A review of recent economic and financial market developments, and what we expect going forward.

September 30, 2017
Key Takeaways

- The stock market has continued to rally without much interruption. There are certainly some reasons for investors to be optimistic, including synchronized global economic growth and strong corporate earnings.

- We recommend that investors avoid being lulled into complacency and relaxing their investment standards in this era of extreme market tranquility.

- We continue to discuss moving to a neutral weighting but remain slightly overweight stocks versus bonds. Our long-term return expectations for both asset classes continues to be below their historical averages.

Intel co-founder Andy Grove once wrote that "success breeds complacency." Investors may want to take heed. Since early November of last year, the S&P 500® has risen more than 20%, and, perhaps more remarkably, it has pulled back no more than 3% along the way.

We believe that there are justifiable reasons for recent investor optimism, including synchronized global economic growth and strong corporate earnings. However, we are also concerned that success has bred complacency in many areas of the market.

Just as sure as autumn follows summer, the stock market will experience periods of decline. We recommend that investors avoid being lulled into complacency and relaxing their investment standards in this era of extreme market tranquility.

Synchronized Global Growth

For the first time in several years, we are experiencing synchronized global economic growth. (Figure 1) The economies of Europe, Japan and many of the emerging markets are finally on the upswing. And the U.S. economy continues its long expansion – an expansion that appears long by date only, not by aggregate growth.

We are seeing synchronized global growth for the first time in years.
U.S. economic activity in both the manufacturing and services sectors continue to point to solid expansion, according to recent surveys from the Institute for Supply Management. The labor market remains fairly strong with the unemployment rate near its lowest levels since 2000. And the national housing market continues to recover. The recent fleet of hurricanes will likely negatively affect third quarter GDP, but we believe this will be largely offset in subsequent quarters as repair efforts commence.

Many investors may have concerns about recent saber-rattling from North Korea. While a potential military conflict with North Korea could negatively impact the financial markets, historically, geopolitical crises have generally had only short-term impacts on the stock market, especially during bull markets. Rather than trying to forecast when an event like this could occur or how much it could affect the markets, we suggest that investors focus on things they can control, including how they react to such events.

The overall improvement in the global economy has helped lift corporate profits significantly in 2017, with strong growth expected for next year too. These factors have provided support for the stock market gains so far in 2017. No longer is the market rising merely in anticipation of potential policy changes from the new administration (the so-called ‘Trump Bump’); it is rising because of improving fundamentals. (Figure 2)

Corporate profits have rebounded sharply in 2017, with strong growth expected next year too.

However, common valuation metrics like the price to earnings ratio now point to a stock market that looks richly valued. Low interest rates provide some justification for higher-than-average valuations, but the market does not look cheap at these levels. This does not mean that a correction is imminent, as valuations have proven to be very poor market-timing indicators. But high valuations have often foreshadowed weak equity returns over the longer term. We believe that valuations remain more attractive outside of the U.S. stock market, which is one reason that we continue to like international stocks long-term.

**Investor Complacency**

While the current investment landscape looks positive overall, we are concerned by the apparent lack of fear among investors in many areas of the financial markets. The CBOE Volatility Index® (the VIX, or the market’s “fear gauge”) remains near the lowest level in its 27-year history. The greatest drawdown in the S&P 500 this year has been just 3%, marking the smallest pullback of any year since 1995. And there exists an anointed group of large
growth stocks priced for near-perfection that are driving much of the markets’ gains this year. Complacency doesn’t just exist in the stock market, or in the U.S. for that matter. Yields on emerging market debt are currently below those of U.S. high yield bonds, which are near their lowest levels in history themselves. European junk bonds offer a lower yield than European equity dividend yields. And the issuance of loans with very light covenants, or lender protections, continues to rise as investors show an insatiable appetite for yield. As Howard Marks, Chairman of Oaktree Capital Management, recently wrote, "when capital is in oversupply, it is inevitable that risk aversion dries up, gullibility expands, and investment standards are relaxed."

As we survey the current investment landscape, we remain cautious amid what we feel is increased investor complacency. We continue to have somewhat low return expectations for both major asset classes over the next five to ten years relative to their historical averages. We remain slightly overweight stocks versus bonds, driven in part by the continued low interest rate environment.

