QUARTERLY INVESTMENT REVIEW & OUTLOOK

People's United Wealth Management

Mid-Year Review - A Tale of Two Markets

by John S. Traynor, CIO

A casual review of the U.S. stock market to this point reveals a rise of nearly 2% in the S&P 500 and a rise of just .18% in the yield on the 10 Year Treasury. That placid surface hides incredible turmoil as investor sentiment has moved from optimism to pessimism and back again on topics such as U.S. economic growth, employment, Fed policy and the impact foreign markets will have on the U.S. The yawning gap between equity and bond market performance during the month of January, as depicted in **Chart 1**, (on pg. 2) caught many optimistic investors by surprise as sentiment on four key financial headlines shifted to the negative. After the yield on the 10 year Treasury reached the low of 1.64% at month end, a level last seen in May 2013, sentiment shifted and investors refocused on the growing economy thus driving interest rates higher and bond prices lower. Equity markets in the U.S. and Europe rose thereby reversing the performance difference between stocks and bonds as depicted in **Chart 2** (on pg. 2).

Our thoughts on the dominant themes driving second half returns and market volatility follow:

1. Employment.

While joblessness has fallen consistently since 2010, the pace has been far too slow compared to prior expansions. At 5.5%, the current unemployment rate is finally below the post 1970 average. The slight uptick in the participation rate in May gives us hope that formerly discouraged workers may finally begin re-entering the workforce

2. The timing of the initial Fed funds increase.

We began the year with most forecasts for the first Fed rate increase to take place at the June meeting. Currently, the consensus seems to be coalesing around one increase in the final four months of the year. Our focus has been less on the precise timing of an increase but rather on the pace of increase once the Fed starts raising rates, which we believe will be slow and thoughtful. This slower pace to increases should be positive for the economy and equity markets.

(Continued on pg. 2)

Economic Dashboard		
Economic Growth	Positive	The U.S. and Eurozone economies are both growing following a disappointing first quarter. Housing and auto sales are leading the U.S. economy higher while a determined ECB has lowered interest rates in Europe in order to ignite their moribund economies.
Employment	Positive	Even though the unemployment rate rose by 0.1% to 5.5% in May we believe job growth will remain strong in 2015. Strong job growth should lead to rising wages and rising consumer spending.
Profits	Neutral	Rising wages, energy prices and the dollar will all have a negative impact on profit margins and therefore earnings growth this year.
Inflation	Positive	The employment cost index has accelerated to +2.6% year over year. We have long said that this is one of our key indicators for future inflation levels. The core inflation rate is still below 2% which gives the Fed the latitude to raise interest rates slowly.
Interest Rate	Negative	The rise in interest rates since the low set in January reflects a lessening of fear in Europe of Greece and a recognition of a gradual growth trend in the developed world. We see rates continuing their slow upward climb throughout the year.

Positive Neutral Negative

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3. The flight to safety trade.

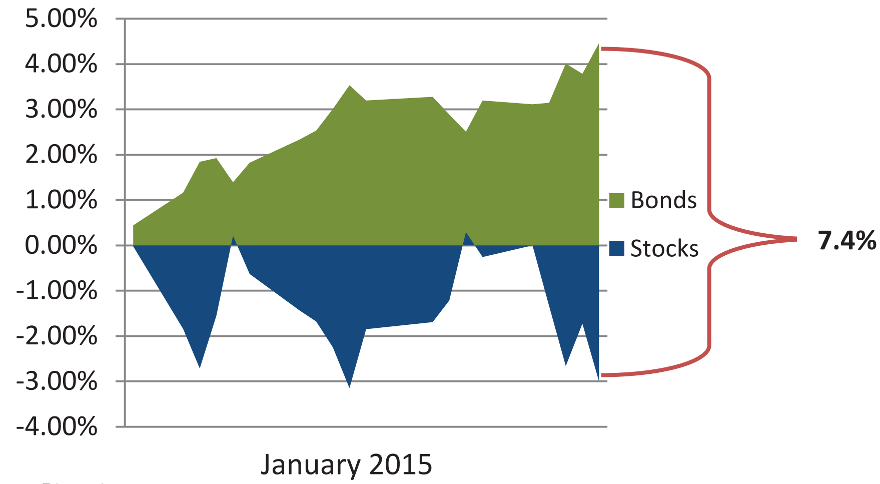
Nervousness over the potential exit of Greece from the Eurozone (Grexit) has led global investors to seek safety in the bonds of the highest quality issues, primarily the German Bund and the U.S. Treasury. While economic fundamentals should have called for higher interest rates, the yield on the bund and Treasury were pushed lower as investors sought their relative safety. As fears eased during the second quarter, interest rates rose to more normal levels. As of this writing the drama in Greece is still roiling stock and bond markets so the flight to safety trade is still alive and well.

