PeoplesBank Wealth Management
Economic & Investment Strategy Outlook
November 21, 2017

Economic Outlook

A poll of 2,000 British people taken this January by Casumo.com and reported in the UK Daily Mail ranked the top 50 most boring things in life. According to the poll, the top three are being stuck in traffic, standing in line, and being on hold. I found it funny that The Kardashians were No. 14, and reality TV shows in general came in at No. 19. PowerPoint presentations were No. 38, so that's a good reminder to me to use them sparingly. Surprisingly, watching paint dry was not on the list. I imagine Fed Chair Janet Yellen would argue for its inclusion as she recently said the Fed's process of reducing the number of bonds the Fed holds will be as boring as watching paint dry. The global economy and the stock market have also been rather boring over the past month although in a good way as there has been little change in either economic conditions (decently strong around the globe) or financial markets (they keep heading slowly but relentlessly higher). Therefore this month the Investment Strategy Committee changed gears and discussed an interesting theory as to why the US market is exhibiting little volatility and why it keeps going up seemingly every day. This theory, which I am going to call the Archetype Theory, is courtesy of Rusty Guinn at asset manager Salent. Note that the theory does have investment implications that I will return to at the end.

Stock price movements are at their core a behavioral phenomenon. This is true because only the marginal buyer and seller actually participates in the price setting process and something must induce them to buy or sell. The Archetype Theory says that investors tend to form blocs adhering to the same general archetype, or the same general framework for thinking and talking about investments that color their behavior. The idea is that in order to understand the market, it is important to consider what archetype(s) is most dominate at any given time in the price setting process and what implication this has for future stock price movements in general. The most easily understood archetype is the value archetype. These are very price-conscious investors who like to buy stocks that are out of favor or forgotten and are cheap. They are not the sellers of a stock when it trades from 30 times earnings to 40 times earnings because they sold long ago.

Another important archetype is the growth archetype. These are investors who buy stocks with a narrative of growth. These investors generally do not care much about price as long as the company's growth is intact. As a side note, many growth investors must choose this posture as they have future liabilities to meet - think pension funds.

A third archetype is the momentum archetype. These investors buy what has been going up or sell what has been going down simply because the investment has been trending that way. This is not necessarily a bad strategy as winners tend to keep winning and losers tend to keep losing. Momentum investors support the market's current trend in either direction and they are generally not concerned with price.

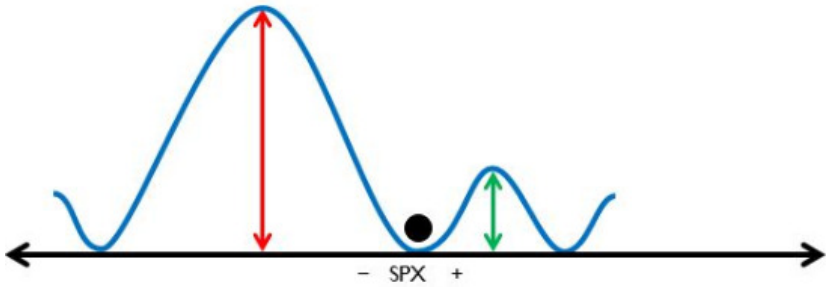
The fourth and last archetype relevant to this discussion is the mean-reversion archetype. These investors tend to be consciously contrarian asset allocations. These investors are looking to call market tops and bottoms. They do this by selling winners and buying losers, which is opposite of the momentum strategy.

There is another large group of investors that exists that does not participate in the price setting process at all. It's the passive investor. This group is becoming ever larger (I've seen figures as large as 30% of the US market), and it expresses no opinion on the price of individual securities at all.

So what is happening now? It is the author of the theory's opinion (and the Investment Strategy Committee generally agrees) that in terms of the investors actually participating in the price setting process, the value archetype investor is long gone. The market is too expensive for these investors. The mean reversion archetype investor is also stepping away from the market. The market is exhibiting strong momentum and selling winners and buying losers has been very

unprofitable recently. This leaves us with growth and momentum archetype investors dominating the market with passive investors along for the ride. Therefore, in general there are few investors left to sell because there is no one left in the price setting process who cares nearly enough about valuations or has confidence in their ability to time a market top. The result is a levitating market and one that has a great deal of difficulty generating any price action to the negative.

A good way to visualize the current situation is the graphic at right. It is called an information surface. The horizontal line represents the S&P 500 with the black ball representing its current price. The blue line represents new information for investors to consider. The graphic shows that with few motivated sellers left in the market, there is a very high negative news hurdle to climb (the red line) before the price goes down, but a very low positive news hurdle (green line) for the price to go up. As there has yet to be a negative news catalyst large enough to overcome that hurdle, the market keeps going up.



Source: Salient 2017

As mentioned on the first page, there is an investment implication to this theory. To us, the implication of the preceding thought exercise is that as a committee, we need to have strong convictions but hold them weakly. This means that despite the market's amazingly low level of volatility, our reading of the evidence says we see little sign of an imminent long-term market top or a recession. Therefore, our conviction is to recommend an overweight to stocks versus bonds. This also means that given an expensive US stock market and an already long economic cycle, we must not be wedded to this overweight (hold our views weakly). We will remain vigilant and change our views as the weight of the evidence suggests that we should.

Investment Strategy

We continue to hold a cautiously optimistic viewpoint as we have for the past several months. The typical signs we look for to indicate that a recession and a long-term market top are on the horizon, such as upside-down interest rates, accelerating wage growth and a volatile stock market are currently absent. Therefore, as mentioned in the first section, we continue to favor stocks over bonds. In terms of equity asset classes, broad emerging markets continue to be our favorite given its lower valuation level and relatively faster earnings growth.

On the bond side of portfolios, we feel it is most likely that longer-term interest rates either tread water, or head slightly higher. Combined with our view that a recession over the next several months is unlikely, we prefer areas of the bond market with offer above-market yields and slightly less interest rate sensitivity, such as preferred securities and corporate bonds.

We made no changes to our asset allocation recommendations this month. Please see our overall asset allocation recommendations on the next page.

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

PeoplesBank Wealth Management
Relative Asset Class Recommendations

As of 11/21/17

	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 11/21/17. 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.