Winslow, Evans & Crocker, Inc.℠

FEB. 2016 GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY

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Overview

The vicious, record setting volatility of the equity market in January is beginning to feel much like the cruel winter weather of last year. In this month's report we will set forth our interpretation of these events (not the weather) and provide our outlook for the economy and the markets.

In last month's commentary we observed that the timing of the increase in the fed funds target interest rate was both unusual and somewhat dangerous. It was unusual because the rate had never before been increased during a time when both economic and financial indicators were so poor and dangerous because the Fed's actions could worsen those conditions. We cited as problematic the rise in US credit spreads and emerging market bond yields; a strengthening in the US$; falling inflation expectations; and, the fall of the ISM Manufacturing Survey to below 50 which has historically been an indication of contraction in that sector.

CHARTS 1-3

Unfortunately, many of these concerns have proven to be correct. High yield credit spreads spiked to 7.43% mid-month and BAA spreads are now at their highest level in a year, Chart #1. In Chart #2 you can see that emerging market bond yields and the US$ continued to increase in January although both now appear to be levelling out. These disappointments in financial and economic indicators have driven the economic surprise indicators for the US, China, emerging markets and even Europe into negative territory, Chart #3. It is no surprise, then, that the US equity markets have had their worst and most volatile calendar year start in over fifty years, Chart #4.

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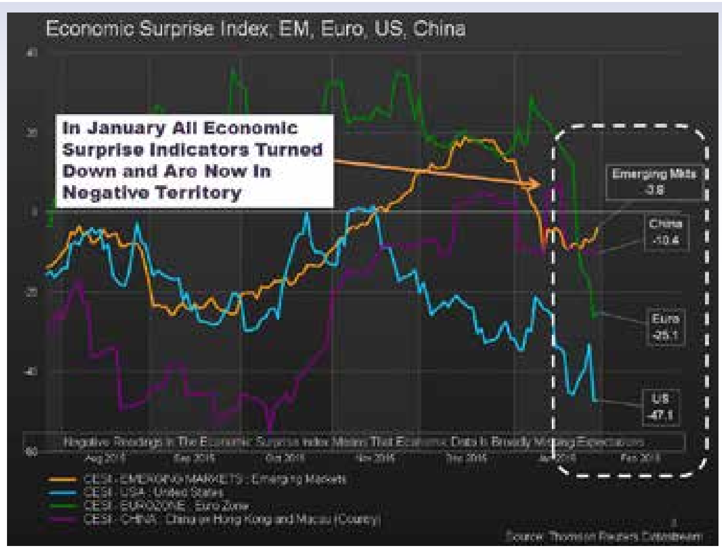

CHARTS 4-5

It is important to determine the extent that these financial and economic indicators will truly impact the economy and the future returns of the equity markets. To better understand the impact of widening credit spreads, we rely heavily on the more sophisticated economic stress indicators published by several of the regional Federal Reserve Banks. Chart #5 illustrates the weekly and monthly financial stress indicators calculated by the Kansas City and St. Louis Regional Federal Reserve Banks. When these indicators are below zero, which they presently are, financial conditions are considered to be easy. Notice that during the 2011 market correction these indicators were much higher than they are now and were in territory considered to be indicative of heightened systemic risk for the financial system. We therefore conclude that the current high yield and BAA credit spreads are not indicative of further stress in the financial system.

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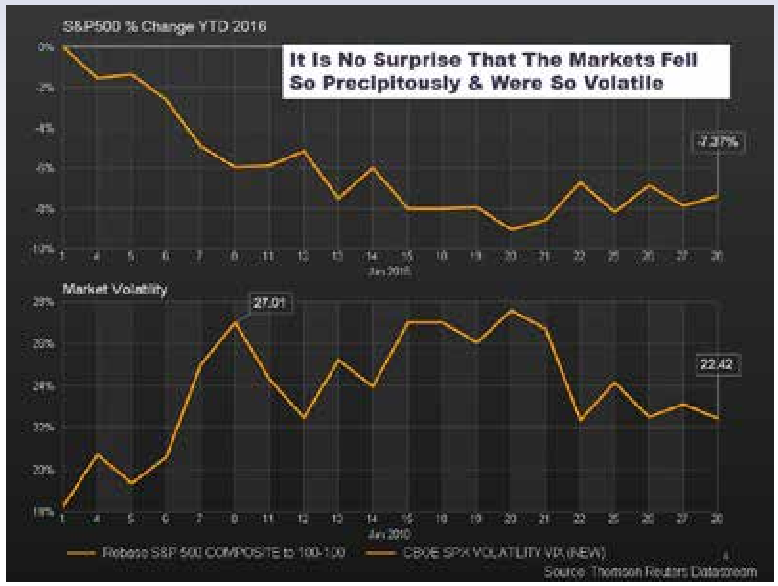