4. Saudi Arabia versus the "fracker".

The decline in the price of a barrel of oil from $104 in July 2014 to $47 in January reminded investors of the last time the Saudis flooded the market with oil in 1986. In both instances, the Saudis hoped to restore pricing discipline to the market. This latest attempt has been a boon to oil consumers but the hoped for collapse in U.S. production has not materialized. We believe U.S. production will begin to decline from current record levels but the economics of fracking will allow production to return as prices rise. We believe a new price range of $45-$75 per barrel should define the oil market for the near future.

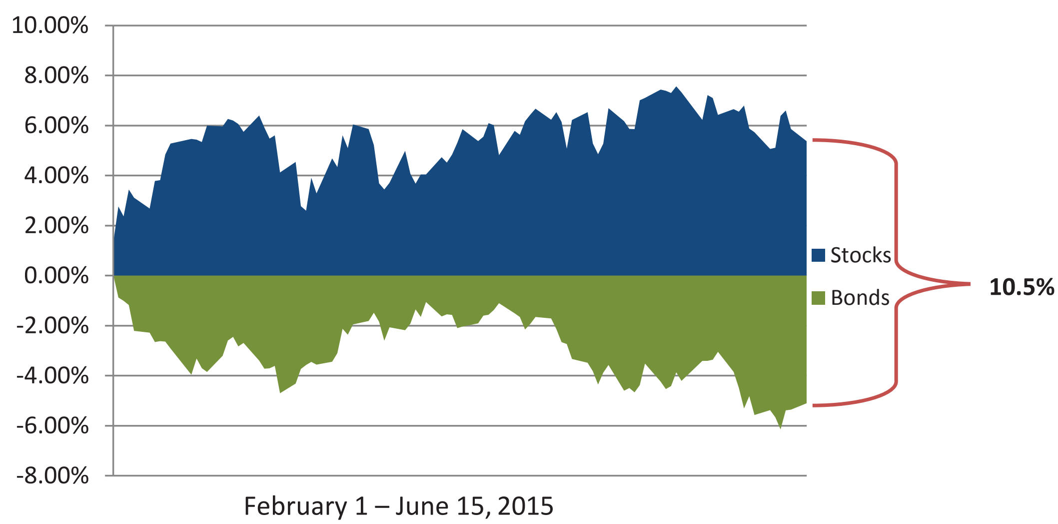
The question on investor's minds now as they look back at the "two markets" in the first half of the year is - what is in store for the remainder of the year? Will economic growth slow, causing equities and yields to decline, or will growth on a global basis reaccelerate, supporting higher earnings and wages? We are firmly in the economic growth camp. That does not mean that investors will only have blue skies ahead. Eventual Fed interest rate increases will dampen equity returns just as rising wages will put pressure on profit margins. Rising interest rates will also put pressure on bond prices, which supports our tactical underweight to bonds.

