PeoplesBank Wealth Management
Economic & Investment Strategy Outlook
February 12, 2019

Economic Outlook

Nick Saban, the head football coach at Alabama, is widely regarded to be the greatest coach in college football history. He is tied with Bear Bryant for winning the most national championships at six. His team has played in the national championship game in each of the past four years and Alabama is tied for the most first-round NFL draft picks produced over the past 10 years. Saban himself attributes this success to "The Process", which is the process-oriented approach he teaches to his players. The basic idea is to focus on preparation and on what seem like trivial details. In other words, if you focus all of your effort and concentration on the task at hand in that particular moment, the results will work out positively.

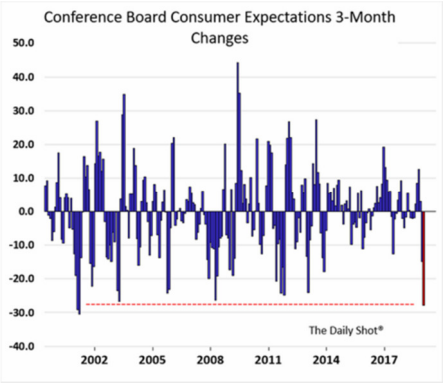
At PeoplesBank Wealth Management, we also believe that following a process is extremely important. As part of our investment process, at our January Strategy Committee meeting we laid out a framework for considering the current US stock market correction. To recap, at our January meeting we noted that long-term bear market tops have historically occurred around an economic recession in the US. After our usual survey of economic and financial market data, we again came to the conclusion that a recession was unlikely to occur in the next several months. Therefore, we felt that the current market correction was likely to be simply a correction and not a long-term top. While we were fairly confident with this view, we remained conscious that the future is unknowable with certainty. This led us to then survey all of the large stock market corrections over the past 30 years, after which we laid out the following framework for how we envisioned three possible future-states of the world:

> **State #1** – We are wrong. In this state, a recession does follow, and the December 24th price bottom in the stock market is not the final low of this correction.
>
> **State #2** – We are correct, but the market price re-tests the December low (within a few percent above or below) before moving higher again.
>
> **State #3** – We are correct, and the stock market makes a V-shaped recovery in which the market price does not again approach its December 24th low.

The Committee noted that a V-shaped recovery had only occurred at the end of the 1982 and 2009 bear markets. The other large corrections had all formed a bottoming process (i.e. a price re-test of the initial correction low). Therefore, we felt that the most likely state to unfold was State #2. Finally, we noted that while it is important to have a well-informed opinion on which to act, we wanted to find data that we could use to help us observe rather than predict which state of the world was unfolding. To this end, we found that when stock market rallies are characterized by low volatility (the size of the market's daily price movements) and strong breadth (the majority of sectors and stocks participating in the rally), the rally was most likely to be a sustainable rally that heads to new all-time highs. This month, the Investment Strategy Committee observed the economic and financial market data as well as the market's volatility and breadth in order to determine which state of the world we believed was actually unfolding.

Starting with economic data, there is no doubt that the economy is growing more slowly at the beginning of 2019 than it did during 2018. Our guess is that this is due in no small measure to a drop in business and consumer confidence. Consider the chart at the top of the following page which depicts the three-month change in consumer expectations about the future. The red bar at the far right is the three-month change as of January, which shows the largest three month drop since 2001. Given the record-long government shutdown and all of the headlines surrounding the March 1st tariff deadline with China, we are not surprised to see businesses and consumers retrench. Overall though, when we

look at the leading recession indicators we analyze and various measures of risk aversion in the financial markets, we see a picture that paints an economic expansion. Therefore, we continue to believe that State #1 as described on the first page is not the state in which we find ourselves.



Turning to the likelihood of State #2 (an eventual price re-test of the December low) versus State #3 (a V-shaped bottom), the S&P 500 has risen over 15% with almost no pause from its December price low (at the time of this writing). Looking at the historical corrections when a re-test of the price low had occurred, a 15% price increase is about as far as the index had risen before falling back to re-test. Said another way, to the extent that the S&P 500 index rallies further, it makes the re-test scenario less likely and the V-shaped bottom scenario more likely. The Committee also noted that the market's level of volatility has been continuously decreasing this year, and the measures of breadth that we analyze continue to show more stocks and industries participating in the rally. These volatility and breadth measures have not yet reached the point where we are confident to declare a re-test of the December price-low off the table, but they are close. The Committee will continue to monitor developments and change our allocation recommendations as necessary.

Investment Strategy

The picture at right is a dove, a species that we have recently found our Federal Reserve Chairman Jay Powell resembling. Prior to late January's Fed meeting, Chairman Powell had been quite resolute in expressing the Fed's desire to both continue raising interest rates in 2019 and continue indefinitely reducing the amount of bonds the Federal Reserve holds (quantitative tightening). After the stock market expressed its unhappiness with this plan (and other concerns such as the trade war, slowing growth, etc.) by falling 20%, Chairman Powell and the rest of the rate-setting committee did a prompt about-face in January. The Fed removed language from their most recent statement regarding further interest rate increases this year, and they also expressed flexibility in slowing or stopping quantitative tightening. We imagine the Fed's dovishness is helping to fuel the strong market rally that has occurred this year.

In theory, the Fed once again pausing its rate hiking campaign should lead to a weakening US dollar. The dollar had been rising in value since the middle of 2018 since the Fed had been the only major developed-country central bank to raise interest rates. Higher interest rates should attract more money flowing into the US and push up the value of the dollar. One would then expect the value of the dollar to begin to fall once the Fed stops raising rates. In practice though, the opposite has happened as the dollar has continued to increase in value almost every trading session since the Fed's announcement. Our guess is that the currency market is not focused on interest rate differentials but rather differences in economic growth rates. While US economic growth is slowing, economic growth in the rest of the developed world is slowing to a greater extent.

Turning to our asset allocation recommendations, both relatively strong US economic growth and a strengthening dollar lead us to continue to recommend that client portfolios have more US equity exposure than they would normally have. In particular, we favor small US companies to large ones as their earnings should be less exposed to a rising dollar and more exposed to the relatively stronger US economy.

On the bond side of portfolios, we continue to favor areas of the bond market which perform best during economic expansions such as preferred securities and short-term high-yield bonds. These types of bonds also help to reduce the interest rate sensitivity of a bond portfolio. 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 2/12/19

	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 2/12/19. 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.