STRATEGY INSIGHT

May 2018

People's United Advisors

Economic Overview

Economic Indicators	3Q'17	4Q'17	1Q'18	2Q'18	3Q'18	4Q'18
Real GDP *	3.2%	2.9%	2.2%	3.1%	3.0%	2.7%
CPI (year over year)†	2.2%	2.1%	2.4%	2.7%	2.7%	2.5%
Unemployment Rate†	4.2%	4.1%	4.1%	3.9%	3.8%	3.8%
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* Quarter over quarter annualized † end of period

Increase from last reported

Decrease from last reported

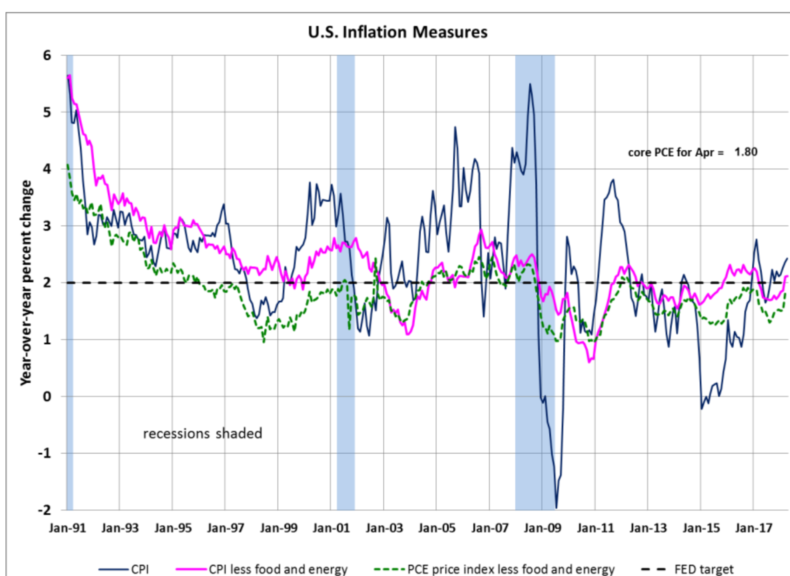
Inflation Revisited – Heading for a New Challenge?

Last June's Strategy Insight was headlined "Inflation – Lower for Longer?" as inflation appeared to be stuck below 2% at the time. One year later, **inflation has risen to the Federal Reserve's 2% target level**. Consumer price indices (CPI) with and without food and energy are both above 2% at 2.4% and 2.1% respectively as of April (the blue and red lines on the chart). The personal consumption expenditure (PCE) price index – the broader measure that is the Fed's target by statute – is up 2.0%. The core version of PCE, less food and energy, is just below target at 1.8% (the dashed green line). All indices are trending higher.

The Fed has been fighting to get inflation up to 2% since the financial crisis. Price deflation is a greater risk to the economy than price inflation. When prices drop, the risk of default rises on all fixed-price contracts as obligations have to be met with dollars that are worth more than when the contract was struck. Stable and moderate price increases avoid that trap. And they give the Fed room to set interest rates at a level where it can respond to future economic downturns.

So, now that the battle against deflation appears to be won, **the key question for investors is what's next ? – a return to fighting higher prices or a period of stable inflation in the 2% range?**

We expect inflation to increase moderately but not move outside an acceptable range around 2.0%. CPI will spike this summer due to higher energy costs compared to last year, but should decline later in the year, as noted in the table above. A tight labor market will eventually push labor costs higher, although technology and changes in business models have restrained labor costs so far. Inflation expectations remain firmly anchored, and global excess capacity in many industries will keep prices from rising. Increased capital spending holds the promise of increased productivity that will support both higher wages and moderate prices.



Sources: Bureau of Labor Statistics & Bureau of Economic Analysis

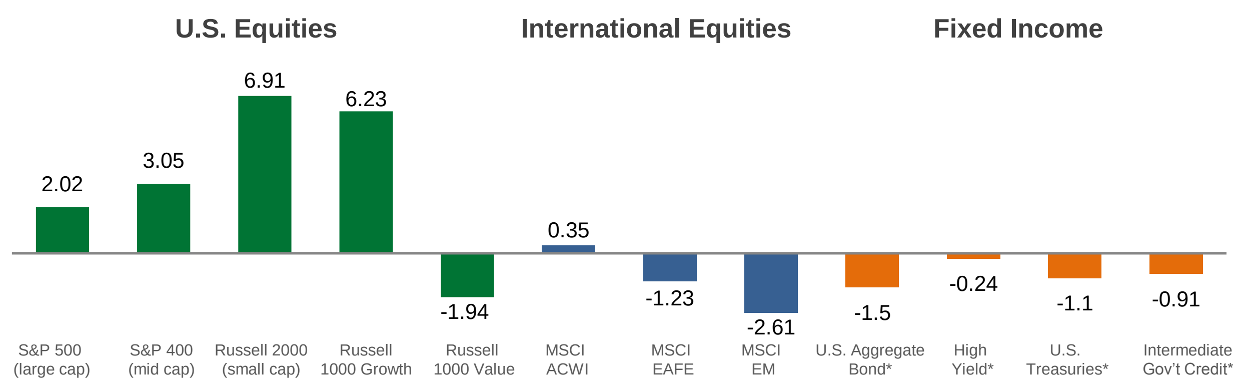
Equity: Small Caps Leading the Way, but Don't Give Up on Large Caps

- Small Caps continue to outperform large caps, even setting a high while large caps continue to work through a correction. We believe that the strength in performance is due to both fundamental differences and sector specifics. Because of their lack of international exposure, small caps are benefitting from fears of possible trade wars and tariffs. In addition, with a greater portion of earnings from domestic sources, small caps reap a greater benefit from the recent tax legislation.

- In regard to sectors, small caps have eight of 11 sectors in positive territory while large caps have only four. Technology and Health Care make up 31% of small cap exposure, and they are up double digits year to date. Also, with a domestic focus and a greater positive impact from deregulation, small cap Financials are up while large cap Financials are down.

- Based on historical trends, the large cap correction is nearing the beginning of the end, which is expected to occur over the summer. In addition, Technology, which makes up 25% of the S&P 500 has a number of market trends working in its favor. Large cap exposure to global markets should also work to its advantage once the irrational fear regarding tariffs and trade battles subsides.

Market Returns (%) Year-to-Date As of May 31, 2018 Source: Bloomberg *Bloomberg Barclay's indices



Fixed Income: Bond Market Strategy - Things are fine until they aren't

- Bond market action in the last week of May provided investors a good reminder of why it is imperative to understand the risks they're taking to generate returns.
- Despite continued provision of liquidity by central banks, the flight to safety during the last week of May – demonstrated by a significant drop in rates and sharply wider credit spreads – showed that the health and tradability of the bond market is potentially not as robust as it may appear on the surface.
- Other notable instances where buyers went on strike due to the unquantifiable risk in the market occurred during the financial crisis and during the European debt crisis in 2011. These are not just interesting esoteric market moves. Cases where entities are not able to roll maturities have the potential to lead to solvency crises – meaning, lack of market liquidity can translate directly into real economic trouble and defaults [e.g. Lehman not able to roll maturing commercial paper and defaulting as a result in 2008]
- While we are not suggesting we are at place of market crisis at this point, we do think bond investors need to take note when bond market trading becomes impaired as it did last week – these may be portents of broader market stress down the road.
- As we like to reiterate, an investor's upside has a ceiling in the fixed income market – the best case is that you get your money back, worst case you can experience a default or other market–imposed price losses. This recent market experience provides a framework for bond investors to reassess risks in their portfolios.

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