**Our Outlook**

<table>
<thead>
<tr>
<th></th>
<th>2017</th>
<th>2018</th>
<th>2019 Est</th>
<th>2020 Est</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP Growth (1)</td>
<td>2.5%</td>
<td>3.1%</td>
<td>2.1%</td>
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<tr>
<td>Change in Consumer Prices (2)</td>
<td>2.1%</td>
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<td>2.1%</td>
<td>2.0%</td>
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<tr>
<td>Fed Funds Target Rate (3)</td>
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<td>5-Year Treasury Yield (3)</td>
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<tr>
<td>10-Year Treasury Yield (3)</td>
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<tr>
<td>S&amp;P 500 EPS</td>
<td>$133</td>
<td>$161</td>
<td>$166</td>
<td>$173</td>
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</table>

(1) 4th quarter/4th quarter  (2) December/December  (3) Year-end rates

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. We are pleased to share our economic outlook with you. Please be advised our crystal ball is just as clouded as other prognosticators and that all forecasters have a poor track record.

**Markets in Review**

The U.S. stock market, as measured by the S&P 1500 SuperComposite, rose 7.1% during June and 4.16% for the second quarter. The market had wild gyrations during the quarter: up 4.0%; down 6.5%; and finally up 7.1%. Market sentiment mirrored the fluctuating outlook for trade negotiations.

The stock market is up 18.4% year-to-date and 9.3% over the last twelve months. While a 9.3% return is almost 50% greater that the twenty year average of 6.3%, investors experienced several gut wrenching sell-offs to get there.

During June, the materials sector was the best performing sector with an 11.7% total return. The real estate sector was the worst performing sector with a 1.76% return. Year to date, the information technology sector topped the chart with a 27.1% total return. Health care stocks brought up the rear with an 8.1% total return.

Large cap stocks have significantly outperformed their mid-cap and small cap brethren. Growth stocks continue to outshine value stocks. Over the last ten years, growth stocks have outperformed value stocks by 3.0% per annum. This period coincides with slower than average economic growth. During such periods, growth often commands a premium. We think this environment will continue for a couple more years. Over the last twenty years, growth stocks and value stocks have performed essentially in line with each other.

Prepared by Damian Howard
July 8, 2019

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THIRD QUARTER 2019 MARKET OUTLOOK

U.S. stocks bested international developed market stocks by 1.2%, 0.5%, 4.3%, and 8.2% for the month, quarter, year-to-date and 1 year, respectively. Over the last ten years, US stocks have outperformed international developed stocks by 7.8% per annum. US stocks have also significantly outperformed emerging market stocks, posting a total return of 18.4% versus 10.6% year-to-date and 14.7% versus 5.8% over the last ten years. U.S. stocks are likely to continue to outperform other developed market stocks as long as US earnings growth is superior to other developed countries. Emerging markets may begin to outperform if the dollar has a sustained period of weakness.

Liquid alternatives (hedge funds) continue to disappoint and are only up 4.6% year-to-date versus 18.4% for the stock market. We continually review hedge funds and have yet found one worthy of our investment. With long term interest rates down 0.69% year-to-date, investment grade bonds returned 6.1%.

Our Forecast

In January, we had forecast the economy would grow 2.1% this year, inflation would run about 2%, and the S&P 500 earnings would be $168. Our forecast has not materially changed. The big difference is the level of interest rates. Interest rates have fallen globally. In many places, interest rates are negative. Trade tensions and a slowing global economy have spooked many investors into bonds.

In early May, President Trump began another round of trade skirmishes. The President’s negotiating style can still rile the markets. U.S. stock markets panicked and sold off 6.5%. The short end of the yield curve inverted dramatically. The Federal Reserve Board (FRB) attempted to calm the markets by signaling its willingness to cut rates to rescue the economy. This calmed the equity markets but only increased the expectations for lower rates. The close-in part of the yield curve is now negative 0.50% versus a positive 0.71% last year. Most investors, including us, believe the FRB is boxed in and will lower rates at its July 31st meeting.

