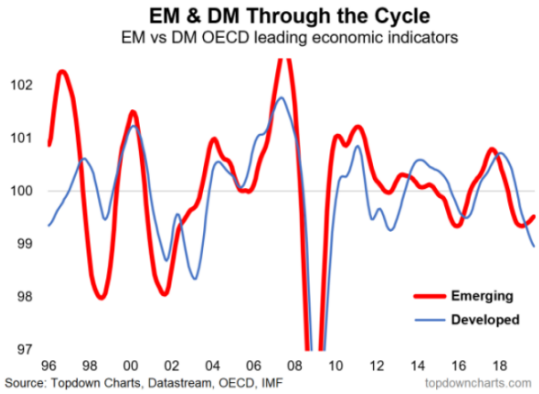
PeoplesBank Wealth Management
Economic & Investment Strategy Outlook
December 10, 2019

Economic Outlook

Every decade has its memorable TV show theme songs. The 1970s had the cheerful theme song from *Happy Days* and the much more somber theme to *M.A.S.H.* From the 1980s, who can forget "Thank You for Being a Friend" from *The Golden Girls* or perhaps the most famous theme song of all, "Where Everybody Knows Your Name" from Cheers. In the 1990s, we listened to "I'll Be There For You" by the Rembrandt's from *Friends* and "Yo Home to Bel-Air" rapped by The Fresh Prince, aka actor Will Smith. More recently, readers might recall the opening song to the mockumentary show *The Office* or the haunting instrumental theme that opened *Mad Men*. Each of these opening theme songs set the tone for what the viewer was going to see in the actual show itself. This month, while we didn't sing (no one wants to hear that), the Investment Strategy Committee did discuss eight themes, four economic-related and four-investment related, that we thought set the economic and investment tone to begin 2020.

Theme #1 discussed by the Committee is that we believe that the US economy will continue to expand for the foreseeable future. Leading economic data that we follow such as growth in the money supply, new single family home sales, weekly unemployment claims (a proxy for economy-wide layoffs), and the shape of yield curve all support this view. Credit conditions, or the ease with which households and businesses can borrow, also support this view. Despite our overall positive view on the economy, we acknowledge that the manufacturing sector of the US economy remains weak. Fortunately, the degree to which manufacturing has slowed down is not enough to drag down the rest of the economy. In order to maintain our optimistic view on the economy in 2020, at minimum we will want to continue to see signs that the slowdown remains confined to manufacturing. If we get a meaningful reduction in the tensions caused by the subject of Theme #4 below, we may even see a manufacturing rebound in 2020.



The second theme discussed by the Committee is that the global growth slowdown may be ending. Global economic growth has been slowing since trade tensions began in 2018. As discussed in this outlook last month, we have started to see some "green shoots" that suggest global growth may have bottomed. For example, see the chart at right. The two lines depict the composite leading indicators indices (CLIs) compiled by the OECD for emerging market countries (EM) and developed market countries (DM). According to the OECD, these indices are designed to predict turning points in an economy relative to trend six to nine months ahead. These indices are constructed so that a reading above 100 means the countries in aggregate are growing faster than their long-term average and any number below 100 means the countries are growing more slowly than their long-term average. Rather than the actual level though, it is the direction of the CLIs which we find most useful. Note that while the developed market CLIs are still in a down trend, it appears as though the emerging market CLIs have bottomed and are reversing direction. This means that emerging market economic growth should pick up over the next several months. While this development is positive, we want more of the indicators that we follow to tell the same story before we fully embrace the idea that global economic growth has bottomed and is starting to accelerate. We will watch closely for more signs of this potential bottoming as we head into 2020.

Our third theme for 2020 is that we expect that the Fed will remain on hold for the year, i.e. neither raising nor lowering its policy interest rate. According to Chairman Powell, the Fed only intends to raise rates in the future if inflation runs too hot, and the Fed only intends to lower rates if the economy deteriorates materially. As we look into 2020, we expect that neither situation will occur over the next twelve months. Despite this being the longest expansion in US history,

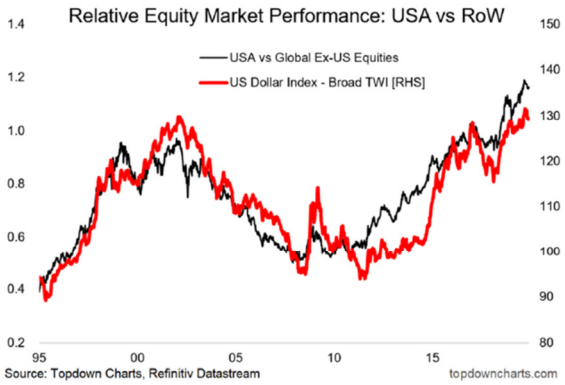
inflation remains benign, and the Fed has actually had trouble pushing inflation up to its 2% target. Now the Fed says that the 2% target is "symmetric", meaning that it will tolerate inflation running a little above or below its target. Therefore, we believe that inflation would have to accelerate strongly before the Fed would react by raising rates. As noted in Theme #1 above, we do not currently foresee a recession in 2020. Therefore, we do not believe that the Fed will have to lower rates in an attempt to stave one off. Overall then, we expect that 2020 will be a year in which the Fed is likely to be simply a bystander from a rate-adjusting standpoint.

