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GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY

GLOBAL ECONOMICS

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Overview

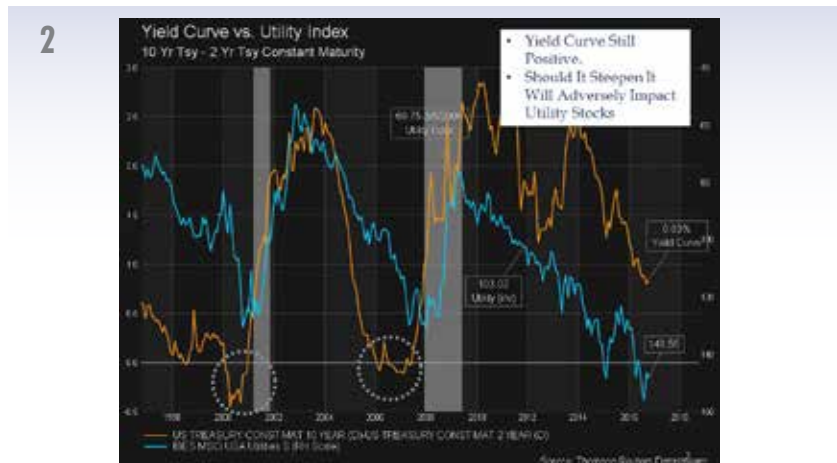
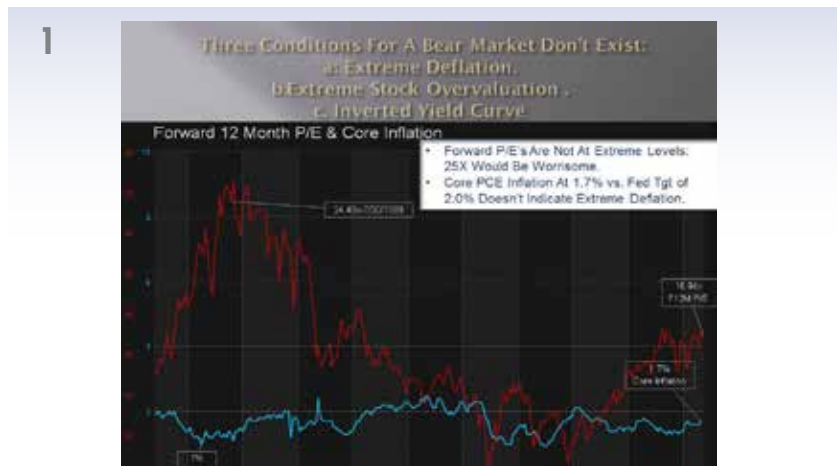
In last month's publication we discussed the idea that the so-called neutral rate of interest, R^* , is very likely lower than it has been for nearly a generation and may even be, in real terms, close to zero. This is due to several factors such as the lower growth potential for the US economy, increased risk aversion, higher financial disintermediation costs and a higher savings rate. This will likely cause the Federal Reserve to take a very cautious approach to raising rates. In the Fed's September meeting not only did they not raise rates but they also lowered their forecast for the US economy's long term growth rate to 1.8% which is down from their projection of 2.2% of just two years ago. This environment of low interest rates, tepid economic growth and low inflation has implications for stock market valuations.

There has been much discussion about the potential risk that the US equity market is in "bubble" territory. We do not believe this to be the case. The three fundamental conditions that need to be present for a bubble are: 1) extreme deflation; 2) extreme stock overvaluation; and, 3) an inverted yield curve.



CHARTS 1-3

As you can see in Chart #1 the market's forward P/E ratio is well below the 1999 bubble peak and inflation, the blue line, is just below the Fed's 2.0% target. In Chart #2 the yield curve is depicted by the yellow line which, when it falls below zero, means that it is inverted. Although it has been flattening over the past several years it clearly remains positive. The last two times it was inverted are circled in white and occurred just before recessions. Incidentally, the blue line represents the US Utility Index, inverted. Utility stocks have been steadily rising as investors searched for higher yields but you can see that if the yield curve begins to steepen again it would mean that utility stocks could go down in value. So now that we have established that the US equity market is not in bubble territory we must now examine its value on a relative basis. Chart #3 shows the amount by which the earnings yield of the S&P500 exceeds the yield on the 10 year US Treasury bond. You can clearly see that it is over one standard deviation above its 20 year average...4.28% vs. 2.40%.



