

FOURTH QUARTER 2017 MARKET OUTLOOK



Our Outlook

	<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017 Est</u>	<u>2018 Est</u>
GDP Growth ⁽¹⁾	2.5%	1.9%	2.0%	2.1%	2.0%
Change in Consumer Prices ⁽²⁾	0.7%	0.7%	2.1%	1.7%	1.9%
Fed Funds Target Rate	0.25%	0.50%	0.75%	1.50%	2.00%
10-Year Treasury Yield	2.17%	2.28%	2.43%	2.60%	3.15%
S&P 500 EPS	\$117	\$116	\$118	\$130	\$139

(1) 4th Quarter y/y change

(2) December year/ year change

Security National Bank's Wealth Management Department maintains an economic forecast that provides our Investment Committee background assumptions for use in our investment decisions. Our general outlook for the U.S. economy is "this tortoise's got game." 2017 will look a lot like 2016, only a little faster. U.S. and global economic growth is a bit faster. The slow pace of normalization will continue unabated.

The U.S. stock market, as measured by the S&P1500 SuperComposite was up 4.44% last quarter and is up 13.70% year to date. The market has been quite steady recently with only three down months in the last three years. Despite the havoc from Hurricanes Harvey and Irma, the economy remains solid with modest growth. While wage growth has been tepid it has outpaced inflation, resulting in real wage growth. Corporate earnings have been stronger than expected with energy and technology leading the way and weakness in Consumer Discretionary.

Year to date, large capitalization stocks are outperforming small capitalization by a substantial margin, 5.32%. Growth stocks are also besting value stocks by a wide margin, 10.84%. Value, cyclical and small stocks (the Trump-reflation trade) rallied into the end of 2016. They then faded along with the likelihood of infrastructure spending, health care reform or tax reform. In September and into early October, the Trump-trade is back in vogue along with the prospects of meaningful tax reform. A pick-up in global growth and a weaker dollar has led to significant gains in foreign stocks.

The U.S. Treasury yield curve held steady during the quarter with both the short end and the long end gaining 3 basis points. The bellwether 10-year Treasury ended the quarter at 2.33%. Credit spreads narrowed further during the quarter with both investment grade (8 bp) and high yield (17 bp) tighter. They remain very tight versus their twenty year average.

The Federal Open Market Committee (FOMC) announced their plan to begin the process of reducing its balance sheet at their September 20th meeting. At that meeting and in subsequent speeches, Chair Yellen reiterated her policy of gradual rate increases: once more this year and three times next year. We concur with the consensus of one additional rate hike in December. We currently believe there will be only two rate hikes next year. The Fed Funds Futures market currently implies a 93% probability of a December rate hike and a 58% chance of an additional hike in June.

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Our Forecast

We are raising our forecast for economic growth to 2.1% this year to reflect the recent economic releases. We do not believe the economy can sustain faster economic growth without significant tax and policy changes. We have lowered our inflation forecast to incorporate recent results and continued modest wage growth. Inflation for the last six months has been running at a 0.5% rate.

Excesses that have marked the end of previous economic expansions are largely absent. The overheating pressures that have historically prompted swift and excessive monetary tightening are not present. The FRB has the luxury of continuing its tortoise like normalization process.

The S&P 500 Index trading at 21.3 trailing earnings and 18.0 times next twelve months expected earnings. We have long contended that a market multiple of 18.0 times forward earnings is the upper limit to reasonable valuations and 20 times is clearly dangerous. We are at the upper end of reasonable. The current low interest rate environment does support the current market multiple. It does not support an increase in the multiple. We look for stock prices to rise in line with to slightly behind earnings growth. Our outlook is for mid-single digit earnings growth over the forecast horizon. Mid-single digit earnings growth coupled with a 2% dividend yield should provide a mid-to upper-single digit total return over the next twelve months.

Please see the obligatory disclosures at the bottom of each page and at the end of this report.

