Winslow, Evans & Crocker, Inc.℠

MAR. 2016 GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY

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Overview

During the month of February we have seen an easing in many of the short term financial and economic stress indicators that contributed to the record volatility in the US equity markets earlier this year. We will review how these have changed and how they could impact the market's progress for the balance of this year. Beyond the near term we remain concerned about how China will manage its excessive level of debt while it transitions to a consumer-centric economy. A fiscal or monetary policy misstep by China could adversely impact what is already a weak global economic growth rate.

As can be seen on Chart #1 the S&P500 has had a strong recovery of c.6.7% from its February 11th trough and has now crossed back above its 50 day moving average. Much of this recovery has been a direct result of an easing in financial stresses.

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CHARTS 2-4

This is illustrated in Chart #2 by the sharp drop in high yield credit spreads from their peak of +8.47%. A more nuanced view of financial stresses can be seen in the financial stress indicators published by the St. Louis and Kansas City Federal Reserves. In Chart #3 you can see that they haven't reached the heights that they did during the 2011 correction and that the weekly St. Louis index has remained below zero in the "easy" zone. Although this index had been trending toward the "tightening" zone it has just recently begun to reverse back down.

The underlying cause for the movement in the various financial stress indices has been the precipitous drop in oil prices. As shown on Chart #4 there has been a sharp correlation between the decline in both oil prices and inflation expectations. The latter decline has been interpreted as an indication of slowing economic growth with the possibility of an ensuing recession. You'll notice that with the recent stabilization

in oil prices inflation expectations have begun to increase. Not coincidently cyclical sector stocks, which had badly underperformed defensive sector stocks, have lately been rallying.

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CHARTS 5-6

In Chart #5 you can clearly see that, through February 9th, the classical defensive sectors of Utilities, Telecoms and Consumer Staples led for the year. Cyclical sectors occupied the bottom with negative absolute and relative returns. The financial sector, already heavily burdened with the new Frank-Dodd regulations, suffered even further when rumors of negative US interest rates began to circulate. Although these rumors have since been debunked by the Federal Reserve, financials will continue to struggle if the yield curve continues to flatten and if loan defaults in the Oil and Gas sector become worse than current expectations. On Chart #6 you can clearly see that since February 9th, after oil prices stabilized, inflation expectations began to move up and financial stress indicators eased, the field of performers reversed. Cyclicals sectors are now outperforming defensive sectors. This is an indication that, for now, the equity markets are no longer building in a high probability of an imminent recession.

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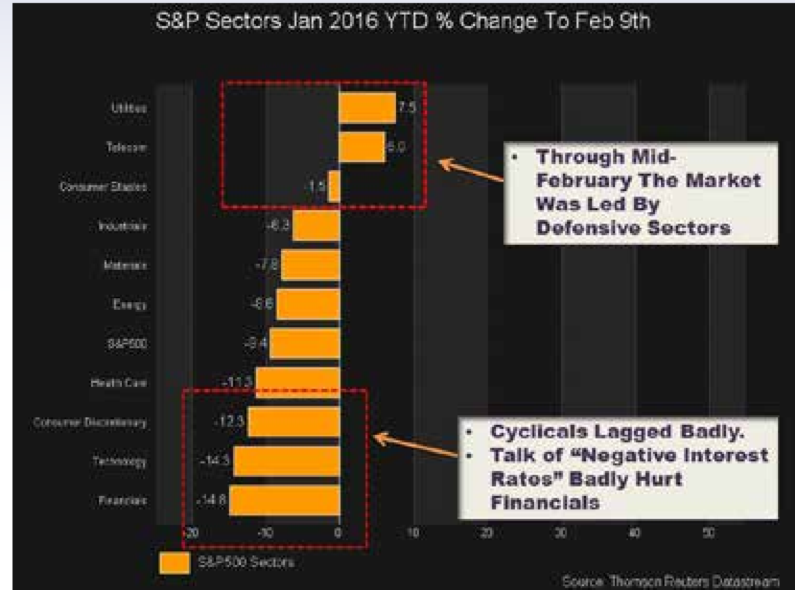

