Winslow, Evans & Crocker, Inc.SM

JAN. 2017 GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY

GLOBAL ECONOMICS
Douglas E. White, CFA
Chief Investment Officer
Executive Vice President
(617) 896-3518
dwhite@e-winslow.com

Rand Folta, CFA
Executive Vice President
(617) 896-3590
rfolta@e-winslow.com

INSTITUTIONAL TRADING
Fixed Income
Nomi Caperton
Managing Director
(617) 896-3526
ncaperton@e-winslow.com

David Strimaitis
Managing Director
(617) 896-3577
dstrimaitis@e-winslow.com

Equity
John Bridges
Managing Director
(617) 896-3524
jbridges@e-winslow.com

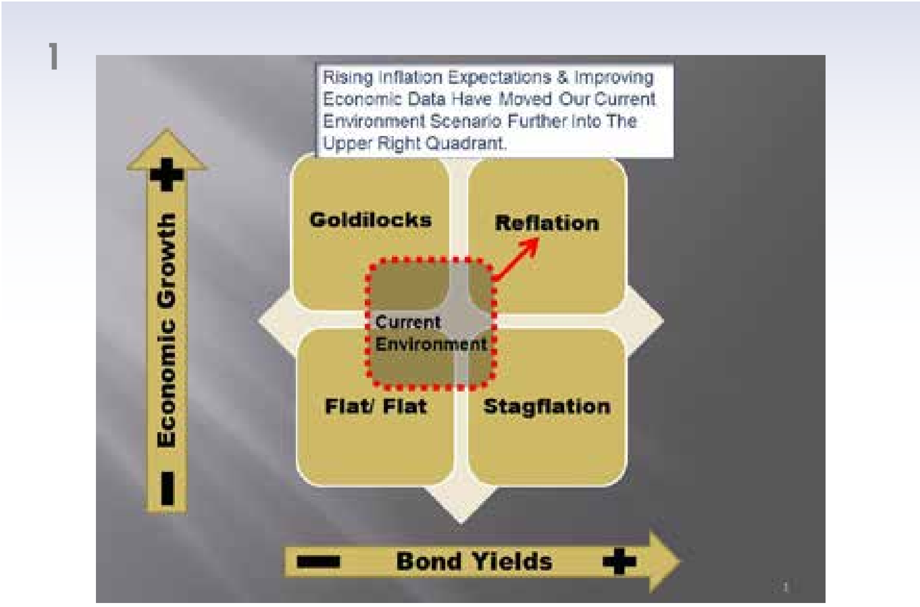
SETTLEMENT AND TRADING
OASYS: WYNS
MPID: WYNS
DTC: 0443
Clearing: Pershing, LLC.

WINSLOW, EVANS & CROCKER
175 Federal Street, 6th Floor
Boston, MA 02110
Phone: (617) 896-3500
Member: FINRA/SIPC

2017: Economic Momentum & Expectations

In last month's report we continued to analyze our market outlook and current situation within a framework represented by two variables: economic growth and interest rate increases.

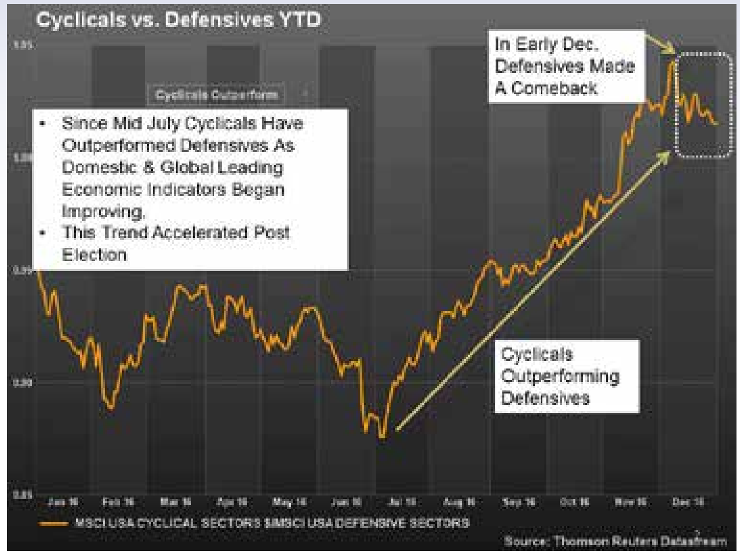
This is represented by the matrix in Chart #1.



