THIRD QUARTER 2018 MARKET OUTLOOK

Our Outlook

	2015	2016	2017	2018 Est	2019 Est	Long Term
GDP Growth (1)	1.9%	2.0%	2.5%	2.8%	2.2%	2.0%
Change in Consumer Prices(2)	0.7%	2.1%	2.1%	2.2%	2.1%	2.0%
Fed Funds Target Rate (3)	0.50%	0.75%	1.50%	2.25%	3.00%	3.00%
5-Year Treasury Yield (3)	1.78%	1.83%	2.20%	2.85%	3.55%	4.00%
10-Year Treasury Yield (3)	2.28%	2.43%	2.41%	3.05%	3.85%	4.70%
S&P 500 EPS	$116	$118	$133	$159	$167	

(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.

The Quarter in Review

The U.S. stock market, as measured by the S&P 1500 SuperComposite, rose an impressive 3.65% during the second quarter and is up 2.91% year to date. The star of the show was small capitalization stocks. The small cap index rose 8.77% last quarter and is up 9.39% year to date. Small cap stocks are seen as least likely to be harmed by trade frictions and are the primary beneficiaries of tax reform. Growth stocks also bested value stocks by 9.50% year to date.

The Federal Reserve Board has raised rates seven times since it began the current tightening cycle in December 2015. We expect the Fed will raise rates one more time in 2018 and three times in 2019. We are below the Fed's own projections that call for two more rate hikes this year and three more next year.

It is time for our mid-year assessment. Here is our assessment in a condensed form.

What is Going Right?

Economic growth is strong

- ✓ Estimates for the second quarter GDP growth are hovering above 3.75%. This year's growth rate will likely be close to 2.8%. This will be the highest growth rates since 2005.

Consumer confidence is high

- ✓ The most recent consumer confidence reading was 126 compared to 27 reached at the depth of the Panic of 08 and the twenty year average of 94.

Small business optimism is high

- ✓ The index of Small Business Optimism is at its second highest reading in its 45 year history.

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Payroll growth is robust

- ✓ A record 155.6 million people are employed. This is up 1.5% year over year (y/y). The private sector has added 2.4 million jobs in the last twelve months.

Unemployment is low

- ✓ Unemployment is currently 4.0% and may fall to close to 3% by year end. It has not been this low since Ike was in the White House.

S&P500 earnings are strong and rising

- ✓ First quarter earnings grew 25% y/y and are expected to grow 20% y/y in the second quarter. For the full year earnings are expected to grow 21% y/y. Next year, earnings are expected to grow a respectable 9.9%

The chances of a hot war on the Korean Peninsula have diminished.

- ✓ Not too long ago, Messrs. Trump and Kim were bragging about how big their nuclear buttons were and threating war. Today, progress toward denuclearization may be possible.

What Worries U.S.

Tight labor markets may bring wage inflation

- × Some measures of wage growth show that wages are growing faster than 3.0%. Reports of compensation increases at small businesses are at an all-time high.

Margins are so good that they must fall

- × Tight labor markets may force companies to give workers a bigger share of the pie, eating into profit margins.

Tariffs and trade wars may derail the expansion

- × Tariffs pose only a modest threat to the S&P 500earnings for now. Exports to China are just 1% of U.S. GDP and imports from China are only 3% of U.S. GDP. Proposed tariffs will have minimal direct impact on GDP growth or overall corporate earnings. The most likely impact of rising trade tensions will be on sentiment. Business surveys show concern in expected future conditions. This may cause executives to pull back on future business expansion. So far, there is no hard evidence that trade issues have impacted the data.

Input costs continue to rise

- × The ISM surveys and corporate earnings reports show continued raw material pressures. This has especially harmed industrial companies.

