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Overview

In last month's publication we observed that the sharp rebound in the S&P500 from its February 11th bottom was attributable to several factors. Some of the more impactful ones were a narrowing of credit spreads, the decline in financial stress indices, and, most importantly, the statement from Janet Yellen that the Fed would be more sensitive to international conditions when making their interest rate decisions. Many of these factors, as we will show below, have continued to improve. The one major caveat that we highlighted last month was that the increase in the market's forward P/E ratio to nearly 17 had not been paralleled by a rebound in earnings estimates. As a consequence, the S&P500 was nearly flat for the month of April but remained volatile as evidenced by its fluctuation from peak to trough by nearly 3.0%! You can clearly see this in Chart #1.

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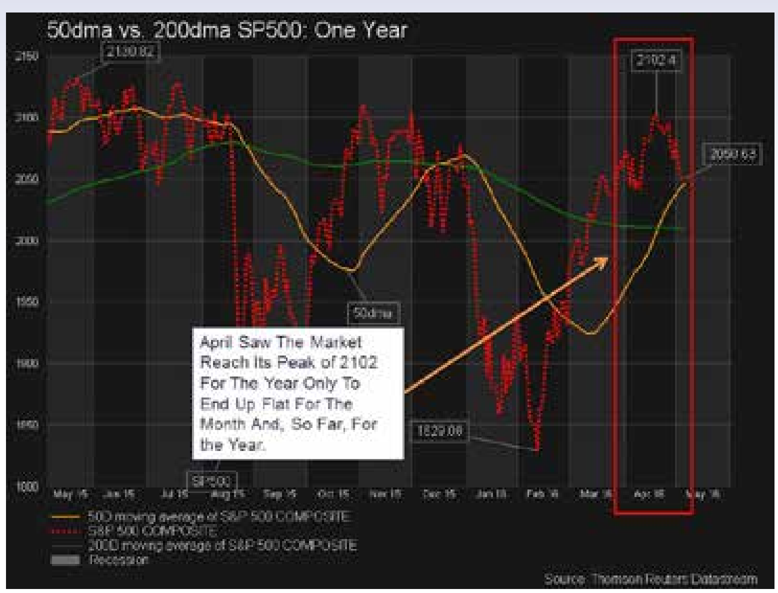

CHARTS 2-4

In Chart #2 it is evident that the decline in high yield bond credit spreads, an indicator of economic stress, has been a major boost for the equity markets. This decline in spreads has been caused by the rise in commodity prices, notably energy, along with the fall in the US$. Broader measures of systemic financial risk put out by the St. Louis and Kansas City Federal Reserve Banks have also been falling. These two indices, shown in Chart #3, are now indicating that stresses in the financial system are below average and trending down which, for both the economy and the financial markets, is positive. The elephant in the room, however, is the rise in the market's price earnings ratio in the face of declining earnings estimates, Chart #4.

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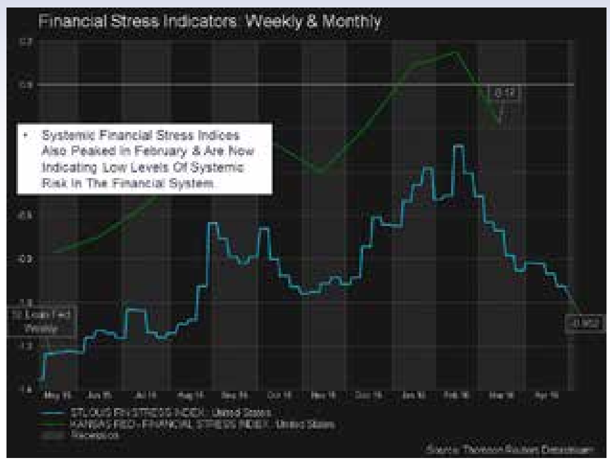

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CHARTS 5-6

This increase in the market's P/E is being driven, for now, by the decline in the 10 year US Treasury yield, Chart #5.
The outlook for improving earnings and revenue growth is, at this time, cloudy. As can be seen in Chart #6 the forward twelve month estimated growth rate for earnings and revenues is presently flat to negative. The green dashed line in this chart represents the new orders from the ISM Manufacturing and Non-Manufacturing monthly surveys which are well above 50 and trending up. This is usually a good leading indicator for earnings growth. This apparent divergence may eventually be resolved by a return to growth in earnings but for now the markets do not appear to be giving this scenario any credence.

