PeoplesBank
WEALTH MANAGEMENT

Economic & Market Perspectives

Winter 2021

"Winter is the season of recovery and preparation" – Paul Theroux

The United States and other countries continue to make progress in their recovery from the economic and financial impact of the coronavirus (COVID-19) and its variants. Nevertheless, there are some key challenges that lie ahead including the fast-spreading omicron variant, slower economic growth, higher inflation, labor shortages, and shifting fiscal and monetary policy.

As we prepare for the year ahead, we will review where we are in terms of the economy, financial markets, and how we are positioned vis-à-vis investment strategy.

The Economy

COVID-19 cases are surging, driven by the Delta variant and spread of Omicron. The Omicron variant is fast-spreading and now accounts for more than half of the COVID-19 cases in the U.S., according to the Centers for Disease Control and Prevention. There is concern the new variant could prolong supply-chain disruptions and keep inflation elevated. However, high vaccination rates, signs the Omicron variant may be less severe, and recent Food and Drug Administration approval of the potentially game-changing antiviral COVID-19 pills developed by Pfizer and Merck may mean that the economy will avoid the shutdowns and restrictions we experienced at the front-end of the pandemic.

The pace of economic growth is slowing. IHS Markit recently reported that flash Purchasing Manager Index surveys for December signaled a slowdown in growth in all four of the world's largest developed economies -- the United States, Eurozone, Japan and United Kingdom – as Western economies experience a renewal of COVID-19 case growth.

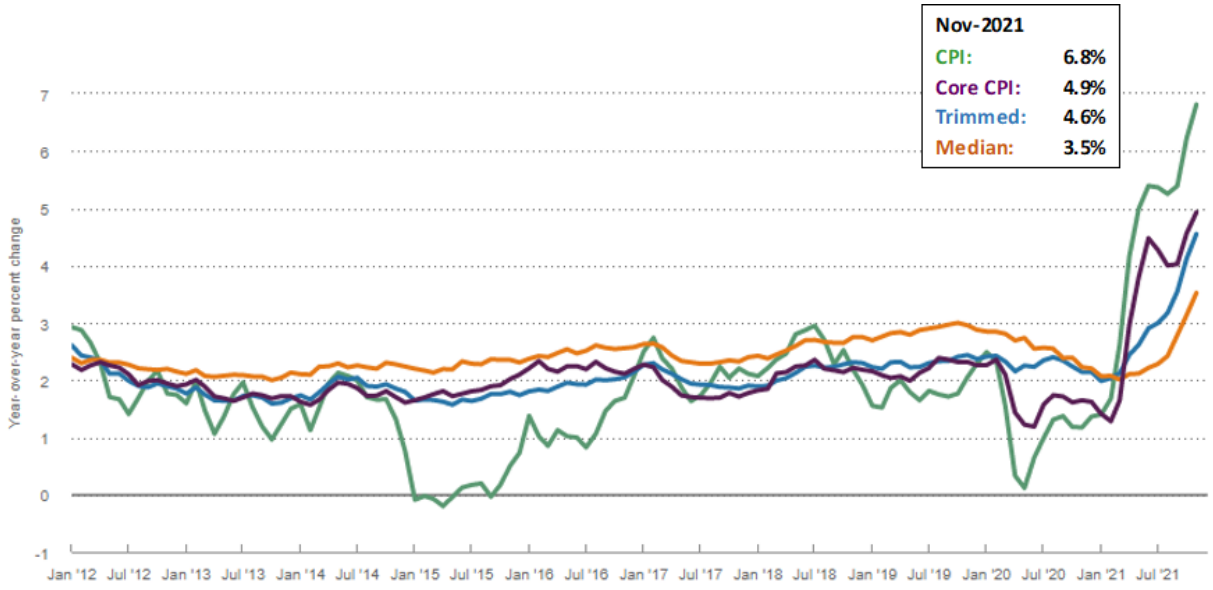
Economic growth in the U.S. slowed to an annual rate of 2.3% in the July-September quarter, down from a 6.5% rate for the first half of 2021. Supply-chain bottlenecks and the Delta-variant constrained growth in the third quarter, but a significant rebound is expected in the October-December quarter. The Atlanta Fed's latest (December 23rd) estimate for real Gross Domestic Product (GDP) growth in Q4 2021 is 7.2 percent. And the U.S. Leading Economic Indicators index jumped in November, signaling growth momentum will continue into next year.