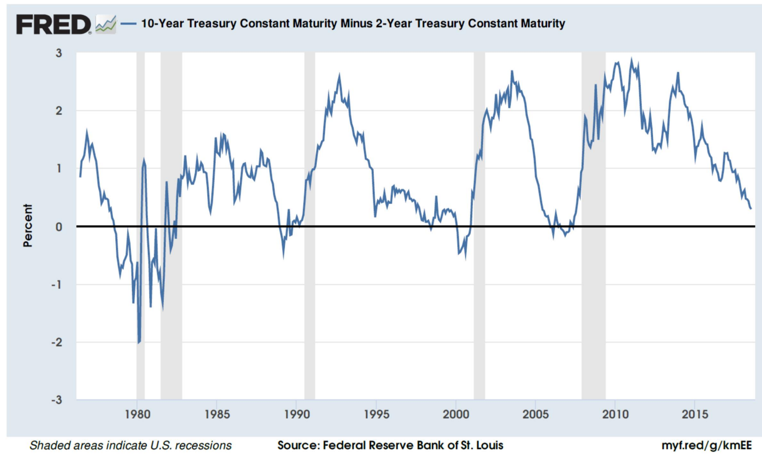
The Fed may raise rates too far

- × The Fed may be too reluctant to stray from its predefined path of rate hikes. They may be too slow to recognize a slowing global economy. This would push the U.S. into a classic recession. We do not believe real interest rates are high enough to push the U.S. into a recession. It is likely that the Fed Funds Rate would have to double for this to happen.

Earnings growth may have peaked

- × Second quarter earnings growth is unlikely to match the first quarter's 25% growth rate. Next year's growth rate of 9.9% pales in comparison to this year's 21%. In other words, our best days are behind us. While we agree that we are unlikely to match today's heady growth rates, a 9% growth rate surely justifies the current 16 to 17 P/E and would allow for total return high enough to exceed most investor's needs.

The yield curve may invert



- The yield curve has traditionally been a strong signal of a pending economic downturn. Currently the difference between the two year Treasury yield and that of the ten year is 0.31%. This is down from 0.51% at the beginning of the year. Because of Quantitative Easing (QE) and other temporary factors surrounding tax reform, the yield curve may be giving a false signal. If we are right, long term rates will rise and the yield curve will steepen toward the end of this year and into next year. In addition, as seen by the chart at the right, the lead times between initial inversion and recession can be quite long.

Mid-Term elections may increase political risk

- Most Americans have become benumbed by the constant political rancor. The strident fringes have turned to verbal intimidation to emphasize their position. The political theater is likely to get uglier as the year progresses. Out best guess is that the Republicans maintain and maybe increase their control of the Senate with the House as a toss-up. President Trump's economic agenda stays on track. Tax reform will not be repealed. Fiscal policy will remain excessive. These will provide a tailwind for equity investors.

As interest rates rise so does the risk of a recession happening. Our forecast does not call for a recession prior to 2020. The U.S. is currently in the ninth year of economic growth, the second longest in U.S. history. Interest rates are likely to rise beyond the current accommodative level to neutral and into the restrictive territory sometime in late 2019 or early 2020.

The length and depth of recessions are not correlated to the length or strength of the previous expansion. Just because this expansion was long and shallow does not mean the next recession will be short or long or deep or shallow. It depends on the underlying cause of the recession and it's too early to tell.

Outlook

We maintain our favorable outlook on equity returns. U.S. and global growth remain strong. Monetary policy remains accommodative. The story for inflation and growth is playing out close to our original expectations. In response to continued strong quarterly results, we have raised our 2018 S&P 500 earnings estimate from \$156 to \$159. Prior to tax reform we had projected 2018 earnings to come in at \$145. We still remain slightly more conservative than consensus.

Prepared by Damian Howard
July 11, 2018

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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

