INVESTMENT OUTLOOK
SECOND-QUARTER 2019

QR2

HELPING YOU NAVIGATE YOUR INVESTMENT, TRUST, RETIREMENT, BANKING, AND PLANNING CHALLENGES

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From Apollo to the iPhone

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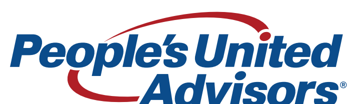
FOR CURRENT AND PROSPECTIVE CLIENTS



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INVESTMENT OUTLOOK
SECOND-QUARTER 2019

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FEATURE

From Apollo to the iPhone

John S. Traynor
Executive Vice President
Chief Investment Officer

As you read this note, we hope the warming signs of spring are shining brightly upon you. This annual rebirth of the world around us reminds us of the inexorable march forward we all make, regardless of the occasional setback or chill wind.

With thoughts of spring in mind, many investors may find that a casual reading of the morning headlines or a quick review of the daily cable news cacophony would convince anyone that we are in the midst of a never-ending winter of discontent and that society is far from a march forward. The clashing in Washington over socialism or capitalism, immigration or border walls and tax cuts or wealth taxes speaks to a polity battling less for intellectual clarity than for ideological dominance. The current debate seems so focused on our collective challenges that it becomes all too easy to forget just how fortunate we are at this very moment to be citizens, voters and investors in this great country at this propitious time.

While not neglecting our challenges, such as ensuring that everyone participates in our economic growth to their fullest, that military conflicts the world over are resolved peacefully and that we pass on a livable planet to future generations, we must remember that we are living in the greatest period of human endeavor in history. A loss of perspective when viewing our current state leads to a heightened focus on our challenges while neglecting our achievements and opportunities. This anxiety is dangerous for us as a society and presents a particular set of challenges for investors. As Ben Graham, the father of modern security analysis said: “The intelligent investor is a realist who sells to optimists and buys from pessimists.”

This year we celebrate two anniversaries that we hope will put into perspective for investors the tremendous journey we have been on over the last 10 and 50 years. The first is depicted in Figure 1, the rally in stocks since the low set on March 9, 2009, has become the longest rally

FIGURE 1: THE WALL OF WORRY

S&P 500 INDEX PRICE (LOGARITHMIC SCALE)

Source: Franklin Templeton

in U.S. history, returning over 400% for those intrepid enough to remain invested. Throughout the rise there were many calls for the rally to end as noted. To say that this rally is one of the most unloved would not be an understatement. Too many investors let their fear of reliving another 2008 market plunge keep them from fully participating in the rally. As John Templeton said: "Bull markets are born in pessimism, grow on skepticism, mature on optimism, and die on euphoria." For many investors, they never got over their disbelief in the sustainability of this rally; they let fear guide their investing decisions.

The second anniversary will occur on July 20th, the 50th anniversary of the Apollo moon landing. To think that Neil Armstrong could take his famous footsteps on the surface of the moon with the now-antiquated technology of the late 1960s is incredible. The IBM 360 mainframes that powered mission control were the size of a car and cost $3.5million in 1969 dollars. Today, an iPhone 6 can perform calculations 120 million times faster and fit in the palm of your hand. By combining technology with skilled workers, the U.S. economy has remained second to none. While productivity has slowed over the last several years, we believe today's innovations will power our economy to new heights and higher standards of living. We disagree with those proponents of "secular stagnation" and their forecasts of American economic decline.

We note these two anniversaries in particular because both were born during otherwise desperate times. The stock market rally followed a 57% decline in the S&P 500 during the preceding 18 months. Legendary corporate names either failed or were teetering and the "Occupy Wall Street" protests were just beginning. Similarly, the Apollo moon landing occurred in the midst of the Vietnam War protests and followed tragic assassinations. Investors must always strive to see the bigger picture and not miss the forest for the trees.

Outlook

The strong first-quarter equity performance this year was driven in large part by the pause in interest rate increases by the Fed. Investors were heartened by the pause because it reduced the fear that the Fed would push the economy into a severe slowdown or possibly a recession. We believe first-quarter GDP growth, when reported, will further demonstrate to the Fed that the pause was the correct course of action. Our expectation for a slowdown in growth is due in part to an inventory drawdown along with the government shutdown.

