PeoplesBank Wealth Management
Economic & Investment Strategy Outlook
August 13, 2019

Economic Outlook

A chain reaction is a series of events related to each other in that the previous action initiates the next action in a self-reinforcing feedback loop. Falling dominos is an example of a physical chain reaction. If the dominos are aligned properly, only the first domino needs fall to bring down all the other dominos. Chain reactions are also behind nuclear fission, which is the nuclear process that is used in nuclear power plants. Three important financial/political events occurred in a chain reaction over the last month. First, on July 31st, the Fed lowered its benchmark interest rate by 0.25%. The next day, President Trump, unhappy with both the progress of the China trade talks and with the small size of the Fed's rate cut, announced new tariffs on Chinese imports. A few days after that, China slightly devalued their currency in a tit-for-tat escalation of the trade war. This month, the Investment Strategy Committee discussed the details of the chain reaction itself and the potential effects of this chain reaction on the economy and the financial markets.

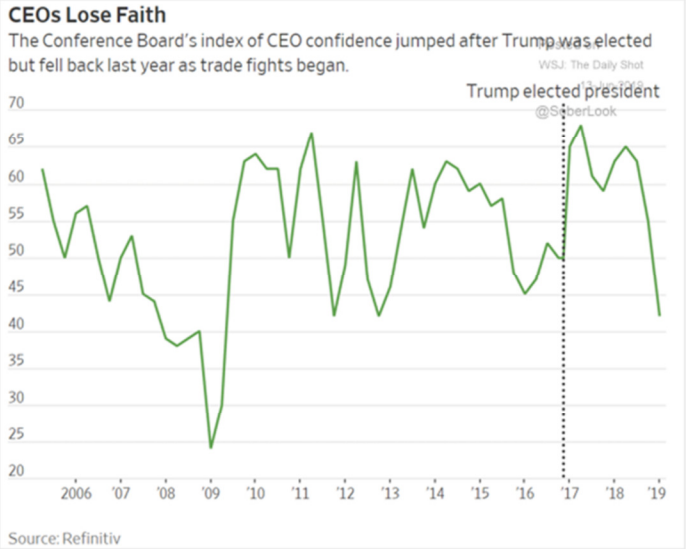
The first reaction in the chain was started by the Federal Reserve. As was widely expected, the Fed lowered the federal funds rate by 0.25% at the conclusion of its July rate-setting meeting. In the statement released after the meeting, the Fed cited "the implications of global developments on the economic outlook and muted inflation expectations" as the reason for the rate reduction. When asked to clarify during the press conference that followed the meeting, Fed Chairman Powell explained that "global developments" meant uncertainty caused by the trade war with China. Chair Powell also went to great lengths to explain that the Fed did not intend this rate cut to be the first in a long series of cuts, but rather a one-off reduction with future rate moves to be determined by economic data.

The second stage of the chain reaction occurred the following day. Prior to the Fed's July meeting, President Trump had been quite vocal about his opinion that the Fed should start with a large rate cut in July and even restart its bond buying program to stimulate the economy. Also, according to various news reports, the President was frustrated that the trade talks with China had ground to a halt. Presumably due to his unhappiness with both the Fed and China, President Trump announced new tariffs on Chinese imports the day after the Fed meeting. This new round of tariffs will involve a 10% tariff on the $300 billion of Chinese imports not already subject to a tariff, and it is set to be implemented September 1st. Several days later, the President did say he will delay tariffs on some consumer goods until December 15th so as not to hurt the Christmas shopping season.

The third and final part of the chain reaction happened two days after President Trump's tariff announcement. For the past few years, China has been intervening in the currency markets in order to keep its currency from depreciating beyond 7 yuan/dollar. The blue line in the chart at right shows the value of the yuan versus the dollar. Notice that when the exchange rate got close to 7 yuan/dollar, in both 2016 and 2018, China intervened to strengthen it. While there is nothing intrinsically important about the number 7, it has become psychologically important to markets. On margin, China would like to have a stronger currency versus the dollar, as a strong currency helps to attract investment into the country. China does have the ability to use its currency as a weapon in the trade war though by devaluing it to

offset the impact of US tariffs. By allowing its currency to devalue slightly and fall below 7, the markets took this as a sign that China was warning the US that it was not afraid to use this weapon if the need arose.

Overall, the financial markets did not appreciate the chain reaction and the tit-for-tat escalation of the trade war. The US stock market quickly lost 5% from its July all-time high and interest rates around the globe fell to new lows as investors became more risk averse and purchased bonds. For example, at the time of this writing, the entire German government bond yield curve carries a negative interest rate, including its 30-year bond. The yield on the US 30-year Treasury bond briefly fell below 2% for the first time in history, and the amount of bonds around the globe with negative yields rose towards $16 trillion. Also, the US bond market is now pricing in three more Fed interest rate cuts over the next twelve months, presumably in a belief that further rate cuts will be needed to help spur the US economy as it continues to face the trade war.



Turning to the global economy, this tit-for-tat escalation comes at a time of slowing global economic growth. Around the world, including in the US, growth is being pulled down due to slowing global trade and a global manufacturing recession. Looking at the US specifically, we expect the US economy to continue to grow for the foreseeable future, despite the manufacturing slowdown. In aggregate, the economic, credit market and financial conditions indicators we follow suggest that a recession is unlikely to begin over the next several months. That being said, we are becoming increasingly concerned about the uncertainty caused by the escalating trade war. For example, on US corporate earnings calls, references to "political uncertainty" are at an all-time high. Also, see the chart at right. It depicts results of the Conference Board Index of CEO confidence. This is a quarterly survey of 100 large-company CEOs. By this measure, CEO confidence reached its weakest point in the last 7 years. When CEOs lose confidence, they cut back on spending and hiring.

Overall, we remain positive on US economic growth. The biggest recession risk we see though is the continued escalation of the trade war, and the uncertainty it causes. Also, we don't expect global economic growth to reverse course and accelerate until some resolution to the trade conflict is found. We will continue to monitor the overall message told by the economy, credit markets and financial conditions and adjust our investment recommendations accordingly.

Investment Strategy

Given that we see no end in sight to the US/China trade war and therefore little reason for economic growth outside the US to accelerate, we decided to reduce our recommended equity overweight by 2% this month. Specifically, we are recommending a reduction in exposure to emerging market stocks. With global growth and trade slowing, analysts' estimates of emerging market corporate earnings growth are being revised down and growth prospects appear weak. Also, given that the US has one of the only bond markets that offer positive interest rates after accounting for inflation, the dollar has been strengthening versus most emerging market currencies over the past several months. This is also a headwind to emerging market stock outperformance.

With the proceeds from the emerging markets reduction, the Strategy Committee increased its recommended exposure to US REITs (companies that own and operate real estate) and investment grade bonds. As noted last month when we added REIT exposure, REITs tend to outperform when interest rates fall or remain flat. Given that the bond market is pricing in three rate cuts over the next year, the President's vocal desire for lower rates, and a near-term resolution to

the trade war unlikely, we expect no chance that short-term interest rates rise prior to the next Presidential election. Finally, we increased our recommended exposure to US investment grade bonds in order to slightly reduce risk in client portfolios. Overall though, we continue to recommend a stock versus bond overweight. Please see our overall recommendations below.

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

PeoplesBank Wealth Management
Relative Asset Class Recommendations

As of 8/13/19

	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 8/13/19. 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.