COUNTRY Trust Bank®
Special Report: The Case for International Stocks

COUNTRY FINANCIAL®

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Key Points:

- **The U.S. stock market has enjoyed several years of outperformance relative to internationals markets. This remarkable winning streak isn't likely to last forever, particularly with a large valuation gap between U.S. and international stocks.**
- **Although some long-term headwinds persist, recent economic data indicates a brighter economic outlook overseas, which has helped drive strong international equity performance so far in 2017.**
- **Given their positive diversification benefits and attractive long-term return potential, we believe that international stocks should be a key part of a diversified portfolio.**

If the global stock market were like the Olympics, then the United States would be standing atop the podium. For the last several years, the S&P 500® has trounced most international indexes, both developed and emerging. (Figure 1) One of the primary reasons for this outperformance has been a steadily improving economy in the States, which has helped drive corporate profits to near-record highs.

However, we do not expect similar underperformance from international stock markets going forward. The recent period of U.S. dominance is currently among the longest stretches in recent history. This has led to a large valuation gap between U.S. and international stocks, with overseas stocks looking comparatively attractive. And while there are many long-term headwinds for international economies, recent data points to an improving outlook.

Investors often have a preference for investing more heavily in their own country. While this "home bias" has been a winning strategy for Americans over the last few years, we believe that international stocks offer diversification benefits and potential for better returns than U.S. stocks going forward.

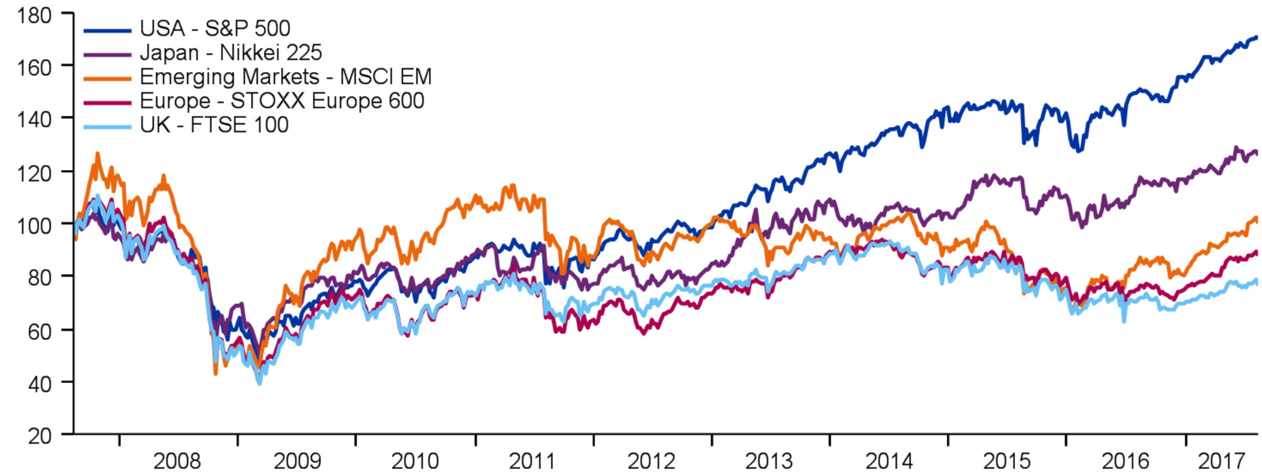
'Solid and Broad' Recovery

The outperformance of U.S. stocks over the last several years has been impressive, but history shows an ebb and flow between U.S. and international outperformance. (Figure 2) While U.S. equities have largely outperformed for several years in a row, as economist Herbert Stein once said, *"if something can't go on forever, it will eventually stop."*