But note that we have become less aggressive over time in our stock weightings and continue to discuss moving to a neutral weighting. Perhaps such a move would be premature amid what looks like a favorable investment environment for equities. And we know that markets can rally for long periods of time. Yet, we believe that it is important to recognize when sentiment becomes overly bullish. Unfortunately, unlike in some past markets, this overt bullishness appears to have gripped both the stock and bond markets, dampening return prospects for most investment options. (Figure 3)

**Figure 3**

Earnings Yield vs. Corporate Bond Yield

<table>
<thead>
<tr>
<th>Year</th>
<th>S&amp;P 500 Earnings Yield</th>
<th>Moody’s Corporate Baa Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>2%</td>
<td>2%</td>
</tr>
<tr>
<td>2000</td>
<td>4%</td>
<td>4%</td>
</tr>
<tr>
<td>2002</td>
<td>6%</td>
<td>6%</td>
</tr>
<tr>
<td>2004</td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
<td>2006</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>2008</td>
<td>12%</td>
<td>12%</td>
</tr>
<tr>
<td>2010</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>2012</td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
<td>2014</td>
<td>6%</td>
<td>6%</td>
</tr>
<tr>
<td>2016</td>
<td>4%</td>
<td>4%</td>
</tr>
<tr>
<td>2018</td>
<td>2%</td>
<td>2%</td>
</tr>
</tbody>
</table>

Source: Thomson Reuters Datastream

The Great Unwinding

Arguably one of the biggest drivers of investor complacency has been the low interest rate environment, which has nudged many investors into risky assets in search of returns. However, the Federal Reserve continues to take steps to move monetary policy off of extraordinarily accommodative levels as the U.S. economy continues to improve. The Fed has raised short-term rates three times since last December and recently announced that it would begin to "normalize" its balance sheet by gradually reducing its bond holdings.

Back in 2008, amid the financial crisis, the Fed began buying bonds through its “quantitative easing” programs, which finally ended in 2014. The Fed will now allow some of these bonds...
to mature without reinvesting the principal, which will reduce its $4.5 trillion balance sheet, albeit slowly. (Figure 4)

**Figure 4**

Fed Balance Sheet & Government Bond Yields

![Graph showing the Federal Reserve balance sheet and 10-year government bond yields over time.](source: Thomson Reuters Datastream)

The move is expected to increase longer-term interest rates. However, the full effects of the Great Unwinding remain uncertain, as this is unchartered territory for both our central bank and financial markets. As JPMorgan CEO Jamie Dimon recently cautioned, the Fed’s unwinding “could be a little more disruptive than people think. We act like we know exactly how it’s going to happen, and we don’t.”

Meanwhile, Fed Chair Janet Yellen has been signaling that the central bank likely isn’t going to wait around for core inflation to reach its 2% target before raising short-term rates again. In a recent speech, Yellen stated that "without further modest increases in the federal funds rate over time, there is a risk that the labor market could eventually become overheated, potentially creating an inflationary problem down the road that might be difficult to overcome without triggering a recession."

All of these factors point to a modestly higher interest rate environment. Amid the threat of rising rates, we prefer a somewhat shorter duration target within fixed income holdings (duration is a measure of bond prices' sensitivity to changes in interest rates; shorter duration bonds are less sensitive to interest rate movements than longer duration bonds). We also continue to favor high quality bonds in this environment, as credit spreads remain tight (meaning that the difference in yield between bonds of different credit quality is small). While high quality bond yields remain low overall, we believe that they offer portfolio stability and provide important diversification benefits for investors.

**Summary**

The stock market continues to rally without much interruption. There are certainly some reasons for investors to be optimistic. We are experiencing synchronized global growth for the first time in years, and corporate earnings remain strong, and growing.

However, we are concerned with potential complacency in many areas of the financial markets, as we believe that risk aversion has declined and investment standards have been relaxed. We continue to discuss moving to a neutral weighting but remain slightly overweight stocks versus bonds. Our long-term return expectations for both asset classes continue to

---

We prefer a shorter duration amid the threat of rising rates.

We continue to expect long-term returns below their historical averages.
be below their historical averages. (Figure 5)

The financial waters currently remain calm, and investors have enjoyed smooth sailing for an extended period of time. But we suggest that they remain attentive and not relax their investment standards – for the winds of the financial markets can change quickly and without warning. Investors should not let recent success breed complacency in their portfolios.