Chart 1: **Bonds Beat Stocks +4.4% vs. -3.0%**



Source: Bloomberg

Chart 2: **Stocks Beat Bonds +5.4% vs. -5.1%**



Source: Bloomberg

John S. Traynor
Chief Investment Officer
Senior Vice President

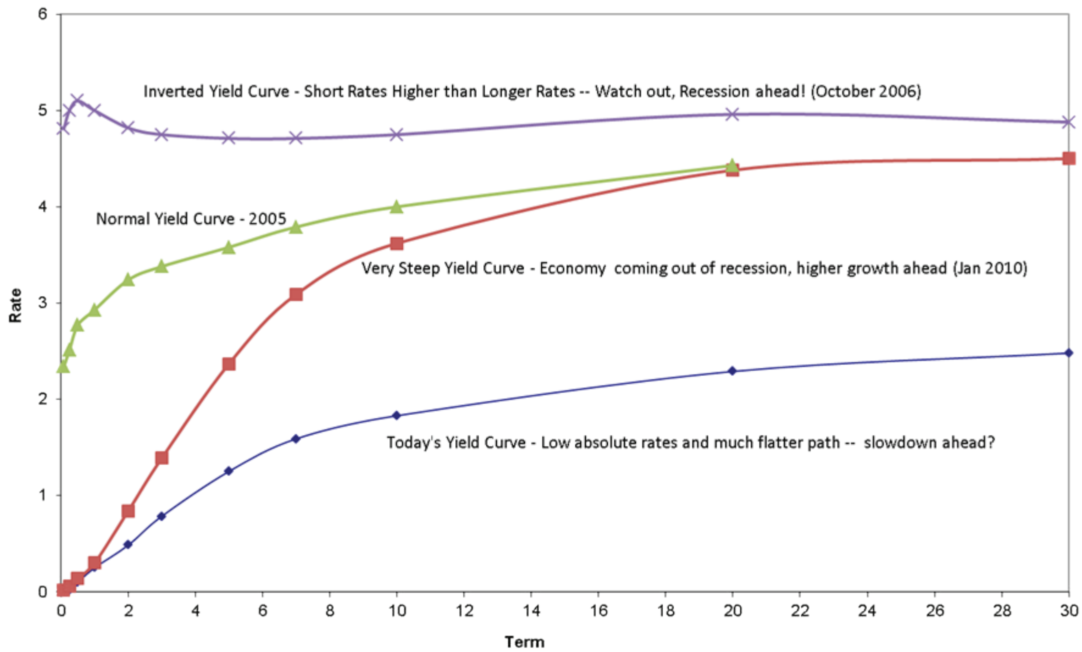
3Q15 Fixed Income Outlook – Into the Fray

by Karissa A. McDonough, CFA

The bond market has entered transition. Federal Reserve policies enacted over the past six years in reaction to the financial crisis – zero percent federal funds rate, $4 billion worth of Treasury and Agency purchases by the Federal Reserve to push down longer term interest rates, followed by similar programs by the European Central Bank and Bank of Japan – are at the point of expiration as the U.S. economy heals.

While the bond purchase program has already expired, the beginning of increases in the Fed Funds rate is something the bond market is nervously anticipating. Fed members have been discussing the potential timing and pace of these hikes for years at this point; however, it seems to be only recently that bond investors are starting to truly position for the hikes.

Chart 1: **The Yield Curve is a Powerful Economic Indicator**



Source: Bloomberg

Tighter liquidity resulting from higher rates and reduced provision of liquidity by central banks has broad implications for the global capital markets. Not only might higher interest rates potentially negatively impact economic growth, the global "reach for yield" – the movement of investors into riskier parts of the global markets in an effort to generate income when Treasuries provided little to none – looks set to unwind.

A large, swift reversal of this trade will serve to magnify the impact of Fed policy tightening. High yield bonds, emerging market debt and potentially even corporate bonds may experience a high level of fund outflows as investors leave these areas in favor of Treasury securities as those yields begin to approach more reasonable levels. A much-reduced base of investors for these bonds means lower available funding to the weakest borrowers – meaning that defaults could start to increase again after a 5 year hiatus.

The bond market has started to anticipate some of these follow-on effects from the pending tightening of policy. Heading into the 3Q, the Treasury market has experienced a rapid sell-off in tandem with other low yielding, safe haven government securities, in particular German Bunds. 10 year Treasury yields reached a year to date high of 2.50% following strong U.S. payrolls in conjunction with the sell-off in German Bunds.