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Recent Economic Reports

		<u>1 Month Change</u>	<u>YTD Change</u>	<u>1 Year Change</u>
Fed Funds Target	1.00% to 1.25%	---	50bp	+75bp
3-Month Treasury Yield	1.03%	+2bp	+76bp	+76bp
10-Year Treasury Yield	2.33%	+21bp	+72bp	+72bp
SNL 30Yr Fixed – US Avg	4.01%	-3bp	-16bp	+41bp
S&P 500 Index*	2,519	2.06%	14.24%	18.61%
S&P Midcap 400*	1,796	3.92%	9.40%	17.52%
S&P Small Cap 600*	904	7.71%	8.92%	21.05%
S&P SuperComposite 1500*	584	2.36%	13.70%	18.61%
S&P 500 Growth*	1441	1.11%	19.33%	19.90%
S&P 500 Value*	1,066	3.28%	8.49%	16.47%
Crude Oil – WTI Spot	\$51.68	9.35%	-3.85%	8.30%
Gold – NYMEX Near Term	\$1,282	-2.64%	11.48%	-2.38%

Data as of September 30, 2017. * = Total return

Hurricanes Harvey and Irma will wreak havoc with the economic reports for several months. We will endeavor to highlight the estimated impact for each of the economic indicators. In general, the economic picture will be muddied just enough to give bulls and hawks an excuse for weak numbers and bears and doves a reason to be concerned. Everyone will be able to spin the numbers to justify their particular outlook. We caution the reader to not to get too excited about any economic releases for a couple of months. They are likely to contain too much noise to make any lasting decisions on.

Employment

The Employment Situation (Jobs) Report released on October 6, 2017, was distorted by the hurricanes. Please use extreme caution when interpreting this report. Federally-designated disaster

counties in Florida and Texas accounted for 7.7 percent of the U.S. employment in March, according to the Labor Department. The report is derived from two surveys, the household survey and the establishment survey. The two differ on how they treat people who did earn a paycheck during the pay period that includes the 12th of the month. If you have a job but are unable to work because of the storm, you are counted as unemployed in one and employed in another.

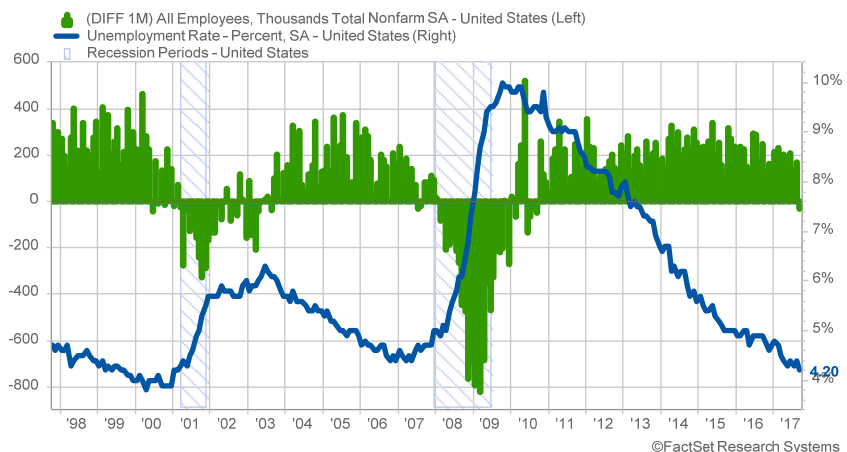
The Labor Department reported that the economy lost 33 thousand jobs last month. A sharp drop in restaurant and bar employment and below-trend growth in other industries led to the first monthly job loss

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since September 2010. Most restaurant workers do not get paid if they are unable to work because of the storms. According to the establishment survey, the leisure and hospitality sector lost 110 thousand jobs last month. The consensus was for an 80 thousand gain in employment. The totals for the previous two months were revised down a combined 38,000. The trailing three month average job growth rose to 91,300 versus 172,300 last month and 238,700 last year.

