COUNTRY Trust Bank®

Market & Economic Outlook

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

December 31, 2017
Key Takeaways

- The stock market delivered strong returns with record low volatility in 2017, driven by improving fundamentals. Equities also rallied overseas amid positive global economic growth. We believe that the investing landscape remains positive for equities and continue to slightly favor stocks over bonds.

- While the environment could remain favorable for equities, we recommend that investors stay disciplined in this era of unprecedentedly low volatility. A lack of recent volatility does not equate to a lack of risk.

- We continue to expect longer-term returns from both asset classes to be below their historical averages. While future returns may not be as robust as in the past, we continue to believe that successful investing is about ‘time in’ the market rather than ‘timing’ the market.

When stock market historians look back at 2017, it will be remembered as the year without volatility. It was the first year in history that the S&P 500® index delivered positive total returns every month. Peak-to-trough, the index never lost more than 3%, equaling its smallest pullback since 1995. And the CBOE Volatility Index® reached its lowest level in its 27-year history.

But don’t confuse a lack of volatility with a lack of risk. Historically, investing in the stock market has not produced steady gains month after month. Last year was the exception, not a new rule. We recommend that investors stay disciplined in this era of unprecedentedly low volatility.

Nonetheless, the strong stock market returns have been underpinned by improving fundamentals. We believe that the investing landscape remains positive for equities and continue to slightly favor stocks over bonds in this environment.

Improving Fundamentals

The global economy experienced synchronized growth in 2017 for the first time in years, and economic momentum remains positive around much of the world. The U.S. labor market continued to improve throughout the year, adding an average of 174,000 jobs per month through November. Both the official U-3 unemployment rate and the broader U-6 rate are near their lowest levels in over a decade, although wage growth remains somewhat sluggish. The housing market continues to recover nationally as both prices and homeownership rates rise. The combination of rising asset prices and a strong labor market also has consumers feeling their most optimistic in years. (Figure 1)

Corporate profits rallied, along with stock prices, and earnings projections for 2018 call for continued strong growth. The new tax law could certainly help boost the bottom line for many companies. That would be good news for business owners (i.e. stock owners). The tax overhaul is expected to boost overall economic growth too, but we worry that it could also boost deficits – a bill that will come due at a later date.
The S&P 500 delivered total returns of more than 21%, marking its strongest gain since 2013. While equity prices marched higher for many stocks in 2017, large cap stocks generally outperformed their smaller counterparts, and growth stocks generally outperformed value stocks. (Figures 2 and 3) It was an ideal environment for the large, tech-oriented “FAANG” stocks (Facebook, Amazon, Apple, Netflix, Google), which delivered outsized returns to investors. While the market winds are currently blowing at their backs, we recommend that investors stay well diversified, as the winds can change quickly.

We remain somewhat cautious given all of the optimism in the U.S. markets. While rising corporate profits have helped justify the stock market rally, valuations have risen to levels that point to somewhat lackluster future returns. The S&P 500 currently trades around 19x expected 2018 earnings, which is well above its long-term average. However, valuation metrics are typically poor market-timing tools, and near-term results will be driven largely by investor sentiment, which remains firmly in bullish territory. Nonetheless, we expect to see
more volatility in 2018 as investor expectations have risen along with stock prices and we enter the later stages of the economic cycle. Given the record low market volatility last year, this seems like a safe bet.

Meanwhile, 2017 wasn’t just a great year for U.S. markets. International equities also delivered strong returns after several years of disappointment. (Figure 4) Similar to the U.S., many developed and emerging economies experienced solid growth in 2017. Unlike the U.S., many international stock markets haven’t enjoyed nearly nine straight years of a bull market, leaving valuations comparatively attractive overseas. We continue to believe that international equities offer attractive total return potential over the next several years.

**Figure 4**

**2017 Equity Market Returns**

<table>
<thead>
<tr>
<th>Total Return %</th>
<th>MSCI Emerging Markets</th>
<th>S&amp;P 500</th>
<th>MSCI EAFE</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>34.2</td>
<td>21.8</td>
<td>21.8</td>
</tr>
</tbody>
</table>

Source: Thomson Reuters Datastream  
*Latest data point as of 1/1/2018*

**Cryptocurrencies: Use Caution**

Of course, the recent stock market returns pale in comparison to the meteoric rise in many cryptocurrencies, which are primarily decentralized digital currencies that use cryptography to secure transactions. The most famous cryptocurrency, Bitcoin, captured a lot of headlines in 2017 as it soared to stratospheric levels.

It seems to us that most investors have become attracted to cryptocurrencies simply because they have risen so much in value, not because they are true believers in the technology. It is likely that many new buyers have been heavily influenced by that pernicious human emotion that comes from seeing others around them make easy money.

We are intrigued by the potential applications of blockchain technology, which is essentially a decentralized digital public ledger. However, we remain skeptical that Bitcoin or any other cryptocurrencies, which are different from blockchain itself, will replace fiat currencies for everyday transactions anytime soon. A lot of people probably know someone who owns Bitcoin or similar cryptocurrencies, but how many people know someone who actually uses them to make more than just novelty (or illicit) transactions?

Many cryptocurrencies have experienced – and will likely continue to experience – violent price swings that are not for the faint of heart. Will the next crash present a buying opportunity or a permanent impairment? We don’t know. Stocks, bonds and real estate all have underlying cash flows that can be used to value the assets with varying degrees of confidence. Cryptocurrencies do not. As students of financial history, we enjoy watching it all
play out. But we caution anyone who wants to participate in it to only bet money that they can afford to lose.

