

A review of recent economic and financial market developments, and what our team expects going forward.

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Key Takeaways:

- The overall economy remains on solid footing, and we are still on the right track for the Fed to have the opportunity to bring interest rates down while not sending the U.S. into a recession.
- We remain neutral within U.S. stocks between market capitalizations, acknowledging stretching valuations in large-cap, but also their relative stability to their small and mid-cap peers.
- Bonds performed well in multi-asset portfolios, cushioning losses when stocks sold off in July and early August.

Benjamin Graham, often referred to as the “father of value investing,” was a highly influential financial analyst, investor, and professor. He once summarized, “The intelligent investor is a realist who sells to optimists and buys from pessimists.” This mindset is prevalent and influential among our investment team.

At our most recent quarterly meeting, our team engaged in a spirited discussion about the global economy and the current state of financial markets. These quarterly gatherings sometimes lead to significant changes in our portfolio strategy, while at other times, we choose to maintain the status quo and wait for a better opportunity.

Today, we are seeing more signs that the Federal Reserve’s interest rate increases are having their intended effect of slowing down the economy. However, stock valuations have not yet reflected the level of pessimism that would make us excited about taking on more risk within a client’s stated investment objective. Conversely, bond yields remain an attractive opportunity, even though interest rates have fallen over the last few months. For these reasons, we prefer to wait for a more attractive entry point into stocks before shifting back to a neutral or overweight position in equities in multi-asset portfolios.

As long-term investors, it is often more important to be patient and wait for the right opportunity. Today, fixed income investments provide us with the luxury of earning a favorable rate of return with less volatility than stocks. However, we expect that the next few months could present a chance to shift our viewpoint, and we stand ready to act if the market tone turns overly pessimistic.

A Labor Market Trending Towards Normal

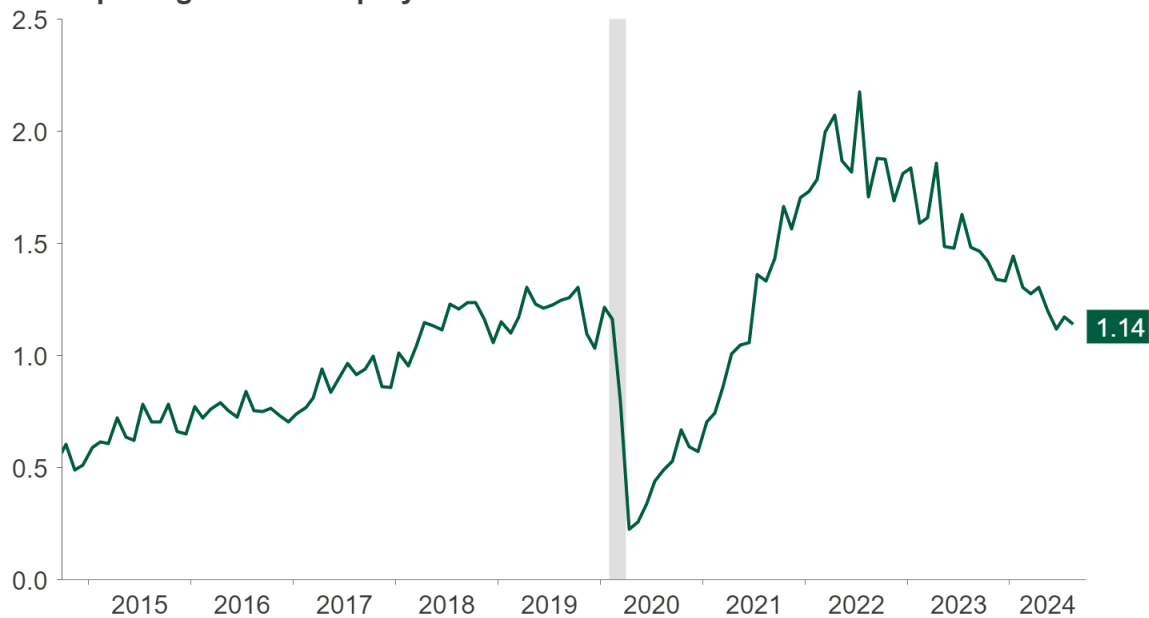
And so, it begins. The Fed launched their first rate cut at their September meeting opting to cut rates by 0.50% before they slow to a projected 0.25% cadence at the final two meetings of the year. But what brought us to this point of needing to resort to a larger up-front cut?



