FIRST QUARTER 2018 MARKET OUTLOOK

SECURITY NATIONAL BANK
Wealth Management

Our Outlook

	2015	2016	2017 Est	2018 Est	2019 Est
GDP Growth (1)	1.9%	2.0%	2.5%	2.8%	2.2%
Change in Consumer Prices(2)	0.7%	2.1%	2.0%	2.0%	2.0%
Fed Funds Target Rate (3)	0.50%	0.75%	1.50%	2.25%	2.50%
10-Year Treasury Yield (3)	2.28%	2.43%	2.41%	2.95%	3.20%
S&P 500 EPS	$116	$118	$131	$145	$154

(1) 4th Quarter y/y change

(2) December year/ year change

(3) Year end

Security National Bank's Wealth Management Department maintains an economic forecast that provides our Investment Committee and the Bank's Funds Management Committee background assumptions for use in investment decisions. Our general outlook for the U.S. economy is steady as she goes. For the first time since the Panic of 2008, almost all major economies globally are enjoying faster economic growth with low inflation. The slow pace of monetary policy normalization will continue unabated, not only in the U.S. but eventually in Europe and Japan.

The U.S. stock market, as measured by the S&P 1500 SuperComposite, was up 6.53% last quarter and was up 21.13% in 2017. The market has been quite steady with no down months in 2017 and only one down quarter since 3Q2012. Large capitalization stocks outperformed small capitalization stocks by a substantial margin (8.60%) in 2017. Growth stocks also bested value stocks by a wide margin (12.08%). In other words, large growth stocks lead the way and small value stocks trailed by a wide margin. There was over a 15% performance differential between the two.

The Treasury yield curve has been flattening for much of this year. The difference between long and short maturities narrowed to lows not seen since the Panic of 08. Last year it narrowed 74 basis points. (A basis point is 0.01%.) Short term interest rates continue to creep up along with the Fed Funds rate, while long term rates are anchored in place. Normally a flattening yield curve signals slowing economic growth and typically shows up late in the cycle. We believe continued low inflation expectations and low international interest rates are the primary causes instead of a slowing economy.

The bellwether 10-year Treasury ended the year at 2.42%. Credit spreads tightened significantly during the year with both investment grade (30 bp) and high yield (66 bp) spreads tighter at the end of the year versus the start of the year. They remain very tight versus their twenty year average.

In December, the Federal Reserve Board increased its Fed Funds interest rate by 0.25% to 1.25% to 1.50%. This was the third increase in 2017. Currently The CME FedWatch Tool has a 68% probability of a March rate hike and a 51% chance of a second rate hike in August. The timing of the next rate hike may be complicated by the pending FRB leadership change, as the new administration establishes itself.

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In December, the Trump administration enacted their tax reform package, the Tax Cuts and Jobs Act. While most of the impetus for the reform arose from the desire to cut the corporate marginal tax rate, only 23% of the benefit will accrue to corporations. The broad reduction in taxation should spur stronger economic growth in 2018 and 2019. Tax reform should boost 2018 GDP by 0.60% and 2019 by an additional 0.20%

We now estimate 2017 GDP growth to be approximately 2.5%. Growth should climb to 2.8% in 2018 and post a respectable 2.2% in 2019. If recent economic momentum continues, along with the impact of tax reform, 2018 GDP growth may top three percent. The U.S. economy has not posted an annual growth rate in excess of three percent since 2005.

The faster economic growth is likely to drop the unemployment rate to the mid-three percent range. This will be the lowest rate since the Eisenhower administration. Faster growth, generational low unemployment, and hopefully higher wages should lead to higher inflation. We added an additional rate hike in 2018 to account for the higher growth, lower unemployment and higher inflation outlook. We now expect three rate hikes in 2018. We have also raised our forecasted S&P 500 Index to $145 from $139 to account for tax reform. We have initiated a 2019 EPS estimate of $154.

Misunderstanding Indexing

It appears investors are expecting more than index funds can deliver. A recent survey by Fidelity noted "one in five mutual fund buyers believes that stock index funds can protect them from market ups and downs." Another survey by Natixis Global Asset Management found that 60% of individual investors said using index funds can help minimize investment losses.

