American National Bank & Trust™
TRUST AND INVESTMENT SERVICES

Market Rally: Can it continue? Looking to International Equities
May 30th, 2017

A couple of weeks ago the S&P 500 Index stumbled to its biggest decline in more than 8 months only to promptly reverse course and rally back to all-time highs. The decline was attributed in part to a fear that major tax reform could be delayed by challenges the Trump administration is facing. We continue to ask, can the rally continue?

As we have indicated in other market comments (*"Washington D.C. and Tax Reform Continue to Drive Stock Prices" March 3rd, 2017*), the high probability of Trump's pro-growth business agenda is largely priced into stocks. If the tax reform becomes law we anticipate approximately $8 per share added earnings for the upcoming fiscal year. This additional earnings potential, along with an already very good first quarter earnings quarter, has continued to move stocks to all-time highs.

With the exception of Energy, most major US corporations reported solid first quarter earnings, and many businesses continue to revise their earnings higher. Collectively the companies within the S&P 500 Index increased their earnings-per-share (EPS) by 13% in the 1st quarter. This is strong and speaks to the overall health of the US economy. However, the bond market remains stubbornly unconvinced. We continue to see yields muted with little to no movement. Another interesting observation, the spread between the 2-year and 10-year treasury dipped to the lowest levels since the presidential election. Historically this tells us to not expect much growth from the economy in the near future.

We continue to favor international equities, despite some challenges in certain economies. And we think relative valuations of international companies seem more attractive than their US counterparts. The MSCI Emerging Market Index is trading around 12.5 times earnings and the MSCI Europe, Australasia and Far East (EAFA) Index is trading around 15 times earnings, considerably better than the S&P 500 index which is around 18 times forward earnings.

A longstanding lackluster euro-area economy has suddenly started to show signs of life. Its first quarter Gross Domestic Product (GDP) gained 0.5% or 2.0% annualized. This is considerably higher than the 0.7% annualized growth rate of the US. Additionally, certain emerging economies seem to be improving despite President Trump's tough talk on foreign trade. Global economies are benefitting from stabilizing commodity prices and a return of consumer spending, with some exceptions to China and Brazil. These economies face certain headwinds unique to their situations.

China once funded its massive GDP growth with large amounts of debt and unrealistic governmental spending projects, but now they seem to be getting serious about fiscal reform. Regulators have limited liquidity and changed certain lending rules. Although there is a strong likelihood China's GDP could continue to fall, these steps should serve as a positive in the long-run.

Brazil's political corruption scandal has resulted in nearly half of all elected political officials being indicted. The scandal involving its state-owned oil company, Petrobras, and several other industries has created one of the largest political fall-outs in history. We find with the greatest amount of uncertainty comes the greatest amount of opportunity, and so far Brazil has been able to avoid a restricted money supply and credit remains natural, allowing the scandal to not sink its economy. This could become an attractive investment opportunity.

Successful international investing is realized by assessing the risk associated with certain economies, navigating and diversifying accordingly. Given the past several years of strength in the US markets and relative underperformance in the international markets, we feel shifting a portion of equity assets is now warranted.
