2019 OUTLOOK

Life is a Journey

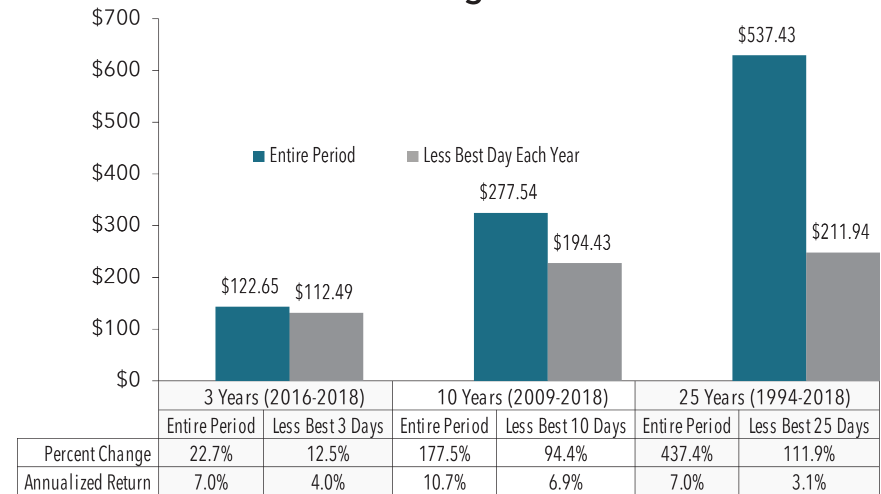
Life is a journey filled with moments that matter. These may take the form of hardship, heartache, joy, celebration or even daily routines. The road will not always be smooth. Throughout our lifetimes we will encounter many challenges, some of which will test our resolve. Sometimes these temporary setbacks are really opportunities in disguise.[i]

In many ways, investing for life goals can also be described as a journey. The current market volatility feels like a significant risk, leading clients to ask questions like:

- Is it time to get out of the stock market?
- Should I make changes to my portfolio?
- Should I wait to invest?

In times of volatility, investors can have a sense of lack of control. While we individually can't control the markets, we do have power over our own behavior and actions that can lead to meeting financial goals over time.

As illustrated, being out of the stock market on the best day of the year can mean significantly lower returns.[ii] No one has proven the ability to consistently time the market. The challenge is to not only know when to get out of the market, but also when to get back in. There have been 36 corrections (10% decline or more) since 1950, and in each instance the market has gone on to new highs.[iii]



	3 Years (2016-2018)		10 Years (2009-2018)		25 Years (1994-2018)	
	Entire Period	Less Best 3 Days	Entire Period	Less Best 10 Days	Entire Period	Less Best 25 Days
Percent Change	22.7%	12.5%	177.5%	94.4%	437.4%	111.9%
Annualized Return	7.0%	4.0%	10.7%	6.9%	7.0%	3.1%

Source: Crandall, Pierce & Company using S&P 500 Stock Index data through 12/31/2018
**Assumes $100 original investment*

FIRST NATIONAL BANK'S INVESTMENT PHILOSOPHY:
What it IS, and what it is NOT:

Consider the following two types of portfolios created using different investment philosophies:

> ***Fundamental Portfolios:*** Fundamental investing involves an emphasis on high-quality companies with strong business models. These firms tend to have solid balance sheets and may be in the growth and expansion stage of business development. Investing in stable companies and paying reasonable valuations will likely lead to portfolio growth.

> ***Speculative Portfolios:*** Speculative investing involves buying companies with weak fundamentals that are either in the startup or decline stage of their business cycle, and firms that maintain high debt levels. In either case, if the company succeeds, the value may soar; alternatively, the business may not survive.

First National Bank's Wealth Management team invests in fundamental portfolios. Our focus on companies with solid financials and proven management teams puts the probability of long-term success in your favor. Understanding the relationship between your life journey and investment portfolio should help the stock market feel more like an investment and less like speculation.

In last year's Outlook, we asked the question, "Why do some investors achieve their goals while others do not?" We stated that maintaining a long-term disciplined perspective and staying invested in a diversified portfolio consistent with your investment objectives was vital for success.

In this year's Outlook, we provide more depth on key investment principles that successful investors employ to meet financial goals (pages 4–7). Next, we articulate the investment process utilized to enhance returns and/or mitigate risks given the current market conditions (pages 8-14). We believe implementing both our investment principles and process increases the likelihood of goal achievement.

THERE ARE FOUR KEY PRINCIPLES EVERY INVESTOR SHOULD APPLY:

People save for a number of financial goals. One emerging theme is that while many short-term objectives are being met, most are making limited progress toward long-term endeavors. In a recent survey, just 27% of non-retired investors have made meaningful progress toward the goal of saving for a child's college education, while 38% of people have made no progress. An even more concerning statistic is that only 36% of non-retired investors have made meaningful progress toward saving enough to live comfortably in retirement, while 7% have made no progress.[iv]

Due to the importance of having enough for retirement and the extent of the shortfall, we emphasize retirement planning to illustrate some key investment principles. The following points can also be applied to other types of sizeable, long-term goals like saving for a child's college education, or leaving a legacy.

Key to Success: Adapt to the shift in responsibilities.