When we build portfolios with a longer-term view we are guided by two broad beliefs. First, that the U.S. economy will slow from the strong pace set last year, but remain in a growth mode for several more years. This belief drives our positive view of equities and neutral opinion of bonds. Second, the increase in volatility last year, compared to 2017, will continue and we must therefore be prepared to take advantage of price movements to either add to holdings or take profits.

OVERVIEW

What if There is No Recession?

ECONOMIC DASHBOARD

- POSITIVE
- NEUTRAL
- NEGATIVE

GROWTH

This quarter, the current economic expansion will tie with the longest consecutive expansion on record. Slow growth will continue into 2020.

JOBS

Job openings are plentiful. Labor supply is expanding. New entrants to the labor market will outnumber Baby Boomers reaching retirement age for the next three years.

INFLATION

Inflation is near the Fed's 2% target but has been moderating, which will forestall tighter monetary policy.

OIL

Oil price depends on supply more than demand. U.S. and Saudi production are likely to keep prices range-bound.

THE DOLLAR

Countervailing forces will keep the dollar in neutral. U.S. trade and fiscal deficits pressure its value, but U.S. interest rates and reserve-currency status support it.

INTEREST RATES

Slower economic growth, moderate inflation, and financial stability concerns are likely to keep the Fed on pause for most—if not all—of 2019.

Recession is a real fear for investors and rightfully so. Companies downsize. People lose jobs. Corporate profitability tanks, and stock prices fall. Only bondholders benefit, as investors sell stocks and buy bonds.

Recessions in the United States used to occur with greater frequency than they do now. In the 40 years after World War II, the U.S. experienced eight recessions —one every five years on average. But in the 33 years since 1985, the U.S. has experienced only three. Economists have termed the change the "great moderation."

Economists speculate that the Fed's improved management of inflation has contributed to the great moderation, even as the U.S. has hesitated to use its tax and spending authority to smooth cyclical activity. The information age has also contributed, as businesses can manage production and inventory to meet demand more precisely.

The length of the current expansion has created anxiety among investors who expect that growth must come to an end with a recession. "What goes up must come down," the thinking goes. This expectation is deeply rooted in the human penchant for seeing history as a repetition of cycles, as the great historian Mircea Eliade argued.

But is a recession inevitable? Not necessarily. Australia, for instance, has experienced 26 years of continuous economic growth. And as we argued in last quarter's economic outlook, the consumer has been the engine of the current expansion, and the consumer remains in good shape.

It is too soon to declare that recessions are a thing of the past, however. As University of Chicago economist Austan Goolsbee reminded us recently, policy errors can erode consumer confidence and precipitate downturns. Nevertheless, investors should not assume a recession looms just because the current expansion will become the longest in U.S. history once it extends beyond June. What looks like the "ninth inning" from a historical perspective may turn out to just be the "fifth inning."

Albert Brenner, CFA
Director of Asset Allocation Strategy

Compiled with the assistance of John Conlon, CFA, Chief Equity Strategist; Karissa McDonough, CFA, Chief Fixed Income Strategist; and Celia Cazayoux, CFA, Director of Investment Solutions.

INVESTMENT SUMMARY

Opportunities for 2019

OVERWEIGHT
NEUTRAL
UNDERWEIGHT

Equity

Despite tempered global growth, U.S. stocks are up more than 10% through mid-March while international markets are up over 8%. Strength could continue, especially if U.S.–China trade negotiations progress. Valuations remain near the long-term average for U.S. stocks but below average for international equities.

TOTAL EQUITIES

We expect equities to outperform bonds over the next 12 months.

U.S. EQUITIES

Second half 2019 earnings growth and the potential for favorable valuation changes warrant an overweight.

INTERNATIONAL DEVELOPED MARKETS

Valuations, especially in Japan, suggest upside.

U.S. LARGE-/MID-/SMALL-CAP

Comparative measures are neutral.

GROWTH/VALUE

Late cycles favor growth, but beware richly-priced small cap growth stocks.

EMERGING MARKETS

A slowdown in China may worsen.

