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

December 31, 2018
**Key Takeaways**

- Most major asset classes were in the red in 2018, with the stock market falling sharply in the fourth quarter. This seems to have been driven largely by a change in investor sentiment, not in fundamentals. Market volatility could very well carry over into the new year, but signs point to further economic expansion and positive earnings growth in 2019, albeit at reduced rates.

- Valuations look attractive overseas, but headwinds remain, including slower economic growth and a stronger U.S. dollar. Patience will be required for global investors.

- Given the tight spread between long-term and short-term interest rates, we continue to prefer shorter-term bonds. We also favor high-quality bonds as we remain concerned about credit quality.

- Many investors experience a roller coaster of emotions during the ups and downs of the stock market, but successful investors keep their emotions in check and stay focused on the long-term.

Diversification had a tough year. Most major asset classes were in the red in 2018, while the bond market was virtually flat. (Figure 1) Just as 2017 is known as the year without volatility, 2018 will be remembered as the year when almost nothing worked. Thanks only to a late rally in Treasuries, 2018 narrowly escaped becoming just the 4th year since 1928 in which total returns for the S&P 500® and the 10-year Treasury note were both negative.

This poor performance came in spite of the fact that economic growth accelerated at rates many thought were no longer possible, corporate profits surged to record highs, consumer confidence jumped to levels not seen since before the dot-com bubble burst, and the unemployment rate fell to its lowest level in nearly half a century.

Yet, from its peak in late September through Christmas Eve, the S&P 500 fell 19.8%, based on closing prices. It was just a breath away from becoming a bear market, nearly ending the record-long bull market that began almost a decade ago.

**Figure 1**

2018 Asset Class % Returns, in US$

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Investment Grade Bonds</td>
<td></td>
</tr>
<tr>
<td>US 10 year Treasury</td>
<td></td>
</tr>
<tr>
<td>U.S. Large Cap Equities</td>
<td></td>
</tr>
<tr>
<td>U.S. Small Cap Equities</td>
<td></td>
</tr>
<tr>
<td>Developed Intl Equities</td>
<td></td>
</tr>
<tr>
<td>Commodities</td>
<td></td>
</tr>
<tr>
<td>Emerging Market Equities</td>
<td></td>
</tr>
<tr>
<td>Brent Crude Oil</td>
<td></td>
</tr>
</tbody>
</table>

Source: Thomson Reuters Datastream

Most major asset classes declined in 2018 despite strong economic growth.
So what caused stocks to fall in 2018, particularly in the fourth quarter?

It seems to have been mostly a change in investor sentiment, not in fundamentals. The precise cause of the shift from greed to fear is a bit of an enigma, but ongoing trade disputes, the government shutdown, and fears of a potentially inverted yield curve (which has often foreshadowed recessions) certainly didn’t help. Falling prices seem to have induced more selling, which led to falling prices and, thus, more selling.

This feedback loop of “panic selling” occurs from time to time in financial markets. It is best not to run with the herd in these situations but to focus instead on the fundamentals and keep a long-term perspective. Many investors experience a roller coaster of emotions during the ups and downs of the stock market, but successful investors keep their emotions in check, as brilliantly displayed in this chart by Andrew Neligan.

While 2018 felt like a roller coaster year for equities, it wasn’t that unusual from a historical perspective. Since 1980, the average intra-year decline for the S&P 500 has been 14%, just a few percentage points less than 2018’s 19.8% drawdown. (Figure 3) And since World War II, the stock market has experienced 37 corrections (>10% declines) – excluding the current one – 12 of which turned into bear markets (>20%). It has recovered 100% of the time. Market volatility is normal, but those who have ridden the ups and downs have been rewarded for their patience.
So What’s Next?

Market volatility could very well carry over into the new year as the same clouds hanging over the market in Q4 linger. Ongoing trade disputes, uncertainty over the effects of rising interest rates, and slower economic growth are still likely to remain on investors’ minds in 2019. While we believe recession risks remain low, we do see signs pointing to the U.S. being later in the economic cycle. A tight labor market (demonstrated by a multi-decade low unemployment rate and rising wages), tighter monetary policy (as the Fed raises short-term interest rates), and a flat yield curve (tight spread between long-term and short-term interest rates), all point to an economy near the later innings of its cycle.

The relatively rapid pace of expansion in 2018 is likely to slow, although we note that slowdowns without recessions are possible. Most leading economic indicators continue to point to growth. (Figure 4)
Corporate profits are also projected to grow at a solid, albeit reduced, clip in 2019. The most recent consensus estimates for the S&P 500 project 8% earnings per share growth, although estimates are often revised downward as the year progresses. Stock returns tend to follow earnings growth, but only over the long-run. Year to year it is collective investor sentiment that largely drives equity prices.

