QUARTERLY INVESTMENT REVIEW & OUTLOOK

People's United Wealth Management

Our "Super Banker" to the Rescue: Economic growth in an uncertain world

by John S. Traynor, CIO

The long awaited increase in the Federal Funds rate, held at zero since December 2008, **(see chart 1)** will probably begin by year-end. Last month the Federal Reserve Board decided to defer a rate increase because of uncertainty over economic growth in China and in many emerging economies. Between now and year-end financial commentators will parse each statement made by Fed Chair, Janet Yellen, to glean any insight into the timing of an eventual rate increase. While we certainly are keeping a focused eye on potential Fed actions, we have long believed the more important long-term stimulus should have been emanating from our elected politicians in the form of policy, regulatory and tax changes rather than easy money from our Central Bankers.

"This year may also be remembered as the beginning of the end of the age of the 'Super Banker'."

The Age of the Super Banker

The first nine months of this year will be remembered for the unending Greek economic drama, the bursting of the Chinese stock market bubble and the Syrian diaspora across the face of Europe. This year may also be remembered as the beginning of the end of the age of the "Super Banker".

In 1979, during the dark days of gasoline lines, high inflation and economic malaise, the appointment of Paul Volker as Chairman of the Federal Reserve Board, introduced investors to a new breed of steadfast "Super Banker". Volker raised interest rates to historic levels which contributed to pushing the U.S. economy into a deep recession in 1982. With the election in 1980 of Ronald Reagan, the tough monetary policies of Volker were combined with the free market, low tax and reduced regulatory ideas of Reagan to restart the stalled economy.

By 1984 Ronald Reagan was running for re-election on the theme of "Morning in America" in part due to the incredible renaissance seen in the U.S. economy through the policies and actions taken by Volker.

(Continued on pg. 2)

Economic Dashboard		
Economic Growth	Positive	The U.S. economy continues to improve as auto sales and housing show strength. Concern over a slowdown in China and the implications of that slowdown on emerging market economies has raised global growth concerns as we enter 2016.
Employment	Positive	The unemployment rate fell to a cyclical low of 5.1% in August. An encouraging note in the report was the increase in full-time positions relative to part-time.
Profits	Neutral	With unemployment low, we believe wages will start to grow at a rate higher than 2% in 2016. This will put pressure on margins next year and keep earnings growth in the high single digits over the next twelve months.
Inflation	Positive	Lower oil prices have kept the headline inflation CPI at near zero levels this year. This benefit will begin to ebb as prices gradually rise next year. We believe inflation will finally top the 2% level in 2016.
Interest Rate	Negative	We believe the Fed will act to raise the Fed Funds rate for the first time since 2006 by year-end. Rates should rise very slowly in 2016 as the Global Growth environment does not merit dramatically higher rates.

Positive Neutral Negative

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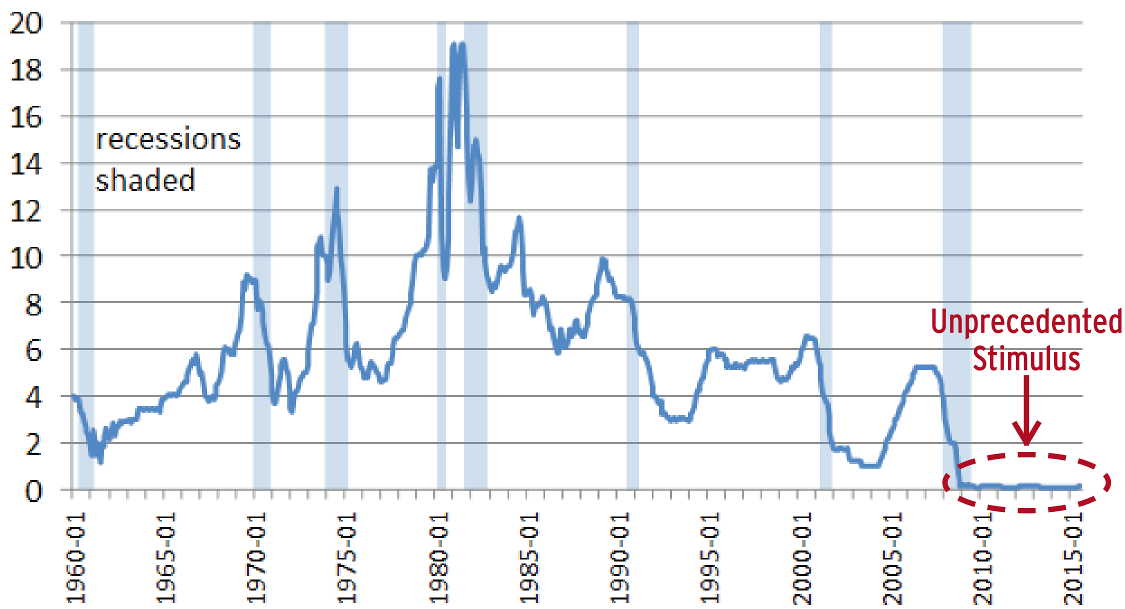
Chart 1: **Federal Funds (effective) Rate**