Fixed Income

The rate outlook has eased since last quarter. The Fed left the target federal funds rate unchanged in March. As of mid-March, yields were in a tight range across maturities, and the 1-year Treasury yield was higher than the 2-, 3-, and 5-year issues. This unusual configuration reflects the market's expectation for a rate cut before year-end.

CREDIT RISK

Credit spreads widened in December but have retreated. We are closely watching defaults.

TOTAL BONDS

Slower growth and a cautious Fed have reduced rate forecasts. Treasury returns should be positive in 2019.

DURATION

Interest-rate risk is down, but investors are receiving little for longer maturities.

LEVERAGED LOANS

This high yield subcategory has seen large capital inflows and looser covenant protections.

Cash, Real & Alternative Assets

Lower inflation has reduced the attraction of real assets. Declining operating margins have made real estate the most expensive it has been in 10 years. Commodities continue to face unfavorable pricing, and gold has lagged amid rising real interest rates. Cash remains the preferable asset for risk mitigation in the near term.

CASH

With short rates above 2- through 5-year Treasuries, cash yields are competitive.

HEDGE FUND STRATEGIES

Select funds may help in managing risk for some portfolios. Selection is critical given wide dispersion among hedge fund strategies.

REAL ESTATE

The ratio of net operating income to sales price is down significantly.

COMMODITIES

Forward prices are a headwind.

GOLD

Higher real interest rates reduce return potential.

The economic and market views and forecasts above reflect People's United Advisors' judgment as of the date of this publication and are subject to change without notice. Views and forecasts are estimated based on assumptions, and may change materially as economic and market conditions change.

PORTFOLIO NOTES & INSIGHTS

The Humans Behind the Rules

Albert Brenner, CFA
Director of Asset Allocation Strategy

A simple mechanism, the rule, has freed up unbelievable human capacity. The technology that advances around us every day nearly all comes back to this simple premise: that you can put instructions, or rules, in place to automate previously manual tasks. If situation A occurs, do action 1. If situation B occurs, do action 2. Such a basic approach has expanded to the point that rules-based technology is part of every industry, including money management.

The more complex the rule system and/or the larger the set of data inputs, the greater the advantage of using a computer to make decisions. In the investment world, computers are what enable us to find performance patterns or to screen securities for particular characteristics, as they process large quantities of data and free investment analysts from untold hours of number crunching just to create the data. Computers have even enabled us to better understand investor behavior—to know how investors are likely to react in certain situations and what features investors reward with higher prices.

It's easy to disconnect these tools and applications of technology from the humans who made them. But, we must always remember that rule-creation is a human activity. The rules come from us.

Sometimes, rules-based technology fails—either because the rules were wrong, or because a situation arises that never arose before. In investing, we're lucky that the consequences are not nearly as dire as in other circumstances, but we are still keenly aware that the technology at our fingertips ultimately relies on the set of rules or instructions programmed into the computer to be effective.

Therein lies the rub. No set of rules or instructions will ever be a perfectly complete or sufficient set for investment decision making unless we can be assured that the set of rules covers all possible cases in all possible circumstances.

Is that even possible, in investing? Investors must always ask whether the past patterns and relationships that underpin the rules apply today will apply tomorrow. Investors who fail to ask are effectively committed to the belief that the future faithfully replicates the past. Markets often follow patterns from the past, but they can diverge from past patterns and occasionally do so in a persistent manner and can do something brand new, something never seen exactly that way before.

A simple example is value investing. A statistical analysis of historic returns shows that value stocks have outperformed growth stocks over the long term. A rule for successful investing, therefore, would be to overweight value stocks in your portfolio. However, if you had followed this rule since 2012, your portfolio would have lagged as growth stocks outperformed value stocks by more than 20%.

Ultimately, then, a rules-based investment program needs to have flexible rules. It needs to be able to recognize and capture the sustained periods when the standard rules do not apply.

It's easy to disconnect these tools and applications of technology from the humans who made them. **But, we must always remember that rule-creation is a human activity.** The rules come from us.

Since these periods are, by definition, anomalies, detecting them usually requires a deep knowledge and experience of the markets. It is where expert analysis can supplement quantitative research and make a real difference for investors. And for all the technology around us, there's only one source that can provide this kind of activity: humans.

