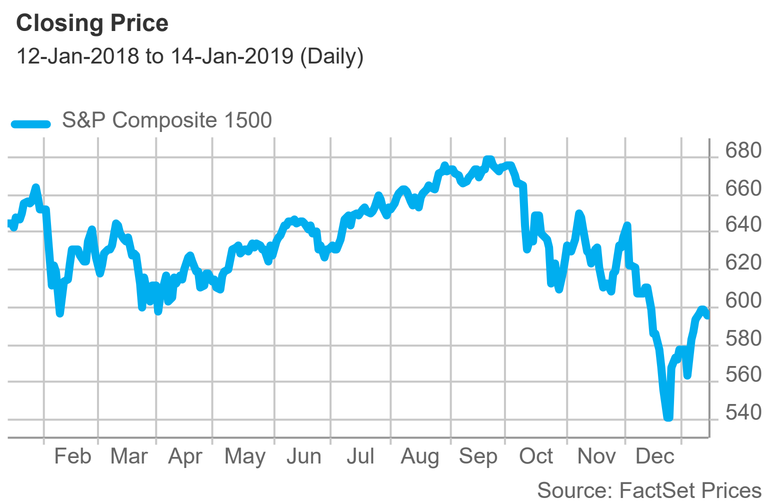
First Quarter 2019 Market Outlook

Our Outlook

	2016	2017	2018 Est	2019 Est	2020 Est
GDP Growth (1)	1.9%	2.5%	3.0%	2.1%	1.7%
Change in Consumer Prices(2)	2.1%	2.1%	2.0%	2.0%	2.0%
Fed Funds Target Rate (3)	0.75%	1.50%	2.50%	2.75%	2.75%
5-Year Treasury Yield (3)	1.83%	2.20%	2.51%	2.85%	2.85%
10-Year Treasury Yield (3)	2.43%	2.41%	2.69%	3.10%	3.10%
S&P 500 EPS	$118	$133	$162	$168	$176

(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 Stock Market in Review

The U.S. stock market, as measured by the S&P 1500 SuperComposite, tumbled 9.27% during the month, 13.97% during the fourth quarter and ended the year down 4.96%. From the market peak on September 21st to Christmas Eve it fell 20.18%. Including dividend the market posted a total return of -19.77% during its swoon.

For 2018, large cap stocks posted a loss of 4.38%. Mid-cap stocks lost 11.08% and small capitalization stocks lost 8.48%. Growth stocks about broke even with a loss of just 0.01%. Value stocks lost 8.95% in 2018. For the fourth quarter, value lost 12.04% while growth stocks lost 14.71%. December was clearly a month to forget.

Christmas Eve Email

On December 24th, we sent out an email reaffirming our belief that the economy was in good shape and that a recession was unlikely. We also cautioned not to over react to the financial market's turbulence. Since sending the email, stocks are up about 10%. While we are not calling a bottom, we remain convinced the economy is strong and corporate America is in good shape.

The Powell Pause

It appears the FRB Chairman Jerome Powell received the message that the 20% decline in the stock market was sending him. Financial conditions are tight enough. The ISM Manufacturing Index suffered its steepest monthly decline in over ten years. While the index still suggest growth in the manufacturing sector, the report highlights growing concerns about slowing global growth and continued worries about the ultimate impact of trade tensions.

Prepared by Damian Howard
January 14, 2019

FIRST QUARTER 2019 MARKET OUTLOOK

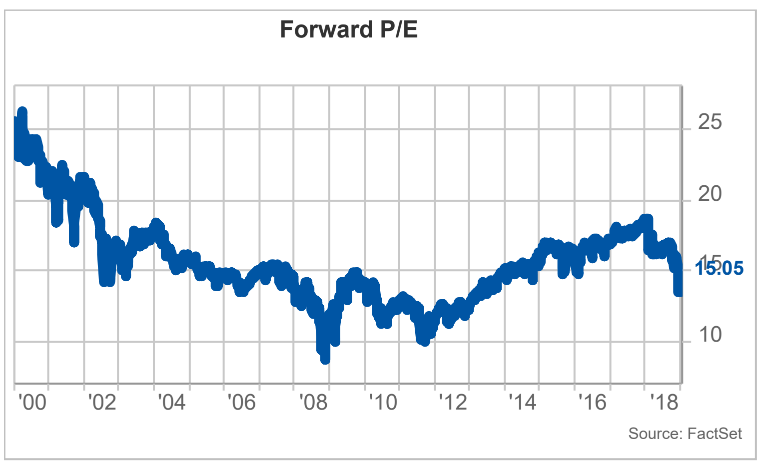
The last time financial conditions tightened this fast was the start of 2016. In December 2015, the Open Market Committee (OMC) of the Federal Reserve Board (FRB) had just raised the fed funds target for the first time since the Panic of '08 and was forecasting four additional hikes in 2016. Worries about growth in China and volatile financial markets caused financial conditions to tighten. Following the initial rate hike, the FOMC paused and remained on hold until December 2016. The stock market posted a total return of 13% for 2016.