Index funds track a benchmark index. They cannot eliminate stock market volatility. They are in fact designed to fully match market volatility, both up and down. For most investors, the volatility that matters the most is when the stock market declines. If avoiding major losses is a significant goal for investors, index funds are not the right investment vehicle. In each of the last three bear markets, U.S. large-capitalization actively managed funds outperformed their benchmarks after fees, while index funds underperformed after fees. Average active outperformance ranged from 0.5% during the Panic of 2008 to more than 4% during the dot-com bust.

Downside protection is a top priority when we review a mutual fund or a stock for inclusion into our portfolios. It is also primarily the reason we hold investment grade fixed income securities. When the next bear market comes, our equity portfolios will most probably also lose money. We believe they will lose less than the overall market and our fixed income securities will soften the blow considerably.

Next Market Correction May Be Just Around the Corner – or Not

Last April, we wrote, "between now and year-end, we are likely to have a 10% plus correction." Luckily, we have been wrong so far. The largest sell-off for the S&P 500 has only been 3% last year, tying the record for the smallest drawdown in 38 years.

The stock market is fully priced at 18.4 times 2018 expected earnings. This does not mean a market crash is eminent. High valuations are poor predictors of subsequent stock market returns, especially for shorter time periods such as one year or less. High valuations are, however, good predictors of long term returns when looking at periods as long as a decade. Based on various common valuation ratios, we look for the stock market to provide a 4% to 7% annualized total return over the next decade versus the 9% to 11% historically experienced.

Bond Bubble

One very large asset class is in a bubble that may burst soon. Since the Panic of 2008, investors have piled into bonds, viewing them as safe havens. Few investors realize that bonds are likely to suffer a loss as high as 12% to 15% if interest rates go up just 2%. While we continue to invest in bonds, we limit our risk by maintaining a duration about half that of the average investor. This will limit the negative impact of rising interest rates and also provide us the opportunity to reinvest maturities at higher rates. We also maintain a high quality bond portfolio. This is designed to limit losses when credit spreads eventually widen. Again, we construct our fixed income portfolio to be a shock absorber for the eventual corrections. We believe the better risk/return balance is found in equities.

Subprime consumers are increasingly at risk of default. Wage growth has not kept up with health care and rent inflation. Shut out of the housing market, they have been unable to benefit from rising home prices. Delinquency rates for subprime loans have been rising and look to continue rising. Fixed income funds that invest in this sector are likely to have disappointing results.

Final Thoughts

Given enough time, stock prices will follow earnings. Interest rates and earnings are closely tied to economic conditions. The next bear market will likely be tied to the next recession. Thus, the boring economic analysis that follows. While there definitely is a recession in our future, we do not believe one is likely until late 2019 or 2020. Historically, stocks have returned an average of 16.2% in the penultimate year of an economic expansion. We believe stocks will again outperform bonds in 2018.

We held our Economic Outlook Luncheon on January 9th at Security National Bank's conference center. For your convenience, we recorded the presentation, and it can be found on our website here along with the presentation slides.

If you have friends or family that may benefit from the Market Outlook, feel free to have them send me their email address, and we will add them to our mailing list.

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

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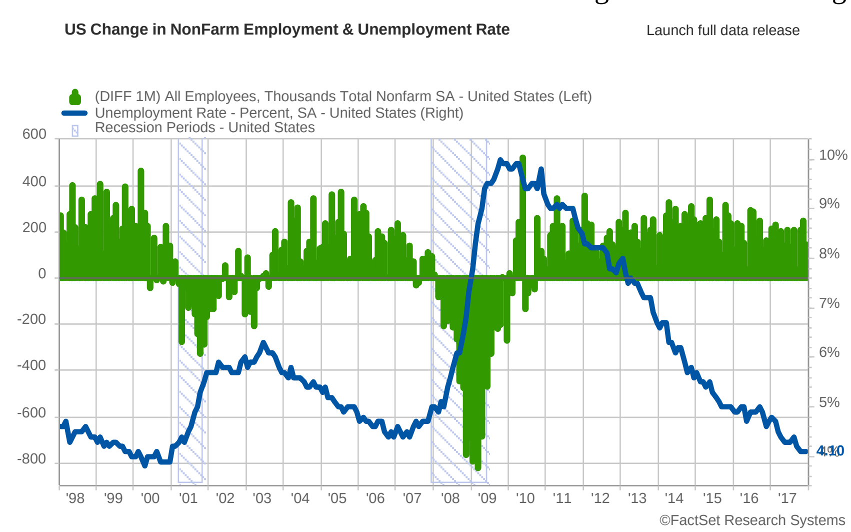
Recent Economic Reports