Last year was a prime example of this. While earnings for the S&P 500 grew at a blistering 20% rate, a sharp reduction in the price-to-earnings (P/E) ratio – or how much investors are willing to pay for one year of earnings – led to negative returns for the market (there are many factors influencing the P/E ratio, but it is a decent gauge of investor sentiment). While further contraction in the P/E ratio is possible, it currently sits slightly below its long-term average. (Figure 5)

**Figure 5**

**S&P 500 Index Forward Price-to-Earnings Ratio**

<table>
<thead>
<tr>
<th>Year</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>14x</td>
</tr>
<tr>
<td>1995</td>
<td>Average</td>
</tr>
<tr>
<td>2000</td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td></td>
</tr>
<tr>
<td>2010</td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td>14x</td>
</tr>
</tbody>
</table>

Source: Thomson Reuters Datastream  
As of 12/27/2018

We believe that valuations look particularly attractive overseas, especially in the emerging markets. This should bode well for international equity returns long-term. However, low valuations are not a very useful tool for timing when those returns will come. Patience will be required for global investors. We believe that recent headwinds for international stocks could continue, namely slower economic growth (Figure 6) and a stronger U.S. dollar.

**Figure 6**

**Global Manufacturing PMIs**

<table>
<thead>
<tr>
<th>Index</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States: ISM PMI</td>
<td>50</td>
<td>55</td>
<td>58</td>
</tr>
<tr>
<td>Euro Zone: Markit PMI</td>
<td>50</td>
<td>52</td>
<td>54</td>
</tr>
<tr>
<td>China: Caixin PMI</td>
<td>50</td>
<td>52</td>
<td>54</td>
</tr>
<tr>
<td>Japan: Nikkei PMI</td>
<td>50</td>
<td>52</td>
<td>54</td>
</tr>
</tbody>
</table>

Source: Thomson Reuters Datastream
Shifting to Neutral

Amid a tighter labor market, stronger economic growth, and inflation near its 2% target, the Federal Reserve has been “normalizing” monetary policy by steadily raising short-term interest rates off of emergency levels. Since late 2016, the Fed has increased its benchmark federal funds rate 8 times, or two full percentage points. These increases have shifted what the Fed has described as “accommodative” monetary policy to more of a “neutral” stance, in which monetary policy is neither accommodative nor restrictive.

What the financial markets – and even the central bank itself – have been trying to figure out is when it will stop raising rates. A major fear for investors is “overtightening”, meaning that the Fed raises interest rates too high, thereby slowing economic growth too much (some caution by investors is warranted; this has happened before).

Federal Reserve Chairman Jerome Powell has tried to provide clarity on where the Fed is likely to pause rates. Current projections by Fed members and comments by Chairman Powell suggest around two rates hikes in 2019, which would put the fed funds rate near 3% by year end. (Figure 7) Based on current data and Fed forecasts, rates aren’t expected to move much higher from there.

Figure 7

Federal Open Market Committee Projections

Nonetheless, if the Fed does raise rates twice next year, and long-term rates stay put, then the yield curve would become inverted, a scenario that has often portended economic recessions. (Figure 8) This is something that we’re watching closely. Given the tight spread between long-term and short-term interest rates, we continue to prefer shorter-term bonds.

We also favor high-quality bonds as we remain concerned about credit quality. Nearly a decade of ultra-low interest rates helped drive a sharp expansion in corporate credit, leveraged loans, and shadow banking. As interest rates have risen, we have become concerned about the impact of higher interest expenses on less creditworthy borrowers. While we may be giving up a bit of yield now by favoring high-quality securities, it helps us sleep better at night.
The Bottom Line

Last year was a tough one for investors. The new year could bring continued volatility as many of the same concerns loom over the market. Trade disputes, uncertainty over monetary policy, and fears of a slowdown remain. Yet, while the pace of growth is likely to diminish, signs continue to point to further economic expansion and positive earnings growth.

Nonetheless, stock market performance will depend largely on investor sentiment. Estimating the magnitude of a shift in this sentiment is likely a futile exercise. As Sir Isaac Newton once said, “I can calculate the motion of the heavenly bodies but not the madness of people.” The best course for investors will be to keep emotions in check and remain focused on the long term. (Figure 9)

**Figure 8**

10Y - 2Y US Gov’t. Bond Spread

< 0 = Inverted Yield Curve

Source: Thomson Reuters Datastream

*It is important for investors to keep emotions in check and remain focused on the long term.*

**Figure 9**

<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>1-3%</td>
<td>3.4%</td>
</tr>
<tr>
<td>Balanced Portfolio</td>
<td>4-6%</td>
<td>7.8%</td>
</tr>
</tbody>
</table>

(50% Stocks / 50% Bonds)

* Expected average annual returns

*Source: Morningstar and COUNTRY Trust Bank*
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 is 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 yield curve plots the interest rates of similar-quality bonds against their maturities. The most common yield curve plots the yields of U.S. Treasury securities for various maturities. An inverted yield curve occurs when short-term rates are higher than long-term rates.

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 Conference Board Leading Economic Index® is a composite economic index designed to signal peaks and troughs in the business cycle. It is constructed to summarize and reveal common turning point patterns in economic data in a clearer and more convincing manner than any individual component—primarily because they smooth out some of the volatility of individual components.

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 generally 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 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.

The long-term average return data in Figure 9 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**

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.