Our fourth economic theme as we head into 2020 is that we believe that the trade war remains the biggest risk to the outcomes we expect in Themes #1 - #3. As mentioned previously, the beginning of global economic growth slowdown coincided with the first round of tariffs being implemented in 2018. We continue to see the situation as a game of chicken in which the long-term outcome is unknowable in advance. Therefore, we feel the best way to invest given the situation is to observe rather than predict. One important negative consequence we can observe at this point in the US is an economy-wide lack of business confidence (based upon CEO surveys). This lack of confidence manifests itself in reduced business investment in things such as plant, property, and equipment. In fact, weak business investment has detracted from US GDP for the prior two quarters. At the time of this writing, there is talk in the media that a "phase one" trade deal is close to being announced. To the extent that this deal, if eventually announced and signed, lowers trade tensions, then it will be positive for US and global economic growth. Longer-term though, it is difficult for us to imagine a situation in which trade tensions disappear entirely. As we head into 2020, we will continue to observe the situation closely.

As always, we remain evidence-based investors, and we will adjust our themes and expectations as our reading of the economic and financial market data suggest that we should. The Investment Strategy section of this outlook details the four major investment themes that flow from the four economic themes just discussed.

Investment Strategy

Our first investment theme for 2020 is that we continue to favor exposure to stocks over bonds. As mentioned in the previous section, we expect the US economy to continue to grow for the foreseeable future, and it is possible that growth outside the US will begin to accelerate in the next few months. We think that US corporate earnings should begin to grow again next year (they were flat on a year-over-year basis in 2019). It also seems likely that non-US corporate earnings will pick up next year. When making the stocks versus bonds recommendation, we think that it is also important to consider potential return of bonds in general. According to John Hancock Investment Management, over any five-year period back to the 1970s, 87% of the US bond market's return was attributable to its beginning yield. To put this in perspective, the yield on the broad investment-grade bond market was just under 2.3% at the end of November 2019. Therefore, looking forward, history says it is likely that the average annual return of the US investment grade bond market won't be much greater than 2.3% over the next five years. Said another way, we would only favor bonds over stocks when we felt the need to begin to invest defensively.



The second investment theme we discussed for 2020 is that US dollar strength continues to favor US assets. The chart at right shows why. The red line shows the value of the trade-weighted US Dollar Index and the black line represents the return of the US stock market versus the global stock market outside of the US. When both lines are moving up the value of the dollar is strengthening and US stocks are outperforming non-US stocks. Notice the strong tendency for both lines to move together. There a few factors at work that have caused the US dollar to continue to strengthen. We have both stronger economic growth and higher interest rates in the US than most other developed markets. This combination increases the demand for US dollar denominated assets. Also, China's economy has slowed down as have the economies of other emerging market countries that are dependent upon Chinese demand. Due to slower

economic growth, emerging market currencies have weakened versus the dollar. Looking into 2020, we will watch for any signs that the trend of dollar strength may reverse, such as a reduction in trade tensions or accelerating economic growth outside of the US.

Our third investment theme for 2020 follows from the second theme: we remain overweight US stocks versus non-US stocks, but we are looking for the opportunity to reduce that overweight. We have recommended an overweight to US stocks for most of the past few years. As shown on the chart on the previous page, this has been the correct call. Looking into 2020, if economic growth outside the US does accelerate, trade tensions ratchet down, and the value of the dollar begins to fall, we would expect this combination of events to lead to foreign stocks outperforming US stocks. As mentioned throughout this outlook, we are not ready to make that call yet, but we are watching developments closely.

The fourth and final investment theme we discussed for 2020 is that we continue to favor large cap US stocks over small cap stocks. There are several reasons for this. First, the trend of both profit margins and earnings are weakening for small cap versus large cap. Second, history tells us that large cap stocks tend to outperform small cap stocks after Fed rate cutting cycles that don't end in recession. Third, the sector weighting of the indices favors large cap. For example, the large cap index has a 7% higher weight in technology, which has been the strongest sector during this long bull market. Finally, technical trends, meaning the pattern and strength of price movements, continue to favor the large cap index over the small cap index.

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

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

PeoplesBank Wealth Management
Relative Asset Class Recommendations
As of 12/10/19

PEOPLEsBank WEALTH MANAGEMENT

	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 12/10/19. 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.