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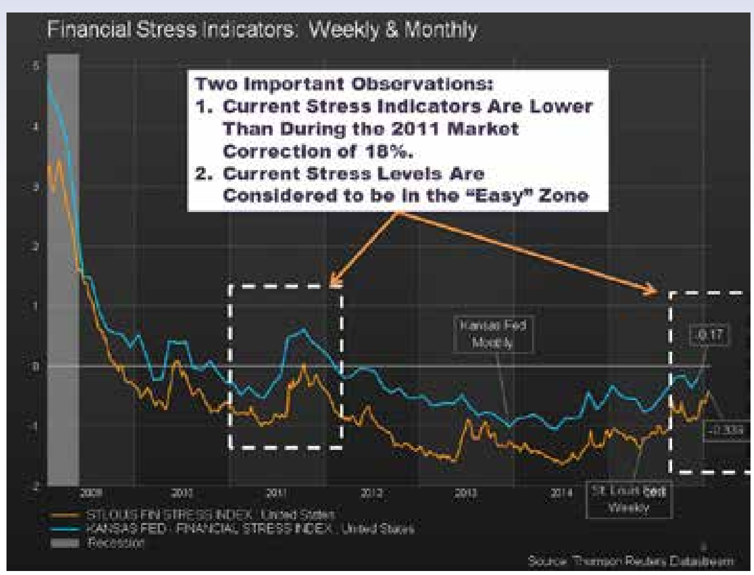

CHARTS 6-7

In addition to knowing that financial stress indicators are low, it is helpful to know what implications this has on economic outlook. In Chart #6 you can see that there is a very strong inverse correlation to the Chicago National Financial Conditions Index and the St. Louis Financial Stress Index. The Financial Conditions Index, which uses 85 economic measures of the current state of the economy, tends to get stronger as financial stresses get easier. We then use this information to try to determine the future growth of the economy. The correlation with US real GDP growth is fairly good and, as shown in Chart #7, current conditions point to RGDP growth in the range of 2.2%-2.5%. Our conclusion is that the current financial conditions such as credit spreads are not, for now, pointing to a recession but rather to continued moderate economic growth.

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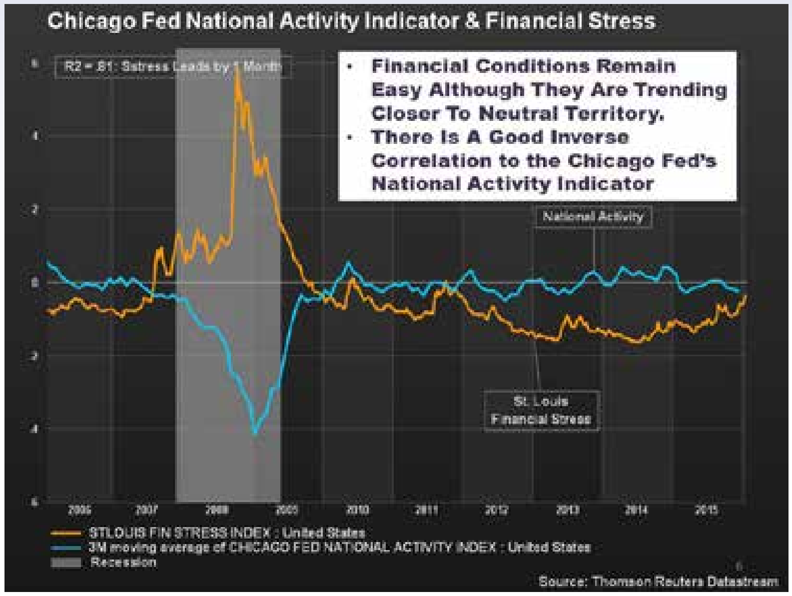

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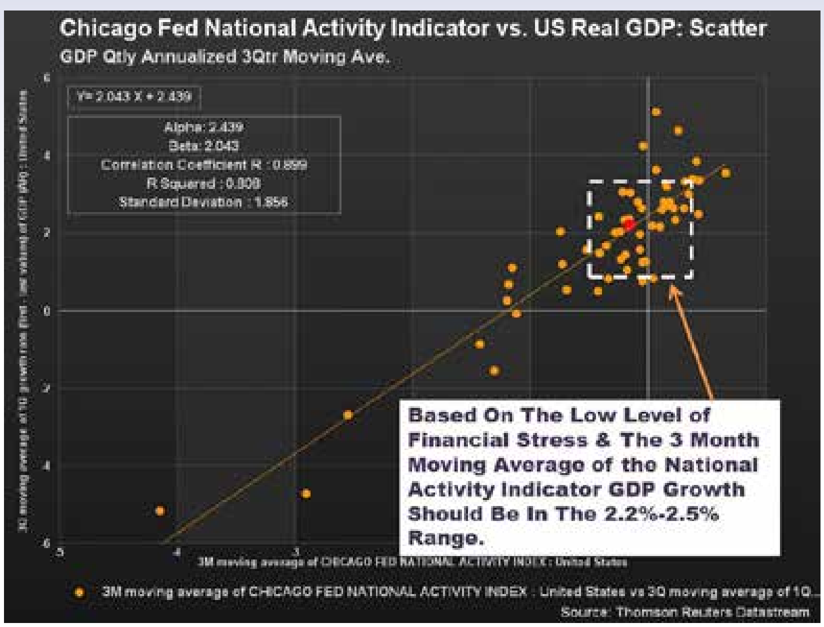

