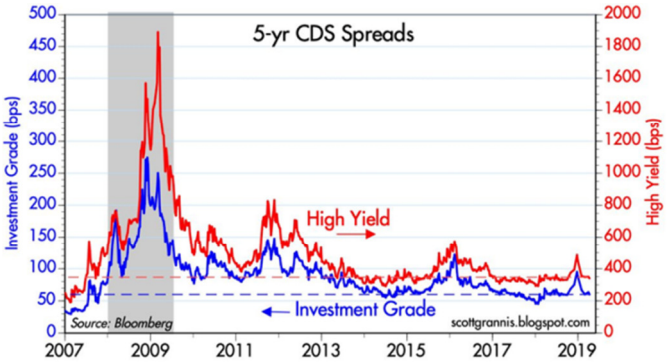
PeoplesBank Wealth Management
Economic & Investment Strategy Outlook
April 9, 2019

Economic Outlook

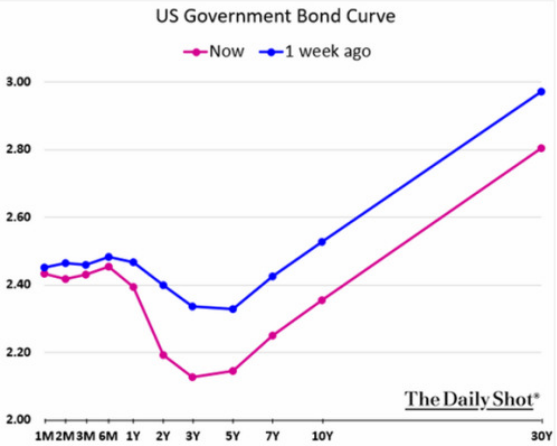
A mosaic is a piece of art made from the assembling of small pieces of glass, stone or other flat materials. An individual tile in a mosaic is known as a tessera. Each tessera is arranged in such a way that the mosaic's observer sees an overall image or pattern. The example at right is of a Greek floor mosaic found on Cyprus. Mosaics originated in Mesopotamia in the 3rd century BC and mosaic art has been found in cultures around the world. This month, the Investment Strategy Committee created a mosaic of our own. Our mosaic was not formed from tiles but was created from data sourced from the economy, the credit markets, and the treasury market. Our goals in creating this mosaic were to determine the overall image created by the economy and the financial markets and to decide if now might be the appropriate time to recommend the return of our client portfolios to our desired equity overweight.

The first set of tiles we added to our mosaic consisted of data points from the US economy. These data points were mostly positive, as the leading recession indicators we follow continue to suggest that the probability of a recession starting in the next several months remains low. In particular, the Committee noted that the labor market remains strong. In fact, the timeliest measure of the labor market, initial weekly unemployment claims, which is a proxy for layoffs, recently reached its lowest level since December 1969. Not all of the incoming data is quite as positive though. For example, retail sales have slowed markedly for the past three months. Also, the Fed's real-time "nowcasting" models of GDP growth (which are reasonably accurate historically) suggest the economy is currently growing around a 2% annualized pace. This is slower than last year's unsustainable 3%+ pace. Overall, the economic data tiles we added to our mosaic help to create a picture of continuing economic expansion.



Data from the US corporate credit markets were the second set of tiles we added to our mosaic. Specifically, the Committee was trying to determine the overall level of risk aversion of corporate bond investors. Historically, in advance of a recession, corporate credit investors correctly transitioned from being risk-seeking to being risk-averse as economic conditions deteriorated. The chart at right is a good example. The lines represent the relative cost of purchasing a contract that essentially provides insurance against a basket of corporate bonds defaulting anytime in the next 5 years. As the lines move down, the cost of the insurance is less (less demand for insurance by risk-seeking investors), and as the lines move up so does the cost of the insurance (more demand because investors are becoming risk-adverse). Notice that in 2007, the lines began to steadily rise ahead of the recession which began in 2008 as corporate credit investors began to realize that economic and business conditions were deteriorating. Contrast that with 2019 when the cost of default insurance remains relatively low. Overall, the credit market tiles we added to our mosaic also help to create a picture of continuing economic expansion.

The last set of mosaic tiles came from the US Treasury bond market. Investors in the Treasury bond market are generally most concerned with the direction of interest rates because US government bonds are considered to have no default risk. As most readers may be aware, parts of the yield curve briefly flipped upside down (inverted) in late March when the interest rate of a 3-month maturity bond rose above the interest rate for a 10-year maturity bond. The picture at right shows the yield curve as of March 26th. Many investors became concerned by this development (the 10-year rate falling below the 3-month rate) because it has happened ahead of every recession since WW2. After examining the situation, we concluded that this fear is overblown for two main reasons. First, we think Treasury market investors are over-reacting to what the Federal Reserve said at the conclusion of its March 20th rate-setting meeting. At the press conference, Chairman Powell said that instead of hiking rates twice this year as it planned to do in January, the Fed no longer plans to increase the overnight lending rate at all this year. Powell also said for the first time that the Fed will stop shrinking the number of bonds it owns (quantitative tightening) in September. The Treasury bond market went well beyond this though and has actually priced in a 70% chance of at least one rate cut this year and a 27% chance of two or more rate cuts this year (at the time of this writing). We believe this is the reason for the "kink" in curve between 6-month and 10-year rates. With the economic expansion remaining on track, we disagree with the Treasury market and we think rate cuts this year are unlikely. The second reason we think that recession fears are overblown is that the entire curve has not inverted, meaning the highest rate is the shortest rate. Inversion is what has historically happened ahead of a recession. Note the curve looks more like the Big Dipper, with the highest rate still belonging to the 30 year bond by a wide margin. Overall, we think that the Treasury market mosaic tiles show a market over-reacting to the Fed rather than actually pricing in a recession.



When we step back and look at the mosaic we have created using tiles from the economy, the corporate credit markets, and the Treasury bond market, we see a picture of a relatively healthy US economy that looks likely to expand for the foreseeable future.

Investment Strategy

The Strategy Committee also created a mini-mosaic from US stock market data. The goal in creating this mosaic was to determine if the image of a sustainable rally was clear enough to recommend rebalancing client portfolios back to an equity overweight (if they were not overweight stocks already). Several of the data points the Committee discussed were related to the breadth of the market, meaning the degree to which individual stocks and sectors are participating in the rally. Collectively, the breadth of the market looks strong, and this part of the mosaic suggests that the market is in a sustainable rally, i.e. one that looks unlikely to fall and re-test December's lows. The market's low level of volatility (size of the daily increases and decreases) is also suggestive of a sustainable rally. Another interesting data point we added to the mosaic is investor sentiment. Investor sentiment is generally useful as a contrarian indicator, meaning when the majority of investors begin to favor an asset class, such as stocks, that particular asset class typically begins to underperform. Based upon measures the Committee examined, investors appear overweight cash and underweight stocks. This is also a positive sign that the US stock market rally is sustainable. Overall, the Committee judged that the image of a sustainable stock market rally created from our mosaic was clear enough to recommend client portfolios be rebalanced back to an equity overweight.

In terms of other recommendations, we continue to favor US stocks over non-US stocks. On the bond side of portfolios, we continue to favor exposure to preferred securities and short-term high yield bonds. We expect these assets to perform well during a continued economic expansion.

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 4/9/19

	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 4/9/19. 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.

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