In a round table at the American Economic Association's annual meeting in Atlanta on January 4th with former Chairs Janet Yellen and Ben Bernanke, Chairman Powell stated "as always, there is no preset path for policy…. And particularly with muted inflation readings that we've seen coming in, we will be patient as we watch to see how the economy evolves." Chairman Powell added the FRB is "always prepared to shift the stance of policy and to shift it significantly." The FRB has clearly set the table for a prolonged pause.

Chairman Powell also took the FRB's balance sheet off autopilot. A significant part of the negative reaction during Chairman Powell's FOMC press conference was his statement that the balance sheet roll-off was on "autopilot" also stating that "I don't see us changing that" In Atlanta, he stated that the Fed would "be prepared to adjust normalization plans" and "wouldn't hesitate to change" plans if the situation required.

Our Forecast

We now forecast just one rate hike in 2019. The FRB will likely be on hold until late in the year. The wait and see approach will give policy makers a chance to gauge the impact of four rate hikes in 2018. It will also give time for a resolution to trade tensions. Inflation will remain well controlled.



We have lowered our longer term interest rates to incorporate the flatter yield curve and fewer Fed Funds increases. We do not believe the curve will invert or a recession is eminent. We have a more in depth yield curve discussion at the end of this report.

We lowered our S&P 500 earnings forecast by $2 to reflect the lower oil prices. Lower energy prices are likely to lower earnings in the energy sector and associated industrial companies. We expect earnings for the S&P500 to grow 3% next year. This is lower than consensus earnings growth of 7%.

Following the recent market correction, the market is currently trading a forward P/E of 14.2 times consensus earnings and 15.1 times our estimate. This is materially below its 25 year average of 16.1 times forward. We do not have major concerns about overall valuations. With the recent sell-off, there is room for the multiple to actually rise.

We look for stock prices to grow in line with or slightly faster than earnings growth. Low single digit earnings growth coupled with a 2%+ dividend yield should provide a mid-to upper 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.

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

Prepared by Damian Howard
January 14, 2019

FIRST QUARTER 2019 MARKET OUTLOOK

SECURITY NATIONAL BANK
Wealth Management

Recent Economic Reports

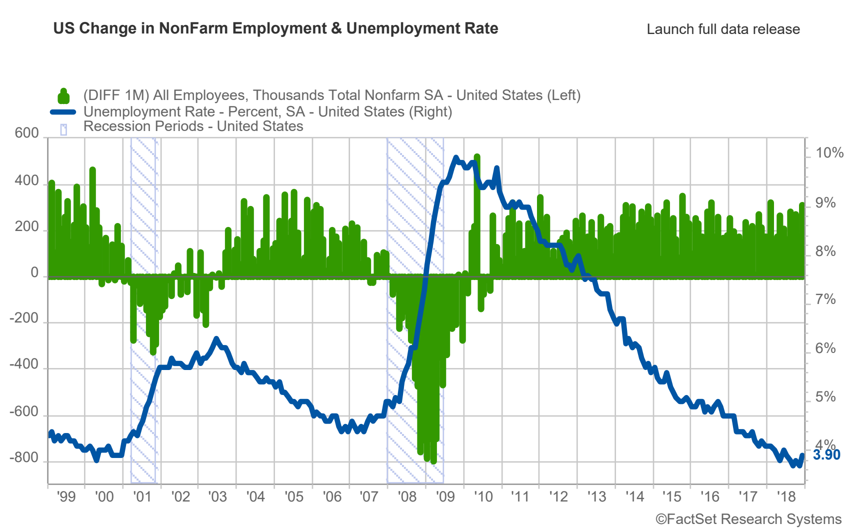
		1 Month Change	YTD Change	1 Year Change
Fed Funds Target (Upper)	2.50%	+25bp	+100 bp	+100 bp
2-Year Treasury Yield	2.48%	-32 bp	+91 bp	+91 bp
5-Year Treasury Yield	2.51%	-33 bp	+31 bp	+31 bp
10-Year Treasury Yield	2.69%	-32 bp	+29 bp	+29 bp
SNL 30Yr Fixed – U.S. Avg.	4.84%	-9 bp	+76 bp	+76 bp
S&P 500 Index*	2,507	-9.03%	-4.38%	-4.38%
S&P Midcap 400*	1,663	-11.32%	-11.08%	-11.08%
S&P Small Cap 600*	845	-12.07%	-8.48%	-8.48%
S&P SuperComposite 1500*	577	-9.27%	-4.96%	-4.96%
S&P 500 Growth*	1,512	-8.62%	-0.01%	-0.01%
S&P 500 Value*	1,000	-9.48%	-8.95%	-8.95%
Crude Oil – WTI Near Term	$45.41	-10.84%	-24.84%	-24.84%
Gold – Near Term	$1,278.30	4.76%	-2.14%	-.14%

*Data as of December 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 released its latest Employment Situation (Jobs) Report on January 4th. The labor market ended 2018 on a strong note as payrolls surged 312 thousand in December versus expectations of 176 thousand jobs created. Wages grew 3.2% y/y. The unemployment rate ticked up to 3.9% as 419 thousand workers joined the labor force.



