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

Overview

Our Bear Market Barometer: What Our Indicators Are Now Telling Us

The S&P500, as shown on Chart #1, has had an extraordinarily strong run since the end of the Great Financial Recession and is up around 10.5% for 2017. For 2017 the market has been led by Technology, Consumer Discretionary, Materials and Health Care. The latter sector is usually associated with defensive investing but its good performance this year may have much to do with the new administration in Washington, D.C.

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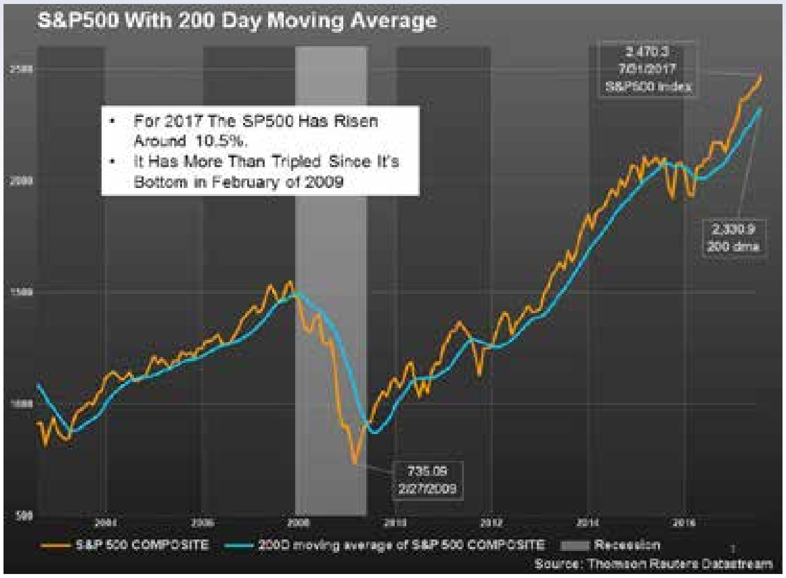

CHARTS 2-3

Defensive sectors such as Utilities and Consumer Staples have done well this year because of continued low interest rates and low inflation expectations, Chart #2 and Chart #3.

Our Investment Policy Committee will periodically review several fundamental factors which will help us in determining whether or not we are approaching a bear market. Our conclusion, as you will read below, is that, on the whole, those conditions which would cause us to worry are not yet in place.

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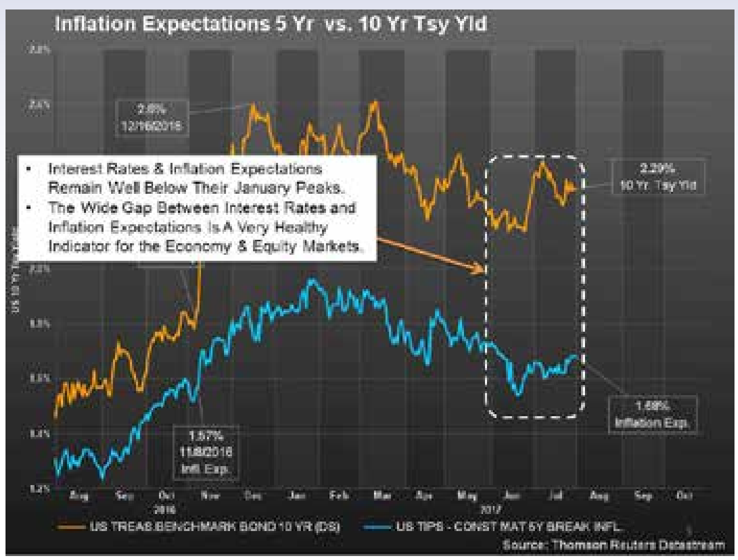

CHARTS 4-5

1. Economic Outlook: Current economic indicators are pointing to continued US strength for the balance of 2017 and into 2018. The US Economic Surprise Index is turning back up after having collapsed earlier this year, Chart #4. Additionally, the Industrial Production readings for the US have turned back up and are an important leading indicator of corporate sales and earnings, Chart #5.

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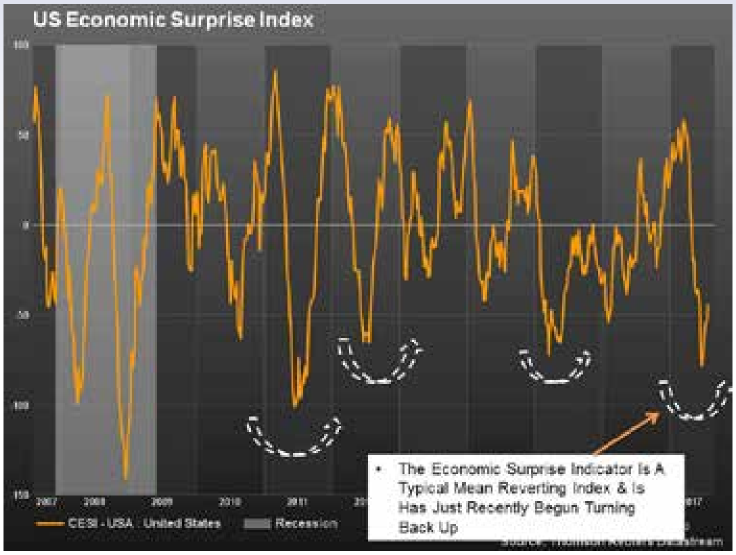

