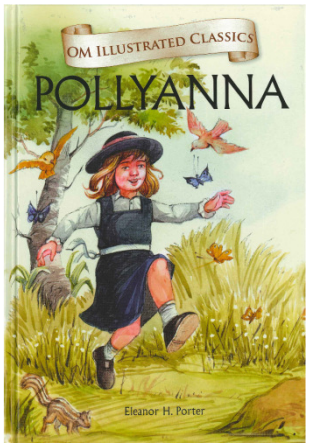
PeoplesBank Wealth Management
Economic & Investment Strategy Outlook
September 28, 2017

Economic Outlook



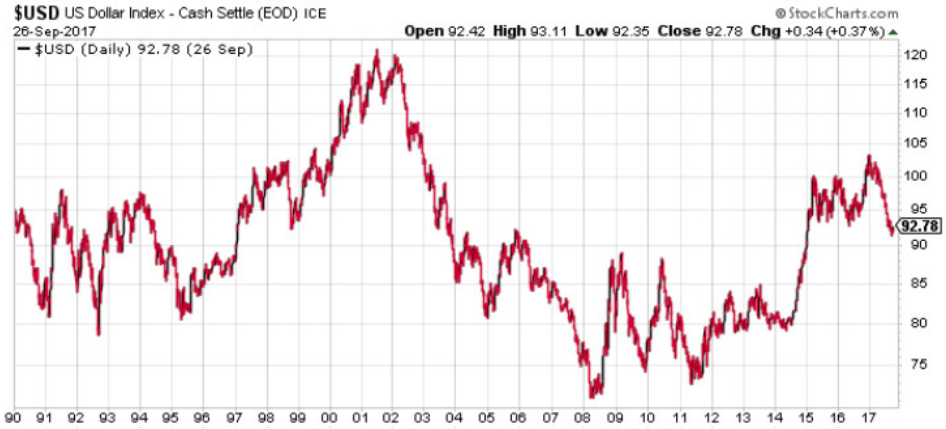
Pollyanna is a best-selling children's book written in 1913 about a little girl with an always optimistic outlook. The name has now entered popular usage in that calling someone a Pollyanna typically means you are accusing them of having excessive or naïve optimism. The investment management industry as a whole is frequently accused of having this trait. Think of the stereotype of the "talking head" on TV business news that always calls for the stock market to head higher. As an organization, being Pollyannaish is something we strenuously attempt to avoid. We consider ourselves to be evidence-based investors and we seek to change our views as our reading of the evidence suggests that we should. This month, the Investment Strategy Committee surveyed the investment landscape to determine if the cautiously optimistic viewpoint that we have held for quite some time is still appropriate.

On the surface, there seem to be many reasons to feel cautious. First among these is a US stock market that seems to head relentlessly higher with little volatility. In fact, by some measurements the market is having its least volatile year on record. For example, at the time of this writing, year-to-date the S&P 500 has fallen no further than 2.7% from its yearly high (which is also an all-time high). If 2.7% remains the largest fall during the entire year, 2017 will have the smallest drawdown in any year dating back to at least 1914. Other reasons that could make an investor feel cautious include an expensive stock market, a feeling that that we are "due" for a correction since it has been so long since one has occurred, the situation with North Korea, and a polarized political environment in which it is difficult to get any meaningful legislation passed.

Despite the potential reasons for caution noted above, history tells us that long-term bear markets typically don't occur outside of an economic recession. Once again this month, the Investment Strategy Committee discussed the fact that we do not yet see the typical warning signs of either a recession or a long-term market top. Broad economic data suggest that the economy will continue to grow at its slow but steady pace over the next several months. Another example of an early warning sign that we look for is interest rate movements that indicate that the bond market is becoming risk-adverse. Historically, the bond market has correctly turned risk-adverse ahead of a recession. At the time of this writing, interest rates are behaving as we would expect during a continued economic expansion.