Source: Board of Governors of the Federal Reserve

After bringing inflation down from a peak of 14.8% in March 1980 to 4.3% by August 1987, Volker left the Fed and was followed by Alan Greenspan. Just two months later, Greenspan was challenged by the stock market crash of October 1987 which he navigated superbly. Greenspan remained Chairman until 2006 when he was followed by Ben Bernanke who soon faced the 2008 financial crisis. Each of these Fed Chairmen faced market corrections and economic turmoil with great skill, further burnishing the image of the Chairman as a "Super Banker", able to navigate the dangerous shoals threatening the global economy. Whether this image was justified will be debated for years to come. We believe

> "THE "SUPER BANKER" HAS LULLED POLITICIANS INTO NEGLECTING THEIR ROLE..."

the success of the "Super Banker" has lulled politicians into neglecting their role in promoting economic growth.

Today Janet Yellen is facing her own financial market challenge as she plans the first Fed interest rate increase since 2006. After nearly seven years of a Zero Interest Rate Policy (ZIRP) and multiple rounds of Quantitative Easing (QE), U.S. economic growth has been the slowest in the post WWII period. Since 1946 the U.S. economy has had an average annual growth rate of 3.2%, but has only grown at a 2.2% rate since the end of the recession in June 2009. Consumer and business confidence in the strength and sustainability of the current recovery has been below normal levels throughout this entire recovery. Economists now talk of "Secular Stagnation", a term not heard since the Carter administration during the late 1970's economic malaise. It seems that investors in particular and Americans in general have begun to doubt the powers of the "Super Bankers" to direct the economy higher. The difficult task faced by Janet Yellen, raising interest rates while maintaining economic growth, has been made all the more challenging because of the lack of a bipartisan growth plan from Washington.

As the 2016 election season heats up, we hope both parties will focus on those policies which will help grow the economy, grow household income and unleash the economic dynamism and creativity we know still exists in the hearts and minds of individuals nationwide.

John S. Traynor
Chief Investment Officer
Senior Vice President

Fixed Income 4Q15 Outlook: The Crystal Ball is Clouding Up

by Karissa A. McDonough, CFA

Our message in these pages over the past two years has been somewhat consistent – Interest rates remain at cycle lows and we believe it is reasonable to expect some reversion to the mean. The Fed is seeing progress in U.S. unemployment which should theoretically provide cover for removal of the excess levels of monetary accommodation of the past seven years.

However, just as we stand on the precipice of tighter monetary policy here in the U.S., and perhaps because of it, the case for the Fed to start hiking the fed funds rate is not as clear cut as it seems.

The changing global picture requires a bit more nuance in how we think about the path of future interest rates. This also requires a necessary separation of the different segments of the Treasury market into the shortest-term interest rates, which the Fed has the most direct control over, and longer term rates which are more beholden to global dynamics.

Our more nuanced view is this: Rates on the shorter maturity end of the Treasury yield curve are likely to rise, primarily reflecting either anticipated or actual Fed action on short rates. For longer term Treasuries, we expect interest rates might stabilize or rise much more slowly relative to shorter term rates, depending on the growth rate of the global economy and the implications for the potential demand for safety.

