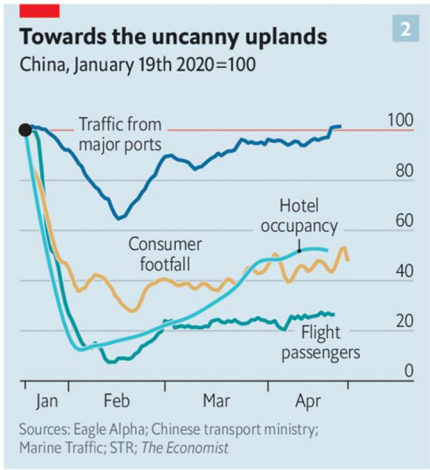
PeoplesBank
WEALTH MANAGEMENT

Economic & Investment Strategy Outlook
May 11th, 2020

Economic Outlook

One of my favorite shows is the American version of *The Office.* Actor Steve Carrell plays the bumbling but well-meaning regional manager Michael Scott, and Rainn Wilson plays the "assistant to the regional manager", Dwight Schrute. In one episode that I find particularly hilarious, Michael and Dwight are driving back to the office in a rental car, and the car's GPS tells them to take a wrong turn. Michael blindly follows the GPS directions and the turn ends up sending them off the map and directly into Lake Scranton. Many investors these days probably feel like they have been led off the map. The recession we are entering, caused by the economic shutdowns enacted to slow the spread of COVID-19, is without modern historical precedent. For reference, a recession is typically defined as two quarters of negative GDP growth. Given that this is the first modern recession led by falling consumer spending, there is no historical roadmap to guide investors for what to expect in the months ahead. Also, despite the fact that we know the economy has entered a recession, the US stock market has rallied sharply off the late-March lows. Therefore, this month, the Investment Strategy Committee decided to investigate the assumptions that we believe are driving the strong market rally and what has to go right in order for the stock market rally to keep going higher.

The first two assumptions we believe that the market is making are that "the economy will recover quickly!" and "the restart will be great!". These are inter-related so let us examine them together. For context, the recession that occurred as a result of the Great Financial Crisis in 2008 saw GDP drop by 4% from peak to trough. In other words, at its worst in 2008, the economy lost 4% of its economic output and retained 96%. The current Wall Street consensus calls for the economy to lose 10% of its output at its trough in the second quarter, but by the end of the year only be down 4%. Therefore, to have a recession no worse than the 2008 recession, GDP needs to snap back very quickly by the end of the year. "The restart will be great!" assumption means that consumers will rush back into stores and start spending as soon as they can and economic activity will return fairly quickly. How likely is this? Well, China might hold a clue. If any country should recover quickly, it should be China. China began to reopen their economy six weeks ago, and the government is forcing people back to work by bussing them. The chart at right shows several different measures of the Chinese economy, and the consumer-related economic data on the chart shows that the economy is far from normal. In fact, the Chinese economy seems to be running at about 90% of its pre-virus peak and has flat-lined for the past few weeks.



The Economist

The third assumption that we believe is driving the US stock market rally is that the various government programs enacted in the wake of COVID-19 will provide the economy with a bridge over the economic chasm we will face in the next few quarters. As of the time of this writing, the government has launched support programs of over $3 trillion or almost 12% of our country's total GDP. Two of the most important measures are the Paycheck Protection Program (PPP) loans and the addition of $600 per week of unemployment benefits until July 31st. Will these programs be a sturdy enough bridge to allow the economy to snap back quickly? Time will tell, but the Strategy Committee made two observations about these programs that suggest that they might not be as supportive as intended. In regards to the first round of PPP loans, states with a larger proportion of small businesses shutdown in general got a smaller number of loans approved in that state. This means that the funds might not be going where they are needed the most. In regards to the enhanced unemployment benefits, while essential to the unemployed individuals collecting the enhanced benefits, the program could cause unintended consequences that the government will eventually

have to figure out how to unwind. To explain, the average weekly unemployment benefit provided by the states is just under $400. Combine that with the $600 weekly Federal enhancement, and the average person collecting unemployment benefits is now collecting $1,000 per week. That equates to a $25 per hour wage. Will businesses be able to re-hire employees who make less than that? From a political standpoint, will the government be able to eventually end this program? These answers are unknowable but seem to present a challenge to rapidly returning employees back to work as the PPP loans are intended to do.

The fourth assumption that we believe is driving the stock market rally is that the Fed faced the worst of the market's liquidity problems in March, and it conquered those problems. When the economic shutdowns first began in March, the credit markets froze as risk-aversion in the bond and money markets skyrocketed. This was a classic liquidity crisis, where market participants were afraid to lend to each other, even very short-term. In other words, because of the heightened level of risk aversion, businesses that were financially sound were unable to borrow. By the end of March, the Federal Reserve said that they would financially support the functioning of these markets. This caused risk-aversion to drop, and businesses were able to borrow again. The Committee observed that the Fed was effective in fighting this liquidity crisis, and if the economy bounces back in the next few quarters, we might have seen the worst of the issues that the Fed has to combat. If the economy does not bounce back that quickly though, the Fed might be called upon again to support the markets. The question for investors to consider is: will the Fed always be successful in quickly stomping out risk-aversion?

The final assumption that we believe is driving the stock market rally is that corporate earnings will decline modestly in the next few quarters and rebound strongly in 2021. At the time of this writing, the Wall Street consensus is for S&P 500 earnings in 2020 to fall 16% from their 2019 level before rebounding to a new all-time high in 2021. Is 16% a reasonable level of decline? History tells us that on average, earnings fall 16% during a recession. Will this be an "average" recession? If earnings only fall 16%, then at its current level, the market was last priced this expensively during the tech bubble. If earnings decline less than 16% though, the market looks less expensive.

Will all of the market's assumptions turn out to be correct? While it is certainly possible, it seems unlikely to the Strategy Committee. We will continue to observe and debate the situation and change our investment recommendations as necessary.

Investment Strategy

To the Strategy Committee, it looks like the stock market rally is based on the idea that all of the assumptions discussed in the first section are correct. In other words, we believe that the market is currently priced for perfection, and the US market rally leaves little room for something to go wrong. Therefore, for the first time in the eight years that I have led the Strategy Committee, we recommend an underweight to stocks. Specifically, the Committee reduced its recommended stock exposure by 5%, from neutral to 5% underweight, and added 5% to short-term bonds. Prior to this month, we were neutral on stock exposure, underweight bonds, and overweight cash. After the change this month, we recommend client portfolios be underweight stocks, slightly underweight bonds, and overweight cash.

We continue to believe that the best equity opportunities are in the US, and prior to this month, our recommendations were strongly overweight US equities versus foreign equities. Given the recent strong market rally in US large cap stocks though, we reduced our recommended US large cap exposure by 5% in order to sell into the strong rally.

Please see our overall recommendations on the next page.

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

PeoplesBank Wealth Management
Relative Asset Class Recommendations
As of 05/11/20

PeoplesBank
WEALTH MANAGEMENT

	Unattractive	Slightly Unattractive	Neutral	Slightly Attractive	Attractive
Stocks		X			
US Large Cap				X	
US Mid/Small Cap				X	
International Developed		X			
Emerging Markets	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 05/11/20. 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 ten 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.