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

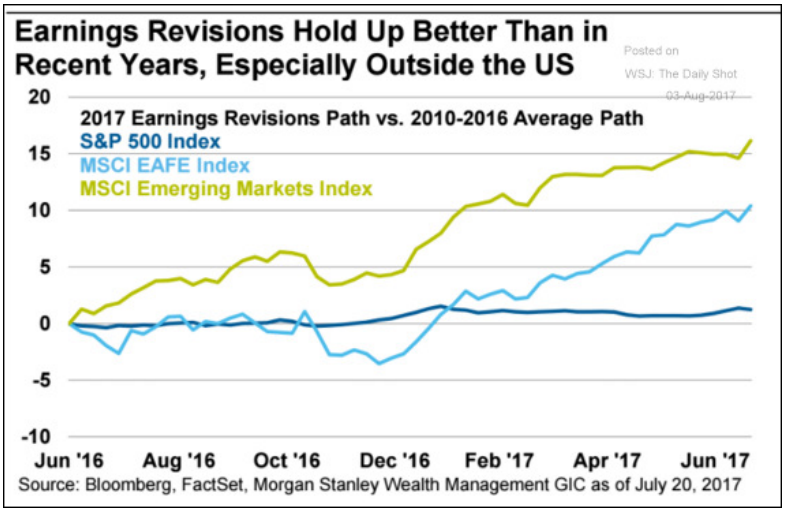
Economic Outlook

In baseball, a typical play might last eight to ten seconds. Since baseball has no time clock, plays tend to be short as a play ends when a runner safely reaches a base or becomes the next out. According to a recent ESPN article, the longest play in baseball history actually lasted two minutes and thirty two seconds. This is notable not only for its extreme length, but also because at the end of the play, absolutely nothing at all had happened. Allow me to explain.

The play took place in a 2006 Rhode Island high school state championship game. The team from Portsmouth was up to bat with runners on first base and third base. They had a two run lead in the top of the 7th inning (the last inning in high school baseball). At this point, the head coach called for a trick play called "Skunk in the Outfield". Instead of taking his lead a few feet towards second base, the runner on first base, the "skunk", sprinted into the middle of right field to take his lead. This is a legal play as the runner can take his lead anywhere. It is designed to either cause such a shock that the pitcher balks or throws the ball away, or to tempt the pitcher to go after the runner in the outfield and allow the runner on third to score easily. Unfortunately, that's where the plan for the play ends. If the pitcher does not take the bait, there is no game plan for what the runner standing in right field is supposed to do. In this case, the opposing pitcher from East Greenwich just stepped off the mound and stood there glaring at the runner in the outfield. According to the ESPN account, as the stand-off continued, the fans and players began to get agitated which eventually turned into yelling chaos. After an excruciatingly long two more minutes, the runner in right field, having nowhere to go, simply trotted back to first base and play resumed. Even though nothing actually happened with the play, it backfired as the East Greenwich team felt so insulted that Portsmouth had run a stupid trick play against them that they rallied in the bottom of the 7th to win the game. What does this story have to do with investing? It is a good reminder to always have a game plan. Whether taking a position in a single stock or making asset allocation recommendations, an investment manager needs to have an idea of how they might change their strategy given a different set of circumstances. With this thought in mind, this month the Investment Strategy Committee discussed our long standing underweight to stocks traded in developed markets outside the US and if/when the appropriate time to reduce the underweight might occur.

The Strategy Committee currently sees many positive tailwinds for international developed stocks (mostly companies in Europe and Japan). The first of these tailwinds is relatively strong economic growth in Europe. Measures of manufacturing, consumer sentiment, and retail sales are sitting at or are close to multi-year highs. To be clear, growth is not off the charts, but is now close to 2% on a year-over-year basis which is the fastest pace of growth in years.

A second positive tailwind is earnings growth. The chart at right shows the trend of Wall Street analysts' earnings revisions over the past year as compared to the average trend of the previous six years. When the lines are heading up, it means that analysts are revising their earnings estimates higher. The light blue line represents a commonly used index of companies in developed countries outside of the US. This line has been headed higher over the past several months as compared to the dark blue line which represents companies in the S&P 500. This tells us that not only do analysts expect higher earnings growth over time, but they have been increasing these estimates too. This is a positive trend.