Domestically, the case seems pretty cut and dried. The U.S. economy appears to be approaching full employment; however, inflation remains persistently below target. We believe that it is less a case of "if" the Fed will officially move this year, and more "when". As of the time of this writing, bond investors themselves were divided on the timing and number of interest rate hikes that will occur in 2015. One thing the Fed has been very consistent about is the message of a gradual process of hiking rates, regardless of start date.

Concern regarding global growth and increasing market volatility may also impact the Fed's decision. This single powerful exogenous factor is what has led us to a lack of conviction about the timing of the first hike. During the several years of robust levels of monetary easing and zero interest rate policies in the depths of the financial crisis, global investors naturally searched for markets that still provided yield as well as the opportunity for growth. Emerging Markets fit both of those bills, and so for the ensuing several years, trillions of investor dollars found homes in the foreign reserves of emerging market central banks as part of a gambit to increase yield and return in a global bond market starved of both.

Global central banks are on different tracks, with Europe, Japan and now China as well on a path to continued monetary easing in the face of slowing economic growth, while the U.S. is looking to tighten policy. **This policy disconnect is more than just an interesting theoretical discussion.** Very real market and economic implications arise from this dynamic. Global investors, seeing that they no longer have to take the risk of investing in China to get relatively higher rates of return once rates in the U.S. start to rise, will pull their trillions of dollars back out of emerging markets and into the U.S.

This potentially massive flow of funds out of emerging markets will have the effect of tightening liquidity in these more fragile markets, just when those central banks are trying to increase liquidity to support both the capital markets and their domestic economies. This situation will potentially be destabilizing for emerging markets, leading to increased volatility globally, and could increase the volatility of riskier asset classes domestically – equities, high yield bonds both being possible candidates for a selloff in such a scenario.

Longer term, this is what domestic investors are facing: A transition from a global market supported by central bank-provided liquidity, to the tune of $15 trillion, back to normalized fiscal-policy driven economic and capital markets, and concurrently, a normalized [lower] level of returns across asset classes. Given the level of accommodation and the length of time such support has been in place, the transition back to unsupported markets could be difficult, particularly in light of a relatively weak global recovery.

Fund flows into the U.S. should be largely positive for domestic bond investors; however, investors need to be aware

(Continued on pg. 4)

Fixed Income 4Q15 Outlook: The Crystal Ball is Clouding Up - Continued

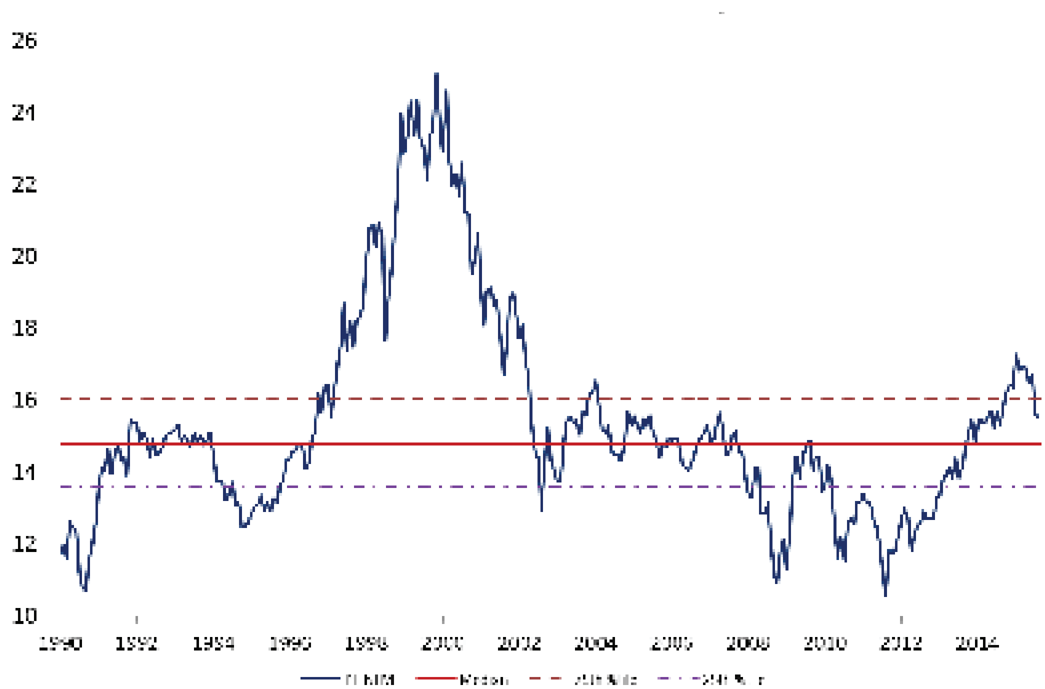
of the degree to which bond portfolios may have migrated to higher income generating assets and away from "core" bond exposure over the course of the past several low interest rate years. We've discussed de-risking the bond portion of investment portfolios over the recent past and posit that bond investors still have an opportunity in here to upgrade the quality of their bond portfolio further, ahead of another high volatility market episode and the pending transition away from Fed life support.

