JUNE 2015 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

William Kleinfeld
Managing Director
(617) 297-2155
billy@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: ARCA/FINRA/SIPC

Overview

In last month's commentary we talked about the fact that the US economy appeared to be near an upward inflection point despite recently mixed economic data. First quarter GDP has since been revised down to a -0.75% level and forecasts for second quarter GDP is an uninspiring 2.70%. It seems that the inflection will bring us to an economy that is just plodding along! There are, however, several important and strong signals that could very well presage even stronger growth entering the second half of the year. These signals consist of both economic data, such as housing and labor as well as financial indicators. Since the end of the recession the housing market has, until recently, been missing in action. The recent two month spike up in household formations, Chart #1, has been followed by a jump in new housing starts (orange line).

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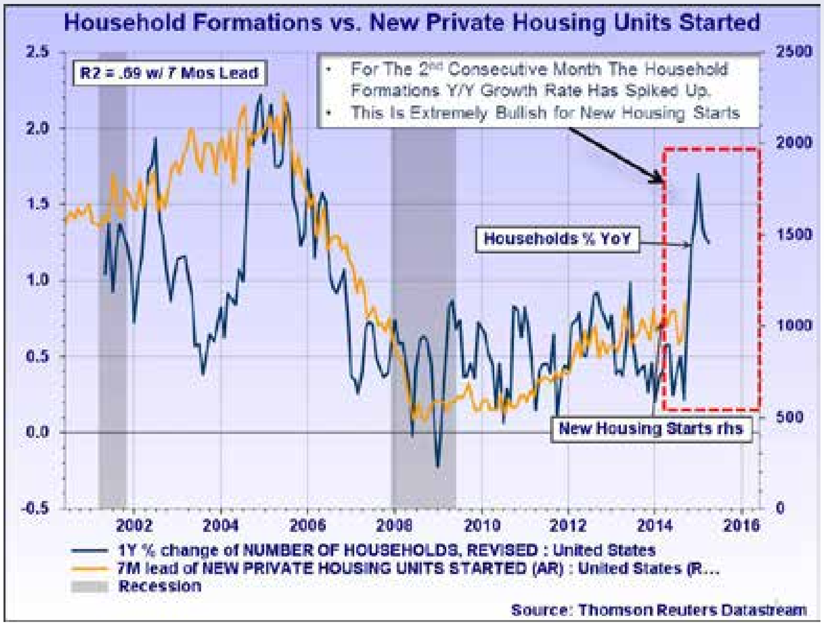

CHARTS 2-3. In Chart #2 you can see that until recently there has been a very high coefficient of determination (R squared) of .81 between the National Association of Home Builders (NAHB) Index and new housing starts. The gap in recent years was likely due to slow household formations as families searched for employment, repaired their balance sheets and improved their overall confidence. Additionally, when home prices appreciate faster than their financing costs it then puts upward pressure on new housing starts as shown in Chart #3. By the end of 2015 housing may be playing a larger role in overall economic growth.

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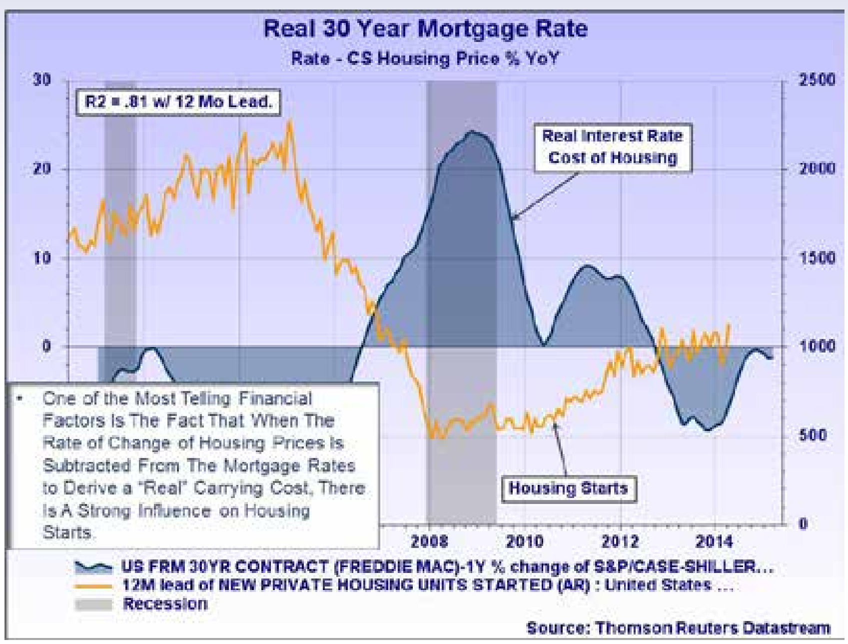