The economy added 312,000 jobs last month blowing past the 176,000 consensus expectation. The previous two months total was revised up a net 58,000 jobs.

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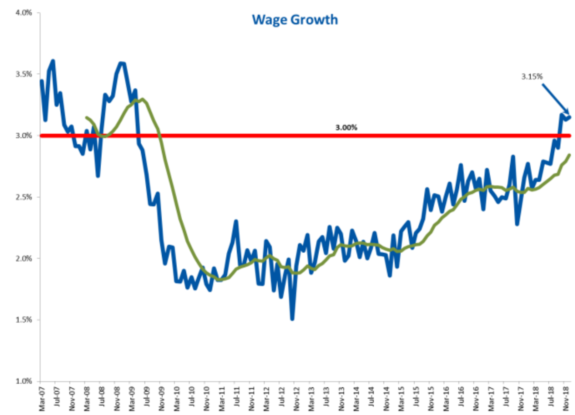
January 14, 2019

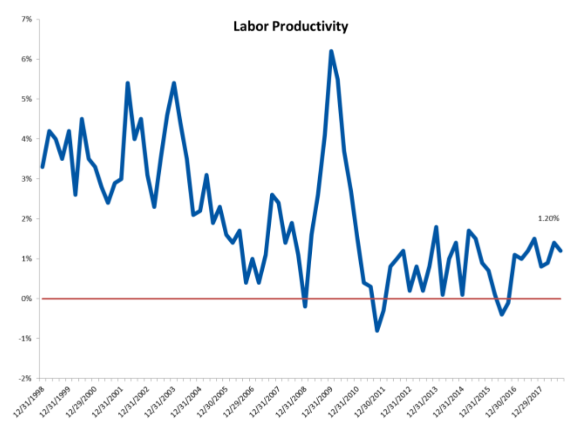
The trailing three month average job growth was 254,000 versus 189,667 last month and 220,667 last year. Despite tariff worries and a softer ISM, manufacturers added 32,000 jobs. Construction related industries added 38,000 jobs. Health care related employers added 58,000 jobs.

The unemployment rate ticked up 0.2% to 3.9%. This is down from 4.1% last year. The broader U-6 measure held steady at 7.6% last month and is down from 8.1% 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 12 months the U.S. economy added a net 2.6 million jobs. The number of employed individuals has increased 1.9% over last year. During the same time, the labor force has grown by 2.6 million or 1.62%. The labor participation rate rose to 63.1% from 62.9% last month and 62.7% last year. The participation rate has remained in a narrow range of 62.5% to 63.1% these last couple of years. The most recent reading is at the upper end of the range.

Last month's average hourly earnings (wages) grew at a 3.15% y/y rate up ever so slightly from the 3.13% recorded last month but up from the 2.66% wage growth reported last year. The average work week rose to 34.5 hours up from 34.4 hours reported last month and last year. Average weekly earnings are up 3.15% from last year to $948.06. Wage growth has exceeded 3.0% for three months in a row. As a general rule of thumb, wage growth will not add to inflation if it grows less than the sum of productivity and inflation. Currently productivity is growing at a 1.2% annual rate and as seen below inflation is running at about 2.0%. Wages are currently not inducing inflation. If the economy manages to sustain its recently higher productivity improvement, wages can increase further without inducing wage push inflation.



Last month's disappointing number of jobs created has been revised away and replaced by this month's exceptionally strong number. Recent economic reports are mixed. A weak housing report is followed by a weak ISM report to be followed by an exceptionally strong labor market report. There is enough ammunition for both camps. Raise rates and hold off on raising rates.

We contend the economy is cooling from its fast 2018 pace on its own. Financial conditions have tightened. Economic growth will moderate in 2019. The FRB will pause to let its previous rate hikes work their way into the economy. They are likely to toss in one additional hike mid-year for good measure then pause until 2021.

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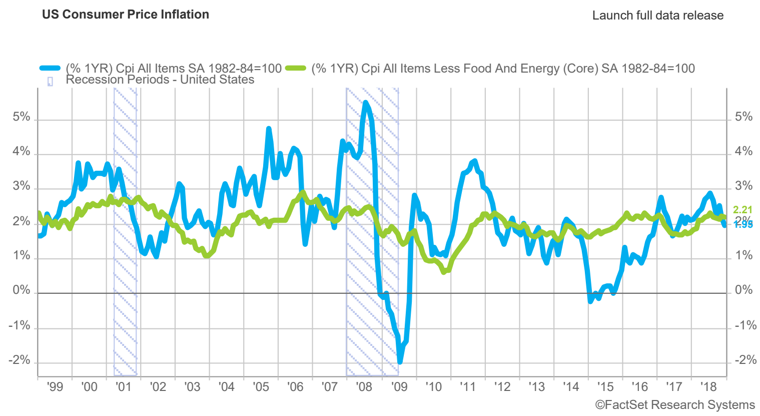
January 14, 2019