Karissa A. McDonough, CFA
Director of Fixed Income Strategy

Why Equities? Why Now?

by Albert Brenner, CFA

Chart 1: S&P 500 Valuation Price to Next Twelve Month Earnings



Source: Bloomberg

Equities have been the place to be since before the Great Recession ended in June 2009, and the economy started its long, slow recovery. From March of that year through August 31st of this year, investors realized a total return of more than 200% from the S&P 500, or nearly 19% per year on average including the August sell-off. Fortunately, we have been overweight equities in every investor objective for more than four years, and investors who have followed our guidance have benefited from this tactical over-weight.

The picture for 2015 isn't so pretty, however. As of September 11, the total return for the year was -3.3% for the S&P 500 after being at +3.4% at July 31st. Although the equity overweight boosted returns in the first half of the year, the sell-off in world equity markets precipitated by China's surprise devaluation of the yuan on August 11 has more than taken away the first-half advantage and left some investors wondering why be overweight equities now.

We continue to be overweight equities for the simple reason that equities offer better return prospects than bonds, real assets, or cash. Although not all equity markets are created equal (and we have been significantly underweight in emerging market equities for some time) U.S. and foreign developed market equities offer returns that – modest though they may be – should outpace bonds, real assets and cash.

Investors can't be faulted for wondering if this isn't just a little bit crazy. What about China, the global economic slow-down, the stronger dollar, and the threat of recession? Isn't this the time to get out of stocks? We don't think

Why Equities? Why Now?

so. If anything, the recent sell-off increases the future return prospects for equities.

Although August reminded investors that stock values do not march inexorably higher, as they seemed to from March of 2009 until recently, the return of volatility and the late summer sell-off have not materially changed our forward-looking perspective. As John Traynor has written in the lead article of this issue, we do not expect a slow-down in China to push the U.S. into recession. The direct impact of China on the U.S. is small. U.S. exports to China are equivalent to less than three-quarters of one percent of GDP, and only 16 companies of the S&P 500 derive more than 10% of their revenue from China. The indirect impact remains to be seen, especially since China is more important to emerging market economies and its regional trading partners. With the exceptions of Japan, Australia, and New Zealand, however, most developed economies are more important to China than China is to them. This fact is good news for China, as the recovering and/or expanding economies in Europe and the United States will support China's economy.

No doubt a slower growing China will remove some stimulus for global growth overall, but the two largest economies in the world, the U.S. and the eurozone, are expanding. The U.S. economy is in the seventh year of expansion. Growth continues to be driven by consumer spending, increasing employment, and a recovering housing market even as household balance sheets improve and debt burdens remain near historically low levels. With this support, the prospects for a recession are remote in the near- to mid-term, and investors' concerns about a possible recession are overblown. Although the recovery in the eurozone is not as strong or on as firm a footing, the bond-buying program of the European Central Bank is providing support to financial assets, if not the economy in general.

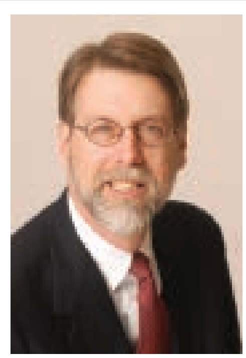
Yes, the economy is not the stock market, but it can become the stock market when a recession looms, which is why monitoring the state of the economy is important for investors. In the current case, however, anxieties are exaggerated, and the August correction is not a sign that the economy is about to contract. The momentum of the world's developed economies is sufficiently strong, in our estimation, to withstand a slower growing China. Investors should keep in mind that slower growth in China can provide the same support that higher growth rates provided in the past simply because China's economy is larger today.

