JUNE 2017 GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY

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Overview

US Equities Breakout & Breadth And Where Is The Inflation?

In last month's commentary we observed that despite a weak first quarter GDP number the US equity markets remained strong and appeared ready to break out to new highs. Additionally, the so called "hard" economic data was still substantially lagging the "soft" data as represented by the positive consumer and business optimism surveys. In Chart #1 you can see that over the past month the "hard" data, the orange line, has since turned up into positive territory.

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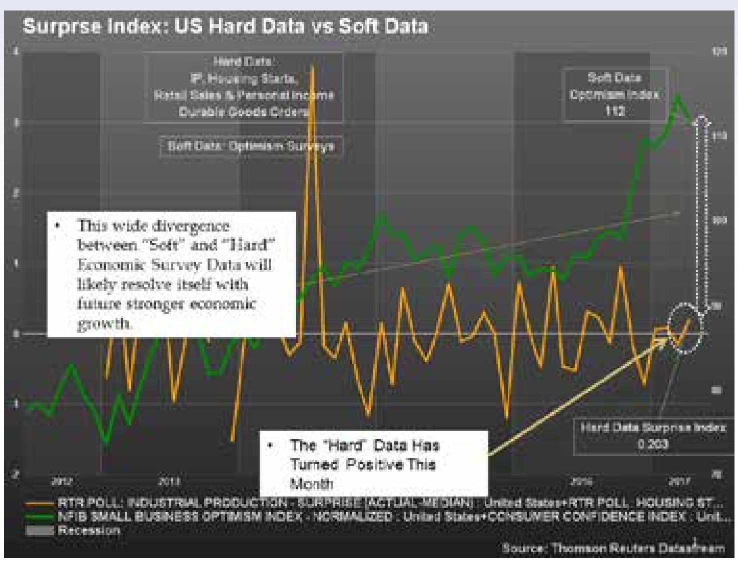

CHARTS 2-3

Although this data has been mixed it has, on net, been improving. As a consequence, the S&P500 has broken out to new highs as illustrated in Chart #2. A common concern of investors is that the S&P500 is market cap weighted and that its advance is being led by just a few of the mega-cap stocks such as Amazon and Google. We can answer this question by examining, in several ways, the breadth of the market's rise. First, as shown in Chart #3, we look at the S&P500 index on an equal weighted basis and see that it too broke out to the upside at the beginning of June thus indicating that it wasn't just the big names making new highs.

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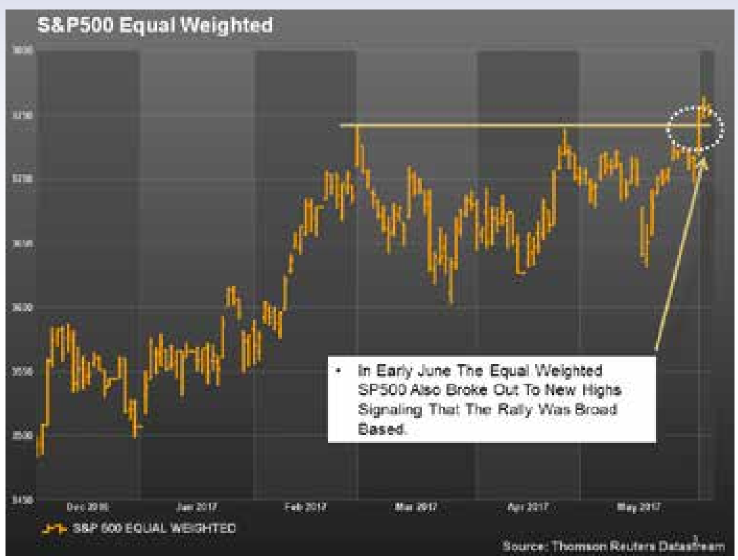

CHARTS 4-5

Another indicator of market breadth is the six month moving average of the daily net number of stocks that go up and down as represented by the orange line in Chart #4. The blue line represents the market's momentum. You can see on the right side of the graph that today's market breadth and momentum are both positive. In contrast to this look at the market during the late 1990's and you'll see that the market's momentum was positive but the breadth had become very negative thus signaling the coming correction. One last indicator that today's market advance is broad based is illustrated by the fact that both growth and defensive sectors are doing well, Chart #5.

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CHARTS 6-7

The strength of the equity market's advance was originally aided by the expansion of the Fed's balance sheet, or Quantitative Easing, as shown on Chart #6. However, as this chart shows, the market kept rising long after the Fed stopped their Quantitative Easing program because the projected earnings and sales growth, which had bottomed in early 2016, have since risen rapidly and now exceed the peaks of 2014, Chart #7.

With all of the positive elements mentioned above supporting the US equity market's current advance there still remains the potential for periodic corrections along with disappointing economic news. The sources of potential risk range from the disarray in the Trump administration; the upcoming elections in England and Italy; and, the potential slowing of the Chinese economy.

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CHARTS 8-9

Of all of the economic data that is most puzzling to observers is the absence of higher inflation in the US economy, Chart #8. Commodity and energy prices have certainly moderated lately but what confuses most people is the absence of much stronger wage increases in the face of low unemployment. As you can see in Chart #9 the current rate of unemployment is near its thirty year lows and yet the growth rate of Average Hourly Earnings (AHE's) is well below past peaks.

