

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 attorney's, accountants and insurance professionals to achieve a comprehensive financial strategy.

MARKET RECAP

The third calendar quarter of the year was a tale of two halves. In the first half, we continued to see strong performance from a select group of US large-cap growth equities, primarily driven by the Technology sector and the ongoing excitement around Artificial Intelligence (AI). However, a significant shift occurred on August 5th, when the Bank of Japan (BoJ) raised its key interest rate to 0.25%, triggering a historic 12% decline in the Nikkei 225—its largest one-day drop ever. Just 48 hours later, the BoJ was backpedaling, promising “not to disrupt the markets” with its future actions. This decision had major repercussion for global markets. It ushered in a different set of dynamics for the rest of the quarter, characterized by a broadening of the rally and stronger performance from several under-owned segments of the market, including small cap and value stocks. Interest rates in the US retreated meaningfully during the quarter, pushing returns on fixed income assets higher as well.

The S&P 500 Index returned 5.9% in the quarter despite significant volatility along the way. Value stocks outperformed growth stocks, with the S&P 500 Value Index returning 9.1% during the quarter, compared to the S&P 500 Growth Index's 3.7%. Small cap stocks, represented by the Russell 2000 Index, were up 9.3%. Utilities were the best performing sector, up 19.4%, taking its year-to-date return to 30.6%. Other interest-rate sensitive sectors, including Real Estate and Financials, also did well. In contrast, Energy was the only sector to experience a decline, falling 2.3%, while Information Technology and Communication Services underperformed the broader market.

Overseas equities also performed well during the quarter. The MSCI EAFE Index, which tracks developed markets, rose 7.4%, bringing its year-to-date return to 13.6%. Despite a rocky start in early August, the Nikkei 225 Index finished the quarter up 8.4%. The Eurozone STOXX 50 Index was up 6.6% while the MSCI Emerging Markets Index saw an 8.8% increase.

Commodities retrenched in Q3, with the GSCI Commodity Index down 5.3%. Oil was a significant contributor to this decline, down 16% as measured by WTI Crude Oil. Although agricultural commodities and metals saw modest gains, the overall commodity complex managed to maintain a positive return year-to-date, with the GSCI Commodity Index still up 5.2% through the end of September.

Investors geared up for the Federal Reserve's anticipated interest rate cuts, leading to increased demand for fixed-income assets across market segments. The Global Aggregate Bond Index rose 7% during the quarter, with longer-duration US Treasuries and lower-quality corporate bonds delivering the strongest performances. The Bloomberg US High Yield Corporate Index was up 5.3% in Q3. Meanwhile, the US Dollar, as measured by the DXY Index, fell 4.8%, providing a favorable environment for international bonds.

MARKET RECAP & OUTLOOK FOURTH QUARTER 2024

KEY POINTS

MARKET SCORE CARD as of 9/30/2024	TOTAL RETURN IN USD	
	Q3	2024 TR
DOW JONES IND AVG	8.7%	13.9%
S&P 500	5.9%	22.1%
NASDAQ	2.8%	21.8%
MSCI EAFE EQUITY (GROSS)	7.4%	13.6%
RUSSELL 2000 INDEX	9.3%	11.2%
MSCI EMERGING MARKET EQUITY (GROSS)	8.8%	17.1%
BLOOMBERG GLOBAL AGG BOND INDEX	7.0%	3.6%
BLOOMBERG INTERM. TREASURY	4.0%	4.2%
BLOOMBERG INTERM. GOV'T/CREDIT	4.2%	4.7%
BLOOMBERG 5 YEAR MUNI INDEX	3.0%	2.2%
BLOOMBERG HIGH YIELD CORP INDEX	5.3%	8.0%
ishares S&P GSCI COMMODITY TR INDEX	-5.3%	5.2%

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

- The Federal Reserve lowered its benchmark Fed Funds Rate by 0.50% in September, responding to weakening inflation and labor market concerns.
- Lowering short-term interest rates should spur some improvement in the level of economic activity, but that has also historically been correlated with rising risks across all of the major asset classes.
- The change in market leadership that occurred in Q3 has the potential to have an enduring quality as investors are yet to account for late-cycle dynamics and relative valuations across key asset classes.
- We see the market as being too complacent about the potential return of inflation amidst an easing monetary policy cycle. The increasing U.S. budget deficit, along with a weakening US Dollar, is likely to limit the Fed's ability to be as accommodative as it would need to be this time around.