CHARTS 4-5. Another conundrum which has clouded the economic picture is that the precipitous drop in gas prices didn't lead to an equal but opposite rise in retail sales. Instead, as you can see in Chart #4, retail sales, ex gasoline, for 2015 (orange line) collapsed in apparent sympathy with gas prices! To try to understand the causality and timing we need to look at several factors. The University of Michigan Consumer Sentiment Index found that, initially, consumers didn't believe that lower gas prices would persist and thus didn't spend their windfall savings. Subsequent readings, however, showed that consumers now believe that low gas prices will persist for an extended time, thus eliminating anticipatory behavior as a reason. Another theory is that consumers have become more conservative and have chosen to increase their savings rate as shown on Chart #5. As represented by the red dashed line, the savings rate as a percentage of Disposable Personal Income (DPI) is now at 5.5% and has been trending up since late 2014. After the 2008 financial crisis this is a reasonable conclusion except that, for the past seven years, consumers have brought their balance sheets and financial obligations back to early 1980 levels.

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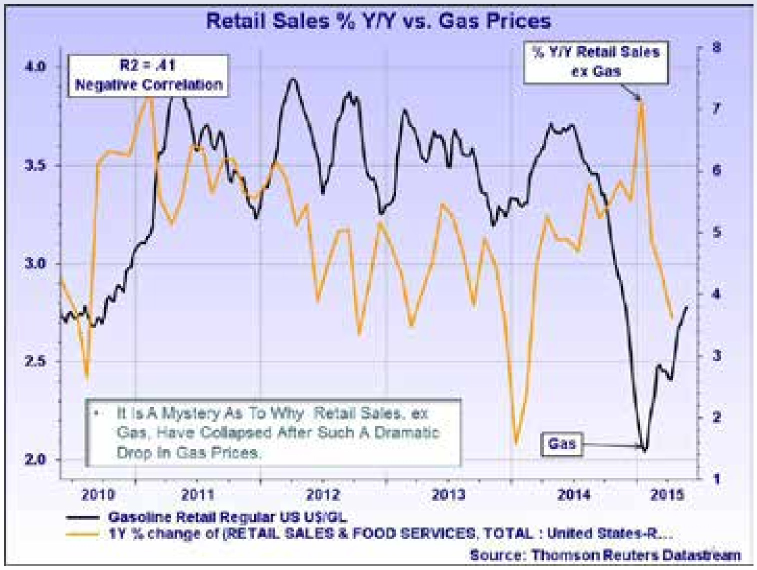

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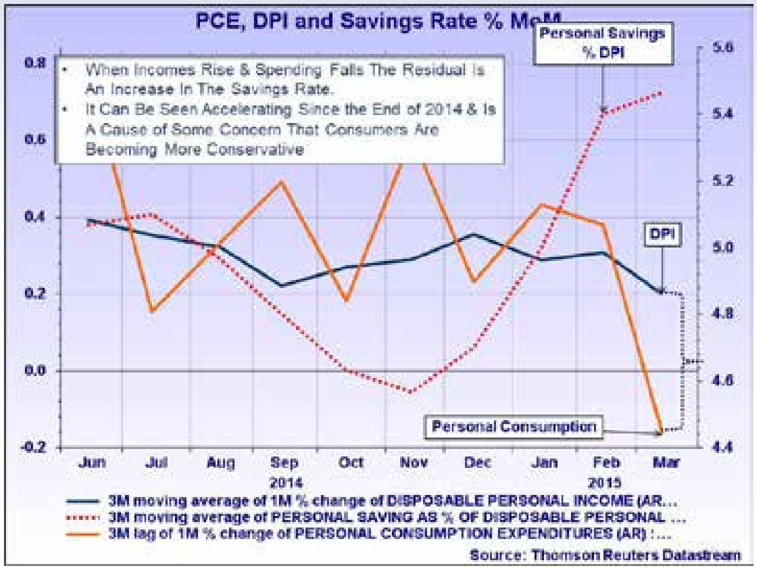

CHARTS 6-7. The real answer probably resides in a study done by the Congressional Budget Office (CBO) on the effect of tax rebates on consumer behavior. Since the rapid fall in gas prices is similar to a cut in income taxes the study should be applicable. In it the CBO found that it takes about three quarters for a tax rebate to pass through the consumer and have an impact on the economy and, since persistently low gas prices are more akin to a tax cut, the effect should be longer lasting. Therefore we expect a surge in retail spending in the second half of 2015, Chart #6, and thus remain overweight Consumer Discretionary as shown in Chart #7.