A logical question to ask then seems to be: What could cause a recession? While it is admittedly difficult to forecast the cause of a recession in advance, the Investment Strategy Committee's leading candidate for a cause is a policy mistake by the Federal Reserve. By policy mistake, I mean the Fed raising interest rates more quickly than the pace they are currently projecting to the market. The Fed believes they will raise rates in December of this year and three more times next year. We see two scenarios in which the Fed raises rates more quickly than this pace. We think this could occur if a new Fed Chairperson is appointed who is more hawkish than Janet Yellen. Her term is up in early 2018, and President Trump has yet to announce if he will reappoint her. The other reason the Fed may raise rates more quickly than they currently expect is if the rate of inflation begins to accelerate above the Fed's 2% target. While we don't see signs of accelerating inflation now, it may occur if the labor market becomes tight enough that employees in aggregate can demand and receive larger wage increases.

Faster Fed rate hikes could cause problems in at least two broad ways. The first is a potential spike in the value of the US dollar like the one that occurred during 2014-2015. The chart at right shows the dollar's value since 1990. The reader may recall that when the dollar spiked in 2014-2015, oil prices concurrently crashed and US companies experienced an earnings recession. The dollar's upward movement began in 2014 when the Fed was the first major central bank to discuss ending its bond purchasing program. A rapidly rising dollar can also cause problems for emerging market countries who borrow in dollars. As the value of their home currency weakens versus the dollar, it makes the dollar denominated debt more expensive to pay back. The other way in which faster Fed rate hikes could have a negative effect is if the Fed pushes short-term rates above long-term rates. This upside-down interest rate scenario, known as an inverted yield curve, has reliably forecasted every recession back to WWII.



As noted on the first page, we remain evidence-based investors. The weight of the evidence as we currently read it suggests a continuation for the foreseeable future of both the current economic expansion and the long bull market we have had in stocks. We will change our expectations as our reading of the evidence suggest that it should.

Investment Strategy

Given the continuation of our cautiously optimistic (and non-Pollyannaish) viewpoint, we decided to recommend an increase in our client's exposure to stocks based in developed countries outside of the US (international developed in the chart on the next page). The loyal reader may recall that the Investment Strategy Committee was close to making this recommendation last month, but we decided against it based upon unfavorable price movements of several international stock markets. This month, the markets' price action once again became favorable. This favorable price action combined with the tailwinds of sustainable economic growth, increasing corporate earnings, relatively lower valuations, and the continued easy money policies of the regions' central banks led us to eliminate a long-standing underweight we have had to this region. We recommend this increase be funded by decreasing investment-grade bond exposure. Given our expectation that there is no recession lurking on the horizon, we continue to expect stocks to outperform bonds over the next several months. This was the only change to our recommendations we made this month. Please see our overall asset allocation recommendations on the next page.

Michael Haun, CFA, CFP ®
Vice President, Investment Strategist

PeoplesBank Wealth Management
Relative Asset Class Recommendations

As of 09/28/17

	Unattractive	Slightly Unattractive	Neutral	Slightly Attractive	Attractive
Stocks				X	
US Large Cap			X		
US Mid/Small Cap		X			
International Developed			X		
Emerging Markets					X
Energy Infrastructure MLPs					X
Bonds		X			
US Investment Grade				X	
Inflation Protected Securities (TIPS)		X			
High-Yield			X		
International Bonds	X				
Municipal Bonds				X	
Preferred Stocks					X
Real Assets					
Real Estate		X			

As of 09/28/17. Recommendations subject to change at any time without notice.

Investment Process

PeoplesBank Wealth Management's asset allocation process develops both long-term (strategic) and shorter-term (tactical) recommendations. The strategic recommendations are based upon how the Investment Strategy Committee believes investment portfolios should be positioned in a generally neutral market environment over the next five to seven years. The tactical recommendations are meant to highlight opportunities over the next one to two years where the Committee sees either increased opportunity or risk.

The Wealth Management Investment Strategy Committee (ISC) is responsible for establishing and updating both the strategic (long-term) and tactical (short-term) asset allocation for Wealth Management's investment management and trust relationships. The committee is comprised of the senior members of Wealth Management and is chaired by Michael Haun, our Investment Strategist. The committee is also responsible for monitoring and updating strategies, managers, and funds within client portfolios. The ISC meets on a monthly basis.

If you have any questions or would like to discuss PeoplesBank Wealth Management's outlook further, please call Michael Haun at 717.747.2419 or email him at mhaun@peoplesbanknet.com.