the buckets are upright. This is the norm when investing. However, there are those few times when select buckets turn upside down and the investment can often be significantly damaged. We will discuss one such time later in this article.

Diversification can be defined as owning many different types of investments inside one single portfolio in order to minimize risk. Not only should an investor own many different stocks but should also own many different bonds all from different companies. In addition to looking for different stocks and bonds, a proper portfolio would diversify across different asset classes. Appropriate asset classes should include large capitalized us companies, small capitalized us companies, real estate, developed international companies and emerging international markets. This list is not the only things investors can own but each investment should be chosen based on each investor's own risk tolerance and investment objective.

> *"Not only should an investor own many different stocks but should also own many different bonds all from different companies."*

Below is a chart showing returns of various asset classes from 2006-2017. Each color represents individually an important part of a diversified portfolio. We have selected the **Dow Jones U.S. Select REIT Index** to see what happens to an undiversified portfolio over time. If we follow the red line from 2006 through 2017 we see large swings in annual returns. Over that 12 year period the REIT index had an annualized return of 9.20%. The black line represents a balanced 60% stock/40% bond portfolio. The portfolio



represents the inclusion of all the asset list below in a diversified portfolio. As we follow the black line you can see that it is significantly flatter than the red line. The 60/40 balanced portfolio had an annualized return of 7.34% for that time period. While this portfolio had a lower annualized return than the REIT index it had significantly less volatility.

Not only should you diversify by asset classes but it is important to look not only at home but abroad for diversification. Many times investors and financial professionals have a home bias that dictates where we invest. We know GE, Coca Cola, Lowes and other companies familiar to us. These companies are comfortable in our eyes and are visible to us on a daily basis. This leads to problems with a lack of diversification. Dimensional funds wrote "During this period, often called the "lost decade" by US investors, the S&P 500 Index recorded its worst ever 10-year performance with a total cumulative return of –9.1%. However, looking beyond US large cap equities, conditions were more favorable for global equity investors as most equity asset classes outside the US generated positive returns over the course of the decade". (Dimensional Funds, 2018)

> ***"This misconception led many to forgo the step of diversifying their investment portfolio and buying the hottest investments or even worse only buying company stock for their whole portfolio."***

Let's revisit our Ferris wheel example with a company from 2001. The stock market had been roaring the preceding years. Many thought of the stock market as a saving account that had no risk and only went up with increased fervor. This misconception led many to forgo the step of diversifying their investment portfolio and buying the hottest investments or even worse only buying company stock for their whole portfolio.

Enron Corporation was looked at as a sure bet by most financial analysts in the late 90's. As we soon learned, it was because they couldn't decipher their financials. The company's books appeared like they were profitable and their growth was spectacular. Enron's employees were so loyal to the company that many of them put all their retirement savings in company stock. The company was so appreciative of their employees that they would match retirement contributions in company stock. All through the late 90's and into the early 2000's this looked like sound financial move. At this time I'm sure many felt as if they were falling behind if they had decided to diversify instead of purchasing Enron stock for their 401k account. The stock hit an all-time high of $90 per share on August 23, 2000. (Houston Chronicle, 2004) Then as fast as the stock has risen the news of an accounting scandal rocked the price of the stock. Many of Enron's employees that had their retirement in all company stock began to feel the pain of being undiversified.

From the New York Times, Nov. 22, 2001: *"Through the 401(k) retirement plan, employees chose to put much of their savings in Enron shares, and the company made contributions in company stock as well. But around the time Enron disclosed serious financial problems last month, the company froze the assets in the plan because of an administrative change. For several weeks, as the stock lost much of its value, workers stood by helplessly as their retirement savings evaporated. They were not allowed to switch investments at all -- even though the plan had far less risky choices".* (OPPEL JR., 2001)

> ***"Many employees were left with no retirement savings, out of a job and having to start their lives all over again."***

The stock plummeted and shareholders were eventually wiped out as Enron would declare bankruptcy. Many employees were left with no retirement savings, out of a job and having to start their lives all over again.

Diversification is achieved on many levels. It's important to own not only stocks and bonds but different companies inside those asset classes. It's also important to realize that investors may have a home bias for companies they know but diversifying outside of the US brings added diversification. As we review our portfolios it is important to have someone look to make sure it is properly diversified.

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