The once tight labor market has loosened considerably. Each year, the Bureau of Labor Statistics adjusts payrolls figures. This time around, total non-farm employment figures were revised down by 818,000, a 0.5% decline, which was the largest revision since 2009. Along with the downward revision, payrolls for July and August both missed the mark. Job openings have also come down reaching 7.67 million by the end of July and heading towards parity with the number of unemployed individuals (Figure 1).

Figure 1

Job Openings Per Unemployed Individual



Source: LSEG Datastream

As of September 30, 2024

It is the Fed’s stance that any further declines in job openings will directly result in increases in the unemployment rate and suggests that the labor market is now closer to a proper balance between labor supplied and labor demanded. The unemployment rate increased during the quarter to 4.2% while jobless claims came down to a 4-week average of 224,750 claims.

Positive Data Leads to Strong Returns

The overall economy remains on solid footing, and we are still on the right track for the Fed to have the opportunity to bring interest rates down while not sending the U.S. into a recession. Personal Consumption Expenditures (PCE) is just a stone’s throw away from where the Fed would like to see it, declining from 2.6% at the end of the second quarter to 2.2% today. Gross Domestic Product (GDP) for the second quarter grew at a seasonally adjusted annual rate of 3.0% with consumers increasing their spending on goods and services by 3.0% and 2.7%, respectively. With consumers continuing to spend and retail sales coming in well ahead of expectations the first two months of the third quarter, the



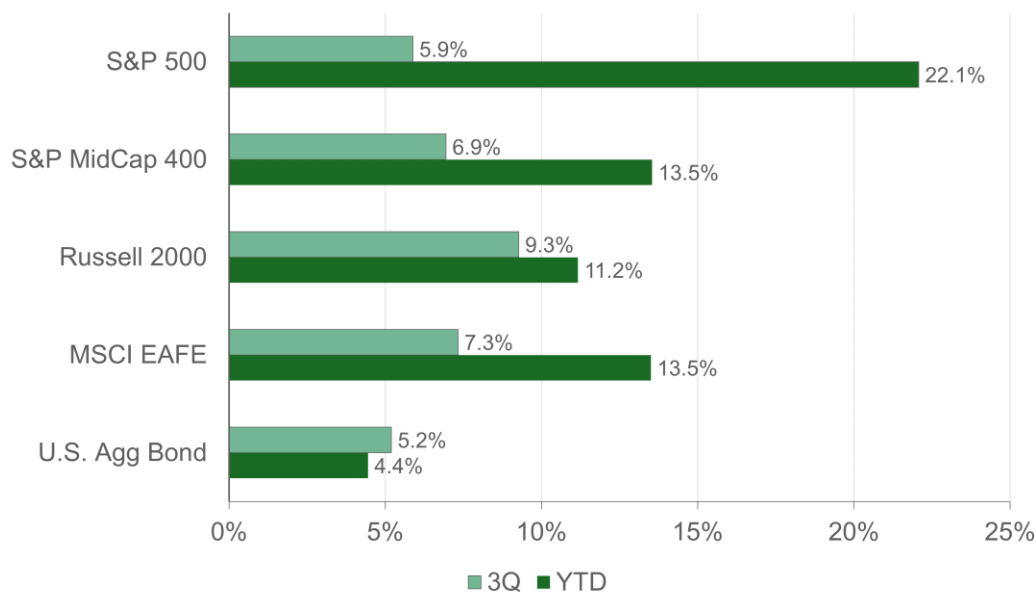
Federal Reserve Bank of Atlanta’s GDPNow model is forecasting an increase in third-quarter GDP growth of 3.1% as of the end of the quarter.