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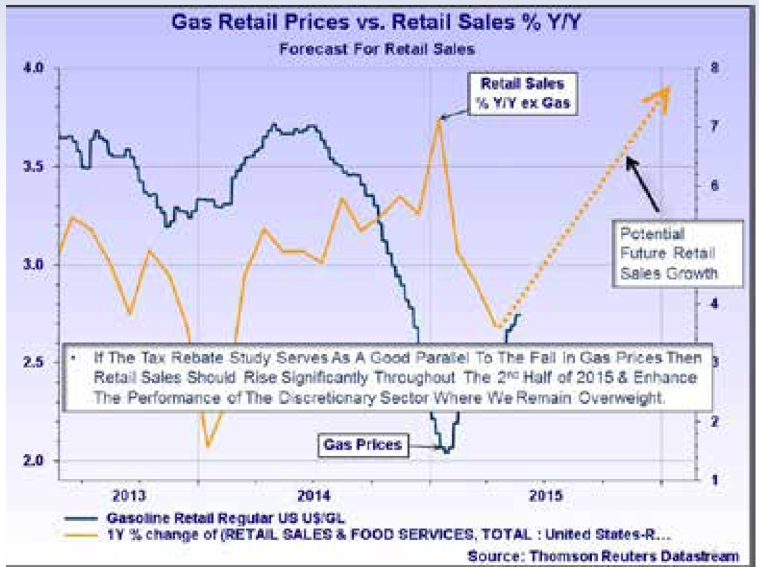

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CHARTS 8-10. Perhaps the most important data supporting the notion that the economy is strengthening are the employment numbers. As you can see on Chart #8 the Non-Farm Payrolls are near the peak achieved in the last economic cycle while the weekly initial unemployment claims four week moving average, a good high frequency leading indicator, is well below the trough of the past cycle. This employment strength is further confirmed by the Job Openings and Labor Turnover Survey (JOLTS) data and rising consumer confidence shown on Chart #9. The JOLTS number is well above the peak of the prior cycle. Increasing earnings, Chart #10, in combination with the strong jobs market reinforces our confidence in our Consumer Discretionary bias.

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CHARTS 11-13.

While housing, jobs and consumer spending are important indicators of a strengthening economy, there are also some interesting financial indicators which are also leading us to the same conclusion. The strong showing this year of High Beta Stocks, Chart #11, is the market's way of indicating confidence in economic growth. Additionally, the strong performance of Value Stocks, Chart #12, indicates an expectation that as the economy strengthens rates will increase and the yield curve will steepen. This should also benefit the Cyclical Sector which, year to date, has been flat because it contains the Material and Energy Industries. Rising rates and a steepening yield curve should also benefit the Financial Sector, Chart #13. As the blue line in this chart goes up it means that the yield curve is steepen-ing. The orange line represents the performance of the Financial Sector relative to the S&P500. It is interesting to note that when the yield curve goes negative, or inverts, as shown by the two lower left red circles, it always precedes a recession.

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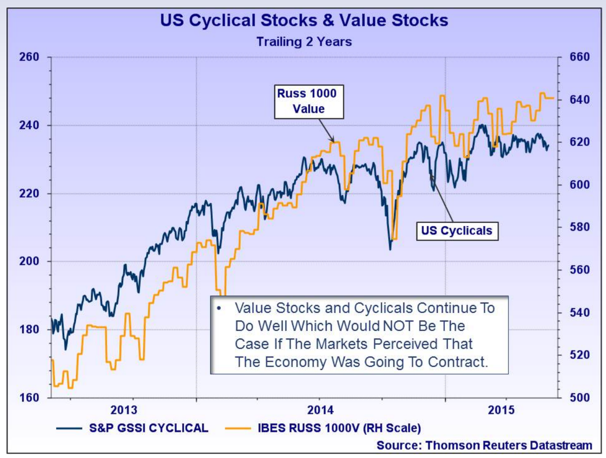

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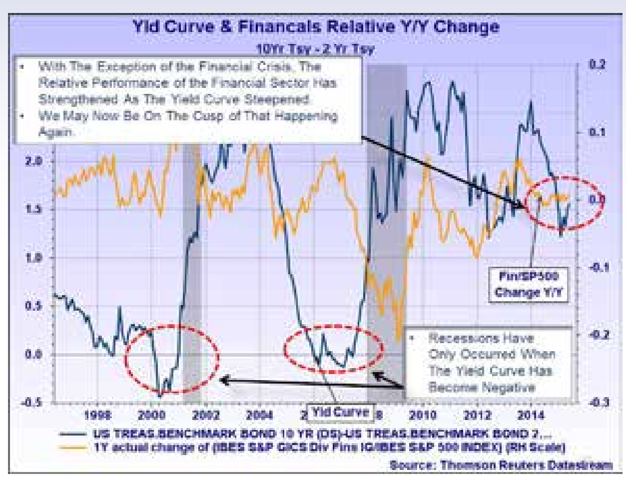

