Winslow, Evans & Crocker, Inc.[SM]

Oct. 2014 GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY

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Overview

In this month's publication we will examine some of the issues that have caused volatility in the form of the VIX to increase; review the market's equity risk premium and our view that the market will be driven by earnings rather than multiple expansion; examine some of the conflicting US economic data; and, briefly touch upon some of the economic worries being generated by China and the Eurozone.

CHART 1. As can be seen in Chart #1 the volatility of the US markets as represented by the VIX clearly spiked up during the month of September. This was likely caused by geopolitical events as much as by economic concerns.

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CHARTS 2-4. If, however, we examine the VIX for the past ten years in Chart #2 we can see that the most recent has so far been insignificant when compared to the 2008-2009 recession and the Eurozone peripheral crisis of 2011.

The US equity markets are not cheap by historical standards with a forward P/E of around 15.8X earnings, Chart #3. This chart illustrates that the markets will likely be driven by earnings, the green line, rather than by increasing multiples. Overall, however, the US markets remain inexpensive relative to other asset classes such as government and corporate bonds and, in many cases, real estate. The market's earnings yield in excess of Baa yields, Chart #4, is about one standard deviation above its historical mean but, more interestingly, at a premium that we feel is unwarranted by the historically low financial stress index, the red dashed line.

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CHARTS 5-6 One of the best leading indicators that we have found for the year over year growth in forward earnings estimates is the 3 month moving average of the ISM New Orders Survey, Chart #5. Forward earnings are growing 7.4% year/year and the New Orders 3 month moving average is pointing to even stronger future growth. Using the ISM New Orders, the Financial Stress Index and the US Output Gap as independent variables we have modeled in Chart #6 what the market earnings yield premium should be, yellow line. Based on these variables this model is implying that the market is about 37% cheap.

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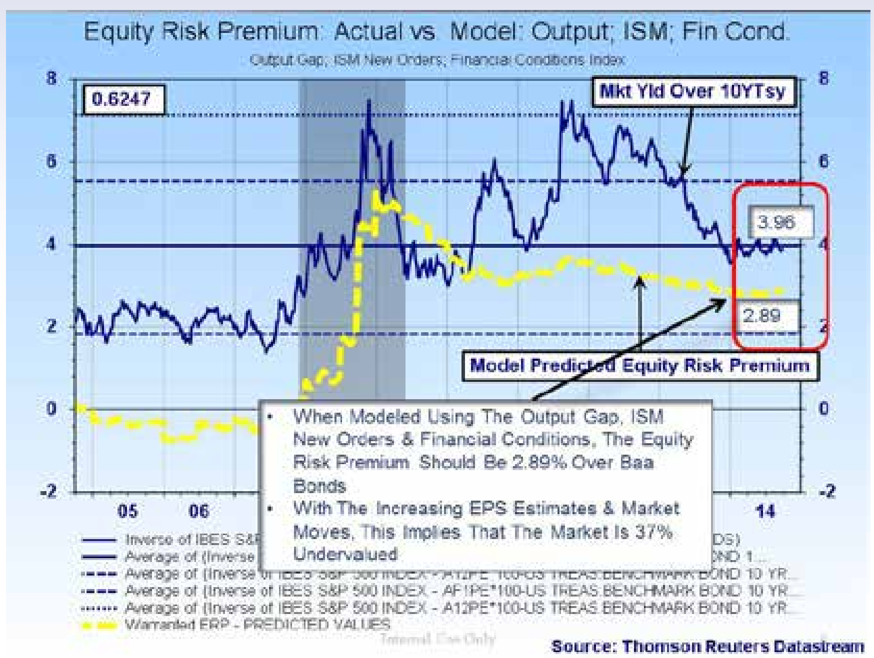

CHARTS 7-9 Chart #7 shows the Core Durable Goods orders and Initial Unemployment claims that came out the week of 9/22 and both data points were excellent with Core Durable Goods at their highest level in 10 years! If you were to examine past periods of private investment as a percentage of GDP as shown in Chart #8 you can see that the next recession didn't occur until 4 to 8 years later so that even though we are 5 years into this recovery we may still only be mid-way through!

Chart #9 shows that both personal consumption and income on a month over month basis grew last month, a positive sign for the consumer discretionary sector.