There are areas to watch as well. Consumer confidence surprisingly dropped with consumers becoming more concerned about future job and income prospects. The Conference Board’s Leading Economic Index has also been trending downward with six consecutive monthly downward moves led by the manufacturing orders contracting 5 of the last 6 months and a still inverted yield curve (shorter term rates are higher than longer-term rates).

The positives have far outweighed the negatives, though, and this is reflected in stock market performance. U.S. stocks marched higher in the quarter pushing the year’s return for the S&P 500 above 22%. Small cap stocks were the big winner in the quarter rising over 9% while international stocks picked up their pace jumping ahead of U.S. stocks. The decline in interest rates during the quarter has helped drive bonds up by a strong 5.2% (Figure 2). We hold a slight overweight to bonds as we acknowledge the risks that are present within the stock market.

Figure 2

Third Quarter and Year-to-Date Total Returns



Source: Factset financial data and analytics

As of September 30, 2024

Central Bank Implications for Stocks

While the S&P 500 demonstrated steady returns during the 3rd quarter, finishing +5.9%, the last 3 months saw its share of market gyrations as investors digested the flurry of incoming economic data and changing forecasts of Federal Reserve policy shifts. We also saw a prime example that foreign central bank policy can lead to implications for the global stock markets.



In late July, the Bank of Japan increased their short-term rates to combat inflation they are seeing in their country. These higher rates in Japan helped contribute to a sharp strengthening of their currency, the Japanese Yen (JPY). Meanwhile, as expectations began to price in the eventual cutting of the Federal Funds rate by the Federal Reserve, the U.S. dollar weakened during this period as well (Figure 3). These factors put pressure on a popular, but complex, trade where investors have borrowed currency in a low-interest rate country, such as Japan, to reinvest in higher interest rate markets, like the U.S. and others, known as a carry-trade.

