PeoplesBank
WEALTH MANAGEMENT

Quarterly Economic & Market Perspectives

January 2024

"I personally don't see any good reason to think that the last mile is going to be especially difficult"

– U.S. Treasury Secretary Janet Yellen

Whether talking about e-commerce delivery logistics or running a marathon, the last mile is often considered the most difficult. In fact, Amazon has a well-defined strategy around reducing costs and other issues associated with improving the last mile delivery.

Many economists believe that the last mile of getting inflation down from its current level to the Federal Reserve's ("Fed's") target will be the hardest, according to The Wall Street Journal ("WSJ"). In an interview at the WSJ CEO council summit in December, U.S. Treasury Secretary Janet Yellen said that she sees no reason, given the path we are on, why inflation should not gradually decline to levels that are consistent with the Fed's inflation goal.

Yellen's views are consistent with those expressed by Fed officials at the December Federal Open Market Committee ("FOMC") meeting, according to the recently released meeting-minutes. They believe the U.S. economy is on track for a "soft landing"; that is, inflation should continue to come down to the Fed's target without the U.S. economy experiencing, in Yellen's words, a period of high unemployment or recession.

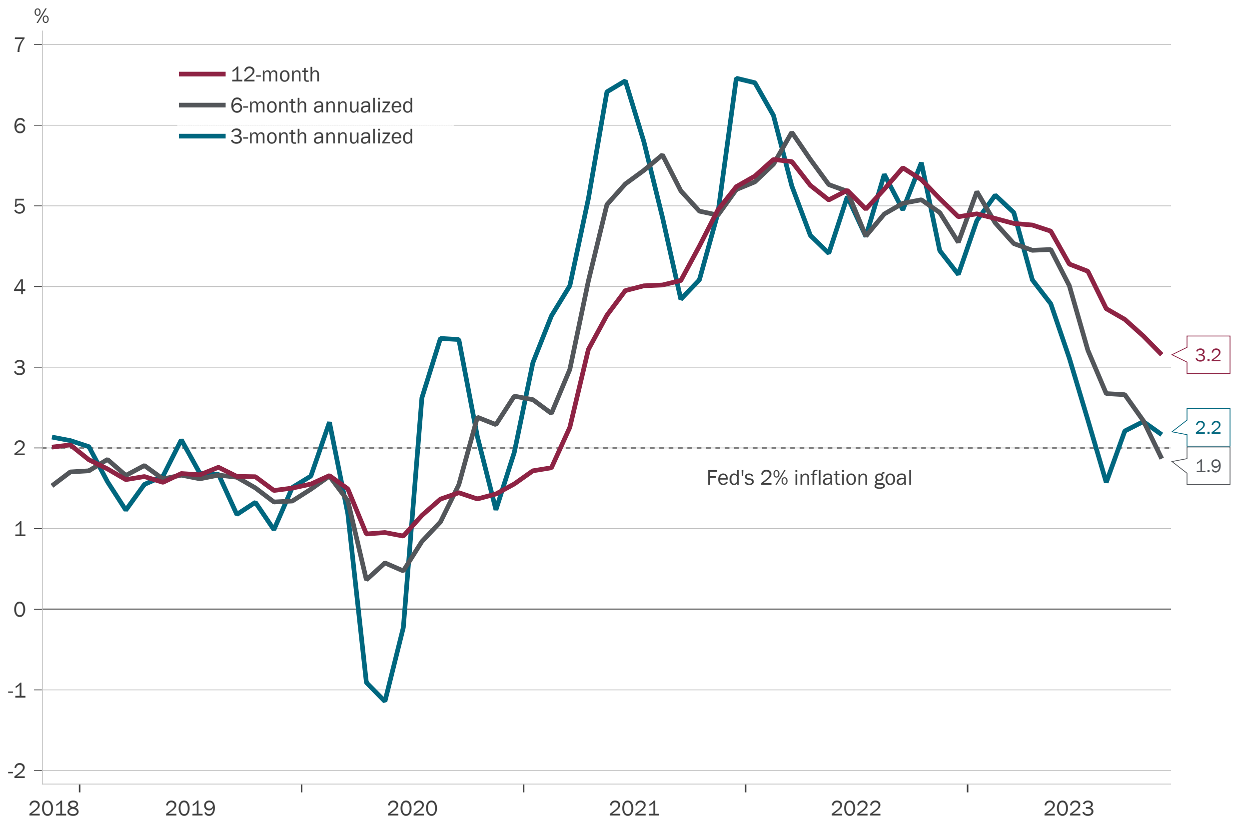
Rate of inflation drifts down toward Fed's target

Inflation remains elevated and above the FOMC's longer-run goal of 2% but continues to show signs of easing.