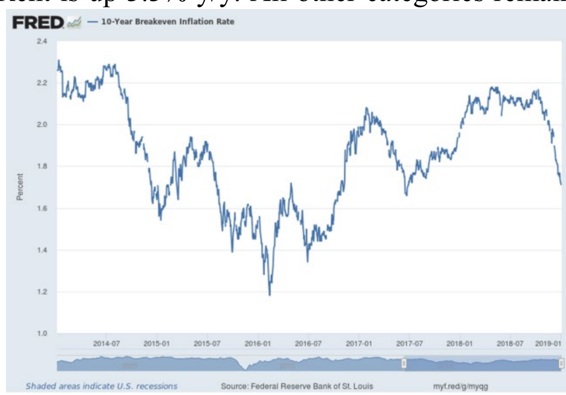
Inflation

The consumer price index was flat in November and is up 2.2% y/y. Headline inflation is running slightly above the FRB's 2.0% target for both the trailing twelve months. The trailing six months rate is 1.9%, pointing to decelerating inflation. The recent drop in oil prices is slowly working its way into inflation numbers.



Energy prices were down 2.2% in last month's report but are up 3.2% y/y. The price of gasoline fell 4.2% for the most recent month but was up 5.0% y/y. Energy inflation is likely to be the main wild card for this and next year. Next year, tariffs may provide a one-time boost to inflation.

Medical costs are up 2.0% 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. Consumer prices excluding food and energy are up 2.2% 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% last month and is up 1.8% y/y. The core PCE was also up 1.9% y/y.

Inflation expectations continue to fall and are well below 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. The current 10-year breakeven inflation rate implies that inflation will average 1.70% over the next ten years. Inflation is well anchored.

Current economic conditions do not point to an inflation overshoot. Slower global growth, expected slower 2019 domestic economic growth, lower oil prices, all have contributed to lower inflation expectations. We contend that softening inflation expectations give the FRB the opportunity to be patient with monetary policy and to wait and see how their previous rates hikes and other events will impact the economy.

Prepared by Damian Howard
January 14, 2019

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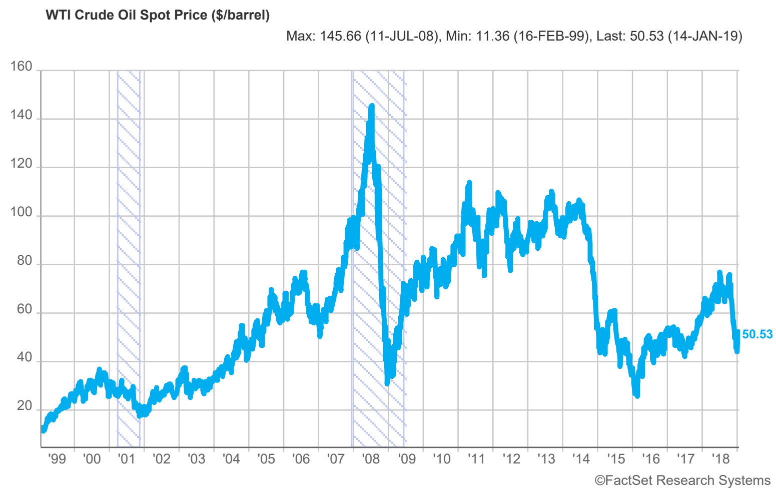
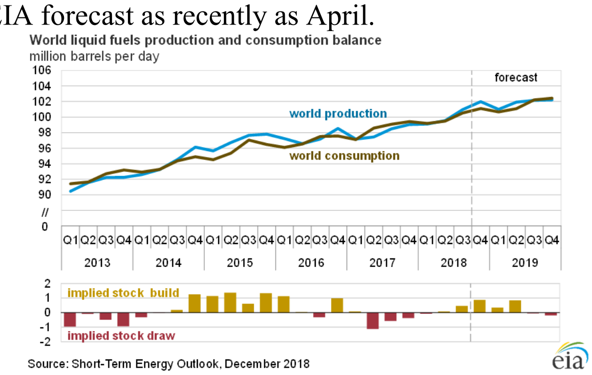
Oil

After surging to $76.41 on October 3rd, the price of oil fell to $42.53 on Christmas Eve, a collapse of 44%. Prices have rallied a bit but are still down 37% from recent highs. Oil prices have fallen sharply on fears that production is increasing whilst demand has weakened.



The Trump administration cajoled Saudi Arabia and other OPEC nations into raising production to off-set the anticipated cuts due to renewed Iranian sanctions. In response, Saudi and Russian production increased dramatically. The Trump administration then gave eight countries waivers to continue purchasing Iranian crude. This has led to excess production during a time of weakening demand. On December 7th, OPEC and non-OPEC agreed to cut production by 1.2 mb/d with OPEC members responsible for 800 kb/d and non-OPEC members the rest. OPEC production surveys for December from both Reuters and Bloomberg show cartel output dropping month over month by 460 kb/d and 530 kb/d from respectively with Saudi cuts driving the declines in each. It appears the agreement is holding. If the Iranian waivers are not renewed, an additional 500 kb/d are likely to be removed from the market. This makes achieving the 1.2 mb/d cuts more likely.