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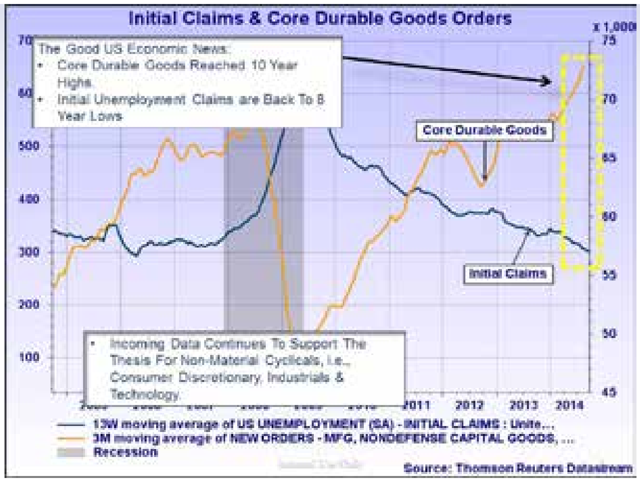

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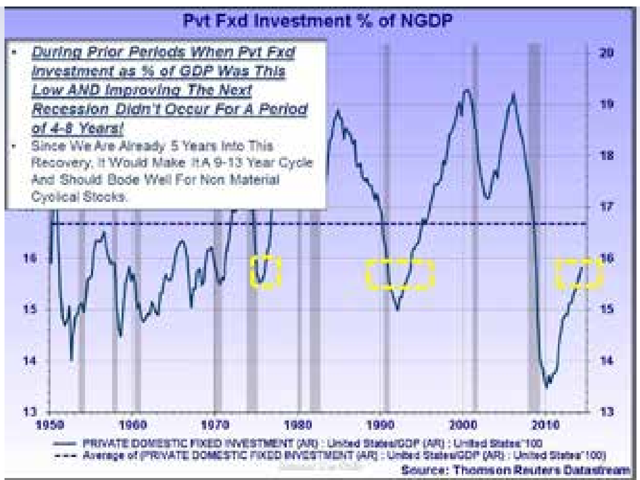

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CHARTS 10-13. In Chart #10 we have removed the energy costs from the PCE inflation data and correlated the remainder number with the relative performance of the consumer discretionary sector to the S&P500. With a 90% coefficient of determination it is clear that as energy costs decline those expenditures are diverted to other discretionary items. The major conclusion from this graph is that there has been a gap that has opened up between the these two time series and it is our expectations that it will be closed by an improvement in the relative performance of the consumer discretionary sector.

Many economists have been waiting for housing to make a strong comeback and contribute to the economy's growth but, so far, the comeback has been tepid. There is encouraging news on Chart #11 as the National Association of Homebuilders Index (NAHB) has made a nine year high and tends to correlate very well with the index of homebuilders stocks. Currently, the NAHB index looks very bullish for the homebuilders. Housing starts, which also correlates well with the homebuilders, is represented by the orange line in Chart #12 and as you can see they tend to track framing lumber prices fairly closely which, for the past few years, has been bullish for housing starts.

Chart #13 shows the interest rate spread between high yield bonds and both corporate and government bonds. This has spiked up during September, causing considerable angst because this type of move has historically presaged a 10% market correction. Although it was likely caused by a combination of weaker than expected economic data and growing geo-political upheaval, it certainly bears watching.

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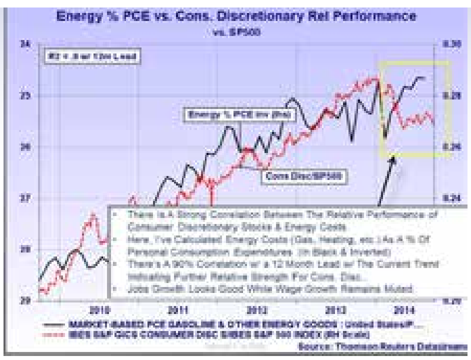

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CHARTS 14-16 Looking at it from a longer time horizon on Chart #14 we can see that the spike in spreads was not nearly as severe as it was prior to mid-2013. Furthermore, the spreads had been trading below Fitch's Probability of Default Index, the dashed green line, for most of the past year and it isn't surprising that they have risen to equal the index.

Another area of concern is the collapse in the Chinese real estate market with its potential to drag down the Chinese economy below their targeted growth rate, Chart #15. Other indicators of weakness are in the fall in electricity production and the collapse in railroad freight volume over the past year, Chart #16.