Fed Funds futures are pricing in a 100% chance that the FRB will lower rates by at least 0.25% on July 31st. The futures market implies a 48% chance the FRB will have cut two additional times by year end for a total of 0.75% bringing the Fed Funds rate to 1.75%

At this point, we must put aside our views of what should be, instead we try to forecast what is likely to happen. With an economy growing at 2.0% and inflation at 1.50%, the Fed Funds rate should be 2.5% to 3.5%. This would normally be considered neutral. We continue to experience extraordinary global monetary policy. The bond market will force the FRB to act. We have lowered our interest rate forecast from one rate hike this year to two rate cuts. The FRB will try mightily to return to its path of gradual rate hikes next year.
The stock market is currently trading a forward P/E of 17 times earnings estimates. This is above its 25 year average of 16.1. The lower interest rate environment does justify a slightly higher multiple. We currently classify stocks as fully valued.

If the market multiple were to rise to 20 times we are likely to seek to reduce our equity exposure. At that point we would characterize the stock market as overvalued. Our base case is that the stock market drifts higher over the next year, slightly behind earnings growth. This should provide a mid-single digit total return. There are likely to be several short sell-offs corresponding to trade negotiations.

We believe the bond market is currently too rich, especially lower rated debt. This is not saying rates cannot go lower. An expensive market can always get more expensive. We do not believe investors are adequately compensated for taking risk in the credit markets. We remain short in duration and above average in credit quality. We will accept lower returns in exchange for safety at this time.

Please see the obligatory disclosures at the bottom of each page and at the end of this report.
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 June Jobs Report was strong enough to take a 0.50% rate cut off the agenda but weak enough to ensure a 0.25% cut. Job growth handily exceeded expectations and wage growth remained under control. The CME FedWatch odds of a July rate cut remains at 100% after the report.

The Labor Department released its latest Employment Situation (Jobs) Report on July 5th. The labor market added 224 thousand jobs in June compared to expectations of 160 thousand new jobs. Wages grew

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3.1% y/y. The unemployment rate, broader U-6 rate, and participation rate all ticked up slightly to 3.7%, 7.2% and 62.9%.

The economy added 224 thousand jobs last month. The previous two months total was revised down 11 thousand jobs for a net 213 thousand jobs added. The household survey showed a gain of 247 thousand jobs. In total, 157.0 million people are working versus a working age population of 259.0 million.

To smooth out some of the revisions, we also look at the trailing three month averages. The trailing three month average job growth was a solid 170,700 versus a revised 147,000 last month and 242,700 last year. Despite trade tensions and slowing industrial production, manufacturers added 17 thousand jobs. Construction related industries added 21 thousand jobs on top of the 39 thousand added the previous two months. Healthcare added 50.5 thousand jobs. Governments added 33 thousand jobs.

The broader U-6 measure rose to 7.2% from 7.1% but is down from 7.8% 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 either 2.3 million (establishment survey) or 1.4 million (household survey) jobs or somewhere in between. The number of employed individuals has increased 0.9% over last year. During the same time, the labor force has grown by 0.8 million or 0.5%. The number of working individuals has grown faster than the labor force resulting in a lower unemployment rate. The employment to working age population has increased by 0.2% to 60.6%. The labor participation rate has held steady at 62.9% y/y. Over the next couple of years, job growth will slow to the pace of that of the labor force: 0.8 to 1.0 million per year or 65,000 to 85,000 monthly jobs added.

Last month’s average hourly earnings (wages) grew at a 3.1% y/y rate even with last month but up from the 2.9% growth reported last year. The average work week held steady at 34.4 hours but is down from 34.5 last year. Average weekly earnings are up 2.8% from last year to $959.76 ($49,908 annualized) versus $933.23 ($48,528 annualized) last year. Wage growth has exceeded 3.0% for ten out of the last eleven months.

Wage growth is losing momentum. Wage growth has decelerated these last four months. This should provide cover for the FRB to lower rates. When wage growth was accelerating, there was a real fear of wage push inflation. Productivity has also increased to 2.4% y/y from close to zero. As a rule of thumb, when wages grow slower than the sum of inflation and productivity, wage growth is a deflationary force. Stable wage growth and rising productivity give the FRB cover to cut rates.