A likely reason for the retirement savings gap is that the landscape for accumulating assets is changing. As shown, individuals previously relied primarily on Social Security and employer funded defined benefit plans.[iv]

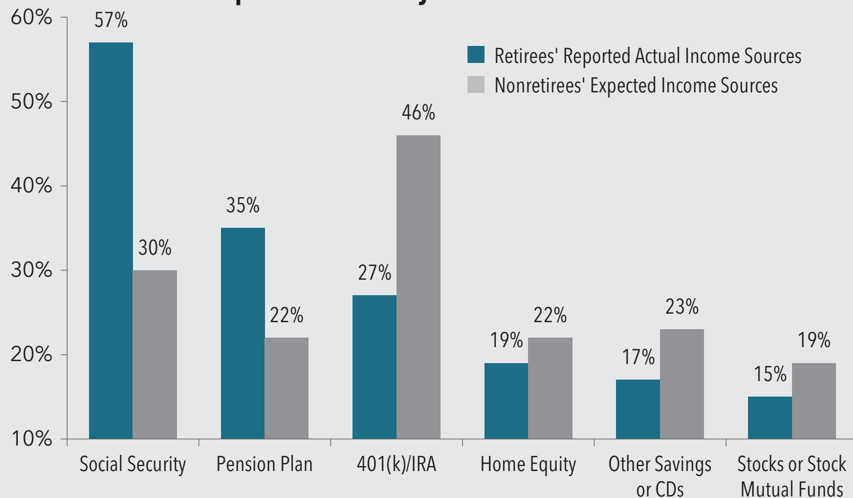
Currently, most people are responsible for saving for their own retirement and making their own investment decisions. For non-retirees, 401(k) plans and IRAs represent the highest expected income source.[iv]

The shift in responsibility highlights the need for quality planning and investment advice in order to understand both how much to save and how to invest.

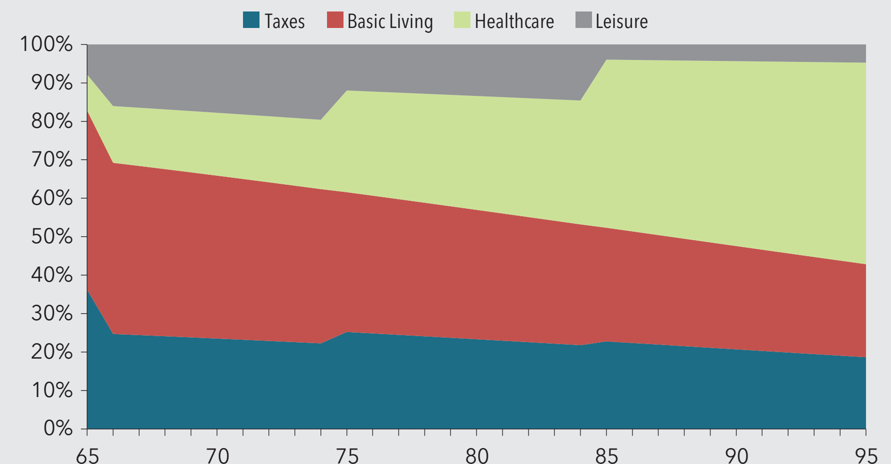
Key to Success: Determine retirement needs.

Financial planners have the expertise to help you determine how much is needed to comfortably fund your retirement. This can mean something different to everyone, but some things to consider are: Where do you want to live? How much do you want to travel? What sort of assisted living standards would you like? Are you comfortable depending on your children? Do you want to leave a legacy?[v]

Traditional thinking indicates that expenses will decrease in retirement, but many of our clients find that their initial expenses do not change much. Often, people spend more money on leisure activities initially until eventually healthcare costs become a larger portion of the budget, as illustrated.[vi]



Source: Gallup Poll April 2-11, 2018
Survey responses do not add up to 100% and reflect multiple income sources.



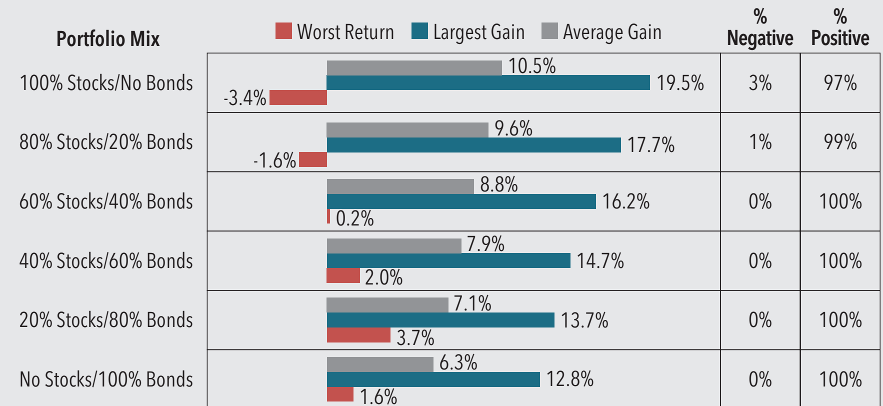
Source: Association for Financial Counseling and Planning Education, Copyright 2005
Assumptions: $90k budget, retirement at age 65, 3% inflation rates on taxes and basic living, 7% inflation on healthcare and leisure, lifestyle factor adjustments at age 65, 75 and 85

The financial industry has done the public a disservice by making risk synonymous with market volatility. We believe that risk is not having sufficient assets to adequately fund your goals.

Key to Success: Invest in stocks as a potential driver of growth and bonds for portfolio stability.

When completing financial plans, we assume that people live to their mid-90s. Depending on asset levels, living longer typically means investment portfolios require some exposure to equities in order to meet higher return needs.

The chart depicts the best (blue), worst (red) and average (gray) 10-year returns of various equity and bond portfolios. The average historical return rises as the stock allocation increases with nearly all of the portfolios having positive returns over the time horizon. Although we use more conservative return assumptions for financial plans, we believe these tendencies will stay intact. This is why we advise clients to maintain the appropriate mix of stocks and bonds.

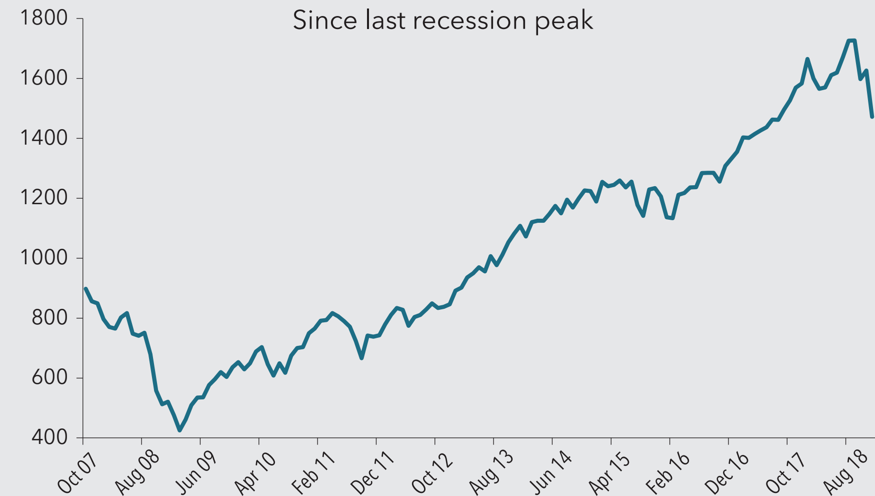


Sources: Crandall, Pierce & Company
Data: Rolling returns using monthly data (705 Observations)
Stocks: S&P 500 Stock Index; Bonds: Intermediate Treasury Bonds

Key to Success: Time in the market outweighs perfect timing.