U.S. bond investors are realizing just how global the bond market has become as the correlation between developed market government bonds is at historic highs. There has been a 96% correlation between the yield on 10-year German Bund yields and that of U.S. Treasuries since the start of 2014 according to the WSJ.

Our bond portfolio recommendations have not yet changed but we are watching the situation closely. As we've stated before, bond investors are effectively on a tightrope, balancing income generation in a portfolio with safety. Right now, the income being provided by higher

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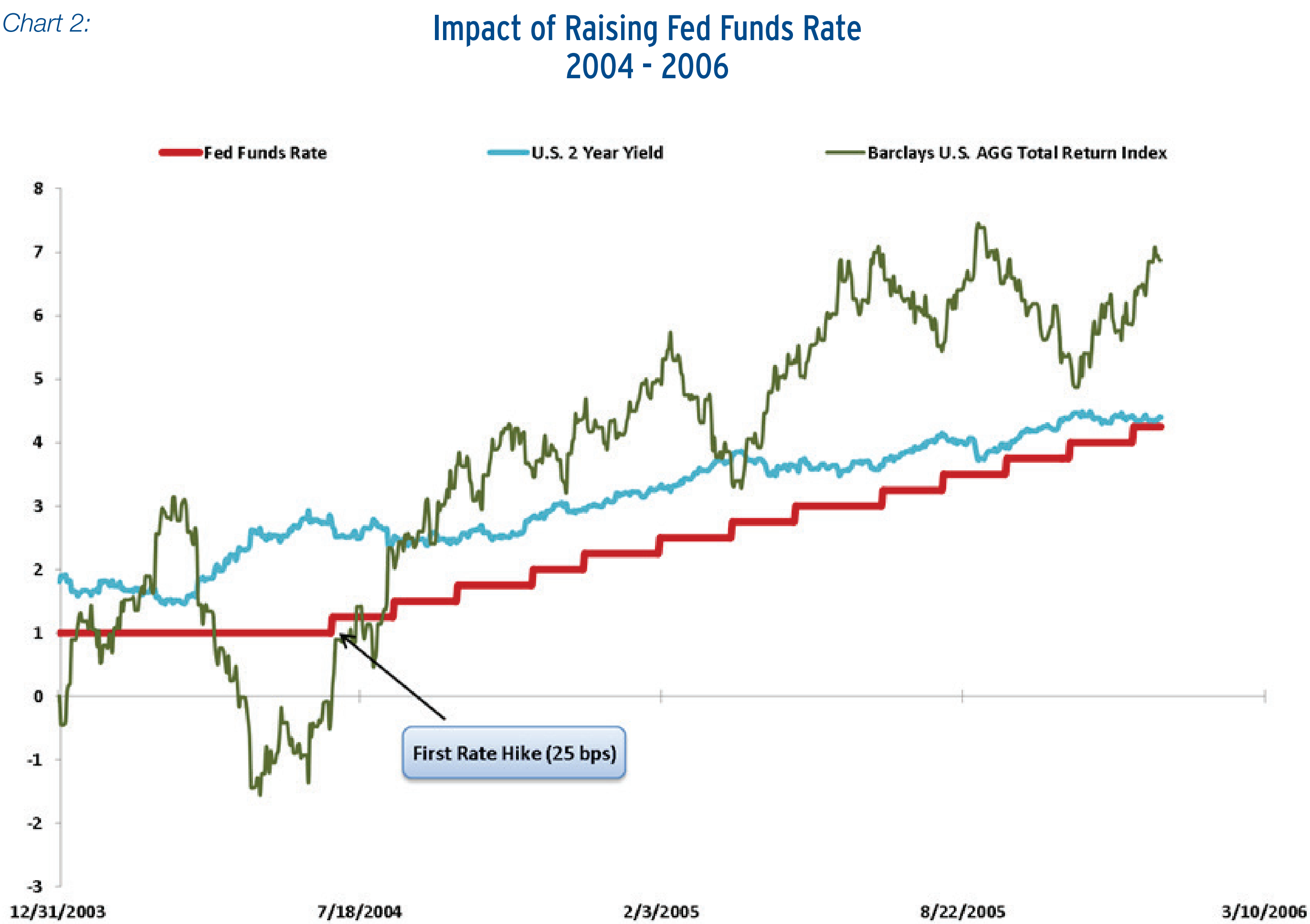
3Q15 Fixed Income Outlook – Into the Fray

