Winslow, Evans & Crocker, Inc.℠

SEP. 2016 GLOBAL ECONOMICS & CAPITAL MARKET COMMENTARY

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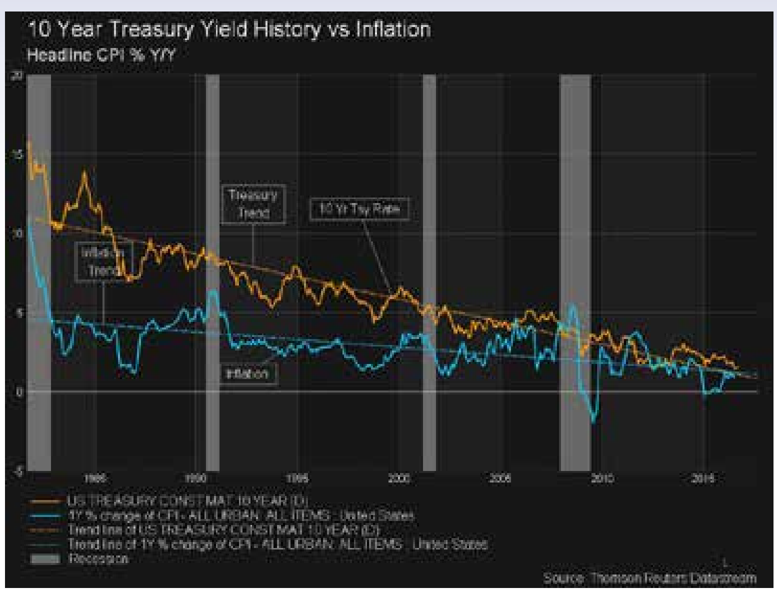
Overview

In this month's issue we will discuss interest rates and emerging markets, two subjects which, in many ways, are closely linked.

As we noted in last month's issue the level of interest rates is at multi-generational lows and has been in a down trend since the peaks reached in the early 1980's as can be seen in Chart #1. This chart also shows the rate of inflation during this same time frame as represented by the blue line. Although both time series have been on a downward trend it is clear that interest rates have been declining much more rapidly than inflation.

1



CHARTS 2-3 . Although low interest rates have been driven down by the easy monetary policy of the major economy central banks since the 2008 recession it is clear that this downward trend had long been in place beforehand. This is now raising the interesting question as to whether or not there is a more fundamental force beyond central bank activity that is driving this trend. As emphasized in the most recent Janet Yellen speech the US Fed is now focusing on what they call the neutral rate of interest, or R*. In theory if the general level of interest rates is above R* then the economy would contract and, conversely, if they were below it inflation would accelerate. Chart #2 shows that the output gap of the US economy as calculated by the International Monetary Fund (IMF) is at -2.83%...well below its potential. However, because of declining productivity, anemic global growth and weak business investment the Fed now believes that the growth potential of the US economy is lower than had been previously thought, which implies that the neutral rate should also be lower. If this new thinking takes root it means that the Fed will not raise rates as quickly or as sharply as been previously thought.

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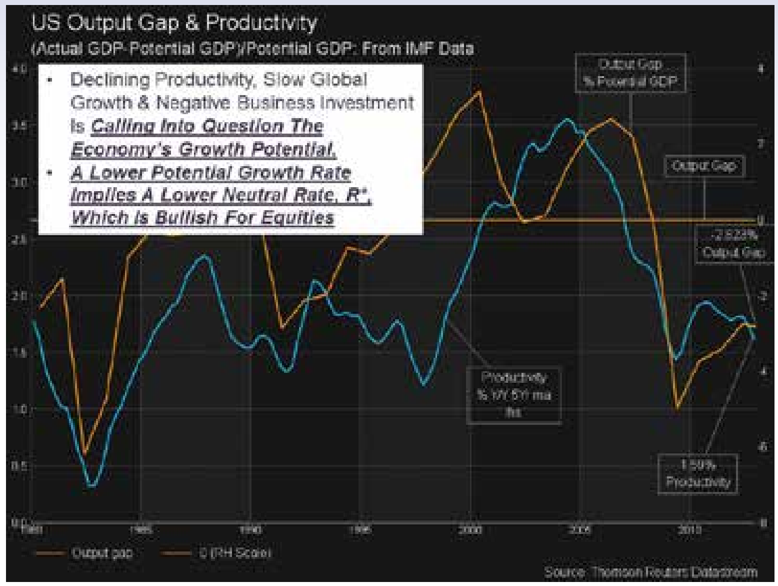

