Winslow, Evans & Crocker, Inc.[SM]

AUG. 2015 GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY

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Overview

In last month's commentary we reviewed the never ending Greek crisis and its impact on the rest of the Eurozone, concerns over US retail spending and the Consumer Discretionary sector, and improving US economic data and the steepening yield curve. This month we will update you on these issues and comment on China which, in our opinion, represents the greatest risk to global growth.

CHARTS 1-2

As you can see in Charts #1 and #2 the probability of Greece exiting the Eurozone and subsequently defaulting on their debt, as indicated by the futures market, still remains high even after agreements for debt relief and emergency funding were reached with the European Central Bank and the International Monetary Fund.

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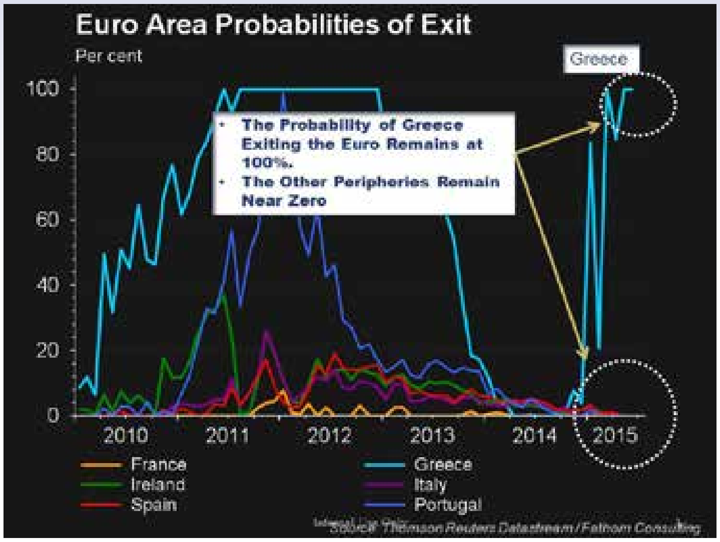

CHARTS 2-4

What is interesting to observe in these two charts is how much lower a probability of exit and default has been assigned to the other peripheral Eurozone countries. This is one indication of how well the Greek problem has been isolated from the rest of Europe. The European market, which has outperformed the US market by four percentage points year to date, is another such indication. Their forecasted earnings growth rate is both stronger and better than that of the US, Chart #3. This market performance and earnings growth in Europe is no surprise given the rapid growth of money supply provided by the European Central Bank, Chart #4.

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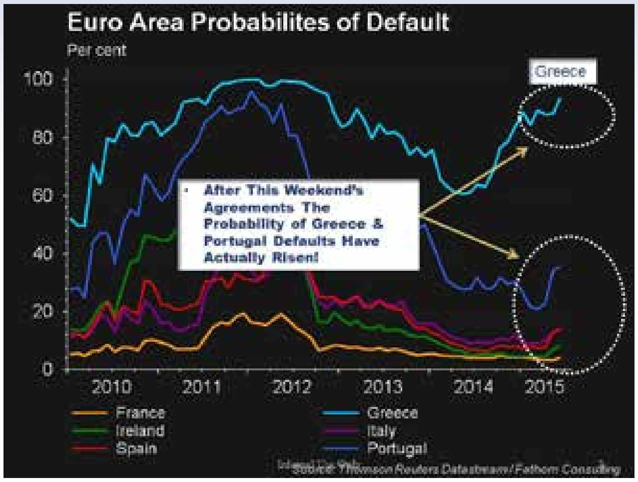

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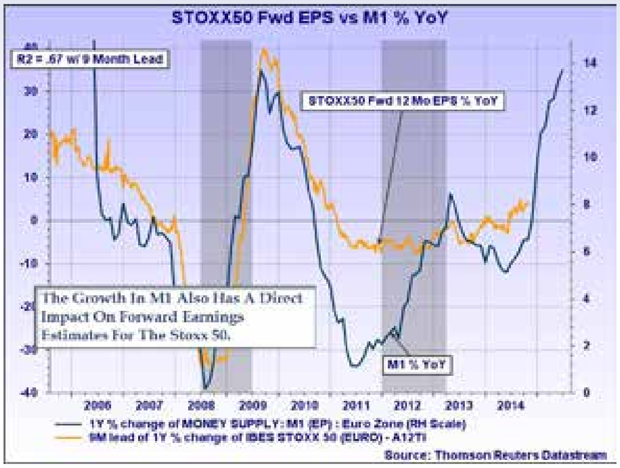

