FARMERS TRUST COMPANY

Market Update and Outlook for Fourth 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

- A gradual pickup in investment spending in the major developed economies should fuel a cyclical rebound in potential GDP growth. Structurally, however, the outlook remains challenging.
- We continue to maintain a cautious view toward global equities in the near term, but things look better over a one-to-two year horizon.
- After many years of low interest rates, we now see the potential for rates to start moving higher.
- A stronger dollar is bad news for commodities, but increasing supply shortages in some areas of the commodity complex should support prices.

Market Recap and Outlook Fourth Quarter 2016

MARKET SCORECARD to 9/30/2016	TOTAL RETURN IN USD	
	Q3	YTD
DOW JONES IND AVG	2.78%	7.21%
S&P 500	3.85%	7.82%
NASDAQ	10.02%	7.09%
MSCI EAFE EQUITY	6.43%	1.73%
RUSSEL 2000 INDEX	9.05%	11.46%
MSCI EMERGING MARKET EQUITY	9.03%	16.02%
BARCLAYS INTERM. TREASURY	-2.06%	3.39%
BARCLAYS INTERM. GOV/CREDIT	0.16%	4.24%
BARCLAYS 5 YEAR MUNI INDEX	-0.02%	2.30%
BARCLAYS US HIGH YIELD	5.13%	12.91%
S&P GSCI COMMODITY INDEX	-4.15%	5.30%

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

Market Recap

After a strong start to the third quarter in July, equity markets in the US largely moved sideways during the months of August and September as the S&P finished the quarter with a total return of 3.9%. Small capitalization stocks performed even better in Q3 with the Russell 2000 index up 9.0%. International markets were mostly higher as the MSCI EAFE gained 6.5%. Among the largest European markets, France rose 6.4%, while Germany gained 10.0%. In the emerging markets, the MSCI EM Index ended 9.2% higher continuing to rebound from last year's negative performance. Returns in Q3 were more modest for fixed income investors, but still positive. The Barclays Aggregate Bond index finished up 0.5% in the third quarter.

Investment Outlook

We continue to maintain a cautious view toward global equities in the near term. A December Fed rate hike; uncertainty over the outcome of the U.S. presidential elections; weak earnings growth, combined with stretched valuations and diminished buyback activity; and concerns about European banks all pose near-term risks to stocks. Things look better over a one-to-two year horizon. The likelihood of a recession is low in most major economies, while rising populist sentiment could actually prove beneficial if it leads to fiscal stimulus.

After several years of contrarian thinking on interest rates (we held that rates could move lower as most others expected them to rise), we now see the potential for rates to start moving higher. Our more cautious view on bonds partly reflects a narrowing between our view and the market's. Even the Fed now sees that the neutral rate as much lower than in the past. Yet, there is more to the story than that. The gap between aggregate demand and supply is narrowing in most economies. This means that inflation could begin to rise – a clear negative for bonds. In addition, easier fiscal policy and the slow erosion of excess savings as more people enter retirement could push up the neutral real rate – another potential headwind for bonds.

A stronger dollar is bad news for commodities, but increasing supply shortages in some areas of the commodity complex should support resource prices. The lack of new investment in the oil patch will result in less supply hitting the market over the coming years. We favor energy over metals. While both gold and silver could weaken if the dollar continues to appreciate, rising inflation will prove to be bullish for precious metals in the long run. We believe that commodities deserve a strategic place in investors' portfolios.

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Global Macroeconomic Review and Outlook

A gradual pickup in investment spending in the major developed economies should fuel a cyclical rebound in potential GDP growth. Structurally, however, the outlook remains challenging. Working-age population growth will continue to slow and future gains in educational achievement are likely to be minimal. Supply growth over the next 5-to-10 years will be modest at best.

Slower potential GDP growth is deflationary at first, but becomes inflationary later on. At the outset, lower productivity growth tends to be deflationary because it depresses business investment and household spending. Eventually, however, economies that suffer from chronically weak productivity growth tend to find themselves rubbing up against supply-side constraints. This leads to higher inflation. Likewise, a slowdown in labor force growth tends to morph from being deflationary to inflationary over time. When labor force growth first slows, investment demand drops and savings rise, as spending on children declines and a rising share of the workforce moves into its peak saving years. The result is a large excess of savings over investment, which generates downward pressure on inflation and interest rates.

As time goes by, the deflationary impact of slower labor force growth tends to recede. Workers who once brought home paychecks start to retire en masse and begin drawing down their accumulated wealth. Also, since there are few young workers available to take their place, labor shortages emerge. At the same time, healthcare spending and pension expenditures rise as a larger fraction of the population enters its golden years.

In summary, we are preparing to deal with an environment where inflation is gradually picking up while the return potential on financial assets is low. This makes for a tricky investing environment, but it will be one in which the diligent investor and creative thinker can outperform. It will require making decisions that are outside-the-box to add incremental value.

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