Figure 1

Equity Returns in US Dollars

Index, 2007 = 100

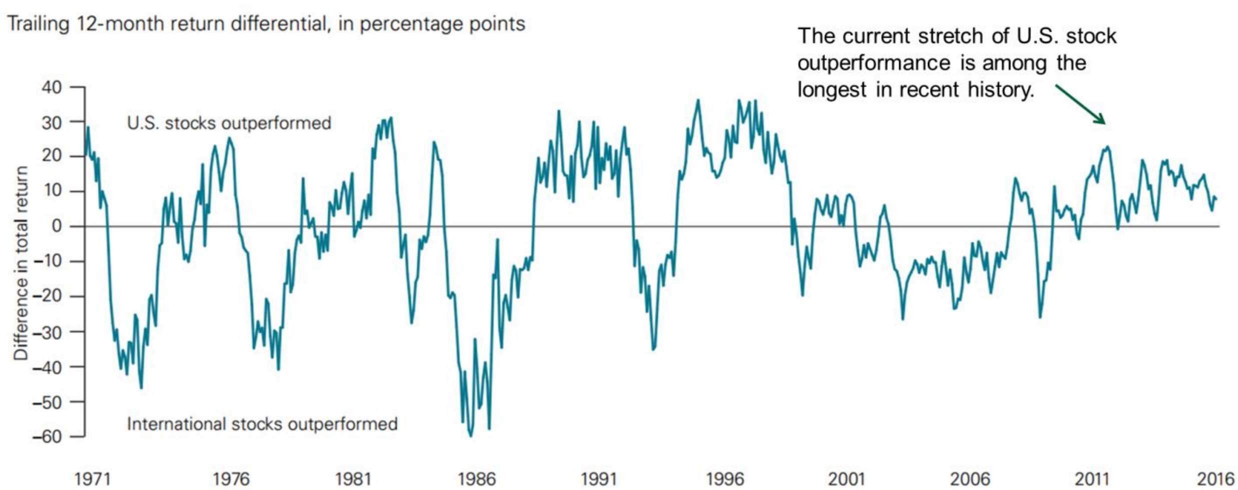


Source: Thomson Reuters Datastream

In fact, this trend may already be reversing as international stocks are currently outperforming U.S. stocks so far in 2017. Through August 15, 2017, the MSCI U.S. Broad Market Index had returned nearly 11% year-to-date. However, the MSCI Europe, Australasia and Far East (EAFE) Index had gained over 17% while the MSCI Emerging Markets Index had rallied more than 25%.

Figure 2

U.S. and international stocks have alternated as global market performance leaders



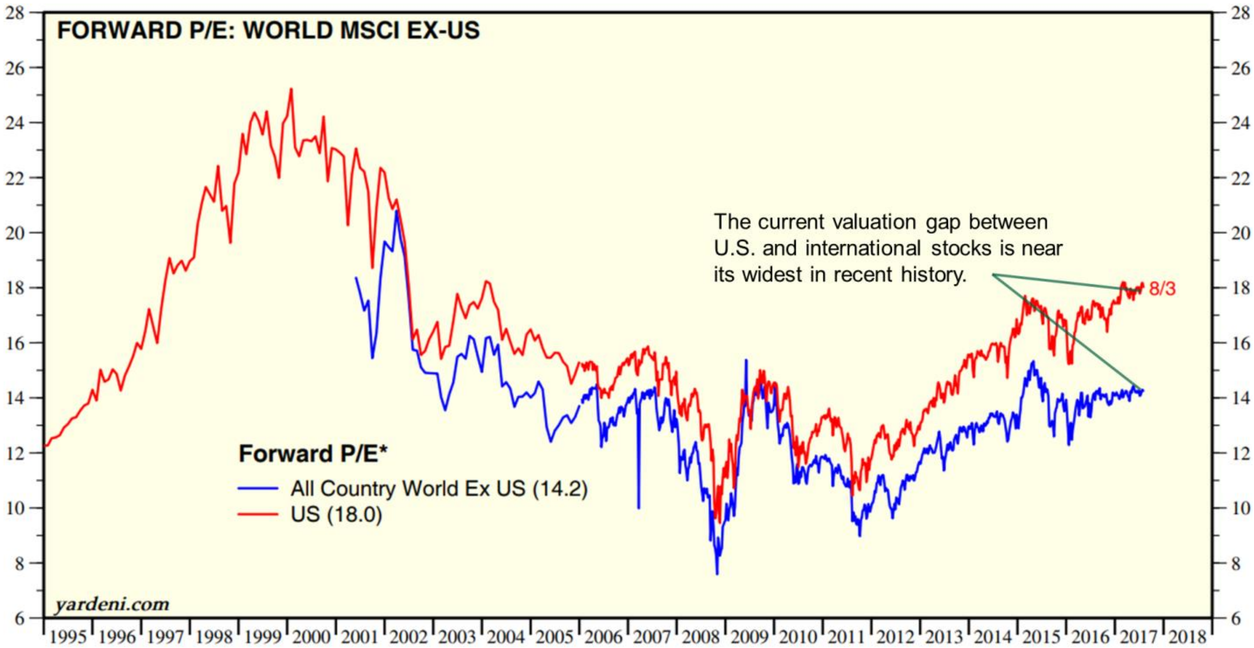
Notes: U.S. equities represented by MSCI USA Index; international equities represented by MSCI World Index ex USA from 1970 through 1987 and MSCI All Country World Index ex USA thereafter. Data as of Decenber 31, 2016.