The unemployment rate fell to 4.2% from 4.4% last month and from 4.3% last month and 4.9% last year. The unemployment rate is calculated from a separate survey as the jobs report. The BLS stated that this survey was not likely impacted by the storm. The broader U-6 measure fell to 8.3% from 8.6% last month and 9.7% last year. This measure includes part-time workers who would prefer a full-time position and people who want a job but are not actively looking for one (so-called discouraged workers).

Over the last twelve months the U.S. economy added a net 2.4 million jobs. The number of employed individuals has increased 1.59% over last year. During the same time, the labor force has only grown by 1.3 million thousand or 0.82%. The labor participation rate jumped to 63.1% from 62.9% last month and 62.9% last year.

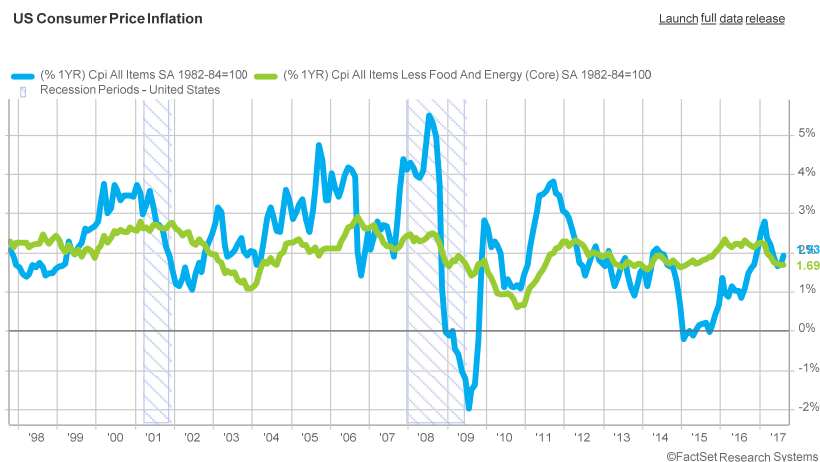
Last month's average hourly earnings (wages) grew at a 2.87% y/y rate, up from the 2.53% reported last month and the 2.75% reported last year. The average work week held steady last month 34.4 hours. Average weekly earnings are up 2.87% from last year to \$913.30. The reported rise in wages may be due to the drop in restaurant employment. The storms kept lower wage earners from working, making the numbers look better than they actually are. Wage growth may revert to the lower number in the coming months.

Over the longer term, job growth will eventually slow to the growth in the labor pool, less than 1%. The slower job growth will put downward pressure on economic growth. Slower job growth is the primary factor behind our below consensus GDP growth rate. Consensus estimates are for 2.2% real GDP growth in 2017 and 2.3% growth next year.

Full unemployment does not necessarily mean the recovery has run its course. Historically the economy can run at or above full employment for several years before the FRB is forced to boost interest rates far enough to put the economy into a recession. The party can continue a bit longer before the punch bowl is taken away. We expect the party to continue until wage inflation surpasses 3% for an extended period of time. At that level, wage induced inflation starts to become a concern. Until then monetary policy will remain accommodative, just not as accommodative as it has been.

Inflation

The consumer price index was up 0.4% m/m in August and up 1.9% y/y. This was the highest reading since July and the second highest since February 2013. The bump in inflation was led by the price



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of gasoline, up 6.3% during the month. The rise in gasoline prices is directly linked to the hurricanes as refining capacity was knocked off-line. It will likely take several months before the full impact of the hurricanes flow through data.

The price of used vehicles is down 3.8% and that of new cars is down 0.7% in the past twelve months. The hurricanes may have destroyed 500,000 to 900,000 vehicles according to Cox Automotive. This will provided temporary support for prices, as these vehicles are replaced. However, the auto industry still faces chronic overcapacity and peak demand. We do not expect the increased demand to support prices beyond a couple of months.

The FRB prefers the Personal Consumption Expenditure (PCE) as its measure of inflation. Due primarily to differences in how health care costs are allocated between employers and consumers, the PCE tends to run 0.25% to 0.50% below the CPI. The PCE was up 0.2% in August and is up 1.4% y/y. The core PCE was up 1.3% y/y.

