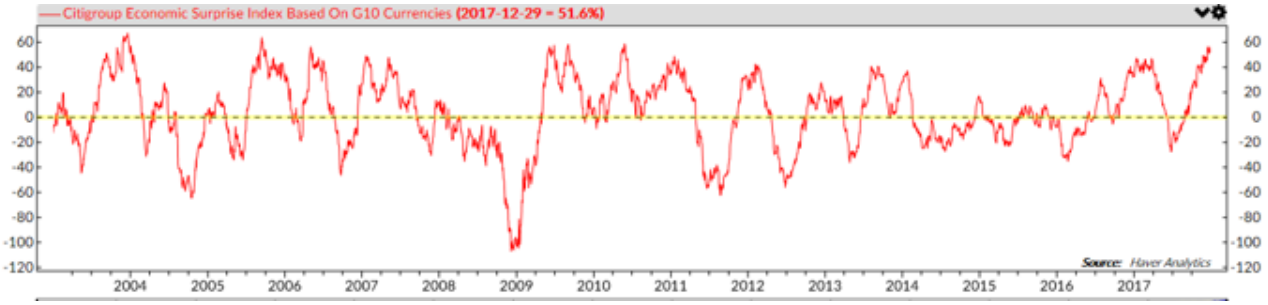
PeoplesBank Wealth Management
Economic & Investment Strategy Outlook
January 3, 2018

Economic Outlook

Perfection is a commonly used word, but there is no consensus definition as to what exactly constitutes perfection. The ancient Greeks for example believed that a perfect work of art would have the correct proportions and a harmonious arrangement of parts. In mathematics, a perfect number is one that is the sum of its divisors smaller than itself such as 6, for 1+2+3=6. Another way to define perfection is that which lacks nothing. This is used in medicine as in "she is a picture of perfect health". Something that achieves its purpose is also sometimes referred to as perfect. A perfect clock is one that that always keeps the time correctly, i.e. it's neither too fast nor too slow. In looking at the stock market, in 2017 the S&P 500 can now claim perfection. For the first time in its history, the total return of the index was positive every single month of the year. In fact, through year-end, the market's total return was positive for the past fourteen consecutive months, and it has gone the longest number of consecutive days in its history without a 3% correction. This month the Investment Strategy Committee discussed our 2018 outlook and whether we expect this level of perfection to continue into the new year.

Starting with the world economy, more countries' economies are expanding now than at any point during the last nine years. Furthermore, economic data around the globe is coming in stronger than economists' expectations, signaling further growth ahead. The chart at right is courtesy of Ned Davis Research and it depicts the Citigroup Economic Surprise index for the 10 largest developed economies. When the line in the chart is moving up, recent economic data releases are more positive that what economists expect. Notice that the line is the highest it has been since 2011. Other leading economic indicators continue to suggest that the world economy at large is poised to continue to expand in 2018.



Turning to the US, real economic growth (not including inflation) in the second and third quarters of 2017 were over 3% and growth in the fourth quarter should be close. While not rapid, this is some of the fastest growth the economy has seen during this long expansion. Looking forward, we continue to see little in the way of warning signs that a recession is around the corner. Also, the tax reform package passed at the end of December should add a small boost to growth over the next year or two.

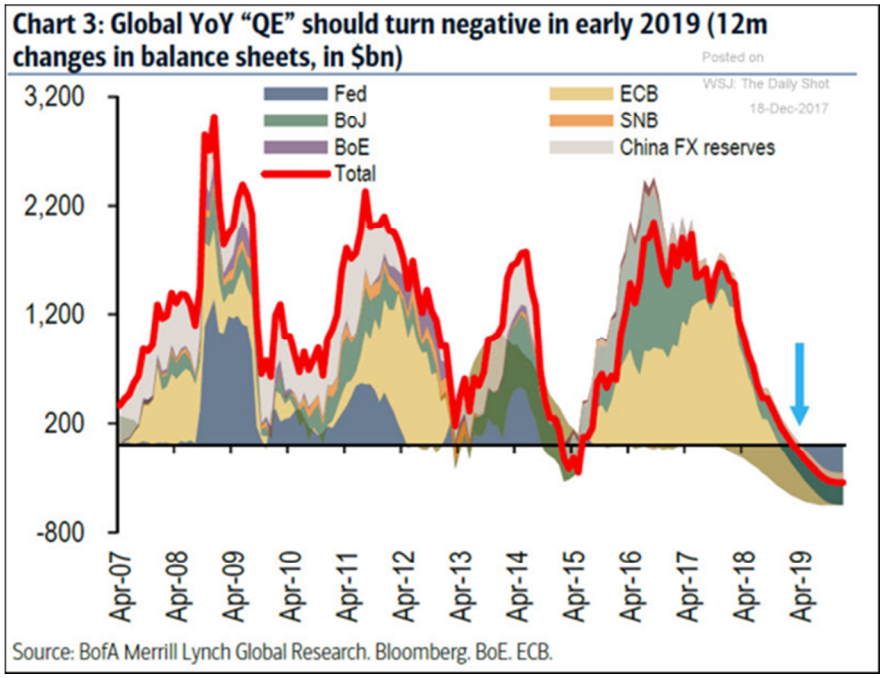
Given that we expect both the US and world economy in general to continue to grow, we also continue to hold a positive outlook for corporate earnings growth next year. In the US, record high corporate profit margins have supported earnings for the last few years. With employees' aggregate annual wage growth stuck near 2.5%, well below 4% which is typically seen during an economic expansion, we expect corporate profit margins to remain intact. Outside of the US, we expect corporate earnings growth to be faster than inside the US next year.