		1 Month Change	YTD Change	1 Year Change
Fed Funds Target	1.25% to 1.50%	+25 bp	+75 bp	+75 bp
2-Year Treasury Yield	1.89%	+11 bp	+69 bp	+69 bp
10-Year Treasury Yield	2.40%	-2 bp	-5 bp	-5 bp
SNL 30Yr Fixed – US Avg	4.08%	--	-9 bp	-9 bp
S&P 500 Index*	2,674	1.11%	21.83%	21.83%
S&P Midcap 400*	1,901	0.22%	16.24%	16.24%
S&P Small Cap 600*	936	-0.52%	13.23%	13.23%
S&P SuperComposite 1500*	619	1.00%	21.13%	21.13%
S&P 500 Growth*	1,533	0.58%	27.44%	27.44%
S&P 500 Value*	1,117	1.67%	15.36%	15.36%
Crude Oil – WTI Spot	$60.36	5.16%	12.30%	12.30%
Gold – New York Spot	$1,302.50	2.19%	13.17%	13.17%

*Data as of December 31, 2017. * = Total return*

Employment

The Labor Department reported in its January 5th Employment Situation (Jobs) Report that the economy added 148 thousand jobs last month. The consensus was for a 190 thousand gain in employment. The totals for the previous two months were revised down a net 9 thousand. The trailing three month average job growth was 203,700 versus 167,000 last month and 147,700 last year.



The unemployment rate held steady at 4.1%, a 17 year low. This is down from 4.7% last year. The broader U-6 measure rose to 8.1% from 8.0% last month but down from 9.1% 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 2.1 million jobs. The number of employed individuals has increased 1.17% over last year. During the same time, the labor force has only grown by 0.9 million or 0.54%. The labor participation rate held steady at 62.7% versus last month and last year.

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Last month's average hourly earnings (wages) grew at a 2.50% y/y rate, up from the 2.43% reported last month but down from the 2.85% reported last year. The average work week held steady at 34.5 hours but was up from 34.4 hours reported last year. Average weekly earnings are up 2.80% from last year to $918.70. Wage growth has not exceeded 3.0% since April 2009.

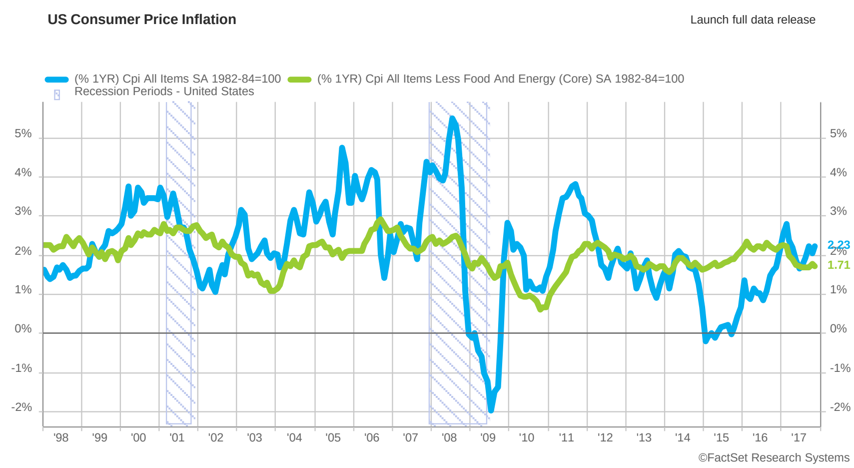
Over the longer term, job growth must eventually slow to the growth in the labor pool, less than 1%. The slower job growth will put downward pressure on economic growth. Over the next two years, the Tax Cuts and Jobs Act will boost economic growth and offset the downward pressure from slower labor market growth.

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 November and up 2.2% y/y.

Gasoline prices rose 7.3% last month as the recent increases in crude prices started showing up at the pump. Gasoline is up 16.5% y/y. Consumer prices excluding energy are up a more modest 1.7% y/y.



