

Our Outlook

	<u>2016</u>	<u>2017</u>	<u>2018 Est</u>	<u>2019 Est</u>	<u>2020 Est</u>	<u>Long Term</u>
GDP Growth ⁽¹⁾	1.9%	2.5%	3.0%	2.3%	1.9%	2.0%
Change in Consumer Prices ⁽²⁾	2.1%	2.1%	2.3%	2.1%	2.0%	2.0%
Fed Funds Target Rate ⁽³⁾	0.75%	1.50%	2.50%	3.25%	3.25%	3.00%
5-Year Treasury Yield ⁽³⁾	1.83%	2.20%	3.15%	3.80%	4.00%	4.00%
10-Year Treasury Yield ⁽³⁾	2.43%	2.41%	3.30%	4.00%	4.25%	4.75%
S&P 500 EPS	\$118	\$133	\$161	\$170	\$177	

(1) 4th quarter y/y change (2) December y/y 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 7.35% during the third quarter and is up 10.47% year to date. This far exceeds our expectations coming into the year. Large capitalization stocks rose 7.71% last quarter and are up 10.56% year to date. Small cap stocks rose 4.71% during the third quarter and are up a heady 14.54% year to date. Growth stocks bested value stocks by a whopping 13.73% year to date. Fixed income (bonds) was flat for the quarter and is down 1.6% year to date. International stocks were up 1.42% during the third quarter but are down 0.97% year to date.

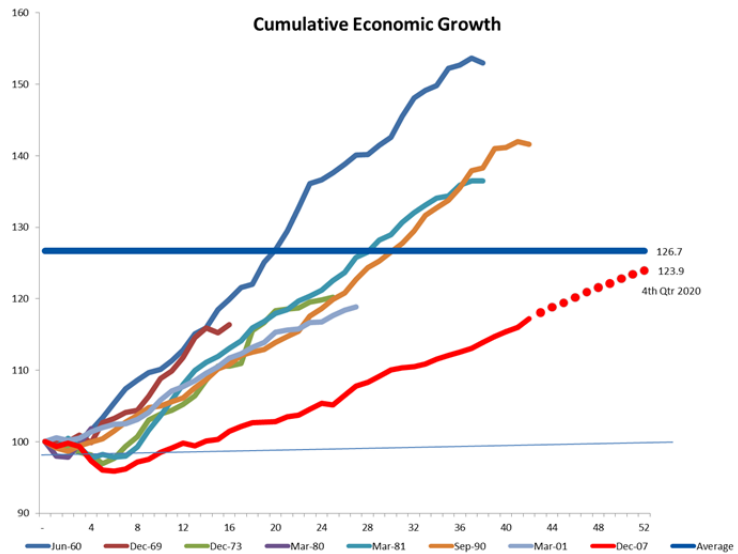
FOMC Meeting

On September 26th the Federal Open Market Committee (FOMC) of the Federal Reserve Board (FRB) raised the funds target rate by 0.25%, as widely expected. The target rate is currently 2.00% to 2.25%. This was the third increase this year and the fourth in the past twelve months. The only notable change in their statement was the removal of the sentence characterizing monetary policy as "accommodative". This was expected as the funds rate has moved closer to neutral. Currently the FOMC believes a 3.0% funds rate is neither stimulating nor restricting economic growth.

The FOMC also released their Summary of Economic Projections (SEP). The SEP shows that the FOMC expects to raise rates one more time this year, three times next year and one time in 2020. They also expect the economy will grow 3.1% this year, 2.5% next year and 2.0% the following year, slightly above our expectations. Inflation is expected to hold steady at 2.1% over the forecast period. This is well within the FRB's comfort zone.

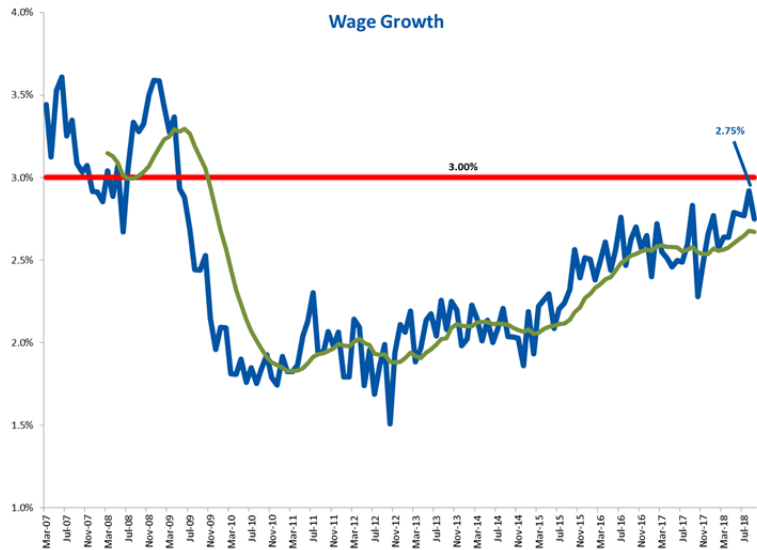
Economic Cycle

This time next year, the current expansion will become the longest in U.S. history going back to the 1850s. Next year in July, the expansion will surpass the 1990s boom, which lasted 10 years. Even though the current economic expansion will be the longest, it will still be a below par achiever. As seen by the chart on the right. The average economic expansion since 1960 experienced 27% cumulative growth. The current expansion will not likely reach par by the end of 2020.



