PEOPLEs Bank
WEALTH MANAGEMENT

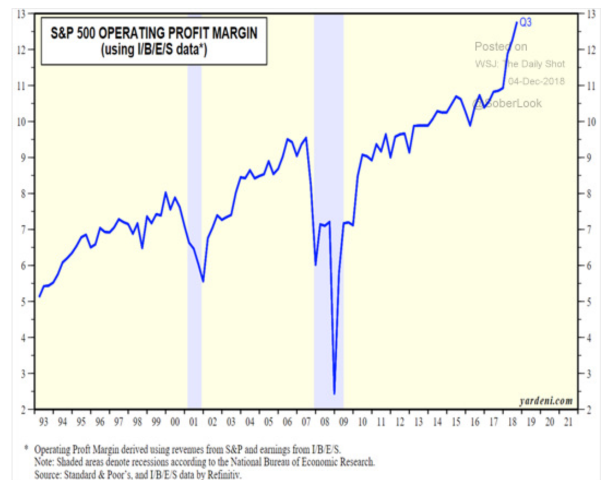
PeoplesBank Wealth Management
Economic & Investment Strategy Outlook
December 12, 2018

Economic Outlook

The number 3 has an important place in American culture because things in America tend to come in 3's. It starts with our names as most people have 3: first, middle, and last. It is in our superstitions as we believe both good and bad things come in 3's. We also have many 3-word phrases such as "snap, crackle, and pop", or "win, lose or draw". Our culture even has 3-oriented phrases like "the 3rd time is the charm". Looking at the current stock market correction, we see the number 3 at work here too. We believe that the correction is being driven by fears regarding 3 peaks in the economy and 3 geo-political events. This month, the Investment Strategy Committee debated these two groups of 3 concerns to determine if we should shift from our long-held cautiously optimistic outlook.

The first peak about which we believe the financial markets are concerned is a peak rate of economic growth in the US. Economic growth is simply the combination of two factors: labor force growth and productivity growth (how many services and how many goods an economy can produce with that labor force). Based upon current labor force growth and productivity growth, the US economy should be able to grow around 2% annually. Due to the stimulative effect of the tax cuts passed in 2017, the economy has been growing faster than 3% for the last few quarters. This growth rate is unsustainable, and US economic growth should slow back towards 2% in 2019. We believe that the stock market correction is partially driven by the fear of some investors that the slowdown won't stop near 2% but that the economy will fall into recession. Looking at our leading recession indicators, we are currently unable to find support for the view that the economy will inevitably slow into recession in the near future. Only one of our several leading recession indicators, new single family home sales, is flashing a caution sign, and this indicator tends to have a long lead time before a recession. Therefore, we currently consider this fear to be exaggerated.

The second peak we believe the markets are struggling to digest is peak profit margins for US corporations. Profit margin is an accountant's way of measuring how much a company is able to keep in earnings for each dollar of sales. As depicted by the blue line in the chart at right, profit margins have increased dramatically over the past year to a new all-time high, as tax cuts have raised corporate profitability. Looking forward, we believe that the market is concerned that corporate profit margins have peaked, and that they may begin to shrink as they have prior to the past two recessions. This would lead to lower corporate earnings all else being equal. While we agree with the view that profit margins are unlikely to increase further, we don't believe that they will rapidly contract either as tepid wage growth and slow Fed interest rate increases should keep margins from declining too far. We also consider this fear to be exaggerated.



* Operating Proft Margin derived using revenues from S&P and earnings from I/B/E/S.
Note: Shaded areas denote recessions according to the National Bureau of Economic Research.
Source: Standard & Poor's, and I/B/E/S data by Refinitiv.