In November, the consumer price index ("CPI") rose 3.1% over the last 12 months and core CPI—which excludes changes in food and energy prices—rose 4.0% over the same period. Both measures are well below their year-earlier levels. The personal consumption expenditures ("PCE") price index increased 2.6% over the 12 months ending in November, while the Fed's preferred inflation gauge, core PCE inflation, grew by 3.2% over the same period. Both total and core PCE inflation are also well below their year-earlier levels. The six-month annualized core PCE inflation in November is 1.9%, an encouraging sign inflation is trending in the right direction and back to the Fed's 2% target. See chart on next page.

The Fed closely watches longer-term inflation expectations, which are at pre-pandemic levels. Short-run inflation expectations are declining and reflect consumers' more favorable view on the direction of inflation.

PCE* Core Inflation Rate



*Personal consumption expenditures price index
Source: PeoplesBank, Macrobond, U.S. Bureau of Economic Analysis (BEA), Bespoke Investment Group

U.S. economic growth expected to slow in 2024

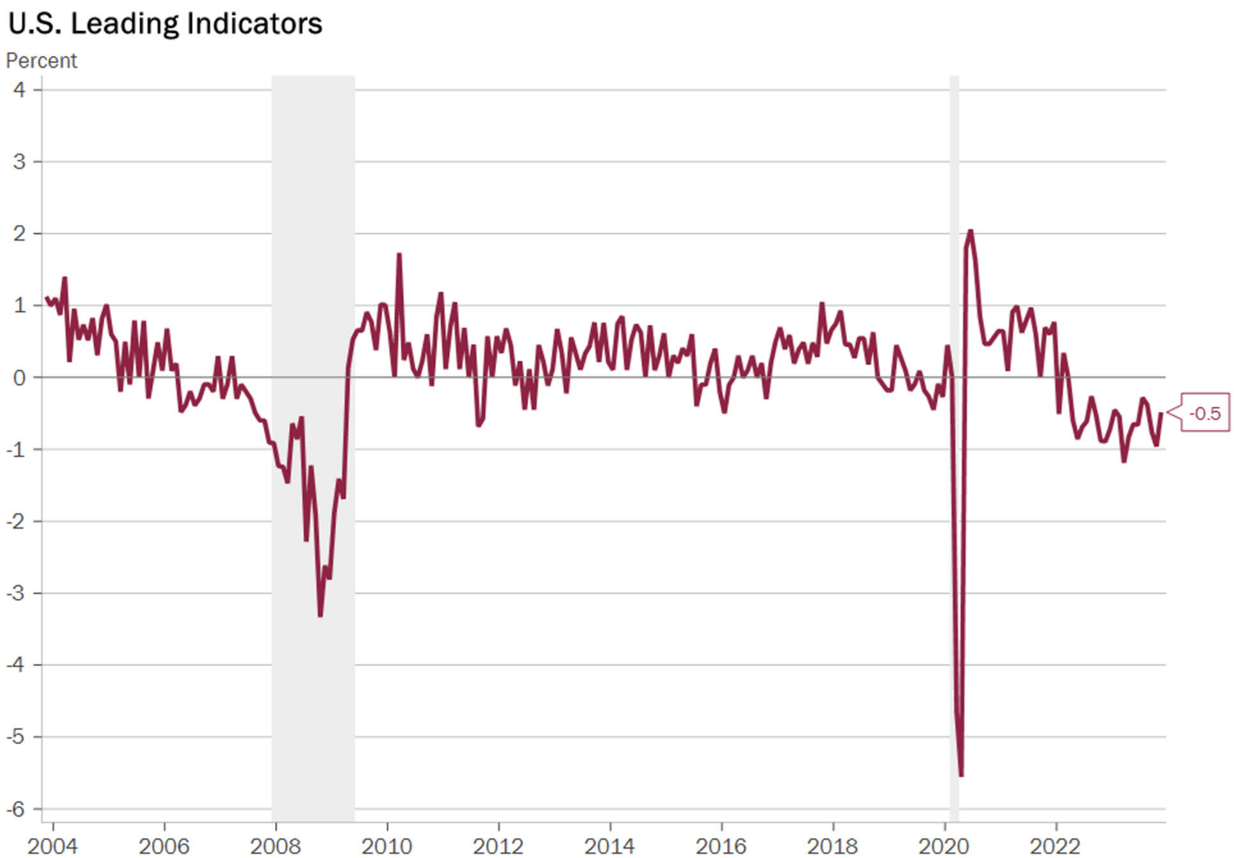
The U.S. economy continues to grow. Real gross domestic product (“GDP”) expanded at a 4.9% annual pace in the third quarter, driven by strong consumer spending, which represents about 70% of the economy. Retail sales, which represent about one-third of all consumer spending, rose in November, suggesting the consumer and economy remain resilient despite high inflation and interest rates. The Atlanta Fed’s GDPNow model estimate for real GDP growth in the fourth quarter of 2023 is 2.5%, which is lower than the previous quarter but still above the Fed’s longer-run target.