Chart 2:



Source: Bloomberg

yielding securities such as the corporate bonds, high yield and emerging market bonds provides for some stability in a bond portfolio which would otherwise be almost completely beholden to price changes in Treasuries with very little coupon to cushion these moves. However, as we are seeing, funds are beginning to move away from these spaces. We will need to determine if and when to reduce exposure to these areas when negative price action on these assets looks to overwhelm the yield they generate.

For now, we recommend maintaining the two primary allocations in bond portfolios that we've had in place: Overweight credit exposure relative to Treasuries – although Treasuries or another safe haven proxy should still represent a quarter to a third of a diversified bond portfolio – and try to minimize interest rate exposure through adding higher coupon securities as well as floating rate securities. **The time will come to reallocate bond investments; however, we are not quite there yet.**

Karissa A. McDonough, CFA
Director of Fixed Income Strategy

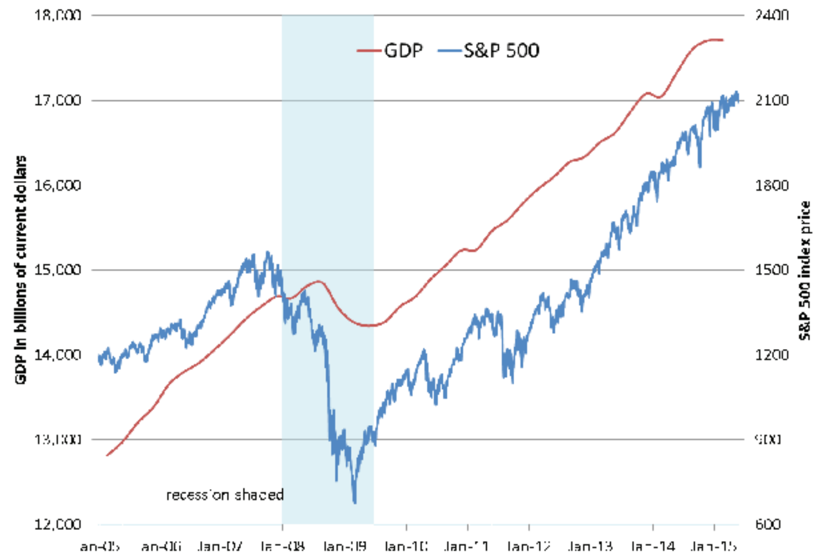
"More Risk Please?" Avoiding the Temptations of a Market Rally

by Albert Brenner, CFA

Investors have much to wonder about these days as we enter the seventh year of economic expansion in the U.S. and the seventh year of a bull market in equities. Will the rally in stocks continue? Will the economy keep growing? Are we in the middle innings or the late innings of the current cycles?

Investors who invested in risk assets post the Great Recession have done well since Ben Bernanke and the Fed took the economy in hand and flooded the market with liquidity. The S&P 500 index of large company stocks has increased more than three-fold from 676.53 on March 9, 2009 to 2092.83 on June 5, 2015. Meanwhile, economic output, as measured by GDP, has increased from $14.3 trillion annualized in the second quarter of 2009 to $17.7 trillion annualized in the first quarter of 2015 **(See Chart 1)**.

Chart 1: **Gross Domestic Product and S&P 500 stock index**



Source: Bureau of Economic Analysis and Bloomberg

The current expansion followed the sharpest economic contraction since the Great Depression and one of the worst years on record for the U.S. stock market. The reaction of many investors to the sharp drop in stock prices in 2008 (the worst year for large-cap stocks since 1931) was to reduce their risk exposure by reducing the allocation to equities in their portfolios. As natural as this reaction is to a loss experience, it was the wrong reaction in 2009. Investors who reduced their risk exposure lost out on the subsequent recovery.