CHARTS 2-3

Beginning around mid-year and accelerating post-election, our current situation status has been moving to the upper right quadrant and, as we had pointed out, this directional shift has accrued to the benefit of the financial, industrial and energy sectors over the more defensive consumer staple and utility sectors as shown in Chart #2. We also observed in last month's report that the post-election acceleration in interest rates and economic growth expectations may have gotten ahead of the facts on the ground. If you look at the month of December in Chart #2 you can see that cyclicals gave back some of their relative performance when the defensive sectors had a rebound. It was evident to us last month that interest rates had shot up much more quickly than was warranted by the rise in inflation expectations. You can see this in Chart #3. The 10 year Treasury yield rose by 40% from 1.86% to a peak of 2.6% while inflation expectations rose by only 18% from 1.57% to 1.86%. You can also see that interest rates have since backed off their peak and that inflation expectations have remained stable.

2

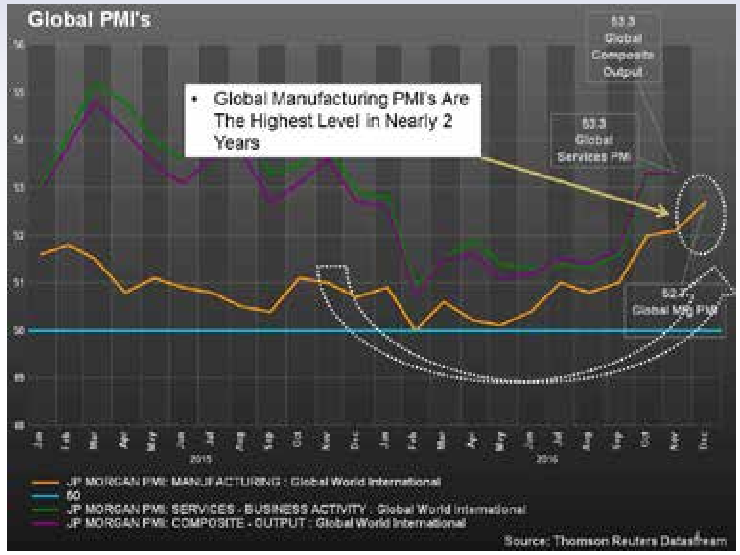


3

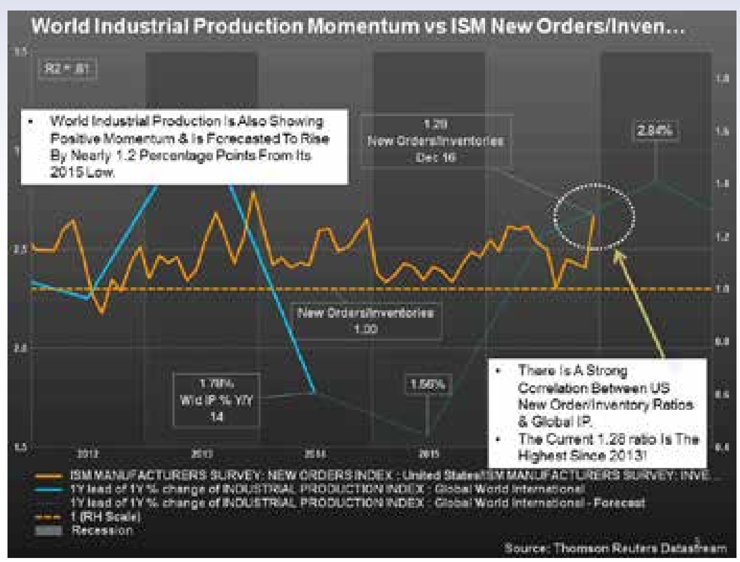
CHARTS 4-5

Although the cyclical to defensive outperformance took a break last month the fundamental background remains in place for a resumption of its outperformance. The first place to look for evidence of this is in the continuing improvement in the global and domestic leading economic indicators. In Chart #4 we show the Global Manufacturing Purchasing Manager's Index ("PMI") as the gold line. It is now at its highest level in nearly two years and demonstrates clear, posi-tive momentum. Additionally, as shown in Chart #5, Global Industrial Production growth is now forecast to increase by 82% from 1.56% year/year in 2015 to 2.64% by 2017. This forecast was recently reinforced by the US Manufacturing Institute for Supply Management ("ISM") survey which found that the new orders to inventory ratio at 1.28 is the highest since 2013. This ISM ratio is a leading indicator to Global Industrial Production with a strong correlation of R2 = .63.