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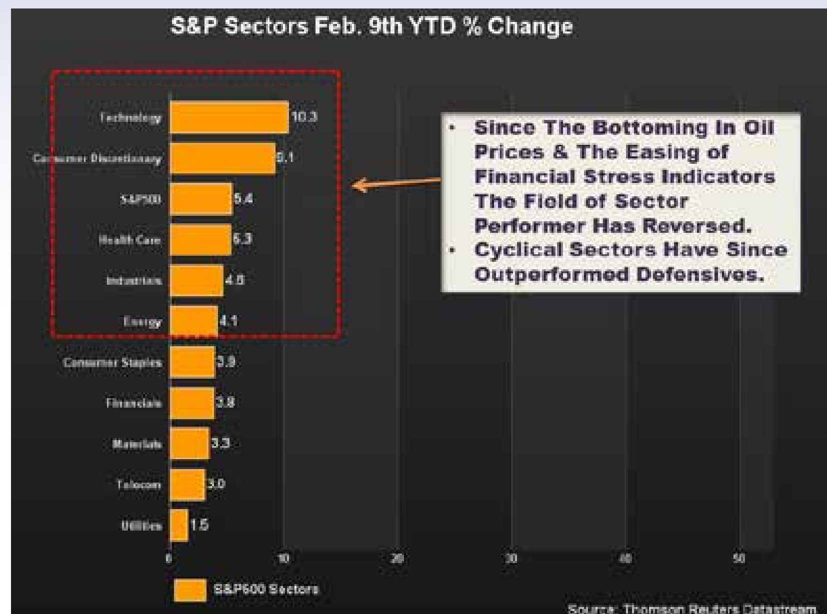
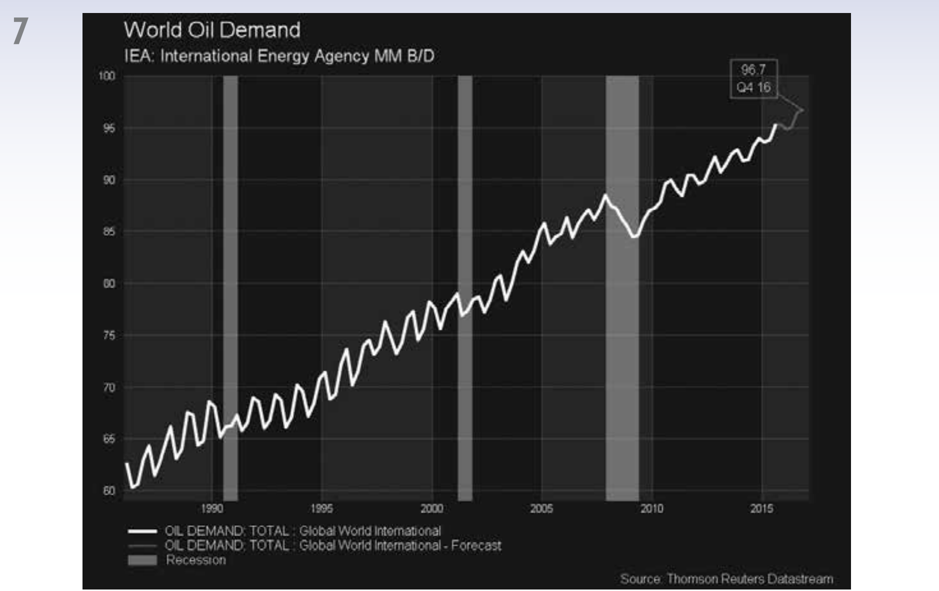
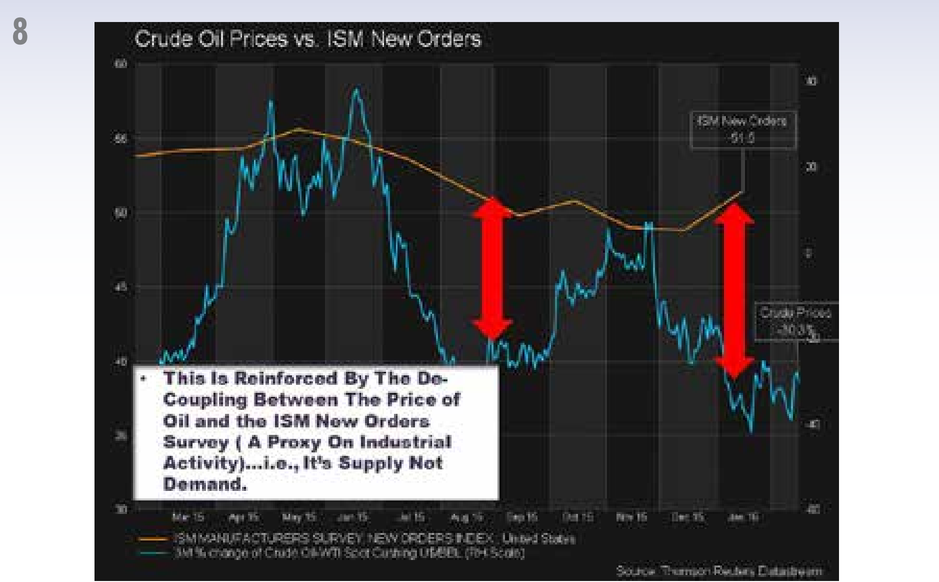