"But aren't stocks overvalued?" the skeptical investor asks.

We don't think so. Although the ratio of price to forward or estimated earning – our preferred valuation measure – had risen above its long-term average before the sell-off, it had not risen to extreme levels. With the sell-off, valuations declined. In mid-September, with the S&P 500 at 1960, stocks were priced at roughly 15.5 times estimated earnings – near to the long-term median and far from extreme levels as shown in the accompanying chart.

Aside from what we think are reasonable prospects for U.S. and developed market equities, we are overweight equities because bonds, cash, and real assets offer no attractive alternative. With interest rates as low as they have been, return prospects for investment grades bonds are 2.0% or less over the next one to three years. Cash returns have been virtually zero and are not likely to increase materially until rates are closer to normal levels. The world-wide over-supply of commodities combined with lower levels of demand from China and the developed world will likely result in very low returns on commodities, even with some normalization of crude oil prices.

Bonds, cash, and real assets still play an important role in risk management through portfolio diversification, but developed market equities continue to offer the best return prospects for now.



Albert J. Brenner, CFA
Director of Asset
Allocation Strategy

The Importance of Downside Protection as Volatility Spikes

by Celia Cazayoux, CFA

As we entered 2015, the financial press was writing extensively about the underperformance of active managers over the course of this bull market and, in particular, during calendar year 2014. In our Q1 2015 Investment Review & Outlook, we wrote that it was worth examining the drivers of the market to gain a better understanding of why active managers were lagging their respective benchmarks and highlighted the impact of quantitative easing programs in creating an era of low interest rates, subdued volatility and low dispersion. Such an environment can be a difficult one for active management to add value; rather it is in times of volatility or bear markets that active management demonstrates its value.

> "This most recent episode of volatility reminds us that equity markets do indeed experience drawdowns..."

As we have discussed throughout the year, we expected volatility to return as central bank policy around the world begins to diverge. August certainly delivered as volatility spiked and domestic equity markets experienced the first painful 10%+ pullback in over four years. This most recent episode of volatility reminds us that equity markets do indeed experience drawdowns on this order of magnitude on a fairly regular basis and that investors should not become too complacent. It also reminds us of one of the primary benefits of including active management in investment portfolios – downside protection.

If we consider the universe of truly active managers; i.e. those with high active share, not "closet indexers", we find that they have consistently captured less of the downside than their respective benchmarks.

Invesco conducted a study of approximately 3,000 equity mutual funds over the past twenty years, which includes five distinct market cycles. On an asset-weighted basis, approximately 64% of these active managers had better downside protection versus their respective benchmarks over this period. In addition, these managers demonstrated better downside protection, on average, in all five of the specific market cycles. The net result is that this level of protection from losses translates into excess returns over time.

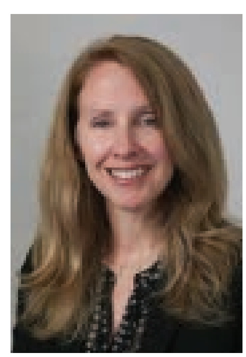
> "Downside protection is a key consideration in our manager selection process."

Downside protection is a key consideration in our manager selection process. In a perfect world, investors want all the return, but none of the risk. As equity investors, we know that simply isn't possible, so risk management is critically important. Active managers control for risk, in part, by focusing on fundamental analysis and valuations in security selection, providing a degree of protection against losses during market sell offs.

In fact, we would be willing to sacrifice some participation in the upside for protection against losses when the market goes against us. Why? Because less money lost means less to make up over time and, because investors are generally risk averse, they are more likely to stay invested if they lose less than the benchmark averages in tumultuous markets.

> "Less money lost means less to make up over time..."

Our takeaway is that incorporating active managers with a well-articulated and time tested investment process and philosophy provides an opportunity to generate returns that are in line or better than benchmark averages with a lower level of risk.