With monetary policy no longer accommodative and a low grade trade war looming, professional economists have increased the odds that the GDP will decline one year ahead to almost 20%. For them, the expansion is late-cycle and destined to end in the near future.

We characterize the labor markets as currently at or close to late-cycle. The unemployment rate is currently 3.7%. The Federal Reserve believes the economy is at full employment at 4.5%. The same above mentioned professional economists put the full employment rate at 4.3%. The labor market has zoomed past full employment and continues to tighten. The civilian labor force grows by about 130 thousand people per month and about 63% of those people are actively in the job market. This means that the economy needs to generate about 80 thousand jobs per month to meet the new supply of workers. Recently the economy has been adding 185 thousand jobs per month. This is well in excess of what is needed. The tight labor market sets the condition for run-away wages and an inflation overshoot.



An inflation overshoot would force the FRB to raise the funds rate high enough to put the economy into a recession, thus cooling inflation. A recession would lead to lower corporate earnings and significant stock market losses. As wealth managers we not only seek to reap the benefits of a bull market, we also endeavor to mitigate losses during a bear market. Keeping an eye out for a recession will not guarantee we will be successful, but it will improve our chances.

We are watching wage gains and inflation expectation to gage the possibility of an inflation overshoot. Wage gains as outlined below remain muted. The exact reason wage growth has not shot up remains hotly

debated. Global competition, retiring baby boomers, the residual effects of the Financial Panic of '08 have all contributed to muted wage growth. There is also evidence that steady inflation expectations can anchor wage demands, thus providing a reinforcing central tendency for inflation/wage levels.

Inflation expectations remain well anchored around the FRB's 2.0% target. We can measure inflation expectations from the difference between a 10-year Treasury security and the ten year Treasury Inflation Protection security (TIPS). The difference implies what market participants expect inflation to average over the next ten years.



Current economic conditions do not point to an inflation overshoot. The economy is clearly growing faster than its long run potential of about two percent. We contend that well anchored inflation expectations give the FRB the opportunity to cool the economy, thus avoiding an eminent recession. They might just be able to engineer a “soft landing”. We believe economic growth will slow next year and into 2020.

We are sure the U.S. will eventually experience a recession. We are just as sure it is too soon to batten down the hatches. There are plenty of stock market gains to be reaped. We remain fully invested with an over-weight in U.S. equities. We will, as always, continually test our hypothesis and will adjust our forecast and investments accordingly.

Trade Tensions

In mid-September, President Trump ordered the U.S. Trade Representative (USTR) to impose 10% tariffs on roughly \$200 billion of Chinese goods effective September 24th. On January 1 the rate will jump to 25%. This brings the goods subject to tariffs to \$267 billion. In the meantime, President Trump seems to have settled his differences with Mexico and Canada and is content with minor changes to NAFTA. It appears that the Trump administration has focused its attention on China. It is likely that this trade dispute will last several years. It is highly unlikely that China will succumb to any pressure the U.S. can impose. We do not have sufficient leverage in this case. Unless the Trump administration changes its stance, the U.S. economy will likely decouple from China's. This will result in slower growth, lower corporate earnings and higher inflation on the margin.

Our Forecast

Since our third quarter Outlook, we have raised our growth forecast by 0.2% and added a fourth Fed Funds rate hike this year. We believe the FOMC will raise rates one more time this year and three more times next year. They are then likely to pause for an extended period of time. This should allow the other central banks time to catch up to FRB in the normalization process. This should lift long term rates. We have also introduced our 2020 forecast. Please note we do not have a recession in our forecast.