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 November and is up 1.8% y/y. The core PCE was up 1.5% y/y.

We recently raised our expected CPI inflation (as measured by December y/y) for 2018 to 2.00% from 1.9% last quarter, to incorporate higher energy prices and faster economic growth from tax reform. Inflation is near the FRB's stated goal of two percent. This should allow the FRB to increase the Fed Funds rate at a steady pace in 2018. We believe they will raise rates three times in 2018. The FRB will keep monetary policy accommodative until wages run in excess of 3.0% for an extended period of time.

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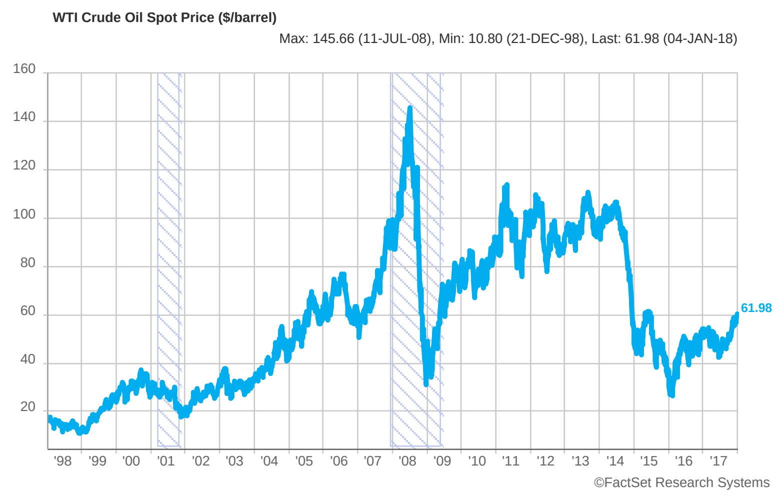
Oil

During the fourth quarter of 2017, the price of oil rose from $51.68 per barrel to end the year at $60.36 per barrel, an incerase of 16.80% and a two and half year high. Oil prices are currently trading well above our $42.00 to $52.00 per barrel range we had in our third quarter report. We are constantly reminded of the futility of projecting short term oil prices.

In response to softer prices earlier in the year, drillers backed off the throttle a bit. The rig count fell from 753 in August to 713 at the beginning of November. The rig count tends to lag oil prices by about three to six months. Now that oil prices are above $55, more rigs should be deployed. The most recent report places the U.S. on-shore rig count at 733. Drillers are returning to growth mode. This should help boost U.S. production in 2018.



The U.S. Energy Information Administration, EIA, expects that crude oil price increases in late 2017 will contribute to U.S. crude oil production growing to more than 10 million barrels per day (mb/d) by mid-2018. Overall, U.S. crude oil production is forecast to increase by an average of 0.8 mb/d in 2018. This is 0.1 mb/d higher than EIA's previous forecast. Forecasted 2018 annual production will mark the highest in U.S. history, surpassing the previous record of 9.6 mb/d set in 1970.

Experts at a Financial Times Commodity Conference in Tokyo said the rapid spread of electric vehicles may cause crude demand to start declining sooner than expected, starting in 2025. In one short decade, the debate about oil has gone from peak supply "We are running out of oil!" to peak demand "We don't need as much oil." Oil companies are likely to shift more effort to gas production than oil. China is especially keen on developing an electric vehicle industry. These vehicles will be charged with gas produced electricity.

The recent rise in energy prices is likely put upward pressure on inflation and interest rates. We expect a supply response to increase oil supply toward the middle of 2018. This should put downward pressure on prices about mid-year. Thanks to U.S. shale, the probability of a major oil price spike and its economic impact has greatly diminished. The anticipated higher rig count will likely boost U.S. industrial production, capital goods investment and earnings for the S&P 500 Index. $50 to $60 per barrel oil seems to be the Goldilocks range for the stock market, not too hot, not too cold.