Some investors today are feeling compelled to increase their risk after six years of market gains just as investors felt compelled to reduce their risk at the trough of the market in 2009. In more than one recent client meeting, discussions have turned to increasing the portfolio risk exposure.

Although the clients in these cases had plausible reasons for increasing their portfolio risk, I wondered how much they were motivated by a sense of lost opportunity. Were they saying to themselves, "Just think where I would be if only I had been willing to assume more risk five years ago."

It is difficult to avoid the influence of historical returns when making investment decisions, however, especially when stocks have returned over 23% per year for the last six years and bonds have returned over 4.6%.[1] But investors cannot buy past returns, and the choice of investing in a strategy that has produced strong returns in the past is little comfort if the strategy is not suitable for the future.

Should investors be increasing their risk exposure right now? Should they be adding equities and reducing bonds?

The answer to these questions depends on the state of an investor's financial plan and the answers to the following questions, among others.

1. Have plan objectives changed in a way that will require more or less money than previously planned?

2. Have unanticipated additions or withdrawals been made to the portfolio?

3. Will the current value of the portfolio be sufficient to meet the objectives given a reasonable rate of return consistent with the portfolio's current risk exposure?

4. Have there been changes in circumstances that warrant a change in risk tolerance?

An acceptable level of risk depends on the reasonable requirements of the plan and the psychology of the investor. A plan that requires a higher level of risk than is comfortable for the investor is a plan that needs changing. Assuming that plan objectives remain relatively constant, most investors should be inclined to reduce their risk tolerance over time as they get older. All things being the same, then, portfolio risk exposure would normally decrease over time.

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"More Risk Please?" Avoiding the Temptations of a Market Rally

Since the normal trend is for risk levels to decline over time, it appears suspicious when investors start asking about increasing risk exposure – especially when those questions occur after a period of strong market performance. Past returns can be very tempting, but we can't buy the past and we have to be alert to the temptation to let past high risk performance lead us to take on more risk than called for by a well formulated financial plan.

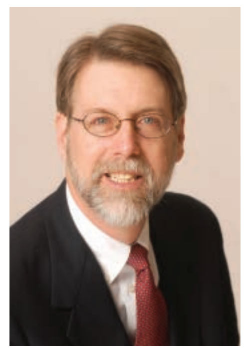
Although we do not think we are near the end of the current cycles of economic expansion and stock appreciation, we do think future returns will be much more modest than the past six years and investors should adjust their expectations and financial plans accordingly. Equity returns over the next seven to ten years are likely to fall short of the 7.9% compound growth rate they produced from 2005 to 2014 and well short of long-term historical averages. Similarly, bond returns are likely to fall short of the 4.7% compound growth rate they produced from 2005 to 2014.

Are more modest return expectations a good reason to increase risk? We don't think so. Although returns will be lower, volatility will not. The combination of the two might lead to potentially higher levels of loss than historically experienced. Modest return expectations may require a change in an investor's financial plan, but increased allocations to risk should be a last resort and only after careful consideration.

Chart 2: **Compound Average Return Rates, Actual & Projected**

	2005-2014	3/9/2009 to 6/5/2015	Next 7 to 10 years*
Stocks (Russell 3000 index)	7.93%	23.00%	Less than 6%
Bonds (Barclay's Aggregate bond index)	4.71%	4.65%	Less than 4%