**Spreads Tightening, Rates Normalizing, Curve Flattening**

Optimism wasn't just isolated to the equity and cryptocurrency markets in 2017. Many fixed income investors flocked to the riskier end of the credit spectrum amid an improving global economy. This has led to somewhat tighter credit spreads than normal. (Figure 5) We believe that investors are not being adequately compensated for the amount of risk in some areas of the fixed income market. As a result, we continue to favor higher quality fixed income investments in this environment.

**Figure 5**

*Moody's Corporate Bond Spread Baa - Aaa*

![Moody's Corporate Bond Spread Baa - Aaa](image)

Source: Thomson Reuters Datastream

Meanwhile, the improving U.S. economy was enough to convince the Federal Reserve to raise its short-term federal funds rate three times in 2017 in spite of continued low inflation. While short-term rates rose, long-term rates did not, leading to a flattening of the yield curve. (Figure 6) The current difference in yield between 10-year and 2-year U.S. Treasury notes is just over 50 basis points, marking its tightest spread in over a decade. Just as we believe that the credit risk premium is currently too small, we believe the term premium is too small to compensate investors for the risk of investing in longer-dated securities. We continue to prefer a somewhat shorter duration target within fixed income holdings.

**Figure 6**

*U.S. Treasury Yield Curve*

![U.S. Treasury Yield Curve](image)

Source: Thomson Reuters Datastream

A flattening yield curve could become a key concern in 2018.
The central bank is expected to continue “normalizing” short-term rates in 2018, assuming the economy continues to improve. We do not anticipate a shift in monetary policy from incoming Federal Reserve Chairman Jerome Powell, who has been a member of the Federal Reserve Board of Governors since 2012 and consistently voted in-line with the majority of the rate-setting Federal Open Market Committee.

We believe that certain cyclical forces, including a tightening labor market, could push inflation higher than many are expecting, which could force the Fed to continue raising rates. While long-term rates may also move higher, we expect them to remain low by historical standards for quite some time. There appears to be an insatiable appetite for yield among foreign buyers and an aging population here at home, which could keep a lid on long-term rates, despite a potential push on yields from the gradual unwinding of the Fed’s balance sheet.

If short-term rates do continue to rise but long-term rates do not rise in tandem, then the flattening yield curve could become a key concern for investors in 2018. We also note that further tightening by the Fed could lead to a stronger dollar, which could be a headwind for corporate profits. Overall, though, we are glad to see the central bank continuing to lift interest rates off of extremely accommodative levels as the economy continues to improve.

The Bottom Line

The stock market delivered remarkably strong and steady returns in 2017. Investors had good reasons to be optimistic, as economic growth accelerated around the globe and corporate profits swelled. These factors don’t appear to be slowing as we start a new year, creating a favorable investing landscape for equities in 2018. However, with rising stock prices comes rising investor expectations, and we do not expect a repeat of the exceptionally low volatility we experienced in 2017. We remain overweight stocks versus bonds but only slightly.

Over the next five to ten years, we continue to expect returns from both asset classes to be below their historical averages. (Figure 7) Narrow spreads and the low interest rate environment point to lower-than-historical returns for fixed income investors. And as the bull market continues to mature, corporate earnings growth is likely to slow, which, combined with above-average valuations, makes it unlikely for stocks to deliver exceptional returns from these levels.

While future returns may not be as robust as in the past, we continue to believe that successful investing is about time in the market rather than timing the market. People who have been standing on the sidelines awaiting the next correction to get in the game have been disappointed throughout the bull market. We believe that will continue to be the case going forward regardless of when the next pullback actually occurs, as correctly timing the market will remain a futile exercise for nearly all investors, professional and amateur. As investing legend Peter Lynch once said, “more money has been lost trying to anticipate and protect from corrections than actually in them.”
### Figure 7

<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>
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</tbody>
</table>

* Expected average annual returns

Source: Morningstar and COUNTRY Trust Bank

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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 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 U-3 unemployment rate is the nation’s official unemployment rate, as measured by the Bureau of Labor Statistics. It defines people as unemployed if they do not have a job, have actively looked for work in the last four weeks, and are currently available to work. The U-3 rate is calculated by dividing the number of unemployed by the labor force (the sum of the employed and unemployed).

The U-6 unemployment rate is a measure of labor underutilization. It factors in all unemployed persons, plus all persons marginally attached to the labor force (those who want to work, are available for work, have looked for work in the last 12 months, but who are not currently looking for work for various reasons), plus persons working part time for economic reasons (involuntary part time), as a percent of the labor force plus all persons marginally attached to the labor force.

The S&P SmallCap 600® Index measures the small-cap segment of the U.S. equity market and consists of 600 stocks. The index is weighted according to market capitalization.

The Russell 1000® Growth Index is a subset of the Russell 1000® index that includes companies whose share prices have higher price-to-book ratios and higher expected earnings growth rates. The Russell 1000® Value Index is a subset of the Russell 1000® index that includes companies whose share prices have lower price-to-book ratios and lower expected long-term mean earnings growth rates. The Russell 1000® Index measures the performance of the 1,000 largest companies in the Russell 3000® Index.

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 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 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.

Credit spreads measure the difference in yields between bonds with the same maturity but different credit quality.

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 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 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.

The long-term average return data in Figure 7 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 |

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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.

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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.