Figure 3

US Dollar Index vs Japanese Yen



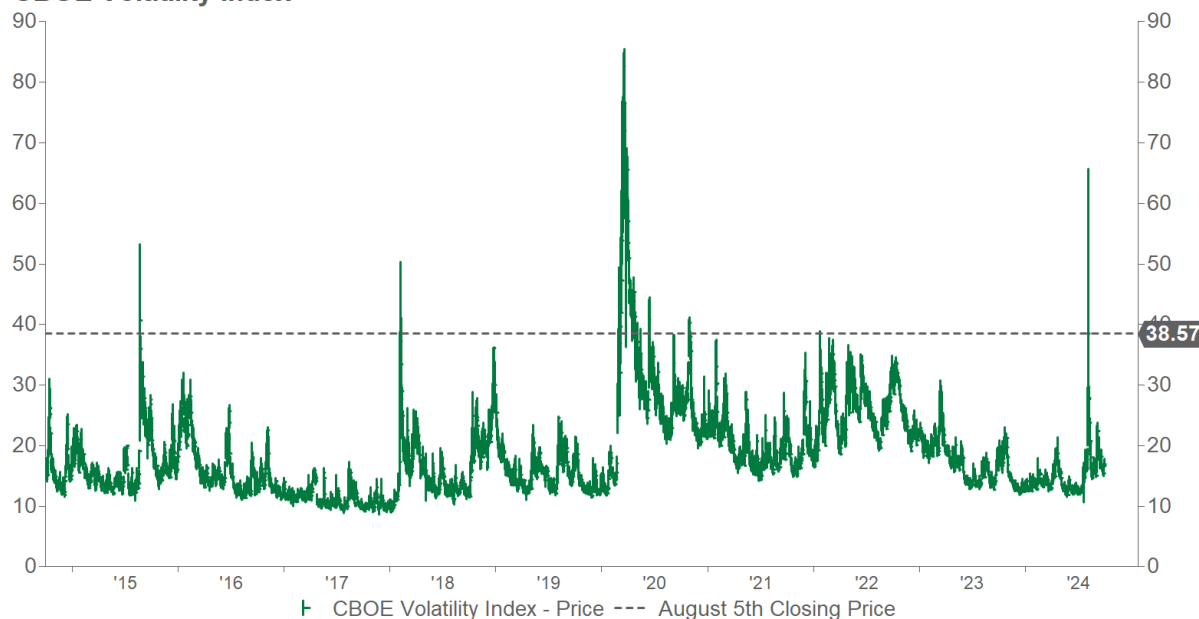
Source: LSEG Datastream

As of September 30, 2024

This pressure reached a tipping point on August 5th, when the Japanese stock market, as measured by the Nikkei 225 index, finished down over 12% for the day as these investors unwound risk positions to deleverage their portfolio. This contributed to a global stock market sell-off which included the S&P 500 finishing down 3% that day. The CBOE Volatility Index (VIX) known as the “fear gauge” hit its highest level since the onset of the COVID-19 pandemic, before moderating at the close while still finishing at some of the highest levels seen over the last 10 years (Figure 4).

Figure 4

CBOE Volatility Index



Source: FactSet financial data and analytics

As of 9/30/2024

Mindful of Risks and Positioning

While markets calmed quickly from the early August turmoil, it demonstrates that markets can be impacted for many reasons such as global policy shifts, geopolitical events, economic data, company specific reasons, or countless other factors. While it is unsettling to see daily swings of this size, we encourage clients to take a long-term view on stocks, but to also ensure that portfolio exposure to stocks and other asset classes is appropriate for their willingness and ability to take risk.

Currently, we remain neutral within U.S. stocks between market capitalizations, acknowledging stretching valuations in large-cap, but also their relative stability to their small and mid-cap peers, particularly during periods of volatility. We also remain neutral on international stocks overall, while maintaining a preference for developed market stocks versus emerging market stocks.

Monetary Marshmallows

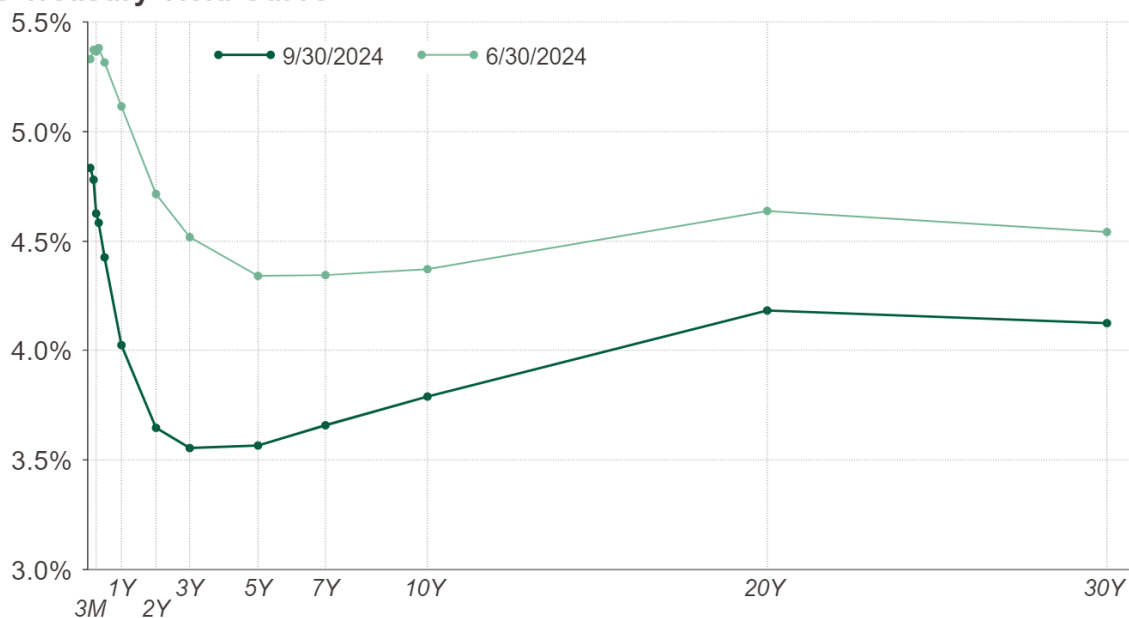
The Federal Reserve has shifted to an accommodative stance, cutting the federal funds rate by 0.50% in September, with projections for 2-3 more cuts by early 2025. Historically, such environments have steepened the yield curve. This quarter, the 2-year Treasury rate fell below the 10-year rate for the first time since October 2022.



