Winslow, Evans & Crocker, Inc.[SM]

JAN. 2016 GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY

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Overview

In our commentary last month we emphasized our constructive outlook for equities in the intermediate term but with the caveat that there were risks to the downside in the near term. These risks, which are still present, stem from tightening credit markets, the loss of economic momentum in global economic growth – especially in emerging market economies, and slowing economic and earnings growth in the United States. Additionally, although the Federal Reserve only raised rates by 0.25%, they had never before done so this late in an economic cycle and in an economic environment with such poor momentum. Unfortunately, the recent market volatility has justified our concerns.

CHARTS 1-2

As you can see in Chart #1 credit spreads for high yield, in blue, and investment grade corporate bonds, in gold, have risen over the past month. This has been particularly acute for the high yield sector which is suffering from the deleterious impact of the collapse in oil prices on the energy sector. Energy companies constitute about 20% of the high yield bond market. The implicit tightening on the US economy is worsened by the rise in value of the US dollar. In addition to dampening the earnings of companies with foreign sales, the rise in the dollar is encouraging capital flight from many emerging market economies causing interest rates there to increase. Chart #2 illustrates the correlation between the increasing dollar and the rise in yields on the Emerging Market Bond Index, blue line. This rise in yields has a dampening effect on emerging market economies.

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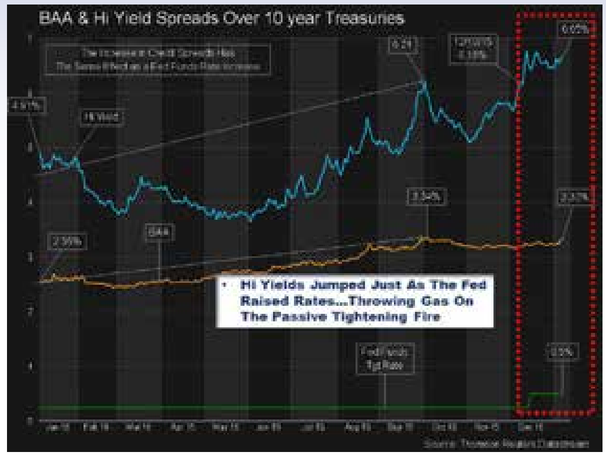

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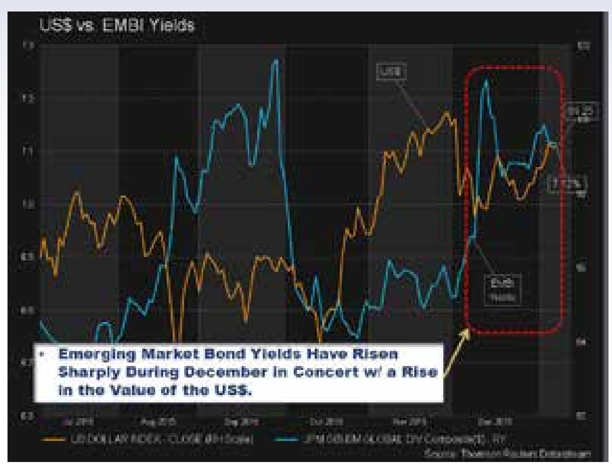

CHARTS 3-4

The continuing decline in global economic momentum is easily seen by the falling Global PMI survey, Chart #3. This fading momentum has caused esti-mates for global GDP growth to fall to about 2.8%-3.0%. It is important to note that the PMI num-ber shown in Chart #3 remains above 50 which is consistent with economic growth and NOT a recession. A further worry for the markets has been a similar decline in Chinese economic momentum. As an $11 trillion economy they certainly have an outsized impact on the emerging market economies as well as on total global GDP growth. Chart #4 shows that our China economic leading indicator is implying a much slower growth in GDP than the most recent 7.0% reported by the Chinese National Bureau of Statistics.

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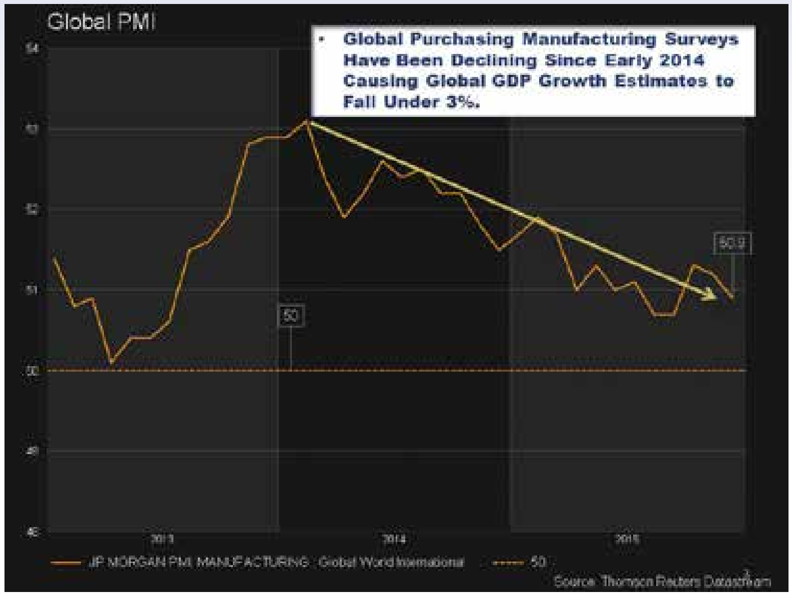

