

Economic and Interest Rate Outlook

With each statistical release it becomes more evident that the worst recession since the 1930s ended in late 2009.

At the same time it is increasingly clear that this recovery will be less robust than most witnessed in the last half-century. Let's look at some of the cross-currents in place today.

On the positive side, massive fiscal and monetary stimulus remains with no expectation of tightening until later this year. Export activities are picking up, and inventory restocking is giving a boost to manufacturing. In all, many of the components of a decent jump-start to 2010 are in place.

In the opposite corner is the continuing specter of a housing market searching for a trough and employment data suggestive of no near term turn in consumer spending – still two-thirds of our economy and the engine that powers sustainable long term prosperity. Inflation will remain subdued in this environment but this is a large price to pay for temporary price stability.

In the near term it appears that the latter negatives will carry the day. As such, we expect the Federal Reserve will maintain short term interest rates at minimal levels for some time to come. Historically, the Fed does not begin raising rates until about a year after the peak in unemployment. This suggests no changes are forthcoming in Fed policy until later this year.



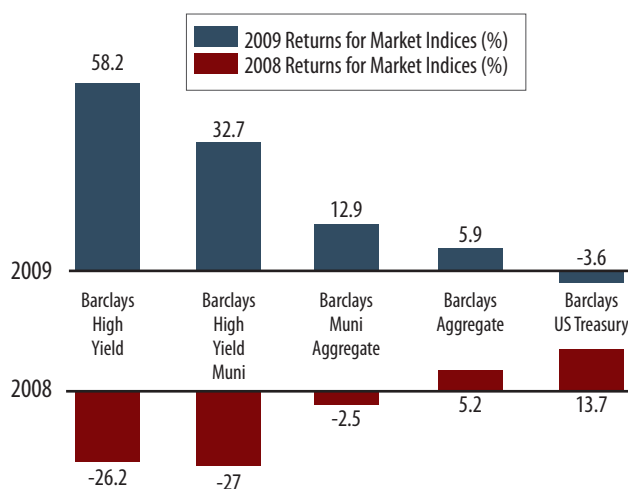
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This places the traditional fixed income investor in a classic “trap”. The yield curve – the difference between short and long term rates – is historically steep. The enticement to extend maturities to capture incremental yield is strong – and probably incorrect. We will not chase returns when risk of price loss in a different environment is as pronounced as it is today.

Our expectation for the bond market in 2010 is a return to a normal relationship between risk and reward. The graphics below show the returns of various bond indices in 2008 and 2009. The first was a year of risk aversion and flight to quality. Treasury issues far outgained other major debt categories. As the crisis receded, the opposite occurred – risk assets far outperformed safe harbors.



Data Source: Morningstar & Bloomberg as of December 2008 & December 2009, Goldman Sachs & Co.

We expect category returns to be much more in line with one another in 2010, and aggregate bond returns to be in the low- to mid-single digits. Credit spreads should continue to narrow as the economy improves, suggesting that non-government sectors offer advantages. Portfolios will be constructed accordingly with an emphasis on capital preservation.

Stock Market Outlook

We believe consensus estimates of 19% S&P 500 earnings growth in 2010 are too optimistic. This may endanger stock market progress in the months ahead and we are tempering our total return expectations as a result.

While we welcome the optimistic earnings scenario, it's hard to comprehend where the growth is going to come from given the economic headwinds. In fact, 19% earnings growth would rank as the third best year over year EPS growth in the last fifteen years.

Yearly S&P 500 Earnings Growth

	1995	1996	1997	1998	1999	2000	2001	2002
EPS	37.71	41.18	45.0	44.5	50.9	56.3	45.2	48.1
% Change	20.6	9.2	9.4	(1.2)	14.4	10.7	(19.8)	6.6
Price-to-Earnings	16.3	18.0	21.5	27.6	28.9	23.4	25.4	18.3

	2003	2004	2005	2006	2007	2008	2009	2010 est.
EPS	55.6	67.0	76.3	88.2	86.2	68.6	65.3	77.5
% Change	15.4	20.6	13.9	15.6	(2.2)	(20.4)	(4.9)	18.7
Price-to-Earnings	20.0	18.1	16.4	16.1	17.0	13.2	17.1	16.1

Source: Thompson Reuters Baseline, Goldman Sachs & Co.

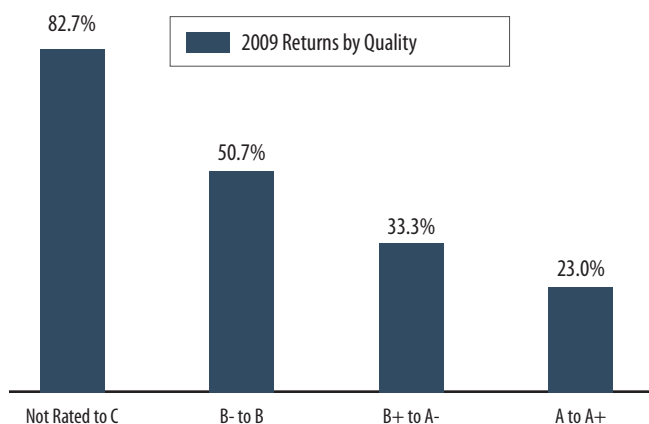
Domestically, 2009's rally was primarily led by lower-quality companies. We expect a reversal of this trend as 2010 progresses, with a renewed focus on companies with high-quality earnings, sound balance sheets, and strong global franchises.



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Source: Thompson Reuters Baseline. The earnings and dividend quality is a measure ranging from NR (not rated) to A+ assigned by Standard and Poors to measure a company's earnings and dividend quality.

Certainly there are sectors within the S&P 500 and areas within the global equity universe that will post total returns in 2010 commensurate with Wall Street's optimistic growth forecast. But in our expectations these will be the exception rather than the rule. The outperformance from these bright spots in an otherwise subdued environment will likely not be sufficient to push the whole market ahead at much beyond an average, or even slightly less than average, rate of return in 2010.

At the beginning of the year we were encouraged by the opportunities abroad when compared to the domestic investment opportunities. Our global equity outlook remains positive, but given the first-quarter events in some of the emerging economies, uncertainty surrounding China's currency revaluation (if, when, how much, and which U.S. and global sectors and industries it will impact), and the possibility of tighter monetary policy in other emerging market countries, our global equity outlook is also a little more tempered today. That being said, we still favor emerging markets and developed international equities relative to U.S. equities, but are recommending no significant allocation changes given the current environment.