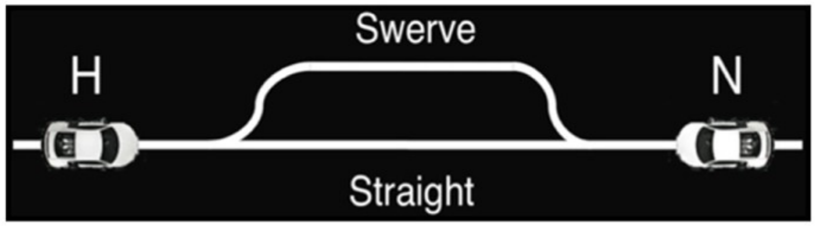
PeoplesBank Wealth Management
Economic & Investment Strategy Outlook
May 14, 2019

Economic Outlook



A game of chicken is a game theory model of conflict. The best known example is a game in which two drivers race towards each other at a high rate of speed. In order to avoid a crash in which both drivers are likely to die, one must swerve out of the way. The first driver to swerve is termed the "chicken", i.e. a coward and loses the game. Game theory has developed several strategies for winning a game of chicken such as signaling your intentions quite convincingly before the game begins. For example, this can be done by disabling your steering wheel in advance of the game so that it is impossible to swerve. The trick to this strategy is that your opponent must know before the game begins that it is impossible for you to move out of the way. From an observer's standpoint though, the problem with a game of chicken is that it is impossible to predict the outcome of the game before it begins. This is because there are two equally likely outcomes. The first outcome is that both drivers will swerve because they both know that the possible results of a crash (death or severe injury) are so much more severe than the results of being branded the chicken. The second and equally likely outcome is a crash. Each driver knows it's in the other driver's best interest to swerve, so each driver assumes the other driver will be rational and swerve, and neither does.

Now that the trade negotiations between the US and China have broken down and new tariffs have been implemented on both sides, the US/China trade war has essentially become a game of chicken. While the final outcome is unknowable, investors can observe the trade war situation, the economy, and the financial markets and adapt their strategy as necessary as events evolve. This month, the Investment Strategy Committee reviewed the economy and the financial markets as the trade war rhetoric began to heat up.

At the beginning of May, trade negotiations between the US and China broke down somewhat unexpectedly. President Trump, in retaliation for what he described as China trying to change the terms of the deal at the last minute, increased tariffs on $200 billion of Chinese imports from 10% to 25%. China then announced that they will levee 25% tariffs on $60 billion of US imports effective June 1st. The question for investors is where do we head from here? The next likely major event in the trade war saga is the potential for a personal meeting between President Trump and Chinese President Xi at the end of June at the G20 Summit in Japan. Outside of the G20 Summit, we will be observing the extent to which both sides do or do not raise their respective levels of hostility. For example, political actions around the disputed South China Sea, threats from China that it will float its currency, or a US political narrative that China is an existential threat will be signs that any deal is increasingly unlikely.

While it is important to acknowledge that the further escalation of the trade war could be harmful for global growth, we think it is also important to consider the health of the economy and the outlook for risk taking in the financial markets. Overall, we believe that the US economy remains in decent health. The leading recession indicators we follow improved in April as weekly unemployment claims hit a new cycle low, and the Leading Economic Indicators Index hit a new all-time high. Also, both consumer and business confidence have improved in each of the last few months, although confidence remains below levels seen last fall. We think decreased confidence is where the trade war troubles will appear in the economy first, and we will continue to monitor these surveys closely. Another positive sign for the economy is that lending conditions to both households and businesses remain quite favorable. Ahead of a recession as the economy begins to deteriorate, lenders typically tighten their lending standards, which makes it difficult for businesses and households to borrow.

The financial markets are also suggesting that the outlook for US economic growth remains relatively healthy. Risk aversion in the bond market, which has historically risen sharply ahead of recessions, is higher than it was last summer, but nowhere near the levels seen in 2011 or 2015/2016 when it looked possible that the US economy might fall into recession. Also, the US Treasury market, while acting unusually, does not seem to be suggesting that it is worried about an imminent US recession. We describe the yield curve as kinked. This means that interest rates for short-term government bonds are higher than rates for intermediate-term bonds, but the longest term bond, 30 years, still maintains the highest interest rate. Our reading of this unusual shape is that the treasury market expects the Fed to cut the short-term rate that it controls sometime this year. If the Treasury market was concerned about a recession, we would expect the yield curve to be fully inverted with short-term rates higher than the 30-year rate.

Overall, there is no doubt that the further escalation of the trade war is a risk to US and global economic growth. While the final outcome of this game of chicken is unknowable, we will be observing the rhetoric used by both sides for clues. At the time of this writing though, we think the data from both the US economy and the financial markets suggest that the US economy looks likely to expand for the foreseeable future. We will continue to search for signs that the outlook for growth has deteriorated, and if we observe those signs, we will change our recommendations accordingly.

Investment Strategy

US stocks have outperformed international stocks for the past several years. In fact, it has been an unusually long time of US outperformance. There are two major reasons for this. First, according to research from Blackrock, companies in the US as a whole have been increasingly more profitable than companies outside the US since 2010. Secondly, US companies as a whole have been consistently more profitable than non-US companies. According to Blackrock's research, there has not been one single month since the 2010 where US corporate profitability as a whole has been below that of the rest of the world's profitability. Our asset allocation recommendations reflect this situation as we continue to expect US stocks to outperform non-US stocks.

Given that we expect the US economy to continue to expand for the foreseeable future, in bond portfolios we recommend exposure to preferred securities and short-term high yield bonds. These areas of the bond market tend to outperform during 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 5/14/19

	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 5/14/19. 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.

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