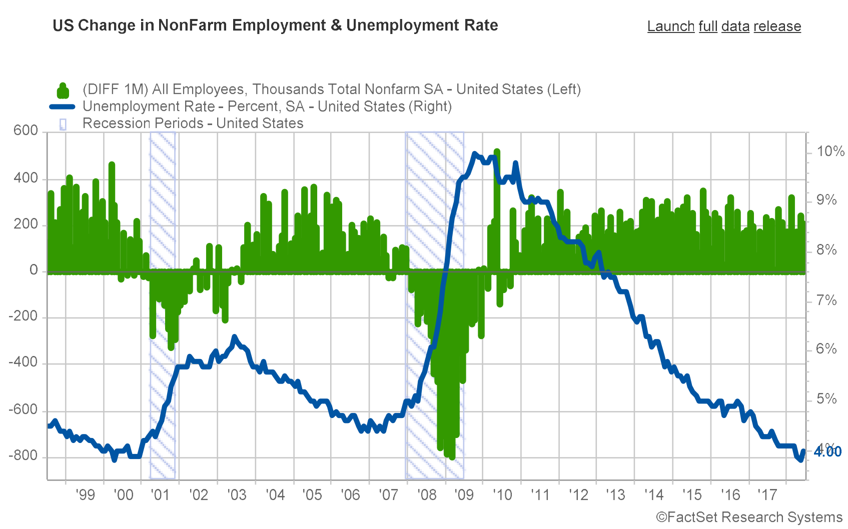
		1 Month Change	YTD Change	1 Year Change
Fed Funds Target	1.75% to 2.00%	0.25%	0.50%	+75 bp
2-Year Treasury Yield	2.52%	+12 bp	+63 bp	+114 bp
5-Year Treasury Yield	2.73%	+5 bp	+53 bp	+84 bp
10-Year Treasury Yield	2.85%	+2 bp	+ 45 bp	+54 bp
SNL 30Yr Fixed – U.S. Avg.	4.60%	+8 bp	+54 bp	+53 bp
S&P 500 Index*	2,718	0.62%	2.65%	14.37%
S&P Midcap 400*	1,952	0.42%	3.49%	13.50%
S&P Small Cap 600*	1,017	1.13%	9.39%	20.50%
S&P SuperComposite 1500*	631	0.62%	2.91%	14.50%
S&P 500 Growth*	1,634	0.60%	7.28%	20.63%
S&P 500 Value*	1,088	0.63%	-2.22%	7.58%
Crude Oil – WTI Spot	$74.13	10.67%	22.61%	61.08%
Gold – New York Spot	$1,252	-3.51%	-3.88%	0.9%

*Data as of May 31, 2018. * = Total return*

Since 1977, the Federal Reserve has operated under a mandate from Congress to "promote effectively the goals of maximum employment, stable prices, and moderate long term interest rates" – what is now commonly referred to as the Fed's "dual mandate." For this reason we always start our economic review with employment followed by inflation. We then review other factors that drive our economic outlook.

Employment

The Labor Department reported in its July 6th Employment Situation (Jobs) Report as better than expected. The labor market continues to surprise on the upside and to defy expectations for inflationary wage growth.



The economy added 213 thousand jobs last month. This was significantly above the 193 thousand consensus expectation. The totals for the previous two months were revised up a net 37 thousand.

The trailing three month average job growth was 210,700 versus 191,300 last month and 189,700 last year. Job gains were broad based with most sectors showing y/y gains.

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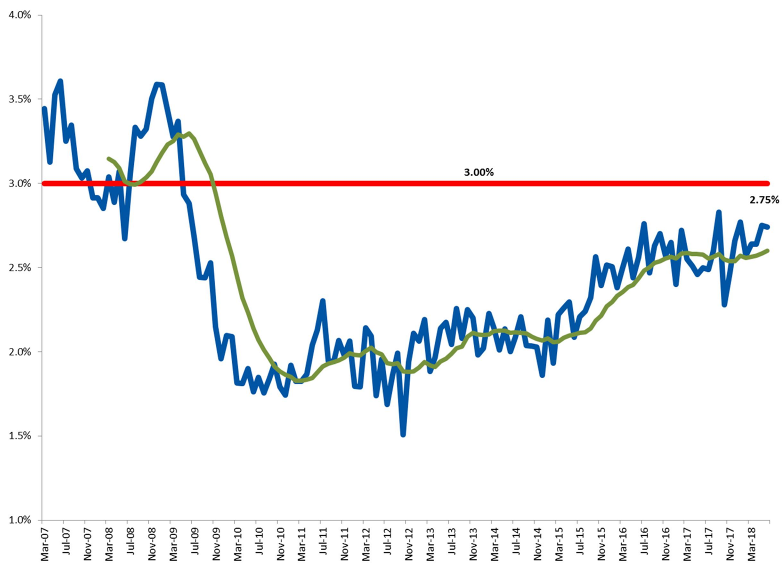
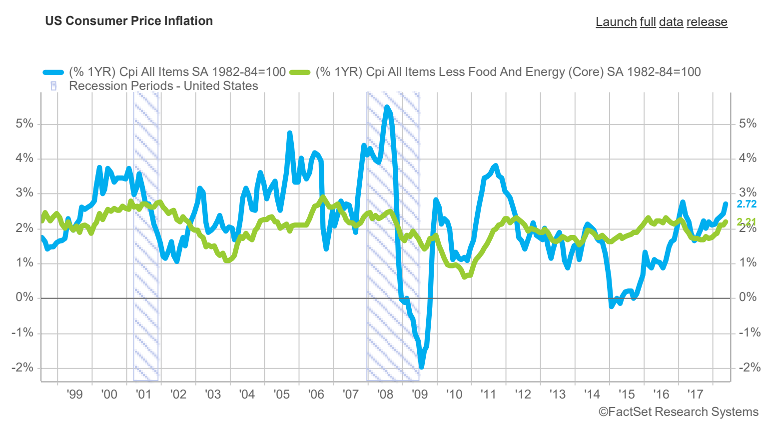
Despite the strong job growth the unemployment rate rose to 4.0%. This is down from 4.3% last year. The broader U-6 measure rose to 7.8% from 7.6% and is down from 8.5% last year. This measure includes part-time workers who would prefer a full-time position and people who want a job but are not actively looking for one (so-called discouraged workers). The Labor Department started tracking U-6 in January 1994. Last month's reading was the lowest ever recorded.