We recommend people concerned about investing in the stock market at the wrong time spread out their purchases over an appropriate time period, typically three months or more. This reduces the risk of investing the entire sum right before a downturn.

However, even if investors bought at the peak before the last recession and initially experienced a sharp decline in portfolio value, they still would have benefited from having their stock exposure, as shown in the chart.



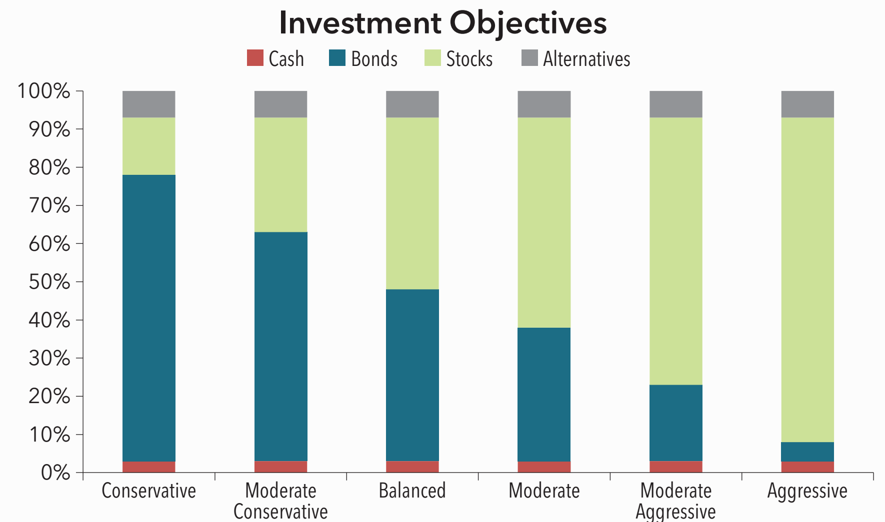
Source: Bloomberg data as of 12/31/2018

The primary factor driving long-term returns is the strategic asset allocation, or the weightings of cash, stocks, bonds, real estate and alternatives. Finding the right asset mix for your portfolio is a personal decision based on goals.

Key to Success: Match the investment objective to financial goals.

The chart depicts multiple asset allocation plans ranging from predominantly bonds to stocks. These investment objectives are used as a starting point to determine the appropriate level of assets invested in each area.

When guiding clients on the investment objective decision, we strive to get an understanding of their hopes and concerns. The following questions produce general guidelines that may factor into the long-term strategic allocation:



Source: First National Bank as of 12/31/2018

Allocation Barometer

	Conservative Portfolio	Moderate Portfolio	Aggressive Portfolio
What is your time horizon?	< 3 Years	3 - 10 Years	> 10 Years
Are you taking distributions from the portfolio?	Yes	Limited	No
How much financial flexibility do you have?	None	Somewhat	A Lot
During market downturns, do you trade?	Sell	None	Buy
What are your return requirements?	Low	Medium	High

Source: First National Bank

Key to Success: Adhere to the Financial Plan

The asset allocation plan should be reviewed periodically and adjusted for changes in circumstances or goals when appropriate. Unfortunately, some individuals sell out of equities based on fear and anxiety, resulting in a permanent loss to the portfolio. If an investor doesn't have the risk appetite to weather a market downturn with their recommended asset allocation, the asset mix should be adjusted more conservatively. This will fare better over the long run than switching from a portfolio tilted toward equities to a conservative allocation at the wrong time. The expected return and asset accumulation will need to be adjusted downward given a lower risk portfolio.

The financial industry has identified several advantages of diversification.

1. **Loss minimization** – Holding multiple securities reduces the impact if a given investment were to decline.

2. **Low correlations** – Investors benefit from holding assets that react differently to market conditions.

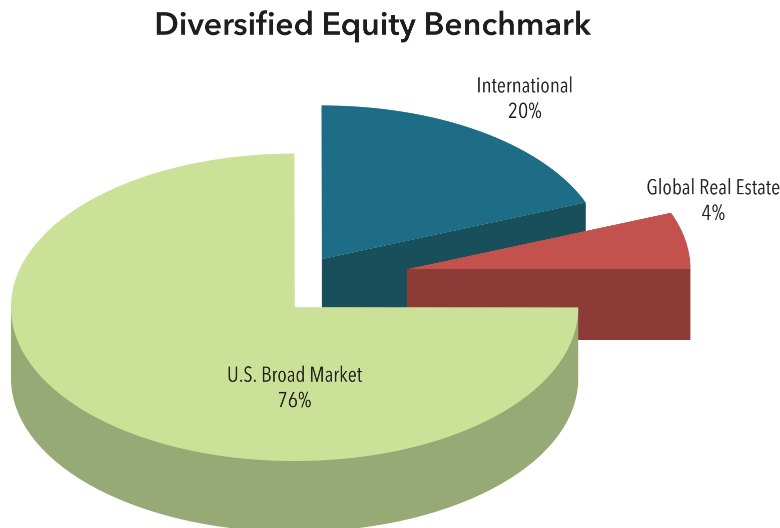
3. **Return generation** - Investments don't always perform as expected. By diversifying, your returns should be more consistent over time.[vii]

Key to Success: Combine different equity subsectors to increase risk-adjusted returns.