The U.S. Energy Information Administration (EIA) in its most recent Short-Term Energy Outlook (STEO) forecast global petroleum and other liquid fuels consumption growth of 1.5 million barrels per day (b/d) in 2019. This is down from the 1.8 mb/d the EIA forecast as recently as April.



The EIA estimates that U.S. crude production averaged 11.5 mb/d in November. It forecasts that production will average 10.9 mb/d (up 16% y/y) in 2018. In 2019 the EIA expects crude oil production to continue to increase, reaching an average 12.1 mb/d (up an additional 11% y/y). The U.S. will most likely be the world's leading crude producer in 2018 and 2019.

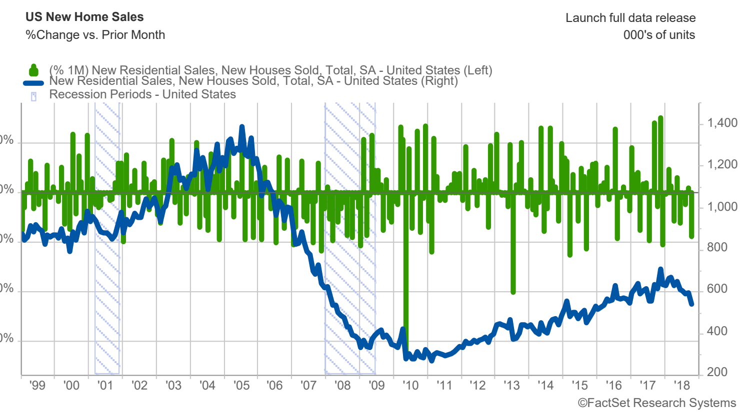
We remain very cautious of our oil related investments. Peak oil demand is closer than most people think. Electric vehicles (EV) and the rise of the ride share culture will usher in a prolonged period of weaker oil demand. In the meantime, oil prices will remain volatile, subject to global growth and political trends.

Lower energy prices will eventually lead to lower inflation, lower earnings for U.S. energy companies, lower capital investment by those companies. In response, we have lowered our inflation outlook for 2019 and our S&P 500 earnings outlook. It is likely lower oil prices will trim about three dollars from 2019 S&P500 earnings.

Prepared by Damian Howard
January 14, 2019

Housing

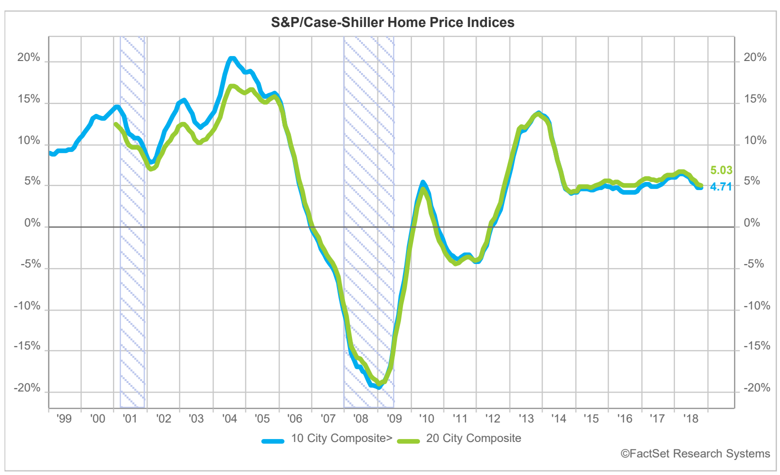
For years, the story in housing has been one of strong demand, rising prices and limited supply. The story is now changing to one of continuing deterioration. High prices, tax reform and rising interest rates have taken their toll on affordability. There may also be structural changes in the housing market to cause a permanent lowering of new home demand.



Due to the partial government shutdown the New Homes Sales report is unavailable. We will use the most recent report for the following section. In October, new single-family home sales were 544,000 down from an upwardly revised 597,000 pace the month before. The report on single family home sales is based on small samples, tends to be volatile, and is often revised significantly. This makes it unwise to rely on data from any single month for the big picture.

To even out the volatility, we use a rolling three month average. September's trailing three month trend was down 4.5% y/y. The slowdown in new homes sales was led by the Northeast region. New home sales in the Northeast are down 29% 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. Every region, except the West, saw y/y declined in new home sales.

The trailing three month average median sales price fell by 1.1% y/y to $318,000. The slower price appreciation was likely impacted by a mix shift to the less costly regions of the South and Midwest.