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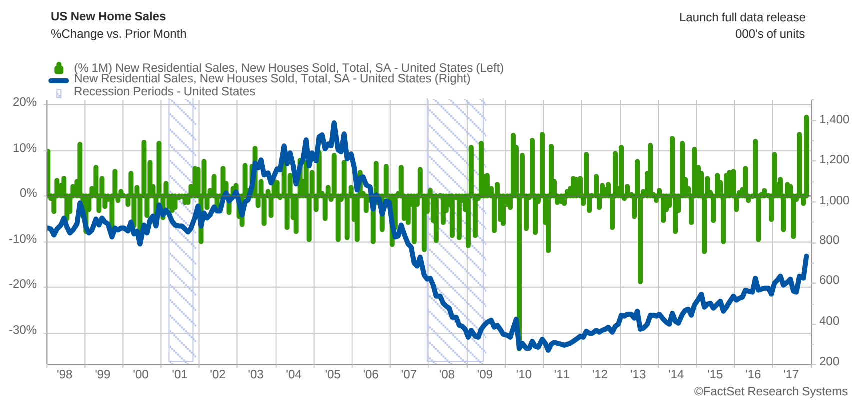
Housing

In November, new single-family home sales were 733,000, up from a revised 624,000 pace the month before. Monthly data tends to be volatile and is often revised significantly. To even out the volatility, we use a rolling three month average. November's trailing three month trend was up 15.4% y/y. The gains were broad based and across most regions of the country, not only those impacted by the hurricanes.



The trailing 3 month average median sales price is up 3.7% y/y to $322 thousand. For the last year, new home prices have risen slightly faster than disposable personal income per capita (3.0%). Existing home prices as measured by the Case-Shiller 20-City Index are up 6.4%. If home prices rise too much above incomes, potential purchasers will be shut out of the market and new home sales growth will falter. The current pace of price increases should not materially retard new home construction.

November's trailing three month single family housing starts are up 6.8% y/y to an 882 thousand homes pace. 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.

While housing has been a steady preformer since 2011, tax policy is has now turned into a potential headwind. The Tax Cut and Jobs Act reduced the cap on principal for interest deduction on new mortgages from $1 million to $750 thousand and added a cap of $10 thousand for state and local property and income tax deductions. It also doubled the standard deduction, thus eliminating the need to itemize for about chunk of tax filers. 29.6% of tax filers itemized in 2015. The Tax Policy Center estimates that only 11% of filers will itemize after tax reform. These three items are seen as headwinds for the housing industry because it reduces the tax advantage of homeownership.

We do not believe the housing market will be materially impacted by tax reform. Younger and less affluent households typically do not itemize. They are the marginal home buyers. Itemizers are concentrated in upper income brackets and more than likely live in the high cost coastal states. For this bracket, homeownership is a lifestyle choice as much as a tax shield strategy. The reduction in the tax shield will, however, likely reduce home price appreciaiton in the upper end of the market. As mentioned above home price appreciation was 6.4%.

Housing is estimated to be 3.8% of the economy. Residential construction directly employs 771 thousand persons. 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. This sector will continue to provide support for economic growth.

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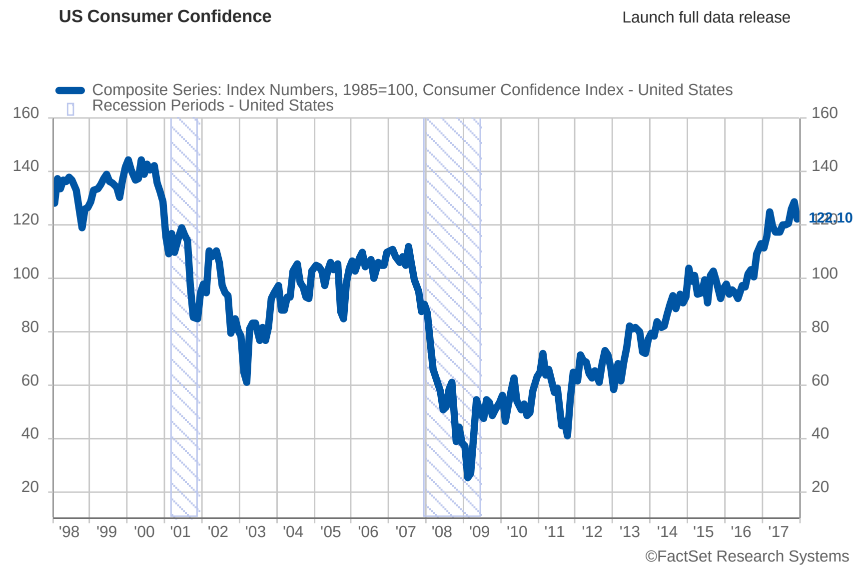
The Consumer

The Conference Board reported that consumer confidence fell to 122.1 in December from 128.6 the previous month. The previous month's reading marked a new cycle high. The slightly lower reading was impacted by a less optimistic outlook for jobs and business conditions. Consumers' assessment of current conditions remains quite favorable. The Index suggests that the economy will continue expanding at a slightly faster pace. The average over the last twenty years has been 93.