The US bond market also continues to be supportive of our positive outlook. While the difference between long and short-term interest rates has narrowed during 2017, long-term interest rates are still comfortably above short-term interest rates. Historically, interest rates have flipped upside down well before the US economy has entered recession. Another useful bond market measure we look at is the amount of extra interest the bond market charges corporate

borrowers above what it charges the US government to borrow. Normally, over the course of an economic expansion, the bond market becomes increasingly comfortable with corporate credit risk and charges corporate borrowers less and less extra interest. The bond market is still in this phase, which is positive for the economy and financial markets. Historically, ahead of a recession, the bond market then becomes more risk averse and the extra amount it charges corporations starts to climb. This this is an important signal for which we will watch.

While our outlook as described above sounds rather rosy, there are several risks the Investment Strategy Committee discussed that we will continue to watch for carefully. Accelerating inflation is one of the risks we discussed. Keep in mind we consider the risk to be accelerating inflation, not run-away inflation. Despite the massive bond-buying program the Fed has engaged in the past several years, it has been unable to cause inflation to rise to its 2% target. As to a reason, our best guess is that wage growth has not accelerated, as discussed on the first page. If wage growth finally picks up, inflation may do the same. The risk is if the Fed is forced to raise interest rates more quickly than it currently plans to in order to deal with inflation, both the bond and the stock market could sell off.

Another risk the committee discussed is the coming reduction in stimulus from global central banks. The major central banks throughout the world have followed the Fed's lead and purchased bonds over the past several years (the Bank of Japan and Swiss National Bank have also purchased a considerable amount of stocks) in order to stimulate their economies. While the effect on economic growth is debatable, we are convinced that the bond buying has crushed interest rates, lowered the income and return potential of safe investments, forced investors to buy riskier assets, i.e. stocks, to earn a decent rate of return. This sequence of events has in turn pushed up the value of global stock markets. We are concerned as to what will happen when other central banks join the Fed and cease their bond-buying programs as they are likely to begin to do this year. The chart at right depicts a scenario in which, on a year-over-year basis, global central bank support becomes a net negative in early 2019. Each color represents the stimulus from a respective central bank and the red line shows the aggregate stimulus from all of the major central banks. We are not exactly sure how this scenario plays out as there is no historical precedent for it, but we will watch developments carefully.



Other potential risks the Committee discussed include hitting the peak of investor euphoria (we think we might be at the beginning stage of this) and a slowdown in the pace of earnings growth that disappoints stock market investors. As always, we will follow the evidence and adjust our views as the weight of the evidence suggests that we should.

Investment Strategy

Given the views described in the first section, we continue to favor stocks over bonds. While we expect the market to return to a more normal (higher) level of volatility this year and expect to see a normal 10% correction at some point, we still feel stocks are poised to outperform bonds. We remain most favorable towards emerging markets which in aggregate have lower valuations and faster earnings growth than stocks in the US.

We still feel it is more likely for longer-term US interest rates to rise slightly than fall as the economy continues to expand. Therefore, we prefer areas of the bond market with which have generally less sensitive to interest rates than the broad market. These areas include preferred securities and short-term high yield bonds.

We made no changes to our asset allocation recommendations 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 1/3/18

	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 1/3/18. 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.