Winslow, Evans & Crocker, Inc.℠

DEC. 2015 GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY

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Overview

In last month's publication we pointed out that the elevated volatility of the equity markets was being driven by widening credit spreads in both the US and Emerging Markets.

As shown in Chart #1 this spike in US credit spreads has since eased off but remains above levels seen at the beginning of the year.

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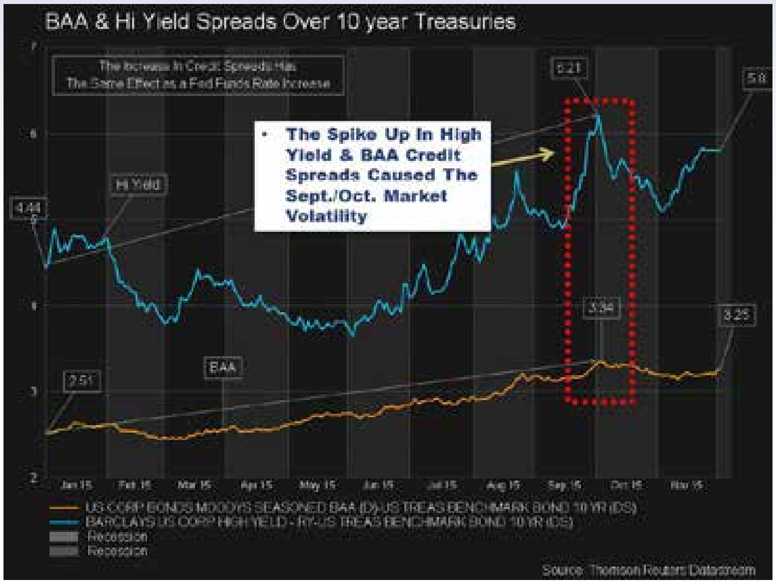

CHARTS 2-4

Another cause of volatility was the steep rise in the value of the US$ which, among other things, led to capital flight in emerging market economies and a spike in their interest rates, Chart #2. These emerging market rates are also now lower but still remain elevated for the year.

As shown in Chart #3 the US equity market began a downward correction in August when the Chinese announced that they would devalue their currency. Since the market's late September bottom it has risen by nearly 15% and is only about 2% to 3% from its high for the year. Much of this rally is due to the easing of credit spreads, as mentioned above, and by the market's perception that the US Federal Reserve will raise rates more gradually than their official forecast.

You can see in Chart #4 that the futures market has raised the anticipated path of the Fed Funds rate but that it remains well below that of the Fed's stated goal of 1.0% in 12 months. Although we remain constructive about US equities for the intermediate term there are several conditions which cause us to be wary of potential near term downside risks.

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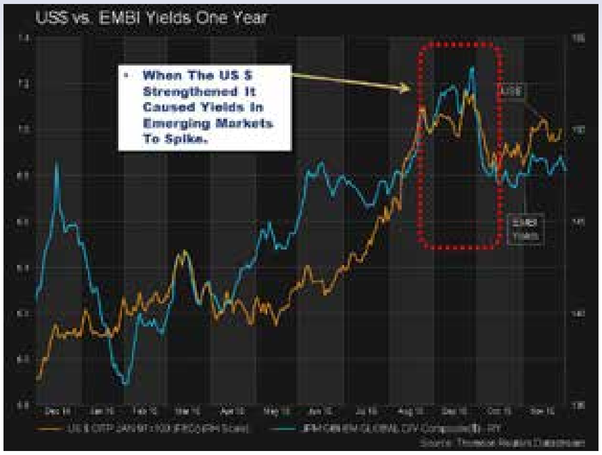

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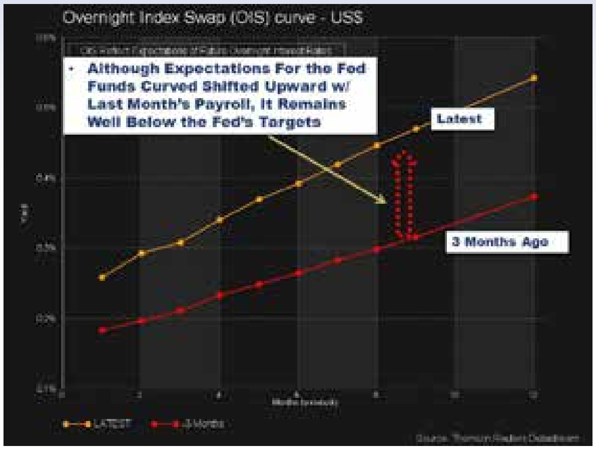

CHARTS 5-6

Our first concern is that the Fed is about to raise rates at a time when credit spreads are elevated and have been on a rising trend over the past year. As can be seen in the red boxes in Chart #5 going back to the 1980's the Fed has only raised rates when credit spreads were falling. In December they will potentially be raising rates while credit spreads are increasing. Chart #6 shows US corporate profits as a percentage of US GDP, the gold line. In this chart you can see that the Fed raised rates only during periods when corporate profits were increasing.

