Winslow, Evans & Crocker, Inc.[SM]

MAY 2015 GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY

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Overview

There are three major areas that I would like to cover in this month's commentary. First, the economic data coming in for the US, although mixed, is pointing more convincingly toward stronger economic growth going forward. In fact, we may well be at a positive inflection point after having suffered through a miserable 0.2% first quarter growth rate. Second, the growth rate of monetary liquidity outside of the US is unprecedented and is contributing to excess funds flowing into bonds and equities, higher inflation expectations, and increasing interest rates. Third and last, the apparent bottom forming in WTI oil prices due to the rapid decline of drill rig usage. Because of other factors there now appears, in our opinion, to be a higher probability of downside risk to the price of oil than upside for the balance of the year.

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CHARTS 1-2. ECONOMIC DATA: Much of the data that has come in over the past few weeks is helping to bring better clarity to the growth outlook in the US for the balance of the year. An important component of GDP growth prior to this past recession had been the housing market which, since the end of the recession, has failed to rise to its prior significance as can be seen in Chart #1. Although housing starts are trending up nicely, the impact on GDP still lags. In Chart #2 we can see a very important upward spike in new household formations for both the February and March periods, well above the 0.5% average since the end of the recession. This has a high correlation with new housing starts and is a leading indicator by about seven months.

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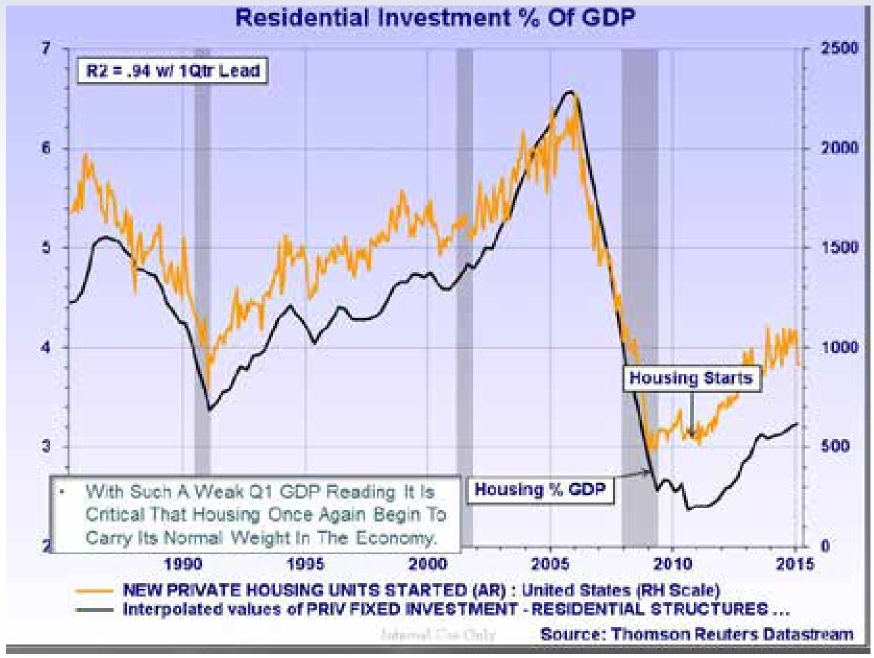

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CHARTS 3-4. Further evidence of a strong upward bias to new housing starts comes from the National Association of Home Builders survey, Chart #3. In addition to the historically strong correlation with new housing starts, the NAHB survey appears to have been stronger than the number of housing starts. This gap should close through an increase in housing starts, thus giving a boost to the economy. Finally, the increase in housing starts will have a positive impact on the Homebuilders Industry, Chart #4, where there is also a very strong correlation between these two time series.

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CHARTS 5-6. Perhaps one of the most important statistics for the capital markets and the economy is the monthly payroll number which, for March, was a disappointment. As shown on Chart #5 not only did it miss expectations but the prior two months were revised down. Much of this disappointment was attributed to factors which appear to be fading: severe winter weather, the West Coast dock strike, the collapse in oil prices and consequent capex and employment shrinkage in that industry and, finally, the sharp, sudden rise in the US$. Certainly when the record number of job openings is examined, as shown on Chart #6, it becomes clear that the forces that depressed the jobs numbers are transient in nature. The Jobs Opening and Labor Turnover Survey number (JOLTS) is at a record high for this cycle and has surpassed the peak of the prior economic cycle. Additionally, the quit rate, shown in orange, is also on a strong uptrend and indicates growing consumer confidence about finding jobs.