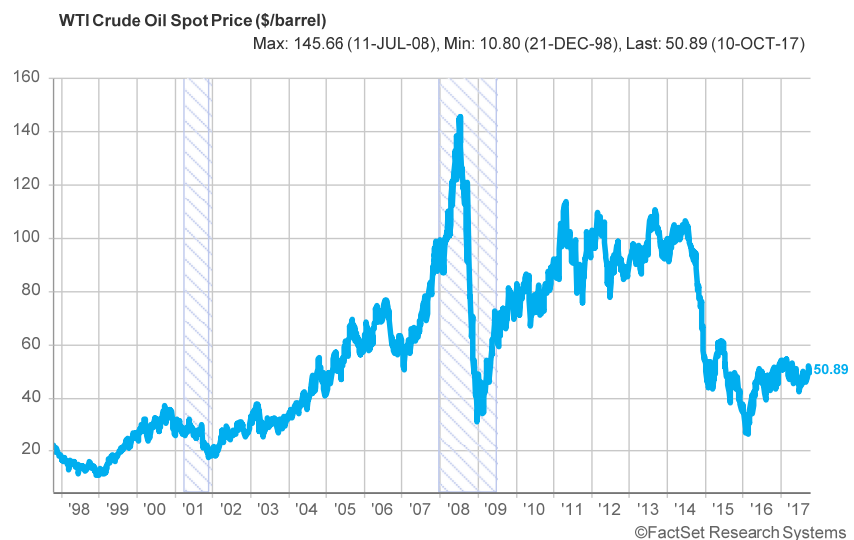
Reported inflation will likely be elevated for a month or two due to the impact of the storms. Their impact should fade by year end. We currently expect CPI inflation (as measured by December y/y) to run at a 1.7% pace for 2017 and 1.9% for 2018. This should allow the FRB to continue to normalize its monetary policy at a glacial pace.

Oil

Oil continues to trade in a narrow range of \$42 to \$52. Prices recently hit the upper end of the range. The tight range is not a result of softening of demand; rather it is a result of American technology.

There remains a rapid feedback loop, where oil prices above \$50 per barrel lead to more drilling activity that then leads to more oil production and lower oil prices that lead to lower drilling activity that lead to higher oil prices. Thus we remain in the narrow range of \$42 to \$52 per barrel.

After rising in a straight line from 298 in May of 2016 to 753 in August of 2017, the oil rig count declined modestly to 732 last week. This plateauing is most likely a result of oil prices falling to the low \$40's during the summer. With oil prices at the upper end of the range again, we look for the rig count to increase slightly in the coming months.



The U.S. Energy Information Administration (EIA) forecast a slight surplus for the next six quarters. We look for oil to trade in a relatively tight range of \$42.00 to \$52.00 per barrel for the next several years. Energy prices are likely to have a neutral or muted impact on inflation and interest rates. Thanks to U.S. shale, the probability of a major oil price spike and its economic impact has greatly diminished.

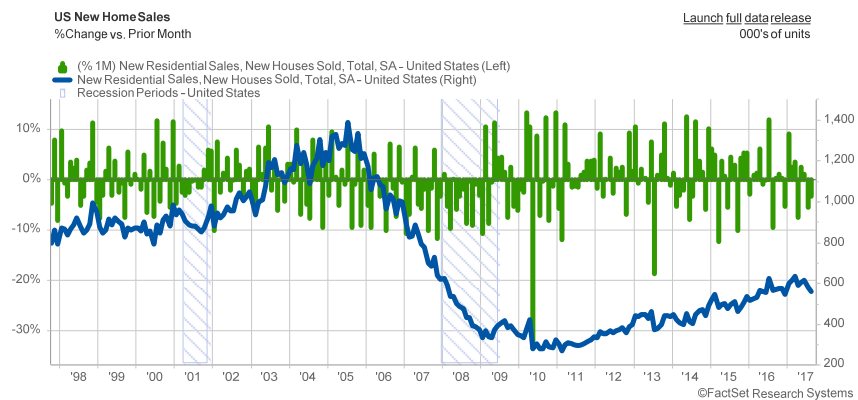
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Housing