Over the last twelve months the U.S. economy added a net 2.4 million jobs. The number of employed individuals has increased 1.5% over last year. During the same time, the labor force has grown by 1.9 million or 1.2%. The labor participation rate rose slightly to 62.9% from 62.7% versus last month and 62.8% last year.



Last month's average hourly earnings (wages) grew at a 2.74% y/y rate, even with a revised 2.75% last month and up from 2.50% wage growth reported last year. The average work week held steady at 34.5 but rose from 34.4 last year. Average weekly earnings are up 3.04% from last year to $930.81. Wage growth has not exceeded 3.0% since April 2009.

Sustained wage inflation has not yet reached the 3.0% level. We believe wage growth can surpass 3% for an extended period of time before wage induced inflation starts to become a concern. This report should keep the FRB on track to raise rates at their September meeting and possibly at their December meeting.



Inflation

The consumer price index rose 0.2% m/m in May and is up 2.7% y/y. This is above the FRB's 2.0% inflation target. The above-target inflation rate is closely tied to the surge in the price of oil. Core inflation is up 2.2% y/y.

The price of gasoline rose 1.7% last month and is up 21.8% y/y. Energy prices are up 11.0% y/y. Medical costs are up 2.4% y/y and Owners' Equivalent Rent is up 3.4% y/y. All other categories remain under control. Consumer prices, excluding energy, are up 2.1% y/y.

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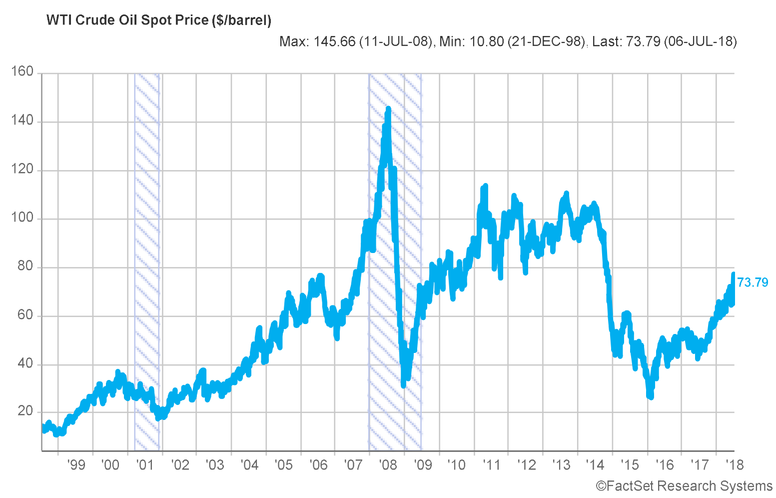
The FRB prefers the Personal Consumption Expenditure (PCE) as its measure of inflation. Due primarily to differences in how health care costs are allocated between employers and consumers, the PCE tends to run 0.25% to 0.50% below the CPI. The PCE was up 0.2% in April and is up 2.3% y/y. The core PCE was up 2.0% y/y.

The FRB can declare victory on the inflation front. Inflation is now firmly anchored at the FRB's stated goal of two percent. Unless wage growth starts to induce wage-pushed inflation, there is no reason why the FRB needs to alter its planned course of steady rate increases thru 2019. We believe they will raise rates at least one more time in 2018 and at least three times next year, for a total of four additional hikes between now and year end 2019. If we err, it is likely that the FRB will raise rate one additional time each this year and next. We are holding steady on our rate increases due to slower international growth and rising trade and political tensions.