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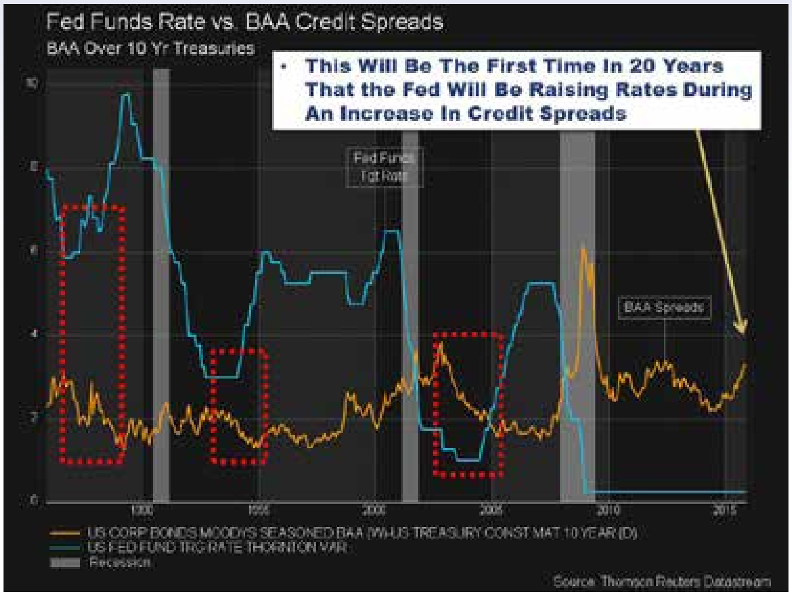

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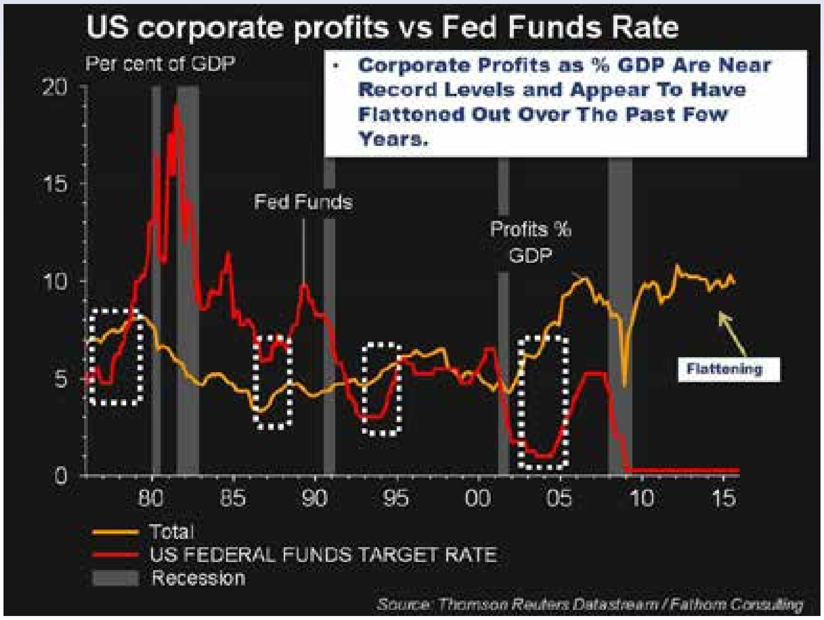

CHARTS 7-8 Today, corporate profits appear to have peaked and may be starting to roll over. Finally, the futures market for 5 year and 10 year inflation expectations are near cycle lows and well below the Fed's target rate of 2.0%, Chart #7. Low inflation expectations are a reflection that the markets think that economic growth will be slow, clearly a bad time for the Fed to raise rates.
Although we believe that the timing of a December Fed rate hike is unusual and could be a near term headwind for risk assets, our concern is somewhat ameliorated by the fact future rate increases will likely be slow in coming and moderate in size.

Our second major concern about the US equities market is that corporate margins have peaked and may be rolling over. As can be seen on Chart #8 corporate margins are now at their lowest level since the beginning of the cycle. More significant is how closely they correlate to core Producer Price Index readings, the blue line, which is currently trending down. This trend in the PPI is consistent with the low inflation expectations referenced above.