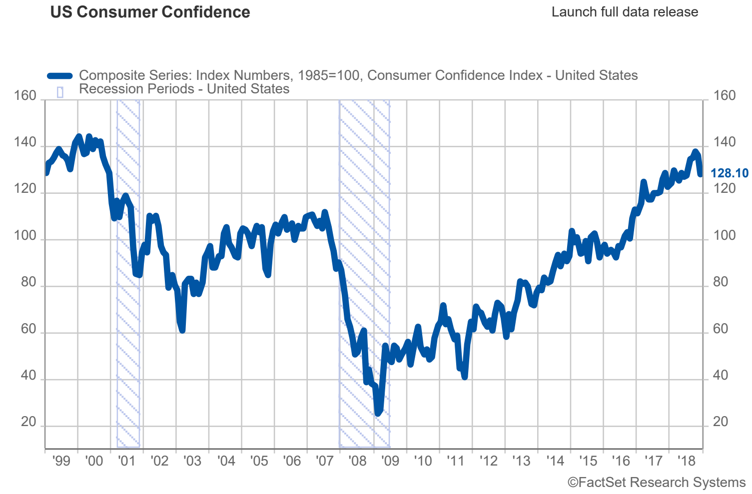
For the last few years, new and existing home prices have risen faster than disposable personal income per capita (4.0%). Existing home prices as measured by the Case-Shiller 20-City Index are up 5.0% y/y. While this is down from recent months, it still exceeds income growth.

Builders have been squeezed by the high cost of land, lumber and labor. The housing market has hit an affordability wall. High prices, higher mortgage rates and the loss of key tax advantages have combined to dampen affordably. Housing is estimated to be 3.3% of the economy. Due to the slowdown in construction during the third quarter 2018, residential construction subtracted 0.1% from GDP growth. Housing is likely to be a slight net drag on growth in 2019.

Prepared by Damian Howard
January 14, 2019

The Consumer

Consumer confidence took a dip in December as recession talk and volatile financial markets took their toll. The Index fell to 128.7 from a revised 136.4 the previous month. Consumers' assessment of economic conditions remains slightly below its average for the year and above the average for last year. This suggests continued economic expansion but at a slightly slower pace. The average reading over the last twenty years has been 93.



The present situation component fell slightly to 171.6 from 172.7 the previous month. The expectations component took a header, falling to 99.1 from 112.3 the previous month and 115.1 in October as recession talk and volatile financial markets darkened consumers' mood. 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 slightly to 34.6 from a revised 34.2 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) fell to 25.9 from a revised 31.3 the previous month, reflecting turmoil in the financial markets.

Personal income is estimated to be up 4.2% in the past year versus a 4.6% pace reported last year. Private sector wages and salaries are up 4.5% from last year. Disposable personal income is up 4.7% 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 4.0% y/y.

Consumer spending on goods and services is up 4.9% from last year. This is higher than both income and disposable income growth. In order to make up the shortfall, the personal savings rate fell to 6.0% of disposable income from 6.2% last year. Consumer credit is up a modest 4.7% y/y.

According to the GDP report, personal consumption rose at a 3.5% annual rate during the third quarter and was up 2.9% y/y. Based on solid consumer confidence, wage and employment growth, consumer spending should continue to support positive economic growth.

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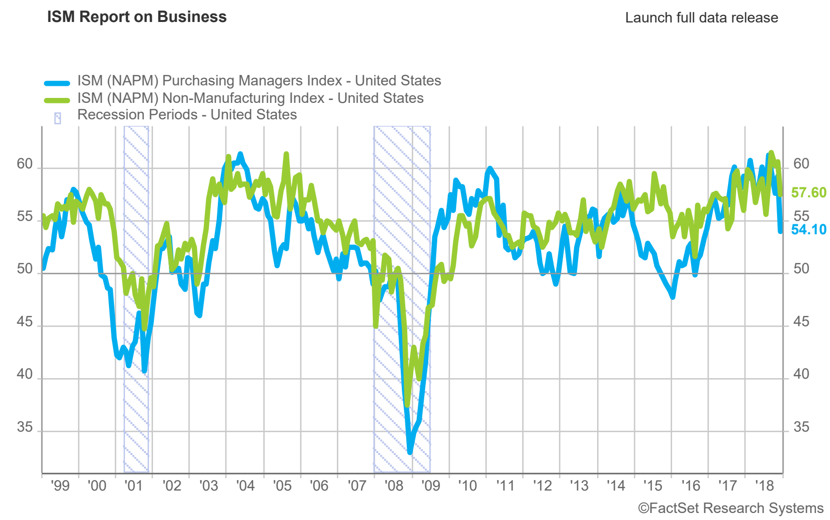
Business Activities Report

The Institute for Supply Management's (ISM) non-manufacturing index fell to 57.63 from 60.7 the previous month. While the reading was a bit softer than consensus (58.8), it did not have the dramatic tumble the manufacturing index had. This reading marks the 107th consecutive month of economic growth in the service sector. The Index indicates that the service sector cooled off in December but is still growing. Comments from the survey panel indicate "there still is concern about tariffs, despite the hold on increases by the U.S. and China. Also, comments reflect that capacity constraints have lessened; however, employment-resource challenges remain. Respondents are mostly optimistic about overall business conditions."