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THIRD QUARTER 2019 MARKET OUTLOOK

Inflation
The consumer price index rose modestly in May. The price index rose 0.1% and is up 1.8% y/y. Headline inflation is running at or below the FRB’s 2.0% target on both a trailing twelve months and on a trailing six months basis, pointing to stable inflation.

The volatility in the oil markets is impacting inflation measures. Energy prices were down 0.6% in last month’s report after being up 2.9% and 3.5% the previous two months. Energy prices are down 0.5% y/y. The price of gasoline fell 0.5% after surging 5.7% and 6.5% the previous two months. Despite energy price volatility, inflation has remained subdued. Energy is only 7.5% of the CPI versus 31.5% for rent and owners’ equivalent rent.

Owners’ Equivalent Rent is up 3.3% y/y. Consumer prices excluding shelter are up 1.0% y/y. If you own your own home, your cash inflation, is closer to 1.0% than 2.0%. Renters’ cash inflation is closer to 2.0%. All other categories remain under control. Consumer prices, excluding energy, are up 2.0% y/y. Core consumer prices, excluding food and energy, are up 2.0% 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. In May, the PCE was up 0.2% and is up 1.5% y/y. The core PCE was up 1.6% y/y. The PCE excluding energy was up 1.6% y/y.

Inflation expectations are well anchored around the FRB’s 2.0% target plus or minus 0.2%. 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 1.69% over the next ten years.

Current economic conditions do not point to an inflation overshoot or deflationary spiral. We contend that inflation expectations are well anchored. This gives the FRB the opportunity to be patient with monetary policy or if desired, the FRB can purchase an insurance policy to offset policy uncertainty. The insurance policy would be in the form of one or two easing totaling 0.50%.

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Oil
Oil prices bottomed about mid-month in the low $50s as escalating U.S.-China trade tensions coupled with bearish U.S. stockpile data held sway (fear). Prices then rallied into the tail end of June as Persian Gulf tensions grew on additional tanker attacks and Iran shooting down a US drone (greed).

Recently the market has been supported by a renewed agreement OPEC + Russia to limit production through the second half of 2019. In addition, the DOE reported the largest weekly crude inventory draw since 2016, halting a nine week trend of steady US inventory builds.

OPEC production cuts only served to offset US and Russian production increases. In addition, it appears that global demand growth has slowed more than expected. Private forecasts have demand growth falling from 1.2 mb/d to around 1.0 mb/d. Recent global manufacturing PMI surveys support this assessment. EIA’s forecast does not yet incorporate this lower demand growth. If recent private forecasts are correct, oil prices are likely to come under pressure as production again outstrips demand toward the end of the year. It is unlikely that oil prices will rise significantly from here without a major disruption in production.

While demand growth has fallen, we are most likely not at a level that would signal a recession. During a recession demand growth turns negative by a couple of hundred thousand barrels per day. Slow demand growth confirms our forecast of slow domestic and global growth.

Research has shown that the most accurate forecast for oil prices is no change in prices. This forecast significantly outperforms the collective effort of professional oil forecasters. The average target price as tracked by FactSet is for WTI to end the year at $59.13 and end 2020 at $59.20. This is not too far from the current price of $59.09. We’ll stick to a no change forecast of $59.00.

On a side note, U.S. electricity generation from renewable sources has steadily increased while coal-fired generation has steadily decreased. In April, renewable electricity generation outstripped coal-fired generation for the first time on record. The decarbonization of America’s energy consumption continues unabated and will likely accelerate as technology advances. We invest with this in mind.

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Housing

New single-family home sales fell 8% m/m in May to a 626 thousand annual rate, significantly below the consensus estimate of 680 thousand. New home sales were down 4% y/y. The single family home sales report is based on small samples, tends to be volatile, and is often revised significantly. To even out the volatility, we use a rolling three month average. May’s trailing three month trend was up 3% y/y. The housing market has been essentially flat lined for the last year and a half. With weakness in the Northeast and West being off-set by strength in the South and Midwest.

The median selling price fell 2.7% to $308 thousand with the trailing 3 month average down 1.4% y/y. The median new home selling price is influenced by a mix shift. New home construction has shifted to South and Midwest.

Existing home sales are also down a similar amount. Existing home price appreciation continues to decelerate, mirroring new home prices. After four years of steady 5% price appreciation, existing homes are currently appreciating at a 2.5% rate.