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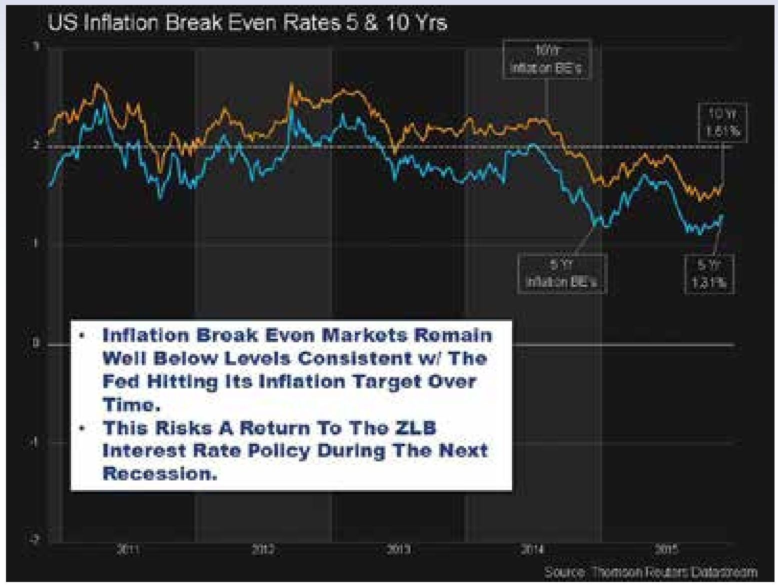

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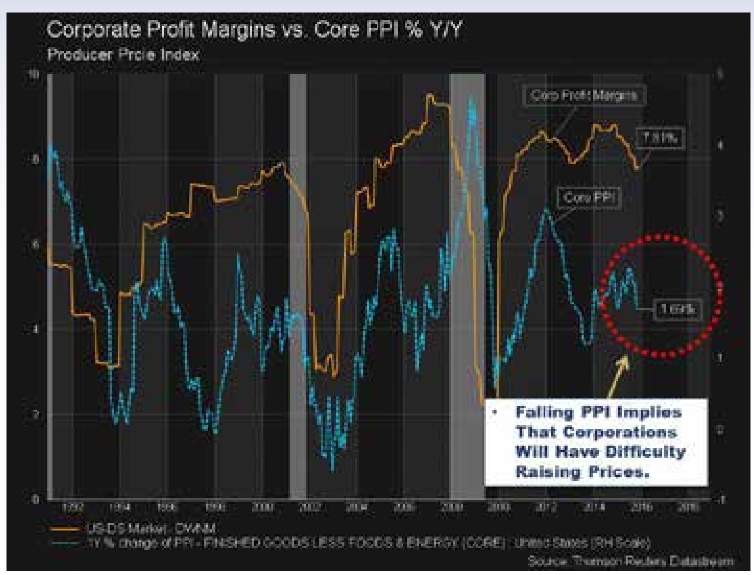

CHARTS 9-11

The implication for corporations is that profit margins will be squeezed as revenue growth slows while at the same time unit labor costs are beginning to increase, Chart #9. The evidence that leads us to believe that labor costs will continue increasing can be deduced from the continued decline in the U3 and U6 employment figures, increasing minimum wage mandates, and, most interesting, the increasing mismatch between job requirements and applicant skill sets as illustrated by the rightward shift in the Beveridge Curve, Chart #10.

As shown in Chart #11 the twelve month forward earnings growth projection for the S&P500 is approximately -1.6% year/year and has been on a downward trend. This, also, is a headwind for the equity markets. Historically the forward earnings growth has correlated fairly well with the New Order Surveys from the Manufacturing and Non-Manufacturing monthly PMI numbers as represented by the gold line. Although both surveys declined for the November readings, the current absolute level of the three month moving average implies that forward earnings should be growing in the 5%-8% range.

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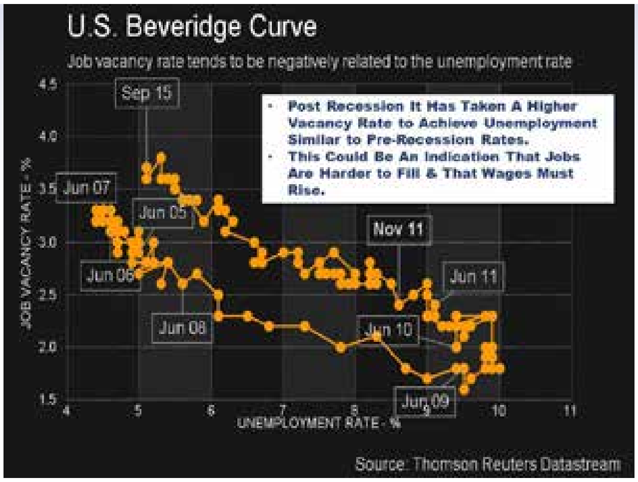

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Either the future PMI readings will fall or we are at an earnings trough. One argument for the latter is that the severe downward drag on earnings from the energy and materials sectors will soon annualize out and allow overall estimates to rise once again.