CHARTS 14-15. Additionally, it is apparent that the relative performance of the Life Insurance Index has an exceptionally tight fit to interest rates as shown on Chart #14. This is because as interest rates go up the present value of the insurer's liabilities goes down so their stock tends to rise. Finally, we examine our model of the S&P500's earnings yield spread over BAA yields, Chart #15, and observe that the market is below one standard deviation and trending closer to its 20 year historical mean relationship. Essentially, the market's earnings yield is getting closer to that of BAA bonds.

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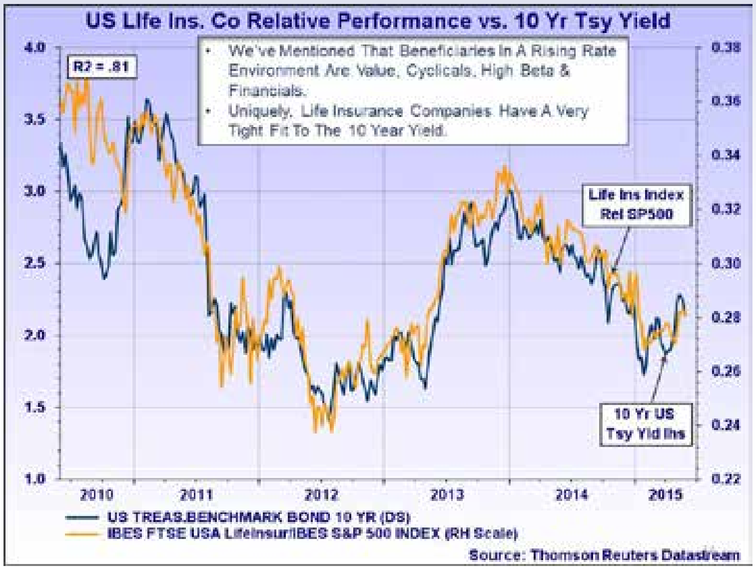

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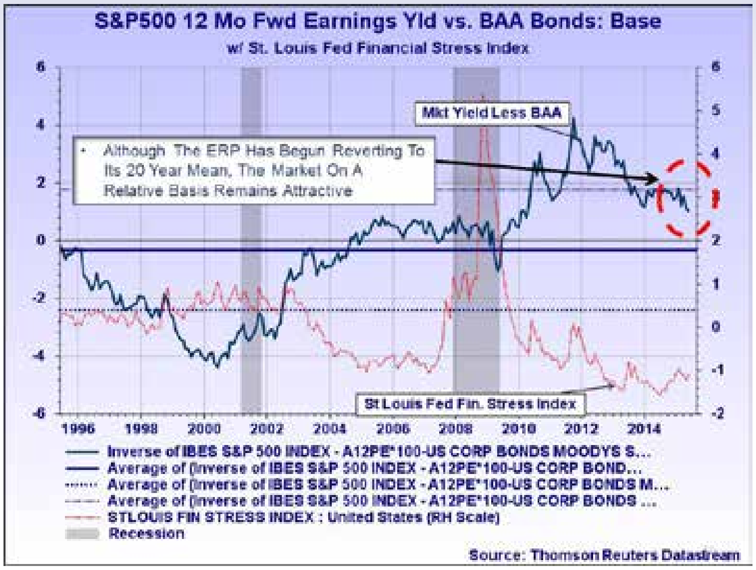

CHARTS 16-17. This is being caused by the recent spike up in BAA yields and the decline in 12 month forward market EPS estimates, Chart #16. The spike in yields, we believe, is a reflection of the expectation that the economy will strengthen. Additionally, the decline in earnings estimates is due to a number of one-time factors which are now fading and we are beginning to see estimates rise once again. This perception is reinforced by the recent ISM Manufacturing New Orders survey which recently rose for the third consecutive month to a level of 55.8. As shown in Chart #17 this is a good leading indicator of future S&P500 earnings estimates and is now consistent with future estimates growing at a 4.36% year/year rate.

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In conclusion, we feel that there are more positive than negative indicators for a strengthening economy to be found in both economic and financial data. The Federal Reserve will likely raise rates before the end of the year but the sluggishness of economic growth combined with quiescent inflation will temper their action. The equity markets are expensive but not in any stretch of the imagination in bubble territory while the bond markets are even more expensive. To understand how the above commentary may impact your portfolio, please consult with your investment advisor.

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