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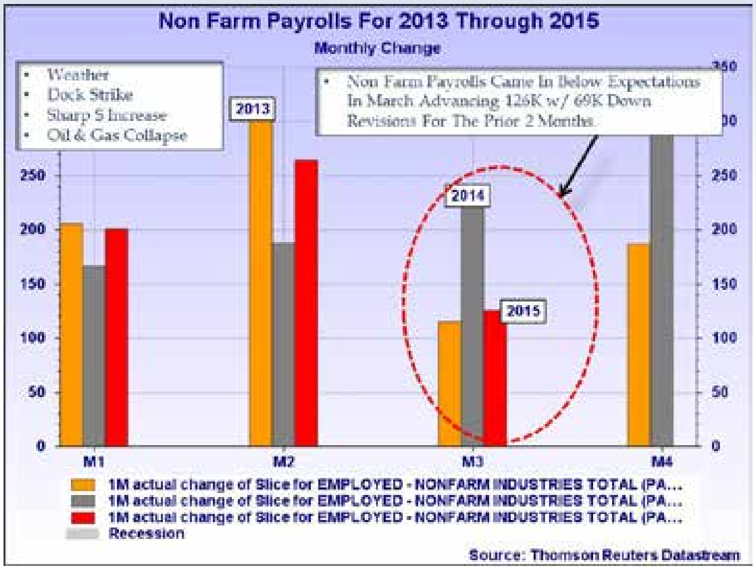

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CHAPTERS 7-9. The implication that the increase in the JOLTS numbers and the quit rate are a sign of continued strength in the jobs market is further supported by the recent rise in the Employee Cost Index (ECI) as illustrated by the blue line in Chart #7. It is currently at a record high for this cycle. The growth rate in actual wages paid, represented by the orange line, has remained muted so far during this cycle but may soon begin an upward trend with a strengthening jobs market. The strengthening data for the US housing market, the US labor market and the Quantitative Easing being pursued by the European Central Bank are causing inflation expectations of both regions to begin strengthening, Chart #8. Because energy and commodity prices remain muted, this rise in inflation expectations is being fueled by the expectation of stronger economic growth later this year and next. This increase in inflation expectations has caused US and German 10 year bond yields to increase, Chart #9.

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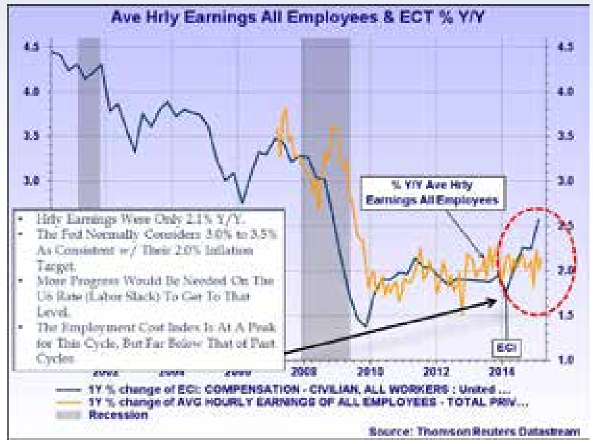

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CHAPTERS 10-12.

MONETARY LIQUIDITY: Rising inflation expectations coupled with rising interest rates brings us to the topic of excess global liquidity. This is defined as the rate of growth of money supply when it is above the rate of growth of nominal GDP, as shown in Charts #10 and #11. This condition can lead to increased inflation expectations and therefore higher interest rates. Chart #12 shows the rapid growth of M1 in the eurozone and its correlation with Industrial Production (orange line) thus illustrating the importance of money supply in driving the economy.

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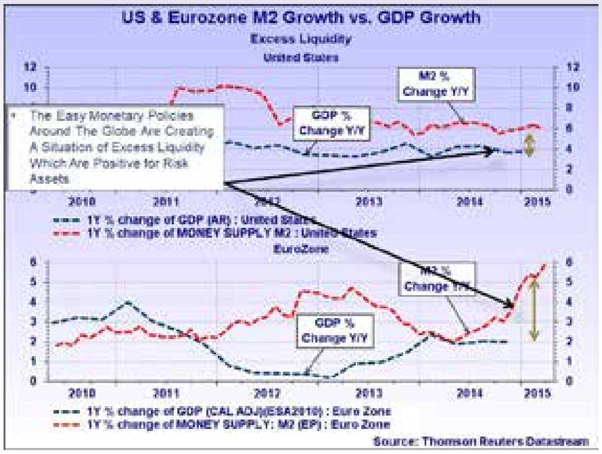