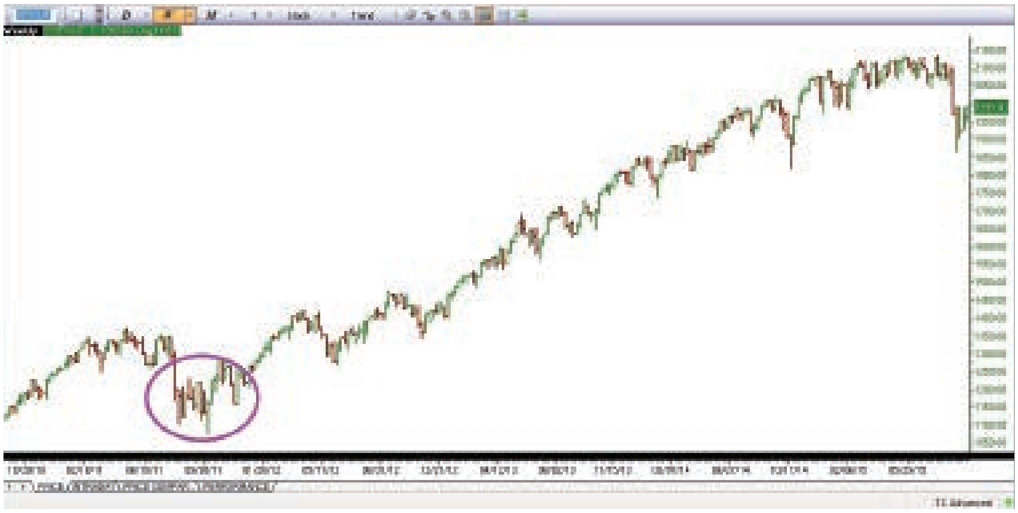
Celia Cazayoux, CFA
Director of Manager Strategy

“May You Live in an Interesting Age.” – a purported Chinese curse

by John Conlon, CFA

In the 1979 movie “The China Syndrome” fear arises that after an earthquake, damage to a nuclear reactor could cause a melt-down. [The title comes from the exaggerated description of a melt-down going straight through the earth to China. Actually, the Indian Ocean is on the opposite side of the earth from the U.S., but “The Indian Ocean Syndrome” is not as catchy a movie title.] I am sure there are some investors that after the past three weeks would label this stock market “the China Syndrome”, fearing that it is going to drop clear through to China.

Chart 1: **Weekly Chart of S&P500 Index (SPX) 2010 - 2015**



Source: Thomson One

Over the past three weeks, concerns about what impact slower economic growth in China and the devaluation of the yuan may have on global economic growth has led to an 8% downturn in the market. China is more of an excuse, however, than a reason for the sell-off in equities.

We need to keep what has happened in perspective. First, regarding China’s impact on economic growth, U.S. exports to China represent only about 1.2% of GDP. For most of Europe it is a comparable percentage, with Germany being an exception at about 2.7%.

Second, in regard to the movement in equity markets, since the market (the S&P 500) began its recovery in March of 2009 through Friday, the market is up about 180%. Since the 17%-18% correction in 2011, the market is up over 70% **(see chart 1)**. Also historically, markets have averaged three pull backs of 5% or more a year, one correction of 10% or more every year or so, and a decline of 20% or more every four years or so. These events have not happened so the market was overdue for this type of action.

Lastly, we also need to remain focused on the economic fundamentals since that is what wins out. Second quarter GDP growth was estimated at 3.7%. Consumer spending and consumer confidence is up. Durable goods orders are up. Claims for unemployment have declined. Auto sales are on track for the best year in a decade. U.S. home sales are up. In addition, business and consumer surveys are showing that the Europe’s economic recovery is continuing in the third quarter.

We expect the uptrend in the stock market to be re-established but not before the market establishes what is known as a base. For the ten weeks that followed the 2011 correction, the weekly swings in the equity market ranged from over 10% to around 5%. The average weekly price swing during this 2 ½ months was 6%. **(see chart 1)** Although the swings may not be as large, we do expect similar volatility following this correction. During this time, we will be taking advantage of discounted share prices to further strengthen our portfolios with quality names.

Investors should take advantage of this period to re-examine their risk profile. In the past this was done by answering questions concerning hypothetical situations of market volatility. Having lived through the current volatility, investors now have real life experience to draw from.