CHARTS 5-7

Finally, the measure of European systemic risk has fallen from its June spike and is well below its April peak, Chart #5. With the Greek problem isolated, we turn our attention to the much more serious threat of a hard landing in the Chinese economy. Although the Chinese economy recently achieved a 7.0% annualized growth rate, our momentum indicator, represented by the blue line in Chart #6 clearly indicates that the growth rate of their economy is losing steam. Their economy has three major, interrelated issues needing resolution: 1) Excess private leverage, Chart #7; 2) A real estate bubble second only to Ireland and Spain, and 3) The need to pivot away from an infrastruc-ture centric economy to one that is consumer focused. All of this is further complicated by the heavy handed govern-ment interference in their equity markets. Although real estate at 50% of personal net worth far outweighs equities at 10%, the capital markets will never be able to efficiently allocate capi-tal and clear financial stresses unless allowed the freedom to do so. Referring back to our momentum index in Chart #6 it is clear that the falling prices of both energy and industrial material commodities is linked to expectations of Chinese economic growth.

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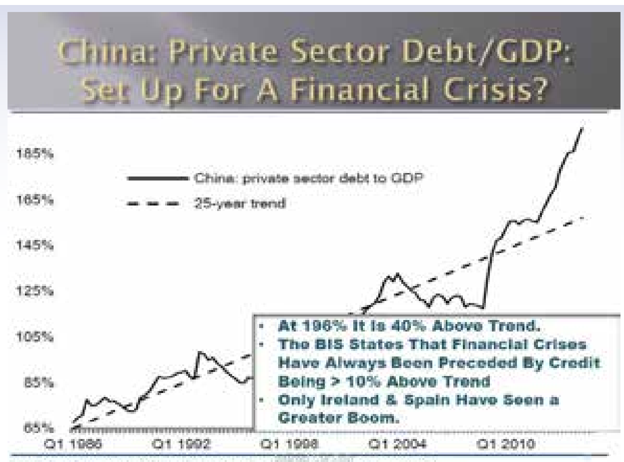

CHARTS 8-9 This has an obvious direct impact on energy and commodity producers and a secondary effect on the industrial and capital goods sectors both of which have been significant underperformers this year. The Chinese are not oblivious to this risk and certainly are not without significant resources to meet it. They have the world's highest level of foreign exchange reserves, Chart #8, which provides a significant financial cushion, and they have been easing monetary policy by lowering interest rates (SHIBOR) and bank reserves, Chart #9. Concerns over slowing global growth is also forcing the central banks of other major economies to follow a similar course. Australia, Canada, New Zealand & Hungary are lowering their interest rates; Japan is likely to accelerate their Quantitative Easing program; and, as mentioned above, the European Central Bank has been aggressive in trying to cushion the Greek crisis. All of this activity means that global financial liquidity is rising which is generally positive for equities.

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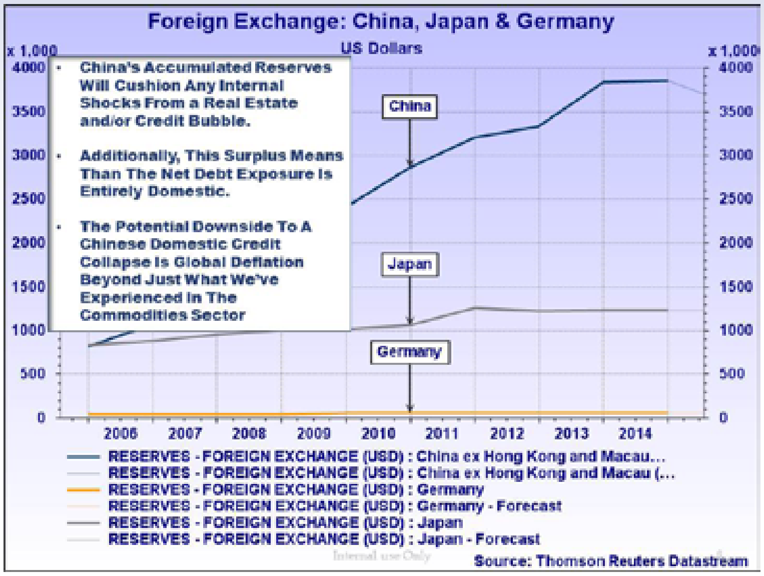

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CHARTS 10-12

In Chart #10 we can see that excess liquidity in the OECD economies is rising and that, historically, it has correlated very well with a rising global equities market.