4



5



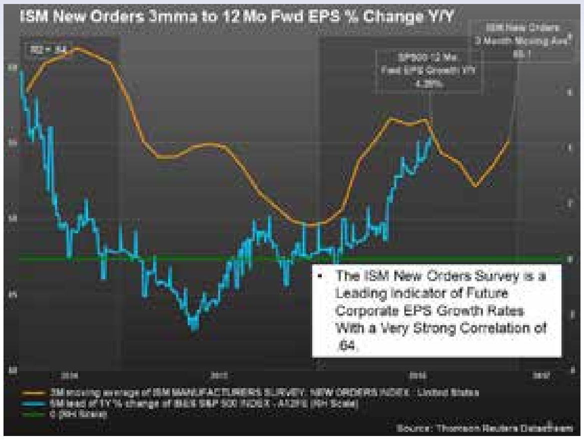
CHARTS 6-8

Domestically, the leading economic indicators continue to strengthen. Manufacturing appears to be on the rebound as the aforementioned Manufacturing ISM number for December was strong. In fact, the New Orders component of the survey was at its highest level since November of 2014. This is important for corporate earnings. Chart #6 demonstrates the strong correlation between the New Orders Survey and the forward S&P500 earnings growth estimate.

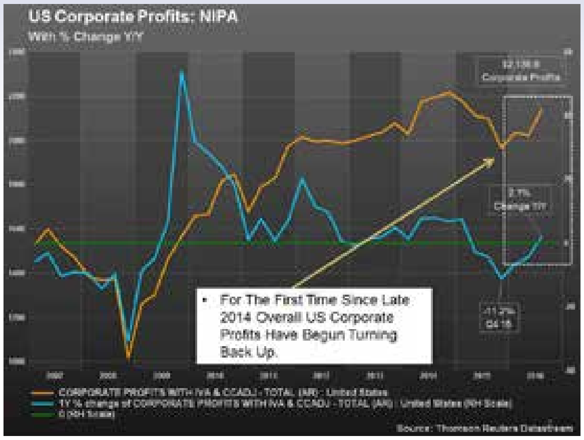
Additionally, overall US corporate profits for 3Q2016 turned back up for the first time since 2014, Chart #7.

The improvement in leading indicators coupled with a declining unemployment rate is leading to an increase in inflation. As shown in Chart #8 the core CPI, PCE and PPI have been rising for the past year.

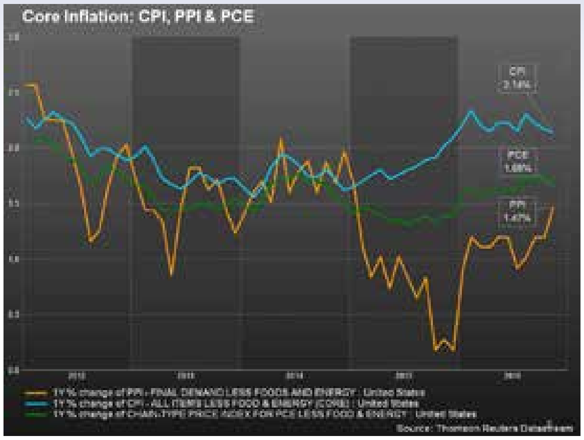
6



7



8



Although they are not at worrisome levels it does strengthen the case for the US Fed to raise rates this year at least two and possibly three times. Rising inflation should allow for better corporate top line growth but could drive interest rates to a level that would threaten the valuation of equities. Unlike the end of 2015, however, current low financial stress indicators such as credit spreads; strengthening leading indicators and a stable currency will help cushion any negative impact from higher Fed Funds rates. For 2017 it is clear that the Trump presidency will start with strong economic tailwinds. With regard to the Trump policy platform and the current global situation we see the following as issues:

I. The Positives:

a. Corporate tax relief will benefit companies paying high effective tax rates which are typically small to medium companies with a strong domestic focus.

b. Fiscal stimulus should be positive for overall aggregate demand and thus corporate profits. The amount, however, is unlikely to be nearly as much as put forward during his campaign.

c. The easing of government regulations is a net positive for corporations. This should especially benefit financial institutions and small to medium sized companies.

d. The repatriation of overseas cash should benefit capital investment, economic growth and corporate earnings.

II. The Negatives:

a. There is a risk that inflation, and therefore interest rates, could rise too high too quickly and reduce corporate earnings, discourage corporate stock buybacks and, perhaps most significantly, adversely impact equity valuations.

b. If in the unlikely case that Trump’s immigration policy is fully implemented this would drive labor costs even higher in an already tightening labor market and adversely impact corporate margins.

c. There is also a risk that some of Trump’s trade policies would lead to an even stronger US$ and a potential trade war both of which would be negative for corporate earnings and US exports.

III. The Risks:

a. China represents a looming problem on the horizon. For now they have successfully reversed their declining economic momentum, see Chart #9, but they are struggling with several other problems: accelerating capital flight; managing an overleveraged economy; and, dampening a domestic real estate bubble. Furthermore, there is the ever present “Black Swan” event lurking behind their increasing militancy.

b. Iran and North Korea both remain fertile ground for a significant outlier event which most likely will present itself as a military clash.

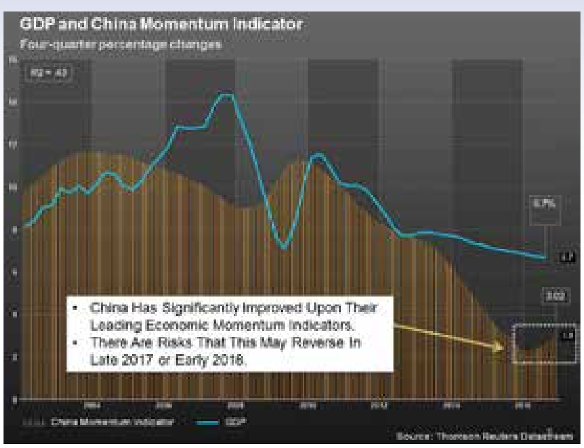
c. Trump’s foreign policy positions remain, for now, fairly opaque and his cabinet appointees have yet to have their views vetted by the Senate’s confirmation hearings.

CHARTS 9-10

In summary, we see that 2017 is off to a good start with improving domestic and global leading indicators, improving corporate profits and rising earnings estimates. As our current situation indicator in Chart #1 moves towards the upper right quadrant we should continue to see cyclical sectors outperform defensive sectors. Our relative market valuation model, Chart #10, indicates that the increase in interest rates and the rise in the S&P500 have pushed the Equity Risk Premium to its lowest level of this cycle but it still remains above its 20 year average. This indicates to us that the S&P500, although elevated on an absolute and historical level, is not overvalued on a relative basis. There are many instances during prior cycles when this premium has fallen well below its long term average as markets moved higher during periods of strong economic growth and accelerating corporate earnings. This does not mean, however, that the markets are immune to corrections. Chart #10 also illustrates that in past occasions when the equity risk premium has quickly fallen the S&P500 has been prone to corrections precipitated by unexpected events. The 2015 Chinese Yuan devaluation and the first Fed Funds rate hike during elevated financials stresses in late 2015 are two recent, illustrative examples.

Please contact your investment advisor if you would like to discuss these comments in further detail.

9



10