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CHARTS 7-8 As shown in Chart #7 the market this year has been led by the defensive sectors such as Consumer Staples and Utilities. This is very likely a reflection of the concern over the tepid economic growth being experienced both domestically and globally. Also, corporate profit margins may be peaking now that wage growth is accelerating and productivity growth trends are the lowest in thirty years, Chart #8.

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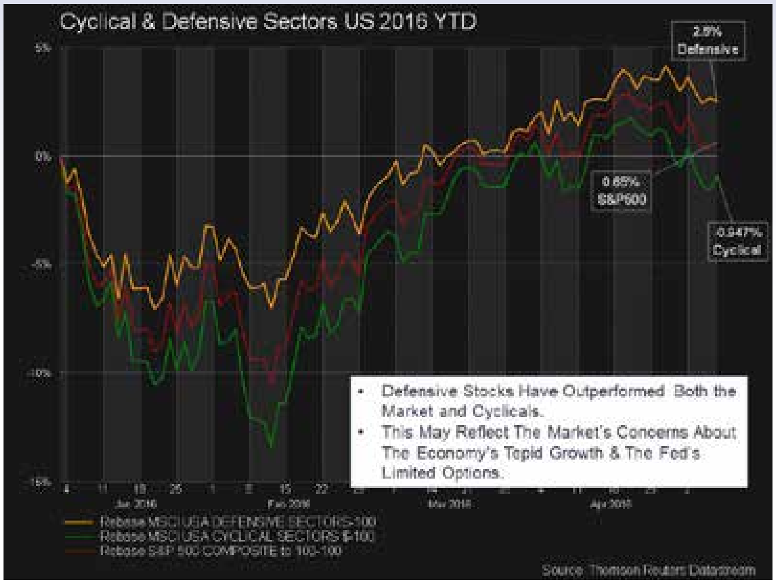

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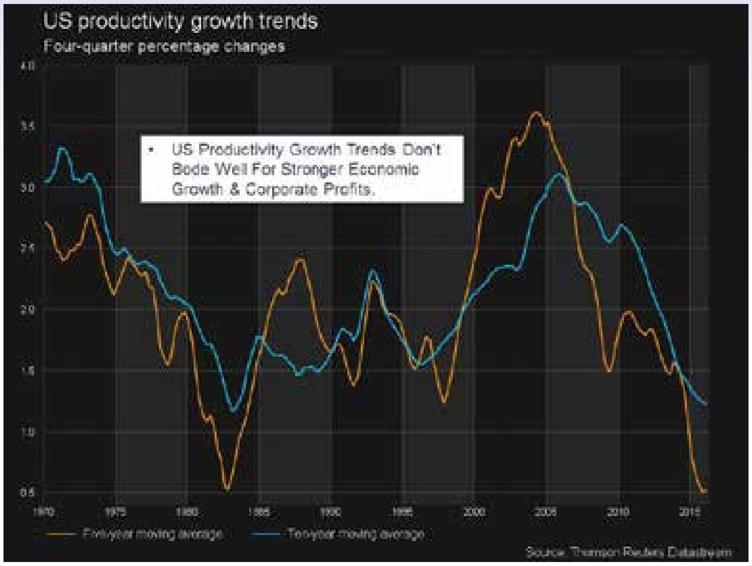

CHARTS 9-10 Since the US equity market is being propped up by low domestic interest rates it is important to understand some elements of the global environment which may well be a major catalyst for these low rates. Most major central banks outside of the US such as the Eurozone and Japan are on a mission to increase inflation through easier monetary policies. Success in this effort has, to date, been relatively elusive. The cause may be that their efforts are being overwhelmed by the pivot in the Chinese economy towards the consumer coupled with their excessive levels of debt and misallocation of capital. In Chart #9 there is a clear correlation between global inflation, which is rapidly declining, and the decline in Chinese fixed capital investment. As a consequence, the MSCI World Consumer Staple index has been outperforming on a relative basis as Chinese foreign reserves have shrunk, Chart #10.