The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index. Past performance is no guarantee of future returns.

Sources: Vanguard calculations, based on data from Thomson Reuters Datastream.

Meanwhile, valuations still look attractive overseas relative to U.S. stocks. According to Yardeni Research, the spread between forward price/earnings ratios among the U.S. and international stocks is near its widest margin in recent history. (Figure 3)

Figure 3



* Price divided by 12-month forward consensus expected operating earnings per share. Monthly through December 2005, weekly thereafter.
Source: Thomson Reuters I/B/E/S.

To be sure, we believe that the U.S. stock market warrants premium valuation to most international equity markets given its strong investor protections, stable government and corporate focus on shareholder maximization. However, we also believe that the exceptionally wide valuation gap is not likely to persist and that international stocks offer attractive long-term total return potential. Additionally, dividend yields on international stocks are meaningfully higher than U.S. stocks in many parts of the globe. For example, the STOXX® Europe 600 Index, which tracks 600 companies across 17 countries in Europe, yields around 3.9% - approximately twice that of the S&P 500.

When valuations become extremely low amid a bleak outlook, the slightest hint of improvement can lead to big returns for investors. This could be the case for many international markets. Recently, there have been several bright spots overseas that have given investors cause for optimism as economic data has generally been better than expected. For instance, the IHS Markit Eurozone Composite PMI® Index, which is a timely indicator of business conditions across Europe, is currently near a six-year high. This corresponds with strong economic sentiment in the region. (Figure 4) And in Japan, economic growth recently hit a solid 4%, driven by strong consumer and business spending. Its economy is currently experiencing its longest expansion since 2006.