We have extensively researched equities at the sub-asset class level and describe our proprietary long-term allocation as the diversified equity benchmark. We believe the long-term equity portfolio should be 76% U.S. broad market, 20% international and 4% global real estate, as shown.

Within U.S. broad markets, we advocate exposure to large-cap, mid-cap and small-cap. The international allocation includes large-cap developed, small-cap developed and emerging markets. The global real estate allocation is invested in approximately half U.S. and half international real estate.

Diversified Equity Benchmark



Source: First National Bank as of 12/31/2018

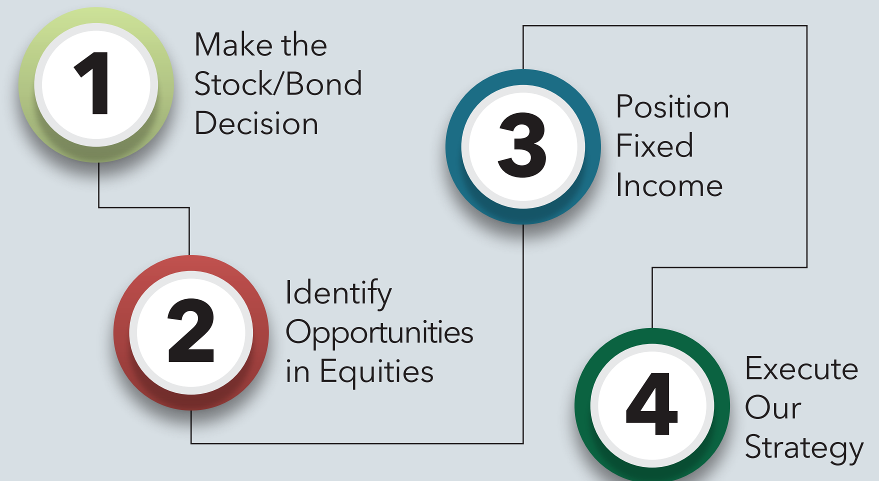
Key to Success: Implement a short-intermediate, high-quality bond strategy.

In fixed income, we utilize a core and satellite approach and emphasize investing in stable, income producing bonds. The core bond taxable allocation consists of investment-grade corporate bonds, government securities, and asset and mortgage-backed securities. The tax-exempt core allocation is invested in high-quality municipal bonds. These municipal bonds are typically general obligation and essential revenue securities, such as utilities, water and school districts. Historically, the core bond allocation has represented 80 – 90% of the fixed income portfolio.

The satellite allocation is intended to take advantage of inefficiencies in the bond market and to manage credit and interest rate risk. This may include investing in sub-sectors such as high yield, floating rate securities and global bonds.

The importance of implementing the key investment principles is critical because it's the primary driver of the investment experience. We believe active management within the long-term framework also helps clients achieve their financial visions.

In addition to the key principles, we utilize the following investment process:



Our process begins with an evaluation of the global economy. A positive outlook for growth leads to a portfolio tilt toward equities. A negative outlook for global economic activity would lead to a lower stock allocation. Similarly, we analyze company fundamentals with a focus on the profit outlook of U.S. and international stocks. Finally, we consider the absolute and relative valuations of major asset classes. Based on our forecast, we make modest tactical decisions with the intention to improve expected returns.

ECONOMIC OUTLOOK

Professional Perspective: Economic growth is expected in 2019.

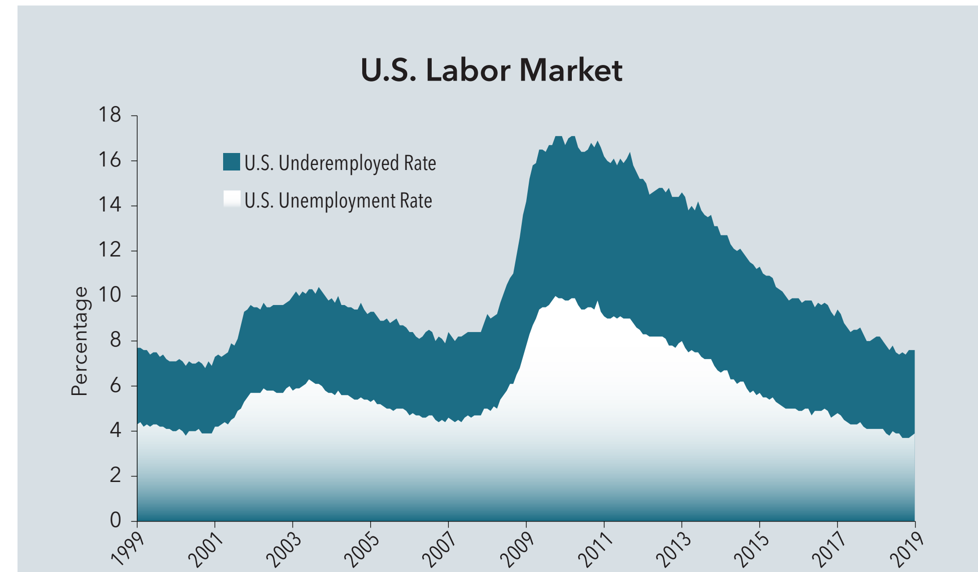
The U.S. economy was relatively strong in 2018, and we think growth will continue in 2019. However, our expectation is that economic activity will decelerate this year.

We believe the driver of the ongoing expansion will come from the consumer sector, which accounts for approximately 68% of economic activity.[viii] As shown, the U.S. unemployment and underemployment rates are at decade lows reflecting the strong labor market. Economic drivers such as strong job growth, wage increases, and high consumer confidence should support increased spending. Consumers have also improved their balance sheet and raised their savings rate, providing the economy modest downside protection.