Even with the fast-spreading Omicron variant, supply-chain induced shortages, and higher prices, consumers have remained resilient. Consumer spending, which accounts for more than two-thirds of U.S. economic activity, or GDP, rose in November. U.S. retail sales -- a good proxy for consumer spending – are up 18% from a year ago. And holiday sales rose 8.5% from a year earlier, which is the fastest pace in 17 years, based on spending data reported by MasterCard.

U.S. consumer confidence improved in December after sinking to a 9-month low in the prior month on inflation and COVID-19 worries, and the University of Michigan's gauge of consumer sentiment, despite also rebounding in December, is still hovering near 10-year lows.

The low consumer sentiment numbers are due primarily to rapidly escalating inflation. Inflation accelerated again in November, driving the rate of U.S. inflation to 6.8%, close to a 40-year high. Even after adjusting for its more volatile components, inflation is still running well above trend -- see Chart #1 below.

Chart #1 – Median Consumer Price Index (CPI)



Source: Bureau of Labor Statistics; the Federal Reserve Bank of Cleveland; Haver Analytics.

Consumer expectations for near-term (1-year) inflation are at 4.9%, the highest level since the summer of 2008. While consumers still expect inflation to revert to a much lower level over the next five years, that anchor has begun to weaken: long-term inflation expectations are holding at 3%, above the pre-pandemic level of 2.3%, according to the University of Michigan Surveys of Consumers.

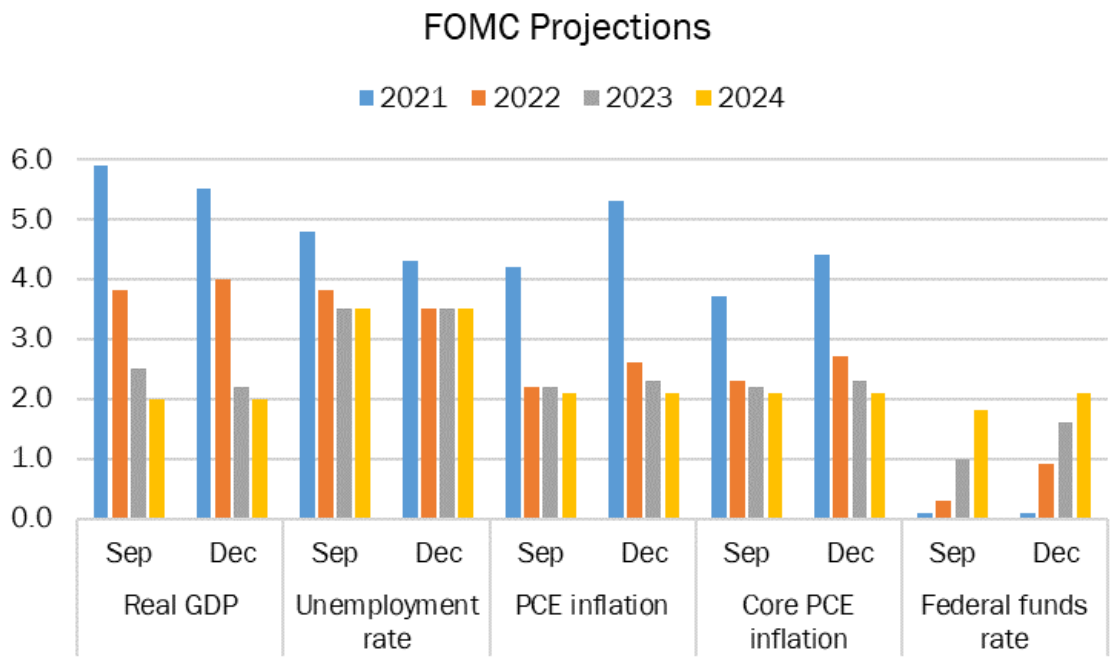
The recovery in the labor market is showing signs of slowing as businesses report difficulty filling open positions. The U.S. added only 210,000 jobs in November, which marked the worst headline jobs increase number of 2021. Job openings rose to 11 million in November, just short of a record 11.1 million in July. There are some 3.9 million fewer people working than in February 2020 – the reasons for the shortfall include early retirement, fear of COVID-19, and child care needs. Reflective of a tight labor market, layoffs are near a 50-year low and wages have increased 4.8% in the past year.