Spike in Interest Rates

Since our last quarterly outlook, we have raised our year-end forecasted 10-year Treasury rate to 3.30% from 3.05% and next year's ending rate from 3.85% to 4.00%. This is mainly to accommodate the one additional Fed Funds rate increase. In the last month, the 10-year Treasury rate rose from 2.90% to

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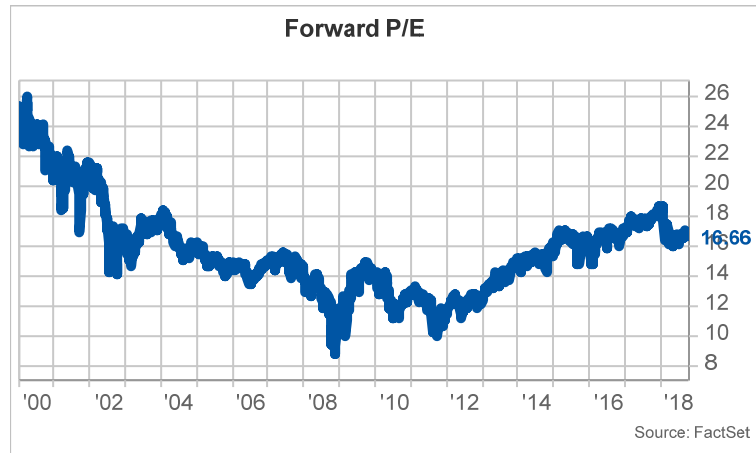
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3.23%. The 33 basis point move is quite unusual. Goldman Sachs classifies the move as a 1.7 standard deviation type move. Such large moves have historically been associated with a flat stock market. We expect the rising interest rate environment to lead to modestly lower stock market multiples.

Company Earnings

Earnings for the S&P500 have come in a bit better than expected. We now forecast earnings will be \$161 this year and \$170 next year. Earnings for the S&P500 Index are expected to grow 21% this year and 6% next year.

The market is currently trading a forward P/E of 16.7 times. This is roughly in line with its 25 year average of 16.1. We do not have major concerns about overall valuations, but we do believe the multiple will slowly compress over our forecast horizon.



We look for stock prices to grow slightly slower than earnings growth. Mid-single digit earnings growth coupled with a 2% dividend yield should provide a mid-single digit annualized total return over the forecast horizon. We continue to invest in companies for the long haul.

We will not invest in a company if we do not believe we can own it for a decade.

As usual, my two page outlook has turned into a four pager. For that, I apologize. Please see the attached economic overview for a more detailed analysis of the data we use to develop our outlook. 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.

Recent Economic Reports

		<u>1 Month Change</u>	<u>YTD Change</u>	<u>1 Year Change</u>
Fed Funds Target (Upper)	2.25%	+0.25%	+0.75%	+100 bp
2-Year Treasury Yield	2.81%	+19 bp	+92 bp	+134 bp
5-Year Treasury Yield	2.94%	+20 bp	+74 bp	+102 bp
10-Year Treasury Yield	3.05%	+19 bp	+65 bp	+72 bp
SNL 30Yr Fixed – U.S. Avg.	4.70%	+8 bp	+62 bp	+69 bp
S&P 500 Index*	2,914	0.57%	10.56%	17.91%
S&P Midcap 400*	2,020	-1.10%	7.49%	14.21%
S&P Small Cap 600*	1,062	-3.17%	14.54%	19.08%
S&P SuperComposite 1500*	674	0.34%	10.47%	17.69%
S&P 500 Growth*	1,780	0.73%	17.24%	25.21%
S&P 500 Value*	1,145	0.38%	3.51%	10.06%
Crude Oil – WTI Near Term	\$73.25	+4.94%	21.23%	41.77%
Gold – Near Term	\$1,192	-0.73%	-8.79%	-7.02%

Data as of August 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

We caution that the Labor Department’s October 5th Employment Situation (Jobs) Report was likely impacted by Hurricane Florence. The storm likely reduced jobs growth by 50-60 thousand. Those lost jobs will filter back into future reports. Payroll growth was less than expected but prior month’s results were revised up. The unemployment rate fell to its lowest since 1969.

The economy added 134 thousand jobs last month. This was below the 185 thousand consensus expectation. The totals for the previous two months were revised up a net 87 thousand.

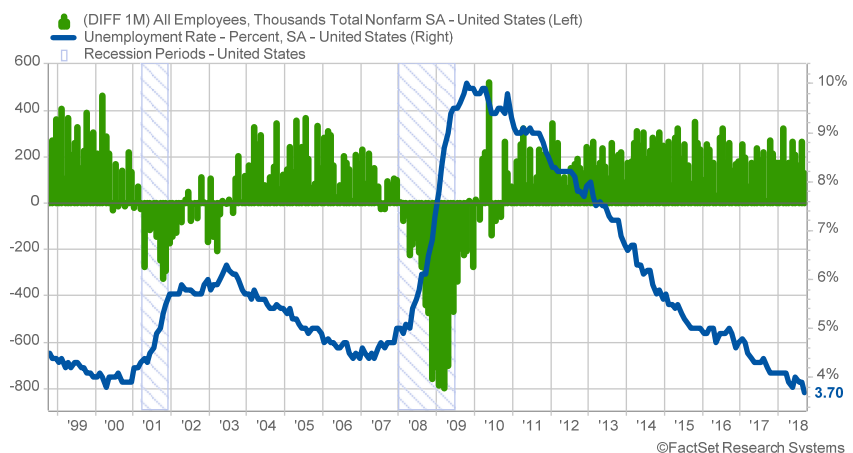
The trailing three month average job growth was 189,700 versus 214,300 last month and 141,700 last year. Professional and business services added 54,000. Transportation and warehousing added 23,800

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jobs. Areas impacted by the storm such as Leisure and hospitality lost 17 thousand jobs. Construction and manufacturing added a total of 41 thousand jobs.