As a final comment on China, it appears that the rest of the world is doing better. In Chart #11 we have compared the US Purchasing Manager's Index to the Industrial Commodities Index. These variables are suggesting that developed market growth is ok while variables related to China (commodities) are underperforming the global cycle. Since our last publication the data coming in for the US economy has been erratic, but generally improving as can be seen in Economic Surprise Index shown in Chart #12. One of the best indicators for the economy comes from the labor market which is also giving mixed messages. Although the unemployment rate is now down to 5.3%, and the weekly initial claims are near a cycle low. The U6 rate, a broader measure of unemployment which captures part-time workers, is still above the peak reached in the last cycle. Furthermore, the percentage of the working age population is near the lows of the 1960's.

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CHARTS 13-14

These latter two factors, in combination with low inflation, will likely keep the Federal Reserve from raising rates too soon, perhaps late 2015, and too sharply. Although this data shows current softness in the labor market, there are leading indicators that point to a future of growing strength.
Specifically, the Jobs Opening Index (JOLTS) and the Employment Trend Index are both above the peak achieved in the last economic cycle, chart #13.
The US equity markets have been buffeted all year long by everything from bad winter weather to concerns over global growth. Although we are not yet through the second quarter earnings reporting season, it is clear that corporations are doing a good job of exceeding earnings expectations, but are struggling to improve revenue growth. The major concern overhanging the market at this time is that rising labor costs will squeeze margins, and thus earnings, if revenues remain stagnant. This problem is compounded by the low level of productivity and corporate capital expenditures since the end of the recession. So far, however, margins have remained elevated while the employee cost index (ECI) has stayed muted.

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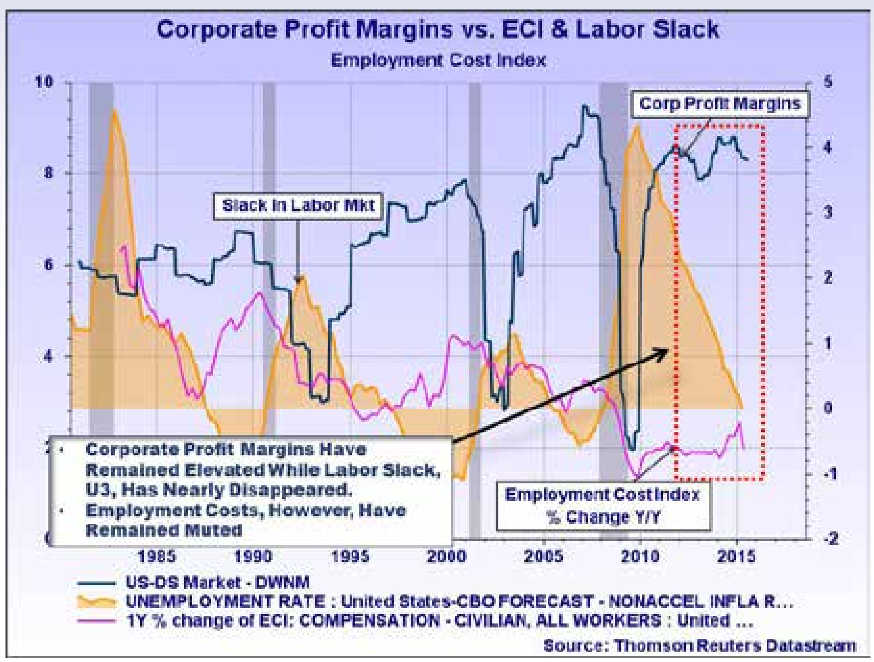

In Chart #14 you can see that corporate margins don't begin to contract unless the Employment Cost Index consistently exceeds 4.0% year over year growth. With its current level of 2.0%, corporate margins don't appear to be in imminent danger of collapsing.

If you would like to discuss how the above observations and conclusions could impact your portfolio please feel free to contact your advisor with questions.