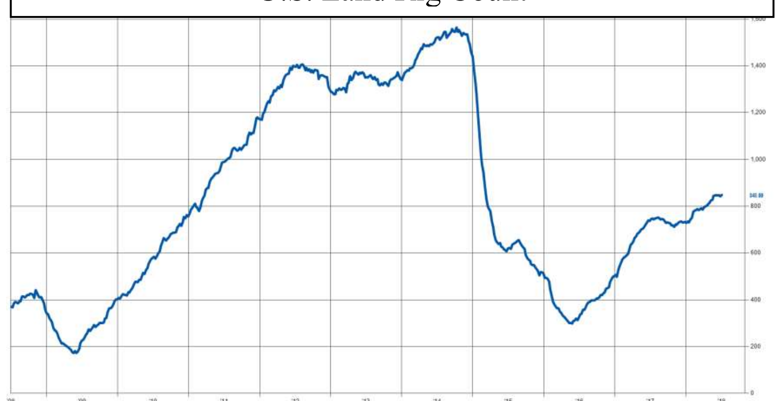
Oil

In late June, the Trump Administration announced a zero-tolerance approach to enforcing sanctions against Iran. The administration wants countries to stop importing Iranian oil by November. Iran is OPEC's third largest producer, selling 2.4 million b/d or 2.4% of global supply. Mr. Trump's actions threw the global oil markets into an undersupplied situation overnight. Since the Trump administration announced its zero-tolerance policy, the price for WTI rose from $65.68 per barrel to its current $73.79, an increase of 12%.



While some Iranian production will find its way onto the global markets, there is still a substantial shortfall that must be replaced. In June, the Saudis increased their production, and non-OPEC oil production is up a hefty 2.2 million b/d y/y and likely will continue to increase. If the new production is able to replace more of the lost Iranian output, prices may stabilize. If not, oil prices will be volatile through the remainder of the year.

U.S. Land Rig Count



In response to higher prices, drillers once again increased the number of rigs drilling for oil. The most recent Baker Hughes survey puts the U.S. land rig count at 848. With oil prices firmly above $70 per barrel, more rigs continue to be deployed. Drillers have returned to growth mode. This will boost U.S. production in 2018 and 2019.

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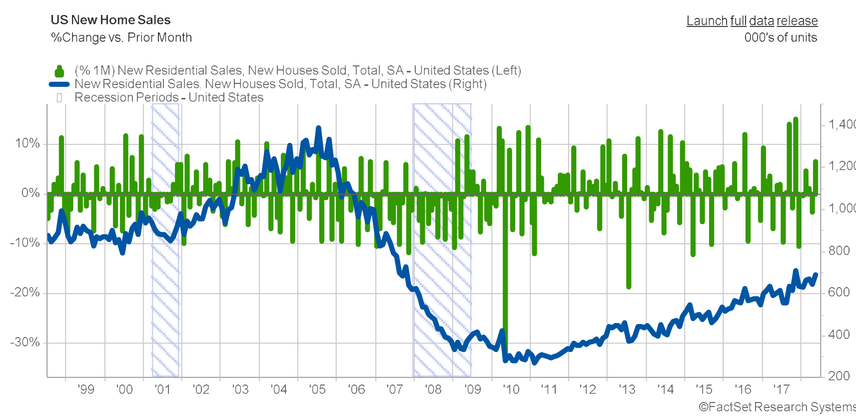
The EIA estimates that U.S. Crude production averaged 9.4 million barrels per day in 2017. This was up 0.5 million (5.7%) b/d from 2016. In 2018, the EIA expects total U.S. crude oil production to average 10.8 million b/d (up 15% y/y). In 2019, the EIA expects crude oil production to continue to increase, reaching an average 11.8 million b/d (up an additional 9% y/y). The 2018 annual production will mark the highest in U.S. history, surpassing the previous record of 9.6 mb/d set in 1970. EIA forecast that crude production will end 2019 at a 12.0 million b/d pace.