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CHARTS 6-8

The most encouraging data comes from the US Leading Economic Indicator which is also trending rapidly back up and provides a very good correlation for future Industrial Production, Chart #6. The US labor market is in something of a Goldilocks phase with unemployment near 50 year lows but with the growth in wages a modest 2.32% year/year, well below the levels attained during past cycle peaks, Chart #7. Other metrics such as consumer confidence, consumer net worth, the Institute for Supply Management surveys have all pointed to continued domestic economic strength. This data, along with the simultaneous pick up in global growth, Chart #8, brings us to the conclusion that the economic environment remains bullish.

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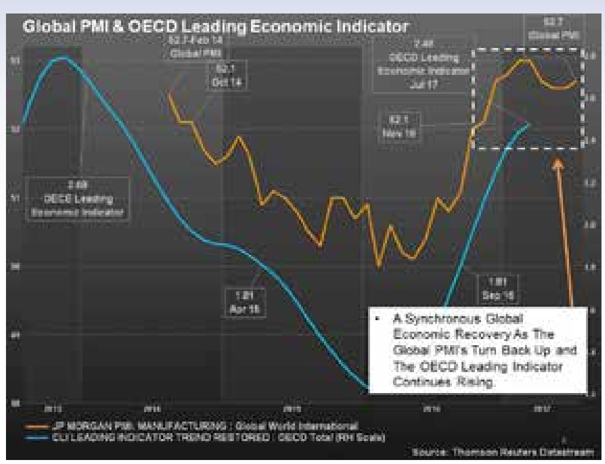

CHARTS 9-10

2. Monetary Conditions: There is a great deal of attention paid to the actions of the US Federal Reserve with regards to the level and amount of increases in the Fed Funds rate along with their outlook for reversing the quantitative easing measures taken post the 2008-2009 financial crisis. Although we consider this to be important, our Investment Policy Committee puts more weight on the various financial conditions indices such as the Chicago Fed Financial Conditions Index shown in Chart #9. The data shown in this chart is telling us that financial conditions in the US economy are at their best, or easiest, level since the recession. This weekly index is a very good leading indicator of national corporate profits which are released quarterly and is currently pointing to a very healthy earnings environment for the balance of 2017. Another measure that we watch is the amount of excess liquidity in the US and the OECD economies. Chart #10 illustrates the fact that the growth in money supply is well above the growth in GDP and is therefore another indication of easy, healthy monetary conditions. When these two indicators are viewed along with other measures such as credit spreads we can conclude that monetary conditions are showing no early signs of an imminent bear market.

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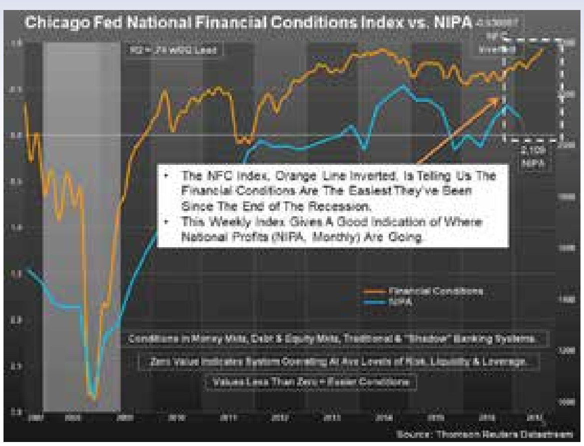

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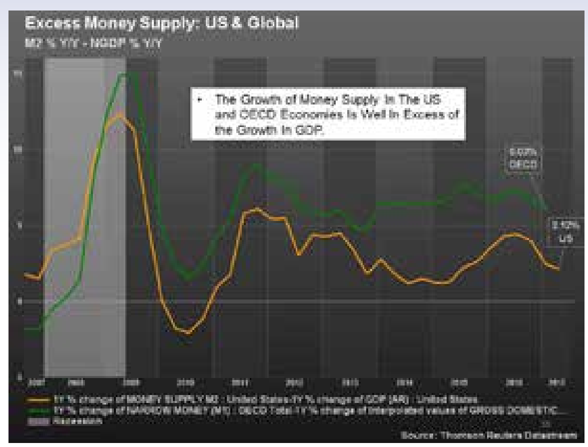

CHARTS 11-13

3. S&P500 Earnings: We believe that the most critical factor in the market's strength over the past eighteen months has been the strong increase in the twelve month forward earnings estimates. You can clearly see how the S&P500 index has closely tracked the earnings growth rate since early 2016 in Chart #11. The question now becomes one of earnings breadth and sustainability. Chart #12 illustrates that the breadth of earnings is trending up and is near its highest level since mid-2011. This indicates that the earnings increase in the S&P500 is being broadly experienced across sectors and industries. To answer our question of sustainability we look to the ISM monthly survey of manufacturing new orders which provides us with a fairly good correlation with earnings growth with about a three month forward looking window. In Chart #13 you can see how this survey, the yellow line, is trending up and is nearing peaks achieved earlier in the current economic cycle. This indicator along with others such as the growth in Industrial Production and the positive trend in the economic leading indicators put out by the Bureau of Economic Analysis give us a high level of comfort that earnings will remain strong through the end of the year.