The fear that the growth rate of corporate earnings has peaked for this economic cycle is the third fear with which we believe the markets are grappling. In 2018, year-over-year earnings growth for the S&P 500 should approach 25% (we will find out Q4 2018 earnings early in 2019). Almost 10% of this earnings growth should come from increased sales, and the rest will be due to increased profit margins as discussed in the preceding paragraph. Looking into 2019, corporate earnings growth will slow as profit margins are unlikely to expand. We feel earnings growth is likely to match sales growth which Wall Street analysts currently expect to be around 5%. The stock market drop over the past two months

suggests to us that investors are pricing in either flat or declining corporate earnings in 2019. While flat or declining earnings are possible if the US dollar jumps in value over the next year, or oil prices continue to decline strongly, we currently believe this scenario to be unlikely. Therefore, we consider this fear to be exaggerated.

Turning to the group of three geo-political events we believe are concerning the markets, the first and the one we believe to be the most worrying is the potential trade war with China. The December 1st meeting between President Trump and Chinese ~~Dictator~~ President Xi resulted in what appears to be a 90-day truce in which both sides will work to come to an agreement on at least some of the trade and tariff issues between the two countries. While the ultimate outcome is impossible to predict, it is definitely positive that the two sides agreed to further negotiations.

The second geo-political event is Brexit, or the U.K.'s attempt to leave the European Union. At the time of this writing, the UK Prime Minister Theresa May delayed the Parliament's vote to either reject or accept the Brexit deal she had negotiated with the EU. The vote was delayed because she did not believe she yet had the support to pass the measure. At this point, the U.K. is scheduled to leave the EU with or without a deal at the end of March, although even this could change if the EU sees a need to extend the deadline. While a no-deal Brexit is a legitimate fear, it would have much more of a direct effect on the economies of the U.K. and the EU nations than it would on the US economy.

The third geo-political event which we believe is concerning to the market is the disagreement between Italy's government and the EU regarding Italy's 2019 budget proposal. At the time of this writing, the EU's official position is that Italy's budget is in "particularly serious non-compliance" with the EU's budget rules. If the EU and the Italian government are unable to compromise, the EU has the ability to use economic sanctions to punish Italy for breaking the EU's budget rules. If the situation gets that far, it would probably weigh on investor sentiment as it is hard to imagine Italy taking economic sanctions lightly. Looking forward though, we think it is likely that this situation resolves itself through negotiations as Italy's Prime Minister has said he wants to continue talks with the EU to work out a solution.

When looking at the sharpness of the current market selloff since the end of September, we think the market is driven by fear. It seems to be pricing in some combination of the worst outcome for each "peak": an economic slowdown into recession, falling profit margins, and declining corporate earnings, versus what we believe to be most likely: an economic slowdown to trend growth rates (near 2%), flat profit margin growth, and slower but still positive corporate earnings growth. It also seems likely that the three geo-political concerns just discussed are weighing on investor sentiment and helping to drive the sell-off. Overall then, while we continue to monitor all of these concerns, we do not think that the worst outcome in any of the situations is likely enough at this point to warrant a change in our overall modestly positive outlook. As always, we will continue to evaluate our views as the incoming data and news-flow evolves.