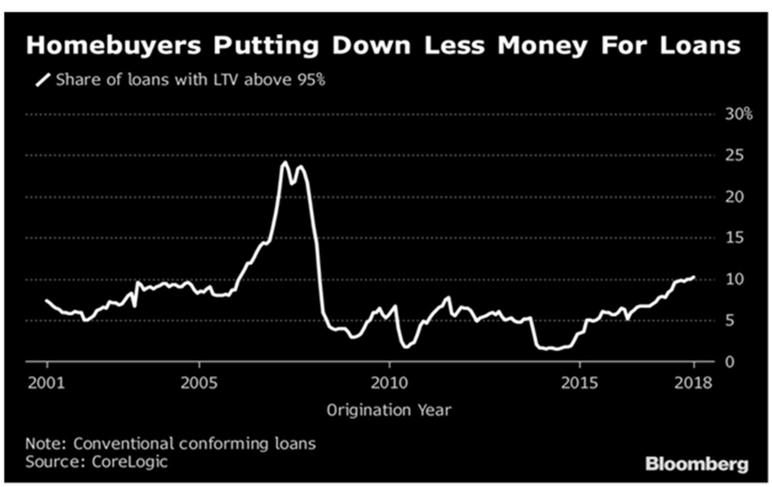
The higher rig count will boost U.S. industrial production, capital goods investment and earnings for the S&P 500 Index. During the first quarter, the energy sector increased its investment spending by 44% y/y to $103 billion. Earnings for the S&P 500 energy sector are forecast to rise 102% this year. One of the upsides of shale production is that higher energy prices are no longer seen as a tax on the U.S. economy. Higher prices shift purchasing power from the coast to the interior of the U.S. It also shifts revenue and earnings from the discretionary section to the energy and industrial sectors.

Housing

In May, new single-family home sales were 689,000, up from a revised 646,000 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. April's trailing three month trend was up 9.3% y/y. The gains were led by a 19.3% growth in the Midwest followed by the South's gain of 10.3%.



The trailing 3 month average median sales price is up 1% y/y to $322 thousand. The slower price appreciation was likely the result of a mix shift to less costly regions. For the last few years, new home prices have risen faster than disposable personal income per capita (3.3%). Existing home prices as measured by the Case-Shiller 20-City Index are up 6.6% y/y. Home prices continue to rise faster than incomes. In response to higher prices, homeowners are borrowing more.



The seeds of the next crisis are being sown today. The share of U.S. homebuyers putting down less than 5% has risen to the highest level since the Panic of 08, according to data from CoreLogic Inc. High loan to value loans are seen as high risk and often a sign of stretching of underwriting standards during the later stages of an economic cycle.

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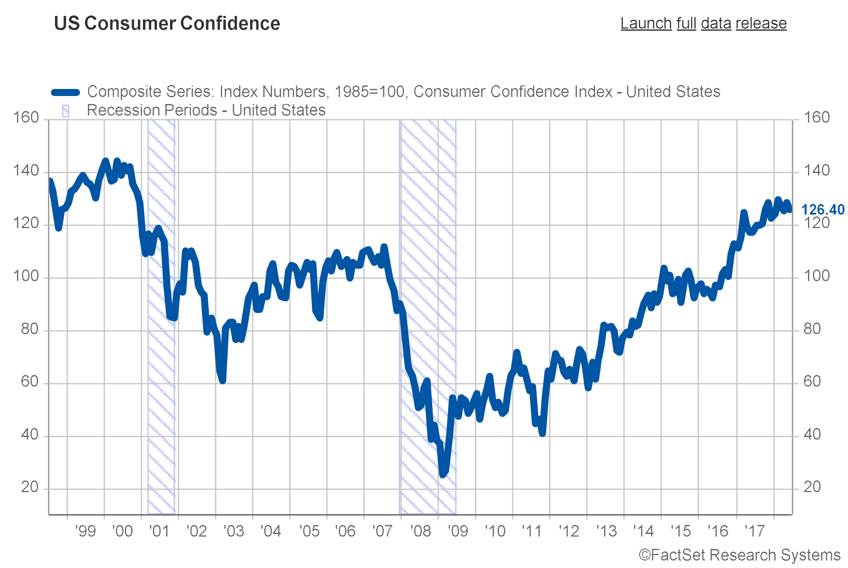
Housing is estimated to be 3.8% of the economy. Residential construction directly employs 797 thousand persons. The housing market was the root cause of the last downturn and has yet to fully recover. It is now showing early signs of late cycle pressures. Housing is not yet overheating but it is getting warmer. This sector will continue to provide support for economic growth for the next couple of years.