CHARTS 8-9

Financial conditions and economic data are both important contributors to market valuation. The earnings yield of the S&P500 relative to the 10 year Treasury yield provides us with insight into the market's valuation on a relative basis. As you can see in Chart #8, the equity markets are at an earn-ings yield of about one standard deviation above its historical relationship to the 10 year US Treasury yield. This relation-ship is, or course, contingent upon the outlook for earnings and interest rates. We view the ISM Manufacturing and Non-Manufacturing New Order surveys as good leading indica-tors of twelve month forward earnings growth estimates. As you can see in Chart #9 the forward earnings growth esti-mates, the yellow line, are now positive after having been neg-ative since the middle of 2015. The ISM new orders index, the green line, provides a fairly good leading indicator of future growth rates. Although this survey has come down from its mid-2015 peak it remains well into expan-sionary territory at 55.82.

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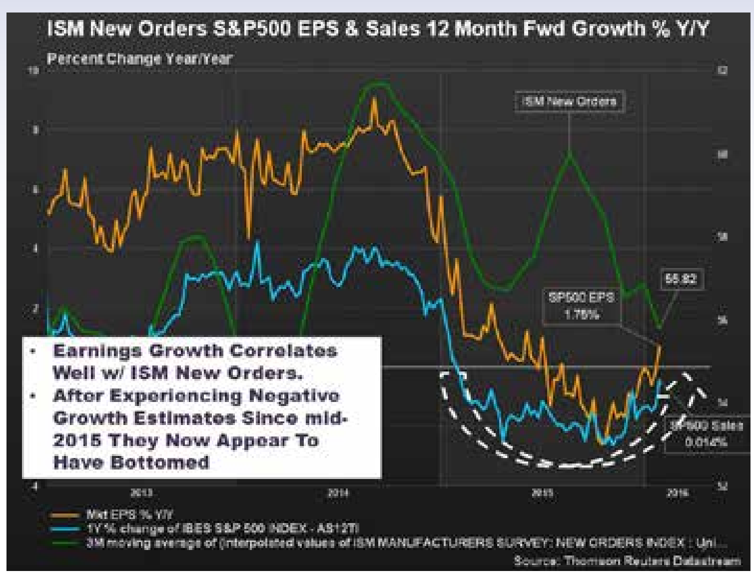

CHARTS 10-12

This absolute level of 55.82 implies, as shown in Chart #10, a forward earnings growth rate of approximately 5% year/year. The caveat is, of course, that the ISM New Order surveys may decline even further in future months thus lowering the prospects of future earnings growth. Given that the economy is growing at such a tepid rate and that inflation is so low, it has now become likely that the US Federal Reserve will delay any further rate increases. Should economic indicators further deteriorate then another round of quantitative easing is not out of the question.

As a result of the extreme volatility that has been experienced in the US equity markets in January it is worth looking at market valuations from a few other perspectives. In Chart #11 you can see that the free cash flow yield of non-financial corporations over and above the yield of high yield bonds is at the lowest level since the end of the recession. This level, however, is still around the peaks achieved in the prior two recoveries. In Chart #12 we show the dividend yield of the Dow Jones Industrial Average relative to the 10 Year US Treasury Yield. It is currently greater than the Treasury yield which, as you can see, is a very rare event and usually presages a market rally.

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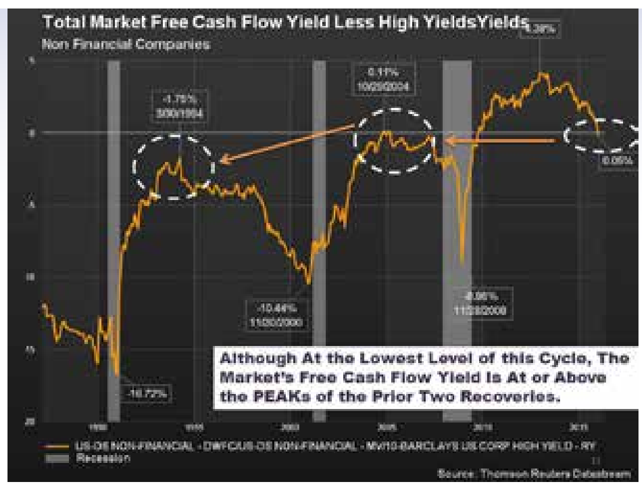

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CHART 13

Finally, in Chart #13, we show the ten economic sectors represented by the S&P500 and rank them by their projected 12 month forward sales growth, in blue. We have also shown the estimated forward earnings growth rates as represented by the gold bars. In a moderate economic growth environment we tend to favor those sectors which can show superior top and bottom line growth rates.

13

Please contact your advisor if you feel that any of the above commentary is applicable to your portfolio.