INVESTMENT OUTLOOK

The Fed lowered the Fed Funds Rate (FFR) by 0.50% in September, acknowledging that inflation was trending toward its 2% target and that employment trends were weakening. This policy change was well anticipated by the markets, leading to a significant rally in the fixed income sector, particularly on the short end of the yield curve. The 2yr yield has moved from 4.33% at the beginning of this year to 3.62% following the Fed's rate cut, while yields on the long end have remained relatively unchanged. This dynamic has caused a "bull-steepening" of the US Treasury Yield Curve. Notably, the 2-10 year interest rate spread, which had been negative for more than 25 months, turned positive on September 6th, signaling investor expectations of further rate cuts by the Fed. Historically, a bull-steepening and the un-inversion of the yield curve have often preceded recessions. The fixed income market is currently projecting that the Fed may reduce rates by at least another 1.25%, likely in response to ongoing economic weakness.

The outlook for the US equity market, however, is less optimistic. Since 1980, there have been six instances of yield curve un-inversions, excluding the current situation, and in each case, the US equity market faced at least a 15% drawdown. While four of those instances eventually led to positive double-digit returns within a year, the other two—December 2000 and June 2007—resulted in negative returns. Both of these periods share characteristics with today's market, including near-record-high valuations, high levels of market concentration, and an underlying narrative that has encouraged investors to prioritize liquidity and flows over disciplined investment strategies.

Given these dynamics, we remain cautious in our equity and fixed income positioning. Our sector positioning on the equity side has benefited from the leadership change in the market during the past 3 months. We expect to see continued broadening of relative performance away from the Technology sector. Five of the seven "Magnificent 7" stocks underperformed the S&P 500 Index in Q3. Similarly, only three of the seven have outperformed the market since the beginning of the year. We have been underweight the Technology sector in favor of Utilities, Energy, Healthcare, Staples, and Materials. As long as the economy stays out of recession, the leadership change away from Large Cap Growth and towards cyclical Value has the potential to endure given the trajectory of the Fed's monetary policy. On the Fixed Income side, we continue to be cautious with respect to extending our duration given the dynamics of the U.S. government's debt situation. We like commodities given our expectation for a return to higher inflationary expectations going into 2025 on the back of easier monetary policy and a potentially weaker US Dollar.

GLOBAL MACROECONOMIC REVIEW & OUTLOOK

The third quarter brought some encouraging economic updates, starting with a continued decline in inflation. In August, the annual rate of inflation in the U.S. slowed for the fifth consecutive month to 2.5%, marking the lowest inflationary reading since February of 2021. Energy costs continued to decline, contributing to softer overall CPI readings. The Core CPI, which excludes volatile items like energy and food, remained steady at 3.2% in August, unchanged from July but down from 4.3% a year earlier.

This easing of inflation was a crucial factor for the Federal Reserve as it considered initiating its next cycle of interest rate cuts, a move the market has been anticipating since July 2023. The Fed acted on September 18, reducing the federal funds rate by 0.50%. While this larger-than-expected cut might seem positive, it also suggests the Fed may be increasingly concerned about the health of the U.S. consumer and the overall pace of economic growth.

Just weeks before the Fed's rate cut decision, the Bureau of Labor Statistics released its preliminary annual benchmark review of employment data, concluding that there were 818,000 fewer jobs than had been previously reported. This means that the US economy had been overstating job creation by an average of approximately 70,000 jobs per month during the past year, which suggests that actual payroll growth was closer to 50,000-75,000 jobs per month. That level of job creation is more consistent with stagnation, if not outright recession. This adjustment reflects broader trends, such as the ISM Manufacturing PMI, which has been in contraction since October 2022, and sluggish U.S. retail sales, personal income, and spending figures, all indicating a clear need for support from consumers who have depleted their savings and maxed out credit cards.

Easier monetary policy could provide a temporary boost to consumer spending driven by mortgage refinancing. However, structural issues persist, which may ultimately limit the scope and effectiveness of the rate cuts. In August, the federal budget deficit surged to \$380 billion, the largest since September 2022. During the first eleven months of the fiscal year, the U.S. Federal budget deficit reached \$1.9 Trillion, a 24% increase from the same period last fiscal year. At the same time, interest costs on public debt exceeded \$1 Trillion for the first time, crowding out discretionary spending.

These numbers highlight our primary concern with the US economy: excessive government spending combined with the Fed's willingness to accommodate large budget deficits are incompatible with low inflation expectations. We have already seen this dynamic reflected in various commodities, the US dollar, as well as the Treasury yield curve. The US dollar has weakened by 8% since October of last year, providing a firm bid to commodities. Given these factors, we remain cautious about adding risk, as we perceive elevated valuations across risk-sensitive asset classes, including U.S. equities and high-yield fixed income. We see potential risks to inflation and bond yields, which could further complicate the economic landscape.

INVESTMENT TEAM

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