Florida and Texas are one quarter of the new single-family market. The areas directly affected by Hurricanes Harvey and Irma accounted for 14% of single-family homes sold in 2016. The storms will definitely have a dampening effect on new home building for the next several months. In addition to the direct impact, a large share of building materials and available labor will be repurposed to rebuilding efforts. We look for new home data to be volatile and misleading for the next several months. Sales are likely to recover by the end of the year and 2018 will likely be stronger.

In August, new single-family home sales were 560,000, down from a revised 580,000 pace the month before. Even without storms, monthly data tends to be volatile and is often revised significantly. To even out the volatility, we use a rolling three month average. August's trailing three month trend was flat y/y. New home sales remain solid.

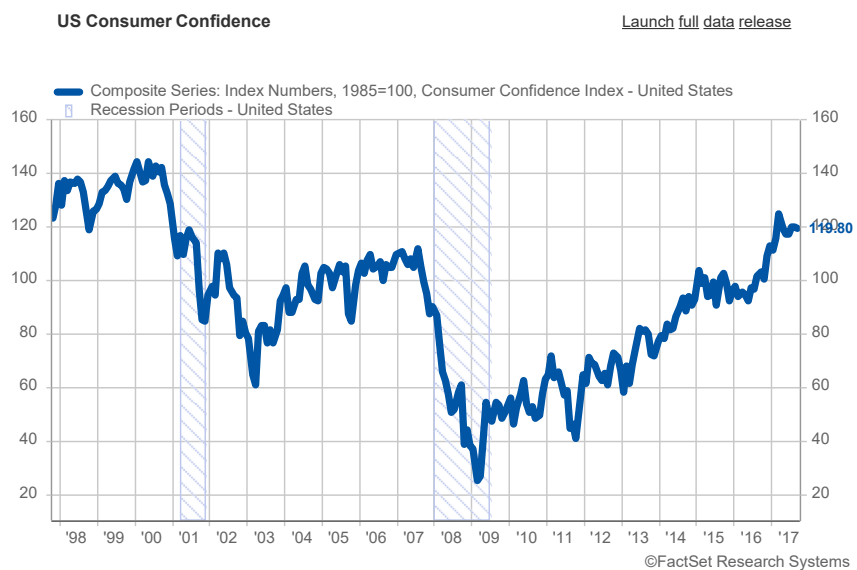
The trailing 3 month average median sales price is up only 2.3% y/y. For the last year, new home prices have risen in line with or less than family incomes. Existing home prices as measured by the Case-Shiller Index are up 5.8%. If home prices rise too much above income, potential purchasers will be shut out of the market.



August's trailing three month single family housing starts are up 12.2% y/y to 849 thousand homes. Housing starts give an indication of future home sales. Based on housing starts, the pace of new home sales is likely to continue its methodical recovery. We look for new home sales and construction to continue to grow at a healthy mid to high single digits pace for the next couple of years.

The Consumer

The Conference Board noted that "Confidence in Texas and Florida decreased considerably, as these two states were the most severely impacted by Hurricanes Harvey and Irma. Despite the slight downtick in confidence, consumers' assessment of current conditions remains



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quite favorable and their expectations for the short-term suggest the economy will continue expanding at its current pace.”

The Conference Board Consumer Confidence Index fell to 119.8 from 120.4 the prior month. The average over the last twenty years has been 93.0.

The present situation component fell to 146.1 from 148.4 the previous month. The expectations component rose to 102.2.0 from 101.7.

The sub-components of the present situations component continue to show broad based strength. The net appraisal of current employment opportunities being plentiful (plentiful less hard to get) fell to 14.5 from 16.0. The strong employment environment has boosted consumers’ confidence in the job market. Consumers’ net perception of current business conditions (good less bad) fell to 20.1 from 21.3.

