Market Update and Outlook for Second Quarter 2019

Company Profile

Farmers Trust Company is licensed by the Ohio Division of Financial Institutions as a bank, authorized to conduct trust business and exercise full fiduciary powers. Our efforts are focused on the administration and management of trust assets. As an independent trust company, Farmers Trust Company offers several investment management options.

We are committed to providing the highest level of service in the areas of investment management, estate settlement, living trusts, testamentary trusts, charitable trusts, charitable endowments and employee benefit plans. Tax and estate planning services are available to our clients as well.

Farmers Trust Company has the unique ability to integrate investment, trust and estate management at a local level. Our clients appreciate the fact that their financial affairs are handled personally and confidentially. They also value our ability to work closely with their attorneys, accountants and insurance professionals to achieve a comprehensive financial strategy.

Market Recap and Outlook First Quarter 2019

MARKET SCORECARD to 3/31/2019	TOTAL RETURN IN USD	
	Q1	2019 TR
DOW JONES IND AVG	11.81%	11.81%
S&P 500	13.65%	13.65%
NASDAQ	16.81%	16.81%
MSCI EAFE EQUITY (GROSS)	10.13%	10.13%
RUSSELL 2000 INDEX	14.58%	14.58%
MSCI EMERGING MARKET EQUITY (GROSS)	9.95%	9.95%
BARCLAYS INTERM. TREASURY	1.59%	1.59%
BARCLAYS INTERM. GOVT/CREDIT	2.32%	2.32%
BARCLAYS 5 YEAR MUNI INDEX	2.11%	2.11%
BARCLAYS HIGH YIELD CORP INDEX	7.26%	7.26%
ishares S&P GSCI COMMODITY TR INDEX	14.97%	14.97%

Note: All returns include invested cash flows expressed in U.S. dollar terms

Market Recap

The last six months have been a tale of two quarters. The 4th quarter of 2018 was marked by heightened volatility in the financial markets, a dire outlook for corporate earnings, and a hawkish Federal Reserve (the Fed). The 1st quarter of 2019 brought a more dovish Fed, better than expected corporate profits (not as bad as feared), and a relative calm in the financial markets. During the last several months, we have witnessed the S&P 500 rise from its low of 2351.10 on December 24th to the current level of 2834.40; a gain of more than 20 percent. During the same time period we watched the yield on a 10-year U.S. Treasury bond fall from around 2.8% to its current 2.4%. The rebound in the 1st quarter of 2019 has been most pronounced in assets that were most hurt during the 4th quarter of last year, most notably small cap stocks and high yield bonds. The Russell 2000 (which measures small cap stock performance) rose 14.58% in the 1st quarter, and high yield bonds (as measured by the Barclays High Yield Bond Index) rose 7.26%. "Growth" stocks have continued to outpace "Value" stocks, with the Russell 1000 Growth Index up 16.10% year-to-date versus the Russell 1000 Value Index up 11.93%. Foreign equities rose by a lesser amount, up 10.13% as measured by the MSCI EAFE Index. The MSCI Emerging Markets Index rose 9.95% for the quarter. Commodities also had a very nice start to the year, up 14.97% as measured by the S&P GSCI Commodity Index. Bonds turned in a respectable performance as well, with the Barclays Aggregate Bond Index returning 2.94% in the first three months of 2019.

Key Points

- The Fed's U-turn on monetary policy has helped fuel a rebound in risk assets
- Global economic growth continues to slow; arguing for some defensive positioning within equity portfolios
- Going forward, growing inflationary pressures are likely to make the Fed's job (and equity market performance) more challenging
- Weaker growth and the expectation of more inflationary pressure has made small cap stocks less attractive on a relative basis
- Further downside in long-term interest rates may be limited at this juncture

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Investment Outlook

The 180-degree turnaround by the Federal Reserve regarding interest rate policy has led to a significant improvement in sentiment toward risk assets, especially U.S. equities. Nevertheless, global economic data continues to weaken on a relative basis. In addition, corporate profit expectations have been softening over the last several months. One of our main concerns is that inflation re-accelerates while economic growth continues to soften (termed “stagflation”). Stagflation adds uncertainty to the financial markets, as the Fed simultaneously is tempted to raise rates to combat inflation, but also wants lower rates to spur economic growth. Before we see this worrisome pattern firm up, we continue to overweight defensive sectors like Utilities and Real Estate while underweighting the Financial sector. Small capitalization stocks are likely more vulnerable in an environment characterized by stagflation, and we have therefore reduced our exposure to this asset class. While we still prefer U.S. equities over foreign equities generally, we continue to look more favorably toward Emerging Markets based on the potential for stronger economic trends and attractive valuations compared with Developed Market equities. Regarding our fixed income positioning, we have benefitted from our long-duration Treasury exposure over the past 6 months, but we may have to consider how much value is left to be realized with long-term Treasury rates back at the lower end of their 2-year range.

Global Macroeconomic Review and Outlook

Economic data in the U.S. continues to soften. The rate of growth in Gross Domestic Product (GDP) has slowed in each of the last three quarters. The most recent reading of 2.2% annualized growth in 4th quarter (2018) GDP is likely to fall again in the 1st quarter of 2019 as well. Unemployment continues to be at or near the full-employment rate at 3.8%. Inflation (as measured by the Consumer Price Index) has been relatively benign, rising at a 1.9% annual rate in the most recent monthly reading. Wage inflation has accelerated more quickly though, rising at a 3.4% annual pace in February 2019. The swift recovery of domestic equity markets in the 1st quarter of 2019 can point to lower interest rates (and interest rate outlook via the new dovish tone from the Fed) as one of the main catalysts. Interest rate policy is considered a tailwind for the stock market now rather than a headwind. The most recent Fed announcement on monetary policy stated that they planned no further rate increases in 2019 and possibly one rate hike in 2020. The about-face on monetary policy by the Fed coincided with the 1st quarter run-up in stocks and the dip in the U.S. Treasury yields. Global central banks are also extremely dovish, with many foreign 10-year bond yields below zero percent (ex. Germany, Japan, and Switzerland). Our forecast of more modest economic growth alongside building inflationary pressures will put the central banks to the test in the coming months.

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