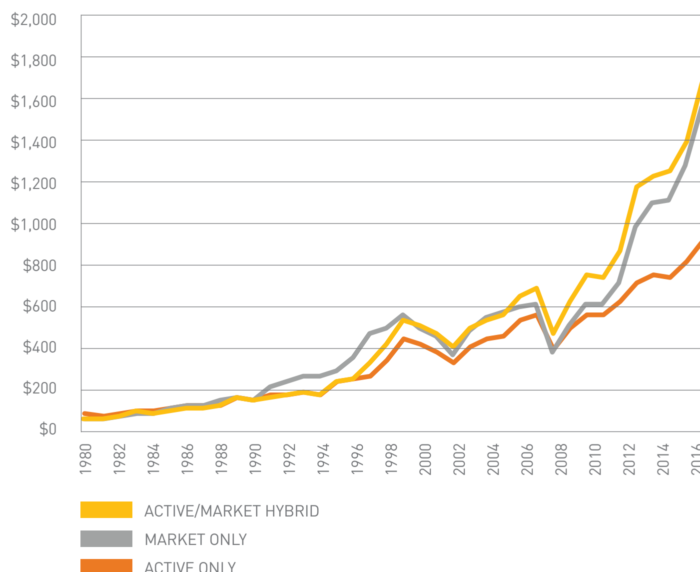
Exploring the Relationship Between Equity Correlations and Active Stock-picking Skill

It's no secret that managers of actively-run strategies struggle to beat passive indices over extended time periods.

For instance, an S&P Dow Jones Indices study found that, during the decade ending in December 2017, 90% of large-cap mutual fund managers underperformed the S&P 500 Index on a net-of-fees basis. I recently conducted research on the perennial active vs. passive question with my coauthor, Michael McDonald, an academic partner of ours and a finance professor at Fairfield University. Of particular interest to us was whether the relative performance of active strategies varies through time according to an influence such as changing correlations (how tightly—or how independently—stocks move with one another) among equities.

We conducted our research on (all) mutual funds, the market, and stocks from 1980 to 2017. Not surprisingly, we found that, across this 38-year time frame, the mean monthly return of mutual funds (0.52%) trailed badly behind that of the market (0.85%). Then we studied whether the relative performance of active funds (of which quantitative multi-factor funds are a subset) or strategies tends to improve during particular periods or market environments.

FIGURE 1: GROWTH OF $100



Source: Gerstein Fisher

We did this by examining the dispersion of betas (a measure of a stock's volatility in relation to the overall market) among equities—when there is greater variation in stock betas, the performance among equities is more dispersed.

In contrast to what we often hear from the industry and managers, we found that periods of greater dispersion of equity correlations (i.e., when stocks are not moving in sync) are associated with weaker performance by active strategies, and that performance improves dramatically when correlations are high but then decline rapidly (a sudden widening of dispersion could be due to an underlying factor such as the economy transitioning from a very stable to a less-stable state). This makes intuitive sense in that, if correlations across all equities were identical, then there would be very little value that active managers could add to a passive benchmark through stock picking.

A Time for Active and a Time for Passive

In short, there are periods in which active will outperform and times when passive indexing will reign. One possible method would be to use both (i.e., to diversify styles and strategies in your portfolio) but to switch between the two based on shifts in correlations. Figure 1 illustrates an example of such a strategy. *Active* in the exhibit is an equal-weighted portfolio invested continuously in all active mutual funds. *Market* is an equal-weighted portfolio continuously invested in the entire universe of stocks. *Hybrid* switches between actively managed mutual funds and the market based on changes in equity correlations in a particular month.

My grandmother always told me that too much of anything was no good. Maybe Grandma was right. Too much of any one thing is no good. As the graph shows, the best performer is not the active-fund portfolio (which includes multi-factor strategies) or the passive-market portfolio; it's the hybrid strategy balancing active and passive.