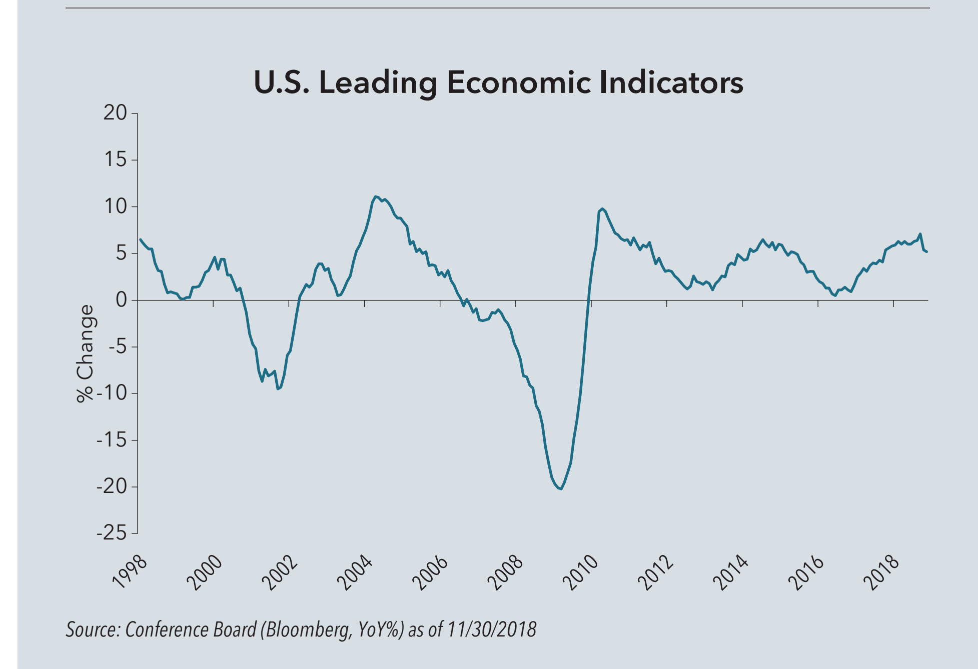
Investment spending accounts for approximately 21% of economic growth and may modestly contribute to the U.S. economy.[viii] Company profitability is at high levels with elevated operating margins and low corporate tax rates. This should support continued business investment.

The Conference Board produces the Leading Economic Index (LEI) on a monthly basis. The Index can be predictive to changes in the overall economy and consists of 10 variables covering the labor market, manufacturing, housing, credit indices, and the stock market.

As illustrated, the indicator took a downturn prior to the economic recessions of 2001 and 2009. The LEIs are currently positive and point to more growth ahead.



Source: Bureau of Labor Statistics (Bloomberg, Seasonally Adjusted) as of 12/31/2018



Source: Conference Board (Bloomberg, YoY%) as of 11/30/2018

Professional Perspective: Risks to the economic outlook are more pronounced.

We have identified two primary risks to our economic forecast:

1. Federal Reserve monetary policy mistake

The Fed increased interest rates four times in 2018 and provided expectations of two more hikes in 2019. As illustrated, monetary policy is considered tight when the fed funds rate is above nominal GDP growth. A recession has historically occurred when the indicator declines below the red line.

At this point, monetary policy remains accommodative by historic standards. Furthermore, slower economic growth and a sharp correction of oil prices in the fourth quarter suggest that inflation will remain contained. This environment should give the Fed flexibility to pause if economic conditions worsen.

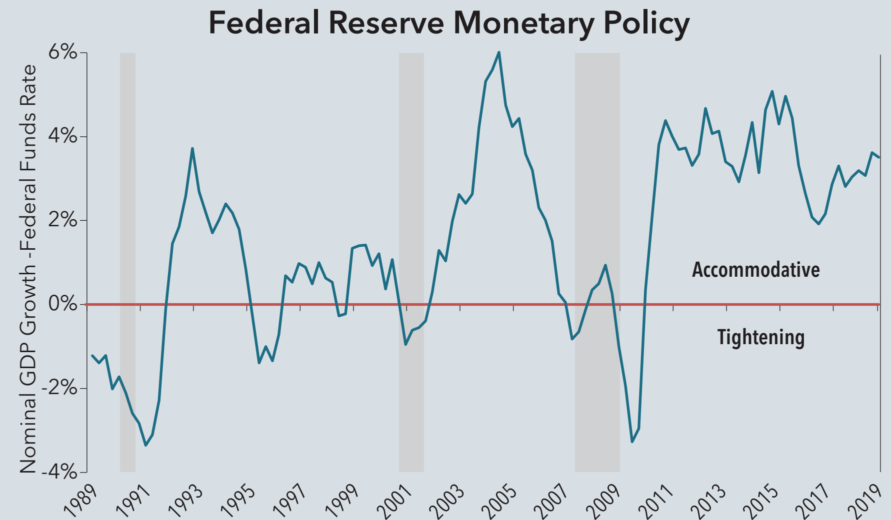
2. Continued deceleration of global economy activity

Germany, Japan and China, the three largest economies aside from the U.S., all experienced lower economic activity as 2018 progressed.

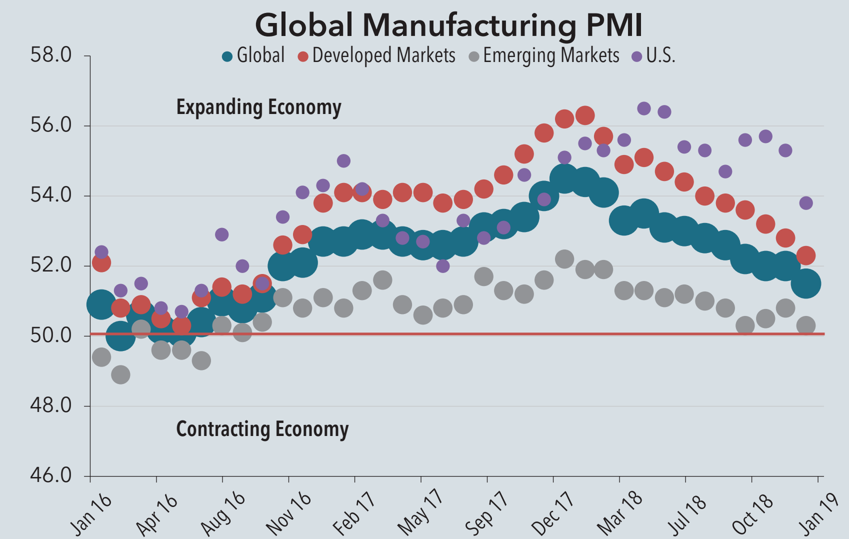
The Global Manufacturing Purchasing Managers Index ("PMI") is indicative of future growth when it is above 50. Although lower than previous readings, the latest survey of 52 is consistent with continued industrial production growth.