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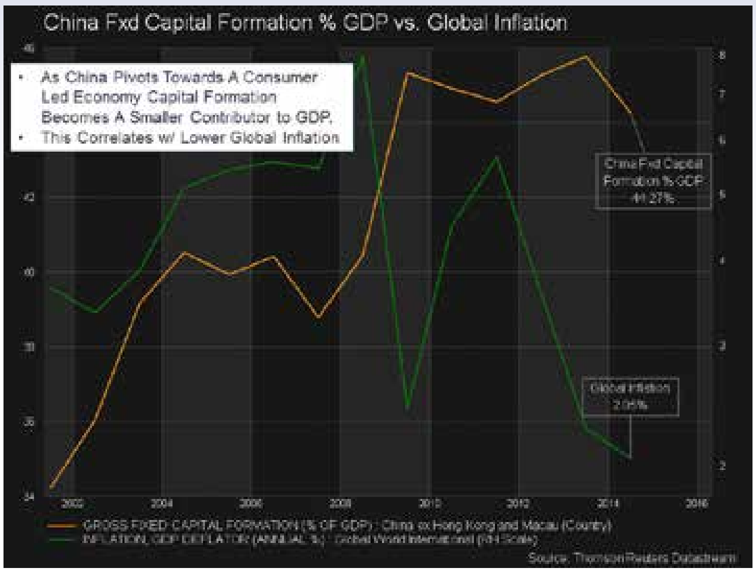

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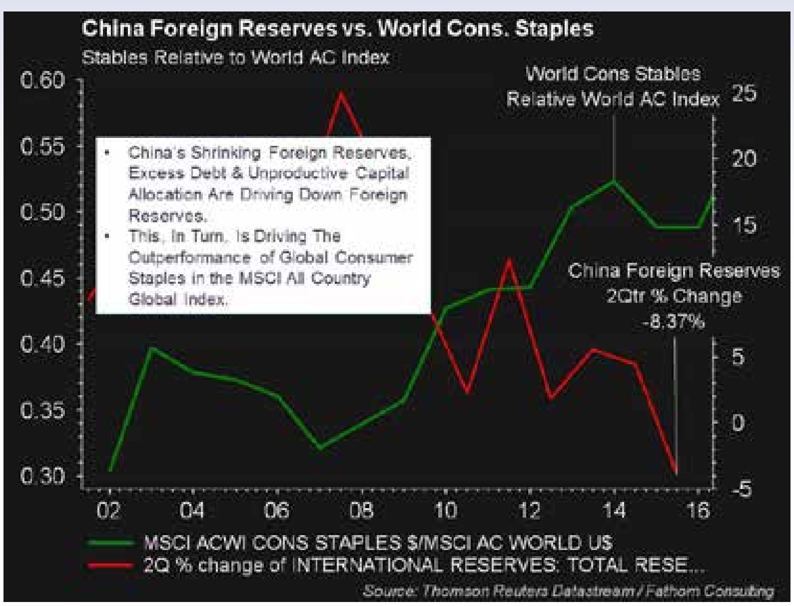

We see the US equity market being fairly, but precariously, valued relative to fixed income. Global deflationary pressures are likely to persist for some time thus keeping US inflation in check and interest rates subdued. Without the cushion of growing earnings and revenue the markets are at risk if US inflation unexpectedly increases.

CHART 11. Our strategy in the face of these uncertainties has been to search out companies with strong dividend growth histories and with well positioned business models. This approach has been validated by the outperformance of the S&P500 Dividend Aristocrats over the Buyback Achievers, Chart #11.

Please consult with your investment advisor if you would like to discuss this publication in greater depth.

11