The unemployment rate fell to a 48 year low of 3.7%. This is down from 4.2% last year. The broader U-6 measure rose slightly to 7.5% from 7.4% but is down from 8.3% 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.

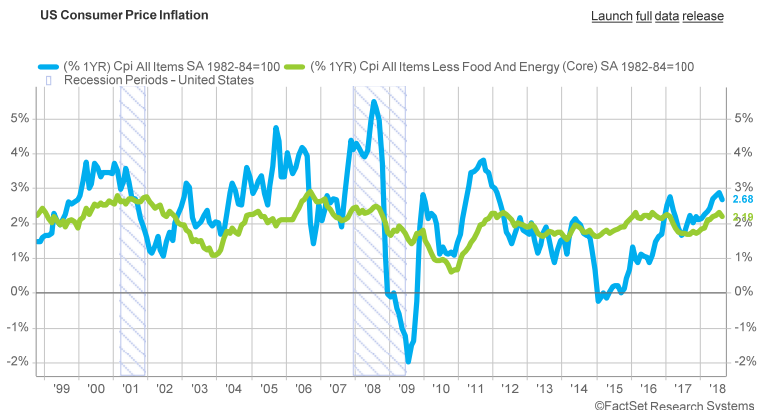
Over the last twelve months the U.S. economy added a net 2.5 million jobs. The number of employed individuals has increased 1.1% over last year. During the same time, the labor force has grown by just 0.8 million or 0.5%. The labor participation rate held at 62.7% and fell from 63.0% last year. The participation rate has remained in a narrow range of 62.5% to 63.0% these last couple of years.

Last month's average hourly earnings (wages) grew at a 2.75% y/y rate down slightly from the 2.92% recorded last month and 2.83% wage growth reported last year. The average work week held steady at 34.5 hours and is up slightly from the 34.3 posted last year. Average weekly earnings are up 3.35% from last year to \$939.80. Wage growth has not exceeded 3.0% since April 2009.

Sustained wage inflation has not yet reached the 3% 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 December meeting and an additional three times next year before pausing.

Inflation

The consumer price index rose 0.2% m/m in August and is up 2.7% y/y. While headline inflation is running above the FRB's 2.0% target, it is running at a 1.8% pace over the last six months. The above-target y/y inflation rate is closely tied to the surge in the price of oil. Oil prices are up 42% y/y. Core inflation is up 2.2% y/y.



The price of gasoline rose 3.0% last month and is up 20.3% y/y. Energy prices are up 10.3% y/y. Energy inflation is likely to be the wild card for the remainder of the year. Medical costs are up 1.5% y/y and Owners' Equivalent Rent is up 3.3% y/y. All other categories remain under control. Consumer prices, excluding energy, are up 2.1% 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 0.1% August and is up 2.2% y/y. The core PCE was up 2.0% y/y.

The FRB can declare victory on the inflation front. Since the Panic of 2008 the FRB has been worried about deflation and stubbornly low inflation. 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

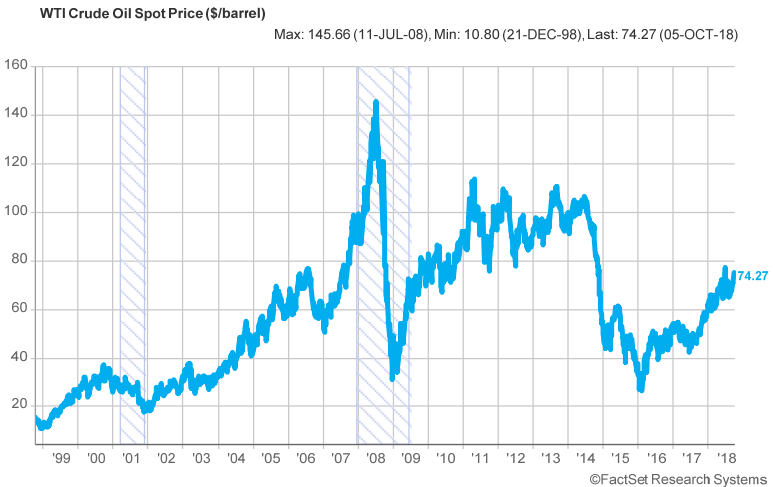
needs to alter its planned course of steady rate increases thru 2019. As discussed above, the FRB has achieved its other goal of full employment. At this stage in the economy, the Fed Funds rate would be at or above neutral. Most observers put the neutral rate at around 3.0%. Unless inflation spikes, we look for the FOMC to raise rates one more time this year and three times next year, for a total of four additional hikes between now and year end 2019. We believe they will then pause to assess the situation.