Fiscal stimulus appears to be fading. President Joe Biden signed a $1 trillion infrastructure bill into law in November, but Senator Joe Manchin, Democrat from West Virginia, recently rejected Biden's $2 trillion spending plan, known as the Build Back Better Act. Goldman Sachs economists noted that the failure of the bill — which includes significant spending on climate infrastructure and social programs -- will act as a fiscal drag on U.S. growth in 2022. Goldman trimmed its real GDP outlook and now projects 2% growth in the first quarter, followed by 3% and 2.75% in the following two periods. Goldman

previously expected growth of 3%, 3.5% and 3%.

We are seeing a shift in monetary policy as the Federal Reserve acknowledges higher inflation may persist longer than anticipated. At its December meeting, the Fed signaled it would double the pace of tapering and end its bond-buying stimulus program by March instead of June, and the Fed is forecasting as many as three rate hikes in 2022. Fed Chair Jerome Powell indicated the economy has made enough progress to justify removing stimulus that the central bank put in place early in the pandemic to avert economic disaster. The Fed also updated its economic projections at the December meeting, lowering its GDP projection for this year and raising inflation expectations for 2021, 2022 and 2023. -- See Chart #2 below.

Chart #2 – Summary of Economic Projections



Source: Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, under their individual assumptions of projected appropriate monetary policy, December 2021. FOMC = Federal Open Market Committee

Financial Markets

The S&P 500 beat both the Dow and Nasdaq in 2021 by the widest margin in 24 years – it is only the sixth time that the S&P 500 has outperformed the Dow and the Nasdaq in a year, with the previous occurrences in 1984, 1989, 1997, 2004 and 2005, according to MarketWatch.

For the year, the S&P 500 surged 26.9%, while the Dow Jones Industrial Average climbed 18.7% and the tech-heavy Nasdaq Composite jumped 21.4%. The economically-sensitive Russell 2000 index advanced 13.7%. The MSCI All Country World Index ex-U.S., which covers approximately 85% of the global equity opportunity set outside the U. S., gained 5.5%, while the MSCI Emerging Markets Index dropped 4.6%.

Equity market performance, especially in the U.S., was spurred by vaccine roll-outs, loosening of COVID-19 restrictions, favorable fiscal and monetary policy, pent-up consumer demand, and strong earnings growth. Emerging market equity performance was pulled down by China and Brazil.

In bond markets, the yield on the benchmark 10-year U.S. Treasury note closed at 1.55% on December 29, up from 1.52% at the beginning of the quarter. Yields are below their 2021 closing high of 1.75%, posted in late March, but are above their low of 0.93% at the start of year.

In commodity markets, Crude Oil surged 55.1% in 2021, propelled by the global recovery. Gold was down 3.5% for the year, as investors flocked toward riskier assets.

The U.S. Dollar Index rose 6.3% in 2021, driven by strong U.S. economic growth.

For top- and bottom-performing selected stock indexes and bond ETFs, see Chart #3 below.

Chart #3 – Top- and Bottom-Performing Selected Stock Indexes and Bond ETFs

Top-Performing Stock Indexes/Bond ETFs	Current Quarter	Year To Date	Bottom-Performing Stock Indexes/Bond ETFs	Current Quarter	Year To Date
DJ Transportation Average	17.7	31.8	Bovespa Index (Brazil)	-5.5	-11.9
S&P 500 Real Estate	16.8	42.5	Hang Seng (Hong Kong)	-4.8	-14.1
S&P 500 Technology	16.5	33.4	IPSA (Chile)	-3.3	-1.8
DJ Select REIT Index	16.4	41.6	International Bonds	-3.2	-5.8
S&P 500 Materials	14.7	25.0	Kospi (South Korea)	-3.0	3.6
S&P 500 Cons. Discretionary	12.7	23.7	Nikkei Stock Average (Japan)	-2.2	4.9
S&P 500 Consumer Staples	12.6	15.6	Bloomberg Commodity Index	-1.6	27.1
Dow Jones Utility Average	12.1	13.4	S&P BSE Sensex (India)	-1.5	22.0
S&P 500 Utilities	12.1	14.0	IBEX 35 (Spain)	-0.9	7.9
NASDAQ 100	11.1	26.6	Emerging-Markets Bonds	-0.9	-5.9

Source: The Wall Street Journal; FactSet. Performance reflects price change (except Bovespa, which reflects total return). Bond categories are represented by the following ETFs: Vanguard Total International; Emerging Market Bonds. Data as December 31, 2021

Investment Strategy

Despite concerns about COVID-19, supply chain disruptions, labor shortages, and inflation, we remain positive on equities as we believe consumers and businesses will continue to adjust and adapt in 2022.