Another positive tailwind we see for international developed stocks is valuation levels. Admittedly, valuation is not good for short-term timing, but we would rather pay less in stock price for each dollar of earnings (or sales etc.) than more. When looking at various stock markets around the globe, we find the US to contain the most expensive stocks as calculated using most of our valuation measures. In contrast, the valuation level of MSCI EAFE index, which contains over 900 stocks from 21 developed countries, is in the cheapest 30% of its history based upon 10 years of earnings. Using the same measure, US large company stocks are in the most expensive 4% of their history, and US small company stocks are in the most expensive 2% of their history.

The continued easy money policies of both the European Central Bank (ECB) and the Bank of Japan (BOJ) are another tailwind for stocks in these regions. While the Fed is in rate-raising mode and may start to shrink the number of bonds it owns, the ECB and BOJ continue to hold short-term rates negative and are still actively purchasing bonds (and stocks in the case of the BOJ). We know in the US that the Fed's policies inflated the stock market, so the policies of the ECB and BOJ should continue to help to do the same there.

The final tailwind the Strategy Committee discussed was the valuation of the dollar. As US dollar investors, we benefit when the value of the dollar falls compared to the foreign currency in which we own stocks. For example, imagine we own a company that trades on a European stock exchange. If the value of the company in Euros is unchanged, but the value of the Euro appreciates 5% versus the dollar (the dollar's value falls), then the value of the stock in dollars will rise 5%. For the last several months, the value of the dollar has fallen versus most major currencies, which has boosted the returns of foreign stocks. Most research we have read suggests that the value of the dollar is still somewhat expensive versus most major foreign currencies. Therefore, while the value of the dollar may not fall in the future as quickly as it has recently, it does not seem that we need to worry about the value of the dollar rapidly appreciating.

This is where having a game plan fits in. With all of these positive tailwinds, is now the time to recommend reducing an underweight to international developed stocks? When we looked at the recent price movements of major stock markets in Europe and Japan, we decided that this is not the correct time to make that recommendation. In general, the stock markets we looked at, including Germany and France for example, most recently peaked in late spring/early summer and are trending downward. We have no reason to believe that these markets are heading down strongly, but they currently look to be in a corrective phase. Therefore, we will continue to monitor both the tailwinds we currently observe and the markets' price action. Once we see better price action, and assuming the tailwinds we observe still exist, we expect to make the recommendation to eliminate our underweight to these markets at that time.

Investment Strategy

Twice already this year we have recommended an increase in our clients' exposure to stocks located in emerging markets. Emerging markets is a broad term, so to put some context around it, the countries that have the largest weighting in the most commonly used emerging market index are China, South Korea, Taiwan, India, Brazil, and South Africa. Emerging market stocks as an asset class have many of the same positive tailwinds that we observe for international developed stocks. In general, economic growth in these countries looks stronger than it has in years. Also, earnings estimates for these companies are increasing at a faster rate than either US stocks or international developed stocks (see the yellow line in the chart on the first page). Furthermore, using the same valuation measure we discussed earlier, the most commonly used index of emerging market stocks is in cheapest 27th percent of its history. Finally, there are more emerging market country central banks cutting interest rates than there are banks raising them. This is also a positive trend.

When the Strategy Committee examined the recent price movements for the largest emerging market country stock markets, we found a different picture than we did for international developed markets. The price movements of many emerging market country stock markets suggest that they remain in a strong uptrend. Therefore, this month the Strategy Committee recommended an increase to emerging market stocks and a decrease to US mid/small cap stocks. As mentioned previously, we find US mid/small cap stocks to be the most richly valued stock asset class that we follow. We are now close to the top end of our potential emerging market exposure, but we currently find this to be one of the

most attractive equity asset classes. This was the only change to our recommendations we made this month. 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 08/28/17

	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 08/28/17. 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.