Higher incomes, moderating home price appreciation and lower mortgage rates have combined to increase affordability. With better affordability, the housing market would normally be booming. Sales have flatlined for the last year and half. The softness can, in part be attributed to the Tax Cuts and Jobs Act. Tax reform eliminated many of the tax advantages of home ownership by limiting the mortgage interest deduction to $750,000 worth of debt; limiting the state and local taxes (SALT) deduction to $10,000 and doubling the standard deduction. The high tax states of the West and Northeast have seen a greater impact. Previous reports have also focused on generational preferences limiting home ownership. For decades, the United States has over-invested in single family residential properties. The adjustment will be slow and lengthy.

During the first quarter, residential construction reduced economic growth by 0.1%, marking the fifth quarter in a row residential construction detracted from growth. With lower mortgage rates on the way, we look for residential construction to grow slightly (low single digits) and have a neutral impact on economic growth in the coming quarters. We do not believe housing will provide a major boost to economic growth. In response to the changing housing market, we have avoided investing in home builders. Instead, we have invested in multi-family housing.

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THIRD QUARTER 2019 MARKET OUTLOOK

The Consumer

Consumer confidence fell sharply in June. The Index fell to 121.5 from 131.3 the previous month. June’s reading missed consensus by a wide margin. Consensus expectations were for a 131.0 reading. Consumer sentiment appears to be heavily influenced by market sell-offs, trade disputes and perceived missteps by the FRB and a weak jobs report. Consumer confidence last fell by this margin in December after a FRB-trade induced sell-off. It is likely confidence will rebound along with the market and lessening trade tensions. The average reading over the last twenty years has been 93.

The present situation component, based on consumers’ assessment of current business and labor market conditions, fell by 8.1 points to 162.6 from 170.7 the previous month. While down, it remains significantly above its twenty-year average of 102.

The expectations component, based on consumers’ short-term outlook for income, business and labor market conditions, fell 94.1 from 105 the previous month, a drop of 10.9 points. The reading is modestly ahead of its twenty-year average of 87. The expectations component is most sensitive to market sell-offs and dower economic news.

The sub-components of the present situations component softened a bit. The net appraisal of current employment opportunities being plentiful (plentiful less hard to get) fell to 27.6 from 33.5 the previous month. Consumers’ net perception of current business conditions (good less bad) held relatively steady at 25.8, down slightly from 26.7 the previous month.

Personal income rose 0.5% in May and is estimated to be up 4.1% over the past year, not much slower than the 4.3% annual growth reported last year. Private sector wages and salaries are up 3.7% from last year. Disposable personal income is up 3.9% y/y. Disposable personal income per capita is up 3.3% y/y. Real disposable income per capita is up 1.7% y/y.

Consumer spending on goods and services is up 4.4% from last year. This is slightly more than disposable income growth of 3.9%. The personal savings rate fell to 6.1% of disposable income from 6.6% last year. Consumer credit is up 5.3% y/y. Consumer credit is growing slightly faster than nominal GDP (4.7%) and disposable income. Despite the slight relevering, the consumer’s balance sheet remains strong. The financial obligations ratio has risen slightly to 15.4% from 15.3% last year.

We look for consumption to mirror the growth of disposable income, about 4%. It does not appear that consumers have an appetite to significantly lever-up their balance sheets. Excesses are not building in the consumer sector. It is highly unlikely that the consumer will be the source of the next downturn.

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Business Activities Report
The Institute for Supply Management’s (ISM) non-manufacturing index fell to 55.1 from 56.9 the previous month. The reading came in just under expectations of 55.9 and is the lowest reading since July 2017. This reading marks the 113th consecutive month of economic growth in the service sector. The Index indicates that the rate of growth for the service sector slowed a bit in June. Comments from the survey panel “reflect mixed sentiment about business conditions and the overall economy. A degree of uncertainty exists due to trade and tariffs.”

Business activities / production, new orders, and employment are growing at a slower rate. Order backlog is growing at a faster rate. New export orders indicate growth at a steady pace.