Oil

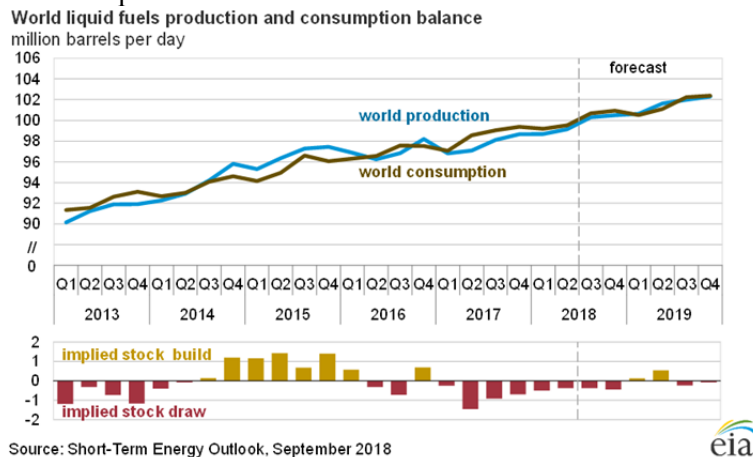
Geopolitical events have once again thrown our oil outlook into the trash. Despite a downward sloping futures curve, oil prices continue to climb. Oil prices are now the highest they have been in nearly four years.

The recent rally is fueled by two factors. The stronger than expected U.S. economic growth is expected to lead to increased demand. In addition, OPEC has declined to increase production to offset a disintegrating Venezuela and the pending Iranian sanctions.

An estimated one million barrels per day (mb/d) of Iran's roughly 2.5 mb/d are expected to be taken off the market due to the Trump administration's renewed sanctions. Global oil supplies are left with limited global spare capacity to offset any further disruptions from Libya or other global hot spots.



Until further pipeline capacity is built, U.S. shale producers are limited in the amount of oil that can be shipped out of the Permian basin. We may see \$100 oil before we see \$60 oil again. The impact of high oil prices is mixed. It will increase inflation but its impact on economic growth has changed. High oil prices no longer act as a huge tax on the U.S. economy. The U.S. is now the world's largest oil producer. High energy prices do shift income from the coastal energy consuming states to the energy producing Heartland. Look for the mid-section of America to be a little bit better off.

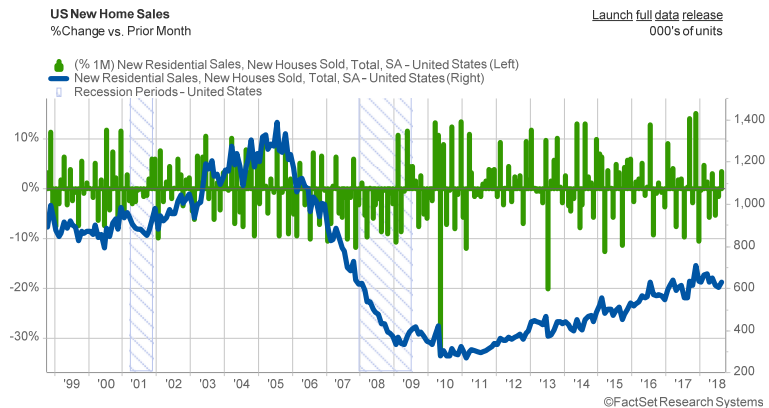


The U.S. Energy Information Administration (EIA) estimates that U.S. crude production averaged 10.9 mb/d in August and will average 10.7 mb/d (up 14% y/y). In 2019 the EIA expects crude oil production to continue to increase, reaching an average 11.5 mb/d (up an additional 9% y/y). This year's annual 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 U.S. will most likely be the world's leading crude producer in 2018 and 2019.

We remain very cautious of our oil related investments. Peak oil demand is closer than most people think. Electric vehicles (EV) and the rise of the ride share culture will usher in a prolonged period of weaker oil demand. In the short term, the EIA forecasts total global liquid fuels inventories to decrease by 0.4 million b/d in 2018 compared with 2017, followed by an increase of 0.1 million b/d in 2019. The latest forecast calls for a slimmer margin for error. This outlook of tight supply/demand balance contributes to the volatile energy outlook.