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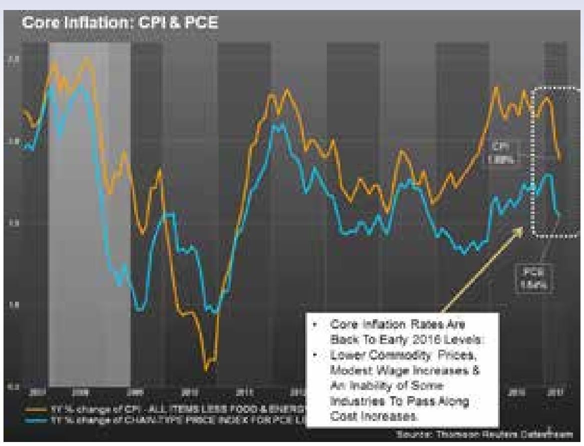

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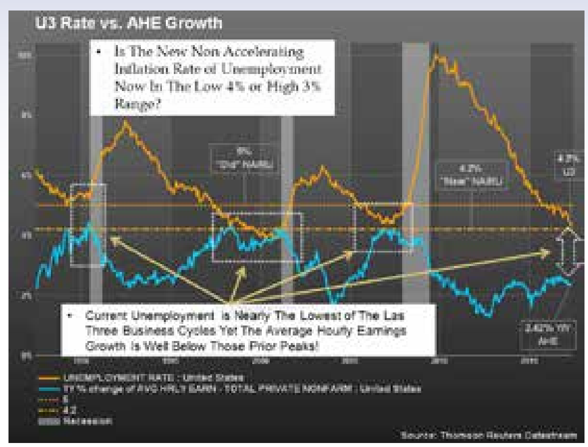

CHARTS 10-11

This is one of the primary reasons that inflation expectations and interest rates are back to 2016 levels, Chart #10. This is a situation that is bound to reverse itself because of all the indicators that point to continued strengthening in the demand for labor: 1) the National Federation of Independent Businesses (NFIB) Survey of employment is near a cycle high; 2) the Conference Board's employment survey is similarly near a cycle high; and, 3) initial unemployment claims are at record lows. The monthly reading of the number of job openings, or JOLTS, just came out at a new all-time high and yet wage growth remains well below past peaks, Chart #11. This divergence will eventually resolve itself with stronger wage growth which, in turn, should increase inflation expectations and interest rates.

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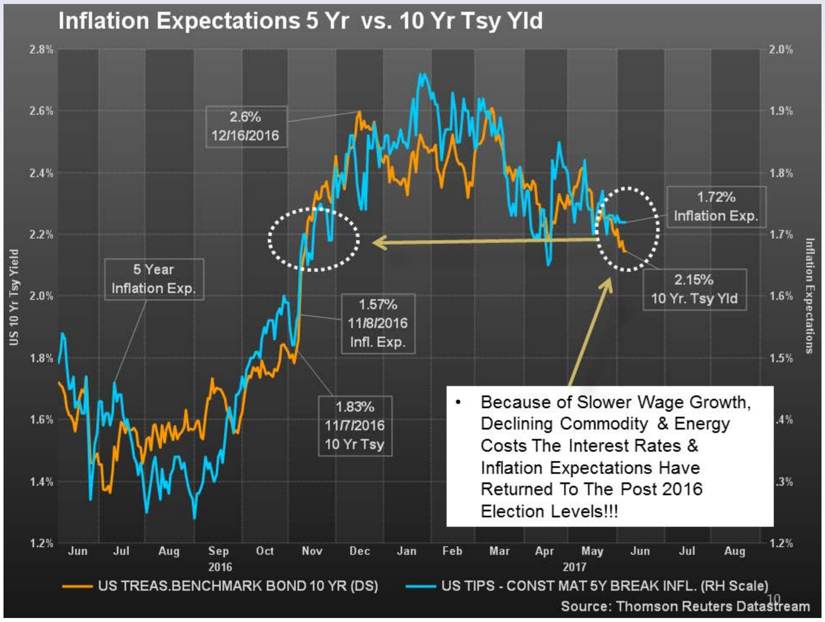

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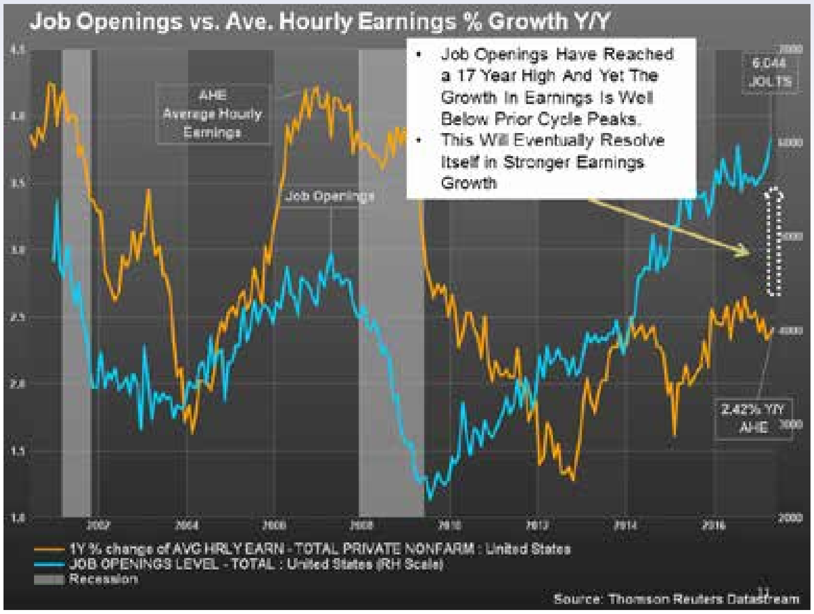

CHART 12

Although the market is near record highs and the forward price earnings ratio is at an elevated level of around 17.7 our Equity Risk Premium model still ranks the market as being about ½ a standard deviation inexpensive relative to the 10 year US Treasury bond yield, Chart #12. The reason for this is that forward earnings estimates continue to increase while, at the same time, interest rates have been declining.

Please contact your Investment Advisor if you would like to discuss in more detail any of the topics mentioned above.

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