The Consumer

The Conference Board reported that consumer confidence fell slightly to 126.4 from 128.8 the previous month. Consumers' assessment of economic 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 fell ever so slightly to 161.1 from 161.2 the previous month. Trade tensions and rising gas prices have dampened expectations for future economic growth. The expectations component fell to 103.2 from 107.2 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) fell slightly to 25.1 from 26.5 the previous month. The strong employment environment has boosted consumers' confidence in the job market.



Consumers' net perception of current business conditions (good less bad) also fell slightly to 24.3 from 26.0 the previous month.

Personal income is estimated to be up 4.0% in the past year versus a 2.8% pace reported last year. Private sector wages and salaries are up 5.3% from last year. Disposable personal income is up 4.0% y/y. Disposable personal income per capita is up 3.3% y/y.

Consumer spending on goods and services is up 4.6% from last year. This is higher than income growth at 4.0%. To finance the buying, consumers are reducing their savings and adding to their debt. Consumer credit outstanding is up 4.8% y/y. The personal savings rate fell to 3.2% of disposable income. The savings rate was 3.8% this time last year. Consumption must eventually slow to match income growth.

While consumer debt has risen faster than income, the consumer is still in good shape. The financial obligations ratio – which compares debt and other recurring payments to income – is still only 15.75%. This is down from its peak of 18.14% prior to the Panic of 08, but up from 14.95% in 2012. U.S. household net wealth reached a record of $102 trillion compared to $15.6 trillion of liabilities.

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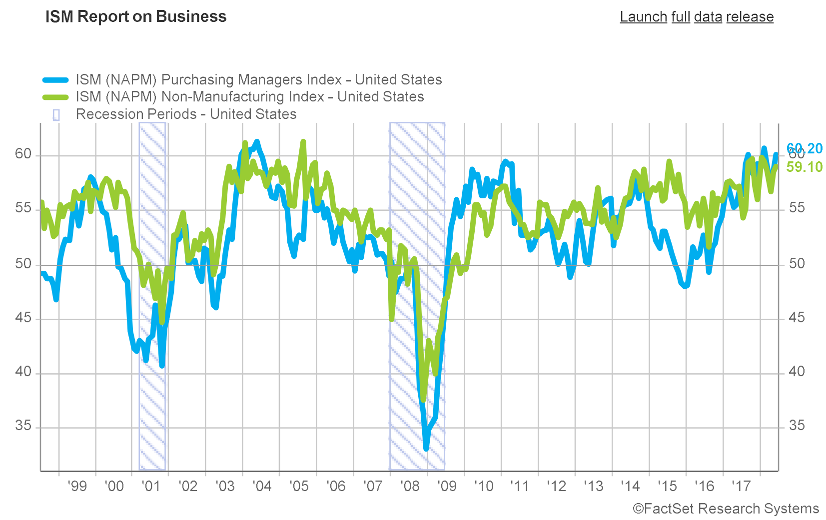
Business Activities Report

The Institute for Supply Management's (ISM) non-manufacturing index rose to 59.1 from 58.6 the previous month. This reading marks the 101st consecutive month of economic growth in the service sector. Comments from the survey panel indicate "Respondents continue to be optimistic about business conditions and the overall economy. There is a continuing concern relating to tariffs, capacity constraints and delivery."



Business activities / production, new orders, and new export orders continue to grow and at a faster pace. Employment, inventories, orders backlog and imports are growing as slower pace. Supplier deliveries slowed at a faster pace. Prices for purchased materials and services rose for the 28th consecutive month but at a slightly slower pace.

Seventeen of the eighteen industries indicated growth in April. Only one industry reported a decrease in activity.

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 60.2 from 58.7 the previous month, indicating growth in the manufacturing sector for the 22nd consecutive month. Comments from the survey panel indicate "Demand remains robust, but the nation's employment resources and supply chains continue to struggle. Respondents are overwhelmingly concerned about how tariff related activity is and will continue to affect their business,"

Manufactures reported widespread raw material price increases. Cost pressures appear to be decelerating. The price index has marked pricing pressures for the 28th consecutive month.

Of the 18 manufacturing industries surveyed, 17 reported growth. No industry reported contraction during the period.