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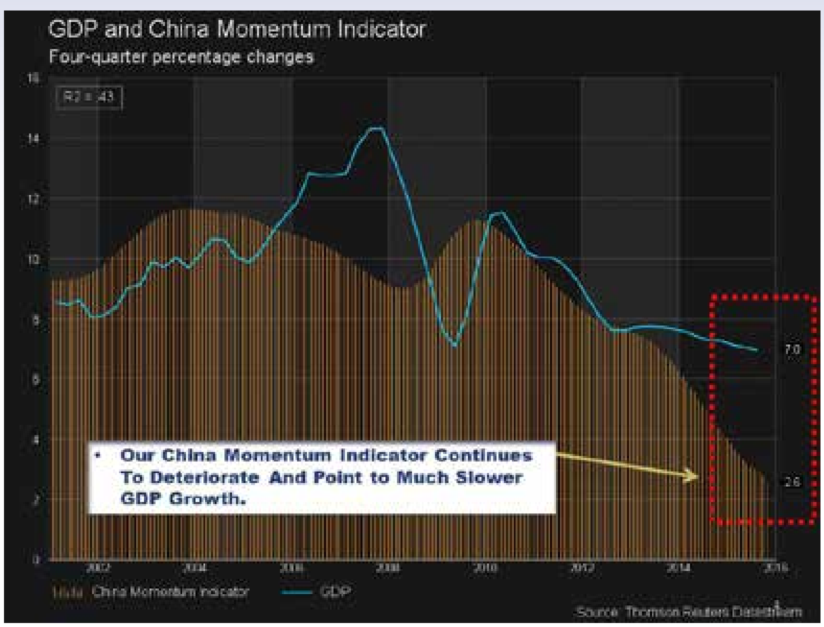

CHARTS 5-6 To combat this loss of momentum the Chinese are using monetary policy by aggressively lowering interest rates and bank reserve requirements, Chart #5. The recent Caixin manufacturing survey for China remained above the expansionary level of 50 but was below consensus expectations. As shown in Chart #6 this caused the economic surprise index for China, in red, to quickly turn from positive to negative. This also helped to drag down the Emerging Market Economic Surprise Index although this still remains in positive territory. The blue line on this chart shows that the economic surprise survey for the US has also been negative and trending downward since early November. The cause for this trend has been the worse than expected data from the manufacturing sector such as factory new orders and the PMI Manufacturing survey. This data is, for now, pointing to the potential of a recession in US manufacturing but not for the US economy as a whole. In fact, we believe that the manufacturing sector will bottom out this year as the energy and mining sectors finish adjusting their cost structures to cope with lower commodity prices.

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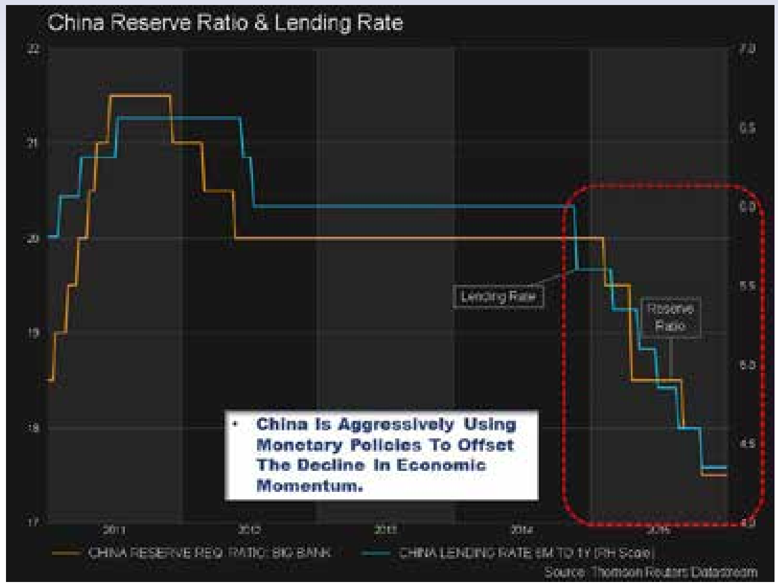