**People's United Wealth Management estimate*



Albert J. Brenner, CFA
Director of Asset Allocation Strategy

JUNE 2015 QUARTERLY INVESTMENT REVIEW & OUTLOOK ASSET ALLOCATION DASHBOARD

STOCKS		Continue overweight in view of return/risk prospects and alternatives.
	UNITED STATES	Overweight. Valuations to forward earnings are above long-term average but not excessive. Economic growth accelerating. Corrections are buying opportunities.
	INTERNATIONAL DEVELOPED	Overweight. Quantitative easing by the European Central Bank and the Bank of Japan. Weaker currencies should continue to support asset values and modest economic growth.
	INTERNATIONAL EMERGING	Underweight. Slower growth in China, lower commodity prices, exposure to rising U.S. interest rates and need for structural reforms make EM equities vulnerable.
BONDS		Underweight. Low yields and rising interest rates warrant continued underweight.
	TREASURIES/ AGENCIES	Underweight but maintain reduced allocation for systemic risk protection.
	CORPORATE BONDS	Overweight. Spreads over Treasury yields provide some return protection as rates increase.
	HIGH-YIELD, EMERGING MARKET, CONVERTIBLE	Neutral to Underweight. Riskier sectors offer some yield protection but are susceptible to changes in market risk appetite.
REAL ASSETS		Underweight. Real estate valuations remain elevated and subject to adverse response to rising rates. Strong dollar and low inflation reduce diversification benefit of commodities and gold.
CASH		Underweight to Neutral. Near-zero rates will continue to depress cash returns.

This table provides a condensed view of our current tactical asset allocations and outlooks by asset class.

Positive Neutral Negative

[1]Returns cited are for the Russell 3000 U.S. broad stock index and the Barclay's Aggregate U.S. bond index. They are based on total return assuming the reinvestment of dividends and interest and are average annual compound (or geometric) return rates from March 9, 2009 to June 5, 2015.

Managing Through Transition

by Celia Cazayoux, CFA

As we prepare for the first increase in the Fed funds rate after an extended period of easy Fed policy, clients want to understand how their portfolios may be impacted and what changes, if any, should be made to be properly positioned for a rising rate environment. Certainly, financial assets have appreciated meaningfully alongside aggressive monetary easing on the part of the Fed. In addition, our clients have benefited as a result of the asset allocation decision to tactically overweight equity exposure over this same period.

"Our clients have benefited as a result of the asset allocation decision to tactically overweight equity exposure over this same period"

Looking forward, however, our expectations for investment returns in both equity and fixed income markets are more muted, with returns likely to be inside of their long run averages over the next 5-10 years. With this outlook in mind coupled with the need to support retirement income, many clients have begun to consider an increase in equity exposure.

Before an investor contemplates changing an investment objective to target higher rates of returns, it is important to revisit the original financial plan. Unless there are meaningful changes in one's financial picture or

Diversified portfolios are built to meet long term return...

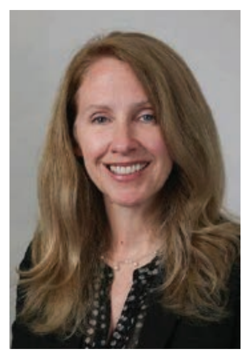
outlook, there is likely little need for a change in overall portfolio positioning. In any event, intermediate term market outlooks should not be the catalyst for these types of changes. Diversified portfolios are built to meet long term return and risk objectives and that each part of a portfolio fulfills a unique role. For example, while the outlook for fixed income as an asset class does not generate much enthusiasm today, its role as a diversifier, a source of liquidity and a ballast to the risk stemming from the equity portion of a portfolio is no less important and, therefore, remains a critical component in a diversified portfolio.

Investors may also need to be reminded of the many tactical allocation shifts that have occurred in portfolios in response to the market environment over the past seven years. In addition to the overweight to equities, there have been tactical shifts within fixed income as well with a transition to a more diversified, credit focused portfolio away from the traditional ladder of U.S. government securities

"The tactical shift to overweight credit exposure benefited investors as the U.S. recovered from the depths of the credit crisis"

and investment grade corporate bonds. Again, the tactical shift to overweight credit exposure benefited investors as the U.S. recovered from the depths of the credit crisis.

These tactical shifts occurred in response to market conditions and without the investor needing to make any changes to long term investment objectives. As we begin to exit this most recent period of extraordinary global liquidity, tactical shifts will again happen across portfolios over time as the transition is made to a more normal interest rate environment and investment returns revert to long run averages. Perhaps it is at these inflection points that it is a good time to revisit one's personal financial picture to ensure original assumptions and goals are still prudent. If that is this case, then an investor likely will not need to make any substantive changes to portfolios to be properly positioned as the market transitions.



Celia Cazayoux, CFA
Director of Manager Strategy

Diversification – A Quilt as Comfortable and Safe as the One Made by Grandma

by John Conlon, CFA

The two most common questions I have gotten from clients recently are: "Considering the fact that interest rates are increasing and bond prices move opposite to rate, why should I maintain an allocation to fixed income?" and "When is the stock market correction going to happen?".