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Next 5 to 10 Years</th>
<th>Long-term Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stocks</td>
<td>5-8%</td>
<td>10.0%</td>
</tr>
<tr>
<td>Bonds</td>
<td>2-4%</td>
<td>5.5%</td>
</tr>
<tr>
<td>Cash</td>
<td>1-2%</td>
<td>3.4%</td>
</tr>
<tr>
<td>Balanced Portfolio</td>
<td>4-6%</td>
<td>7.8%</td>
</tr>
<tr>
<td>(50% Stocks / 50% Bonds)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Morningstar and COUNTRY Trust Bank

COUNTRY Trust Bank Wealth Management Team

Troy Frerichs, CFA  
Director, Wealth Management & Financial Planning

Jeff Clark, CFA, CFP®  
Manager - Investments - Wealth Management

Kent Anderson, CFA  
Senior Investment Officer

Andy Finks, CFA  
Investment Officer

Todd Bunton, CFA  
Investment Officer

Chelsie Moore, CFA, CFP®  
Investment Officer

Jonathan Strok, CFA  
Investment Analyst

Austin Burant  
Investment Associate
Definitions

The S&P 500® Index is an unmanaged index consisting of 500 large-cap stocks. Since it includes a significant portion of the total value of the market, it also considered representative of the 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 Institute for Supply Management's manufacturing index is based on data compiled from purchasing and supply executives nationwide. Survey responses reflect the change, if any, in the current month compared to the previous month. The PMI® is a composite index based on the diffusion indexes of five of the indexes with equal weights: New Orders (seasonally adjusted), Production (seasonally adjusted), Employment (seasonally adjusted), Supplier Deliveries (seasonally adjusted), and Inventories. A PMI® reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent indicates that it is generally declining. A PMI® above 43.3 percent, over a period of time, indicates that the overall economy, or gross domestic product (GDP), is generally expanding; below 43.3 percent, it is generally declining. The distance from 50 percent or 43.3 percent is indicative of the strength of the expansion or decline.

The Eurozone Manufacturing PMI® is created by IHS Markit and based on original survey data collected from a representative panel of around 3,000 manufacturing firms across Germany, France, Italy, Spain, the Netherlands, Austria, the Republic of Ireland and Greece. A PMI reading above 50 percent indicates that the manufacturing economy is general expanding; below 50 percent indicates that it is generally declining.

The Caixin China Purchasing Managers' Index™ (PMI™) comes from IHS Markit and Caixin Media. It is a composite index based on five individual indexes: New Orders, Output, Employment, Suppliers' Delivery Times, and Stock of Items Purchased. These indexes are based on data compiled from monthly replies to questionnaires sent to purchasing executives in over 500 manufacturing companies. Survey responses reflect the change, if any, in the current month compared to the previous month based on data collected mid-month. An index reading above 50 indicates an overall increase, while below 50 indicates an overall decrease.

The Nikkei Japan Manufacturing PMI® is created by IHS Markit and is a composite index based on five of the individual indexes: New Orders, Output, Employment, Suppliers' Delivery Times, and Stock of Items Purchased. These indexes are based on data compiled from monthly replies to questionnaires sent to purchasing executives in over 400 industrial companies. The manufacturing sector is divided into the following 8 broad categories: Basic Metals, Chemicals & Plastics, Electrical & Optical, Food & Drink, Mechanical Engineering, Textiles & Clothing, Timber & Paper, Transport. Survey responses reflect the change, if any, in the current month compared to the previous month based on data collected mid-month. An index reading above 50 indicates an overall increase, while below 50 an overall decrease.

The CBOE Volatility Index® (VIX Index) is a measure of market expectations of near-term volatility conveyed by S&P 500® index option prices. The VIX Index is widely considered to be the world's premier barometer of investor sentiment and market volatility.

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.”

Earnings yield is the inverse of the price-to-earnings ratio, measuring earnings per share as a percentage of a stock’s price.

The federal funds rate is the interest rate at which depository institutions lend reserve balances to other depository institutions overnight. The Federal Open Market Committee, which is the primary monetary policymaking body of the Federal Reserve, sets its desired target range.

Moody’s Investors Service provides ratings to securities in order to provide investors with a simple system of gradation by which future relative creditworthiness may be gauged. Moody’s Aaa-rated obligations are judged to be of the highest quality, subject to the lowest level of credit risk. Its Baa-rated obligations are judged to be medium-grade and subject to moderate credit risk and as such may possess certain speculative characteristics.

The long-term average return data in Figure 5 comes from Morningstar. The long-term annual return for each asset class is the compound average annual return from the period from 1926 through 2016. Stocks are represented by the Ibbotson® Large Company Stock Index. Bonds are represented by the five-year U.S. government bond. Cash is represented by the 30-day U.S. Treasury bill. Balanced Portfolio is representative of an investment of 50% Stocks and 50% bonds rebalanced annually from
1926 through 2016. These returns are for illustrative purposes and not indicative of actual portfolio performance. It is not possible to invest directly in an index.

Chart data comes from Thomson Reuters Datastream, a powerful platform that integrates top-down macroeconomic research and bottom-up fundamental analysis.

**Important Information**

Not FDIC Insured

No Bank Guarantee

May Lose Value

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 in securities. It is not possible to invest directly in an index.