In last month's piece we also highlighted some divergences between a number of economic and financial indicators which implied that we may experience a temporary increase in rates. In Chart #3 we illustrate how the rise this year in the ISM New Order Survey was diverging from its historical relationship with interest rates and that either rates would rise or orders would fall.

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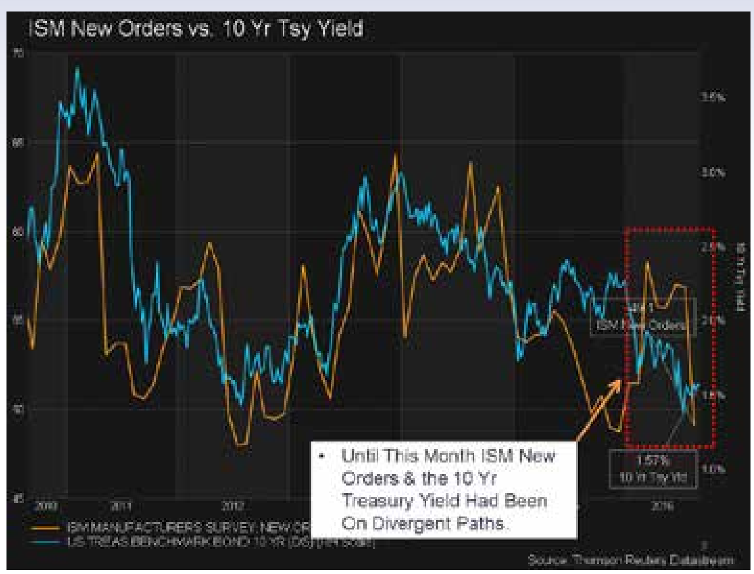

CHART 4. As you can clearly see it is the new orders that have fallen which implies a slowdown in the manufacturing sector and reduces the likelihood of a Fed rate hike in September. Another divergence that we highlighted was the relationship between the Treasury Inflation Protection Security (TIPS) yield and the US Economic Surprise Indicator, Chart #4. You can see that the Economic Surprise Indicator has fallen more than the TIPS yield has risen. This is another example of the economic indictors adjusting down to re-establish their relationship to financial indicators.

The data for the US and global economies has consistently been mixed for all of 2016. Employment, wages and residential construction have been strong while business investment and manufacturing have been weak. We still believe that the economic drag from the collapsing energy and mining sectors will have abated by the end of this year leading to a stronger second half economy. Indeed, the 3Q2016 RGDP forecast from the Atlanta Fed is at 3.5%, well above the anemic 1.2% of the second quarter. Against this backdrop of tepid global growth, mixed economic data and a growing perception that the real potential growth of the US economy has lowered it is clear that the Fed will take a very cautious path for raising rates.

