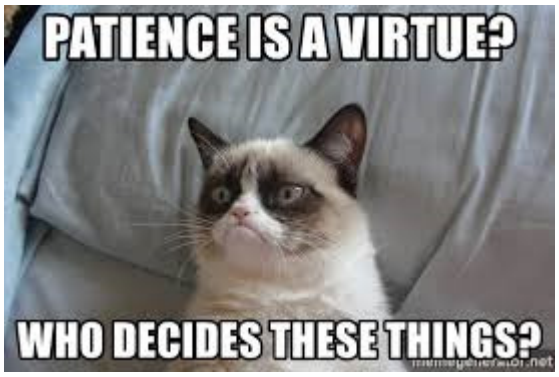
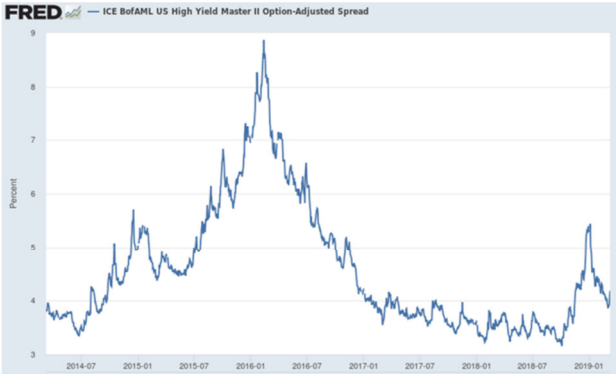
PeoplesBank Wealth Management
Economic & Investment Strategy Outlook
March 12, 2019

Economic Outlook



Most readers are familiar with the phrase "Patience is a virtue." According to my research, the phrase dates back to a 5th century AD poem, written in Latin called *Psychomachia.* The poem is a story about personified virtues battling personified vices. Spoiler alert: the virtues win. "Patience is a virtue" also makes a great meme. As an investor, I think that patience is a challenging virtue to practice. This is especially true recently, given that the markets tend to react daily to geo-political headlines such as every rumor regarding the outcome of the trade negotiations with China. It can be difficult not to react to these headlines by re-allocating a portfolio given that typically the most appropriate response is to do nothing. This month, the Investment Strategy Committee practiced patience as we debated the most recent economic and financial market developments.

To quickly recap our views that had been in place prior to our March Strategy Committee meeting, we believed that even though the US economy was slowing from its above-trend growth rate in 2018, it would continue to expand in 2019. Based upon that view, we further expected that the correction in the 4th quarter of last year was only a painful correction and not the beginning of a long-term bear market. After examining historical corrections, we thought that the most likely scenario for the US stock market would be that the market's price would rise from its December low, fall again at some future point to retest the December price low, and then rise toward new all-time highs. Finally, we tried to quantify how we might differentiate a rise in the market's price that is likely to subsequently fall and retest the December low (a failed rally) versus a rise that eventually makes new all-time highs (a successful rally). Based upon our research, we found that successful rallies are characterized by strong breadth (a majority of stocks and industries increasing in price at the same time) and decreasing volatility (the size of the market's daily price changes becoming smaller). The Committee was waiting until we saw characteristics of a successful rally before recommending an increase in client equity exposure.



After reviewing recent developments at our March meeting, our views remain unchanged. The leading recession indicators that we follow continue to suggest that the US economy will remain in expansion for the foreseeable future, although at a slower pace than last year. Measures of risk aversion in the financial markets also point to an economic expansion that is likely to continue. For example, the chart at right shows a measure of risk aversion in the junk bond market[1]. When the blue line is rising, junk bond investors are becoming more risk adverse and are demanding higher interest rates to lend money to these companies. While the line is higher than it was in 2017, it remains well below where it peaked in 2016 when oil prices were crashing. If a recession were on the horizon, we would expect the blue line to be rising and most likely exceeding the 2016 peak.

While our overall views on the US economy remain positive, the Committee did note risks that we will continue to follow. One risk the Committee discussed was that the European economy remains weak enough that this month the European Central Bank (ECB) announced a new stimulus measure that will begin in September. As the reader may recall,

the ECB has held short-term interest rates below zero for the past several years. Also, while the ECB ended its bond buying stimulus program at the end of 2018, is it still investing the interest and maturities of bonds it owns in new bonds. This month, the ECB announced that it will revive a stimulus program that it ended three years ago. The program will make cheap long-term loans to banks so that these banks will be incentivized to make more loans and hopefully spur economic growth. Another risk that the Committee discussed was that the outlook for US corporate earnings growth has weakened since the beginning of the year. Specifically, Wall Street analysts now expect corporate earnings growth to contract on a year-over-year basis in the first quarter of this year before turning positive again later in the year.

Overall, this month the Committee decided it was appropriate to be patient and maintain our cautiously optimistic view of the US economy. We will continue to monitor developments and change our views when our reading of the data suggests that we should.

Investment Strategy

As mentioned on the first page, we continue to watch for measures of strong breath (a majority of stocks and industries increasing in price at the same time) and decreasing volatility (the size of the market's daily price changes becoming smaller) in order to determine the appropriate time to rebalance our client portfolios back to our desired equity versus bond overweight. In observing these measures, we practiced patience once again this month. Despite the S&P 500 having risen almost 18% (at the time of this writing) with almost no pullbacks since it bottomed in December, the breadth and volatility measures we follow have not yet given us the "all clear" signal, i.e. the signal it is time to rebalance. Therefore, the Committee will continue to patiently wait and observe these measures. In terms of our expectations, since we have not yet received the "all clear" signal, we still think the most likely scenario is one in which the US stock market pauses and corrects before eventually moving to new all-time highs.

We made no changes to our asset allocation recommendations this month. As mentioned previously, we continue to favor stocks over bonds. In particular, the US remains our most favored area of stock exposure, and international developed is our least favored area. On the bond side of portfolios, we recommend exposure to short-term high yield bonds and preferred securities. These are two areas of the bond market that have historically performed well during economic expansions and serve to increase a bond portfolio's yield.

Please see our overall asset allocation recommendations below.

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

(1) ICE Benchmark Administration Limited (IBA), ICE BofAML US High Yield Master II Option-Adjusted Spread [BAMLH0A0HYM2], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/BAMLH0A0HYM2, March 11, 2019.

PeoplesBank Wealth Management
Relative Asset Class Recommendations

As of 3/12/19

	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 3/12/19. 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.