CHARTS 7-8 The dramatic decline in oil prices has been interpreted as a reduction in demand, which would imply a slowing in global growth. We view the price decline as being supply driven. Oil demand has been steadily climbing every year for the past decade and is forecasted by the International Energy Agency to increase by 1.5 million barrels per day to 96.7mmbd by the end of 2016. Chart #7. This notion that it is a supply and not a demand issue is illustrated on Chart #8. This chart shows the gap between the US ISM New Orders Survey, a proxy for industrial activity, and the annual increase in oil prices. The reason that global growth has slowed because of the fall in oil prices is that the energy sector can respond very quickly by cutting costs whereas the benefits of lower energy costs take much longer to show up in economic growth. It has been estimated that the reduction in Oil and Gas investment has had a negative 1% impact on global GDP growth. On the flip side, however, it is estimated that the benefit of lower energy prices will improve global growth by around 1.5%. This benefit has yet to manifest itself.





CHARTS 9-10

One reason seems to be that, as shown on Chart #9, consumers appear to be saving rather than spending their windfall from lower gasoline prices. It is our view that this will reverse itself as employment continues to remain strong, wages keep growing and consumers become convinced that gasoline prices won't be spiking back up to $4.00 anytime soon.

In our last commentary we reasoned that the relatively subdued level of the various financial stress indicators in combination with improvements in the Chicago National Activity Indicator would mean that GDP should grow in the 2.2% to 2.5% range. This indicator has, in the interim, improved which increases our confidence, Chart #10.

It is clear that a continuation of stable oil prices is necessary for lower market volatility, reduced financial stresses and greater confidence in the US economic growth outlook.