Business activities / production, employment, order backlog indicate improvement at a slower pace. Surprisingly the new orders index increase, indicating growth at a faster pace. Prices for purchased materials and services fell by 6.7 to an 18 month low which indicates a lessening of inflationary pressures. Sixteen of the eighteen industries indicated growth in April. 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 most recent ISM Manufacturing Index declined by 5.2 points to 54.1 in December. This was the largest one-month decline in the past ten years and the lowest level since November 2016. The composition of the report showed significant weakness as several sub-indices showed large declines. The new orders index fell **11.0** points to 51.1, its largest monthly decline since 2014. The orders backlog index fell 6.4 to 50.0, indicating a steady backlog. The production index fell 6.3 points to 54.3, its largest monthly decline since 2012. The employment index fell 2.2 points to 56.2. Customer inventories remain too low at 41.7, up slightly from 41.5 the previous month. While the index fell precipitously it is still above 50, indicating continued growth in the manufacturing sector for the 28th consecutive month.

Comments from the survey panel reflect "continued expanding business strength, but at much lower levels. Demand softened, with the New Orders Index retreating to recent low levels, the Customers' Inventories Index remaining too low — a positive heading into the first quarter of 2019 — and the Backlog of Orders declining to a zero-expansion level. Consumption continued to strengthen, with production and employment still expanding, but at much lower levels compared to prior periods. Inputs — expressed as supplier deliveries, inventories and imports — softened as well, with suppliers improving delivery performance, and inventories and imports declining.

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January 14, 2019

Exports continue to expand, but at low levels consistent with November. Price increases relaxed to levels not seen since June 2017, when the index registered 53 percent. The manufacturing community continues to expand, but at much lower levels and at a sharp decline from November."

Manufacturers reported continued pricing pressures but at notably lower levels. The price index fell to 54.9 from 60.7 the previous month. The price index has marked pricing pressures for the 34th consecutive month. The softening of input pricing pressure likely reflects falling oil prices. Of the 18 manufacturing industries surveyed, 11 reported growth. Six industries reported contraction during the period.

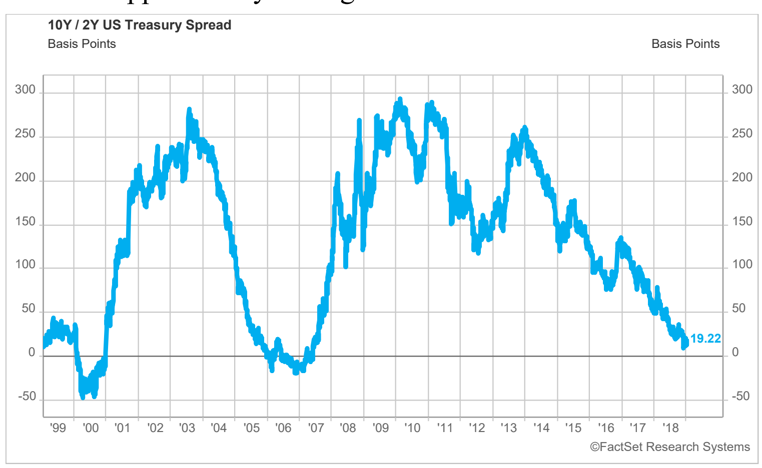
Both manufacturing and non-manufacturing activities continue to grow but at a slower rate. The new orders and backlog components of the manufacturing index suggests that the soft spot may continue for a while. A bright spot is that inventories and input prices remain under control. The ISM index is a survey that can be swayed by the sentiment of supply executives, especially during market declines and negative media narratives which were both plentiful in December.

International Interest Rates and the Yield Curve

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

	Growth	Inflation	1 Year	5 Year	10 Year
United States	3.0%	2.2%	2.58%	2.49%	2.66%
United Kingdom	1.5%	2.3%	0.76%	0.89%	1.24%
Germany	1.2%	1.7%	-0.62%	-0.35%	0.21%
Japan	0.1%	0.7%	-0.18%	-0.19%	-0.04%
China	6.5%	2.1%	2.43%	3.06%	3.19%

Interest rates in Europe and Japan continue to be suppressed by slow growth and 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 attribute some of the yield curve flatness to the demand for protection against large scale systematic risk. Institutional investors typically purchase long term sovereign debt as insurance against major economic shocks. U.S. Treasuries are the only long dated sovereign debt instrument that offers price appreciation during a financial crisis. Other sovereign debt already trade at little or no yield and are unlikely to appreciate substantially during an economic crisis. This boosts the demand for long dated U.S. Treasuries lowering their yield and flattening the yield curve. There is frankly no other place to hide in a storm. Until recession fears and trade tensions ease, long term treasuries are likely to be in demand.