The present situation component rose to 156.6 from 154.9 the previous month. The expectations component fell to 99.1 from 111.0 the previous month. Both readings are significantly above their twenty-year averages of 102 and 87 respectively.

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) rose to 13.4 from 8.2. The strong employment environment has boosted consumers' confidence in the job market. Consumers' net perception of current business conditions (good less bad) rose to 23.1 from 22.7.

Personal income is estimated to be up 3.8% in the past year versus a 1.5% pace reported last year. The growth in personal income is accelerating. Private sector wages and salaries are up 4.8% from last year. Disposable personal income is up 3.7% y/y.

Consumer spending on goods and services is up 4.5% from last year. This is higher than income growth. To finance the buying, consumers are adding to their debt. Consumer credit outstanding is up 5.4% y/y. This is faster than the 4.5% nominal GDP growth. Both revolving and non-revolving debt are growing. In addition, consumers are returning to cash out refinancing. The personal savings rate fell to 2.9% of disposable income. The savings rate is at the cycle low and the lowest saving rate since 2007.

Despite the lower savings rate, household balance sheets are still in reasonable shape. Household net worth is up 8.03% y/y. This is significantly faster than the growth in consumer spending. It may also account for consumers' willingness to reduce their savings rate. Their balance sheet can support more debt. The household debt service and financial obligations ratio remains at 15.5%, down significantly from the 18.1% registered at the end of 2007.

We expect consumer income and spending to continue to post nominal growth of about three to five percent for the next couple of years. Spending will likely mirror the growth in wages.

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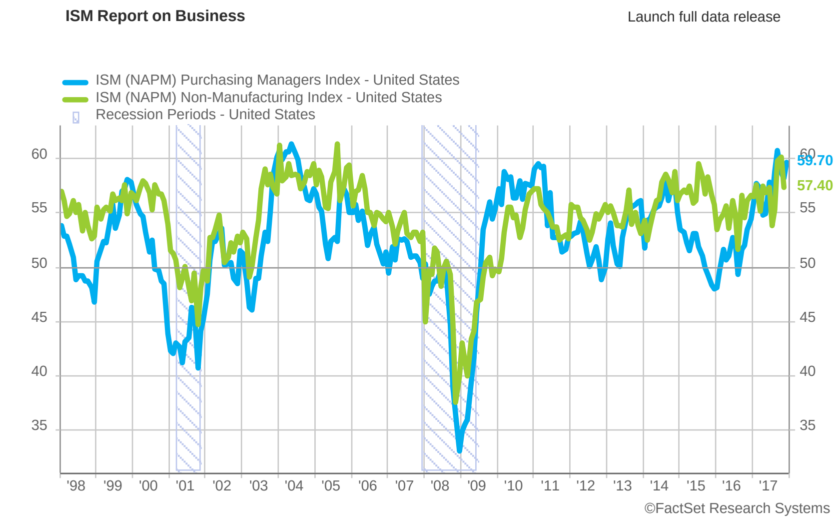
Business Activities Report

The Institute for Supply Management's (ISM) non-manufacturing index fell last month to 55.9 from 57.4 the previous month. This reading marks the 96th consecutive month of economic growth in the service sector. Comments from the survey panel indicate business conditions are expanding at a slightly slower rate. The majority of respondents indicated that they finished the year on a positive note and had a positive outlook for the New Year.



New orders, business activities / production, and export orders all continue to grow, but at a slightly slower pace for the second straight month. Employment trends accelerated while supplier deliveries slowed. Prices for purchased materials and services rose at a slightly faster pace for the seventh consecutive month. Fourteen industries indicated growth with three industries indicating contraction.

