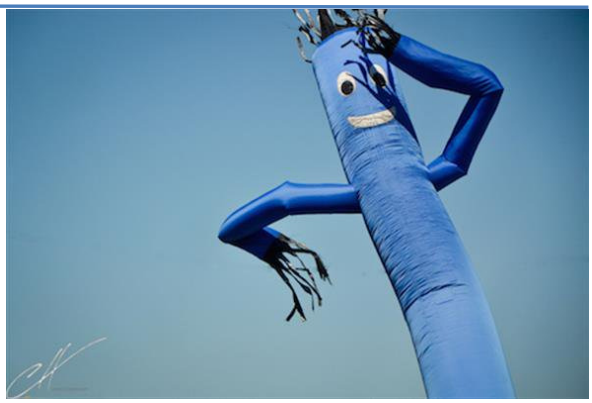
PeoplesBank Wealth Management
Economic & Investment Strategy Outlook
July 28, 2017

Economic Outlook



Earlier this year my wife and I were taking our kids to dinner, and we drove past a Wacky Waving Inflatable Arm-flailing Tube Man that looked a lot like the one at right. When my two-year old daughter saw it, she was frightened at first. In order to convince her that the tube man was in fact not a threat, when we got out of the car my wife and I told our daughter that it was just a "silly guy", and we started hopping around with our arms out in a convincing imitation of the tube man. My daughter and my three-year old son both found this to be rather hilarious, and now they like to randomly do their own "silly guy" imitations while howling with laughter. This "silly guy" reminds me of several silly things that are currently happening in the financial markets. This month, the Investment Strategy Committee discussed these things in the context that silly things tend to happen late in a market cycle when investors are strongly in "risk-on" mode.

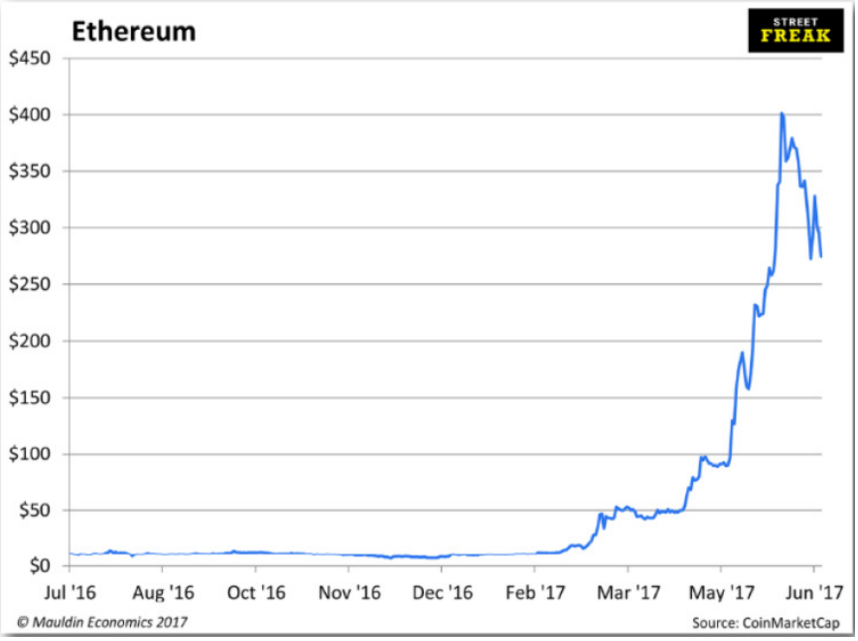


Exhibit "A" of investors' risk-on attitude is the year-to-date price appreciation of competing cryptocurrencies Bitcoin and Ethereum. For those not familiar, according to *Forbes*, a cryptocurrency is a "digital asset designed to work as a medium of exchange using cryptography to secure the transactions and to control the addition of units of the currency". In other words, these are digital currencies meant to be an alternative to our current system of fiat money backed by central banks. For something to be a medium of exchange, it should have a relatively stable value. Instead, speculators looking for return have pushed up the price of Ethereum by almost 3,600% year-to-date. The more popular Bitcoin is only up 158% so far this year. What goes up that fast typically goes down just as fast. Look at the picture at right. It looks like a classic bubble to us and an example of investors (speculators) paying little attention to the risks they are taking.

Given the still extremely low interest rate environment around the globe, another sign of investors' collective embrace of risk is the market's fervor for anything that pays a relatively high interest rate. In June, Argentina sold $2.75 billion of bonds that mature in 100 years. Keep in mind that in its 200-year history, Argentina has defaulted on its debts 8 times, most recently in 2014. All told, Argentina has spent 75 of those 200 years in default. The interest rate investors demanded to lend to this default-prone country for 100 years? A measly 8%. This is another example of investors having little regard for the risks they are taking while they are investing (gambling).