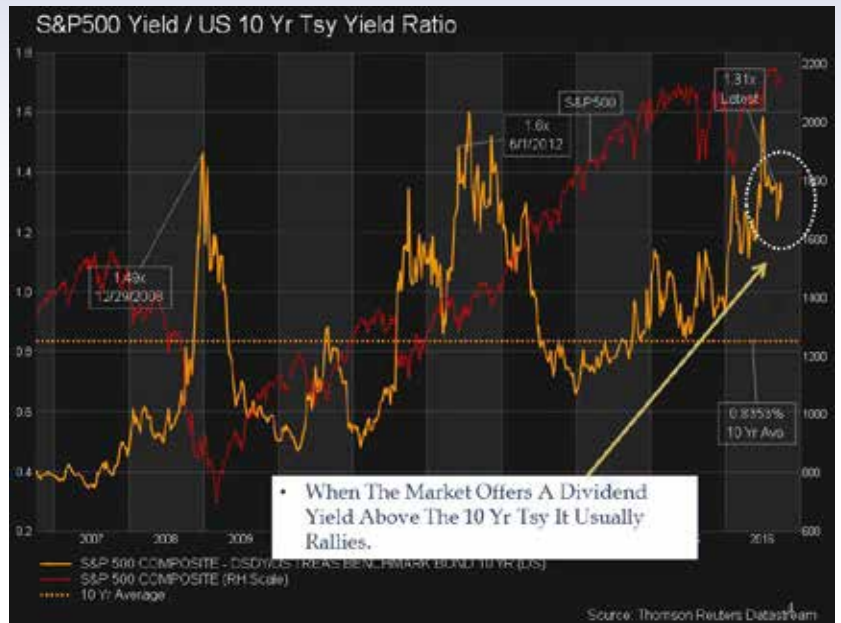


CHARTS 4-5

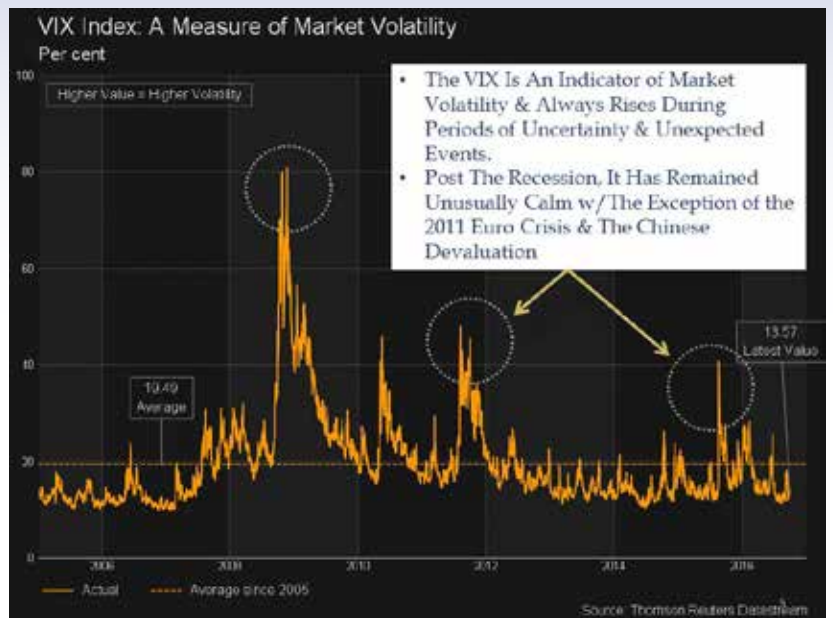
On this basis, therefore, the market looks inexpensive. You will notice the dashed blue line that sits about 1/2 of a standard deviation above the average. This is where the market would be if the forward P/E was at 20x and the 10 year Treasury yield at 2.0% (they are currently at about 17x and 1.6%). The purpose of this exercise is to illustrate that the US equity market has sufficient cushion to handle higher multiples and interest rates without becoming overvalued.

Another interesting way to view the market's relative valuation is to examine its dividend yield relative to the 10 Treasury bond as shown in Chart #4. For the past 10 years the market's yield has been about .83x the Treasury yield but, as the gold line illustrates, it is about 1.31x the Treasury yield. If this chart were to go back 20 years the difference would be even more dramatic. We do not see the market as being in danger of a collapse although we would not be surprised to see periods of heightened volatility being precipitated by unforeseen events such as the Brexit vote or, more recently, concerns over the stability of Deutsche Bank. As measured by the VIX the market has been unusually calm for an extended period of time, Chart #5.

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CHARTS 6-8

The spikes in the chart occurred during times of heightened uncertainty such as the Lehman crisis, the Euro crisis and the 2015 Fed tightening.

One final but very interesting observation that impacts the market is the recent sharp divergence between inflation expectations and the 10 Year US Treasury yield, Chart #6.

Rising inflation expectations generally imply that the markets expect the economy to do better which usually forces interest rates to increase. If this divergence persists it is generally beneficial to risk assets such as equities.

Perhaps one of the reasons that inflation expectations are rising is that the concerns over a further global GDP slowdown have ebbed. Chart #7 shows that global trade has actually turned back up sharply since the beginning of the year and, in Chart #8, the forecast for global industrial production is set to trend back up in 2017.