The ongoing trade rhetoric around NAFTA, Europe and especially China has added a layer of uncertainty to the global economy. Trade wars create the potential for higher inflation and lower economic growth because they are effectively taxes on consumers.

We closely monitor the global and U.S. economies for the possibility of a recession. Our forecast is for U.S. GDP growth of around 2% in 2019.



Source: Bloomberg data as of 9/30/2018



Source: JPMorgan, Markit data (Bloomberg) as of 12/31/2018

Company Fundamentals

Earnings growth is one of the primary determinants of stock returns. The close relationship between next 12 months ("NTM") earnings and stock price changes are illustrated in the graph.

Professional Perspective: Modest earnings growth expected in 2019.

For most of 2018, companies reported strong sales and earnings growth. Recently, companies gave cautious guidance on future earnings. The reasons cited include the slowing global economy, higher wages, tariffs, and the strong U.S. dollar.[ix]

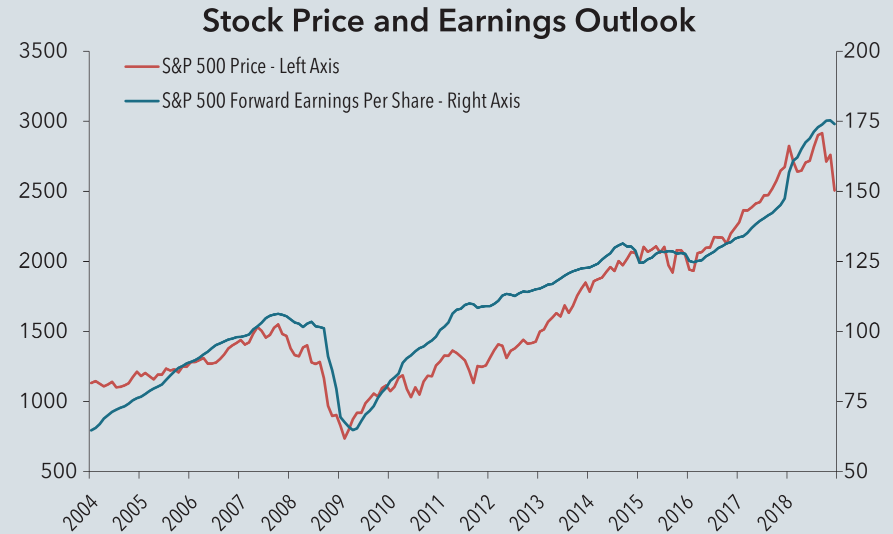
Given our base case of modest economic growth, we believe companies will continue to grow their profits. At the end of last year, analysts were expecting earnings growth of 7.7% for the broad U.S. market (S&P 1500), 6.3% for developed international (MSCI EAFE) and 7.9% for emerging markets (MSCI EMF).[x] These profit estimates were decreased in December 2018, and may decline further in 2019.

We monitor the profit outlook and believe flat earnings is a major market concern.

Absolute and Relative Valuations

An important valuation statistic that we analyze is the next 12 months price to earnings (P/E) ratio. Trade disputes, rate hikes, geopolitical tensions and slower global growth caused investors to lose enthusiasm for stocks. During 2018, P/E multiples experienced one of the largest valuation contractions in 40 years.[xi]

The 2018 P/E for the S&P 500 compressed from 18.2x to 14.4x. As shown in the table, P/E levels in 2019 are at a discount relative to the 15-year average for all major equity asset classes. As P/E valuations have declined, we have increased our expected return for U.S. and international equities.



Source: FactSet data as of 12/31/2018

Stock Market Valuations

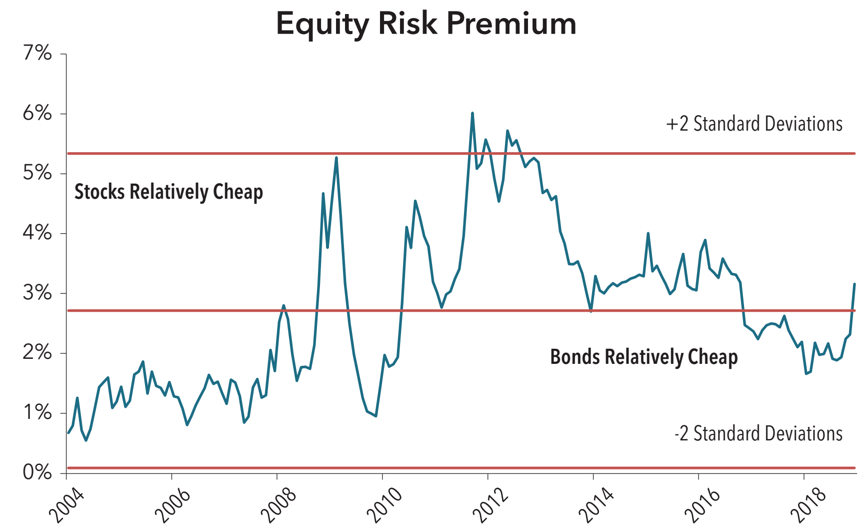
Asset Class	2019 P/E	2018 P/E	P/E Discount to 15yr Avg
S&P 500 Large-Cap	14.4x	18.2x	-0.5%
S&P 400 Mid-Cap	13.4x	18.3x	-14.8%
S&P 600 Small-Cap	14.2x	19.7x	-13.7%
MSCI EAFE	11.8x	14.9x	-9.4%
MSCI Emerging	10.5x	12.4x	-7.6%

Source: FactSet (calculation); as of 1/1/2019 and 1/1/2018 for NTM P/E's

Professional Perspective: Buying assets at lower valuations typically results in higher returns and lower risk.