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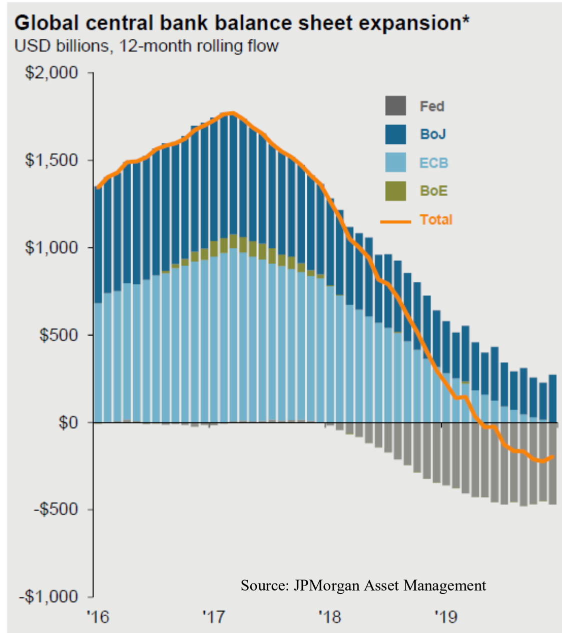
January 14, 2019

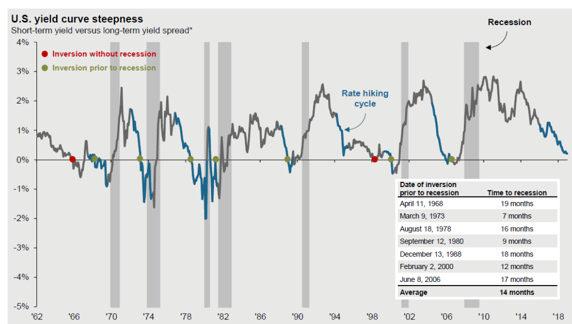
We believe global QE is also in part responsible for the shallow yield curve. Until central banks ease the financial repression, low international interest rates will pressure U.S. long term rates and keep the yield curve shallower than it otherwise would be. QE is likely to turn negative in 2019. (See the chart on the right.) 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.



Notwithstanding the two previous plausible reasons why the yield curve is narrow, it is a powerful predictor of a recession. The yield curve is the first indicator on our Recession Dashboard.

While parts of the yield curve have inverted, the benchmark 2/10 has not. As seen at the chart on the right, the yield curve has inverted prior to the previous five recessions.

There were also several false signals. In the mid 1990's the yield curve came close to inverting before steepening. In the mid1960's and in late 1990's the yield curve inverted and then steepened only to invert a couple of years later. The lead times can vary from a half a year to close to two years. The average lead time is 14 months. While we do not see a recession in our near future, we do see slowing growth. An inverted yield curve would make us question our assumptions.



Date of inversion prior to recession	Time to recession
April 11, 1968	19 months
March 9, 1973	7 months
August 18, 1978	16 months
September 12, 1980	9 months
December 13, 1988	18 months
February 2, 2000	12 months
June 8, 2006	17 months
Average	**14 months**

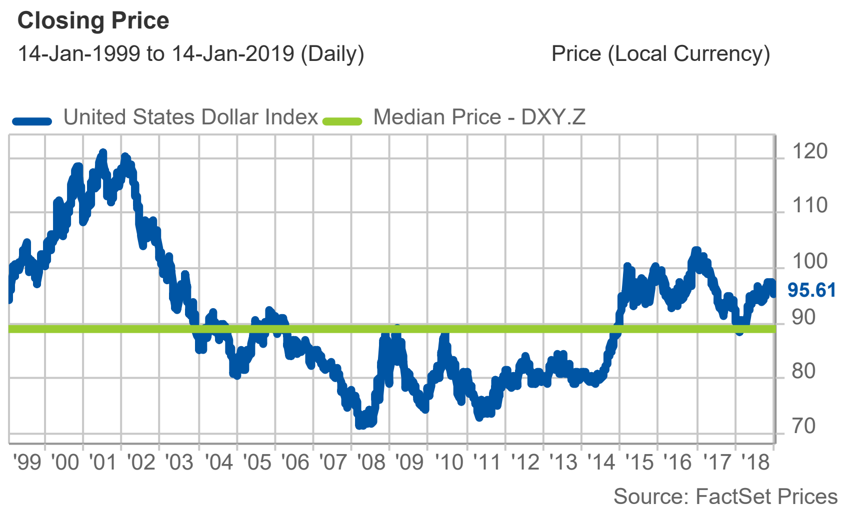
Source: FactSet, Federal Reserve, J.P. Morgan Asset Management. *From January 1962 to May 1976 short-term bond is U.S. 1-year bond. Short-dated bond is 2-year from June 1976. Time to recession is calculated as the time between the final sustained inversion of the yield curve prior to recession, and the onset of recession.
Guide to the Markets – U.S. Data are as of December 31, 2018.

J.P.Morgan Asset Management

Prepared by Damian Howard
January 14, 2019

Trade Weighted Dollar

The U.S. dollar index has risen since mid-April as global geopolitical risks have risen and global growth has slowed. The Index is up 4.6% over the last twelve months. We look for the dollar to moderate in 2019 as the FRB takes a pause in their normalization campaign.



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

Prepared by Damian Howard
January 14, 2019

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