The U.S. and global economies are expected to continue growing in 2022, albeit at a slower pace than we experienced in 2021. Healthy consumer balance sheets should support continued spending, which is a significant driver of GDP.

The outlook for corporate profits is solid. Analysts are projecting earnings growth of 6% for Q1 2022, 4% for Q2 2022, and 9% for CY 2022. And analysts expect record high profit margins (> 12%) for 2021 and 2022, according to FactSet.

With the run up in stocks since March 2020, U.S. stock valuations are high. The forward 12-month price/earnings (P/E) ratio for the S&P 500 is 21, which is significantly above the 10-year average of just under 17, according to FactSet.

International stocks continue to look attractive on a relative valuation basis. The MSCI ACWI ex-U.S. price-to-earnings discount versus the S&P 500 has been running around -33%, which is well above its historical average of just over -13%. And Large Cap Value vs. Growth relative valuations indicate that value is cheap and growth is expensive, according to J.P. Morgan Asset Management.

As we begin the new year, we are maintaining our pro-risk stance across all of our total return investment strategies. Overall, we favor stocks over bonds and have a tactical allocation to inflation hedges (real estate and commodities).

Chart #4 – PeoplesBank Wealth Management (PBWM) – Asset Allocation *

	Asset Class	Strategic (%)	Over/Underweight (%)	Tactical (%)
Equities	U.S. Stocks	32	7	39
	International Developed Stocks	22	-3	19
	Emerging Market Stocks	6	-2	4
Fixed Income	Core Bonds	38	-10	28
	Non-Core Bonds	0	4	4
	Cash Equivalents	2	-1	1
Inflation Hedges	Real Estate-related securities	0	3	3
	Commodity-related securities	0	2	2

* PBWM's strategic and tactical asset allocation for its moderate growth ("60/40") total return strategy as of January 2022.

Sustained economic and earnings growth underpin our overweight to stocks. We favor U.S. stocks, especially economically sensitive small cap stocks, and we are equal-weight large cap (LC) growth and value, even though LC value stocks remain relatively attractive (versus growth).

International stocks have favorable valuation discounts versus U.S. stocks and are positioned well for a cyclical recovery, but we remain underweight international stocks given our current bias toward the U.S. We are also underweight emerging market (EM) stocks as the growth outlook for EM economies is lower than for developed economies. And we have concerns about the impact of China's slowing economic growth and regulatory crackdown.

We are underweight fixed Income as rising inflation expectations and a potential back-up in yields limit the attractiveness of core bonds. We are underweight duration and have tactical positions in floating rate bonds, preferred securities, and short-term high-yield bonds which add yield, while somewhat mitigating interest rate risk. And we are underweight Cash as higher inflation makes cash returns unattractive.

We have a tactical allocation to Inflation Hedges. Real estate investment trusts (REITs) are benefitting from reaccelerating demand and low interest rates. And the post-pandemic recovery, potentially

weaker dollar, and rising inflation support our allocation to commodities.

For more information on our asset allocation positioning, see Chart #4 above.

The Investment Strategy Team

Notes on Investment Process

PeoplesBank Wealth Management's (PBWM's) asset allocation process develops both long-term (strategic) and shorter-term (tactical) recommendations. Strategic recommendations are based on how the Wealth Management Investment Strategy Committee (ISC) believes investment portfolios should be positioned in a generally neutral market environment over the next ten years. Tactical recommendations are based on where the ISC sees either increased opportunity or risk over the next one to two years.

The ISC is responsible for developing both the strategic (long-term) and tactical (short-term) asset allocations for Wealth Management's investment management and trust relationships. The ISC is comprised of the senior members of the Wealth Management team. The ISC is also responsible for monitoring and updating strategies, managers, and funds within client portfolios. The ISC meets monthly. If you have any questions or would like additional information regarding PBWM's investment process, please call or send an email to your relationship or investment officer.

Sources: FactSet, IHS Markit, J.P. Morgan Asset Management, MarketWatch, the Federal Reserve, Federal Reserve Bank of Cleveland, Federal Reserve Bank of St. Louis, and The Wall Street Journal.