John Conlon, CFA, CFP
Chief Equity Strategist

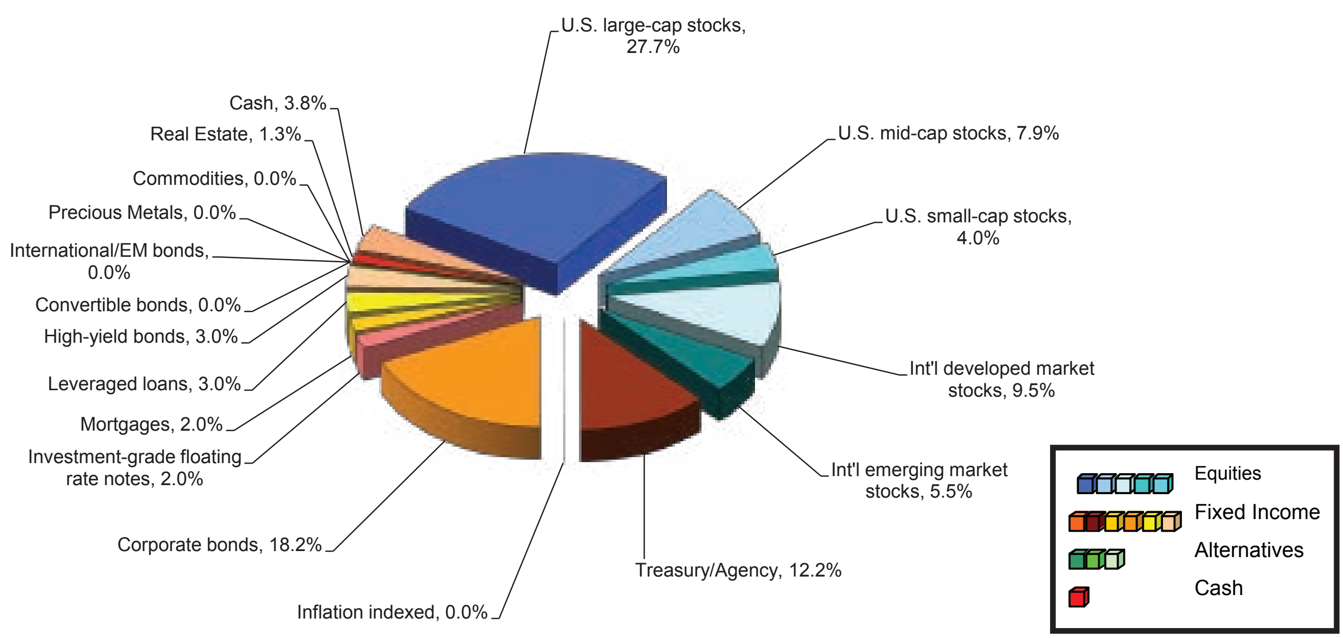
SEPTEMBER 2015 QUARTERLY INVESTMENT REVIEW & OUTLOOK ASSET ALLOCATION

STOCKS (Positive)		Continue overweight in view of relative return prospects.
Positive	**UNITED STATES**	Overweight. Continuing economic growth supports fundamental case for U.S. equities. Valuations to forward earnings were reduced by recent market decline and are closer to long-term averages. Corrections are buying opportunities.
Positive	**INTERNATIONAL DEVELOPED**	Overweight. Quantitative easing by the European Central Bank and the Bank of Japan and weaker currencies should continue to support asset values and modest economic growth. Opportunities for higher profit margins also warrant overweight.
Negative	**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 (Negative)		Underweight. Low yields and the expectation of rising interest rates warrant continued underweight.
Negative	**TREASURIES/ AGENCIES**	Underweight but maintain reduced allocation for systemic risk protection.
Positive	**CORPORATE BONDS**	Overweight. Spreads over Treasury yields provide some return protection as rates increase.
Neutral	**HIGH-YIELD, EMERGING MARKET, CONVERTIBLE**	Neutral to Underweight. Riskier sectors offer some yield protection but watch the credit cycle.
REAL ASSETS (Negative)		Underweight. Real estate valuations remain elevated by some measures. Strong dollar and low inflation reduce diversification benefit of commodities and gold.
CASH (Negative)		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

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 Wealth Management

To see our experts in the news, visit peoples.com/wmnews