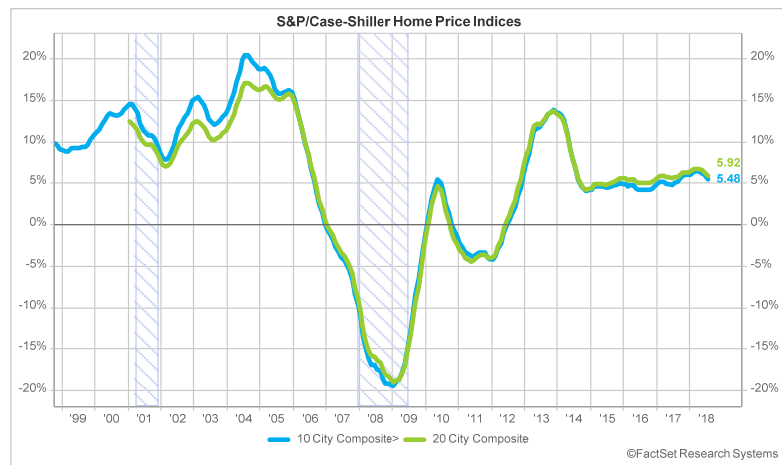
Housing

In August, new single-family home sales were 629,000, up from a revised 608,000 pace the month before. August housing numbers were impacted by last year’s Hurricane Harvey. During the storm event very few homes were sold in the impacted area. 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 up 7.2% y/y. New home sales have slowed from last year’s pace but are still growing at a healthy rate.



The gains were led by a 12% growth rate in the Midwest followed by the South’s gain of 11%. New home sales in the Northeast are down 16% y/y. The Northeast is the market most heavily impacted by tax reform. The recently enacted legislation limits the deductibility of home mortgage interest and property taxes.

The trailing 3 month average median sales price rose slightly by 0.6% y/y to \$319 thousand. The slower price appreciation was likely the result of a mix shift to less costly regions.



For the last few years, new and existing home prices have risen faster than disposable personal income per capita (4.5%). Existing home prices as measured by the Case-Shiller 20-City Index are up 5.9% y/y. Home price increase may be stalling just as income growth is accelerating. This should help housing affordability next year and prolong the housing recovery.

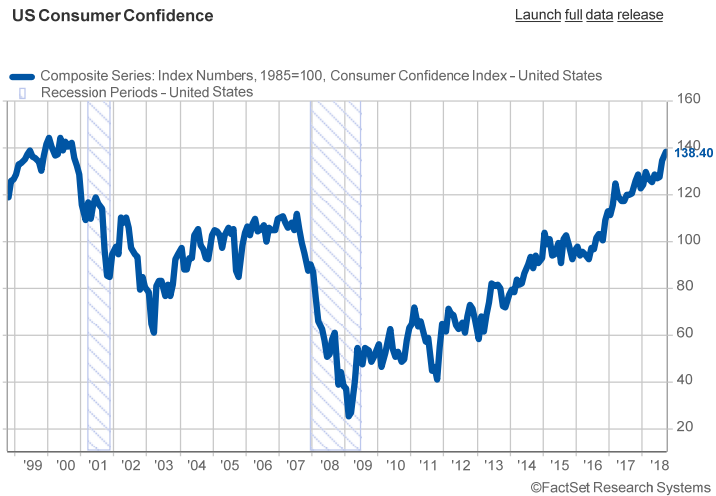
Housing is estimated to be 3.8% of the economy. Residential construction directly employs 802 thousand persons and is growing at a 7.1% annual rate. The housing market was the root cause of the last downturn and has yet to fully recover. This sector will continue to provide support for economic growth for the next couple of years.

The Consumer

Prepared by Damian Howard
October 8, 2018

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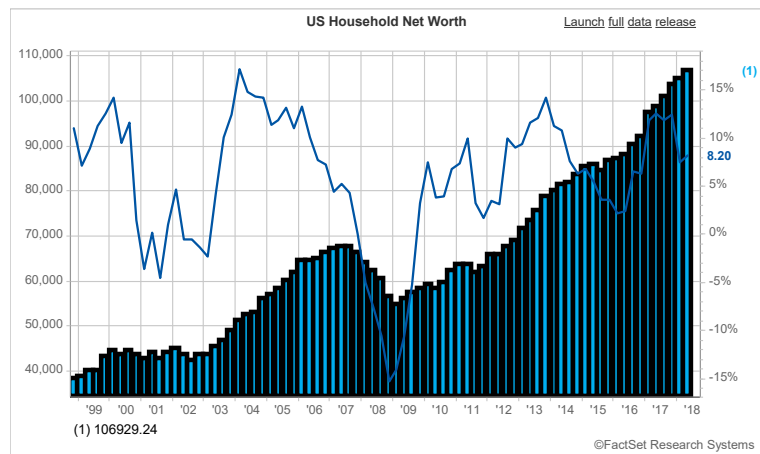
The Conference Board reported that consumer confidence has not been this high since October 2000. Its index jumped to 138.4 from 134.7 the previous month. Consumers’ assessment of economic conditions remains quite favorable. The Index suggests that the economy will continue expanding at a slightly faster pace. The average reading over the last twenty years has been 93.