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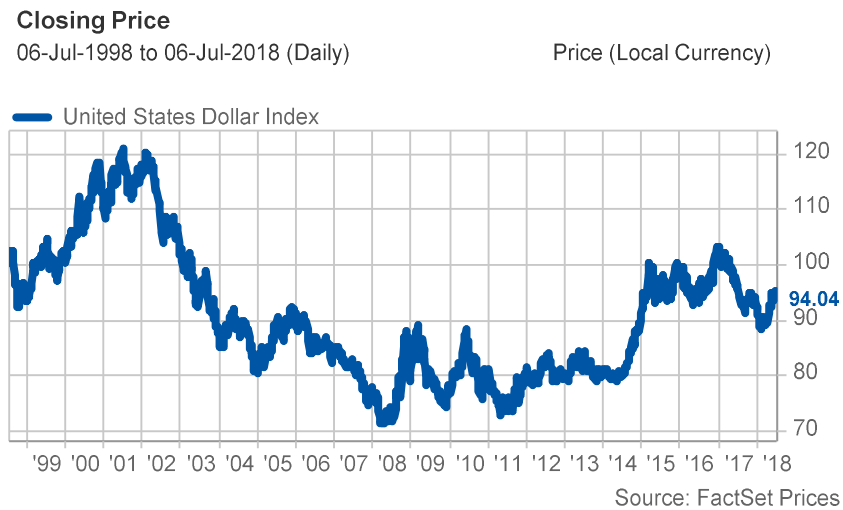
Both manufacturing and non-manufacturing activities are strong and are getting stronger. However, the labor market is stretched as bottlenecks in labor supply and quality are limiting growth. Transportation cost and raw material inflation are becoming a bigger issue. In addition, trade tensions are causing manufacturers to shift production to different locations to avoid tariffs where possible. It is also causing supply chain disruptions. Due to the increasing uncertainty, strategic planning is replaced by contingency planning. This may reduce future investment and growth prospects.



Trade Weighted Dollar

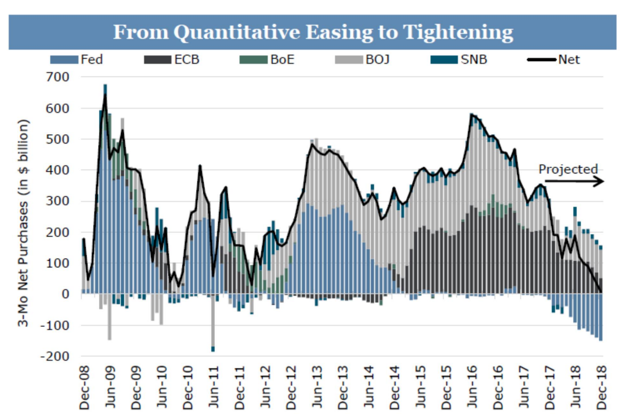
The U.S. dollar index has risen since mid-April as global geopolitical risks have risen and global growth has slowed slightly. The Index is up 2.36% year to date but is still down 1.85% over the last twelve months. The dollar has turned from being a tailwind to corporate earnings to being a neutral factor. A declining dollar generally helps corporate earnings, increases inflation and interest rates.

International Interest Rates

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

	1 Year	5 Year	10 Year
United States	2.32%	2.72%	2.82%
United Kingdom	0.69%	1.03%	1.27%
Europe	-0.69%	-0.30%	0.29%
Japan	-0.14%	-0.12%	0.03%

Interest rates in Europe and Japan have been suppressed by their own central banks engaging in Quantitative Easing (QE). Under QE, central banks purchase long term government, mortgage, and sometimes corporate debt. It can also include the purchase of common stock. The goal of QE is to drive down long term interest rates. We believe global QE is in part responsible for the shallow yield curve. Until central banks ease the financial repression, low international interest rates will pressure U.S. long term rates and keep the yield curve shallower than it otherwise would



Source: Wells Fargo, Bloomberg L.P.

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be. As shown on the chart above, net global QE will reach zero by the end of this year. QE is likely to turn negative next year. QE turns negative when central banks let more bonds mature than they purchase. This adds to supply of long term bonds in the market and should drive long term interest rate higher on a global scale. International interest rates are then likely to join U.S. rates in the glacial pace of normalization.

We welcome your comments and suggestions. Please feel free to contact me at dhoward@snbomaha.com. Also, please see the obligatory disclosures listed below.

DISCLOSURES

Prepared by Damian Howard
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