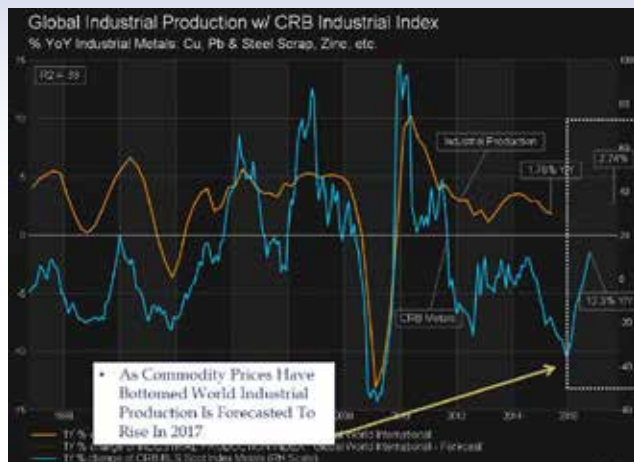
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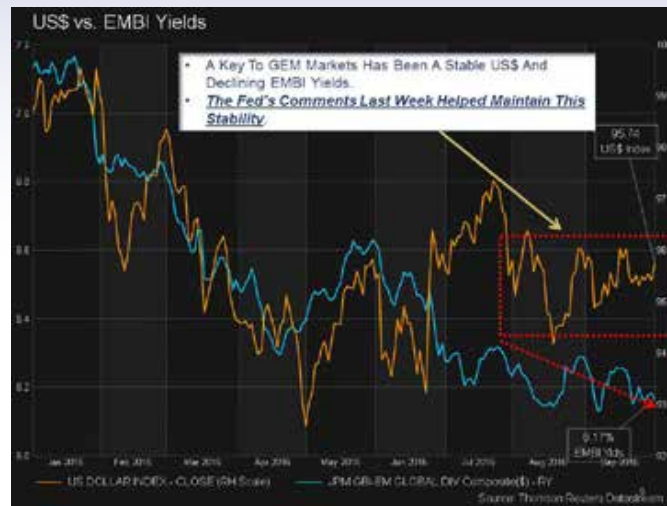
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CHARTS 9-10 An added benefit is the stabilization in the Global Emerging Market economies. This stabilization is due in part to reduced fears of capital flight and lower emerging market bond yields as the US\$ has been declining since the beginning of the year, Chart #9. Also, the current account balances have improved in most GEM's thus lowering their dependency on foreign financing. China, the largest of the GEM's is seeing an improvement in their economy. Our Chinese momentum indicator, Chart #10, has been positive for seven consecutive months. Although they have yet to fully pivot to a consumer centric economy they have at least arrested the decline in economic momentum. In the longer term their growing debt, inefficient capital allocation and zombie state owned enterprises are the foundational elements for a future recession. No developing economy has ever made this transition without suffering several years of economic disruption.

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CHARTS 11-13

Our last observation regards the US consumer whom we think is in good shape despite the disappointing August retail sales data. First, job openings remain strong and wages continue to grow as illustrated by the Jobs Openings data in Chart #11. Secondly, household balance sheets and financial obligations are at some of the healthiest levels in decades, Chart #12. Finally, banks are more willing than ever to lend to consumers, Chart #13, providing additional sources of liquidity for consumption.

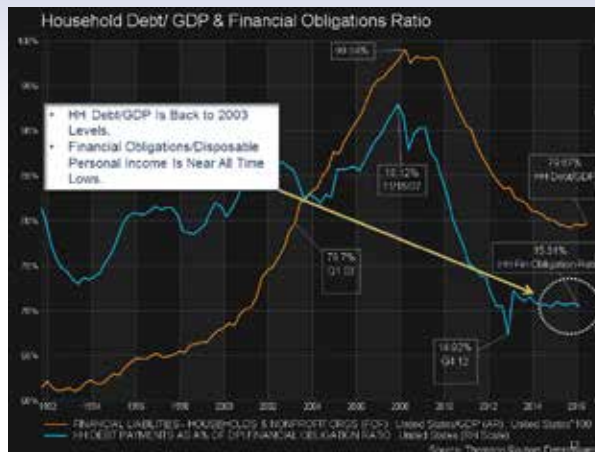
In conclusion, our view is that the US market valuations are on the high end of historical ranges but not in bubble territory. More critically, however, is that they appear fair to undervalued relative to the current low interest rate environment which, by all indications, is likely to remain low for the near term. Also, global and domestic economic growth, although modest, appears to be reversing its declining momentum of the past three years. This is caused in part by the continued strength of the US consumer, aggressive global central bank easing and a bottoming in global commodity prices.

Please speak with your investment advisor if you would like to discuss our comments in more depth.

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