The Fed, having raised rates aggressively to combat inflation, is likely to cut gradually as there does not appear to be an economic crisis on the horizon. The Fed primarily influences short-term interest rates through its monetary policy actions, but long-term interest rates are determined by investor expectations. In anticipation of rate cuts and cooling economic data, the 10-year Treasury yield fell 0.61% to 3.78% at quarter end. This is well below its year-to-date high of 4.70% reached in April. The 2-year Treasury rate fell even more in anticipation of the Fed’s actions (Figure 5).

Figure 5

US Treasury Yield Curve



Source: LSEG Datastream

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However, we feel upside risks to longer term interest rates exist due to ballooning deficits and potential inflationary fiscal policies. We believe these conflicting forces suggest long-term interest rates will remain range-bound in the near term. An area of risk we are watching is the level of credit spreads, or the difference in the yield of two bonds with the same maturity. If recession fears arise, spreads may widen, indicating increased perceived risk of default and leading to higher bond yields and lower prices.

Role Playing

It was refreshing to see bonds perform their intended role in multi-asset portfolios, cushioning losses when stocks sold off during July and early August. The S&P 500 Index fell by -7.86% from July 16th through August 5th. Over that period, the Bloomberg Aggregate Bond Index returned +2.60%. In addition to bond income providing support for total returns, bond duration, which measures the sensitivity of a bond’s price to changes in interest rates benefits bond investors when interest rates decline. Longer durations mean greater sensitivity to interest rate changes. For example, a bond with a modified duration of 5 years would see its price increase by approximately 5% with a 1% decrease in interest



rates across the yield curve. This provides diversification cash cannot, as those types of investments do not change in price.

High-quality fixed income yields remain attractive compared to recent history, with the Bloomberg Aggregate Bond Index yielding near 4.25% at quarter end, allowing high quality bonds to play both defensive and offensive roles in your portfolio. While sitting in cash for fixed income exposure seems reasonable, money market funds tend to adjust their rates in line with the federal funds rate. This means that when the Fed cuts rates, the yields on these funds typically decrease. Investors should consider locking in yields today, matching the bond fund’s duration to their holding period. Short-term bond funds are suitable for holding periods of less than three years, while intermediate-term bond funds are better for holding periods of three to ten years.

The Bottom Line

Our investment strategy remains cautious yet opportunistic. We continue to favor fixed income over equities, awaiting a more favorable entry point into the stock market. As always, we are prepared to adjust our approach should market conditions shift significantly. In the world of investing, risks are an ever-present reality that investors must navigate with caution and preparedness. An updated financial plan along with a trusted financial advisor can keep investors from drifting off course.

Figure 6

Asset Class	Next 5 to 10 years*	Long-term Average
Stocks	5%-9%	10.3%
Bonds	4%-6%	4.9%
Cash Equivalents	1%-4%	3.3%
Balanced Portfolio (50% Stocks/ 50% Bonds)	4%-7%	8.1%

*Forecasted average annual returns of COUNTRY Trust Bank Wealth Management

Source: Morningstar and COUNTRY Trust Bank® - See Definitions and Important Information below



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



Definitions and Important Information

Figures 1,3,5: Chart data comes from LSEG DataStream, a powerful platform that integrates top-down macroeconomic research and bottom-up fundamental analysis.