In March, SNAP Inc., the company behind the popular app Snapchat went public at $24 per share, valuing the company at nearly $30 billion. In another remarkable sign of investor complacency (not caring about investment risks), SNAP did something with their initial public offering that no other company has ever done: none of the shares it sold to the public

have any voting rights what-so-ever. Thanks to this structure, the 26 and 28 year-old co-founders of the company (the current CEO and Chief Technology Officer respectively) control 88.5% of SNAP's voting power. Effectively, this means that every major decision for the company, from appointing board members to a possible sale will be totally controlled by the co-founders. This structure ensures that the co-founders who also continue to manage the company have zero accountably to the stockholders. This is another silly example of investors hoping to make money with no regard to the risk that the management of SNAP can practically run the company anyway these please and the stockholders can't do anything about it.

Purchasing a call option gives the buyer the right but not the obligation (i.e. an option) to purchase something at a fixed price. The proper price of the option is largely a function of how volatile the option's buyer and seller collectively expect the asset to be. All else being equal, the higher the expected level of volatility, the more the buyer of the call should expect to pay (since they participate in gains but not losses) and the more the seller of the call should charge for it (since they are selling away the asset's upside gains but still participating in any losses). Based upon current option prices, you can back into the expected volatility of the asset. Since 1990, the Chicago Board Options Exchange (CBOE) has published an index known as the VIX which tracks how volatile the investors in options on the S&P 500 expect the index to be over the next 30 days. In a further sign of investor complacency, the VIX hit its 2nd lowest all-time level in July. Consider this for a second. Despite all that is going on in the world right now, broken politics in the US, North Korea launching missiles, and extremely overvalued stock market (just to name a few), investors currently have the second lowest level of volatility expectations that they have had in the last 27 years. This is another silly sign that investors have fully embraced risk.

The final silly sign the Investment Strategy Committee discussed was the continued massive inflows to passively managed funds (funds designed to simply track an index) and continued massive outflows from actively managed funds. Over the last 10 years, $1.4 trillion has been invested in passively managed mutual funds and ETFs and $1.2 trillion has left actively managed funds. Investing by simply tracking an index such as the S&P 500 has its merits such as the low fees the investor pays to do so, tax efficiency, and the fact that the investor's performance will match the index's, i.e. it won't underperform. Think about the S&P 500 though. It is constructed by weighting the 500 largest companies by their market capitalization meaning the larger a company is, the larger its index weighting. When an investor buys an S&P 500 index fund for example, they are investing the most money in the company that makes the iPhone simply because it is the largest stock in the index. This becomes a self-reinforcing cycle as more investors index to the S&P 500. They are all purchasing the same stocks in the same percentages which pushes up the value of the market index. This in turn causes more investors to simply index their portfolio too. All the while the market continues to get more overvalued. This scenario represents the opposite of buy low, sell high. Let me be clear though. I am not saying that indexing is inherently a bad thing. In fact, many client portfolios have some passive exposure. What I am saying is that as the self-reinforcing cycle continues and the market keeps getting more and more expensive, we believe that investing one's entire portfolio, or even most of it in index funds is silly and certainly complacent. How much of a portfolio should an investor be comfortable holding in assets that absolutely no one is analyzing? When the next recession comes and investors start selling stocks as they always do (except for our clients of course), we would not be surprised to see the market move downward faster than it otherwise would as index fund holders sell the same 500 stocks in the same percentages.

Taken together, these signs indicate that we are in the late stages of the bull market. Investors seem to be whole-heartedly embracing risk. While these signs are not useful as a short-term timing mechanism, they remind us that we must remain vigilant in our search for the future time to begin de-risking client portfolios.

Investment Strategy

While our interpretation of investor sentiment as detailed in the first section is worrisome, our reading of both economic fundamentals and the market's technical picture (the pattern of price movements) suggests that a cautiously optimistic outlook continues to be appropriate. In terms of economic fundamentals, we do not yet see the typical warning signs that appear ahead of an imminent recession. We are carefully observing how the Fed's interest rate

increases are affecting economic data, and we will also be interested to see what effect the Fed's future plans to shrink their balance sheet will have on both economic data and the markets.

Given that we believe a recession is still in the distance, we recommend portfolios be slightly overweight stocks versus bonds. We continue to favor asset classes with lower valuations such as companies based in emerging markets and companies that own and operate energy pipelines and storage facilities (energy infrastructure MLPs). On the bond side of portfolios, we recommend exposure to areas of the market such as preferred securities that provide an interest rate above the broad bond market and historically perform well during economic expansions.

We made no changes to our asset allocation 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 07/28/17

PEOPLEsBank WEALTH MANAGEMENT

	Unattractive	Slightly Unattractive	Neutral	Slightly Attractive	Attractive
Stocks				X	
US Large Cap			X		
US Mid Cap			X		
US 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 07/28/17. 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.