CHARTS 12-13 Although we have stressed the many headwinds facing the US equity markets our equity risk premium model, Chart #12, indicates that valuations reside in a fair range. This implies that future returns should be in the historical mid to high single digits. Additionally, when the market's free cash flow yield is compared to high yield bonds as shown in Chart #13, it appears that relative valuations remain modestly attractive.

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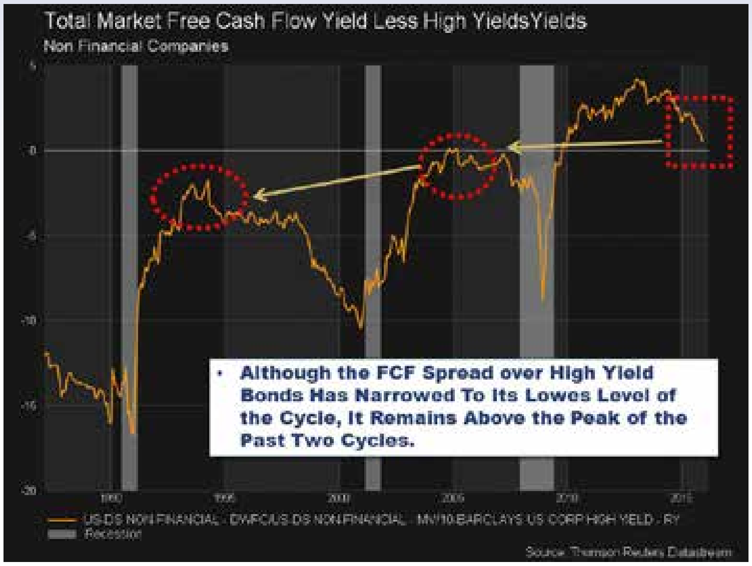

CHARTS 14-16

When faced with an equity market that appears to be in a fair value range it is imperative to seek out those sectors enjoying above average, secular growth. In Chart #14 we compare the Producer Price Index for the Pharmaceutical Sector to the Core PPI. This is evidence that this sector has the potential to grow revenues faster than the market as a whole. It is no surprise that the employment growth rate in the Health Care sector is about 75% faster than overall payroll growth, Chart #15, and that the investments being made by this sector are accelerating, Chart #16.

In conclusion we remain constructive on US equities but, because of our near term concerns, we remain very selective about which sectors to overweight. Please contact your advisor if you have any questions about this report.

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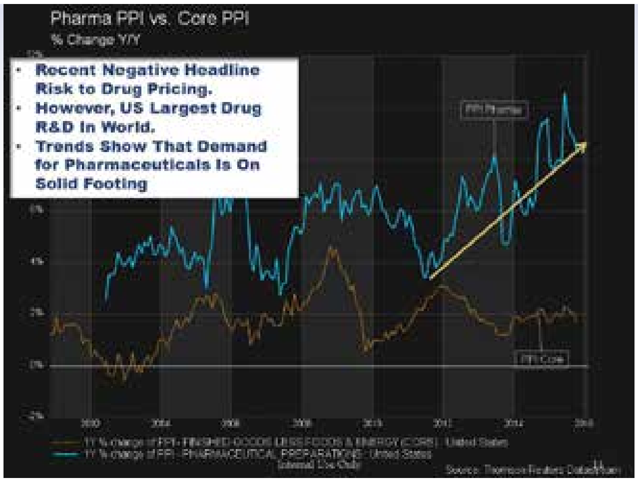

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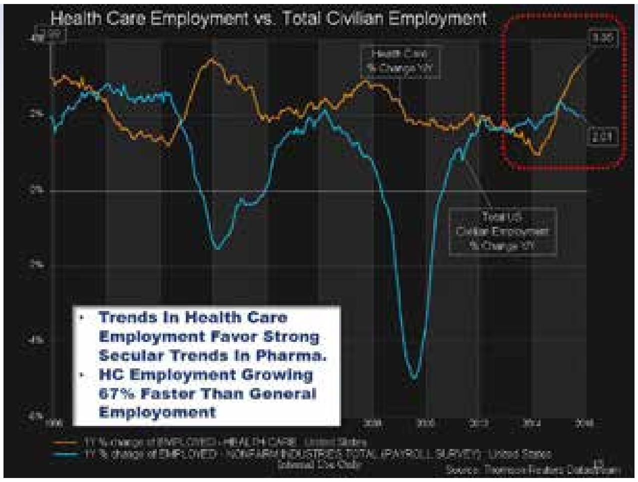

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