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 ISM Manufacturing Index rose to 59.7 from 58.2 the previous month, indicating growth in the manufacturing sector for the 16th consecutive month at a slightly faster pace. Comments from the survey panel indicate expanding business conditions, with new orders and production leading the gains. Employment is expanding at a slower pace. Order backlogs are expanding at a slower rate. Export and import orders continue to grow. Supplier deliveries continue to slow and raw material inventory continues to decline. Customer inventories continue to decline and remain at a low level. Price increases continue at a faster rate. Of the 18 manufacturing industries surveyed, 16 reported growth. Two industries reported contraction during the period.

The soft data (survey related) indicate the economy is growing at a steady pace. Both manufacturing and services continue to see steady economic growth. Both manufacturing and services also report rising prices for inputs.

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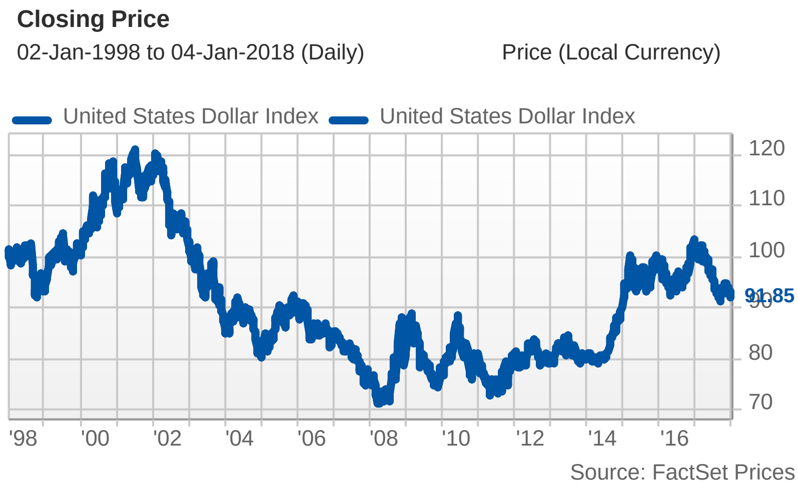
Trade Weighted Dollar

The U.S. dollar Index fell 9.9% in 2017 and is down 6.7% over the last two years. The dollar is likely to be a modest tail wind for corporate earnings, and a slight boost to inflation and interest rates.

The prospect of rising interest rates and stronger economy in Europe and Japan has placed additional pressure on the dollar.

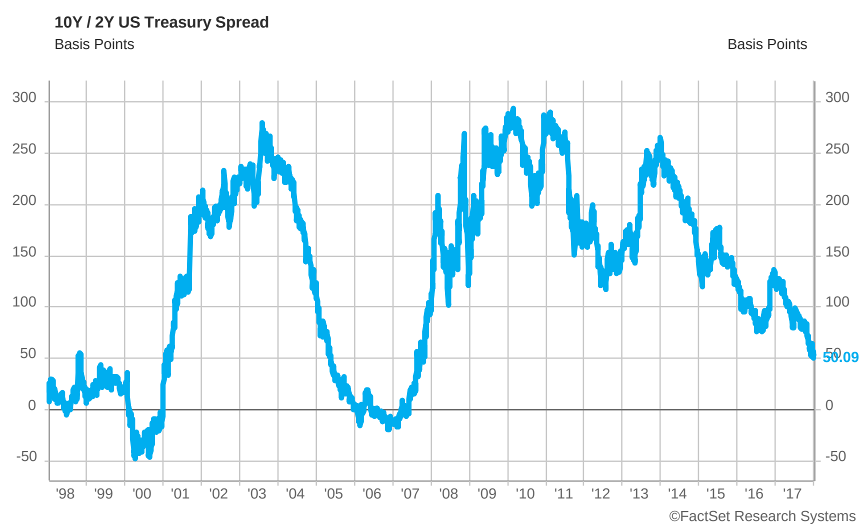


International Interest Rates

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

	1 Year	5 Year	10 Year
United States	1.81%	2.27%	2.46%
United Kingdom	0.42%	0.76%	1.24%
Europe	-0.67%	-0.21%	0.43%
Japan	-0.15%	-0.10%	0.06%

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, 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. U.S. long term rates remain stuck at current levels as a result of ECB and BOJ bond purchases. In 2018, the ECB will begin tapering their bond purchases. This should boost European rates and indirectly longer term US rates.



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One of the benefits of a 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 the European and Japanese central banks' purchases. 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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