Consumers are feeling more confident about the economy and prospects for moderating inflation. The Conference Board’s consumer confidence survey jumped to a five-month high in December and the University of Michigan's consumer sentiment index also rose in the final month of 2023. When consumers are feeling optimistic about the economy, it bodes well for consumer spending.

A robust U.S. labor market has played a key role in underpinning the economic growth we are experiencing. Employers added 216,000 jobs in December and the six-month moving average for monthly jobs added remains above the 2019 average. The Fed closely watches the unemployment rate, which is currently 3.7% -- a level near historical lows and below the Fed’s long-term target of 4%.

Some indicators suggest the U.S. economy is cooling. The number of job openings fell to a 32-month low in November and fewer people are quitting their jobs, which are signs of a softening labor market. Many economists are expecting a slowdown in economic activity in 2024. The Conference Board is forecasting a short and shallow recession for the first half of the year. The Board's index of U.S. leading economic indicators has fallen for 20 consecutive months. See chart below

The FOMC met in December and decided to keep interest rates on hold at a 22-year high – the federal-funds rate is currently at a range of 5.25% to 5.5%. Many market-watchers see the Fed shifting to a less restrictive monetary policy in 2024 and beyond, given data suggesting the rate of inflation is coming down, the economy is slowing, and the labor market is gradually cooling. In fact, traders are pricing in a rate cut as early as March 2024, as implied by 30-day fed funds futures, according to the CME FedWatch Tool.



Note: Shaded areas represent recessions as determined by the NBER Business Cycle Dating Committee
Source: PeoplesBank, Macrobond, NBER (National Bureau of Economic Research), Conference Board

Financial markets bounce back

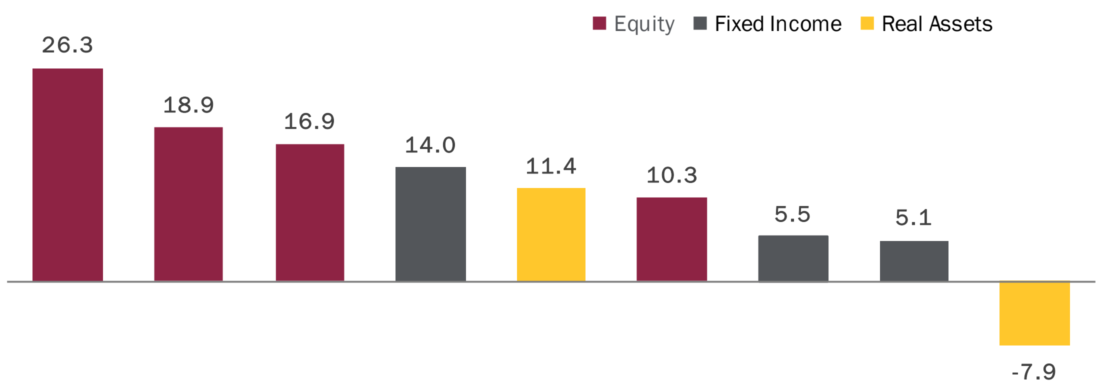
Financial markets posted solid gains in 2023, perhaps supporting the view that the last mile in the Fed's efforts to bring down inflation may indeed not be as difficult as once thought.

Markets had a strong rally in the fourth quarter of 2023, driven by the Fed signaling that its policy rate is likely at or near its peak for this tightening cycle and by a decline in Treasury yields.