Gregg S. Fisher, CFA

Portfolio Manager,
Head of Research & Portfolio Strategy

TRUSTS & BENEFICIARIES

Estate Planning in the New Tax Regime... And Afterward

The 2017 Tax Reform and Jobs Act increased the estate, gift, and generation-skipping transfer-tax exemption to unprecedented levels.

Since the legislation is set to expire at the end of 2025, at which point the exemptions will revert to their lower pre-Act levels unless Congress intervenes, this is the time to review your estate plan with an eye toward capitalizing on the provisions in the current law and minimizing capital gains at the point of your or your surviving spouse's death.

The Basics Haven't Changed

When re-assessing your estate plan, remember that some old techniques still work well:

Gifting

If you expect to pay a federal estate tax at death, it is usually more tax efficient to use the gift-tax exemption during your life rather than subjecting your property to the estate tax after your death. If you give during your life, any appreciation and future income on the gift passes free of estate tax to the recipient. Gifting discounted assets (partial interests in real estate, partnerships, or LLCs) can still be particularly beneficial, since leverage can be applied to the amounts gifted. The IRS regulations governing asset discounts were not changed under the 2017 Act.

Disclaimers

The use of a disclaimer (formally refusing to receive a benefit) can be used to modify the formula clause of a trust and may have the effect of transferring assets to a family/credit-shelter trust over which the surviving spouse still retains significant control while optimizing estate-tax savings. And the use of multiple disclaimers can accelerate the distribution of assets to beneficiaries, allowing for a better overall estate plan. (However, disclaimers do not always address the issue of capital gains at the death of the surviving spouse.)

It is always good policy to review your estate plan with your **financial, legal, and tax advisors** to ensure that it is flexible enough to benefit from the 2017 Tax Act.

Trusts Can Be Helpful

There are also other standard techniques that can be used to reduce estate taxes. Some use trusts that contain specific language. One such technique relies on the trustee or trust protector's authority to use his or her power of distribution to remove assets from a trust—specifically those most appropriate asset(s) for distribution and potential further gifting. Another technique permits an independent trustee or protector to confer a general power of appointment on the surviving spouse. If conferred, this will subject the property to estate tax, but will also establish a new (presumably more favorable) cost basis for the property. There are other valuable techniques as well.

It is always good policy to review your estate plan with your financial, legal, and tax advisors to ensure that it is flexible enough to benefit from the 2017 Tax Act—and from other changes as the laws and your own circumstances evolve over time.

Robert J. Tyler, Jr.
Chief Fiduciary Officer

A CLOSER LOOK

The Three A's of Investing Success

Daniel Darst
SVP, Marketing Strategy

My colleague Bert Brenner notes in this issue that we can't really know which 'inning' the economy, and presumably, the stock market is in.

To a great extent, I would argue, that shouldn't matter much to the everyday investor. In fact, average investors have a dismal record when it comes to timing investment moves. Consider that over the 20 years ending in 2017, the S&P 500 (a broad index of large U.S. stocks) averaged a return of 7.2% a year. At that rate, a nest egg doubles every 10 years. Dalbar, a well-recognized investment measurement and assessment firm, calculates that the average individual investor saw a return of just 2.6% for the same period. At that rate, it would take 30 years to double your investment.

Instead of focusing on getting in and out of the market on the perfect days, investors should focus on those things they can control.

Number One: **Advice**

That brings us to the first A of good investing: **Advice**. The average investors' returns are evidence that when we trust our guts on these things, we often, paradoxically, do exactly the wrong thing at the wrong time. We buy when a security is near its price high, and we sell when it's nearing its nadir. That's why we need objective advice, in the form of a person or online guidance, to help us stay focused on the longer term

Number Two: **Action**

But picking the right investments and staying put through bumpy periods are only pieces of the equation. Many of the factors that will determine your success as a saver happen apart from the investing choices. These are the second A: **Actions**. Actions are what anchor your financial stability:

Save, and make sure some of your nest egg is liquid. Saving should look like 15% of your income—in a bank account, in a 401(k), in an IRA. Advisors will, at a minimum, suggest that you maintain no less than six months' equivalency of your current income in 'the bank'—that is, accessible without penalty or incurred fees.