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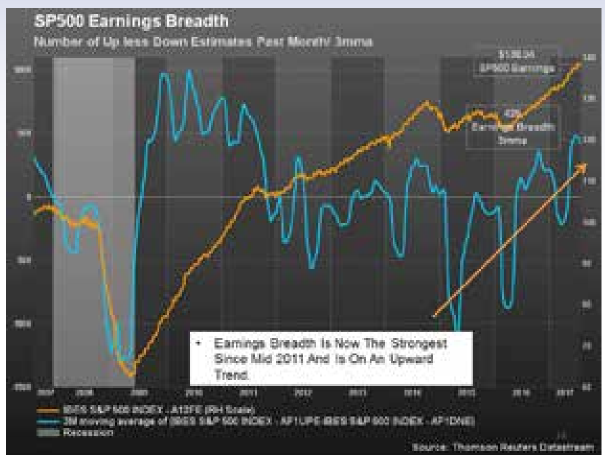

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CHARTS 14-15

4. Valuation: The remaining question is one of valuation and here we agree that, on an absolute basis, the S&P500's forward Price/Earnings ratio is, at ~18x, in the upper range of its historical readings. Chart #14 illustrates how this increase in the P/E has also been tracking the growth in earnings. While the market's valuation of a dollar of earnings is high by historical standards it is actually a little below average when compared to interest rates. Chart #15 illustrates the twenty year relationship between the market's earnings yield (E/P) versus the yield on the 10 year US Treasury Bond. Based on this historical data the S&P500 is about ½ a standard deviation cheap relative to its twenty year relationship to the bond yield. In fact, if you look back at the white outlined boxes for the past two cycles (the grey vertical bars represent recessions) you can see that the market has traded well below its average relationship to the 10 year bond rate. We can therefore conclude that, on a relative basis, the equity markets are not currently overvalued. This conclusion could change in the event that earnings falter and/or interest rates jump unexpectedly quickly.

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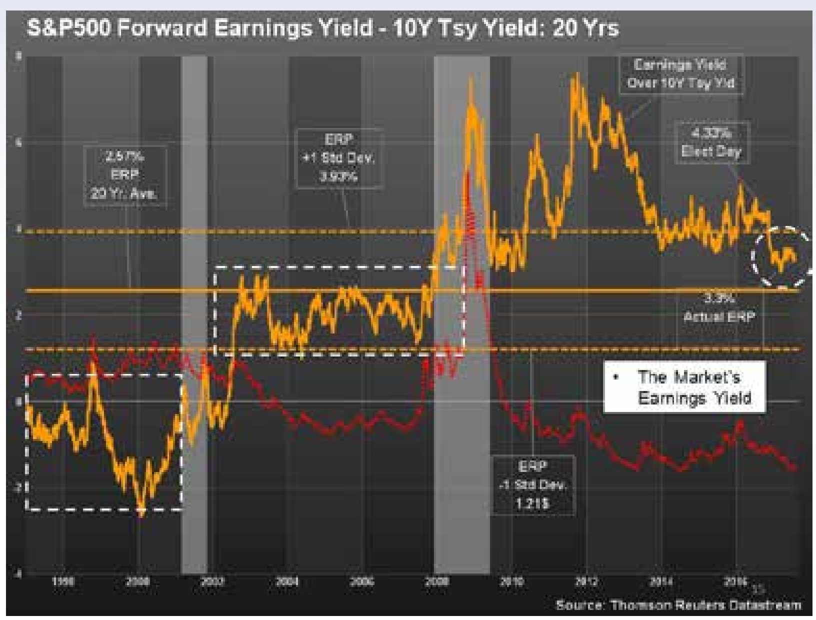

CHART 16

5. Market Technical Evaluation: As markets advance there is always a risk that the index is being led by just a few, large capitalization, high priced companies. This is an indication that the market's progress is narrow and is an early warning that a correction is imminent. We currently don't see evidence of that. Chart #16 illustrates that the market's current momentum and breadth are both very healthy unlike the late 1990's when the two diverged signaling the impending dot-com collapse.

In conclusion we so no evidence that, for the balance of the year, the US equity markets are in danger of entering bear territory. Please consult with your investment advisor if you wish to discuss how the above commentary impacts your portfolio.

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