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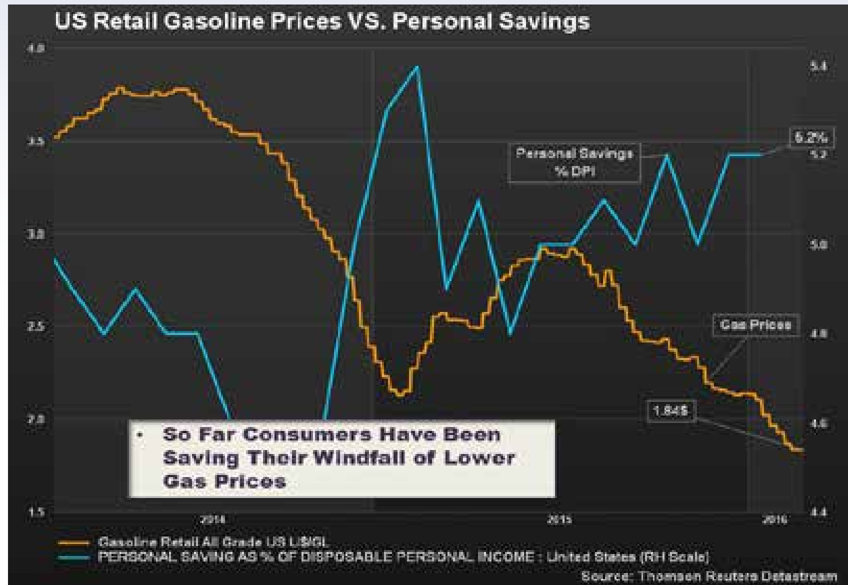

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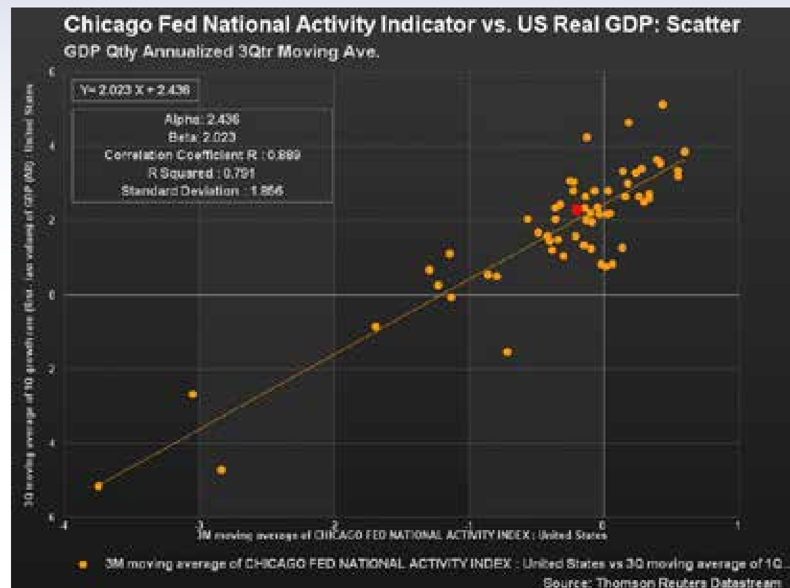

CHARTS 11-12 The major macro global concern for us is the potential for China to have a hard landing. Although we don't see this as an imminent event there are several factors that point to potential difficulty in the intermediate term. As shown in Chart #11 our leading indicator of Chinese Economic Momentum continues to decline and casts serious doubt on the validity of China's official GDP growth rate of 6.9%. Furthermore, there are many independent economic research entities that forecast GDP growth to be below 4% by the end of 2016, Chart #12.

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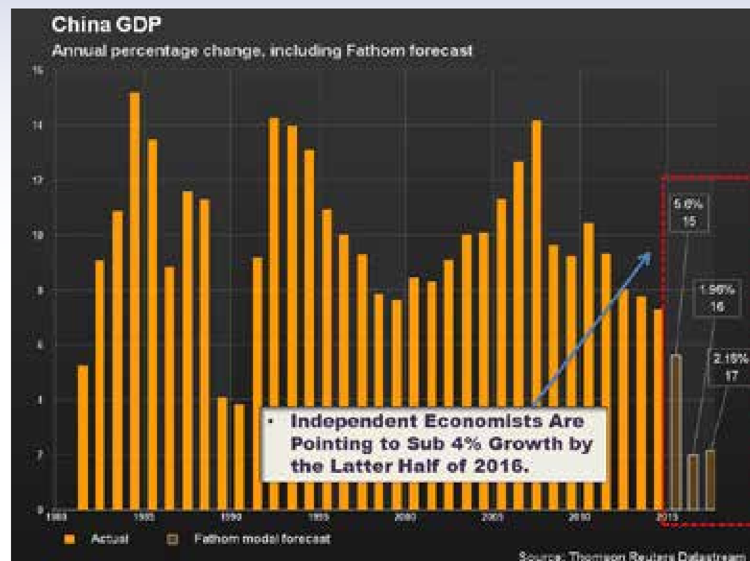