For most of the last 10 years, equities have been cheaper than bonds. The extended bull market and increase in interest rates has recently narrowed the valuation difference between stocks and bonds.

While not as pronounced, equities continued to trade cheaply relative to bonds.



Source: Bloomberg as of 12/31/2018
S&P 500 vs. 10-Year U.S. Treasury Yield

Professional Perspective: Balance short-term opportunities with long-term economic risk.

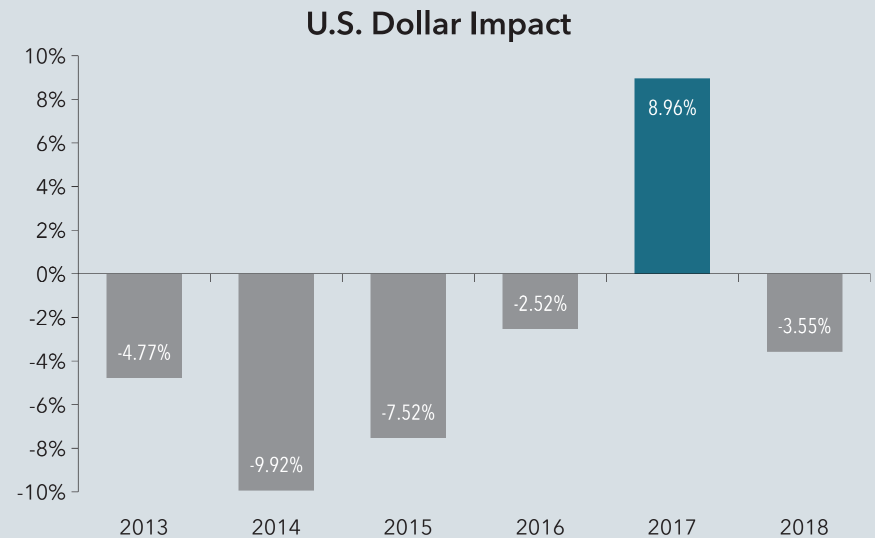
We maintain a modest overweight to equities relative to fixed income based on our expectation of continued economic growth.

Although we see a low probability of a recession this year, some economists are forecasting an economic downturn in 2020. We continue to closely monitor the global economy and company fundamentals to determine if a reduction in the stock allocation is appropriate over the intermediate-term.

Professional Perspective: Allocate 20% of equities to international stocks.

Recently, international returns have varied based on the global economy and swings in the U.S. dollar. In 2017, international equities benefited from synchronized global growth and U.S. dollar weakness. In 2018, the reverse happened as the global economy slowed and the U.S. dollar strengthened.

The table shows the impact of the U.S. dollar on international equity returns over the last six years. U.S. dollar weakness is additive to returns whereas a strong dollar negatively impacts performance. We see the potential for U.S. dollar weakness given the domestic budget and trade deficit, and the likelihood that the Federal Reserve will slow interest rate increases. International markets also trade at valuation discounts to U.S. large-cap equities. Offsetting these positive considerations is the negative impact on earnings growth from the slowdown in global economic activity.

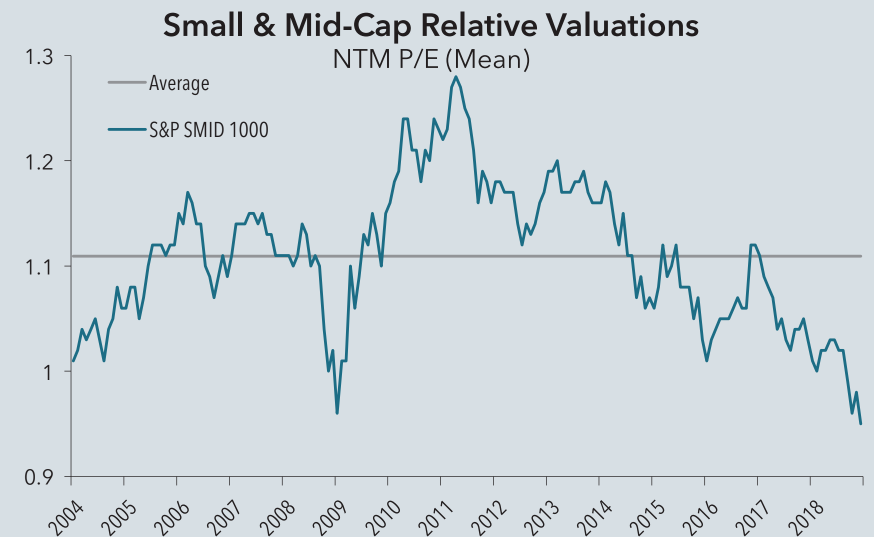


Source: FactSet data as of 12/31/2018

Professional Perspective: Favor small and mid-cap stocks.

The biggest opportunity we see in equities is U.S. small and mid-cap ("SMID") stocks. Normally, these asset classes trade at valuation premiums to U.S. large-cap equities since they typically have higher earnings growth.

As illustrated, U.S. SMID-cap stocks are trading at 15-year valuation lows relative to U.S. large-caps. The cheap valuations reflect fears of an imminent economic downturn. We believe these concerns are overstated and expect the valuation gap to narrow.



Source: FactSet data as of 12/31/2018 relative to S&P 500

Professional Perspective: Maintain allocation to real estate investment trusts (REITs) for diversification benefits.

REITs have experienced strong fundamentals as occupancy rates and rental prices have risen. Offsetting the attractive fundamentals is the negative impact of rising interest rates. In addition, valuations are relatively unattractive as investors have driven up prices in their search for yield. We advocate exposure to global real estate as it provides a diversification benefit to equity portfolios.

Professional Perspective: Higher interest rates are a long-term benefit.

The low interest rate environment for much of the last decade has favored borrowers to the detriment of savers/investors. In 2018, this market condition began to change as interest rates rose. The transition from lower to higher rates can seem painful for investors because when interest rates rise, bond prices decline.