Work, and expect to keep going. Plan on working through the mythologized age of 65 or 67. Retirement is for the ultra-rich or 'for the movies' as my father would have put it. Stay active, involved, engaged. It's been said that an active life is a healthy life. There's something to that.

Plan, and follow through on those plans. Anticipate the rainy day, and more! Make sure that your assets are diversified across different investment strategies and asset classes, and importantly, are registered in the right name and legal structure. All IRAs and trusts are not created equal. Talk with your advisor to help ensure that you have set up your affairs accurately for the next generation.

Instead of focusing on getting in and out of the market on the perfect days, **investors should focus on those things they can control**.

Number Three: **Attitude**

Now, when we contemplate that distant horizon—whether that's college education for children, or retirement for ourselves—we've been conditioned, perhaps, to imagine only a smooth runway toward the sunset. But life happens. College expenses exceed your wildest estimates. Medical and dental costs are practically assured. And that's only two of the more predictable expenses we encounter. Oh, plus the market bumps.

This is where our third A, **Attitude**, comes in. In fact, a successful baseball coach I know tells his teams that it's the first and most important input. I'm confident he would agree: that's important in any inning.

INVESTING

It's a Big World Out There

Gregg S. Fisher, CFA
Portfolio Manager,
Head of Research & Portfolio Strategy

Most investors fall prey to home bias, where their investment portfolios hold a higher share of stocks from their own country than objective measures would recommend. International stocks thus face a bit of a permanent disadvantage, in terms of simple appeal to U.S. investors.

To make matters worse, international stocks have generally lagged U.S. stocks of late, posting a bigger pullback in 2018 and a smaller rally so far this year. Some are surely wondering whether they should invest internationally at all.

We encourage investors to take a step back and take a look at the larger case for holding a global mix. (In the investing world, "global" typically means all countries including the U.S., while "international" indicates ex-U.S.)

For one thing, U.S. stocks are looking comparatively expensive. International stocks have a lower average price-to-book-value, both in relation to historical periods and to U.S. stocks today. And while U.S. stocks have performed better, there's a strong case to be made that their current value doesn't reflect significant risks. Market interest rates in the U.S. are signaling that slower growth could be ahead, and economists broadly agree that the tax-cut boost to company earnings is set to fade, among other pressures.

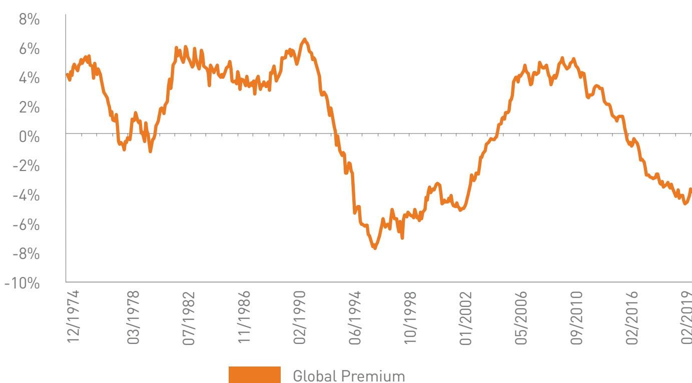
Then there are the long-term arguments. Non-U.S. stocks offer a growth opportunity. Globalization is a tide that is raising many ships, driving economic and investment growth around the world. International markets span the gamut from developed to emerging, and represent just as much growth potential as U.S. companies do, and in some cases more.

They also offer diversification benefits for investors who already hold U.S. stocks. While there can be some correlation in the performance of U.S. and non-U.S. markets, they can also follow opposing cycles, thereby offsetting each other's ups and downs at times. When we look at that from an analytical viewpoint, it means that a portfolio holding both U.S. and international stocks has historically delivered more return-per-unit-of-risk, also known as the Sharpe Ratio, than a portfolio which only holds one or the other.

The U.S. only makes up 5% of the global population, but U.S. stocks account for about 50% of total global stock market capitalization. The companies beyond our shores represent growth opportunities, and the long-term performance of international stocks reflects that. The appeal of diversification should be even more compelling to a U.S. saver—adding international to a U.S.-only portfolio has, over long periods, actually lowered overall risk while maintaining or even boosting performance. Short-term trends do little to disrupt that appeal.