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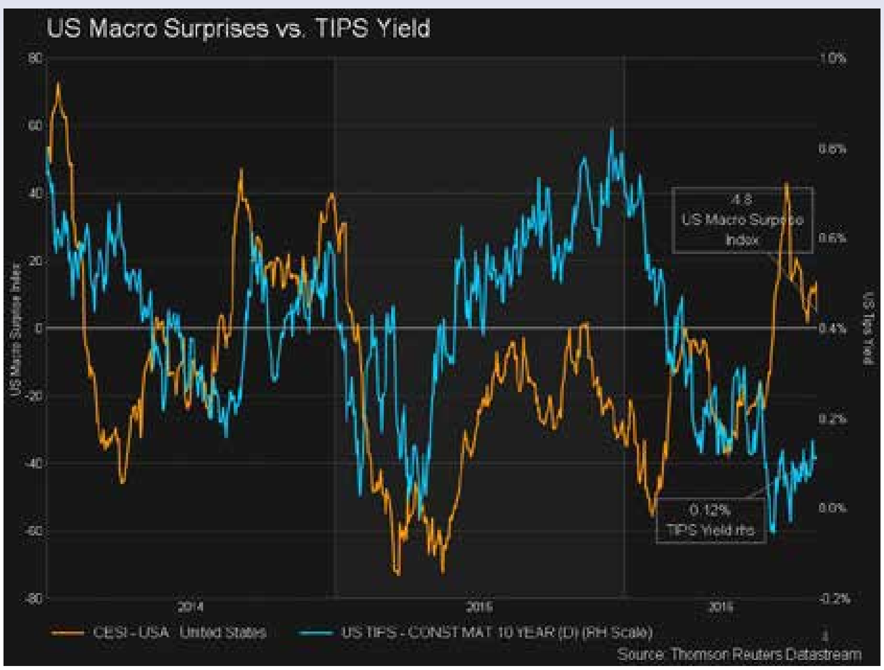

CHART 5-8. Risky assets are clearly a beneficiary of this persistently low interest rate environment. One of the major beneficiaries, however, has been the non-China Global Emerging Market (GEM) economies. Now that the US$ has stabilized, the currencies of the GEM's have begun appreciating as the fears of capital flight have diminished, Chart #5 and current account deficits have improved, Chart #6. The yields for GEM bonds are now back to levels of one year ago, thus lowering their borrowing costs, Chart #7. Finally, the GEM equity markets have reduced their exposure to commodities from 40% to ~15%, thus eliminating the need for a rebound in commodity prices to do well and, after a five year decline, are seeing an increase in net profit margins. This is leading to an increase in fund flows into these markets and, not surprisingly, they are outperforming both the global and US equity bench-marks, Chart #8.

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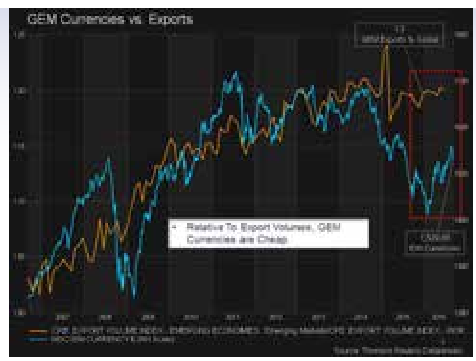

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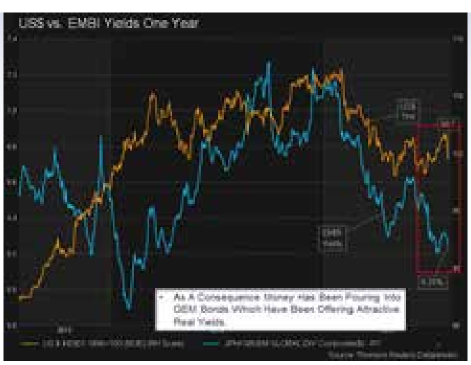

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CHART 9. Much of the data cited above changes from month to month but there is very little doubt that the US and global economies are growing only modestly even though the central banks have been historically loose with monetary policy. The concern that we have is that monetary policy is entering a period of diminishing return. In Chart #9 it is clear that the growth of the US economy has been less and less responsive to the Fed's expansion of its balance sheet. This is also true in the other major G7 economies. The likely next step to keep economies growing will be a form of Fiscal Quantitative Easing, i.e., increased central government deficit spending. This will likely lead to negative real fixed income returns as central banks initially strive to keep interest rates low but eventually lead to inflation, depending on how much government debt is absorbed by the central banks. Stay tuned.

Please contact your investment advisor if you would like to discuss any of these topics in more depth.

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