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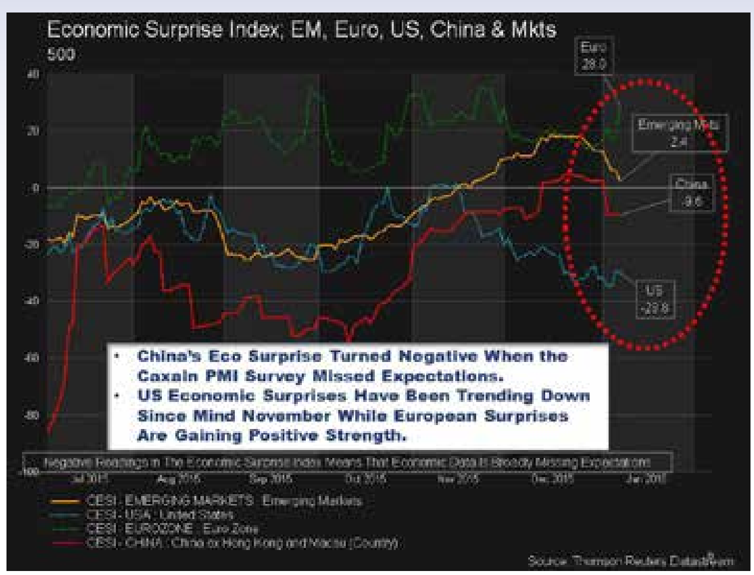

CHARTS 7-9

On Chart #7 you can see that the poor economic indicators mentioned above are causing more volatility and putting downward pressure on the US equity market in a manner similar to the corrections of 2010 and 2011. The difference this time around is that corporate margins appear to have peaked at the same time that average hourly earnings are rising, Chart #8. With corporate margins at peak levels and with labor costs rising the only remaining way to increase earnings is by increasing top line growth, or sales. This, however, will be difficult in an economic environment of slower nominal growth. Nominal GDP growth is a good macro indicator of the ability of corporations to increase sales but, as you can see on Chart #9, NGDP growth is projected to be only about 3.6%/year during this cycle versus an average of over 6.1% for the past two cycles. Correctly selecting companies with superior top line growth in strong secular growth industries will become the most critical factor for adding alpha to portfolios in this new, low growth environment.

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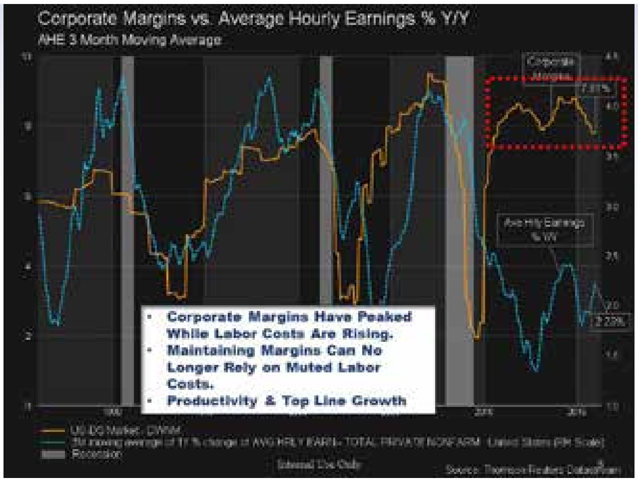

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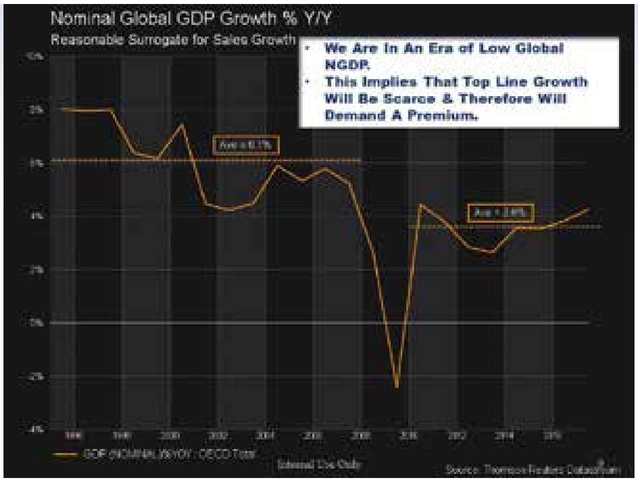