However, we don't believe investors should fear higher interest rates. As shown in the table, 10-year returns are actually higher if interest rates rise by 1% in the first year. Even though investors initially lose money, they recoup the losses by earning higher returns over the next nine years.[xi]

In addition, our bond portfolio limits interest rate risk by taking a short-intermediate maturity approach that is not overly sensitive to interest rates movements. We further manage this risk in the core portfolio by owning shorter maturity bonds than the benchmark.

Professional Perspective: Improve the credit quality within our bond strategies.

Bond investors have the option of taking credit risk to increase return potential. Delinquency and default rates have stayed low and investors have benefited from the higher yields offered by lower quality bonds.

As illustrated, credit spreads have recently increased as investors sold assets with higher credit risk in favor of safer assets like government bonds. Even still, they remain well below the highs of the last economic downturn and are close to their 15-year average.

Based on the deceleration in global economic activity, we have begun to improve the credit quality of our bond portfolio. Specifically, we have added to core fixed income and trimmed high yield and floating rate securities.

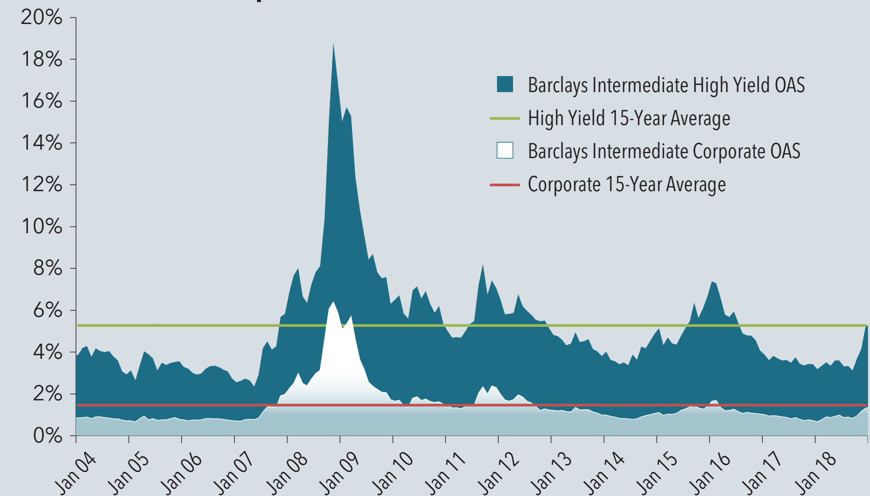
Bloomberg Barclays Int Govt/Credit Index

Yield to Maturity 3.0% Duration (years) 3.9

Change in Rates	Year 1	Year 3	Year 5	Year 10
1.00%	-0.8%	2.4%	3.0%	3.5%
0.00%	3.0%	3.0%	3.0%	3.0%
-1.00%	7.0%	3.6%	3.0%	2.5%

Source: JP Morgan data as of 12/31/2018
**Assumes parallel shift in the yield curve at the beginning of the first year*

Corporate Bond Index (15-Year)



Source: Bloomberg data as of 12/31/2018

Stay disciplined and take advantage of market volatility.

Our investment team continually evaluates the stock and bond market for opportunities to enhance returns in the following ways:

1. Active management

In the last few years, markets favored passive or index investing. We believe the environment is changing and active managers typically protect capital better in volatile and down markets. Our dedicated equity and fixed income teams are analyzing the investment universe to buy/sell mispriced securities.

2. Tactical decisions in asset allocation

Increased volatility creates opportunities for our investment process. We strive to overweight assets with attractive outlooks and underweight investments with a less appealing outlook.

3. Rebalance portfolios

We periodically rebalance portfolios to realign to target allocations. The result of this discipline is to sell appreciated assets and buy lower valued investments. This strategy can enhance returns and help mitigate portfolio risk.

Wherever you are in life's journey, First National Bank is here to guide you. We work with you to understand your long-term financial goals and guide you to the appropriate asset allocation to meet those objectives. By applying our key investment principles to your unique situation, we build your optimal portfolio. We then implement our investment process to identify and execute on opportunities to enhance returns while moderating risk.

History shows that investors are rewarded when they adhere to their financial plan and stay invested through market cycles. Now is the ideal time to meet with your Wealth Management team to discuss any questions regarding your portfolio and to confirm you're on track to meet your investment goals.

Thank you for your interest in this year's Outlook and the trust you place in us.

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Sources:

i. Shannon Spaunburg
ii. Crandall, Pierce & Company
iii. Yardeni Research
iv. Gallup
v. Morningstar
vi. Association for Financial Counseling and Planning Education
vii. Gibson Advisory
viii. Bloomberg
ix. Thomson One Analytics
x. FactSet
xi. JP Morgan Asset Management

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Index Definitions:
Bloomberg Barclays Intermediate US Government/Credit Index: a broad-based flagship benchmark that includes investment grade, US dollar-denominated, fixed-rate Treasuries, government-related and corporate securities, within a 2-10 year maturity range.
MSCI EAFE - Developed International: created to reflect the performance of small- to large-cap stocks across the developed regions of Europe, Australasia, and the Far East (EAFE). The index was developed by Morgan Stanley Capital International (MSCI) in 1969 and lists 926 stocks from 21 countries in the EAFE.
MSCI EM - Emerging Markets: an index used to measure equity market performance in global emerging markets, consisting of 23 economies including Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and the United Arab Emirates.
Russell 3000: a market-capitalization-weighted equity index maintained by the FTSE Russell that provides exposure to the entire U.S. stock market. The index tracks the performance of the 3,000 largest U.S.-traded stocks which represent about 98% of all U.S incorporated equity securities.
S&P Indices: The S&P 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies by market value. Other popular indices include the S&P MidCap 400, which represents the mid-cap range of companies and the S&P SmallCap 600, which represents small-cap companies. The S&P 1000 is a combination of the S&P 400 and 600, representing the small and mid-cap market.The S&P 500, S&P MidCap 400 and S&P SmallCap 600 combine to create a U.S. all-capitalization index known as the S&P Composite 1500.

For 2019 Outlook asset class definitions, key terms and model definitions, please visit www.fnbo.com/outlookdefinitions.

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