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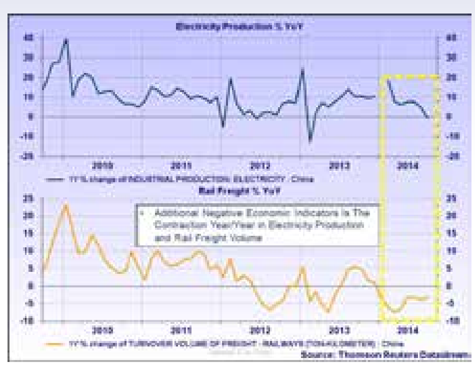

CHARTS 17-19. The offset to these difficulties is illustrated in Charts #17 and #18. In Chart #17 you can see that the gross government debt as a percentage of GDP is only a quarter of that of the US and, in Chart #18, the Chinese have an enormous amount of foreign reserves at their disposal. Both of these conditions provide the Chinese the ability, unlike Europe and the US, to weather the fallout of a bad real estate market. The Chinese small cap market, the ChiNext, generally has little to no foreign exposure and is a good view into the condition of the local economy. As you can see in Chart #19 this has recently set a new high, which, it would seem, is inconsistent with the view that the Chinese real estate and banking sectors will soon precipitate a sharp fall in the Chinese economy.

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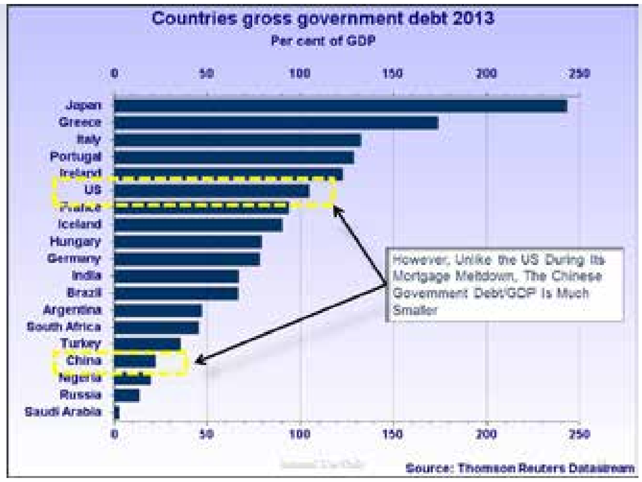

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CHARTS 20-22. Europe is also a source of economic concern as both their business surveys and their leading indicators have peaked and begun to roll over this year, Chart #20. Furthermore, both headline and core inflation are still declining, Chart #21, which gives rise to fears of deflation and a potential return to a recession. As shown on Chart #22 the European Central Bank has lowered interest rates (orange line) but has yet to expand their balance sheet through their own version of Quantitative easing. Faced with higher energy prices from Russia and many intractable domestic structural problems, the actions of the European Central Bank will be critical in the short term for avoiding another recession.

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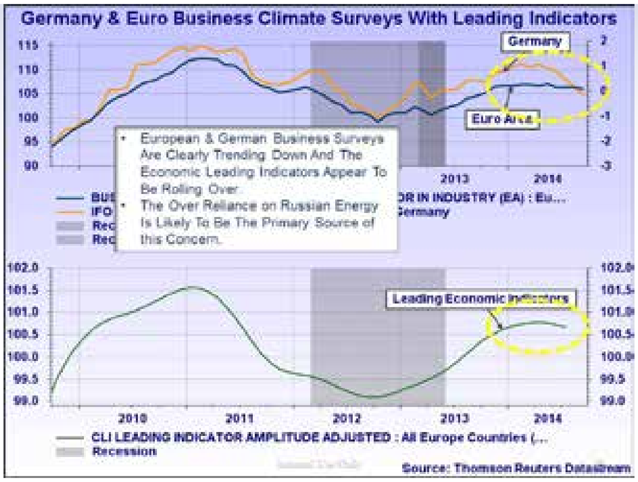

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In summary:

1. US Economic Data has been mixed, but more positive than negative.
    a. This should support non-material cyclicals such as Consumer Discretionary, Technology and Industrials.
    b. If the sharp jump in High Yield credit spreads worsens it could signal a market correction of 10%. This needs to be watched closely but, based on levels of the past few years, it doesn't appear out of line with Default Expectations.
2. Global Economic Indicators remain in positive territory but are weakening.
3. Global Liquidity will be maintained as the ECB and BoJ pursue Quantitative Easing just as the US Fed begins to slow its QE.
4. Europe must battle deflation with their own version of QE but, unfortunately, they still remain exposed to Russian energy costs; threats from ISIS; and, their own reluctance to pursue necessary internal structural economic reforms.
5. China's inflated real estate market could be a major drag on Chinese Economic growth when and if there is a major correction.
    a. The offset is the low government debt to GDP and high balances of foreign reserves.
6. US Equities remain attractive relative to other asset classes such as corporate and government bonds and, in some cases, real estate:
    a. The US has lower exposure to geo-political risks than other economic regions (Ukraine, ISIS, Hong Kong, China)
    b. The US faces far fewer structural problems than does Europe e.g. France and Italy.