The Inventory Sentiment Index held steady at 58.5. This indicates inventories are still too high. Prices for purchased materials and services increased to 58.9 from 55.4 indicating input prices are rising at a faster pace. 27% of respondents reported higher prices, 65% reported no change in input prices and 8% percent reported lower prices. Sixteen of eighteen industries indicated growth in April. One industry contracted.

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 manufacturing sector continued to weaken in June. Trade and tariffs impact manufacturing more than services. The June 2019, ISM Manufacturing Index fell by 0.4 points to 51.7. That marked the third straight month of slowing growth and the slowest pace for the manufacturing sector since September 2016. Manufacturing accounts for 11.4% of economic activity and 8.5% of employment. Even if the ISM were to dip below 50, as it did several times during the current economic expansion, it does not mean the broader economy will dip into recession. It does point to slower overall economic growth.

The manufacturing sector showed growth for the 34th consecutive month. The more immediate indices remain strong with faster growth in production and employment and inventories contracting. However, forward looking indices were weaker. The New Orders Index decreased 2.7 points to 50.0, indicating demand expansion has ended. The Backlog of Orders Index contracted for the second straight month and the New Export Orders barely expanded.

The Inventories Index decreased by 1.8 points in June to 49.1, indicating inventories were contracting. Inventories are being managed down. This harms current activity levels but helps future activity levels. The prices component registered 47.9 a 5.3 point decrease, indicating falling raw materials prices. Twelve of the 18 manufacturing industries reported growth. Five industries reported contraction. Comments from the survey panel reflect “concern about U.S.-China trade turbulence, potential Mexico trade actions and the global economy. Overall, sentiment this month is evenly mixed.”

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The NFIB Small Business Optimism Index increased in May by 1.5 points to 105.0. “Optimism among small business owners has surged back to historically high levels, thanks to strong hiring, investment, and sales,” It also appears that inventories are correcting from the first quarter build.

All three optimism indices are consistent with growth moderating from last year’s 3.0% pace. The indices remain in the expansion territory, consistent with our growth forecast. They do not indicate a recession is on the horizon.

Global Manufacturing PMI numbers are a bit more concerning. The JPMorgan global manufacturing PMI dropped 0.4 points last month to 49.4. This marks the second consecutive month below the 50 threshold. The output index fell below 50 for the first time since October 2012. Global industrial production is estimated to be flat. The global economy appears to be deteriorating faster than the US economy. This can, in part, be explained by dependence on trade and increase trade tensions. The US is the least export dependent major economy with exports only 8% of GDP versus 20% for the Eurozone, 15% for Japan, and 19% for China. Since 1994, global trade volumes have grown at an average of 5% per year. Trade volumes are no longer growing. Flat trade volumes have translated into flat industrial production and slower overall global growth. The US economy is likely the most able to weather reduced trade volumes. Slower global growth keeps us overweight US stocks versus other developed country equities.

The Yield Curve and International Interest Rates
After the President’s escalation of the trade wars, the short end of the yield curve inverted dramatically. The three year less three month curve is now negative 0.50% versus negative 0.09% two months ago and positive 0.71% last year. The significant inversion on the short end of the curve will force the FRB to lower at its July 31st meeting.

Fed Funds futures are pricing in a 100% chance that the FRB will lower rates by at least 0.25% on July 31st. One month ago, market participants placed the odds of a rate cut at only 48%. The futures market implies a 48% chance the FRB will have cut two additional times by year end for a total of 0.75% of rate cuts bringing the Fed Funds rate to 1.75%

The traditional measure for recession watching has been the 10-year minus the 2-year yield curve. This spread has yet to cross the zero line. It has actually widened a bit recently as market participants anticipate that several rate cuts will lead to stronger economic growth in the near future.
As seen in the chart above, interest rates in other developed countries are significantly lower than in the U.S. This will continue to anchor US rates and exert upward pressure on the US dollar.

**Trade Weighted Dollar**
The dollar weakened slightly as the odds of a rate cut increased. However, it has recovered some of its decline with the easing of trade tensions. The index roughly flat year to date and is up only 1.8% over the last twelve months. The dollar index is about even with its five year average and seven percent above its twenty year average. We look for a fairly stable dollar for the next several months. The downward pressure from lower US rates will likely be offset by weaker global growth.

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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