



## The Economy and Interest Rates

Despite our challenges, the U.S. bond market remains a safe haven for global investors. This buys us more time before the first rate hike in the new market cycle.

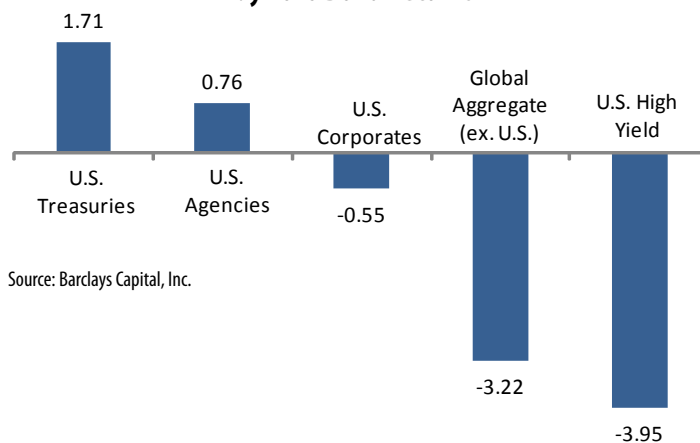
Interest rates on U.S. government securities dropped sharply in the spring months of 2010. The reason was not renewed weakness in the domestic economy but a flight to quality among global investors. The outcome was a shift forward in consensus expectations for the timing of a Federal Reserve policy change.

By nearly all measures the U.S. economy continues on a modest path to recovery. Personal consumption expenditures are rising, and the manufacturing sector is showing sharp gains. Employment data is improving, although at a pace well below that of recent recoveries. The recession is over and a “double dip” is unlikely.

This slow progress is taking place in an environment of minimal inflation risk. Capacity utilization rates in most sectors are running well below levels where cost pressures become a concern. The Fed retains significant flexibility to keep interest rates low for the foreseeable future – at least through the end of 2010 and into 2011. This flexibility is needed – not so much for us but for the European Union.

The disparate fiscal policies of the various EU members have created internal dislocations for some time. These reached crisis proportion in late spring as prospects for default by weaker members rose, rescue packages were cobbled together, and pledges of fiscal reform announced.

May 2010 Bond Returns



Source: Barclays Capital, Inc.

Investors fled the Euro for safer shores. Demand for U.S. Treasury debt soared, pushing prices up and yields down. Risk assets significantly underperformed for the first time in over a year – particularly in May.

This pattern may continue as the efficacy of European fiscal restraint is measured. At the same time, the U.S. high-grade bond market is, at best, fairly valued. Treasury issues are expensive when our ultimate need to address the budget deficit is considered.

As such, bond investors face a variety of price and credit risks. This suggests a strategy of broad diversification and low duration. We will retain global exposure and offset its volatility with shorter-maturity domestic positions. The result should be a reasonable income stream with low price risk.

The U.S. bond market may not be in a bubble, but it is moving toward that outcome. Conservative, diversified portfolios will provide the best protection in this environment.

# Stock Market Outlook

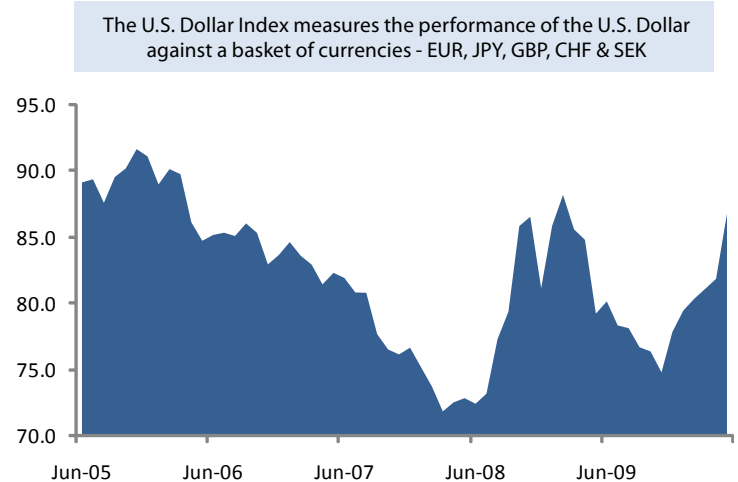
While the market's confidence continues to be shaken by the European debt crisis and the strength of the U.S. recovery remains questionable, opportunities are being created for long-term investors.

As we noted at the end of last quarter, expectations for the U.S. equity market were, in our opinion, overly optimistic. Now it appears the fulcrum is shifting in the other direction and expectations, or at least investor sentiment, is becoming overly pessimistic. There appears to be a disconnect between investors' perception and economic reality. Domestically, the information coming from the companies regarding their forward looking expectations and earnings is improving, and while stock prices have fallen, sales have grown, margins have increased and balance sheets are strong. The truth or reality probably lies somewhere between these two extremes – the overly optimistic scenario which existed in the spring and the current environment which is significantly discounting the improving metrics. While we still expect an average to slightly less than average rate of return for the stock market in 2010, given the current valuation levels, long-term investors will probably be well-served by increasing their exposure to equities.

On the global front our outlook remains cautiously positive. We still favor emerging markets and developed international equities relative to U.S. equities. Given the recent strengthening of the U.S. dollar, additional international investment is becoming increasingly attractive.

Over the past year the U.S. Dollar has reached levels only seen eleven times during the last five years. Following each of these periods, international stocks significantly outperformed U.S. stocks. While the U.S. Dollar is far from parity, it is above its five year average and as the challenges facing the overseas markets are resolved, the U.S. Dollar may weaken once again and international equities should outperform their U.S. counterparts.

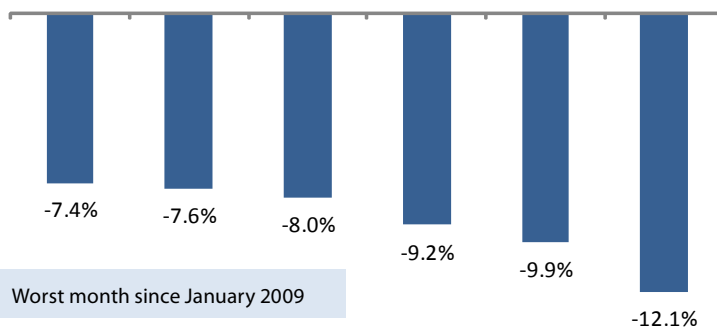
## U.S. Dollar Index



Source: Thomson Reuters Baseline

While it may be premature to suggest a significantly higher foreign equity allocation at this point, we will consider increasing our allocation as more of the uncertainty surrounding the overseas markets subsides.

## May 2010 Stock Returns



Russell Mid Cap   Russell 2000   S&P 500   MSCI Emerging Markets   MSCI World   MSCI EAFE

Source: Morningstar EnCorr



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