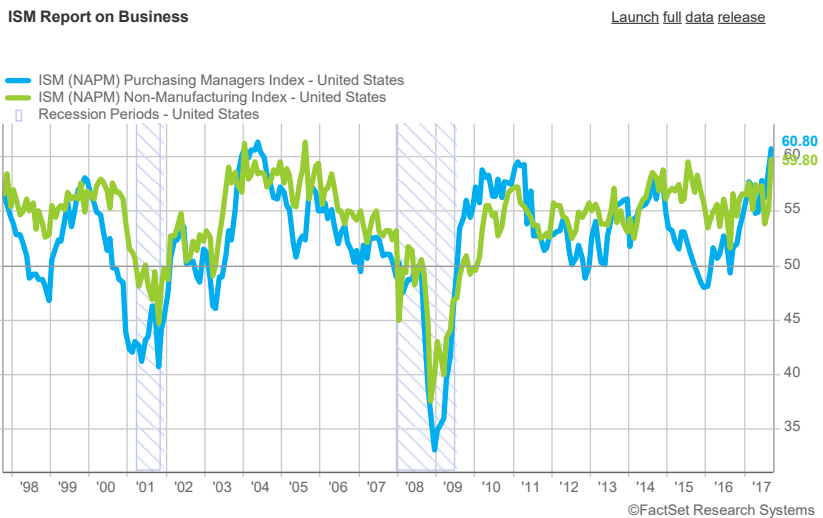
Personal income is estimated to be up 2.8% in the past year versus a 2.6% pace reported last year. Private sector wages and salaries are up 2.8% from last year. Disposable personal income is up 2.7% y/y. Consumer spending on goods and services is up 4.1% from last year. Spending on services is up 4.3%, while spending on goods is up 3.2%. The slowdown in goods purchases is primarily the result of slower new auto sales. Spending on new autos is down 4.6% y/y. Spending on new light trucks is up 1.5% y/y. The personal savings rate is 3.6% of disposable income. Consumer credit outstanding is up 5.9% y/y.

We expect consumer income and spending to continue to post nominal growth of about three to five percent for the next couple of years. Households’ balance sheets remain in good shape. Debt service and other financial obligations are 15.46% of disposable income. This important ratio remains at generational lows. Prior to the Panic of 2008, this ratio peaked at 18.14%. With the government and corporate sector having maxed out their credit cards, consumers remain the only sector able to increase borrowings.

Business Activities Report

The hurricanes likely had a positive impact on the business confidence survey. The storms lengthened delivery times. Longer delivery times usually mean a more robust economy and a higher reading. The impact was probably not as dramatic as the survey was taken after the consumer survey.

The Institute for Supply Management’s (ISM) non-manufacturing index rose last month to 59.8 from 55.3. This month’s reading is the highest since August 2005 and consistent with continued growth in the services sector at a slightly faster pace. This reading marks the 93rd consecutive month of economic growth in the service sector. Per the ISM, “Respondent comments indicate a good outlook for business conditions.”



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As a frame of reference, a reading above 50 indicates expansion; a reading below 50 indicates contraction. Readings approximating 50 indicate the same level of activity.

The business activities component rose to 61.3 from 57.5 last month reflecting growth for the 98th consecutive month. 14 industries reported growth in business activities. Three industries reported a decrease in activity.

The new orders component rose to 63.0 from 57.1 reflecting growth for the 98th consecutive month. 15 industries reported growth in new orders. Only one industry reported a decrease in new orders.

The employment portion of this index reported growth for the 43rd consecutive month. It rose to 56.8 from 56.2 the previous month. 10 industries reported an increase in employment. Five industries reported a decrease in employment.

The prices paid for purchased materials and services index rose substantially to 66.3 from 57.9 the previous month. 16 non-manufacturing industries reported having to pay higher input prices. One industry reported a decrease in prices paid.

