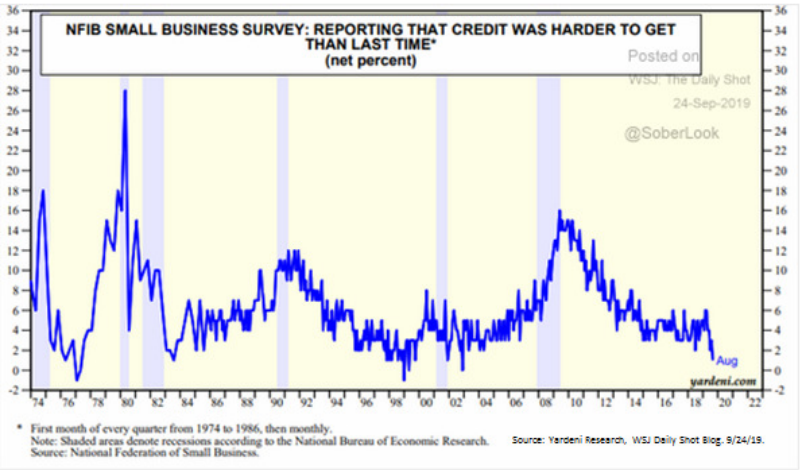
PeoplesBank Wealth Management
Economic & Investment Strategy Outlook
October 8, 2019

Economic Outlook


HIDEBEHIND

Every culture throughout history has had its specific folklore. Folklore typically includes myths, oral traditions, tales, proverbs, and jokes common to that culture. While reading Wikipedia recently, I came across a particularly interesting piece of folklore called "Fearsome Critters". Apparently in the late 1800s, lumberjacks would haze newcomers by convincing them of the existence of fantastical creatures hiding in the woods. My favorite Fearsome Critter is the mythical beast pictured at right – the Hidebehind[1]. As the name suggests, when a person attempts to look at this nocturnal creature, it moves so quickly that it is able to hide behind an object and never be seen. It uses this ability to stalk and devour lumberjacks that strayed too far from camp. Just like the Fearsome Critters, the US economy is also the subject of myths. One of the most often repeated is the myth that the economy has a "stall speed" just like an airplane. Much like an airplane that needs to keep a minimum velocity or its engines will stall leading to a crash, the myth says that the US economy becomes more likely to crash (fall into a recession) simply because the economy's growth rate slows down. There are more financial pundits repeating this stall speed myth now than there have been in the past few years due to the trade-war induced economic slowdown. For example, here is a recent Bloomberg headline: "U.S. Economy Nearing 'Stall Speed' as Factory Gauge Hits 10-Year Low". In fact, economic growth does not end due to slow speed or even old age. Instead, history tells us that growth is stopped by inflation, a bubble popping, or excessively tight credit/financial conditions. This month, instead of simply repeating an oft told myth, the Investment Strategy Committee examined the likelihood of a recession through the lens of current credit and financial conditions and recent economic data.

Credit conditions or the ease with which businesses and consumers can borrow money has historically been a useful leading indicator of recession. For example, the chart at right is a survey of small businesses in which the owners were asked about the ease of borrowing recently compared to the last time they needed to borrow money. When the blue line moves down, it was easier for these business owners in aggregate to borrow. Note that the blue line rises ahead of a recession as it becomes more difficult for business owners to borrow when the economy begins to deteriorate. That is not the case now as the survey suggests borrowing conditions remain easy. Most of the other indicators of credit conditions that we monitor tell the same story. Therefore, credit conditions suggest that economic growth is poised to continue.



Financial conditions, or the overall health of the financial markets, also influence economic growth. Healthy financial markets such as rising stock prices or a positively sloping yield curve suggest that market participants are in a risk-

seeking mode which should help propel economic growth. One of the largest determinants of the health of the financial markets, at least during this economic cycle, has been the actions of the Fed. At its most recent rate-setting meeting at the end of September, the Fed lowered its policy rate by 0.25% for the 2nd time this year. Chairman Powell once again went to pains to explain at the press conference following the meeting that the Fed expects this cut to be part of a "mid-cycle adjustment" as opposed to a full rate-cutting campaign. If it is indeed only a mid-cycle adjustment, then history says the Fed should not lower rates more than one more time for a total rate reduction of 0.75%. Historically, when the Fed has had to lower rates by more than that amount, it had to cut rates further to combat a recession that was already baked-in-the-cake. We will observe what happens, but at the time of this writing, with the US stock market near record highs and the Fed slowly lowering rates, we believe that financial conditions are supportive of economic growth.

Finally, the Committee looked at economic data that tend to lead recessions. These include data points from the labor markets, the housing sectors and manufacturing sectors, and data regarding consumer and business confidence. The labor markets remain strong, and layoffs have not begun to increase as they typically do ahead of a recession. The housing market has been recovering the past several months as interest rates have fallen. Also, despite the fact that consumer and business confidence have fallen over the past year, confidence measures remain historically strong. In aggregate, our reading of the economic data suggests the economy is likely to continue to expand for the foreseeable future. We will continue to monitor the financial and economic data and change our recommendations as necessary.

Investment Strategy

Given our expectation that the US economy will continue to expand, we remain modestly overweight stocks versus bonds and heavily overweight US stocks versus non-US stocks. For the past several months, we have held this US overweight in small cap stocks, particularly small cap growth, but this month we decided to shift our US overweight from small cap to large cap. We made this change for several reasons. First, analysts' estimates for earnings growth continue to rise for large cap companies but have flattened out for small cap companies. Second, profit margins for large companies have held steady while profit margins for small companies have recently been declining, which is a headwind for their earnings growth. Third, large cap indices have a higher weight in technology companies and lighter weight in financial companies which are sectors we expect to outperform and underperform, respectively. Finally, history suggests that large cap companies outperform small cap companies during periods when the Fed cuts rates and no recession follows in the next year.

We made no changes to our bond recommendations this month. We remain overweight preferred securities and short-term high yield bonds. Both of these market segments provide a yield higher than that of the broad investment-grade bond market. They also tend to out-perform during periods of economic expansion.

Please see our overall recommendations below.

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

(1) By Margaret Ramsay Tryon - Tryon, Henry Harrington. Fearsome Critters. (Cornwall, NY: Idlewild Press, 1939), Public Domain, https://commons.wikimedia.org/w/index.php?curid=9004378

PeoplesBank Wealth Management
Relative Asset Class Recommendations

As of 10/8/19

	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 10/8/19. 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.