



Market Update and Outlook for Third Quarter 2016

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.

Key Points

- US stocks should remain range-bound with the potential for volatile market swings in either direction.
- Long-term interest rates may be nearing a low point as the consensus view begins to assume that rates will be “lower for longer”. This creates the foundation for rates to move higher over time.
- Global growth challenges persist, however policy makers remain determined to do whatever it takes to avert deflation.
- Commodity prices have been showing signs of strength, potentially indicating an inflationary impulse beginning to take hold.

Market Recap and Outlook Third Quarter 2016

MARKET SCORECARD to 6/30/2016	TOTAL RETURN IN USD	
	Q2	YTD
DOW JONES IND AVG	2.05%	4.46%
S&P 500	2.46%	3.99%
NASDAQ	-0.56%	-2.89%
MSCI EAFE EQUITY	-2.64%	-12.70%
RUSSEL 2000 INDEX	3.40%	-8.14%
MSCI EMERGING MARKET EQUITY	-0.32%	-14.21%
BARCLAYS INTERM. TREASURY	1.28%	4.04%
BARCLAYS INTERM. GOV/CREDIT	1.59%	4.33%
BARCLAYS 5 YEAR MUNI INDEX	1.16%	4.19%
BARCLAYS US HIGH YIELD	8.09%	0.02%
S&P GSCI COMMODITY INDEX	12.67%	-26.08%

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

Market Recap

Despite a brief but dramatic pullback on the unexpected vote by Britain to exit the European Union, U.S. equity markets rallied into the June month end to finish a very strong second quarter. The S&P 500 index returned 2.45% in the second quarter in part due to an upwardly revised first quarter GDP report, modestly improving leading economic indicators, and weak job creation numbers that appeared to solidify the prospect of sustained lower interest rates into the foreseeable future. In addition, the trend in earnings estimates seems to have troughed and has been steadily improving since February. Developed International markets did not fare as well. The MSCI EAFE index was down 1.46% for the quarter as the Brexit impact was more pronounced and Japanese exporters were punished as a result of a surprisingly strong Yen. Emerging markets were a little better with the MSCI Emerging Markets Index up 0.80% for the quarter. Fixed income markets also had a strong quarter as concerns about Brexit and global deflation pushed some sovereign bonds in Europe and Asia into negative yield territory and long term U.S. Treasury yields continued to test new lows. The Barclays Capital Aggregate Bond Index rose 2.21%. Credit spreads also tightened as fixed income investors searched for yield. The Barclays Capital U.S. Corporate High Yield Index performed well up 5.52% for the quarter. Commodities also had a long awaited modest rebound from an abysmal 2015 and 1st Quarter of 2016. The S&P Goldman Sachs Commodities Index returned 12.67% in the second quarter. Time will tell if this was a modest counter-cyclical rally or an efficient market sniffing out building inflationary pressures.

Investment Outlook

The balance of 2016 is likely to see continued volatility as the post Brexit fallout remains to be seen and the U.S. Presidential race heats up. Fears of a populist uprising will spur governments to adopt more reflationary policies. This is good for global growth. However, we continue to maintain that the upside and the downside remain limited for U.S. stocks. While valuations and tepid economic growth limit upside potential, low interest rates and the lack of a viable alternative will continue to provide support around current levels. These dynamics along with low interest rates will make it difficult for investors to achieve the types of returns they have become accustomed to over the past 30 years.

Global Macroeconomic Review and Outlook

Deflation, rather than inflation, has been the primary risk factor for the global economy. This has been evidenced by the sharp drop in global interest rates to once unfathomable levels. A significant amount of government bonds around the world now have negative yields. The main challenge facing the world economy is a shortfall in aggregate demand. This is evident in a surplus of savings over investment, or equivalently an excess of output over desired spending. Central banks have been attempting to avert deflation through various monetary policies like quantitative easing (buying bonds), zero interest rates, and now NIRP (Negative Interest Rate Policy), which are meant to generate some inflation.

What has changed over the past 12 months is that the growth of populist movements has increased the urgency to act more aggressively. In the United States, Donald Trump was able to secure the Republican nomination, and in Europe anti-establishment parties are threatening to overthrow the existing political order. The recent climax of this movement came on June 23rd when Great Britain voted to leave the European Union. Before Brexit, expectations were for U.K. fiscal policy to be tightened by a cumulative 4.4% of GDP between 2015 and 2019. That is now likely to go out the window, as the British government moves to pacify an angry electorate. The European Commission will also tone down its rhetoric, turning a blind eye to continued budget overruns in southern Europe. Elsewhere, fiscal policy was shifting in a more expansionary direction even before the Brexit vote. The Canadian government promised to increase infrastructure spending. Both Hillary Clinton and Donald Trump have pledged to boost government spending, with the latter also touting sizable tax cuts. In Japan, Prime Minister Abe has postponed next year's planned VAT tax hike and China may also begin to loosen the fiscal screws, at least at the margin. The bottom line is that while deflationary forces are still in control, the underpinnings for inflation and higher long-term interest rates are beginning to be put into place.



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