A GLOBAL PREMIUM

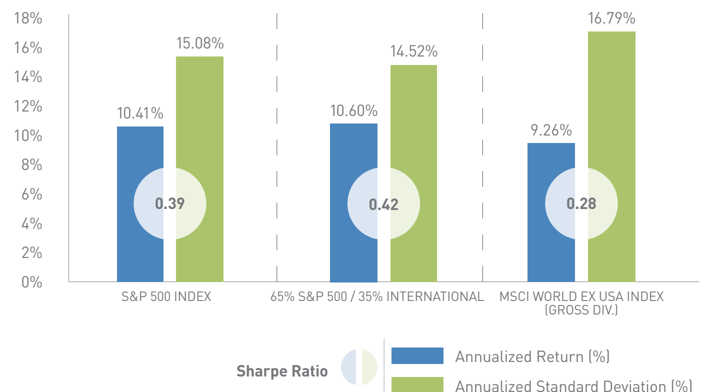
THE DIFFERENCE FOR HOLDING A GLOBAL PORTFOLIO VS. U.S.-ONLY PORTFOLIO



*Represents the difference in annualized returns over a 5-year holding period between a portfolio that holds a 65%/35% mix of U.S./International and a 100% U.S. stock portfolio.

GLOBAL OUTPERFORMS U.S., INTERNATIONAL ON A RISK-ADJUSTED BASIS

1970 — PRESENT, ANNUALIZED



UnPacking "UnRetirement": A Brief Financial Guide

The ubiquitous Baby Boomers are responsible for yet another trend: workers returning to work—although not necessarily to their old positions—after retirement. Indeed, a 2017 survey found that 39% of U.S. workers 65 and older had "unretired" from a previous job.[1]

Why? More Money, for One Thing

Unretirement answers multiple needs. Many retirees discover that they miss the challenges and the personal fulfillment that the workplace can offer. For others—according to at least one survey: it's an economic decision.[2]

So what would our advice be to those contemplating the move?

First, figure out if you want and need to unretire. If you think you're being forced into it, assess your situation with the help of a financial expert. You may find that your funds will likely last longer than you think—or that you're comfortable adjusting your spending, your investment portfolio, or your financial goals.

Investing for Growth

If unretirement is the path you need to take, our first suggestion might be to bolster your investment portfolio. Many retirees flee to the safety of cash—but cash barely grows over time. You can probably afford to take on more risk, especially if you're collecting Social Security or an old-fashioned pension.

Let's say three-month Treasury bills compound at 2% going forward. Over 25 years (a reasonable time horizon for today's 65-year-olds), a $100,000 portfolio would grow to only $164,000. If stocks return 7% a year—not their double-digit results of the past decade—and intermediate-maturity bonds return 4%, the same $100,000 in a 60%/40% mix of the two assets would grow to $432,000.* That's better.

Planning Counts

Reaching for more growth isn't the end of the story:

- Keep an eye on your spending. Some old rules of thumb may be too aggressive.
- Keep your portfolio diversified by asset and geography.
- Be prepared emotionally for some short-term volatility.
- Don't *abandon* cash: Maintain a cash emergency fund.
- Track your portfolio at least once a year on how well it's meeting your objectives.

In all these endeavors, having a financial-planning professional on your side can help ensure your success.

Will Your Social Security Check Go Down?

Finally, if you've reached your "full retirement age" (between 66 and 67 for Boomers), you can work as much as you like with no effect on your Social Security benefits. If you're younger, your check will be reduced. But no matter what your age, up to 85% of Social Security benefits may be taxable, depending on your total income.

Is "unretirement" right for you? Come see us at People's United Advisors.

*Calculations are based on annual compounding, reinvested dividends, and monthly rebalancing back to neutral weights.

1. Source: www.rand.org

2. Source: www.cbsnews.com

RETIREMENT BY THE NUMBERS:[1]

62	84.3	53%	39%
Average retirement age	Average life expectancy for Americans who reach 65	of unretired believe they will re-enter the workforce after retiring	of U.S. workers 65+ had unretired from a previous job

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INVESTMENT MANAGEMENT

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MULTI-GENERATIONAL PLANNING

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