Yields on Treasury securities declined sharply over the three-month period ending December 31 as investors favorably viewed inflation data and communications from the Fed suggesting its policy rate may have peaked. The yield on the 10-year Treasury declined 71 basis points from 4.59% to 3.88%, and the yield on the 2-year Treasury declined 80 basis points from 5.03% to 4.23%. As a result, the returns on risk assets surged in the last quarter of 2023.

Assets classes with negative returns in 2022 reversed course by posting solid gains in 2023, led by U.S. Large Cap stocks. Interestingly, two of the bottom performing asset classes in 2023 – cash and commodities – were the top performers in 2022. See chart below.

YTD Returns (%)



	Large Cap	DM Equity	Small Cap	High Yield	REITs	EM Equity	Fixed Income	Cash	Commodity
YTD	26.3	18.9	16.9	14.0	11.4	10.3	5.5	5.1	-7.9
2022	-18.1	-14.0	-20.4	-12.7	-24.9	-19.7	-13.0	1.5	16.1
Ann.	14.0	7.4	11.3	8.6	10.9	6.9	2.7	0.8	-0.2

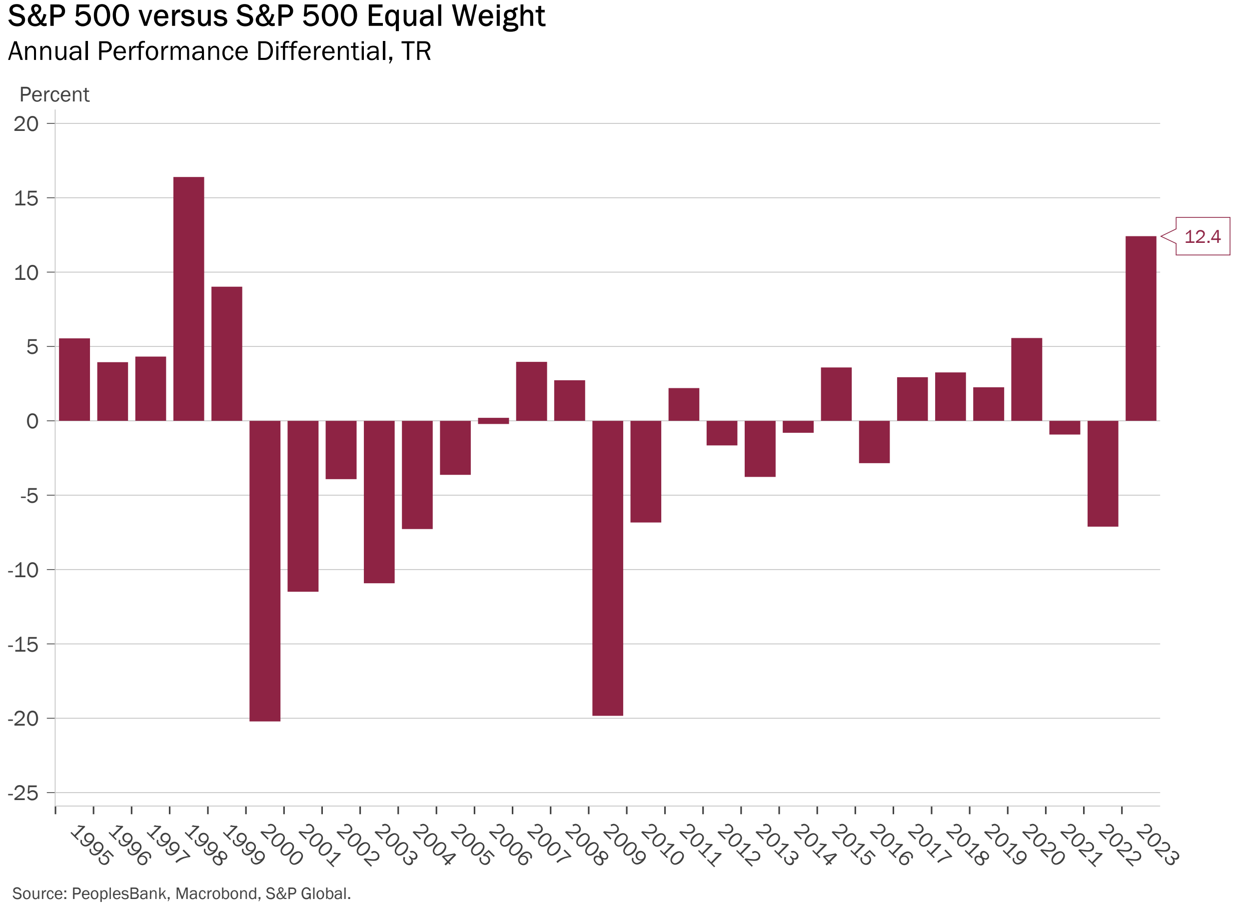
Source: J.P Morgan Asset Management *Guide to the Markets -U.S.* Data are as of December 31, 2023.