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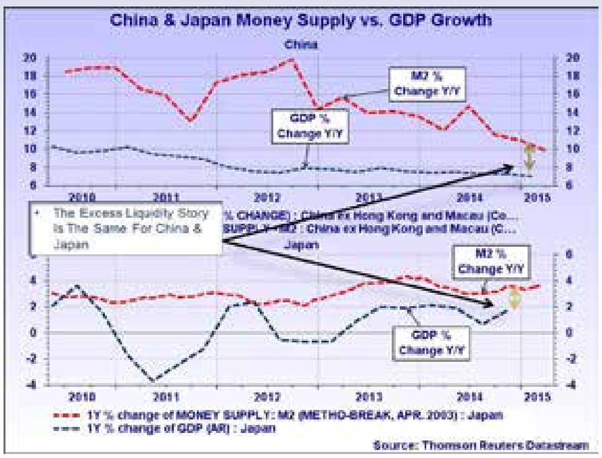

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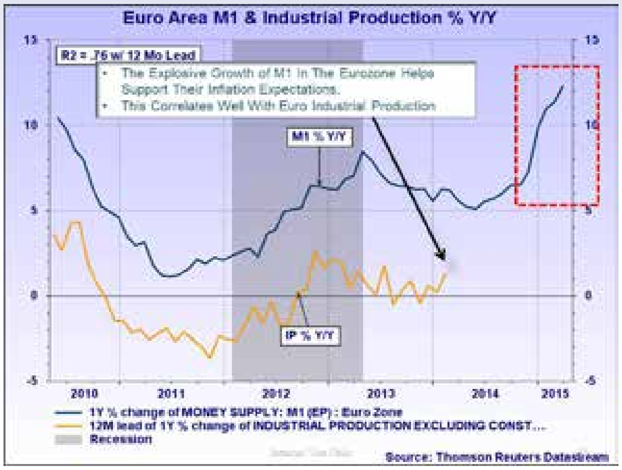

CHARTS 13-14. OIL: In the oil market, the price of West Texas Intermediate (WTI) oil appeared to have bottomed in January of this year, as shown in Chart #13, at about the same time that the US drilling rig count began to collapse (red dashed line). This rig count has continued an uninterrupted fall since December of 2014 and led the markets to believe that the new supply of US oil would begin to slow. This has led to a rally in oil prices to the point where they have risen from a low of ~$45 to the current level of ~ $60 per barrel. Although the expectations of the market that the growth rate of oil production will indeed slow, it certainly won't come to a halt, and in fact we view the risks to oil prices to be skewed to the downside . As we show in Chart #14, the US production of oil is forecasted by the US Energy Information Administration to continue rising through 2016 (blue line) despite the collapse in the drill rig count (red dashed line). In fact, one can go back to prior periods when the drill rig numbers collapsed and yet the oil production figures either remained flat or increased. This is shown on Chart #14 within the green, dashed squares. This phenomenon is likely due to the fact that the oil and gas producers have relentlessly driven down their operating costs as oil prices fell enabling them to maintain the same return on investment in a lower oil price environment. One last observation that influences our view that the risk to oil prices is skewed to the downside is the issue of storage capacity.

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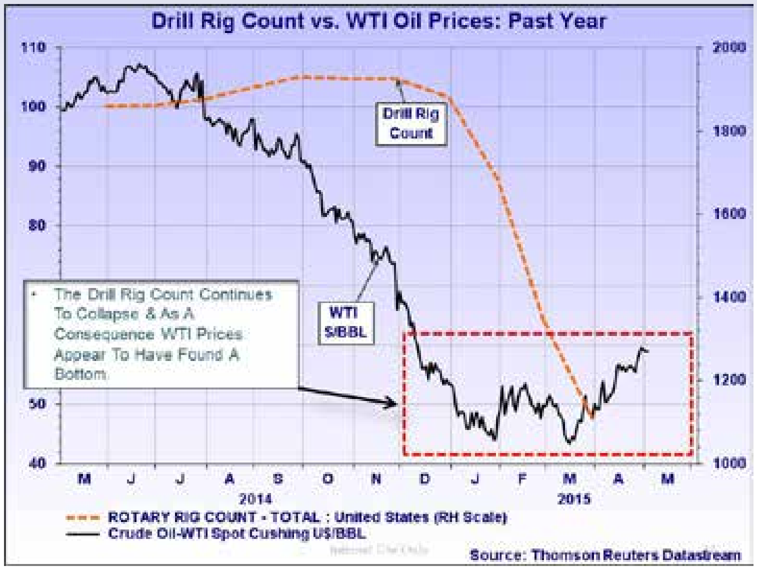