In regard to the first question, my colleague, Albert Brenner, articulates an answer that is much better than one I can offer. In regard to the second, no one knows and there is no hard rule regarding corrections. It is just that historically when the equity markets have enjoyed a good run over a period of time; the market normally corrects (declines 10% or more) and then resumes an uptrend. This run currently ranks third in regard to duration without a correction. The longest stretch was 7 years.

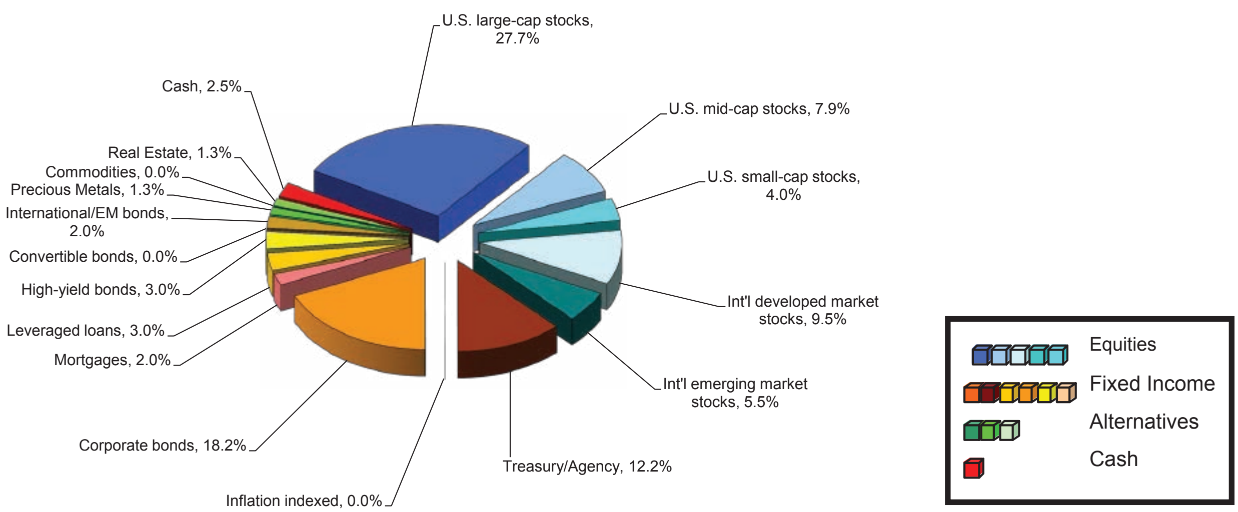
The real question that is being asked is, "Considering an environment of rising rates and a stock market that has enjoyed such good returns over a period of years, is there something I should be doing differently?". Just keep doing what you have been doing: manage risk through diversification with allocations to different asset classes and styles, i.e. fixed income, large company stocks, small company stocks, international, etc. This is what we refer to as the investment quilt.

An important thing is to stay focused on the economic fundamentals and not be distracted by all the noise that is out there. What is important are economic statistics showing the relative strength of the U.S. economy, such as that 280,000 jobs were created in May and that although unemployment did increase to 5.5%, the increase was due to an increase in the participation rate. Or that retail sales in May increased 1.2% and that auto sales reported last week showed that sales finished May at an annualized rate of $17.6 million. The fastest pace since January 2006.

All of this is evidence that the first-quarter economic performance was an aberration due to weather and the West Coast Port strike. Current GDP estimates for the second quarter are around 2%, a sustainable growth figure that is strong enough to bring down unemployment and generate equity growth.

John Conlon, CFA, CFP
Chief Equity Strategist

People's United Balanced Portfolio



We recommend that investors review the investment topics discussed in this strategy note in light of their own unique circumstances. The People's United Balanced Portfolio illustrated above should serve as a starting point for a conversation with your advisory team about building a portfolio customized to meet your goals and aspirations. Source: People's United Bank, Wealth Management

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