Investment Strategy

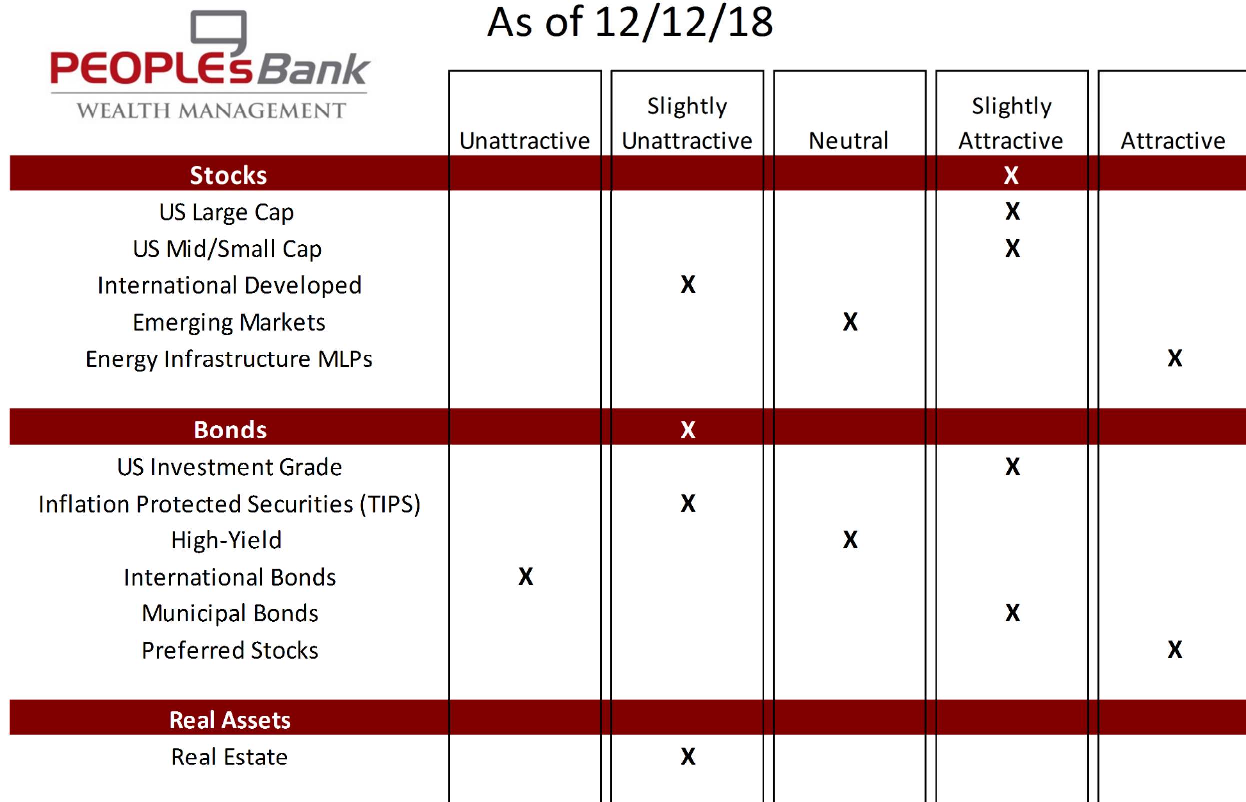
We have recommended that our client portfolios be overweight stocks versus bonds since September 2016, and we continue to hold that view. We think it's important to keep in mind that corrections in the market are driven by fears of some undesirable outcome, in contrast to long-term bear markets which are driven by deteriorating fundamentals, i.e. a recession. As mentioned above, we believe that the market sell-off is driven more by fear than deteriorating fundamentals. Therefore, we continue to view the current sell-off as a sharp and painful correction and not the beginning of a long-term bear market.

Despite our view that this sell-off is only a correction and not the start of a bear market, we have not rebalanced client portfolios back to our overweight equity target. This is because at the time of this writing, we do not yet think the market has reached the end of its correction phase. To determine if we think the correction has ended, we look at various measures of investor sentiment and technical factors such as the number of stocks trading below their long-term price averages. Generally, we are looking at these indicators to find the point at which it looks like investor sentiment has finally bottomed. The point at which sentiment bottoms is when stock market rallies tend to begin. We do not yet feel we have reached that point.

On the bond side of portfolios, we continue to favor areas of the bond market such as preferred securities and short-term high yield bonds which tend to outperform during economic expansions. These types of investments also help to increase the yield of a bond portfolio and decrease its interest-rate sensitivity.

We made no changes to our asset allocation recommendations this month. Please see our overall asset allocation recommendations below.

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



PeoplesBank Wealth Management
Relative Asset Class Recommendations
As of 12/12/18

	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 12/12/18. 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.

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