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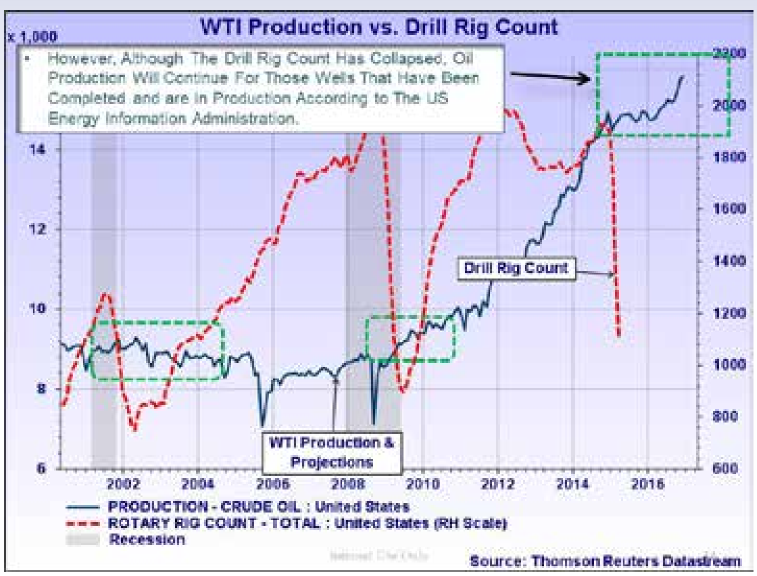

CHART 15. Chart #15 illustrates the amounts of US crude oil inventories for 2013, 2014 and 2015. It is remarkable how the amount of crude oil in inventory in 2015 has rocketed to nearly 500 million barrels and is so much greater than prior years. It is generally estimated that 500 million barrels is the storage limit in the US. Once this is reached there could be more oil being dumped on the market which would cause a temporary decline in prices. When that stops and prices begin climbing again more oil will be released from storage and capped wells will be opened thus creating a natural cap on further price increases.

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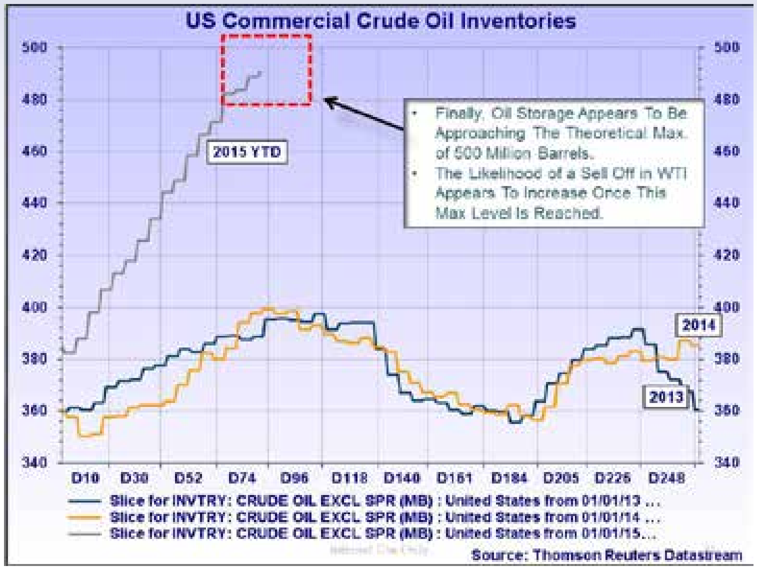

In summary, we think that there is now more clarity pointing to stronger US economic growth for the balance of this year and next; global liquidity is growing while the US Fed is likely to delay a rate increase until sometime this fall; inflation expectations and interest rates are rising in anticipation of better economic growth; and finally, we view the current risk to WTI oil prices to be skewed to the down side for the above stated reasons as well as such geo-political causes as the Saudis remaining price takers and the loosening of Iranian sanctions.