The ISM Manufacturing Index rose to 60.8 from 58.8 the previous month, indicating growth in the manufacturing sector for the 13th consecutive month. The report was the highest since May 2004 and continues to show a strengthening industrial sector. Of the 18 manufacturing industries, 17 reported growth. One industry reported contraction.

The new orders index rose to 64.6 from 60.3 the previous month. New orders have grown for 13 consecutive months. 14 of the 18 industries represented in the survey reported growth in new orders. Three industries reported a decrease in new orders compared to last month.

The production index rose to 62.2 from 61.0 the previous month, indicating growth in production for the 13th consecutive month. 13 of 18 industries reported growth in production during the month. Two industries reported a decrease in production.

The employment component of this index rose to 60.3 from 59.8, indicating growth in employment for the 12th consecutive month. 13 industries reported employment growth. Three industries reported a decrease in employment.

The prices paid index jumped to 71.5 from 62.0, indicating an increase in raw materials cost for the 19th consecutive month. All 18 industries reported paying higher prices for raw material. No industry reported paying lower prices.

The soft data (survey related) indicate the economy is growing at a steady pace. Both manufacturing and services



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continue to see steady economic growth. Both manufacturing and services also report rising prices for inputs.

Trade Weighted Dollar

The dollar is down 8.1% year to date and down 2.4% y/y. The dollar is likely to be a modest tail wind for corporate earnings, and a slight boost to inflation and interest rates.

International Interest Rates

U.S. interest rates remain significantly above interest rates in other developed countries.

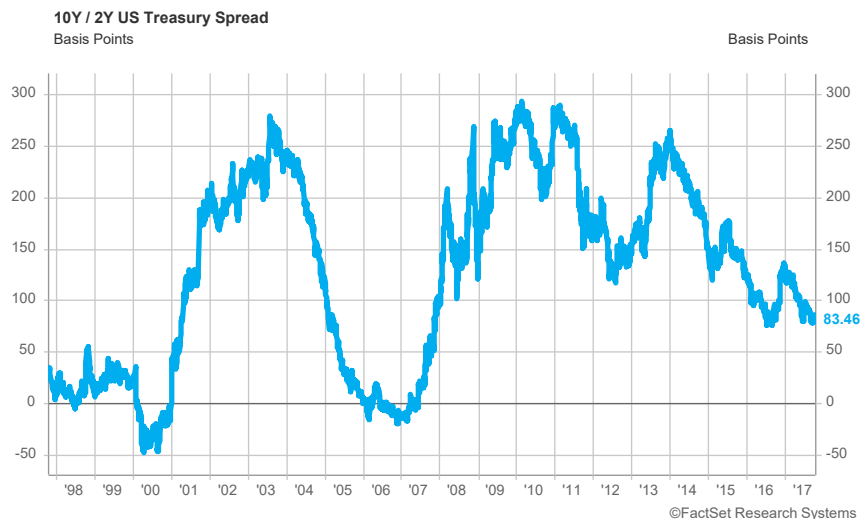
5 Year Treasury Yields		
	Current	Last Quarter
United States	1.95%	1.94%
Germany	-0.27%	-0.17%
Japan	-0.11%	-0.05%

We believe this yield differential will continue to keep a lid on long term U.S. interest rates. U.S. risk free interest rates are simply too attractive. Foreign investors will continue to purchase U.S. fixed income rather than face their confiscatory domestic interest rates. As shown in the chart below the U.S. interest rate curve has flattened as U.S. short term rates rose along with the Fed Funds rate without a corresponding increase in longer term rates.

One of the benefits of flatter yield curve is that the FRB will be able to reduce its balance sheet with less disruption than it would have been able to otherwise. The upward pressure on long term rates caused by the FRB shrinking its balance sheet will, in large part, be offset by foreign buying. The FRB has estimated that its bond purchases have reduced long term rates by 0.80% to 1.00%. There is plenty of room for the yield curve to steepen without causing significant economic damage.

We welcome your comments and suggestions. Please feel free to contact me at dhoward@snbomaha.com.

Also, please see the obligatory disclosures at the end of this report.



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