Figures 2,4: Data sourced from FactSet Research Systems Inc, a global provider of integrated financial information, analytical applications and services for the investment and corporate communities.

Figure 6: The long-term average return data comes from Morningstar and is based upon compound average annual returns for the period from 1926 through December 31, 2023. Stocks are represented by the Ibbotson® Large Company Stock Index, which is comprised of the S&P 500® Composite Index from 1957 to present, and the S&P 90® Index from 1926 to 1956. Bonds are represented by the Ibbotson® U.S. Intermediate-Term Government Bond Index. Cash Equivalents are represented by the 30-day U.S. Treasury bill. The "Balanced Portfolio" is representative of an investment of 50% stocks and 50% bonds rebalanced annually. Forecasted stock returns include small capitalization and international equities. Forecasted bond returns include investment grade corporate bonds. These returns are for illustrative purposes and not indicative of actual portfolio performance. It is not possible to invest directly in an index.

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.

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.

Yield to maturity represents the total rate of return an investor can expect from a bond if they hold it until maturity and reinvest all interest payments at the same rate. It's expressed as an annual percentage.

The S&P 500® Index is an unmanaged index consisting of 500 large-cap U.S. stocks. The index does not reflect investment management fees, brokerage commission and other expenses associated with investing in equity securities.

The S&P Midcap 400 is a stock market index published by Standard & Poor's (S&P). It measures the performance of 400 mid-sized companies in the United States, providing a benchmark for this segment of the market. These companies typically have market capitalizations ranging from about \$2 billion to \$10 billion.

The MSCI EAFE Index measures 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 Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

The Bloomberg Aggregate Bond Index, often referred to as "the Agg," is a broad-based benchmark that measures the performance of the U.S. investment-grade bond market. It includes a wide range of fixed-income securities.

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

Non-farm payrolls are collected by the U.S. Bureau of Labor Statistics (BLS) monthly through the establishment survey which provides information on employment, hours, and earnings of employees on non-farm payrolls.

The CBOE Volatility Index (VIX), often referred to as the "fear index," is a real-time market index that represents the market's expectations for volatility over the coming 30 days.

GDP or Gross Domestic Product is the monetary value of all goods and services produced during a specified period. The figure is used as a barometer of an economy's health including its size and growth rate. In the U.S., quarterly GDP figures are typically "annualized" meaning the quarterly growth is compounded for four quarters.

The GDPNow model is a forecasting tool developed by the Federal Reserve Bank of Atlanta. It provides a "nowcast" of the official estimate of the U.S. Gross Domestic Product (GDP) growth rate before its release. This model uses a methodology like that of the U.S. Bureau of Economic Analysis (BEA) to estimate real GDP growth based on the latest available economic data.

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 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.

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

The Personal Consumption Expenditures (PCE) economic indicator measures consumer spending on goods and services in the United States. It is compiled and reported by the Bureau of Economic Analysis (BEA) and includes expenditures on both durable and non-durable goods as well as services.

The Conference Board Leading Economic Index (LEI) is a composite index published monthly by The Conference Board. It is designed to predict the direction of the U.S. economy over the near term, typically the next few quarters. The LEI is composed of ten economic components that tend to precede changes in the overall economy.

The federal funds rate is the interest rate at which depository institutions (like banks and credit unions) lend reserve balances to other depository institutions overnight on an uncollateralized basis. This rate is a key tool of U.S. monetary policy, set by the Federal Open Market Committee (FOMC) of the Federal Reserve. Changes in the federal funds rate can influence various economic factors, including inflation, employment, and the rates on consumer loans and mortgages.