CHARTS 13-15

The problem of slowing growth is compounded by the rapid increase of Chinese debt to GDP which is forecasted to be over 50% in four years, Chart #13. This forecast doesn't include the shadow banking system which, by some estimates, puts the Debt/GDP ratio above 175%. The dangers of a low economic growth, increasing debt scenario is illustrated in Chart #14 where it is clear that it takes greater and greater debt to obtain a unit of GDP growth. The Chinese banking system, straddled with souring loans and a shrinking capital base, will likely be bailed out by the government. Although China has over $3 trillion in foreign reserves to backstop their banking system they are now beginning to experience a decline in the growth of those reserves, Chart #15. This decline has been precipitated by slowing exports, capital flight and the need to defend the yuan.

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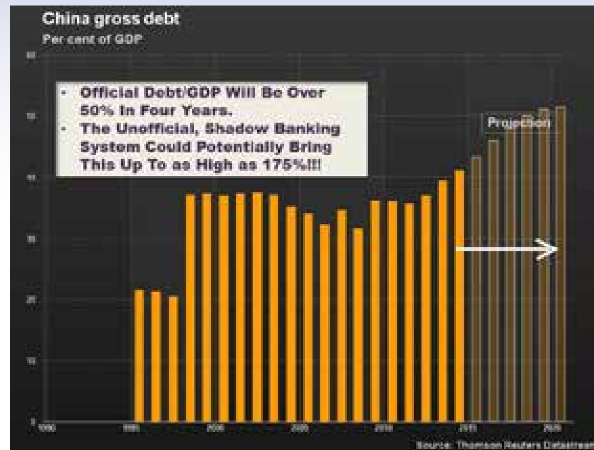

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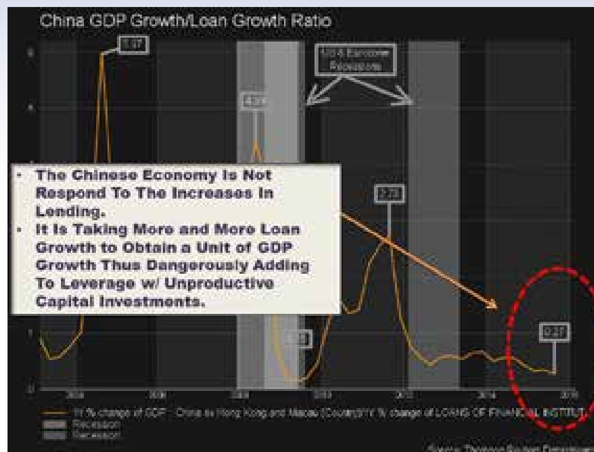

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In summary, the Chinese situation will likely only worsen until the necessary structural reforms of closing inefficient State Owned Enterprises (SOE's) and allowing capital investment decisions to be based on economics rather than politics are implemented. Although they have sufficient reserves to buy the time to do this they have not yet shown the requisite amount of political urgency. The likely outcome of their failed economic policies will be further currency devaluation and more exporting of their excess capacity, both of which will be a drag on global economic growth.

In conclusion, the US economy appears to be moving in that Goldilocks world of not to hot and not too cold. This will likely keep the US Federal Reserve on a modest rate increase pace. US equity markets will likely remain range bound until the rate of forward earnings growth, currently at around 1.0% year/year, begins to re-accelerate. If oil prices stabilize, the energy and mining sectors stop declining and the US consumer begins spending their windfall savings then the US economy could continue accelerating well into 2017.

Please consult with your advisor if you would like to discuss any of these comments in further depth.