CHARTS 10-11 Although we began this commentary with a summary of some of the more negative market and economic characteristics it important to understand that there exist a number of strong elements which support our constructive outlook for the intermediate term. First, it is important to note that the financial stresses caused by rising high yield bond yields are not being transmitted throughout the financial system. This is clearly illustrated in Chart #10. This chart shows three different financial stress indices which provide a more sophisticated and accurate view of the potential of systemic risk in the financial system. There are two observations worth noting. First, all three indices were at much higher levels during the market corrections of 2010 and 2011 than they are today. Second, two of the three indices are currently below zero which is indicative of below average stress in the financial system. The third index, the Cleveland daily financial stress index, is much more volatile and is currently turning back down to more average levels. Our interpretation of these indices is that despite the recent market volatility and disappointing economic data we are not entering a bear market or economic recession. It is also important to point out that the US economy is experiencing strength in many other areas. The labor market, for instance, remains strong. On Chart #11 we compare the Job Openings/Job Applications ratio to the growth in Average Hourly Earnings. The Openings ratio is at its highest level of this cycle which, unsurprisingly, is driving up the growth in hourly earnings. Although the growth in earnings may squeeze corporate margins, as noted above, it will cer-tainly improve overall aggregate demand in the economy.

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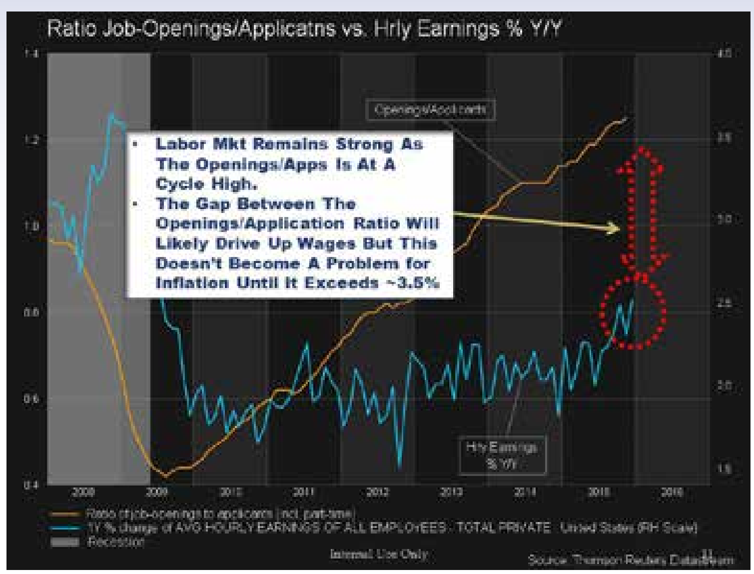

CHARTS 12-14

In Chart #12 we use the num-ber of hours worked times the average hourly earnings as a surrogate for national income and correlate it to retail sales. As you can see there is a very high correlation of .7 between these two series which implies that retail demand will grow as wages respond to the growing number of job openings. Another significant and positive contributor to the US economy is the rebound in the residential and commercial construction sectors. In Chart #13 we com-pare the number of new housing starts to the percent contribution of housing to GDP. This chart clearly illustrates the grow-ing trend in both series. More importantly we remain at levels well below the lowest levels of the past two cycles implying that there is more room to go. This conclusion is corroborated by the recent jump in new house-hold formations and its positive implications for new housing starts, Chart #14.

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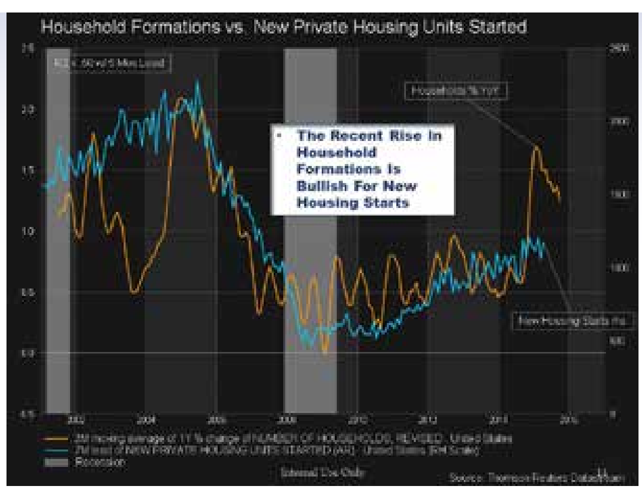

The strength in the residential and commercial housing sectors is helping to offset the weakness in the energy and mining sectors. Should energy prices begin increasing in the latter part of 2016 and into 2017 as many experts are forecasting then US economic growth could begin to re-accelerate in 2017.

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