Cash: Bloomberg 1-3m Treasury, Commodity: Bloomberg Commodity Index, DM Equity: MSCI EAFE, EM Equity: MSCI EME, Fixed Income: Bloomberg US Aggregate, High Yield: Bloomberg Global HY Index, Large cap: S&P 500, REITs: NAREIT Equity REIT Index, Small cap: Russell 2000. Annualized (Ann.) return represents period from 2009 to 2023.

On the surface, the turnaround in equity market performance in 2023 is impressive and the outperformance of U.S. equities, represented by the S&P 500 index, is particularly noteworthy. However, much of the S&P 500's outperformance in 2023 was driven by a small number of stocks with the largest market capitalization. These mega-cap stocks – Apple (AAPL), Alphabet (GOOGL), Microsoft (MSFT), Amazon.com (AMZN), Meta Platforms (META), Tesla (TSLA) and Nvidia (NVDA) – are known as the "Magnificent 7".

One way to measure the outsized impact of the Magnificent 7 on market performance is to look at the annual performance differential between the S&P 500 market-cap-weight and equal-weight indexes.

The market-cap-weight index outpaced the equal-weight index by more than 12% in 2023 – a level of outperformance not seen since 1998. See chart below.



Looking ahead, we have a neutral stance in terms of stocks versus bonds relative to our long-term strategic targets -- see chart on next page.

Both stocks and bonds should offer positive return-potential for investors in 2024. Analysts expect earnings for S&P 500 companies to grow over 10% in 2024, which should provide support for higher stock prices, and bonds offer attractive current yields. If interest rates come down in 2024, it will provide an additional boost for both stock and bond prices. Small and mid-cap stocks have attractive valuations and smaller companies should benefit from lower interest rates. Fixed income sectors such as high yield, preferreds, and long duration provide the opportunity for additional yield as well as the potential for capital appreciation in a declining rate environment.

There are risks to our outlook. For topics we covered, inflation could be more persistent than anticipated, the Fed might keep interest rates too high for too long, and the U.S economy may possibly experience an extreme contraction or recession. Beyond that, other potential risks include: the inability of policymakers to adequately address fiscal challenges and geopolitical tensions escalating further.

PBWM's STRATEGIC AND TACTICAL ASSET ALLOCATION

	Asset Class	Strategic (%)	Under/Overweight (%)	Tactical (%)
Equity	U.S. large cap stocks	28.8	-2.4	26.4
	U.S. mid and small cap stocks	7.2	4.9	12.1
	Int'l developed market stocks	18.3	-1.8	16.5
	Emerging market stocks	5.8	-0.8	5.0
Fixed Income	Core fixed income	38.0	-2.5	35.5
	Non-core fixed income	0.0	2.5	2.5
	Cash & cash equivalents	2.0	0.0	2.0
Real Assets	Real estate-related securities	0.0	0.0	0.0
	Commodity-related securities	0.0	0.0	0.0

PeoplesBank Wealth Management's (PBWM's) strategic and tactical asset allocation for its total return moderate growth strategy as of January 2024.

Notes

PeoplesBank Wealth Management's Investment Strategy Committee ("ISC") develops both long-term (strategic) and short-term (tactical) asset allocation recommendations for Wealth Management's investment management and trust accounts. Strategic recommendations are based on how the 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 also responsible for selecting and monitoring strategies, managers, and funds implemented within client portfolios. The ISC is comprised of senior members of the Wealth Management team and meets monthly. If you have questions or would like additional information regarding PBWM's investment process, please call or send an email to your relationship or investment officer.

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Sources: Atlanta Fed, Bureau of Economic Analysis, Bureau of Labor Statistics, CME Group, FactSet, Federal Reserve, Macrobond, MarketWatch, The Conference Board, and The Wall Street Journal, 'Janet Yellen on Why She Predicts a Soft Landing for the U.S. Economy', December 15, 2023.