The present situation component rose to 173.1 from 172.8 the previous month. The robust economy and job market are boosting consumers’ perception on how things are now. The expectations component rose to 115.3 from 109.3 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 32.5 from 30.2 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) rose to 32.3 from 31.2 the previous month.

Personal income is estimated to be up 4.7% in the past year versus a 4.5% pace reported last year. Private sector wages and salaries are up 5.3% from last year. Disposable personal income is up 5.2% y/y. The difference in disposable income and gross income growth can be attributed to the recently enacted tax cuts. Disposable personal income per capita is up 4.5% y/y.



Consumer spending on goods and services is up 5.3% from last year. This is higher than income growth at 4.7% but in line with disposable income at 5.2%. The personal savings rate held steady at 6.6% of disposable income. Consumer credit outstanding is up 4.6% y/y. This is in line with income growth but less than disposable income growth.

The consumer is still in good shape. The financial obligations ratio – which compares debt and other recurring payments to income – is still only 15.3%. This is down from its peak of 18.2% prior to the Panic of 2008, but up from 14.9% in 2012. U.S. household net worth reached a record of \$107 trillion. Household net worth rose about 8% y/y. Bloomberg recently reported that the average FICO score hit its highest ever, 704. This is up significantly from the 686 nadir experienced during the Panic of 08.

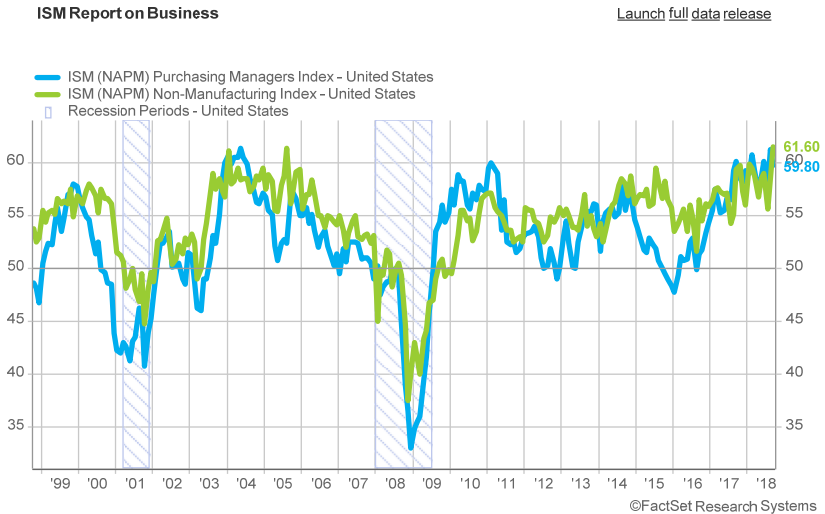
Business Activities Report

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The Institute for Supply Management’s (ISM) non-manufacturing index rose to 61.6 from 58.5 the previous month. This reading marks the 104th consecutive month of economic growth in the service sector. The most recent reading is an all-time high since its inception in 2008. Comments from the survey panel indicate “Overall, respondents remain positive about business conditions and the current and future economy. Concerns remain about capacity, logistics and the uncertainty with global trade.” One panelist commented “Every day is a bit better than the last.”

Business activities / production, new orders, employment, order backlog, export orders and just about every other measure are improving and at a faster rate. Prices for purchased materials and services rose for the 31st consecutive month and at a faster pace.



Seventeen of the eighteen industries indicated growth in April. No 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.

Last month, the ISM Manufacturing Index came in white hot. The index cooled a bit in the most recent report. The index eased to 59.8 from 61.3 the previous month, indicating growth in the manufacturing sector for the 25th consecutive month. Comments from the survey panel “reflect continued expanding business strength Lead-time extensions, steel and aluminum disruptions, supplier labor issues, and transportation difficulties continue to limit potential, but at more manageable levels.”

Manufacturers reported a slight easing of pricing pressures. Cost pressures appear to be decelerating as the index softened for the fourth straight month. The price index dropped below 70 for the first time since December 2017. The price index has marked pricing pressures for the 31st consecutive month.

Of the 18 manufacturing industries surveyed, 15 reported growth. One industry reported contraction during the period: Primary Metals.