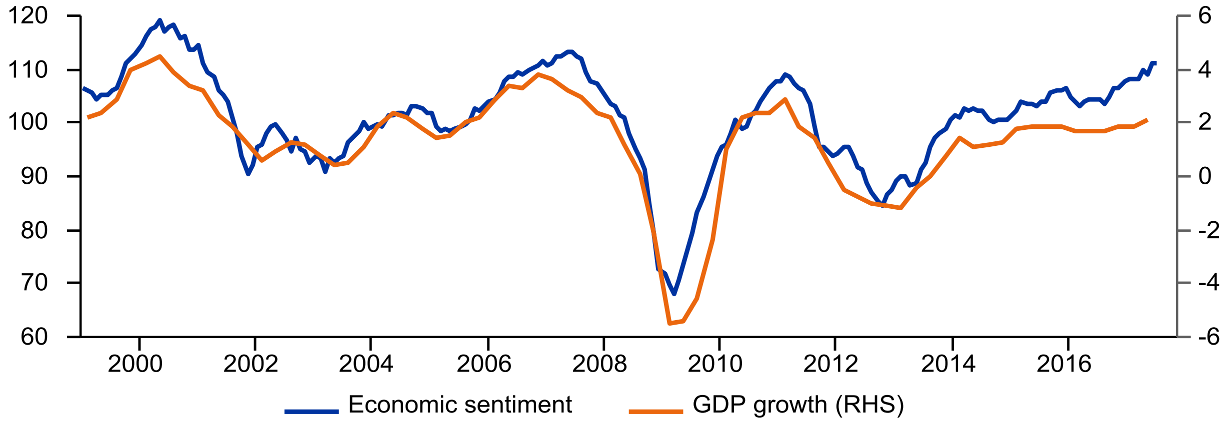
This positive data has led some central banks to ease off the monetary gas pedal a bit this year, which has driven many foreign currencies higher against the U.S. Dollar in 2017. As European Central Bank President Mario Draghi stated in April this year, *"in 2016 we were speaking of a fragile and uneven recovery. Now it's solid and broad."*

Figure 4

Euro area economic sentiment

Four-quarter percentage change

Index, average = 100



Source: Thomson Reuters Datastream

No Place Like Home?

Humans have a tendency to invest more heavily in their own country – a behavior known as "home bias" – which is not exclusive to Americans. But investors with a disproportionate amount of domestic equity exposure are giving up the diversification benefits of international stocks as each country's stock market offers its own unique risks and returns, which are often not heavily correlated with the investors' home market. (Figure 5)

Figure 5

International and U.S. Stock Correlations

Daily returns, six-month rolling correlation

Source: Thomson Reuters Datastream

As of 8/14/2017

U.S. investors have certainly enjoyed strong domestic stock market returns the last several years. This may have some questioning the benefits of investing outside of America's borders. However, we continue to believe that the U.S. economy is entering the later stages of the cycle and that investors expecting a new paradigm of robust economic growth and extraordinary stock market returns going forward are likely in for disappointment.

That is not to say that there aren't many headwinds for international markets. In the developed markets of Europe and Japan, for instance, aging populations and onerous government debt levels threaten long-term economic growth prospects. Moreover, the days of double-digit economic growth in China are likely behind it as its seeks to transition from an investment-driven to consumer-driven economy. And many economies, particularly in the emerging markets, still possess strong state ownership of businesses, leaving outside equity investors uncertain of who the corporation is ultimately working for.

However, many of these concerns are more than reflected in current valuations, in our opinion. Additionally, the emerging markets offer investors access to potentially faster economic growth and a burgeoning middle class. Also, corporate profits in Europe remain well below their peak levels and could rebound significantly if their economies continue to recover. All-in-all, we believe that the return potential looks attractive for long-term investors compared to U.S. stocks. We feel that investors willing to venture outside of the United States will be rewarded.

Summary

The U.S. stock market has enjoyed several years of outperformance relative to internationals markets. This remarkable winning streak isn't likely to last forever, particularly with the valuation gap between U.S. and international stocks at multi-year highs. Although some long-term headwinds persist, recent economic data suggests a brighter economic outlook overseas, which has helped drive strong international equity performance so far in 2017. With overseas stocks offering positive diversification benefits and attractive long-term return potential going forward, U.S. investors may want to reconsider their home bias.

Definitions

The S&P 500® Index is an unmanaged index that contains securities typically selected by growth managers as being representative of the U.S. stock market. The Index does not reflect investment management fees, brokerage commission and other expenses associated with investing in equity securities. It is not possible to invest directly in an index.

The Nikkei 225 index is a price-weighted equity index, which consists of 225 stocks in the 1st section of the Tokyo Stock Exchange.

The MSCI US Broad Market Index represents the universe of companies in the US equity market, including large, mid, small and micro-cap companies. This index targets for inclusion 99.5% of the capitalization of the US equity market. The MSCI US Broad Market Index is the aggregation of the MSCI US Investable Market 2500 and Micro Cap Indexes.

The MSCI EAFE Index is broadly recognized as the pre-eminent benchmark for U.S. investors to measure international equity performance. It comprises the MSCI country indexes capturing large and mid-cap equities across developed markets in Europe, Australasia and the Far East, excluding the U.S. and Canada.

The MSCI Emerging Markets Index captures large and mid-cap representation across 23 emerging market countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI World ex USA Index represents large and mid-cap companies across 22 of 23 developed markets – excluding the United States. The index covers approximately 85% of the free float-adjusted market capitalization in each country and has over 1,000 constituents.

The MSCI ACWI ex USA Index represents large and mid-cap companies across 22 of 23 developed markets – excluding the United States – and 24 emerging markets. The index covers approximately 85% of the global equity opportunity set outside the United States and has over 1,800 constituents.

The STOXX® Europe 600 Index is derived from the STOXX Europe Total Market Index (TMI) and is a subset of the STOXX Global 1800 Index. With a fixed number of 600 components, the STOXX Europe 600 Index represents large, mid and small capitalization companies across 17 countries of the European region: Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom.

The FTSE 100 is an index consisting of the 100 largest companies by market capitalization listed on the London Stock Exchange in the United Kingdom.

The price-to-earnings ratio is a valuation ratio which compares a company's current share price with its earnings per share (EPS). EPS is usually from the last four quarters (trailing P/E), but sometimes it can be derived from the estimates of earnings expected in the next four quarters (projected or forward P/E). The ratio is also sometimes known as "price multiple" or "earnings multiple."

The Eurozone Composite PMI® Index is created by IHS Markit and is based on original survey data collected from a representative panel of around 5,000 manufacturing and services firms across Germany, France, Italy, Spain, the Netherlands, Austria, the Republic of Ireland and Greece. It seeks to provide a timely indication of what is really happening in the private sector economy by tracking variables such as sales, employment, inventories and prices.

In finance, correlation is a measure of how two financial instruments move in relation to each other. A correlation of +1 indicates that as one asset moves up or down, the other moves in the same direction. A correlation of -1 indicates that the two assets move in opposite directions. A correlation of 0 means that there is no relationship at all.

Important Information

Investment management, retirement, trust and planning services provided by COUNTRY Trust Bank®.

All information is as of the report date unless otherwise noted.

Past performance does not guarantee future results. All investing involves risk, including risk of loss.

This material is provided for informational purposes only and should not be used or construed as investment advice or a recommendation of any security, sector, or investment strategy. All views expressed are based on the information available at the time of writing, do not provide a complete analysis of every material fact, and may change based on market or other conditions. Statements of fact are from sources considered reliable, but no representation or warranty is made as to their completeness or accuracy. Unless otherwise noted, the analysis and opinions provided are those of the COUNTRY Trust Bank investment team identified above and not necessarily those of COUNTRY Trust Bank or its affiliates.

Stocks of small-capitalization companies involve substantial risk. These stocks historically have experienced greater price volatility than stocks of larger companies, and they may be expected to do so in the future.

Stocks of mid-capitalization companies may be slightly less volatile than those of small-capitalization companies but still involve substantial risk and they may be subject to more abrupt or erratic movements than large capitalization companies.

International investing involves risks not typically associated with domestic investing, including risks of adverse currency fluctuations, potential political and economic instability, different accounting standards, limited liquidity and volatile prices.

Fixed income securities are subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors. Debt securities typically decrease in value when interest rates rise. The risk is usually greater for longer-term debt securities. Investments in lower-rated and nonrated securities present a greater risk of loss to principal and interest than higher-rated securities.

Diversification, asset allocation and rebalancing do not assure a profit or guarantee against loss.

All indexes are unmanaged and returns do not include fees and expenses associated with investing insecurities. It is not possible to invest directly in an index.