Both manufacturing and non-manufacturing activities are strong. Given the continued strength of new orders and business activities/production, we expect both the service and manufacturing sectors to continue their steady growth. We expect job growth to continue. Deliveries continue to be delayed by the driver shortage in trucking. This is unlikely to change anytime soon. Inflation is likely to continue to run at or above the Fed’s 2.0% target rate.

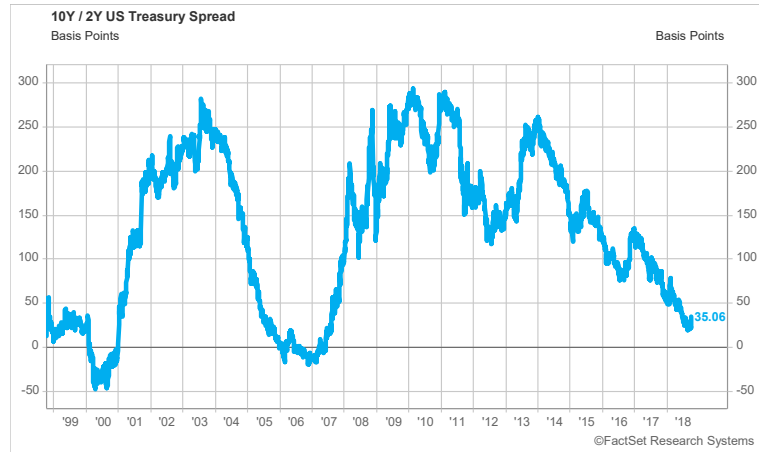
International Interest Rates

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

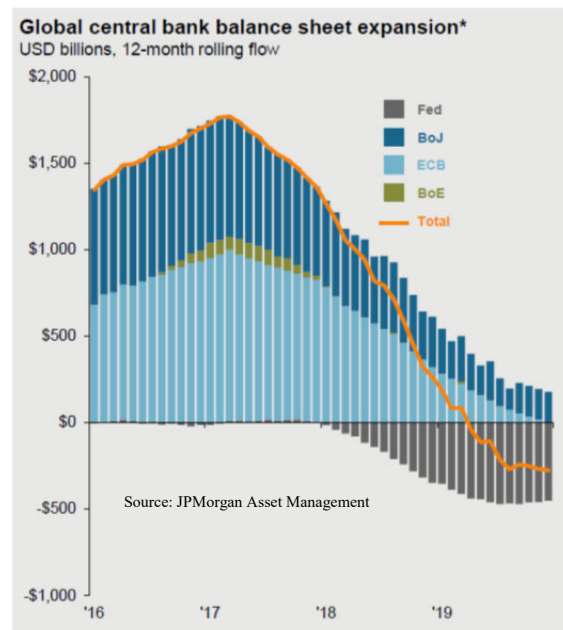
	1 Year	5 Year	10 Year
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United States	2.63%	3.07%	3.23%
United Kingdom	0.88%	1.30%	1.72%
Europe	-0.60%	-0.03%	0.57%
Japan	-0.14%	-0.07%	0.15%

Interest rates in Europe and Japan continue to be 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 be.



Net global QE is scheduled to reach zero some time next year. (See the chart on the right.) 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 rates higher on a global scale. International interest rates are then likely to join U.S. rates in the glacial pace of normalization. Due to the persistent effects of QE, we are forecasting lower longer term rates than we would have sans QE. We do not believe the curve will invert.



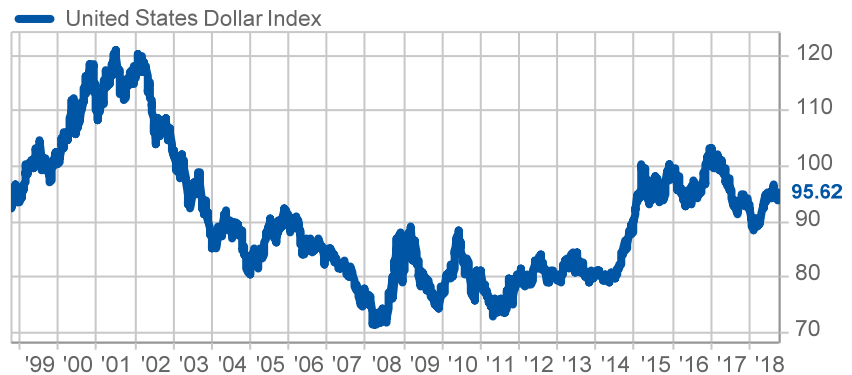
Trade Weighted Dollar

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 3.8% year to date and is up 1.8% over the last twelve months. The dollar has turned from being a tailwind to corporate earnings to being a slight headwind. A rising dollar generally hurts emerging markets and corporate earnings, while putting downward pressure on inflation and interest rates.

Closing Price

05-Oct-1998 to 05-Oct-2018 (Daily)

Price (Local Currency)



Source: FactSet Prices

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

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